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WHAT CAN AMERICA LEARN FROM THE BRITISH TAX SYSTEM?

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Abstract - *This paper examines elements of British tax policy and discusses their implications for the United States, where several recent proposals would mirror aspects of the British system. These include reducing filing requirements under the individual income tax, indexing capital gains for inflation, cutting mortgage interest deductions, enacting a value-added tax, and integrating the corporate and personal income taxes. The paper also discusses implications of the poll tax for tax reform. Britain and America have made different choices involving equity, efficiency, simplicity, and other goals. These choices offer the chance to help identify the impact of tax policy.*

Tax policy debates in the United States are noteworthy for their frequency, intensity, and largely inward-looking focus. Very seldom is reference made to the experiences of other countries, and the references that are made are often seriously misleading. Yet many of the major reform ideas put forth in recent years in the United States are closely related to programs that already exist in other countries.

This paper examines selected elements of British tax policy and experience and discusses their implications for United States tax policy. Britain is an instructive choice for this purpose because the British tax system is fundamentally like the American system in many respects, but contains many features that relate directly to changes currently or recently proposed in the United States.

The systems are most obviously similar in that they rely on income and payroll (social security) taxes for the bulk of their revenue. Both countries experienced, indeed led, the drive in the 1980s to reduce tax rates and broaden tax bases that caught on around the world and was encapsulated in a series of changes made in the 1980s by Conservative governments in the United Kingdom and in the United States Tax Reform Act of 1986.

But many features of the British system differ significantly from that in the United States. For example, the personal income tax is based on individual rather than family income, and only about ten

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percent of taxpayers have been required to file returns in recent years. Capital gains are indexed for inflation, while deductions for mortgage interest and other items are much more limited than in the United States. In general, relative to its American counterpart, the British income tax emphasizes simplicity, downplays the role of social policy, and limits attempts to obtain finely tuned measures of income. These differences date to the origins of the income tax in each country.

The British corporate income tax is partially integrated. Excise taxes and a value-added tax (VAT) raise a significant amount of revenue. The United Kingdom recently lived through an unsuccessful attempt to replace local government property taxes with poll taxes.

Analysis of each of these differences may contain important lessons for academics and policymakers alike. However, it should be clear at the outset that Britain has not found any way to "solve" the various trade-offs among equity, efficiency, simplicity, and other goals. Rather, the lessons stem from the fact that the United Kingdom has chosen different points (hopefully, but probably not) on the frontiers of these trade-offs. Thus, the lessons to be drawn here are not in generating conclusions about what is right or wrong about tax policy, but in providing evidence on the costs and benefits of different policies and in locating the biggest gaps between "textbook" analyses and the real world. Another set of issues involves assessing the political and other factors that have led to the differences in policy in the first place. For one such discussion, see Keen (1997).

The next section provides a very brief overview of the current status and recent evolution of British taxes, along with some comparisons to the United States. The following sections discuss what I view as some of the major differences between the systems, as noted above.

The final section offers some concluding thoughts, but all of the issues discussed below leave plenty of scope for new cross-country and within-country analyses that could sharpen the conclusions. Such analyses—for example, of the impact of alternative forms of capital gains taxation on investment and entrepreneurship—need to consider the interaction of several tax policies as well as other existing regulations or economic conditions. Thus, many of the conclusions are, of necessity, of a limited or tentative nature.

OVERVIEW OF THE BRITISH SYSTEM[1]

Total government tax revenues were 37.6 percent of gross domestic product (GDP) in Britain in 1995, compared to 31.3 percent in the United States. This difference has fluctuated over time and stood at 7.7 percent in 1970, 6.0 percent in 1980, and 7.2 percent in 1990.

Table 1 describes the composition of tax revenues in Britain for 1993–94 and the United States for 1993. The taxes in the table are grouped by United States convention. (British tables typically classify capital gains as a separate tax from the individual income tax.) Both countries obtain the most revenue from their individual income tax and social insurance payroll taxes, though the United States collects more from each than the United Kingdom does. The countries collect about the same proportion of their revenue from corporate income taxes, though the

TABLE 1
THE COMPOSITION OF TAXES IN THE UNITED KINGDOM AND THE UNITED STATES

	United Kingdom, 1993–4		United States, 1993	
	Percent of Taxes	Percent of GDP	Percent of Taxes	Percent of GDP
Income tax	25.6	8.6	36.0	9.7
Individual income tax	25.2	8.4	—	—
Capital gains	0.4	0.1	—	—
Corporate income tax	6.4	2.1	8.2	2.2
Social insurance	17.0	5.7	23.2	6.3
National insurance	17.0	5.7	—	—
Social security and Medicare	—	—	23.2	6.3
Broad-based consumption taxes	16.8	5.6	7.9	2.1
VAT	16.8	5.6	—	—
General sales tax	—	—	7.9	2.1
Specific consumption taxes	10.9	3.6	2.6	0.7
Alcohol	2.3	0.8	0.6	0.2
Tobacco	3.0	1.0	0.6	0.2
Transportation fuel	5.6	1.9	1.4	0.4
Property taxes	9.0	3.0	10.8	2.9
National nondomestic rates	5.5	1.8	—	—
Council taxes	3.5	1.2	—	—
Estate and gift taxes	0.6	0.2	1.0	0.3
All other taxes	13.7	4.6	10.3	2.8
Total	100.0	33.4	100.0	27.0

Sources: OECD Revenue Statistics, 1965–95; Dilnot and Stears (1997); Fleener (1997); and Budget of the U.S. Government, Fiscal Year 1998.

annual figures vary over time. Property taxes and estate and gift taxes account for a somewhat smaller share of revenues in the United Kingdom than in the United States.

The major difference shown in Table 1 is the importance of consumption taxes. The VAT raises about one-sixth of all tax revenues in Britain, more than double the proportion of revenue raised by general sales taxes in the United States. Taxes on specific consumption items also differ. Taxes on alcohol, tobacco, and gasoline totaled 10.9 percent of tax revenues in Britain compared to only 2.6 percent in the United States.

Given these differences, effective tax rates on different types of economic activity may be expected to vary in the two countries. Quick and Neubig (1994) present data on measures of average tax rates. They estimate that, in 1991, consumption tax revenues totaled about 19.4 percent of aggregate consumption in the United Kingdom compared to 6.2 percent in the United States. Economy-wide average tax rates for payroll taxes and combined individual and corporate income taxes were similar in the two countries. The average total tax rate on labor income—including income, payroll, and consumption taxes—was estimated to be 36.5 percent in the United Kingdom compared to 29.3 percent in the United States. While such information is instructive, data on effective marginal tax rates would be more useful in

understanding the tax incentives faced by firms and households. However, obtaining systematic, comparable, and current data is difficult.

There is a general sense in both Britain and the United States that the British system, especially the income tax, has fewer deductions or loopholes. It would be interesting to quantify this difference, but is quite difficult to do so.[2]

Table 2 reports estimates of the distribution of the burdens of taxation in the two countries. Most striking, the British tax system provides virtually no net redistribution of income on an annual basis. This is in part due to the presence of taxes that appear to be regressive with respect to annual income, such as the VAT and excise taxes. In addition, substantial redistribution occurs through government spending in the United Kingdom. In the United States, most redistribution occurs through the spending system, but the tax system also redistributes resources from higher-income to lower-income households.[3]

A series of tax acts has significantly altered the British tax system since the late 1970s. One major theme has been to reduce the income tax and raise consumption taxes—the VAT and excise taxes. The basic VAT rate was raised from 8 percent to 15 percent in 1979 and to 17.5 percent in the early 1990s. Taxes on alcohol, tobacco, and gasoline have also increased substantially. The reduction in income taxes has been tilted toward the high end of the income distribution, while the increase in consumption taxes has been borne by all income groups (Hills, 1988).

TABLE 2
EFFECTIVE TAX RATES BY INCOME QUINTILE, UNITED KINGDOM AND UNITED STATES 1994

Quintile	United Kingdom	United States
First	39.4	5.0
Second	33.9	14.9
Third	36.5	19.5
Fourth	35.8	22.3
Fifth	34.2	27.9

Sources: Calculations based on data from CSO Economic Trends (1994), as reported in Dilnot and Stears (1997, Table 17) and U.S. Congressional Budget Office (1994).

Within the income tax, rates have fallen dramatically. The top rate on wage income fell from 83 percent in the late 1970s to 40 percent by 1988. An additional surcharge of up to 15 percent on investment income, which raised the top rate to 98 percent, was eliminated. The “basic” rate faced by most taxpayers fell from 33 percent in tax year 1978–79 to 24 percent by 1996–7, and is now 23 percent.

The base changed in several ways. Deductions for mortgage interest have been curtailed. At the same time, however, thresholds for the income tax brackets were raised substantially in real terms, the treatment of capital gains was liberalized significantly, and several new saving incentives were introduced.

Income tax rates for large corporations fell from 52 percent in 1980 to 33 percent by 1996–7; tax rates on small corporations fell from 40 percent in 1980 to 24 percent by 1996–7. At the same time, expensing of some types of corporate investment was swept away in 1984 and replaced with a significantly less generous set of depreciation schedules that helped equalize the present value of depreciation allowances across assets. The extent of integration between personal and corporate taxes has been reduced.

In the estate tax, the exemption has grown dramatically, but remains lower

than the U.S. exemption. The large number of estate tax rates that applied earlier have been collapsed to a flat 40 percent. National insurance (social security) taxes have increased by several percentage points, the employer ceiling for contributions has been abolished, and the base has been broadened to cover some fringe benefits.

At the local level, in 1989, residential property taxes were replaced with a "community charge," or poll tax, which was abandoned in two years and replaced with a new tax that is based on property value and number of adults living in a household.

The new Labour government elected in the Spring of 1997 has proposed additional changes that would further reduce corporate tax rates and the extent of integration between corporate and personal taxes, cut mortgage tax relief by one-third, provide targeted investment incentives, and change other items. Other recent developments in British taxation look decidedly American. There has been recent speculation about adding additional tax brackets, moving to a two-tier capital gains tax—depending on how long the asset is held—and introducing tax incentives modeled after United States individual retirement accounts and earned income tax credits. The new Labour government even has its own "no new taxes" pledge—Chancellor of the Exchequer Gordon Brown promised in the campaign at one point not to raise income tax rates for five years and at another not to raise income tax rates on those with income below £40,000.

The Individual Income Tax

The unit of taxation is the individual, although a system of joint filing was used before 1990. The tax base includes wages, interest, dividends, some capital gains, pension benefits, unemployment benefits, royalties, property income, business income and other items.

The personal allowance (the equivalent of a United States exemption) was £3,765 in tax year 1996–7 (which ended in April 1997).[4] Married couples receive an additional allowance of £1,790 that can be allocated arbitrarily across spouses. Taxpayers who are blind, recent widows, or elderly receive additional allowances. There are no child allowances, but there is a child benefit spending program.

After subtracting the exemption and any allowances, the marginal tax rate in 1996–7 was 20 percent on the first £3,900 of taxable income, 24 percent—the basic rate–on additional income up to £25,500, and 40 percent on higher levels of income. The basic rate has since been reduced to 23 percent. It is estimated that in 1996–7 about 25 percent of taxpayers faced the lower rate, 67 percent of taxpayers faced the basic rate, and the remaining 8 percent faced the top rate. Allowances and tax brackets are indexed for inflation.

Filing

From an American perspective, probably the most interesting aspect of the British income tax is that very few citizens actually have to file tax forms. Filing is usually unnecessary because the tax structure is sufficiently simple and because withholding regulations generate, in principle at least, exactly the right amount of withheld taxes at source on wages and other income.

The main instrument of exact withholding is the "pay as you earn" (PAYE) system. The PAYE system is a cumulative withholding scheme that applies to wage income. Workers provide their

employers certain basic information, including marital status and age, that is used to calculate withholding allowances. Employers then withhold taxes as directed by these formulas. The key to exact withholding is that the process is cumulative. At each paycheck, the taxes withheld equal the difference between cumulative taxes owed (on cumulative earnings to date) and cumulative taxes paid until then. Thus, employees that stop working in the middle of the year nonetheless have the correct amount withheld. When an employee changes jobs, information on his or her cumulative wages and taxes is provided to the new employer, and the calculations continue. In contrast, in the United States, taxes on wages are withheld, but withholding is neither cumulative nor intended to be exact.

Withholding wages at source is a necessary but by no means sufficient method of ensuring that most people do not have to file tax returns. Coupled with PAYE, a number of features of the British tax system enhance the feasibility of a nonfiling system. First, exact withholding is facilitated by requiring that taxpayers file individual, rather than joint, returns and setting the tax brackets so that a majority of taxpayers face the same basic rate.

Second, taxes on capital income are structured in a way that reduces filing requirements. Taxes on interest are withheld at a 20 percent rate. Personal-level taxes on dividends are in effect also withheld at a 20 percent, as discussed in a subsequent section. Capital gains on owner-occupied housing are completely exempt from taxes. On other assets, only inflation-adjusted capital gains in excess of £6,300 per person per year are subject to taxation. Indexing, however, cannot be used to turn a gain into a loss or to increase a loss. The effect is that very few households pay capital gains taxes. The first £3,250 of net rental income on rooms in the owner's home is exempted from taxation. Tax-preferred saving is incorporated via payroll deductions for pensions. Taxpayers may also contribute to saving incentive plans, but these contributions are limited and are "back-loaded"—the contributions are not deductible but earnings and withdrawals are not taxed. Thus, moving funds in and out of such accounts does not generate tax consequences.

Third, expenditures that would qualify as itemized deductions in the United States receive much less generous treatment in the United Kingdom. Subsidies for mortgage interest are provided, but not through tax filing and not, in fact, in a way that is at all related to taxes. Limited interest relief is provided at source. In 1996–7, the subsidy was a 15 percent rate, regardless of the taxpayer's marginal rate. For example, a household with a 10 percent mortgage would pay 8.5 percent interest on the first £30,000 of the loan, while the lender would collect the remaining 1.5 percent interest on that amount from the government. The full amount of interest on the remaining balance is charged to the household.

A limited amount of charitable contributions can be made through a payroll deduction plan, and taxpayers can also "covenant" income—earmarking the income to charity for four years or more. The contribution generates a deduction at the basic rate of tax. The charity recovers this amount (the basic rate times the contribution) from Inland Revenue (the British tax agency). Single contributions between £600 and £5 million may also be deducted.

Deductions for employee business expenses are generally very strict and

allowed only for items that are "wholly, exclusively and necessarily" related to business. Medical expense deductions have been extremely limited. (Of course, the structure of health expenditures is quite different in the United Kingdom than in the United States). There are no general deductions for personal interest payments, casualty losses, or local taxes.

Each of these features—individual filing, exact withholding of taxes on wages, a wide tax bracket applying to the basic rate, the treatment of capital income, and the treatment of deductions—reduces the need for individuals to file tax forms in order to reconcile tax liability with taxes withheld. Despite all of these features, however, about ten percent or more of British taxpayers have to file tax returns in any given year. These are largely high-income taxpayers with asset income (taxes on which have been withheld at a lower rate), those with capital gains above the exempted amount, and those with self-employment income.[5]

What can be learned from these policies? First, although filing requirements are clearly an administrative issue, they appear to have important effects on the structure of tax policy. The British income tax is marked by systematically different choices than its United States counterpart. The system has fewer rates, fewer deductions, and more withholding. There are (currently) no dependent allowances, earned income tax credits, alternative minimum taxes, income-based phaseout of allowances, income-based cap on deductions, child tax credits, or education tax credits. In general, then, the British income tax features more compromises in favor of simplicity and in opposition to measuring income or ability-to-pay exactly. There are also fewer attempts to enact social policy through the tax code. This should not be read as British indifference to such social concerns; many such programs are enacted through the spending side instead.

It seems plausible that at least some of these structural differences are due to differences in withholding patterns and the administrative features of the tax code. In particular, once withholding and nonfiling become important aspects of the tax code, many special tax subsidies or loopholes may become more difficult to design and enforce.

For example, there is a long tradition of withholding at source under the British income tax. In 1799, Pitt imposed a ten percent tax on all incomes above £200. The tax raised £5–7 million annually for three years, which was much less than had been predicted by the revenue estimators of the time. The revenue shortfall was due at least in part to "gentle" administration of the tax law by local commissioners and to widespread evasion. In 1802, the tax was repealed, but in 1803, Addington restored the income tax (apparently under the name of a property tax) and included withholding at source. By 1806, the tax raised about £20 million, even though the tax rate was only half as large as under Pitt's income tax. The income tax was repealed again in 1816, but since the tax was restored in 1842, withholding at source has remained a prominent feature (Sabine, 1980). Exact withholding of wage income was established in the 1940s, when the financing requirements of World War II led to a 150 percent increase in the number of taxpayers over a two-year period. The immediate goal of exact withholding was to reduce the number of mistakes and ease the computational burdens imposed on the large number of inexperienced taxpayers.

In contrast, the United States income tax has always contained a variety of special deductions. Even the original 1913 version of the modern income tax included deductions for mortgage interest, state and local income and property taxes, casualty and theft losses, and life insurance investment income, and excluded interest income from state and local bonds. Deductions for employer-provided health care and charity, as well as special treatment of capital gains, were introduced within ten years. Of the estimated $403 billion in tax expenditures in the 1993 United States tax code, over two-thirds were due to provisions enacted before 1929 (U.S. General Accounting Office, 1994). Although the United States did initiate withholding in the 1940s when the income tax was expanded greatly to finance the war, withholding was never intended to be exact and households were still required to file returns. This not only made it possible to enact social policy through the tax code, but made the tax code a highly visible way to enact such programs.

If nonfiling is expected to generate large administrative and compliance savings, the British experience may be somewhat surprising. The total administrative and compliance costs of a tax system include those faced by individuals, firms, and government. Since so few individual forms are filed in Britain, individuals' compliance costs seem much more likely to be higher in the United States (see, for example, Blumenthal and Slemrod, 1992). But costs imposed on government and firms are likely to be higher in Britain. Kay and King (1990) cite Inland Revenue administrative costs of about two percent of revenue collected. This is between three and four times the comparable figure for the IRS relative to total United States revenues. Comparable estimates of costs borne by firms in the two countries are difficult to obtain.

In any case, complaints about the complexity and administrability of the British tax system cannot be ignored. Kay and King (1990) argue forcefully that the compliance and administrative costs are significant. Recent events suggest that the British are moving toward a self-assessment system more like the United States (Johnston, 1996). The interaction of more self-employment, more contract work, and problems with the exact withholding system has pushed the system in this direction. Up to one-third of British taxpayers are expected to be required to fill out forms in the near future. A new system of self-assessment—where taxpayers report all of their own income, claim deductions, and calculate their own tax bill—apparently has broad support from both political parties, even amid criticisms that the forms appear to be quite complex.

Recently, Senator Dole and Representative Gephardt have independently proposed no-return systems for a substantial portion of United States taxpayers. In 1994, about 40 percent of taxpayers filed the simplified 1040A and 1040EZ forms, and about 78 percent of all returns faced a marginal rate of 0 or 15 percent. This suggests that a substantial portion of the population could be integrated into a no-return system. But current withholding formulas are not designed to be exact for any but the simplest situations, and so would need to be amended.

A tax agency reconciliation (TAR) system is an alternative approach to eliminating tax filing. In a TAR, withholding is typically as close to exact as possible, but the tax agency calculates each

household's tax at the end of the year and sends a bill or refund.[6]

Gale and Holtzblatt (1997) estimate that, with minimal changes in the structure of tax policy, but with significant changes in tax administration, withholding at source could be established for wages, the earned income tax credit, interest, dividends, pensions, individual retirement account distributions, and unemployment insurance benefits. If so, then up to 56 million, or almost half, of all United States taxpayers could be placed on a tax-agency reconciliation system. These are households who have income only from the sources mentioned above and do not claim itemized deductions.

The saving in compliance costs may not prove significant, however. Of the 56 million households, 44 million currently file the relatively simple 1040A and 1040EZ returns and probably spend very little time filling out forms to begin with. For example, Blumenthal and Slemrod (1992) provide survey evidence that 30 percent of households spent zero to five hours complying with the income tax (including keeping records, learning about the tax rules, filling out the tax form and other items) and an additional 15 percent spent less than ten hours. Almost half made no financial expenditure on tax preparation and an additional 17 percent paid less than $50.

Adding large numbers of additional taxpayers to a TAR may prove more difficult, and at the very least would require changes either in the structure of policy and/or in how policies are administered. Even if taxpayers with the forms of income mentioned above and who had itemized deductions and capital gains were brought into the system, which would be difficult, only six million more taxpayers would be covered.

No-return systems raise several additional considerations. Many taxpayers may experience significant psychic or emotional costs when filing any income tax return. Thus, even if the vast majority of affected taxpayers already face relatively simple tax situations in an objective sense, a no-return system could still provide significant benefits to certain households. However, in the United States, unless state income taxes were also shifted to a no-return system, the reduction in filing and psychic costs would likely be minimal. Notably, there are no local income taxes in the United Kingdom.

Second, United States taxpayers clearly like receiving refunds, perhaps as a form of forced saving or for some other reason. A cumulative withholding system would likely eliminate refunds, but could in principle be designed to overwithhold systematically. In a TAR, however, refunds could still be obtained.

Third, under either type of no-return system, citizens would likely want to examine the agency-provided forms carefully and would have to keep records to do so. It is unclear whether taxpayers would be willing to trust the IRS to calculate their taxes for them. This might be compounded by the notion that a no-return system is likely to leave people less aware of the tax system they face and hence of the tax consequence of their actions. Indeed, numerous commentators note what they view as the typical British citizen's ignorance of the tax system (see, for example, Kay and King, 1990). In contrast, a recent proposal by Richard Armey would have done away with withholding and required people to file tax payments every month. The idea behind the proposal was to make people more aware of the tax system in general and the tax burdens they face.

Fourth, a TAR system would place much more stringent requirements on payers to file forms with the IRS and on the IRS to process the forms promptly. Whether each of these tasks could be accomplished in a timely and accurate manner is unclear.

Marriage

An income tax can embody at most two of the following three principles: marginal tax rates should rise with income; families with equal income should pay equal taxes; and the tax system should be neutral with respect to marriage.

The British system, like the American, violates the third principle. But, whereas the American system contains a complicated pattern of marriage taxes and marriage subsidies, the British income tax contains only marriage subsidies. This is accomplished directly via individual filing and the additional allowance that married couples can allocate across their respective returns. An additional benefit to married couples stems from the ability, in an individual filing system, to allocate capital income to the family member with the lowest marginal tax rate. The British system violates the second principle as well. Individual filing with rising tax rates implies that, controlling for total income, married couples with unequal income will in general pay more tax than married couples whose income is distributed equally.

Housing

Since housing is both a consumption and investment good and generates income, it is potentially exposed to a wide variety of taxes. The treatment of housing under the VAT and the property tax is discussed in other sections below.

Under the income tax, imputed rent from housing, net of interest and maintenance costs, was taxed in years prior to 1962. Imputed rental values were determined based on periodic government valuations of property. By 1962, however, the imputed rents were still at prewar levels, and the government decided to abandon the tax on imputed rent rather than update the rental amounts.

The British system has never taxed capital gains on an individual's main residence, but some sort of mortgage interest relief has always been provided. When tax subsidies for most forms of borrowing were eliminated in 1974–5, subsidies for interest on the principal private residence were retained, subject to a loan limit of £25,000. No subsidies were provided for mortgages on second homes. This limit was raised to £30,000 in 1983–4 and has stayed fixed ever since. The limit applies to the sum of loans against each property.[7] Tax relief in earlier years was provided at the taxpayer's marginal income tax rate. More recently, the subsidy has been provided only up to a fixed rate, which was set at 25 percent, then reduced to 20 percent, and, in 1995, was reduced to 15 percent for new loans. The new Labour government has proposed cutting the rate to ten percent.

These policies raise several interest issues. First, mortgage interest relief has been effectively divorced from the tax system. The statutory rate of subsidy and the loan limit are independent of marginal tax rates. Second, because £30,000 is well below the average new mortgage loan, mortgage subsidies provide almost no incentive on the margin for most taxpayers. Third, the decline in the value of mortgage interest subsidies has been gradual but gigantic.

By 1996, the price level in Britain was 5.5 times its 1974 level. Over the same period, the loan amount that could be subsidized rose by 20 percent (to £30,000), so that the real loan limit fell by 78 percent. Over the same period, interest rates have also fallen dramatically, and, as noted above, the rate of subsidy is much lower currently than in the past. These factors have combined to reduce the subsidy to a tiny fraction of its former value.[8]

It is very difficult, however, to find any trace of these changes in aggregate U.K. data. Homeownership rates in the United Kingdom *rose* from 52.7 percent in 1974 to 66.8 percent in 1994. By comparison, U.S. homeownership rates were stagnant at about 64 percent during this period. The ratio of mortgage debt to GDP also rose in the United Kingdom, from 25 percent in 1974 to 56 percent in 1994. This exceeds the increase in the United States, where the ratio rose from 47 percent to 64 percent over the same period. Both mortgage debt as a percentage of the housing stock and the housing stock as a percentage of private fixed capital stock rose more in the United Kingdom than in the United States over this period. These trends, of course, are due to many other factors besides the reduction in the value of the mortgage interest subsidies. For example, privatization of public housing in the 1980s undoubtedly raised homeownership rates in the United Kingdom, and liberalization of financial markets accelerated the rise in mortgage debt (Attanasio and Banks, 1997).

Subsidizing mortgage interest at a fixed, low rate, rather than allowing mortgage interest deductions, could have significant appeal for the United States. Suppose the deduction were converted to a credit at a 15 percent rate, the lowest marginal tax rate. This would significantly reduce the cost of mortgage interest subsidies and reduce the overall level of subsidies to housing, which are quite generous in the United States. It would also be a very progressive tax shift, as it would have minimal impact on the taxpayers in the 15 percent marginal tax brackets and, if it were refundable, would assist those in the zero percent tax bracket. Estimates suggest that reducing the subsidies would be unlikely to hurt homeownership rates significantly, if at all (Green and Reschovsky, 1997; Capozza, Green, and Hendershott, 1996).[9]

A major constraint on such proposals in the United States is the alleged firestorm of protest that would occur were policymakers to touch such a sacred cow. In that light, it is interesting to note that the reduction in mortgage subsidies in Britain has been gradual and has been supported by ruling parties on the right and the left.

Capital Gains

Capital gains taxes were introduced in 1965. Only real capital gains that have accrued since 1982 are taxable now, and the first £6,300 per person is exempt from taxation in each year. Real gains less the exempt amount are added to the individual's income and taxed at ordinary income tax rates.[10]

Both indexing and the exemption level raise several interesting issues. Opponents of indexing in the United States have argued that such a change would not be feasible. The British experience, at first glance at least, refutes that claim, but any refutation should be highly qualified. First, it is notable that indexing cannot be used to convert a

gain into a loss, or to raise the value of a loss, and that interest payments are not tax deductible at the personal level in Britain. Each of these features diminishes the opportunity to use indexing to engage in tax sheltering activities, and none of them is commonly raised when indexing is proposed in the United States. Second, indexing does not achieve the goal of taxing real income. For most taxpayers with capital gains in Britain, the gains are fully exempt from taxation either because of the large exemption level or because assets such as housing, which comprise a large portion of most households' wealth, are exempt from capital gains taxation. Third, it is unclear how well the system of capital gains taxes operates. Data on the evasion rates and compliance and administrative costs associated with indexing are difficult to obtain.

The large exemption is interesting in its own right. Suppose the United States exempted the first $20,000 in capital gains for joint filers and the first $10,000 for all other filers. Calculations from the 1994 IRS public use file indicate that the exemption would reduce the number of taxpayers with taxable capital gains by 89 percent, so that only about one percent of taxpayers paid capital gains taxes, but would reduce taxable capital gains by only 29 percent. Thus, in the absence of changes in realization patterns, such an exemption would greatly reduce the number of taxpayers facing capital gains taxes but would reduce capital gains revenues by a smaller amount. These figures indicate the simplification potential of an exemption.

In practice, however, people would change their behavioral patterns to take advantage of the exemption. Formal evidence suggests that the elasticity of the timing of capital gains realizations with respect to taxes is quite high (Burman and Randolph, 1994), and casual evidence suggests that much activity of this sort occurs in Britain currently. Such behavior would reduce both the number of people who had to pay capital gains taxes and the revenue yield. Indexing gains for inflation would reduce both items further.

The net result of the treatment of capital gains is that very few people pay capital gains tax in Britain, and the tax raises almost no revenue, accounting for only 0.4 percent of all taxes and 1.6 percent of taxes raised by the income tax plus the capital gains tax (see Table 1). In the United States, in contrast, federal capital gains taxes alone account for about 2.5 percent of all tax revenue and 7 percent of federal income taxes (Burman and Ricoy, 1997).[11] Thus, capital gains tax revenues are roughly five to six times larger as a percentage of GDP in the United States than in the United Kingdom.

It is unclear, however, which country treats capital gains more generously at the margin, for taxable investors. Indexing and preferential rates of taxation are alternative methods of reducing the tax rate on nominal gains. In principle, the relative generosity should vary by asset and time period. For example, since 1982, the S&P 500 has risen in the United States by about 660 percent, while the price level has increased by only 66 percent. Hence, a 29 percent exclusion, as has been provided in the United States for high-income taxpayers in recent years,[12] would have been much more valuable on the margin than the British system of indexing combined with taxing real gains at the ordinary income rate. The latter would have provided an effective exclusion of about ten percent for

nominal gains at the margin. Clearly, results for other assets and other time periods will vary.

While the notion that the income tax should tax real income is a sound one in principle, the British experience suggests that indexing of capital gains for inflation should be considered in the broader context that includes the tax rates on capital gains, the tax treatment of interest payments, the exemption level for capital gains, and rules about when indexing may not be used. To a large extent, the British system of taxing capital gains appears to be an abolition of gains taxes for almost all households, plus positive taxation of large gains on the margin, in order to reduce large-scale tax arbitrage. The lack of visibility may be one reason why the taxation of capital gains barely appears on the radar screen of major issues in British tax policy, whereas capital gains taxes are hotly contested in the United States.

Saving Incentives and Pensions

Personal saving rates for the United States and United Kingdom have followed different trends. The U.S. rate fell about four percentage points from the early 1980s through 1987 and has remained low. The British rate fell by over 8 percentage points from 1980 to 1988 and then rebounded in almost as dramatic a fashion, rising 5.6 percentage points in four years before leveling off. These trends, of course, are affected by many factors other than tax policy. For example, financial liberalization appears to have been an important part of the saving decline in the 1980s in both countries, with Britain experiencing a dramatic rise in personal liabilities relative to personal income, even relative to the increase that occurred in the United States. The run-up in equity values, social security reform, budget deficits, and other factors may also have played an important role in saving trends.

Tax policy toward saving offers another potential source of the differential trends. The bulk of personal saving in both countries is directed toward assets with generous tax treatment (Banks and Blundell, 1994). Private pensions and housing receive treatment more favorable than just not taxing the return on saving. Like the United States, Britain has also experimented with a variety of other tax incentives for saving. These schemes—TESSAs, PEPs, and PPPs, described below—provide an effective tax rate of zero on the return to saving.

Tax-Exempt Special Savings Accounts (TESSAs) were introduced in 1990. Any individual aged 18 or over was eligible to open a TESSA in an approved financial institution. Contributions could total £3,000 in the first year, and up to £1,800 in each of the next four years, subject to a total of £9,000 overall. Contributions were not deductible, but interest was entirely free of income tax if the principal was left in the account for five years. Withdrawal of the principal would trigger tax payments, but not penalties, so a TESSA, even under the worst circumstances, had at least as generous a tax treatment as ordinary saving. The net-of-tax interest could be withdrawn as it arose without losing the tax preference.

By 1992, there were 3.5 million TESSA accounts (out of about 22 million households in the United Kingdom). Thus, about 15 percent of households took out TESSAs, roughly equivalent to IRA take-up rates in the United States after two years of universal eligibility.

It should be clear that TESSAs are very close substitutes for taxable interest-

bearing accounts. Notably, about 95 percent of households with TESSAs also held other interest-bearing accounts. These households also tended to hold larger TESSA balances than others. Like IRAs, TESSAs tended to be held by wealthier, older households, who could more easily substitute existing funds into these accounts. Banks, Blundell, and Dilnot (1994) present preliminary evidence consistent with the view that increases in TESSA balances were offset to a very large degree by reductions in other interest-bearing accounts. Given the revenue costs of TESSAs (from the foregone tax on interest), they conclude that TESSAs probably did not raise private saving much, if at all, and may well have reduced national saving.

Personal Equity Plans (PEPs) were introduced in 1986 and expanded in subsequent years.[13] Contributions are not deductible, but investments that are retained for one year, with reinvested dividends, are untaxed. The tax benefits of PEPs, however, were initially almost nonexistent for small investors because of the high exemption on capital gains and because, as explained below, dividends were already effectively not taxed at the individual level, at least for taxpayers in the lowest tax bracket. Expansion of the contribution limits led to bigger take up in subsequent years, but PEP ownership remains highest among older and high-income households. The PEPs are likely to be very good substitutes for equity holdings for such households, and most PEP holders had other direct equity holdings. Banks, Blundell, and Dilnot (1994) find evidence of significant substitution between PEPs and other equity holdings.

Britain has also moved toward replacing its unfunded public pension at the margin with a prefunded private alternative; this may have contributed to an increase in the saving rate as well.[14] Britain has a three-tier pension system. The first tier (the basic benefit) is a state-supported minimum annuity payment that is financed out of progressive national insurance contributions made by workers and employers. Basic benefits are about 15 percent of average male earnings and are indexed to the price level, and so are expected to fall to 7 to 8 percent by 2030. The third tier consists of conventional private pensions and other saving.

The second tier is more complex, consisting of a State Earnings Related Pension Scheme (SERPS) and private alternatives. In 1978, the SERPS was introduced to provide a benefit of one-quarter of average wages in the highest 20 years of earnings, subject to earnings limits. Accrual formulas for SERPS entitlements were cut in 1986 and again in 1995. Combined with SERPS being indexed to retail prices rather than wages, these cuts suggest a large reduction in replacement ratios in the future.

Most workers, however, have exercised their option to contract out of SERPS, with 50 percent of workers now in occupational pensions (employer-provided defined benefit plans) and an additional 28 percent in Private Personal Pensions (PPPs). When the personal pension option was initiated in 1988, workers were allowed to contract out to an IRA or employer-provided defined contribution plan. The government provided that workers who chose this option would have 5.8 percentage points of their national insurance contributions redirected to the private pension. Also, an additional rebate of two percent of covered earnings was offered for those who had not already contracted out. In addition, the rebate

was grossed up to take account of the income tax relief on an individual's pension contributions—yielding a total contribution of 8.46 percent of eligible earnings. Given the generosity of the program and the large accompanying volume of advertising, the option turned out to be very popular.[15]

Workers also have the option of contributing additional amounts to their personal pension. Total contribution limits are a function of salary and age and rise from 17.5 percent of covered earnings for those aged 17 to 35 to 40 percent for those 61 and over.

It is unclear how these tax-incentive plans have affected national saving. Estimates in Disney and Whitehouse (1992) indicate that, for about 80 percent of workers, a government contribution of less than 8.46 percent of salary would have been sufficient to induce them to contract out. This suggests that the option created substantial positive income effects that could have raised consumption and thereby reduced private saving.

About 60 percent of workers with PPPs make no contribution to their PPP above the contracted out rebate, incentive payment, and income tax relief. For this group, current disposable income is the same as if they were still in SERPS, but their wealth is higher. This suggests that, if anything, they would increase their consumption. For the other 40 percent, who do contribute beyond their national insurance payment, some of the *extra* contribution may be new saving.

As an illustrative calculation, suppose that the 40 percent of workers who contributed additional amounts contributed twice as much as the ones who only contributed their national insurance contribution, and that all of such additional contributions were new saving. Then 2/7 of all contributions to PPPs would represent net additions to national saving. This seems to be an upper bound for the proportion of contributions that would be new saving (under the assumption that workers who contributed above their national insurance contribution gave double what other workers contributed). However, the additional contributions were tax deductible and thus reduced public saving, all workers may have saved less in other forms because of the income effects of PPPs, and workers who contributed more than their national insurance contribution may have financed part or all of their additional contributions from existing assets or funds they would have saved anyway. Thus, the net effect is unclear.

The VAT

The presence of a significant VAT is the single largest structural difference between the U.S. and U.K. tax systems. Although the United States imposes sales taxes at the state and local level, these generate only about half as much revenue as the VAT does in Britain.

The standard VAT rate is 17.5 percent, with a rate of 5 percent applied to domestic fuel. The VAT system provides special treatment of various goods and services in different ways. Zero-rated goods do not have net VAT levied on the final good or upon the inputs used in its creation. That is, the seller of a zero-rated good owes no VAT, but may claim credits for the VAT paid on inputs. Exempt goods do not have VAT levied on the final good sold to the consumer, but firms cannot reclaim the VAT paid on inputs, so they face effective VAT rates between zero and the standard rate, depending on the fraction of value

added at the retail level. About 25 percent of consumer expenditure in the United Kingdom is on zero-rated goods. These items include most food, new dwellings, passenger transport, books, newspapers and magazines, prescription medicine, and children's clothing. About 15 percent of consumer expenditure is exempt. This category includes rents, private education, health services, postal services, finance and insurance, and burial and cremation. Broadening the base of the VAT has proven very difficult in recent years.

Perhaps the most notable feature of the VAT, and certainly the least examined in the United States, is the extent to which the provisions of the VAT are dictated by international convention. European countries have jointly set certain parameters of the VAT in a series of "directives" over the last several decades. Prior to 1992, VAT rates were unrestricted by the directives. Currently, the standard VAT rate is not less than 15 percent, but reduced rates could apply to certain targeted goods, as noted above.

The elimination of border controls in 1993—part of a larger European agenda that includes removing domestic preferences in public purchases, exchange controls, and restrictions on intercountry mergers—causes additional problems for the VAT and creates the possibility of fraudulent claims since the VAT on exports is rebated.[16]

It is unclear how important the limited autonomy over VAT really is. To some extent, conservative governments in the 1980s may have used the European dictates as externally imposed reasons to do what they wanted to do anyway—raise the importance of the VAT and reduce the income tax. It is also unclear how important such problems might be for the United States were it to adopt a VAT. Presumably, one of the benefits of doing so would be the ability to coordinate if possible with other countries, but a destination-based VAT would not be difficult to enforce internationally as long as the United States did not maintain completely open borders.

The textbook view of the VAT is that it is simple, cheap to administer, and self-enforcing. These attributes apply to the British VAT only with important qualifications, if at all. As noted above, the VAT base exempts or zero-rates a significant amount of consumption. Note also that most health care is provided publicly in Britain and is not subject to VAT. In applying the VAT in the United States, there may be pressure to exempt or zero-rate health care. The VAT base, however, is narrower in Britain than in many other European countries, which raises hope that an American VAT could be relatively broad based.

The United Kingdom employs a credit-invoice VAT—firms calculate their sales, calculate the VAT due on the sales, and then take a tax credit for VAT that has been paid by others on the items the firm purchased.[17] In principle, an enforcement advantage of a credit-invoice VAT is the ability to match invoices from sellers and receipts of buyers. The basic idea is that, since the buyer of a good is going to report the transaction to the tax authorities in order to claim a VAT refund, the seller, knowing that the buyer will report, chooses also to report, so as not to be caught evading the tax. The paper trail also assists authorities in audits.

In practice, the British VAT authorities do not match invoices as an enforcement mechanism, due in part to the belief that doing so would generate only tiny

gains in revenue and compliance. The authorities instead use other methods to estimate revenue, such as total sales, input purchases, etc. This is obviously an indirect approach that relies on incomplete information and, if enforced aggressively, could lead to an intrusive and frequently incorrect tax authority insisting on inappropriate levels of tax payments.

One of the inevitable problems with taxing different goods at different rates is that there are no hard and fast definitions for particular good categories. One famous case involved Jaffa "cakes." The VAT authorities claimed that the product was a biscuit, while the Jaffa company claimed it was a cake, which would face a lower VAT rate.[18] Similar problems arise in the taxation of many other goods. Another problem is the taxation of services, where the absence of a physical inventory makes auditing and enforcement more difficult.

The VAT can also be complex in other ways. For example, many small businesses are exempt from the VAT. Thus, the number of firms in the VAT system exceeds the number of firms paying VAT, because the former want to receive rebates on their purchases. In addition, businesses in the VAT system need to keep track not only of the value of their purchases, but the composition as well.

Compliance and administrative costs average about five percent of VAT revenues. This is about half as high as estimates for the U.S. income tax (Slemrod, 1996) but about the same as the income tax, capital gains tax, and national insurance scheme in the United Kingdom (Sandford, Godwin, and Hardwick, 1989). Compliance costs are heavily weighted toward small firms that pay VAT, and are a very high proportion of VAT payments for such firms. One reason compliance costs are high is that the VAT is not integrated with business income taxes for auditing and control purposes.

Evasion rates also appear to be fairly low, around five percent, and evasion appears to be concentrated in a few sectors, notably small businesses that are just large enough to have to pay VAT but do not. One likely reason for higher evasion in this sector is the higher compliance costs. Another is that declaration of sales not only creates VAT liabilities, but also often creates income tax and national insurance contribution liabilities for the business owner. Thus, the effective return to evasion may be much higher for small businesses than that indicated by the VAT rate alone.

Although almost no one advocates that the United States completely scrap the income tax and replace it with a VAT, many experts note the viability of reducing the size and scope of the income tax and replacing the lost revenue with a VAT (Slemrod and Bakija, 1996; Graetz, 1997). The British experience with the VAT, however, is probably not as satisfactory as one would hope for before signing on to a similar plan. In particular, a VAT that did not zero-rate or exempt so many goods, that was integrated with other business taxes in administration, and that handled exports more effectively would represent a better model for the United States to build on.

Corporate Income Tax

The corporate income tax is levied against the profits of United Kingdom resident companies, public corporations, and unincorporated associations. Deductions are allowed for interest payments, a limited amount of research

and development expenditures, wages, and pension contributions. Depreciation deductions vary by assets. For equipment and machinery, 25 percent of the unused basis may be deducted in each year. Hotels and industrial buildings may be deducted at a four percent straight-line rate. Unused depreciation deductions and losses may be carried back for three years and carried forward indefinitely.

In 1996–7 taxable income faced a marginal tax rate of 24 percent on the first £300,000 of profit and 35.25 percent on profits between £300,000 and £1.5 million. Both the average and the marginal tax rate are 33 percent on profits above £1.5 million.

The British corporate tax is partially integrated with the individual income tax. When a company pays a dividend, it pays an additional 25 percent of the amount in "advance corporate tax" (ACT). For tax purposes, shareholders are deemed to have received both the dividend and the tax payment and to have remitted payments in the amount of the ACT to Inland Revenue. The tax payment is also credited against the corporation's income tax. The net effect is that, for dividends paid to certain taxpayers, there is no change in net tax revenues.

For example, consider a firm that pays £100 in dividends. Under current law, it is required to send a check to Inland Revenue for an additional £25, as the ACT. (This is considered a 20 percent ACT rate, because £25 is 20 percent of the "grossed-up dividend" of £100 + £25.) The firm credits this payment against its corporate income tax, so that the dividend does not change the firm's total tax payments. (The ACT can be carried back six years and forward indefinitely.)

The shareholder receives dividends of £100, and is deemed to have received £125 in income and to have paid £25 in taxes. Thus, if the investor is in the 20 percent tax bracket, there are no further tax consequences. The deemed £25 in tax payments exactly offsets the deemed £125 in income, so that the dividend does not change tax payments for the shareholder. However, a shareholder in the 24 percent bracket would owe an additional £5, and a shareholder in the 40 percent bracket would owe an additional £25.[19]

The ACT credit is a major feature of corporate taxation. In 1995–6, the corporate tax raised £24.7 billion. By way of comparison, the ACT totaled £9.9 billion, 40 percent of corporate tax revenue and 3.6 percent of all tax revenue.

Historically, pension funds, which are tax exempt, could receive refundable ACT credits on their dividend receipts. Because dividends paid to taxpayers in the 20 percent tax bracket have no net revenue consequences, credits given to pension funds *reduce* overall tax revenue. That is, if the dividend had not been paid, tax revenue would have been higher. Thus, the payment to pensions represents not just a tax exemption, but a partial refund of corporate taxes.

The extent of integration has declined in recent years. The Conservative government cut the ACT rate from 25 percent to its current 20 percent in 1993. The new Labour government proposed in July 1997 to eliminate ACT refunds for pension funds immediately and for other zero-rate taxpayers in 1999. Another Labour proposal would reduce the rate of tax credit to ten percent starting in 1999. At the same time, Labour has proposed reducing the top corporate tax rate to 31 percent from 33 percent.

The stated intent of these changes is to encourage investment by reducing the tax rate on corporate profits and encouraging retained earnings. But while raising the tax on dividends might encourage firms to reinvest earnings, it would also raise the overall taxation on corporate earnings. It is thus not obvious that the proposed policy would encourage investment in the long run.

Caution is required in translating these patterns into lessons for the United States. Partial corporate integration is feasible and does not appear to have created a political firestorm, but it could be quite expensive. The effects of partial integration on corporate investment and dividend policy in Britain are of particular interest, but are difficult issues. Since 1985, both investment and the ratio of dividend payments to GDP have soared in Britain relative to the United States. It is not obvious that such trends are largely attributable to tax policy, though.

The Poll Tax[20]

The British experience with the community charge, or poll tax, is a fascinating chapter in recent tax history. Before the poll tax, local government in Britain was financed by a combination of grants from central government and local business and residential property taxes. The latter are referred to as "the rates," because the tax liability was determined by multiplying the notional rental value by a tax rate set annually by the local authorities. The central government grants were often called block grants, but had important matching elements.

This system of local finance was criticized on several grounds, some seemingly more reasonable than others. Rental values were not always adjusted appropriately. Because of the matching elements of central government grants, local governments and their residents did not bear the full marginal costs of decisions to raise local spending. Property taxes varied substantially across localities, which, according to Smith (1991), gave rise to apparent inequities across regions. Finally, because only the head of household was legally liable for property tax, there appears to have been a (mistaken) notion that very few people had to bear the burden of local property taxes, making the general public less accountable for the costs of local decisions and placing unfair burdens on those who paid property tax.

The Thatcher government wanted, in general, to introduce more local accountability for local spending and, in particular, to reduce the level and improve the efficiency of local spending. This was to be accomplished, across localities, by requiring each locality as a whole to internalize the entire cost of its marginal increases in expenditures and, within localities, by requiring the increased costs to be spread over all voters.

Toward this end, a new system of local finance was implemented in Scotland in 1989 and in England and Wales in 1990. The business property tax was altered; business property was revalued, and rates were to be set by the national, rather than local, government. The residential property tax was abolished and replaced with a community charge, an equal tax on each adult in a locality. There were a limited number of exemptions, and rebates of up to 80 percent for the poorest individuals. The central government grant was set so that, if a locality spent funds at its assessed needs level, the local community charge would equal a national standard level. Each dollar by which local spending exceeded its assessed needs had to be financed

from the poll tax. The poll tax was intended to represent about one-quarter of local government revenues. Thus, raising local spending above assessed needs level by, say, 15 percent would require a 60 percent increase in the local community charge.[21]

Both the conceptual basis and the implementation of the poll tax were severely lacking. On the implementation side, central government gave little thought to enforceability, transition, or intergovernmental issues. Unlike property, residents are mobile. Annual population turnover rates were as high as 36 percent in some rural areas and up to 55 percent in inner London. This made it quite difficult to ensure that people registered for the tax. Local governments recognized the compliance problems immediately and opposed the legislation on those grounds.

Smith (1991) notes that, in response to their opposition to the tax, local governments may have set the tax higher than it needed to be. That is, they may have used the change in regimes as a way to increase their own spending, gambling that the concomitant increase in taxes would be blamed on the central government and would increase the unpopularity of the tax. Recall that even small increases in local spending would generate large percentage increases in the required poll tax. The average poll tax ended up being 30 percent higher than predicted and more than double what was proposed in 1987.

The tax change redistributed resources across regions and across families within regions. The major regional winners were areas with high property values in southeast England, an area with strong conservative support. Within regions, multiadult households lost relative to single-adult households. In response to the losses created by redistribution, the national government set up a safety net of compensating payments from "winning" regions to "losing" regions, to be phased out over several years. This system proved inadequate in several dimensions. It raised costs and reduced support for the poll tax in the winning regions, it did nothing to address within-region redistribution across families, and it only redistributed local burdens—it did not reduce the overall local burden, on average.

On the conceptual side, the tax change replaced a set of taxes based loosely on ability-to-pay with one based loosely on the benefit principle. Smith (1991), however, argues that a poll tax is an inappropriate application even of the benefit principle. While it is certainly true that not all taxes need to be progressive to make the overall tax system progressive, it seems clear that voters rejected the idea that, for example, Buckingham palace staff should have to remit more in community charges than the royals themselves.

Moreover, while the poll tax clearly raised the local marginal costs of increasing expenditures, Smith (1991) argues further that it may have done little to improve accountability, since voting mechanisms, in general, are not efficient and local choices, in particular, are often constrained by national parties. Thus, localities received the burden of higher marginal costs without much in the way of increased autonomy.

For all of these reasons, the poll tax came to be regarded as extraordinarily unfair and ultimately unmanageable. Nonpayment campaigns developed, and estimated nonpayment rates reached 50 percent in some areas. A member of

parliament was arrested for not paying the tax. More than 20 percent of taxpayers required a summons before paying the poll tax, 7 times higher than the proportion requiring a summons under the old property tax. Noncompliance was not due primarily to unfamiliarity with the tax, since noncompliance rates rose over time (Besley, Preston, and Ridge, 1997). The administrative costs of local taxes tripled in the first year of the poll tax. Disapproval rates reached 90 percent.

In the second year, the central government provided some overall transition relief in the form of reducing the burden of the poll tax, but the die had been cast. The poll tax was abandoned shortly thereafter, by the Conservative party that proposed it in the first place, on grounds that it was uncollectible.

The new council tax, initiated in 1993, is a function of property value and the number of adults in the households and raised about 20 percent of local revenue in 1995–6. Properties are placed in certain classes based on their value in April, 1991. The rate structure applied to the classes is determined by the national government,[22] but the rate levels are determined by local government. This system allows the national government to control the progressivity of the tax burden, but lets the local government determine the overall level of the tax burden (and spending).

There is obviously much to learn from these events. Smith (1991) lists some appropriate conclusions: the importance of adminstrability and equity in determining whether a tax can remain in place, and the need for transition relief if significant tax restructurings are to be politically palatable. Besley, Preston, and Ridge, (1997) note emerging compliance problems in the council tax, and suggest that this may be an effect of the poll tax. Hence, the longer-run effects on compliance may also be important. They also note that compliance can present problems even in countries with a well-developed tax and monitoring system.

One odd aspect of the entire episode, from an American perspective, is the extent to which central government can dictate local tax policy. This raises obvious issues of autonomy as well as principal/agent problems. The central government wanted to change the behavior of local governments in a way that the locals resisted. To accomplish this goal, the central government needed and expected the cooperation of local governments. There is some evidence to suggest that such cooperation did not occur. The agency problems that arise when one government is expected to enforce another government's taxes is a little explored area of public finance. The issue relates directly, however, to proposals that would establish a national retail sales tax in the United States that would be collected by the states.

A final set of observations falls under the general category "an old tax is a good tax." The property tax clearly suffered from technical complexities in determining rental values and political difficulties in adjusting values. But Besley, Preston, and Ridge, (1997) describe the property tax as a 600-year-old system that faced little noncompliance and was based, at least loosely, on ability-to-pay. Smith (1991) notes that the property tax was easy to administer. This is not to say that all taxes should stay the way they are, just that major changes in taxes should take careful account of the costs and benefits of the existing and new systems, as well as the transition costs of establishing

the new system. Moreover, the fairness, or perceived fairness, of new taxes that are quite different from the ones they replace appears to be an important constraint on policy options. In short, the poll tax episode is, among other things, a case in point about the dangers of overselling the theoretical and empirical advantages of tax reform and about ignoring fairness, transition, and administrative considerations in developing new tax proposals.

Conclusions

The British and American tax systems have much in common, several important differences and experiences, and much to learn from each other.

One major theme is that the structure and administration of the British income tax are much simpler than those of its American counterpart. It seems quite plausible that differences in administrative arrangements led to important differences in the structure of income taxes in the two countries. This could have happened directly, in that some tax subsidies are simply too difficult to handle in a no-return system. Or it could have happened indirectly, in the sense that, when people do not file tax returns very often, they do not immediately look to the tax code as the natural way to subsidize various activities.

In any case, the British example shows that the United States income tax could be much simpler if Americans were willing to reduce the extent to which the income tax attempted to tax all income or tried to administer social policy through the tax code. A larger issue, unexamined here, is whether the resulting tax/transfer system would end up being more efficient and equitable.

A second major difference is the importance of consumption taxes in the United Kingdom relative to the United States. The experience of Britain and other countries shows that a VAT could be established in the United States to replace a substantial component of income tax revenues, but that VATs are neither as simple, nor as much of an elixir for growth, as is sometimes claimed. Also, the willingness of the population to accept the VAT, in the United Kingdom and in other countries, may be conditioned heavily on social spending programs that are more generous than those found in the United States.

It would be of great interest to pursue the behavioral effects of these differences in tax policy: that is, do taxes matter? Detailed investigations along these lines are beyond the scope of the paper, but it is interesting to note that, despite the virtual elimination of mortgage interest subsidies and of capital gains taxes, Britain is neither suffering from a collapse in housing nor benefiting from an extraordinary boom in investment and entrepreneurship. As these are two of the most controversial sets of issues in America, further investigation is clearly warranted.

It would be interesting also to pursue further the role of differing political systems and institutions on the conduct of tax policy (see also Keen, 1997). In the British parliamentary system, the party in control often has much more power than the majority party in Congress. Thus, one might imagine that parties with such extensive authority could push through tax breaks for whatever favored constituency they chose. Yet the British system seems, at least at a distance, to be remarkably devoid of such loopholes, at least relative to the American system. Why

that is the case would be an interesting further "lesson" for America. One possibility is the differing role of campaign contributions in the two countries (Keen, 1997; Graetz, 1997).

Recent changes in the income tax and the corporate tax suggest that Britain may be moving in the direction of the American tax system in certain ways. It is difficult to know what to make of this development. It seems unlikely to be due to any inherent superiority of the American approach to taxation. Rather, the change may be best interpreted as part of the cyclical variation one would naturally expect as taxpayers and political leaders continue to make trade-offs among policies that support the conflicting goals of equity, efficiency, simplicity, and revenue requirements.

ENDNOTES

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[1] Unless otherwise noted, factual information on the British tax system was taken from Dilnot and Stears (1997), Kay and King (1990), King and Robson (1993), Inland Revenue (1996), and HMSO (1996).

[2] Several conceptual problems arise. The value of a tax expenditure depends in part on which taxes are considered part of the "normal" tax structure and what is considered a normal design for each of those taxes, as well as the level of tax rates. The level of tax expenditures will depend on a country's willingness to provide resources via spending programs versus tax preferences.

[3] The United States data in Table 2 apply only to federal taxes, but similar qualitative findings occur when state and local taxes are included as well (Gale, Houser, and Scholz, 1996).

[4] For readers interested in converting the figures to dollars, the British pound was worth about $1.63 as of the writing of this paper. In the past ten years, the value has fluctuated between $1.50 and $1.80.

[5] Taxes on self-employment income are outside the PAYE system, because there were too many disagreements between tax authorities and taxpayers to make the system work well. Kay and King (1990) describe the taxation of self-employment income as follows: "It is impossible to provide a brief and intelligible—or indeed lengthy and intelligible—description of the rules."

[6] Under either a TAR or an exact withholding system, households need to file information to allow withholding to occur. Worldwide, about 30 countries practice some form of TAR, while only the United Kingdom and the Russian Federation use exact withholding systems.

[7] Applying the limit to each property, rather than to all properties owned by a taxpayer, prevents two single people living together from each receiving tax benefits on separate loans of up to £30,000, which would represent an implicit marriage tax.

[8] For example, if the interest rate fell by one-third, the tax rate against which the deduction occurs fell by half, and the real loan limit fell by four-fifths, the current subsidy would be worth less than ten percent of the subsidy in 1974.

[9] The debate largely centers around the effects on the price of housing. See Capozza, Green, and Hendershott (1996) and Holtz-Eakin (1996) for divergent views.

[10] Capital gains tax relief is also available for entrepreneurs who sell their assets upon retirement. As in the United States, the death of the owner does not trigger capital gains tax payments under the income tax.

[11] These estimates are based on "stacking" capital gains income last. That is, the estimates calculate income and taxes due without capital gains, and then add capital gains to income and calculate the increase in taxes.

[12] As of 1996, taxpayers in the highest tax bracket faced rates of 39.6 percent on ordinary income and 28 percent on capital gains. This is equivalent to a 29 percent exclusion of capital gains income for those taxpayers.

[13] Originally, PEP funds had to be invested in equity in United Kingdom firms, but that requirement has been dropped.

[14] See Disney and Johnson (1997), Disney and Whitehouse (1992), and Banks, Blundell, and Dilnot (1994).

[15] The rebate has been cut back and is now structured more generously toward older workers than toward younger workers.

[16] The current set of proposals would change the parameters of the VAT to conform with the

absence of border controls. The specific components include abolition of zero-rating exports in exchange for extending the VAT "chain" to include cross-border transactions; uniform VAT rates and bases across countries; allocation of VAT revenues across European countries in relation to aggregate consumption rather than to derivation of revenues; establishing a single "location" for each business; and cross-country cooperation and supervision of VAT administration. These provisions raise a host of concerns about tax administration, equity, and incentives. See Smith (1997).

[17] Under the alternative approach—a subtraction-method VAT—firms add up their sales, subtract their purchases, and pay VAT on the difference. Both methods give the same tax payments when all goods and services are included in the VAT and are taxed at the same rate. The credit-invoice method facilitates special treatment of different goods and services.

[18] The company won the case, but a little real-time empirical research revealed that the Jaffa cake looks, feels, and tastes like what the British call a biscuit and, in a sample of one shop, is even sold on the biscuit shelf.

[19] The shareholder in the 24 percent bracket would owe total taxes of £30 (=0.24 × 125), but would have been deemed to have paid £25 already. The shareholder in the 40 percent bracket would owe total taxes of £50 (=0.40 × 125), but would have been deemed to have paid £25 already.

[20] Smith (1991) and Besley, Preston, and Ridge (1997) provide detailed and informative studies of the poll tax.

[21] For example, if the poll tax raised £25 out of £100, raising spending to £115 would require raising poll tax revenues to £40, a 60 percent increase.

[22] For example, property in one value class is assigned a rate of one, and policies in other classes are assigned rates ranging from 2/3 to 2.

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