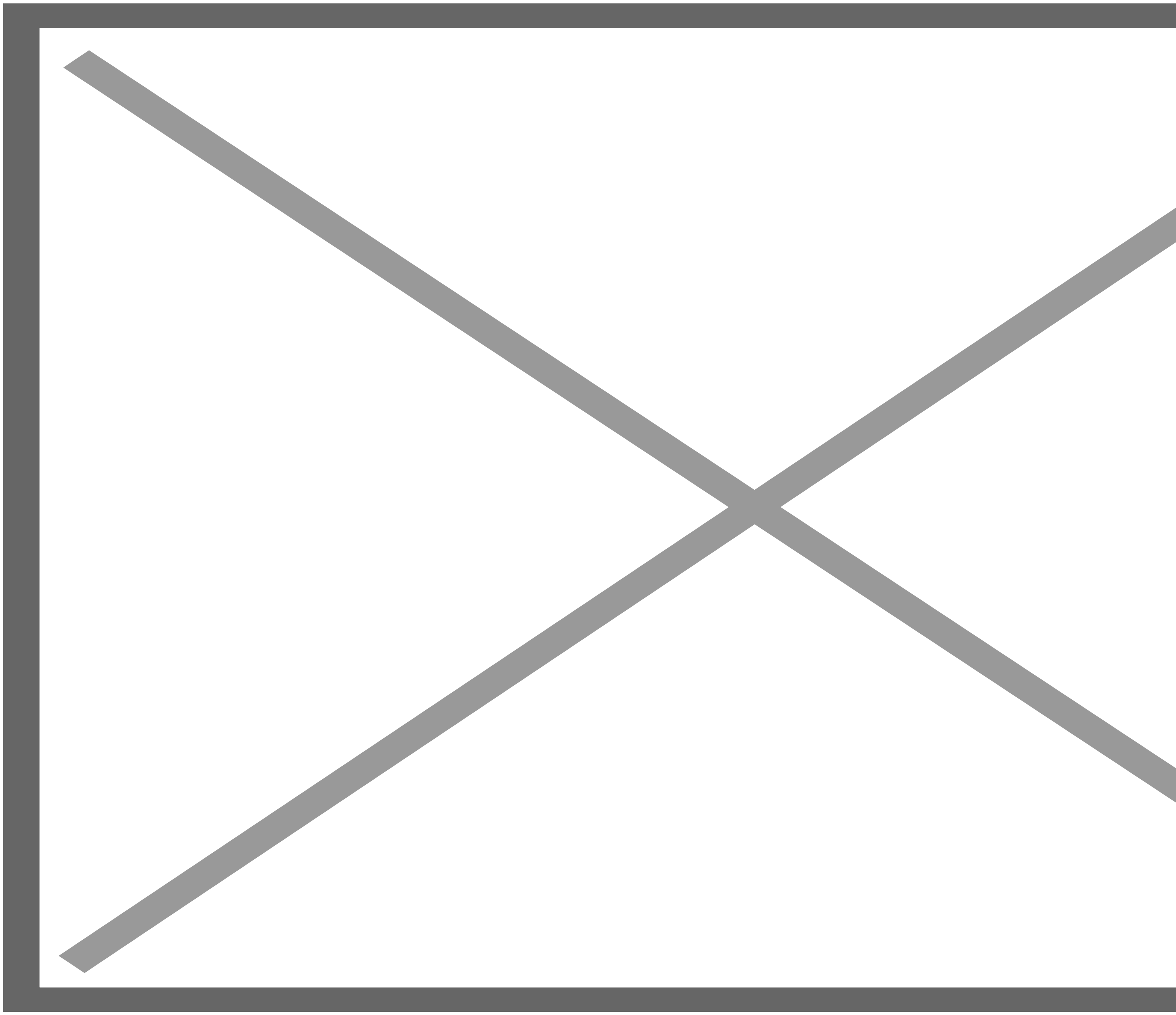
A cause for relief?

Management of taxes



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Bill Dodwell considers the role that tax reliefs play in defining the tax base and their cost to the UK economy

The very first report from the newly formed Office of Tax Simplification looked at tax reliefs. The team counted all the reliefs in the tax system and came up with 1,042. The team looked at 159 reliefs in more detail and proposed the abolition of 47 reliefs. In the end, after public consultation, the chancellor proposed the abolition of

43 reliefs, neatly achieving the short-term target of reducing the reliefs below 1,000.

This first report triggered much greater Parliamentary and public interest in tax reliefs. However, it has not prompted a reduction in tax reliefs generally. Indeed, the National Audit Office pointed out in its first report on Tax Reliefs in 2014 (see bit.ly/2Qn8XYu) that the number of reliefs had climbed to 1,128 by 2013. The latest report from HMRC identified 1,190 tax reliefs.

In part, tax reliefs have grown in number as new taxes have been introduced. As that first OTS report noted, 'abolition is only one route to simplification and … abolition of a relief might in fact add to complexity, by drawing more people or transactions into the tax system'.

Defining the tax base

Often, tax reliefs are part of defining the tax base. As the NAO put it in 2014: 'It is important to recognise that, while the provision of reliefs reflects government's choices about where to place the tax burden, it would be unrealistic to assume that all of the revenue that appears to be foregone through tax reliefs could be collected. Some reliefs simply help define the tax base … and could not be otherwise collected.'

We see this broader point about defining the tax base in several parts of the tax system. The personal allowance for income tax cost £113 billion in 2019/20 (see bit.ly/3axjTcN) and the equivalent for national insurance cost £62 billion. These 'reliefs' define the tax base by providing that those on the lowest incomes (and their employers) are not liable for the taxes.

From the point of view of simplification, higher allowances mean that fewer people are liable to pay the tax and there is a saving in administration. However, the effect of benefits complicates the whole area. One of the aims of universal credit is to take account of tax borne; reducing tax or national insurance typically means that the benefit is reduced as well.
Alongside the reduction in administration needs to be placed the related philosophical point, notably made by former chancellor Nigel Lawson, to the effect that people who pay tax should have an interest and involvement in the tax and public spending systems – and the link between the two.

The cost of tax reliefs

Some of the UK's taxes on assets have reliefs that considerably exceed the tax raised. For example, the cost of the inheritance tax £325,000 nil rate band is about £17 billion, compared to tax raised of about £5 billion. A similar point occurs in capital gains tax, where the annual cost of the main residence exemption is about £27 billion, compared to tax paid of some £8-10 billion. HMRC has not been able to make a reliable estimate of the cost of the £12,300 annual exempt amount but it is clear this considerably exceeds the tax raised.

The National Audit Office (and HMRC) make a further important point in relation to the system of reliefs. It is not possible to add up the individual estimates and assume that the total represents revenue foregone. In practice, many of the reliefs interact and there are also significant behavioural effects too.

However, alongside the growth in the number of reliefs, their value has also grown. The NAO stated that: 'As a proportion of GDP, the sum of all tax reliefs has increased from 16% to 21% since 2005/06 [to 2012/13], while tax revenues have decreased marginally. This increase is mainly explained by increases in the income tax personal allowance, the thresholds for national insurance contributions, and the standard rate of VAT (because as the standard rate of VAT rises, so does the value of VAT reliefs). The value of tax expenditures has increased in real terms from £91 billion to £101 billion over this period (from 5.9% to 6.5% of GDP).'

The International Monetary Fund reviews the financial systems of many countries. Its reports on the UK have praised the UK's overall disclosure and costing of of tax reliefs, but the IMF points out that the UK devoted a higher proportion of GDP to tax reliefs than do many other countries (see 'Figure 1.8: Revenue loss from tax expenditure in selected countries' at bit.ly/3gIfvfd).

The UK's tax reliefs considerably exceed France, Germany and Canada but are below the US and Italy.

The IMF notes: 'Tax expenditure analysis is integrated with tax law design but not with budgetary decision making. As a result, performance of tax expenditure schemes can't be assessed against quantitative measures in an analogous manner to spending programmes.'

Policy decisions over the tax base remain very much a matter for government. Perhaps the broader question, though, is whether the tax incentives offered by reliefs are effective in achieving their policy aims. The higher level of work on evaluation now being undertaken by the Treasury and HMRC is thus to be welcomed.