

**TAX SYSTEM AND REFORMS IN EUROPE:  
THE UNITED KINGDOM**

**Giuseppe Migali  
University of Pavia**

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## TAX SYSTEMS AND TAX REFORMS IN EUROPE: THE UNITED KINGDOM

Giuseppe Migali

Department of Public and Environmental Economics  
University of Pavia - Italy

### **Abstract**

This paper aims at discussing the main features of United Kingdom's tax system, its recent reforms and those underway. It is part of a wider research on European taxation, carried on at this Department, under the direction of L. Bernardi and P. Profeta, and the supervision of V. Tanzi. The current state of the main taxes, their working and future reforms are studied in the context of a 30-year period. Direct taxes, indirect taxes and social security contributions are compared with the European average, trying to focus on the major changes from 1970 to 1999. The structure of the main taxes is surveyed, showing the recent reforms and the differences with the previous system. The analysis goes on observing the evolution of the implicit tax rates from 1970 to 1997, looking at progressivity of the tax system in the UK and how it has changed over this period, and there is too a discussion of the tax wedge in corporate and labour taxation. Finally, after a brief overview of the macroeconomic and budget framework, the paper assesses the fiscal reforms that have taken place during 1990s. The cut of social contributions and the reduction of tax wedge on labour were successful, but the shift toward indirect taxation has not been achieved. The new directions are a reduction in the complexity of VAT and greater support for poor working families.

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**E-mail Address:** [eunice@unipv.it](mailto:eunice@unipv.it)

**Tel.:** +39 0382 504 413 – **Fax** \* 402

## **1. Introduction, contents and main conclusions**

This chapter is devoted to an analysis of the United Kingdom's tax system. We consider the current state of the main taxes in the context of a 30-year period, their working and future reforms.

The current tax system was one born with the reforms of the 1990s. The pre-reform tax system aimed at contributing to negative economic performance in the UK during 1960s and 1970s. It was designed to redistribute income, but in fact achieved a little redistribution and weakened work incentives for many people. Since the 1980s the UK has embarked on a series of structural reform that have changed the institutions and the role of the Government in product, labour and financial markets. The income tax rate structure has been transformed, savings taxation has been repeatedly adjusted, the National Insurance contributions system has been overhauled, VAT doubled, and some excise duties changed.

Section 2 describes the public sector's fiscal framework, and focuses on direct taxes, indirect taxes and social security contributions. The development of the tax system from 1970 to 1999 compared with the European average. The shift from direct to indirect taxes started in the '80s seems not to have reached its objective. In fact the reduction of personal income tax has been offset by the increase in corporation tax, and the rise in VAT offset by the decline of excise duties. However, a cut in social contributions has been realised, and they are now much below the European average.

Section 3 describes the structure of the main taxes: income tax, corporation tax, capital taxes, local taxes, value added tax and other indirect taxes. Personal income tax is analysed focusing on the current tax rates, bands, and the new system of benefits. Corporation tax has a particular structure with three rates and a system of relief to help companies with small profits. Individual capital gain tax is described looking at the 1998 reform that introduced a tapering system, with the objective of encouraging longer-term holding of assets. Local taxes have a small impact on total revenue, due to the different reforms: such as the introduction of poll tax and its subsequent substitution with the council tax, which is a property-based tax.

Section 4 examines the distribution of taxation; the analysis starts observing the evolution of implicit tax rates from 1970 to 1997. Taxation on labour has decreased sharply over the last 25 years, while implicit tax rates on consumption have remained quite stable, despite the increase of VAT. Taxation on capital and other factors fell deeply from 55 percent in 1970 to 38 percent in 1997. The analysis goes on looking at the progressivity of the tax system in the UK, and how it has changed over this period. Finally, we describe the tax wedges in corporate and labour taxation. The tax wedge on labour is lower than EU average primarily due to the reduction of social contributions. Section 5 starts with a brief overview of the new macroeconomic framework, showing that the economy has experienced a period of stability and steady growth. We assess the fiscal reforms that

have taken place during 1990s. The new directions for future tax reform are a reduction in the complexity of VAT, the shift of the National Insurance structure nearer to that of income tax, and greater financial support for poor working families and those with children. Finally, there is an open debate on the reform of double taxation relief for companies, to replace the credit system with an exemption system for direct investment.

This paper has tried to show the main features of the UK tax system and to describe major changes. Some reforms have been more successful than others, e.g. the cut of social contributions and the reduction of tax wedge on labour. The shift towards indirect taxation has not been achieved, and the reduction of income tax, which was initially in a regressive trend, has been corrected to help low income earners. The changes in local taxation resulted in a system looking more like the original than the intermediate one. Revenue is too low, council tax is the only local tax left, and local authorities have little control over their budgets. Finally, the taxation of foreign investments is more addressed to defending UK advantages than to converge with EU standards.

## **2. The structure of the system and its development from the '70s**

### **2.1 The current structure of taxation and social security contributions**

The surpluses of net borrowing, declined from -1.7 percent of GDP in 1999-00 to -0.6 percent of GDP in 2001-02; a net borrowing deficit of 1 percent of GDP it is estimated in 2003-04.

Total managed expenditure declined dramatically from around 44 percent of GDP in 1992-93 to the lowest point over the last 20 years, almost 37.5 percent in 1999-00. The forecasts for the next years show a gradual increase up to 40 percent in 2002-03. The main items are social security and health services, respectively 27 percent and 19 percent of total expenditure. Around 13 percent of Government spending is for education, and 5 percent for housing & environment, slightly more for defence, almost 6 percent; other expenditures amount to less than 5 percent.

In 2001-02 total current receipts are estimated to be 40.5 percent of GDP, over €17<sup>1</sup> billion, this is equivalent to €3.169 for every adult in the UK, or €0.225 per person.

Total revenue can be analysed focusing on:

- 1) direct taxes
- 2) indirect taxes;
- 3) social security contributions.

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<sup>1</sup> Assuming 1€= £ 0.645

Direct taxes include income tax, corporation tax, council tax, and business rate<sup>2</sup>. They represent the largest source of revenue for the Government, around 18 percent of GDP in 2000-01, which is 46 percent of total taxation.

According to HM Treasury forecasts, income tax is the largest source of revenue for the Government, around 11.3 percent of GDP and 26 percent of total taxation in 2000-01. Projections up to 2005-06 show a stable pattern. In 2000-01, corporation tax is around 3.4 percent of GDP and 9.5 percent of total taxation, and it should remain constant until 2005-06. Council tax receipts are 4 percent of total taxation and business rate almost 5 percent.

Indirect taxes include VAT, excise duties and other receipts; they account for 15 percent of GDP and 38 percent of total taxation. VAT raises 16 percent of total revenues, and from 2000-01 to 2005-06 it is estimated to remain constant at around 6 percent of GDP. Excise duties are 13 percent of total receipts and around 4 percent of GDP in 2000-01, and they should decrease by 0,5 in percentage of GDP until 2005-06.

Social security contributions are around 6.5 percent of GDP and 16 percent of total Government revenue in 2000-01. Projections show a stable pattern at around 6.2 percent of GDP up to 2005-06.

In practice, payments are placed in a fund that prevents cash-flow problems. In fact the fund should not fall below 1/6 of National Insurance expenditure; the system works assuring that current contributions finance current benefits. Two groups pay the vast majority of contributions: employees as a tax on their earnings, employers as contributions on those they employ. Contributions paid by the self-employed are rather low, around 3 percent of total.

## **2.2 Developments of the system from 1970 to 2000**

The total taxation as percentage of GDP rises and falls during 1970s, in 1980 it is less than 36 percent of GDP, then total receipts increase reaching an absolute peak of 39 percent in 1983. From 1984 there is a sharp decline of revenues that reach the lowest point for the last 20 years at around 33 percent of GDP in 1993. Then, total taxation rises again and in 2001 it is estimated to be almost 38 percent of GDP (HM Treasury 2002; Eurostat 1999).

Direct taxes are around 18.5 percent of GDP in 1975, the highest value over the last 30 years. Since the end of '70s Government strategy has been to shift from direct towards indirect taxes, but we observe a reduction to 16 percent of GDP in 1980 and then an increase to 17 percent in 1985. Direct taxes remain stable until 1990, when there is a small dip to around 16 percent until 1999. Personal income taxes are on average 66 percent of direct taxes and corporation taxes almost 21 percent.

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<sup>2</sup> See par. 3.5

Personal income taxes are reduced by the structural reform of the end of '70s, and in fact they decrease from 14 percent of GDP in 1975 to 11 in 1980, and then they remain stable at around 10.5 percent until 1999. The hoped for reduction of direct taxes does not happen because the cut in personal income taxes is offset by the increase of corporate taxes: they rise from around 2 percent in 1975 to almost 4.5 percent in 1985. The reform of corporate tax in 1984 provides a small reduction in revenues up to around 3 percent in 1995, but in 1999 the receipts are again around 4 percent.

Indirect taxes show a stable pattern over a 30-year period, varying between 14-15 percent of GDP. The lowest level is 11.4 percent in 1975; then the policy to increase indirect taxes provides a sharp rise of 14 percent in 1980. During the '80s the pattern is quite stable at around 14 percent; in the '90s there is a small increase of almost 0.5 percent.

The introduction of VAT in 1973 and the number of small additions to its base during the '80s and the '90s represent the main features of the shift towards indirect taxation. VAT today is the main source of indirect taxes, on average 48 percent of the total. During the '70s VAT rises gradually, in 1975 it is around 3 percent of GDP. In 1979 there is the first change: VAT standard rate is increased to pay for the reduction in income tax. The receipts increase sharply to more than 6 percent of GDP in 1990. The rate is increased again in 1991 to pay for a reduction of the poll tax, and the revenue rises to almost 7 percent in 1995. The most significant widening of the VAT base, since its introduction, is the imposition on domestic fuel of 1995. VAT raises nearly £3 billion per year by 1996-97.

Despite the considerable growth of VAT we do not observe a big rise of indirect taxes because there is a fall in excise duties. They decrease from 6.6 percent in 1970 to 3.6 in 1990, offsetting the VAT rise. There is a small increase in excise duties of up to 4 percent in 1999, but this ratio is expected to decline over the next years reflecting the assumption that consumption goods subject to excise duties grow by less than GDP.

Social security contributions are on average 18 percent of total revenues, and they remain unchanged at around 7 percent of GDP from 1980 to 2000, despite the radical structural changes introduced. Contributions paid by employers are on average 54 percent of total, and have varied by around 4 percent of GDP over the last 30 years; instead, contributions paid by employees are on average 43 percent of total, and remain stable at around 3 percent of GDP. A residual part of contributions is paid by the self-employed, less than 3 percent of the total and 0.2 percent of GDP. The ratio of social contribution to GDP is projected to fall slightly over the next five years, because higher rates of contracting are assumed out of the state pension scheme, as individuals increasingly make use of stakeholder pensions.

**TAB. 1** Structure and development of fiscal revenues in Italy and European average as % of GDP, 1970-2000

	1970		1975		1980		1985		1990		1995		1999	
	UK	Europe	UK	Europe	UK	Europe	UK	Europe	UK	Europe	UK	Europe	UK	Europe
<i>Direct Taxes</i>	17.4	8.9	18.5	11.9	16.0	12.7	17.3	13.1	17.3	13.2	15.5	13.3	15.8	14.5
Personal income	11.1	5.5	14.0	8.9	11.0	9.3	10.5	9.0	10.6	8.9	10.2	9.6	10.9	9.9
Corporation income	3.7	2.2	2.3	1.9	2.9	2.2	4.6	2.8	4.1	2.9	3.3	2.4	3.7	2.8
<i>Indirect taxes</i>	14.2	13.0	11.4	12.2	13.9	13.2	13.9	13.0	13.7	13.0	14.5	13.6	14.8	14.6
VAT	0.0	5.1	3.3	5.7	5.1	6.6	5.8	6.1	6.2	6.6	6.9	6.9	6.9	7.3
Excise duties	6.6	3.5	4.3	3.5	3.7	3.2	4.2	3.2	3.6	3.1	4.0	3.4	4.1	2.5
<b>TOTAL TAXES REVENUES</b>	<b>31.6</b>	<b>21.9</b>	<b>29.9</b>	<b>24.1</b>	<b>29.9</b>	<b>25.9</b>	<b>31.2</b>	<b>26.1</b>	<b>31.0</b>	<b>26.2</b>	<b>30.0</b>	<b>26.9</b>	<b>30.6</b>	<b>29.1</b>
<i>Social contributions</i>	5.6	11.7	7.3	12.8	6.7	13.4	7.5	13.8	6.9	13.7	6.9	15.0	6.8	14.0
Employers	2.8	7.2	4.2	7.7	3.9	7.8	3.8	7.9	3.9	7.8	3.7	8.0	3.7	7.8
Employees	2.6	3.5	2.9	3.8	2.7	4.3	3.5	4.5	2.8	4.5	3.0	5.1	3.0	4.5
Self Employed	0.2	1.0	0.2	1.3	0.1	1.3	0.2	1.5	0.2	1.4	0.2	1.8	0.2	1.7
<b>TOTAL FISCAL REVENUES</b>	<b>37.2</b>	<b>33.6</b>	<b>37.2</b>	<b>36.9</b>	<b>36.6</b>	<b>39.3</b>	<b>38.7</b>	<b>39.9</b>	<b>37.9</b>	<b>39.9</b>	<b>36.9</b>	<b>41.9</b>	<b>37.4</b>	<b>43.1</b>
<i>Administrative level</i>														
Central Government	28.1	19.7	25.8	21.1	25.5	22.3	26.4	22.1	27.2	22.2	27.5	22.5	28.1	23.7
Local Government	3.6	2.2	3.8	2.8	3.6	2.9	3.9	3.1	2.7	3.8	1.4	4.0	1.4	4.3

Sources: 1970-1995, Eurostat; New Cronos 2002, Annex Eurostat 2001, and Oecd (2001) for Europe (data equalized with Eurostat).

Notes: Minor items are omitted.

Looking at the administrative distribution of revenues, the majority of taxes raised by central Government represent 27-28 percent of GDP, this percentage being less than 26 percent only from 1975 to 1980. Local Government receipts decrease from 1970 to 2000, from around 3.5 percent of GDP to the more recent 1.4 percent.

### **2.3 A comparative view with the European average**

Total fiscal revenue in the UK is higher than the Europe average only during the '70s, from 1980 to 1999 the trend is the opposite. In 1985 the UK fiscal revenue is around 39 percent of GDP and the Europe average around 40 percent; in 1999 the difference is more than 5 percentage points: 37.4 percent of GDP in the UK and 43 percent in Europe.

Total tax revenue in the UK has been higher than the European average since 1970; but the difference has reduced from around 10 percent in 1970 to 0.5 percent in 1999. Direct taxes in the UK are higher than the European average, but following a decreasing trend, the opposite of the European one. In particular, personal income tax in the UK reaches its maximum in 1975, at 14 percent of GDP against 9 percent in Europe. The difference has decreased to just 1 percentage point in 1999, respectively 11 and 10 percent of GDP.

The UK corporate tax revenue is slightly higher than the European average, the range is of 1 to 2 percentage points from 1970 to 1999.

The introduction of VAT in the UK in 1973, and its increase during the '90s seems not to have affected the difference in the indirect tax revenues between UK and Europe. In fact the UK receipts are always (except in 1975) lower than the European ones by around 1 percentage point. This is maybe due to the role of excise duties, that decrease from 1970 to 1999 but are always higher than in Europe, while VAT is always lower.

An important difference between UK and Europe arises looking at the social contribution revenues, which are far less in the UK by at least 5 percentage points. This is primarily due to the structural changes of social contribution structure during the '80s. The UK cut in contributions in 1985 increases this difference from 6 percentage points to more than 7 in 1999.

Finally, central Government revenues in the UK are higher than the European average from 1970 to 1999. This is due to the minor role of local taxes in the UK, which account for 1.4 percent of GDP in 1999 against 4.3 percent in the rest of Europe.



### 3. Some quantitative and institutional features of main taxes

#### 3.1 The Personal Income Tax-PIT

In the UK over 27 million individuals pay income tax, but not all kinds of income are taxable. Tax may be payable on income from employment and self-employment, profit from business, occupational pensions, building society and bank interest, dividends on shares, and income from property. Tax is payable on some social security benefits such as the state retirement pension, widow's pension, unemployment benefit and incapacity benefit, but not on others such as income support, or child benefit.

Income tax is not payable on: incapacity benefit, widow's payment, war disablement pension, interest received from certain National Savings products such as National Savings certificates, interest, dividends and other income from investments held in a Personal Equity Plan (PEP), or from a Tax Exempt Special Savings Account (TESSA) (unless you closed it before the five years were up), or an Individual Savings Accounts (ISA), and finally on premium Bonds, national lottery winnings or gambling prizes.

The Income tax year of assessment runs from 6 April until the following 5 April.

Income tax operates through a system of allowances and bands of income. An individual's taxable income is calculated by adding together all sources of income liable to tax, and then subtracting allowances and reliefs which are available at the taxpayer's marginal rate. Each individual has a personal allowance. Table 2 gives details of some of these allowances and shows their values.

**TAB. 2** Allowances

Financial year 2001-02

	Personal allowance £ p.a.	Married couples £ p.a.	Income limit £ p.a.
aged under 65	4,535	-	-
aged 65 - 74	5,990	5,365	17,600
aged 75 and over	6,260	5,435	17,600

Source: Inland Revenue Statistics, 2002

In 2001-02 a taxpayer aged under 65 years receives a personal allowance of £4.535, if older he is entitled to a higher allowance. Over-65s with an income higher than a certain limit are subject to a

taper of 50 percent on their allowance, which is gradually reduced to a minimum level equal to the allowance for the people under 65. In the past, married couples were entitled to a married couple's allowance (MCA), in addition to their personal allowances. From 6 April 2000, MCA was abolished for couples where the older partner was born after 5 April 1935; this benefit is available at a flat rate of 10 percent (that means 10 percent of £5365).

A specific allowance is available to blind people, £1450 a year per person; married couples where both spouses are blind get double the single amount.

Two other allowances removed recently are the additional personal allowance (APA), which was available for separated and unmarried people with children, and widow's bereavement allowance. The revenue from the abolition of this benefit is allocated to financing a new children's tax credit (CTC), that is payable to all families with children aged under 16 living with them. In 2001-02, the allowance is 10 percent of £5200, but the credit is gradually reduced for high-rate taxpayers.

From October 1999 the working families' tax credit (WFTC) has been introduced: for families with an adult working 16 hours or more per week there is a basic tax credit, certain tax credits for each child depending on his age, and an extra tax credit for working 30 hours or more per week. WFTC is reduced for families with net income above a specified limit.

When all eligible reliefs and allowances have been deducted from income liable to tax, taxable income is subject to different tax rates depending upon the "tax band" in which the income falls.

Table3 shows the actual marginal tax rates and bands.

**TAB. 3** *Tax rates and bands*

Financial year 2001-02		
	Rate of tax	Band of income
lower	10%	0 - £ 1,880
basic	22%	£ 1,881 - £ 29,400
higher	40%	over £ 29,400

Source: Inland Revenue Statistics, 2002

In the 2001-02 financial year, taxable income up to £1880 is taxed at the lower rate of 10 percent<sup>3</sup>; the next £27,520 is subject to the basic rate of 22 percent, and the portion of income above £29,400 is taxed at the higher rate of 40 percent.

The bands and allowances of individual income tax are subject to statutory indexation provisions, the increase is in line with the percentage increase in the retail price index.

According to the Inland Revenue Statistics 2000-01, the number of taxpayers subject to the lower rate is around 3.7 million, 14 percent of the total. 21 millions individuals, that is 76 percent of the total, are taxed at the basic rate and less than 3 millions at the higher rate. However, observing the amount paid as a percentage of the total, the richer individuals pay around 50 percent of all income tax revenue, and middle income taxpayers just under 49 percent.

### **3.2 Corporation tax**

Corporation tax is charged on the profits made by UK resident companies, public corporations and unincorporated associations such as industrial and provident societies, clubs and trade associations; the tax is not levied on partnerships. Profits taxed are the ones made in each accounting period, i.e. the period over which the company draws up its accounts. The rates of tax are set for the financial year- April to March-, where an accounting period straddles 31st March the profits are apportioned between the two financial years on a time basis.

The 'all-in' statutory corporate tax rate in the UK is 30 percent, and is the result of different reforms that in the last 22 years reduced the rate from a maximum of 52 percent to the current one.

In the 2001-02 financial year, there are three rates and a system of relief that produce a smooth progression in the average tax rate from the lower rate to the main rate.

A starting rate of 10 percent is charged on profits below £10,000, earned after 1 April 2000. Between £10,000 and 50,000 (upper limit), taxable profits are charged at the small companies' rate of 20 percent, with marginal relief given, at the fraction of 1/40, on the amount by which the upper profit limit exceeds taxable profits. This relief produces an effective marginal rate of 22.5 percent.

For firms with profits between £50,000 and £300,000 the small companies' rate of 20 percent is applied. Between the lower (£300,000) and upper (1,500,000) limits of the small companies' rate, taxable profits are charged at the main rate of 30 percent with marginal relief given, at the fraction of 1/40, such that an effective marginal rate of 32.5 percent is levied on profits in excess of £300,000.

Over £1,500,00 taxable profits are charged at the main rate of 30 percent.

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<sup>3</sup> Prior to April 1999 the lower rate was 20 percent but applied to a wider band of income.

The profit limits are restricted if a company is part of a group and in proportion to the size of that group, to prevent abuse by a large company fragmenting into smaller ones.

Table 4 shows marginal and average corporation tax rates.

**TAB. 4** Rates and bands of corporation tax

Financial year 2001-02					
Profits	Marginal rate of tax		Marginal tax relief	Effective marginal rate	Average rate
under £10,000	10%			10%	10%
£10,001 - £50,000	20%	+	1/40	22.5%	10% - 20%
£ 50,000 - £300,000	20%			22%	20%
£300,001 - £1,500,000	30%	+	1/40	32.5%	20% - 30%
over £1,500,000	30%			30%	30%

Source: Inland Revenue Statistics, 2002

For corporation tax purposes, a company's profits include its income and capital gains. Income, whether from trading or investments, is calculated in the same way as for income tax purposes, including capital allowances where appropriate.

Business profit must be computed on profit and loss statement basis, which gives a *true and fair view*, subject to any adjustment required or authorised by law in computing profits for those purposes.

Among the positive components of a company's profit there are operating revenues and sundry incomes, excepting property values.

Stock-in-trade is a positive component of income and it is evaluated to be the lower between acquisition cost and market value; if it is not possible to know the value of all undelivered goods, the method of evaluation admitted by law is the FIFO.

Among negative components of income there are all operating costs except costs of capital (distinction between circulating capital and capital assets).

In working out the business profit it is not allowed to deduct the cost of buying, altering or improving fixed assets, or depreciation or any losses that arise when they are sold. Instead, it is possible to claim tax allowances called capital allowances. An adjustment, known as a balancing charge, may arise when an item in the business is sold, given away or no longer used.

Capital allowances provide relief, for corporation tax purposes, for the consumption or depreciation of capital assets incurred for the purposes of trade. Different types of assets qualify for different

rates of allowances, and two methods of depreciation can be used: declining-balance or straight-line (see the **Table 5**).

The declining-balance method means that a fixed percentage of a not amortised cost is written off each year; for example, if investment is £100 and the ratio of depreciation is 20 percent, in the first year it is written off by £20, in the second year by £16 (25 percent of the remaining balance of £80), and so on.

The straight-line method writes off the same percentage of the initial investment each year; e.g., using the same values as above, £20 p.a. is written off for 4 years.

Capital allowances may be claimed in the year in which they accrue and any unused capital allowances may be carried forward to set off against profits in later years.

For plant and machinery the allowances are known as writing down allowances, and these are worked out at 25 percent of the cost of the item or 'pool' of items for each year, using the declining-balance method. In addition, first year allowances are available for expenditure on plant and machinery by small and medium-sized enterprises at 40 percent.

**TAB. 5** *Main rates of capital allowance*

Type of asset	Rates	Method of depreciation
Plant and machinery	25%	declining - balance
Industrial buildings	4%	straight - line
Hotels	4%	straight - line
Other commercial buildings	4%	straight - line
Patents	25%	declining - balance
Know-how	25%	declining - balance
Research and development	100%	

Source: Inland Revenue Statistics, 2002

Most plant and machinery can be lumped together in a single 'pool' of expenditure with just a single calculation, no matter how many items are included. This is known as 'pooling'. If something is bought in the period covered by the accounts, the cost is added to the pool. Conversely, If something is sold, the sale proceeds are deducted from the pool. If the sale price is more than the value of the pool, the difference is a balancing charge. Once these adjustments have been made, the writing down allowance for those accounts is calculated.

If a company makes a trading loss, then that loss can be carried back for one year to set against the profits of an earlier accounting period. An unrelieved trading loss can also be carried forward indefinitely to set against income from the same trade in a future accounting period.

Deductions are allowed from company's total profits for any charges (interest and other payments) it pays and, in the case of an investment company, its management expenses. From April 1996, new "loan relationship" rules have been introduced for the treatment of interest and similar payments. A deduction against tax liability is allowed for income tax deducted at source from interest received (to the extent that it is not used to cover income tax, the company itself deducts on the interest payments it makes). In addition, the royalties paid for the license agreements of patents and trademarks are deductible as charges on incomes; double taxation relief for foreign tax is allowed as a deduction against the tax on profits.

### **3.3 Taxation of income from financial capital**

#### *Dividends*

In 1965 with the introduction of corporation tax the Government added a charge to income tax when profits were distributed. To mitigate this double tax charge, in 1973, a 'partial imputation system' was introduced: the twin mechanisms of advance corporation tax (ACT) and tax credits.

A company paid the ACT when it distributed profits to its shareholders in the form of dividends; the ACT rate was linked to the lower rate of income tax at 20 percent. ACT could be deducted, within a limits, from the corporation tax liability of the accounting period; the remaining tax liability was called "mainstream" corporation tax. ACT financed the tax credit, which the Exchequer made available to the shareholder receiving the dividend. The tax credit could be deducted from the shareholder's income tax liability on the dividend.

A company with the whole of the ACT not offset against the corporation tax had a "surplus ACT". This could be carried back for up to 6 years to reduce tax liability in earlier accounting periods, or it could be carried forward without time limit. In any accounting period the amount of ACT set against corporation tax was limited to the amount that absorbed the whole of the profits of the accounting period. For example, a company with profits of 100 would have had an ACT limit of 20 (a 25 percent rate of ACT is assumed), because a distribution of 80 and ACT of 20 would have absorbed all the profits of 100.

From April 1999 ACT is abolished and a new payment system has been introduced for larger companies. Under the new scheme a big firm pays its corporation tax in four equal quarterly instalments on the basis of its anticipated liabilities for the accounting period; no account for the distribution of profits is due in advance. The first instalment is due in month 7 of the accounting

period with further instalments due in months 10, 13, and 16 with any balance to be paid 9 months after the end of the period.

Small and medium sized enterprises pay all of their tax nine months after the end of the accounting period.

For shareholders, when they get their dividend cheque they also get a tax credit voucher; this shows the amount of the dividend payable and the amount of the tax credit that goes with that dividend. The tax credit is not tax deducted on behalf of the individual, but it represents the fact that the company paying the dividend has paid tax on the profits used to pay the dividend.

Before 1999 the tax credit was equal to the ACT paid by the company, and for individuals that meant 20 percent of the received dividend. Actually, tax credit is 10 percent of the individual's dividend income, and for dividends paid up to 5 April 1999 claim payment of the tax is allowed; instead tax credits on dividends paid after 5 April 1999 cannot be claimed.

For income tax purposes the taxable income is worked out adding dividend and tax credit; for individuals, dividend income is taxed at 10 percent up to the basic rate limit, which for the financial year 2001-2002 is £29,400, and at 32.5 percent above that amount.

Dividends paid by UK authorised unit trusts and open-ended investment companies are treated in the same way as dividends from shares.

### *Interest*

As a general rule, from 6 April 1996 interest paid to investors by building societies, banks and local authorities is credited net of tax at the rate of 20 percent unless the investor is a non-taxpayer and has registered to receive interest without deduction of tax. Only higher rate taxpayers have to pay more tax on their interest.

Net interest is paid also by UK authorised unit trusts, open-ended investment companies, certain British Government securities and securities of foreign Governments. For all taxpayers apart from those paying higher tax rate, this ensures that the individual's tax liability on the income has been met in full and there is usually no need for the individual to make a return to the Inland Revenue.

For income tax purposes, the taxable income is worked out by adding the total 'gross' interest; this is done summing up all the taxable interests got and the taxes taken off.

For example, if interest from a savings account is £160 and £40 tax has already been taken off, the gross interest on the account is  $£160 + £40 = £200$ .

If taxable income in a financial year does not exceed the personal allowance or starting rate band, investors can claim to receive any tax overpaid, and in case of interest the tax taken off.

### *Capital gains*

Capital gain tax (CGT) has been introduced in 1965 and is charged on gains arising from the disposal of assets, such as: shares in a company, units in a unit trust, land and buildings, higher value jewellery, paintings, antiques and other personal effects, assets used in a business (e.g. goodwill). CGT affects individuals, trustees and personal representatives; corporation tax is instead levied on capital gains made by companies.

Some assets are exempt from CGT:

- private car, cash held in sterling, any foreign currency held for personal use;
- jewellery, paintings, antiques and other personal effects that are individually worth £6,000;
- Savings Certificates, Premium Bonds and British Savings Bonds, UK Government stocks;
- assets held in an Individual Savings Account (ISA) or Personal Equity Plan (PEP);
- betting, lottery or pools winnings, personal injury compensation;

In 1998, individual capital gains tax has been reformed:

- introducing a taper relief system;
- removing the previous indexation allowance;
- charging to CGT gains accruing during a period of temporary residence abroad in the year of return to the UK;
- simplifying the CGT charges structure for the gains of trustees and personal representatives of deceased persons.

Taper relief reduces the amount of capital gains tax paid according to the number of whole years (up to a maximum of ten) that an asset has been held. The greater the length of the “qualifying holding period”, the smaller the percentage of the gain that is chargeable to tax. There are two different percentage tables, one for business assets and one for non-business assets. Business assets are assets used wholly or partly for trading purposes, or shares and securities in a company; the regime allows a greater reduction for business assets than for others. However, in both instances taper relief, no matter how long the asset has been held, will not cover a proportion of the gain. The March 2000 Budget has reduced the taper length for business assets from 10 years to 4.

The relevant period of ownership is, generally, equal to the shorter time between the qualifying holding period and the last 10 years of the qualifying holding period.



To calculate the CGT the first step is to list all the assets disposed of in the tax year (6 April to 5 April in the following year). Exempt assets and disposals that do not give rise to a CGT charge, and the disposal of private home can be ignored. Then the gain on each asset is worked out.

The second step is to multiply the amount of any gain chargeable to CGT by the appropriate percentage shown by the taper relief table, according to the years in the qualifying holding period and as it applies to business assets or non-business assets as the case may be.

Losses of the same period and losses brought forward are to be set against untapered gains before the taxable amount is charged to CGT. In this way net gains are tapered after deducting losses and the taxpayer has the greatest benefit from tapering, resulting in the lowest amount chargeable to CGT.

If the total of net gains in a tax year is less than a certain amount, called the annual exemption amount (AEA), CGT is not paid. For the tax year 2002-03 the AEA is £7,700 for individuals, and £3,750 for trusts. If net gains are more than the AEA, capital gains tax is paid on the excess.

It is estimated that in 2001-02 CGT receipts will be £2.5 billion, this is a small proportion of total Government revenues but CGT is important as an anti-avoidance measure, because it discourages richer individuals from converting large parts of their income into capital gains in order to reduce their tax liability. In 1990-00 about 186,000 individuals and 29,000 trustees paid CGT.

### *Inheritance taxes*

Inheritance tax was introduced in 1986. It replaced capital transfer tax that had been in force since 1975 as a successor to estate duty.

The tax is applied to:

- The assets (less deductible liabilities) of deceased persons transferred on death: there is a single rate of 40 percent on the amount that exceed a minimum threshold (£240,000 in 2001-01), with reduction in this rate if the transfer occurred within a seven-year period after death.
- Gifts made within 7 years of death or, made at any time, when there is a reservation of benefit, which continues within 7 years of death; such transfers become chargeable at the time of death.
- Gifts by individuals to discretionary trusts or companies; such transfers are immediately chargeable.

### **3.4 Value Added Tax-VAT**

VAT is payable on the supply of goods and services by way of business in the United Kingdom (UK) or Isle of Man. It is also charged on goods, and some services, which are imported from

places outside the European Community (EC) and on acquisitions, and some services, received from the EC.

There are currently three rates of VAT:

- 17.5 percent - known as standard rated goods; on most goods and services;
- 5 percent - known as reduced rate goods; on fuel and power used in the home and by charities.
- 0 percent - known as zero-rated goods, which do not have VAT levied upon the final good or upon inputs used in its creation. Some examples are: most food, books, newspapers, music, medicines and young children's clothing.

There are also "exempt goods" which are business supplies that have no VAT charged on them at either the standard or zero rate. In this case firms cannot reclaim the VAT paid on inputs. Some examples of exempt supplies are: insurance, selling, leasing and letting land and buildings (not garages, parking spaces, hotel or holiday accommodation) and certain education and training.

It is estimated that almost 56 percent of consumer's expenditure is taxable at the standard rates, and 3 percent at the reduced rate.

### **3.5 Other indirect taxes**

#### *Excises duties*

Excise duties are flat rate taxes charged on five major goods: beer, wine, spirits, tobacco and petrol/diesel.

From 28 April 2002 beer and spirits are taxed according to their alcoholic content; wine, home-made wine, cider and perry are all subject to specific (i.e. by volume) duties.

Tobacco products are subject to an additional ad valorem tax of 22 percent on the retail price, that includes the flat-rate duty and VAT.

#### *Insurance Premium Tax*

Insurance Premium Tax (IPT) is a tax on general insurance premiums, and applies to most general insurance where risk insured is located in the UK. There is a standard rate of 5 percent of the gross premium, but there is a higher rate of 17.5 percent for travel insurance and some insurance for vehicles and domestic/electrical appliances.

Most long-term insurance, such as life insurance, is exempted from the tax, as is reinsurance, insurance for commercial ships and aircraft and insurance for commercial goods in international transit. Premiums for risks located outside the UK are also exempt, but they may be liable to similar taxes imposed by other countries.

IPT is designed to act as a proxy of VAT, which is not charged on financial services because of difficulties in implementation.

#### *Landfill tax*

This is an environmental tax that aims to encourage waste producers to produce less waste, recover more value from waste, for example through recycling or composting and to use more environmentally friendly methods of waste disposal.

There are two rates:

- £2 per tonne for inactive waste;
- £12 per tonne for all other waste.

#### *Petroleum revenue tax*

Companies that earn profits from the extraction of oil and gas from the UK and its continental shelf (mainly from the North Sea) are charged petroleum revenue tax (PRT) as well as corporation tax.

Unlike corporation tax, PRT is not assessed on each company's profits for a 12-month accounting period. It is assessed every six months for each separate oil and gas field, and then levied on the company's share of the cash flow arising in each chargeable period.

The rates at which petroleum revenue tax has been charged since 1993 is 50 percent on existing fields, but new fields are exempt since March 1993.

The corporation tax regime for companies that operate in the North Sea allows any Royalty and PRT liability as a deduction against chargeable profits. In addition to PRT and corporation tax there are royalties levied at 12.5 percent of the value of production, less the cost of initial transportation and treatment, for fields approved before 1 April 1982. Royalties payable are deductible against profits chargeable to PRT and corporation tax.

### **3.6 Local Taxes**

#### *Council Tax*

The Council tax, that replaced the system of local taxation in 1993, or poll tax, is a property-based tax set annually by each Local Council, to help pay for local services.

Each domestic property is evaluated according to the assessment of its "capital value" and placed on a "valuation list" in one of eight "valuation bands", from A to H.

Valuation is carried out by the Valuation Office Agency, not by the local authority, and Valuation lists can be compiled fairly only by assessing values of dwellings on one common date: 1 April 1991 was the date chosen for this exercise.

Capital values estimated the amount of each dwelling as if it had been sold on the open market on 1 April 1991, subject to certain assumptions. The object is to determine the relative values of properties within a particular area on a particular date.

In a local area, basic council tax bills for each band depend on the proportions laid down by law. For example, in band A the range of value of a property is up to £40,000 and the proportion fixed by law is 6. If the council tax for a dwelling in band A is £200:

- the bill for one in band D will be one and a half times that amount (6:9): £300;
- for one in band H three times that amount (6:18): £600
- and for a dwelling in band F, the bill will be (6:13): £433.

There are, however, a range of exemptions and reliefs available: properties with only one resident adult have 25 percent reduction in their bill. If the home is not the main (e.g. empty, second home) the bill is reduced by 50 percent. In addition, properties that are exempt from council tax include student halls of residence and armed forces barracks.

In 2001-02, council tax is estimated to raise almost £14.1 billion, equal to 20 percent of Local Government revenue.

### *Business rates*

Business rates is tax payable on occupied or unoccupied non-domestic properties, such as shops, offices, warehouses and factories, and any other property that is not classed as domestic property.

If a property is used for domestic and non-domestic use (e.g. a shop with a flat above) both council tax and business rates will be charged.

Some types of properties are exempt from business rates, for example: agricultural land and buildings, fish farms, churches, public parks.

Every non-domestic property, unless exempt, has a rateable value, that is an official estimate of the market rent for the property.

The Local Council works out the tax by multiplying the rateable value of the property by the multiplier or 'poundage', set each year by the central Government. In 2001-02 the poundage<sup>4</sup> is set at 43p, for example, if the rateable value is £12,000, the bill for the year will be \$5160.

Properties are normally revalued every five years (the next valuation is in 2005), and the transitional relief scheme introduced in England makes sure that each business rate does not change beyond certain limits because of revaluation.

Furthermore, relief is available for certain types of property: unoccupied buildings, small rural shops, agricultural land and associated buildings, property used for charitable works.

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<sup>4</sup> Called uniform business rate or UBR

Business rates are estimated to raise almost £17,5 billion in 2001-02, this a considerable value greater than the council tax revenue.

## **4. The fiscal burden**

### **4.1 The distribution of taxation charge**

Looking at the evolution of the tax system overall, according to the economic functions, show a stable pattern from 1970 to 1997: labour, capital and consumption remain at 32 percent of GDP.

The taxation on labour is 18 percent of GDP in 1975, but over the following ten years it reaches 15 percent. At the end of the '90s taxes on employed labour account for 39 percent of total taxation or 14.5 of GDP. Taxes on self-employed labour remain stable at 0.2 percent of GDP, for the entire period considered. In the UK capital taxes are very high, accounting for around 27 percent of total taxation. One third of taxes on capital are on real estate and more than half on various kinds of income. Over the last years capital taxes decreased slightly from 12 percent of GDP in 1990 to 10 percent in 1997.

However, one third of the tax revenue in the UK is levied in the form of consumption taxes (mainly VAT and excise duties). Between 1985 and 1995 there has been a shift towards indirect taxation: increasing VAT and extending it to domestic fuel.

Environmental taxes account for around 3 percent of GDP, they remain almost stable from 1970 to 1997. The main component is the tax on energy that is around 2 percent of GDP.

Implicit tax rates give a picture of where the tax burden falls. These rates measure the incidence of the tax burden on each factor: labour, capital and consumption. Implicit tax rates are obtained by relating the broad categories of tax revenue to the corresponding tax bases: labour income (gross wage), capital income (gross operating surplus) and consumption expenditure.

Table 8 shows the implicit tax rates in the UK from 1970 to 1997 (Eurostat, 2000). We observe a gradual increase in tax rates on labour employed from 25 percent to around 28 percent, in the period from 1970 to 1980. The reform of income tax at the end of 70s involved a decrease of 1 percent of implicit tax rates on labour from 1980 to 1985. A further reduction was due to cuts on social contributions in the mid-80s: the implicit rates on labour employed reached 25 percent in 1990. Then we observe some fluctuation but always over a range of just 2 percent<sup>5</sup>.

Over the last 25 years the implicit tax rate on labour employed is quite stable around 26.5 percent, only in 1980 there is a peak to 28 percent.

The implicit tax rates on other factors of production, which include capital taxation and the taxation of self-employed, decrease from a peak of nearly 60 percent in 1975 to around 48 percent in 1980. In 1984 there is an important reform that cut the main corporation tax rate; nevertheless the implicit tax rates rise again, up to 53 percent in 1991. The 1984 reform was intended as neutral revenue, but in fact it raised receipt by bringing many more companies into a taxpaying position.

A further reduction of corporation tax rate (1991-92) instead involved a sharp decrease of implicit tax rates, from 53 percent in 1991 to 37 percent in 1997<sup>6</sup>. In the last decade this development is strongly influenced by the relative decline of the taxes on the real estate.

Implicit tax rates on consumption are quite stable from 1970 to 1997: the lowest value is 13 percent in 1975, then the rates increase by up to 16 percent in 1985, and they vary around 15.5 and 16.5 percent throughout the 90s.

The shift towards indirect taxation provides a mere 1 percent increase of implicit tax rates on consumption, and a greater reduction of implicit rates on capital, around 18 percent in 27 years. Labour is quite stable: the change of income tax does not involve a decline of implicit tax rate. Nevertheless, despite the reforms the highest implicit tax rate remains on others factors: 10 percent higher than labour, and 20 percent more than consumption.

The shift away from direct taxation towards indirect taxation since 1985 affected also the progressivity of the tax system. Looking at the proportion of income of each decile taken by direct taxes (Jiles and Johnson, 1994), it increases strongly from 7 percent in the bottom decile to 30 percent in the top decile, in 1995. This reflects the progressive nature of direct taxation: the tax allowances involve no taxation in the bottom deciles of income, and the average rate increases as income rises.

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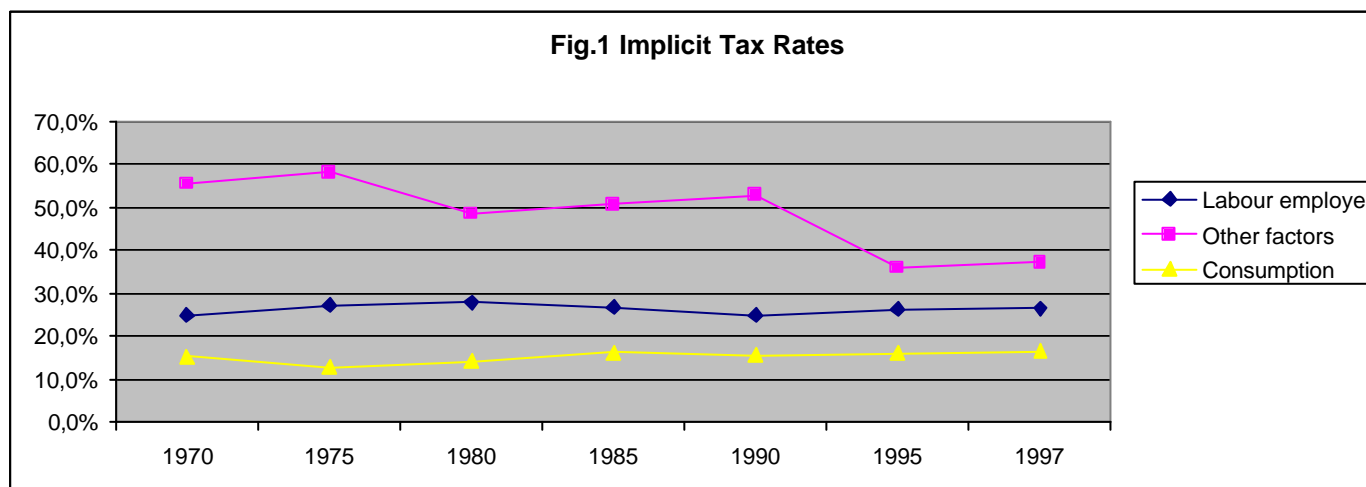
<sup>5</sup> The average effective tax rates on labour, worked out by Carey and Tchilinguirian (2000) since 1980 to 1997, show a gradual declining trend from 25 to 20 percent over the analysed period. Sometimes there are small increases, but the rates are always in a range of 20-22 percent.

<sup>6</sup> The same trend is confirmed by another study (Carey, Tchilinguirian, 2000) that calculated average effective tax rates on capital from 1980 to 1997. During the first 10-year period, the rates rise and fall around 45 and 50 percent. Since 1991 there is a decline to the lowest point of 36 percent in 1994, and then an increase up to 40 percent in the following years

**TAB. 8** *Implicit Tax Rates*

	1970		1975		1980		1985		1990		1995		1997	
	UK	Europe	UK	Europe	UK	Europe	UK	Europe	UK	Europe	UK	Europe	UK	Europe
Labour employed	25.0	28.9	27.3	32.2	27.9	35.1	26.8	37.1	24.8	37.5	26.3	41.7	26.5	41.9
Other factors	55.4	27.5	58.0	38.4	48.4	42.2	50.6	38.7	52.8	37.4	35.9	35.7	37.1	38.2
Consumption	15.2	15.2	12.8	13.0	14.3	13.5	16.2	13.3	15.6	37.5	16.1	14.2	16.5	14.5

Sources: 1970-1997, Eurostat.



Direct tax cuts since 1985 reduced the tax burden in each decile in a regressive way. They reduced the proportion of income taken by direct tax more in the richer deciles than in the poorer ones. In the top decile direct tax burden falls from 34.2 percent to 30.5 percent since 1985 to 1995, and for the 1 percent of the income distribution the drop is bigger, around 10 percent. This means that richer people benefit from the cutting of the higher marginal rate, from 60 percent to 40 percent. In 1999, the Government tries to solve this inequality cutting the lower rate of income tax from 20 percent to 10 percent. This measure should increase the progressivity of the tax, reducing the proportion of income taken by tax in the bottom decile.

Since 1985 the increase of indirect taxation imposes a greater burden in every decile, but by more in the poorer deciles than in the richer ones, thus increasing regressivity. Indirect tax burden rises by 4 percent at the bottom of income distribution and only by 1.5 percent at the top (Jiles and Johnson, 1994).

A simple numerical measure of the redistributive effect of the income tax is the difference between the Gini coefficient pre-tax and post tax. According to the calculated Gini coefficient (Jiles and Johnson, 1994) for pre-tax equivalent income and for post-tax equivalent income under the 1985 and 1995 tax regimes, the first redistributive effect in the first regime is 0.0468 and in the second is 0.0338. The 1995 tax system reduces the Gini coefficient by 9 percent, 3.5 percent less than 1985 system; the RE declines by 0.013 that is around 28 percent. These measures show the regressivity and inequality introduced by the tax changes.

In the study by Wagstaff et al. (1999) RE is 0.0352, which means a post-tax reduction of inequality of around 8 percent; the Kakwani's progressivity index is 0.2278. The reranking index R, obtained comparing the post-tax Gini coefficient with the post-tax concentration coefficient, is 6.3 percent. In absence of a marginal tax rate in excess of 100 percent, reranking is only due to the differential tax treatment. However, the discrepancy<sup>7</sup> between the redistributive effect and the vertical redistribution is very small. This means that in terms of its impact on redistribution of income the differential tax treatment is less important than progressivity.

#### **4.2 Tax wedges on labour and corporate taxation**

The average tax wedge on labour, at the wage level of an average production worker (APW) is less than 28 percent in the UK (Joumard, 2001). It can be divided in three components: the first one is the personal income tax, which is the larger, accounting for almost 15 percent, i.e. more than 50 percent of the total wedge. The second and the third components of the tax wedge on labour are employee and employer's social security contributions: they account for around 6.5 percent each,

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<sup>7</sup> Caused by non zero-values of horizontal inequity and reranking.



i.e. is less than 25 percent of total wedge. At the taxable income level of an average production worker (APW) the marginal tax wedge on labour is around 40 percent. For workers earning 50-60 percent more than the APW, the marginal tax wedge decreases to around 35 percent; for all the remaining higher income earners the marginal tax wedge is more than 45 percent (Joumard, 2001). Between 1991 and 2000 the average tax wedge decreased by almost 2.5 percent. Lower tax wedge is due to the policy of reduction of social contributions at the bottom end of the pay scale, and the introduction of tax allowances for workers whose earnings are below certain thresholds (such as the working families' tax credit<sup>8</sup>). All these measures, reducing the average tax rate on the low-income worker, are effective in terms of creating job opportunities for low-skilled workers and may enhance the vertical equity of the tax system.

The impact of corporate taxation on economic activity can be analysed through the effective corporate tax rates, both average and marginal. The statutory corporate tax rate gives some information, but it is too limited. In the UK there is a negative tax break of around 5 percent: the statutory corporate tax rate is 30 percent, the effective tax rate is almost 25 percent (Joumard, 2001).

According to the forward-looking approach, in the case of equity-financed investment (see Giannini and Maggiulli, 2001), the marginal effective tax rate is around 35 percent and the average tax rate (computed assuming a 20 percent rate of profitability) is 32 percent. Both the effective tax rates are greater than the statutory rate (30 percent), and the average rate decreases with the increase in profitability.

In most countries, the effective marginal rate is lower than the statutory one and the average rate increases with profitability. The reason for the UK's different situation is due to relatively high real property taxes, such as business rates for companies, which impose a greater effective tax burden on marginal investments than on more profitable ones.

When the source of finance is debt, the effective marginal tax rate is negative, -25 percent, because of interest' deductibility and tax allowances for depreciation in excess of economic depreciation. The effective average rate (at 20 percent profitability) is 22 percent and is lower than the statutory rate (30 percent). Effective tax rates in the case of debt finance are always lower than the effective rates in case of equity finance.

The effective marginal tax rate is 25 percent and the average rate (at 20 percent profitability) is 28 percent; both the rates are lower than the statutory rate (30 percent).

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<sup>8</sup> See par. 3.1 Income tax

### **4.3 Taxation by levels of Government and fiscal federalism**

According to OECD classification, in the UK there are three levels of Government: central, local and social security funds.

Central Government raised around 70 percent of total tax revenues in 1975. The percentage is quite similar in 1985 and increases greatly in 1999, reaching 77.5 percent. Social security funds raise about 17 percent of total revenues, from 1975 to 1999 (OECD, 2001).

Local taxation has always been very low in the UK, looking at 1975 it is around 11 percent of total revenue, and 10 percent in 1985, then it decreases dramatically to 4 percent in 1999.

Local taxes have been reformed twice, but the final system is more similar to the original than the intermediate one. In 1990 there was a big reform in local taxation, the introduction of a poll tax to replace the domestic rates. The taxes on the rental value of a home are substituted by a per capita charge, unrelated to income or property value. The unpopularity of poll tax, due in part to its high level, induces the Government in 1991 to introduce a subsidy, paid for by an increase in VAT. This intervention is part of the switch from direct to indirect taxation (Jiles and Johnson, 1994).

If it had not been for the poll tax subsidy, there would have been a general increase in the level of local taxes, instead they have fallen over the period. In the following years the poll tax was abolished, and the actual system is based on the council tax and business rates<sup>9</sup>.

For these reasons today there are local taxes only on property, accounting for just 1.5 percent of GDP (OECD, 2001), although the individual burden of taxation is one of the highest in EU.

### **4.4 A comparative view with European average**

A first analysis of the differences between the UK tax system and European averages can be carried out looking at the implicit tax rates.

The implicit tax rates on labour in the UK were significantly below the EU average (Eurostat, 2000): in 1970 the difference is only 4 percentage points, but while in Europe the rate gradually increases reaching 35 percent in 1980, in the UK the rate is 28 percent. At the end of the 90s the EU average is 42 percent, 15 percentage points more than the UK. The main difference is due to the low social securities contributions paid in the UK: in 1999, the effective tax rate on non-wage labour costs (social contributions) accounts for 12 percent in the UK and for 25 percent in the EU (OECD, 2000).

The implicit tax rate on other factors (capital) in the UK is about 28 percentage points higher than EU average. In 1980 the difference has reduced to only 6 percentage points; and in 1997 the trend changes, in fact the EU rate (38 percent) overcomes UK one (37 percent).

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<sup>9</sup> see par. 3.4.

The implicit tax rate on consumption in the UK is always higher than the EU average; the difference is around 1 percentage point until 1980. Since 1985, the increase of indirect taxes (VAT and excises duties) in the UK involves a rise of implicit tax rate, doubling the difference with the EU average.

In the UK the pre-tax Gini coefficient is the highest among the 12 OECD countries analysed (Wagstaff et al., 1999). Nevertheless, the redistributive effect of the income tax is higher than that of other countries such as Germany, Denmark and US. The UK is in a cluster of countries, comprising Ireland, Italy and Spain, which all have average rate values of around 15 percent. This is a middle value, between a minimum of 6.2 percent for France and a maximum of 32 percent for Sweden. The Kakwani's progressivity index in the UK is one of the highest among the 12 countries; this shows that despite the progressivity-reducing tax reforms during 1980s, the PIT is still progressive by international standards (Wagstaff et al., 1999).

The difference between the effective and the statutory corporate tax rate in the UK (-5 percent) is one of the lowest among the main EU countries: the UE tax break is -10 percent, and more than -15 percent in Belgium, Portugal and Austria (Joumard, 2001).

The statutory corporate tax in the UK is one of the lowest in the EU, along with Ireland and the Nordic countries, and far less than Germany, Italy and France (Giannini and Maggiulli, 2001).

The average tax wedge on labour (28 percent) is very low: it is slightly less than the OECD average (30 percent), far less than the EU average (around 45 percent) and less than Germany, Italy, France and Nordic countries tax wedges. The marginal tax wedge in the UK (39 percent) is a bit less than the OECD average (40 percent), and more than 15 percentage points less than the EU average (Joumard, 2001).

## **5. Tax reform in the '90s and those currently planned**

### **5.1 A quick glance at the budget and the general economic environment**

The UK economy is successful in 2000:

GDP growth increased to 3 percent, significantly above its post-war average of around 2.5 percent; it is expected to increase by 2.25 to 2.75 percent a year over the next three years. Household consumption rose by 3.6 percent. Business investment decelerated in 2000 following rapid growth over previous years, but general Government investment increased by an estimated 5 percent. External demand lifted total export volume growth to nearly 7.5 percent in 2000, and goods volumes rose at their fastest rate since 1973. Manufacturing output rose by 1.6 percent, and saw the

highest growth since 1994; this contributed to a better net trade performance compared to the previous two years.

Unemployment reached its lowest level since the 1970s: between 1997 and 2000 the International Labour Organisation (ILO) measure of unemployment has fallen by 520 thousand, with the rate down from 7.2 percent to 5.3 percent, that means just 3.5 percent on a claimant count basis.

The reasons for the unexpected strength of employment growth are the sharp reduction of the non-accelerating inflation rate of unemployment (NAIRU), the containment of wage pressure, caused by reductions in long-term unemployment, the more effective job search, and the enhanced product market competition.

Across the public sector, the current budget balance has improved from a deficit of 3 percent of GDP in 1996-97 to a surplus of 2.1 percent in 1999-2000. The current budget surplus in 2000-01 is estimated to have risen to 2.4 percent of GDP: current revenue should be 40.5 percent of GDP and current expenditure 38.1 percent. The surplus is projected to be around 1.7 percent of GDP in 2001-02 and 1.5 percent in 2002-03 (HM Treasury, 2002).

The reason for the lower surplus from 2001-02 is the real rise in Government expenditure planned at 2.5 percent a year, more than GDP growth estimated at 2.25 percent a year, and the result of some stimulatory taxation measures. Receipts projections are also lower than expected.

The latest outcome of public sector net investment is 0.4 percent of GDP in 1999-00, and projections show a rise from 0.7 percent of GDP in 2000-01 to 1.5 percent in 2002-03.

Net borrowing is equal to net investment minus the surplus on the current budget. The rapid growth of net investment results in declining surpluses of net borrowing, ranging from -1.7 percent of GDP in 1999-00 to -0.6 percent of GDP in 2001-02; a net borrowing deficit of 1 percent of GDP it is estimated in 2003-04.

The projections of negative net borrowing result in a declining net debt-GDP ratio. It falls from 36.8 percent of GDP in 1999-00, to 31.8 percent in 2000-01 and to 29.6 percent of GDP in 2002-03. In the following years there will be small increases of net debt, caused by the modest level of borrowing, but the debt-GDP ratio will remain fairly constant at around 30 percent of GDP.

The primary balance has risen from a deficit of 0,5 percent of GDP in 1996-97, to an estimated surplus of 4 percent in 2000-01. Projections for the next years show a decline, but the surplus remains positive up to 2005-06, estimated at around 0,5 percent of GDP.

## **5.2 Tax reforms in the '90s and before**

### *Personal income tax*

In 1979 the reform of the rate structure represented the most dramatic change in income tax. Until that date there was a lower rate of 25 percent, a basic rate of 33 percent and a higher rate ranging from 40 to 83 percent. In addition a surcharge of 15 percent was applied to high investment incomes, leading to a maximum rate of 89 percent. In 1979, the Government abolished the lower rate, reduced the basic rate to 30 percent and the higher to 60 percent; in 1984 the surcharge was abolished. In 1988, the top rate was cut to 40 percent, the basic to 25 percent and lower to zero.

In 1992 the very simple rate structure with two rates (25 and 40 percent) was complicated by the reintroduction of the lower rate at 20 percent, and this was further reduced in 1999 to 10 percent. In 2000 we note that the basic rate is lowered from 23 to 22 percent, and in 2001 the bottom tax band is widened.

Other changes concern the allowances system: in 1990 we can see that the independent taxation<sup>10</sup> of husbands and wives is introduced with a married couple's allowance (MCA). Since 1993 MCA has been reduced in value and finally abolished in 2000; contextually child benefits are increased and a means-tested children's tax credit (CTC) has been introduced which provides support for children directly through the tax system.

Since 2000 the more generous working families tax credit (WFTC) has replaced Family credit, and two further reforms are planned for 2003. The first is the integrated child credit that will combine the support for families provided in the CTC, in the WFTC and in means-tested benefits for those out of work. Out of work families and lower paid working parents are eligible for this credit.

The second reform is the employment tax credit (ETC), which extends the principle of WFTC to workers without children.

### *Social security contributions*

Since 1975, National Insurance contributions have been earnings-related, subject to an income floor.

Prior to 1985 the NI contributions were due on earnings higher than £72 per week, with a jump in liability at rates of 9 percent on all earnings for the employee and of 10.45 percent for the employer. In 1985 there was an important reform that reduced the jump in liability and aligned the rates for employees and employers at 5 percent. In 1989 the entry rate for employers was cut to 2 percent, and then in 1997 the Government abolished, for both employees and employers, the jump in liability. Since 2001 employers and employees start paying for NI contributions when the employee's income has reached the income tax personal allowance. After that limit the employees pay 10 percent of all earnings and employers 11.9 percent (with a reduction to 11.8 percent in

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<sup>10</sup> Prior to 1990 married couples were treated as single unit for income tax purposes.

2002). In addition, there is an upper income level (UEL) beyond which employees do not pay further contributions. For employers the UEL was abolished in 1985.

### *Corporate and capital taxes*

Companies have been charged corporation tax since 1965, and since 1973 there has been a lower rate for companies with small profits. The 'all-in' statutory corporate tax in the UK has been through major reform twice in the last 22 years. The first reduction was in 1984 from 52 percent to 35 percent; in 1992 there was a further cut to 33 percent.

In 1997 the main corporate tax rate was reduced to 30 percent; the Government abolished the advanced corporation tax and also changed the taxation on dividend, reducing the tax credit from 20 to 10 percent. In 1998 individual capital gains tax has been reformed<sup>11</sup>, removing indexation and introducing a tapering system, with the objective of encouraging longer-term holding of assets.

The withholding tax on intra-UK payments of interest and royalties made to companies within the corporation tax charge will be abolished from 2001.

### *Consumption taxes*

1995 saw the most significant widening of the VAT base since its introduction in 1973. VAT was also imposed on domestic fuel, and the standard rate was increased from 15 to 17.5 percent to pay for the reduction of poll tax.

In 1993 there was also an increase on excise duties, notably on petrol and tobacco. Since 2000 the duty on this last commodity has risen by 5 percent.

From 2001 a graduated vehicle excise duty for new cars has been introduced, and a climate change levy.

## **5.3 Priorities for future tax reforms**

According to Joumard's (2001) suggestions to improve labour market performance, UK reforms lowered the tax burden on labour. The Government cut the social security contributions at the bottom end of the pay scale, and the trend is a further reduction of NICs for employers. The Government objective is to move the structure of NI nearer to that of income tax, and to change the NI base to match the income tax base more closely. Recent reforms have also reduced the complexity, distortion and horizontal inequity caused by the lack of integration of the two separate systems.

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<sup>11</sup> see par. 3.5

Personal income tax has been reduced, initially for high-income taxpayers involving a regressive redistribution, and since 1999 cutting the lower tax rate. However, in the UK 27.6 million individuals, out of an adult population of 45 million, are liable for income tax. This means that attempts to use income tax reductions to help the poorest are likely to fail. The number of lower-rate taxpayers rose after 1992 with the increase of the lower rate band, and fell dramatically in 1999-00 as the new 10 percent rate was introduced over a narrower range of income than the previous 20 percent rate.

Changes of labour tax and income tax have been accompanied by a reform of the benefits: UK has moved from a system that provided financial support to married people, to one that helps poor working families and those with children.

The central strategy of the Conservative Government from 1979 to 1997 was the shift from direct to indirect taxes. Nevertheless the balance between direct and indirect taxes changed little: the large growth in VAT, was offset by the fall in excise duties, and the reductions in personal income tax were offset by the increase of corporation tax.

The recent debate on VAT concerns two issues: incentives and redistribution (Adam and Frayne, 2001). The revenue-neutral shift from direct to indirect taxation was justified by the reduction of tax-induced disincentives to work. But according to the opposite view, the greater number of goods that can be bought with extra work determines the attractiveness of working an extra hour. So a uniform consumption tax and a uniform earnings tax have the same effects. The cut in income tax does not increase the attractiveness of work, if the price of goods rises by an equivalent amount. The shift proposed will reduce the tax burden for one group and increase it for another, affecting in this way the incentives, but the mechanism concerns little the choice between direct and indirect taxation.

The second argument relates to the justification of zero-rated VAT goods on distributional basis (Adam and Frayne, 2001): low-income earners allocate a large proportion of their expenditure to these items. According to the opposite view, although the better off do not spend much on these goods, they spend a lot of money and are the main beneficiaries of zero rates of VAT. It is unlikely that the best way to help the needy is to identify goods that absorbed a large share of their incomes, then cut indirect taxes for these items.

The direction of new UK reforms, which is consistent with Joumard, is to reduce the complexity of VAT, introducing a package of measures aimed at easing the impact of VAT for small and medium-size enterprises. Moreover, the zero-rating of young children's clothing and footwear will be simplified and modernised.

Enhanced taxation of property should improve the neutrality of the tax system toward different forms of wealth, and can rebalance the tax burden away from labour (Joumard, 2001). The UK is the only EU country that adopted this suggestion; in fact there are two forms of taxation on property:

- national non domestic rates bearing on productive activities that are property-intensive;
- council tax based upon property values.

The problem is that the council tax is the only local tax left, because non-domestic rates are set at national level and it is no longer a local tax in any meaningful sense, but effectively an intermediate tax.

Some suggestions for further reforms arise from the simulations performed by the European Commission for the UK (Leibfritz, Thornton, Bibbee, 1997):

A cut in corporate tax rate by 1 percent of GDP would increase GDP by 4.30 percent, employment by 1.81 percent, and wages by 2.54 percent. Nevertheless, if the Government aims of increasing employment, it should reduce the labour tax: a cut in labour tax rate by 1 percent of GDP would increase employment by 2.26 percent.

Another simulation shows that a shift from corporate income tax to consumption tax would increase GDP by 2.32 percent, wages by 2.56 percent and decrease employment by  $-0.02$  percent. If the employment were a priority for the Government, a shift from labour income tax to consumption tax would increase employment by 0.46 percent. However the shift from labour to corporate tax produces high costs in terms of reductions of GDP and wages

Another important debate concerns double taxation (Inland Revenue, 1999). This occurs when income is taxed both by the taxpayer's country of residence and by the country in which the income arises. The credit method<sup>12</sup> is applied in the UK, while other countries use the exemption method<sup>13</sup>. The purpose of double taxation relief is to remove or reduce the disincentive that double taxation represents to outward investment. Credit systems lead in the direction of CEN (capital export neutrality). However, in the United Kingdom this is only partially achieved. The main reason is the adoption of the "ordinary credit" method, which involves full neutrality for investment in other countries with tax rates at or below the United Kingdom rate and partial neutrality for investment in other countries with tax rates higher than the United Kingdom ones.

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<sup>12</sup> The foreign tax paid on income is deducted from the UK tax payable on the same income.

<sup>13</sup> foreign income is disregarded for tax purposes in the country where the taxpayer is resident.



The current discussion is focused on the opportunity to review the UK's system of double taxation relief for companies, with the introduction of an exemption system for direct investment capable to achieve CIN (capital import neutrality) and an optimal allocation of savings. Nevertheless, unilateral adoption of an exemption system for the United Kingdom does little to deliver CIN, because it requires a group of countries collectively to adopt this system. Current thinking seems to favour a credit rather than an exemption system: the United Kingdom should be more concerned about distortion of allocation of investment than of savings. Moreover, it is not practical to make changes that depend for their effectiveness on the renegotiation of tax treaties.

Finally, statutory corporate rates in the EU are on average 33 percent; while in the UK the rate is 30 percent and is one of the lowest together with the Nordic countries and Ireland (10 percent). The majority of the countries have rates in the range of 35 to 40 percent.

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