I. Introduction

Thirty years ago, the Institute for Fiscal Studies (IFS) published a seminal review of the UK tax system, the fruits of a commission chaired by the Nobel Laureate Professor James Meade. Explaining the motivation for the review, Dick Taverne, then Director of IFS, lamented:

For too long, … tax reforms have been approached ad hoc, without regard to their effects on the evolution of the tax structure as a whole. As a result many parts of our system seem to lack a rational base. Conflicting objectives are pursued at random; and even particular objectives are pursued in contradictory ways.

Unfortunately, this critique of UK tax policy still holds true today. In some important respects, the tax system has evolved in the way that the Meade Report\(^1\) recommended, but it remains the product of often incoherent piecemeal changes rather than strategic design. The tax system has also struggled to adapt to profound changes in the economic, social and institutional environment in which it operates. And tax design has not benefited as much as it could from advances in theoretical and empirical understanding of the way features of the system influence people’s behaviour.

For all of these reasons, IFS felt that the time was ripe once again to ask an expert commission to take a hard look at the tax system: to try to identify the characteristics that would make for a good tax system in an open economy in the 21st century; and to suggest how the UK tax system in
particular might be reformed to move closer to that ideal. Professor Sir James Mirrlees was subsequently invited to chair the review.\(^2\)

In the objectives they set, the members of the Mirrlees Review were, if anything, even more ambitious than their esteemed predecessors on the Meade Report. Whilst Meade focused largely on direct taxes, the Mirrlees Review set out to look across the whole tax system. Indeed, the insight that the tax system needs to be seen as a whole underlies the entire approach. And whilst the Mirrlees Review retained a clear focus on the UK, it also tried to ensure that its conclusions were relevant internationally. The review took more than just a UK-centred approach.

The main outputs of the review are to be found in two volumes published by Oxford University Press for the Institute for Fiscal Studies. The first, *Dimensions of Tax Design\(^3\)*, was published in 2010. It contains reviews by leading experts of many of the key themes in the economics of tax design, alongside commentaries on each paper. The papers in *Dimensions* provide comprehensive and state-of-the-art surveys of the economic thinking in the main areas of tax design.

The second report, *Tax by Design\(^4\)*, was published in 2011. It aims to set out an overarching vision for the tax system and to suggest desirable reforms. It is, of course, an avowedly economic analysis. Its aim was to ask what the latest economic theory and empirical analysis could tell us about the appropriate design of a tax system in a modern economy and then to apply those insights to suggest reform directions for the UK. To put it as Roger Gordon does in his paper in this issue:

> The Mirrlees Review represents an unprecedented attempt to combine state-of-the-art empirical work with state-of-the-art theory about optimal taxation to produce balanced and well-grounded proposals for tax reform in the UK. The final proposals were the culmination of five years of research and debate ...

In this Special Issue of *Fiscal Studies*, we have republished the final concluding chapter of the review, which appears here as the next paper, and published responses by five leading experts in the field. This introductory article starts by describing very briefly what the following papers cover, and then goes on to explore three broad themes that are important to the review and which are picked up on in one or more of the subsequent articles.

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\(^2\)The members of the review team were James Mirrlees (chair), Stuart Adam, Timothy Besley, Richard Blundell, Stephen Bond, Robert Chote, Malcolm Gammie, Paul Johnson, Gareth Myles and James Poterba.

\(^3\)Mirrlees et al., 2010.

\(^4\)Mirrlees et al., 2011.
II. The papers in this issue

Some of the themes in the various papers in this Special Issue are brought out more fully in the next section. Here we simply set out to introduce those papers and provide an overview of the issues they cover.

The next paper provides an overview of the recommendations and directions for reform set out in the review and is designed to be readable in isolation from the rest of Tax by Design. It begins by setting out an abstract perspective on what the features of ‘a good tax system’ should look like and then compares those features against what we see in the UK system. It goes on to lay out the main recommendations of the Mirrlees Review as they apply to taxes on earnings, indirect taxes, environmental taxes, taxes on savings and wealth, and business taxes. Inevitably, the paper can only give a flavour of the detail that is in the main review, but it is designed to give the reader a clear sense of what the review concluded and why.

The paper by John Creedy provides an overview of the differences between the Mirrlees Review and the Meade Report as well as some other recent reviews of tax in Australia and New Zealand. Creedy has some particularly apt observations on the role of value judgements in the Mirrlees Review and in the economics of tax policy more generally, as well as with respect to the relationship between economic theory and the practice of tax policy.

In his paper, Chris Evans draws some fascinating comparisons between the Mirrlees Review and the recent Henry Review in Australia and the New Zealand Tax Working Group.5 The three reviews have come up with significantly different conclusions and recommendations, in part because of their different constitutions and relationships with government. We return to this theme in Section III.

Roger Gordon then sets out to comment on a range of the conclusions and analysis in the Mirrlees Review. He starts off by looking at why the review concluded that a zero rate of tax on the normal return to savings is appropriate, but goes on to suggest that a traditional expenditure tax might have been a better way of achieving that than the rate-of-return allowance which the review suggests could be used. In his discussion of both reforms to safety-net programmes and reforms to the VAT base, he introduces some important complicating considerations which, he suggests, might lead one away from the relatively simple and uniform systems that the Mirrlees Review proposes. These are important considerations, and one of the most difficult balances to be struck in tax design is between the type of broad and simple rules the review tried to follow and the theory and evidence which

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might suggest a case for more complexity. In its discussions of most issues, the review generally weighed the case for uniformity and simplicity rather heavily. On the issue of business taxation, Gordon accuses the review of being too conservative in its recommendations (not an accusation that has been levelled from many quarters!) on the grounds that there is a case to be made against corporation tax continuing at all, especially if other aspects of personal and capital taxation are reformed as the review proposes. He suggests that increasing globalisation gives added weight to this argument.

Louis Kaplow, in his contribution, focuses on the systemic approach taken by the review – an approach that sees the various taxes and benefits as part of a single system and focuses on ensuring the system as a whole delivers the desired outcomes. This is something we look at in a little more detail in Section III.

Finally, Christian Keuschnigg focuses on the design of capital income taxation – an issue at the very heart of the Mirrlees Review. He is broadly sympathetic to the quite radical changes to capital and corporate taxes that the review suggests, seeing them as likely to promote growth. He does, though, raise what the review recognised throughout as one of the key barriers to reform – the fact that the costs of transition to a new system are immediate and rather obvious, while the benefits are delayed and opaque. His call for more quantification of the benefits, and his description of the difficulties inherent in such quantification, we entirely understand. The case for more work here is compelling. It has been a constant refrain of policymakers that, without clear quantification of benefits, the chances of radical reform are much reduced.

III. Issues and lessons in the review

Rather than provide a more detailed summary of each of the papers coming up, we have decided to devote the greater part of this paper to looking a little more at three of the biggest issues with which we wrestled in writing the Mirrlees Review, and which are raised very helpfully and effectively by the contributors to this Special Issue.

The first relates to the role of a review such as this, how its constitution affects its conclusions and how economic prescription fits, or not, with political constraints. The second is related and is the issue of how to think about reform systemically, not just in the pursuit of efficiency but also in relation to equity. The third is about the context – both economic and social – within which tax systems operate and the extent to which this does, and should, lead to differences in structures across countries and across time. We focus here on the issue of globalisation since that specifically is raised by contributors.
1. Economic prescription, political constraints and the role of reviews

In the real world (i.e. not the one inhabited by tax theorists), proposals for tax reform are constrained by politics – not least the unfortunate observation that those who lose from tax reforms tend to be vengeful while those who gain from them tend to be ungrateful. This can lead in tax policy, perhaps more than in other areas of public policy, to a ‘tyranny of the status quo’. The review was not written with any expectation that all its recommendations could confidently expect immediate and enthusiastic support across the political spectrum. That would have left us with a very short report indeed. Whilst it tries to take explicit account of the political economy of tax reform in setting out a possible path to a better system, there will always be a tension to some extent between what is economically desirable and what is politically practical.

An important element of the review, brought out by both John Creedy and Chris Evans in their papers in this issue, was its nature as a review not just carried out by economists, but carried out entirely independently of government. Whilst that does not give its authors carte blanche to ignore political sensitivities, it did allow us to draw conclusions from the analysis that would surely have been impossible if those conclusions were seen to be in any way politically or officially sanctioned. In any case, as Creedy points out, it can be a mug’s game for economists to be second-guessing what will and will not be politically feasible. Following the publication of the Meade Report, an unsympathetic reviewer suggested that its favouring of flat-rate benefits was ‘totally unrealistic. Short-term earnings related benefits are now a well-established fact of life in this country’ (Prest, 1979, p. 251). They were very soon to be unwound.

Both Creedy and Evans contrast this independent approach with recent reviews in New Zealand and Australia, which were much more closely associated with the government of the day. Even so, those reviews have themselves met with very different fates. The Henry Review in Australia, despite being chaired by the Secretary to the Treasury, and despite setting out numerous very specific recommendations, has as yet had relatively little impact on policy. In part, this is a reflection of some rather specific political circumstances and perhaps the perceived association between the review and the government and prime minister of the day. By contrast, it seems that the New Zealand Tax Working Group Review has had many of its recommendations implemented. Evans suggests that this might be ‘because its recommendations were not as deeply embedded in economic theory, and were far more limited, immediate and practical in focus’.

Creedy also points out other specific features of the Mirrlees Review – in particular, its reliance on economics and its style of exposition. It focuses explicitly on the economics of taxation and, bar one tax QC, the review team
was entirely made up of economists. That does mean there is a focus on principles, perhaps with some neglect of practical issues of implementation. That was an entirely deliberate decision reflecting our desire to set out directions for reform rather than get into the immediate minutiae of incremental change. Our second deliberate decision was over the style of exposition, which is intended to be widely accessible without the use of either equations or analytical diagrams. As Creedy points out, that is not always as easy a trick to pull off as one might suppose.

Obviously, we wait to see what the long-term impact of the Mirrlees Review will be on policy in the UK. What we have already observed is considerable appetite among policymakers and indeed politicians to understand the analysis and conclusions at the least as a route to helping their own analysis and understanding of policy.

One thing that policymakers did urge us to do was to be clear about the scale of the potential benefits from reform. Whilst recognising that precision in measuring the welfare benefits from substantial change is difficult, we tried where possible to estimate these benefits. And our best estimates are that some reforms can offer very large benefits. The tax system in the UK, and in most other countries, is so far from being efficient, well designed and rational that the scope for welfare gains is large. The case for tackling some of the political constraints on reform is therefore strong.

2. Considering the system as a whole and the issue of equity

It became increasingly clear to us during the course of the review how important it is to think about the tax system as a whole when making policy. This matters so that efficiency is maintained – the way in which personal taxes and corporate taxes join up, for example, matters enormously for efficiency such that one really shouldn’t be considering the structure of either one in isolation. It also matters enormously for how one thinks about equity. Too much debate focuses on the ‘fairness’ of individual taxes. What matters is the effect of the system as a whole, and an efficient and equitable system will contain some individual taxes that are themselves regressive.

To some degree, this is the focus of Louis Kaplow’s paper in this issue. As he puts it:

Perhaps the signal feature of *Tax by Design* is that it takes a systemic view of optimal tax reform ... [analysis and concrete proposals] are guided by the understanding that each piece is part of a larger whole and that the role of a given component depends on the operation of the others.

The appropriate fitting-together of different parts of the system is crucial. As Christian Keuschnigg recognises in his paper, our proposals are specifically designed to ensure that, however income is received – as wages, as self-
employment income, as profits, dividends or capital gains – it is treated the same and subject to the same rate of tax, thus minimising all sorts of opportunities for avoidance which are inherent in the current system. Some of our more radical proposals are designed to achieve this outcome. In particular, the ‘rate-of-return allowance’ for the taxation of savings is designed to exempt from tax ‘normal returns’ but to tax any additional returns at the full rate of tax on labour income. That full rate includes National Insurance contributions.

This systemic approach has some quite profound implications, obviously with regard to the content of policy, but also with regard to the process of policymaking. Without some overarching strategy and sense of direction, without a capacity to make policy for the system as a whole and without a way of being able to communicate the impact of the whole system, policymaking will be badly compromised.

One can point to all sorts of policy mistakes over recent decades which, at root, appear to reflect this lack of understanding of the system. Some of the most egregious include the introduction of a 0 per cent rate of tax for small companies, the introduction of low and complex rates of capital gains tax, and the introduction of a 10 per cent starting rate of income tax. All these policies were costly and ineffective in their own terms, ended being reversed at some political cost, and seemed to reflect a failure to grasp really quite basic ideas about how the tax system fits together.

Crucially, taking a systemic approach also means considering the distributional effects of the whole tax (and benefit) system. As Kaplow puts it:

It tends to be optimal to employ each instrument to address that objective to which it is best suited, leaving other objectives to other instruments. Regarding the tax and transfer system, this principle tends to imply that the focus of revenue-raising and distributive efforts should be on the income tax and transfer system …

That captures precisely the spirit of the review. Kaplow goes on to illustrate these points in the context of VAT reform, environmental taxes, wealth transfers and income support, in each case adding some useful precision and caveats to the analysis in the review, but accepting the approach and broad recommendations. The distributional point is particularly telling in the case of VAT, where there is clear scope for achieving greater efficiency and similar distributional outcomes by having a uniform VAT system with the direct tax and benefit system achieving the desired redistribution.

Kaplow additionally highlights one of the central analytical approaches of the review, which was to analyse reforms that are, overall, distributionally neutral. This choice was made, not from any belief that the current degree of redistribution is necessarily optimal, but rather to aid exposition and to be clear about where efficiency gains are possible. The review deliberately tried
to avoid making value judgements regarding the appropriate degree of redistribution to be done by the tax (and benefit) system. Our aim was to provide a framework that would allow policymakers to see how to achieve a particular degree of redistribution in the most efficient way.

One issue touched upon by Kaplow, but not focused upon by any of the contributors to this Special Issue, is how to operationalise the concept of equity, or progressivity, when it comes to analysing tax policy and tax changes. This is something to which we gave considerable thought and attention, in particular with regard to life-cycle issues. For, of course, ideally, one generally wants to think about redistribution from a life-cycle perspective but rarely has the data to do so.

These issues can be tackled analytically. The biggest remaining challenge is almost certainly the presentational one, and it is one closely related to the issue of political acceptability. To most economists, the case for a uniform VAT is a strong one. It comes as no surprise that the same degree of redistribution as is achieved by zero-rating some goods can be achieved more efficiently through changes to the direct tax and benefit system. The importance of thinking over a life-cycle perspective is ingrained. The fact that, generally speaking, individuals with high spending relative to income now must have low spending relative to income at another point in their life is an obvious one. But none of these ideas is either obvious or easy to explain in a public and political context. It is incumbent on us as economists to help improve the quality of this debate if we are to improve the quality of policy in this area.

3. Globalisation and the importance of context

Since the Meade Report was published, economic theory and empirical analysis have advanced, and, of course, we drew on new analysis heavily in the Mirrlees Review. But the world has changed as well and this has implications for tax design. No tax system is timeless. And whilst what we tried to do in the review was to offer a framework for reform that is relevant across countries, the details of design must depend on country-specific circumstances. In his contribution to this Special Issue, Christian Keuschnigg puts the point with admirable clarity:

The ‘optimality’ of a tax system is not compatible with a one-size-fits-all approach. Countries differ by the degree of openness, sector composition, the skill and R&D intensity of production, the quality of financial and legal institutions, the reliance of production on entrepreneurship, the riskiness of employment relationships, the age structure of the population and other aspects. These characteristics not only determine the degree of inequality in the pre-tax distribution of income and wealth, but also make some behavioural adjustment mechanisms more important than others. One might expect that the equity–efficiency trade-off in designing the tax–transfer system differs across countries.
Three particular issues of changing context impinged on our consciousness when coming to write the review – globalisation, the dramatically changed labour market context and increased inequality, and the importance of environmental taxes in the context of concerns over climate change. It is the issue of globalisation which Roger Gordon picks up and on which we concentrate here. Gordon worries that the review does not take enough account of it and argues that ‘increasing globalisation is probably the biggest economic change in the years since the Meade Report. Not only can businesses more easily cross borders, but also individuals can easily move between EU countries’. This is, of course, a real constraint on tax policy. Gordon argues that differential tax rates across countries can affect whether, and when in the life cycle, individuals choose to move across borders. He also hits precisely on the reason we give relatively little time to this particular issue: ‘the lack of any empirical work assessing how large this potential migration response might be to changes in tax policy’.

International mobility, and different tax rates, create an incentive to shift taxable income from years living in a high-tax country to years living in a low-tax country. That, of course, is costly to tax authorities and creates costs from tax-induced behaviour change. As Gordon points out, the more flexibility one has over the timing of the receipt of income, the greater the potential revenue loss. From the point of view of a national revenue authority, this was one issue weighing in our minds when considering the merits of moving to a full expenditure tax treatment of savings. If I get full relief at my marginal rate for any saving done out of earned income today, but can take the returns to those savings in a lower-tax regime tomorrow, then the costs to the original tax authority will be high. Gordon also observes that our alternative ‘rate-of-return allowance’ (RRA) proposals also allow considerable flexibility over the timing of income, and may give an incentive to shift income receipts, thereby creating more inefficiency than the expenditure tax.

Gordon also rightly argues that globalisation impacts directly on the appropriate structure of corporate taxes and creates considerable complication in the taxation of multinationals – an issue also focused on by Christian Keuschnigg, who observes that ‘profit shifting by transfer pricing manipulations and the use of internal debt is increasingly undermining the tax base in high-tax countries and eroding tax revenue’. These issues were considered in some detail in two of the contributions to Dimensions of Tax Design.6 Indeed, Auerbach, Devereux and Simpson (2010) put forward a proposal effectively to replace corporation tax as currently conceived with what would effectively be a VAT levied on a destination basis, but with labour costs deductible. We decided not to go down this route in our final recommendations, not least because the point has not been reached at

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6Auerbach, Devereux and Simpson, 2010; Griffith, Hines and Sørensen, 2010.
which corporate tax revenues are falling rapidly, let alone being wholly uncollectable. Instead, we proposed a radical enough reform – an allowance for corporate equity (ACE) – which would align the treatment of debt and equity finance by providing an explicit deduction for the cost of using equity finance. This would result in a system exempting the normal rate of return on capital from corporate tax.

Gordon suggests, though, that this is too conservative a proposal and that a case could be made for the repeal of the corporate tax since the main justification for the corporate tax is to serve as a backstop to the personal tax base. If both dividends and capital gains are fully taxed by the personal tax, then the case for an additional corporate tax falls away.

IV. Conclusion

The writing of the Mirrlees Review has been a huge undertaking spread over five years. As well as the 10 authors of *Tax by Design*, there were 63 contributors to *Dimensions of Tax Design* and numerous others who helped us in one way or another. Yet, with all that time and expertise, we could not, of course, produce something with which all economists would agree, let alone something that will win universal approbation from policymakers. Many of the potential issues for debate and controversy are played out by the commentators in this Special Issue. There are many others.

Some of the disagreements arise from differences of view over what is practicable, over what weight to put on particular theories, and over how to weigh and interpret evidence. In the review, we specifically say that we believe more work is needed to determine the design and practicability of, for example, extending VAT to financial services, putting in place a land value tax, and replacing inheritance tax with a lifetime accessions tax. And while there is much theory and much evidence to draw on – much more, for example, than Meade had access to – some disagreement also stems from lack of evidence. There are still many things we do not know.

We have mentioned some of the gaps in knowledge in this paper – for example, the impact of taxes on migration. There are many others, among the most important of which are the long-term effects of many taxes on behaviour. For example, we know quite a lot about the impacts of income tax and welfare benefits on labour supply in the short term, but very little about their effects on long-term accumulation of human capital. There is also much still to learn about the long-term effects on saving behaviour of different tax designs and about the impact of social insurance contributions on behaviour relative to the impact of unhypothecated income taxes.

And to return to the point made by Christian Keuschnigg: if we are to make progress in reforming tax in rational directions, we need to get better at the very tough job of quantifying the welfare gains to be had from reform. In
many areas, we have been able to offer some quantification, and the numbers are often large. But in crucial areas, particularly with respect to capital taxes, we remain some distance from being able to quantify available welfare gains. We may believe they are large, but belief will not convince those who can all too easily see the short-term costs of change.

The review really was an effort to contribute to the debate. It is not a set of final answers. We hope for three things: that it will improve the quality of debate on tax and help people think coherently; that it will lead to some improvement in policy; and that it will spark further research to help answer some of the very important questions that remain unresolved.

References