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BRIEFING

# Finding some relief

*The case for applying fiscal discipline to tax expenditures*

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July 2015

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*Since becoming Chancellor in 2010, George Osborne has introduced a range of institutional changes to lock-in budget scrutiny, reduce borrowing and restrain welfare spending. But in relation to public 'spending' in the form of special tax rules or reliefs for particular groups, evaluation of value for money remains as weak as ever. Using a narrow definition of such tax expenditure to cover those measures most analogous to public spending, we estimate that the total surpassed £100 billion in 2014-15. Many of these measures serve valuable purposes but, given the scale of forgone funds, significantly closer scrutiny is warranted. Just as we now have a 'cap' on working-age welfare, might we also consider some form of limit on tax expenditures? In this note we set out the various tax expenditures currently in place and consider a range of scrutiny mechanisms that have been proposed from which the Chancellor could choose to further entrench fiscal discipline.*

## Introduction: the fiscal consolidation blind spot

When the Chancellor stands up to present his second Budget of the year tomorrow, he's expected to provide more details of just how the government intends to close the deficit in the coming years. The expectation is that he'll outline a further three years of austerity, meaning we'll have faced eight consecutive years of fiscal tightening – an unprecedented period. According to figures set out in the March Budget, around half of the overall tightening required under his approach was delivered in the last parliament – meaning there remains a long way to go.

*The processes surrounding tax expenditures are very weak [in the UK] compared to those for [departmental and welfare] spending*

That means making extremely tough choices on public services, welfare and taxation. Already we've seen some departmental budgets being cut by over a third since 2010, key taxes such as VAT and National Insurance being increased (even as income tax bills have been reduced) and significant cuts to working-age welfare. The Conservative manifesto promised that welfare would be cut by a further £12 billion in the two years to 2017-18, alongside a £13 billion reduction in departmental spending and £5 billion of savings from clamping down on tax avoidance. If it sticks to its pre-election plans, our estimate is that even after delivering that difficult suite of policies, the government would need to find a further £5 billion in 2018-19 (before being able to loosen its fiscal stance a little in the final year of the parliament).

Going into tomorrow's Budget, though, the Chancellor has tied his hands in a number of ways. First there are the protected areas of spending. As in the previous parliament, cuts to health, schools (for the most part) and international aid are off the agenda, meaning departmental budget reductions must be more heavily loaded elsewhere. Indeed, the Conservative manifesto pledged to raise NHS spending by £8 billion over the course of the parliament, without stating where the money would come from. Funding this via further reductions to spending in other departments would clearly make the task of consolidation harder still.

Second, in relation to welfare, the state pension and universal pensioner benefits have been excluded from the list of benefits considered for cuts. By maintaining this protection, the Chancellor has taken around 40 per cent of the total welfare budget off the table – more if Child Benefit is also protected. Tax credits, Housing Benefit and some disability payments look the most likely candidates for achieving the £12 billion goal, meaning that low and middle income households will inevitably be hit disproportionately hard.

Finally, on tax, the government has limited its options by pledging not to increase the headline rates of income tax, National Insurance and VAT. Indeed, by promising to raise the income tax personal tax allowance to £12,500 by the end of the parliament – and explicitly linking it to growth in the minimum wage – the government has again made its job harder. Combined with the pledge to raise the higher rate tax threshold, the government is directing around three-quarters of a £6 billion tax cut towards households in the top half of the income distribution.

Given how hard it is likely to be to first identify, and then deliver, the policies that the government argues are necessary to balance the books, it is worth considering alternative sources of revenue and savings. In this note, we look at the scope for reforming the processes and institutions surrounding 'tax expenditures' (otherwise thought of as tax breaks or tax reliefs). These processes are very weak in the UK compared to those for departmental and welfare spending, and compared to many other countries.

Using a conservative definition, we estimate that such expenditures amount to around 6 per cent of GDP (over £100 billion a year). At a time when the Chancellor is seeking to institutionalise budget surpluses for the long-term, alongside new rules on tax, welfare and fiscal scrutiny, we find that there are concrete steps that could be taken to improve the governance and fiscal discipline surrounding tax expenditures and ensure that they are as cost-effective and equitable as possible.

## What is tax expenditure?

In the first instance, getting to grips with the scrutiny of tax expenditure requires building a better understanding of what is and isn't meant by the term. Tax expenditures exist where particular groups – personal or corporate – have their tax bills lowered beyond what would normally be expected, by means of exemptions, lower rates, higher allowances or other means. However, identifying just what constitutes 'beyond normally expected' requires knowledge of a benchmark tax system, which is not explicit in the UK.

The Office for Tax Simplification (OTS) has identified 1,140 tax expenditures (which it refers as 'reliefs') in the UK tax system.[1] This is a very broad approach however, and necessarily approaches the topic from the perspective of administration rather than equity and effectiveness. HMRC takes a different approach, providing a list of 'main tax expenditures and structural reliefs'.[2] This covers fewer measures and divides them into:

» *Structural reliefs* – which help form the benchmark tax system, such as the income tax personal allowance;

» *Tax expenditures* – which are those most clearly not integral to the system; and

» Reliefs with *both tax expenditure and structural components*.

Although more useful than the broad OTS approach, in many cases the HMRC divisions are subjective and debateable. A more detailed attempt at categorisation has been made by the National Audit Office (NAO). It has classified tax expenditures into seven groups based on the following intentions:[3]

1. *Promoting economic and social objectives* – such as Film Tax Relief or the Enterprise Investment Scheme;

[1] OTS, *Updated list of all tax reliefs as at July 2014*

[2] https://www.gov.uk/government/statistics/main-tax-expenditures-and-structural-reliefs

[3] NAO, *Tax reliefs*, March 2014

2. *Improving the progressivity of tax* – such as the income tax personal allowance;

3. *Upholding international agreements* – such as those that seek to avoid double taxation;

4. *Ensuring the scope of a tax is as intended* – such as child benefit not being taxable;

5. *Correctly measuring income or profits* – particularly referring to capital allowances (analogous to taking expenses into account when calculating profit)'

6. *Creating simplicity*; or

7. *Other*.

The focus of this report, and where we believe the most additional scrutiny is needed, is on the first of these NAO categories. While there is obvious scope for disagreement about precisely what falls under the heading 'tax expenditure to promote economic and social objectives', we believe it is expenditures of this nature that most closely resemble government spending. The government could, for example, give small companies in a particular industry a cash grant, or it could give them a tax break: the effect on both the recipient and other taxpayers might be practically identical and so, therefore, should the scrutiny.

## The scale of unscrutinised 'expenditure'

Just as defining tax expenditures is difficult, so it is hard to be definitive about the cost of these measures. Figures reflecting foregone tax revenue are usually by necessity less certain than figures for actual government spending or for tax revenue received. In some cases administrative data will provide an accurate figure, but most often the figures are estimates and many come with considerable uncertainty.

Estimating whether a tax expenditure has any economic benefits, and therefore whether its repeal or reduction would come with fiscal costs, is even harder (though the revenue freed up could of course be used for other purposes with their own benefits). Similarly, we do not know what tax planning or expenditure choices people and companies would make in the absence of these measures. For example, higher VAT on food might be expected to lead to lower pre-tax spending on food. And particular caution is required when the costs of tax expenditures are added together, as some will not be independent of each other.

Notwithstanding these difficulties, we can establish some indicative numbers with reference to the latest HMRC estimates of costs (covering 2014-15[4]). Combining the HMRC data with the NAO's categorisations, we calculate that tax expenditure to promote economic and social objectives totalled roughly £108 billion in 2014-15.[5] This is equal to 6 per cent of GDP, or 15 per cent of public spending.

The goal of this briefing is to look at tax expenditures in general rather than make recommendations about individual expenditures. But to provide some detail of what lies behind these total figures, Box 1 provides a list of the ten largest tax expenditures with economic or social objectives, as classified by the NAO.

[4] Unlike other fiscal components, the government publishes no projections of tax expenditure costs.

[5] We include some new additions – not categorised by the NAO – as tax expenditures: the Enterprise Investment Scheme, Film Tax Relief, Small Brewers Relief, Small Lottery Exemptions (Licensed), Seed Enterprise Investment Scheme and Approved Company Share Option Plans. We exclude the negative tax component of (personal) tax credits, as this is elsewhere now counted as welfare spending.

## Box 1: The largest tax expenditures for promoting economic and social objectives

While there are many smaller measures also worthy of scrutiny, the majority of the £108 billion total for 2014-15 comprises:

1. Reduced and zero rates of VAT (e.g. on food, new homes and power): £47 billion.
2. Income tax relief for registered pension schemes: £22 billion.[1]
3. The capital gains tax exemption for primary residences: £13 billion.
4. The exemption of employer pension contributions from employer NI: £11 billion.
5. Entrepreneurs' capital gains tax relief: £3 billion.
6. Foregone income tax on ISAs: £2.6 billion.[2]
7. Income tax relief for charities, primarily through Gift Aid: £1.8 billion.
8. R&D tax credits for corporation tax: £1.7 billion.[3]
9. The exemptions of inheritance tax for qualifying agricultural properties, business assets or transfers to charities: £1.6 billion. The planned additional allowance for main residences will cost around a further £1 billion.
10. The income tax exemption for the first £30,000 of certain payments on termination of employment: £0.7 billion.

[1] Some would argue that pension tax relief (other than the tax-free lump sum) is not a tax expenditure but simply the correct treatment of deferred income.

[2] Though this assumes a baseline tax system in which there is no allowance for even inflationary returns on investment.

[3] The figure includes the payable portion of R&D tax credits, which is classified as public spending. It is unclear whether or not it includes the Patent Box, whose cost is estimated at £1.1 billion a year.

The £108 billion total excludes measures that the NAO classes as being for the primary purpose of progressivity, scope of tax, correct measurement of income, international obligations or 'other', or none of these, but which might be considered by some to fit the tax expenditure definition. The total also includes only those tax expenditures for which HMRC has estimated costs for 2014-15, although those for which figures are unavailable are generally smaller.

Box 2 takes a look at some of the additional tax expenditures that are not included in the £108 billion for 2014-15, to emphasise that this figure might be considered an underestimate and to illustrate some of the difficulties in categorising tax expenditures.

## Box 2: Tax expenditures excluded from this analysis

Some significant tax expenditures that are not currently considered by the NAO as having economic or social objectives, or are otherwise not included in the 2014-15 list, include:

1. The reduced NI liability of the self-employed relative to employees, after accounting for benefit eligibility differences, which cost £2.7 billion in 2014-15.

2. The marriage tax allowance which comes into effect in 2015-16 and costs £0.9 billion.[1]

3. The CGT exemption for assets still held at death. This cost £0.6 billion in 2011-12 but the cost is no longer known or estimated.

4. The pension tax-free lump sum, which is included within the second relief in Box 1 for ease of calculation but might best be considered a separate and substantial tax break worth several billion.[2]

5. The exemption of employer pension contributions from employee NI (rather than employer NI, above), which comes with its own huge cost.[3]

6. The employee NI exemption for the earnings of those above state pension age – estimated at £0.9 billion.[4] (The exemption of unearned income from NI might be considered another tax break.)

7. The lower rate of fuel duty for non road vehicles (i.e. 'red diesel'), which was estimated to cost £2.4 billion in 2011-12.[5]

8. Local taxation, which is not included in HMRC's list. The single person's discount for council tax costs around £1.4 billion and business tax reliefs together cost at least the same.[6]

9. VAT exemptions and VAT refunds (distinct from those in Box 1), as well as the UK's unusually high VAT threshold.

10. Differences arising from what one believes should be an allowable business expense (and therefore offsettable against tax) – and indeed what counts as a business. Tax relief against landlords' mortgage interest is a particularly contentious and costly example.[7]

[1] D Finch, *Making the most of UC: Final report of the Resolution Foundation review of Universal Credit*, Resolution Foundation, June 2015

[2] T Leunig & A Corlett, *Tax justice: whatever your age*, CentreForum, September 2012

[3] Alternatively, this and employer NI could be levied on pension receipts.

[4] *The IFS Green Budget: February 2015*

[5] A Corlett, T Frostick & S O'Brien, *CentreForum submission to the Autumn Statement 2012*, November 2012

[6] *The IFS Green Budget: February 2015*

[7] FOI reported in The Guardian, *Landlords enjoy £14bn tax breaks as figures reveal buy-to-let expansion*, 26 May 2015

Reasonable people may disagree about whether or not some of the measures listed in Boxes 1 and 2 should count as tax expenditures at all and to what extent they fulfil social or economic goals. But all of these – and even many of the smaller expenditures not listed here – are of such a scale that they deserve considerably more scrutiny than they have received so far.

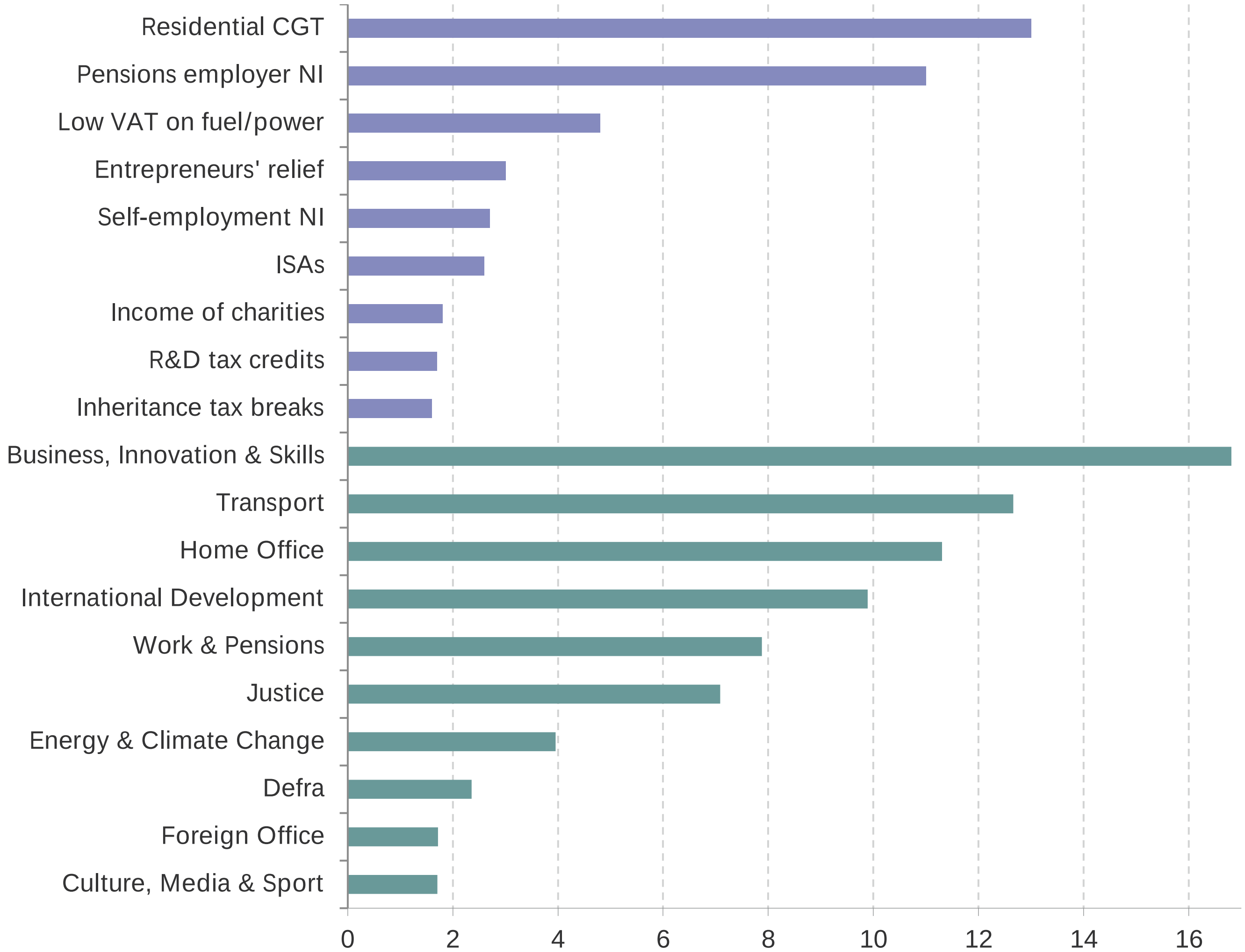
## Illustrating the size of tax expenditure

By way of context, it is worth noting that £108 billion is similar to the entire health budget, all of the spending covered by the welfare cap (which excludes the state pension and select smaller elements), all of the revenue raised by VAT or the budget deficit. The specific examples below are given not as recommendations of trade-offs to be made, but as demonstrations of this scale.

Figure 1 compares selected tax expenditures with some of the major (but not the very largest) government department budgets in 2014-15. It shows, for example, that the cost of exempting employer pension contributions from employer NI (presumably as a way to promote pension saving) comes at a similar cost to the Home Office budget. The exemptions of inheritance tax for qualifying agricultural properties, business assets or transfers to charities come to a combined cost equivalent to the Foreign and Commonwealth Office budget. And the £3 billion spent on entrepreneurs' relief is the same as the total spent by the seven Research Councils – i.e. the lion's share of public science and research (and part of the BIS budget).

Figure 1:
**Cost comparison of selected tax expenditures and government departments**

*Comparison of selected tax expenditures and departmental budgets, £bn, 2014-15*




Source: Tax expenditures from HMRC, 'Main tax expenditures and structural reliefs'. Departmental (DEL) budgets from HMT, 'PESA 2014'.

Looking instead at the welfare budget, scrapping the £6 billion tax deduction of mortgage interest for landlords would potentially allow the promised £12 billion of welfare cuts to be halved, and is similar to the total spent on pension credit.

On the tax side, to further demonstrate the scale of these expenditures we can look at what the some of the UK's main tax rates could be in their absence. Again, this is not to suggest that these tax expenditures should necessarily be removed, nor that a reduction in tax rates would be the best use of any money freed up by such abolition. But it shows the extent to which some groups of taxpayers must lose out to others when some receive special treatment through the tax system, in addition to any public and private administrative costs caused by tax complexity.

» For instance, we consider nine reduced or zero rates of VAT (food, power, UK transport, drugs, water, children's clothing, books, vehicles for the disabled, and certain ships and aircraft), together costing £37 billion. If these tax expenditures were ended, the rate of VAT could be lowered from 20 per cent to the EU minimum of 15 per cent.

» Similarly, if inheritance tax reliefs for agricultural land and business assets were ended[6], the IHT rate could be lowered for all from 40 per cent to 32 per cent (or to 28 per cent if the exemption for transfers to charities was also ended).

» In the case of Capital Gains Tax (CGT), the cost of the two main tax expenditures (exemption for primary residences and entrepreneurs' relief) at £16.3 billion greatly exceeds the total revenue raised from CGT at £5.1 billion. In the absence of these, CGT rates could be lowered from 18 per cent (the basic rate) and 28 per cent (for higher earners) to below 10 per cent (i.e. below the special rate offered to entrepreneurs) for all gains.

» Looking only at two of the larger direct tax reliefs, ending the employer NI exemption of employer pension contributions might allow the employer NI rate to be lowered from 13.8 per cent to 11.8 per cent, while ending pension income tax relief would allow a basic tax rate of 18 per cent rather than 20 per cent.

Finally in this contextual exercise we can consider the budget deficit, noting that the £108 billion of relatively unscrutinised tax expenditures compared with government borrowing of £90 billion in 2014-15.

To reiterate, these comparisons are not necessarily recommendations – merely illustrations that these tax expenditures are substantial and deserve to be pitted against other options based on their results.

## The steady expansion of tax expenditure costs

What is clear from the analysis above is that tax expenditures do not receive attention proportional to their cost. And this is made worse by the fact that costs can exceed expectations without limit and without subsequent scrutiny.

There are, again, significant difficulties associated with comparing tax expenditure costs over time, with methodologies and assumptions tending to change. Nevertheless, we can use HMRC costings to get a sense of the changing scale of tax expenditure costs.

Following the same approach as we set out above, we estimate that costs associated with tax expenditures for promoting economic and social objectives rose from 5.5 per cent of GDP in 2010-11 to 6.0 per cent in 2014-15. This was in large part down to an increase in the standard VAT rate (and therefore the size of VAT tax breaks) but overall if tax expenditure had simply remained at its 2010-11 then revenue might have been £10 billion higher in 2014-15, all else equal.

[6] Assuming 100 per cent relief at present.

At the same time that tax expenditure (as narrowly defined) rose from 5.5 per cent to 6 per cent of GDP the cost of working-age welfare fell from 5.7 per cent to 5.2 per cent of GDP:[7] i.e. tax expenditure now costs more than the entire working-age welfare bill. Yet the volume of political discussion surrounding the latter has of course been many times greater.

Looking over a longer period at specific expenditures, we can see some large changes in costs that have gone without scrutiny. For example, the cost associated with exempting primary residences from CGT has risen from 0.08 per cent of GDP in 1997 to 0.33 per cent in 2008 and 0.74 per cent in 2014. This nine-fold increase in estimated cost is one example of how tax expenditure costs can escalate without any review ever being undertaken as to whether the tax expenditure is delivering on its intended goals in a cost-effective manner.

Similarly, inheritance tax relief for business and agricultural assets rose in value from 0.02 per cent of the economy to over 0.05 per cent in the five years to 2014-15. The cost of entrepreneurs' relief also doubled between 2010-11 and 2014-15. As the NAO has pointed out (and similarly with Seafarers' Earnings Deduction) such rapid increases in costs might be evidence of abuse.

Where tax expenditures have *fallen* in scale in recent years – in relation to age-related personal allowances and the small companies' reduced corporation tax rate for example – it has tended to be the deliberate result of policy, rather than a natural shrinkage.

Given the potential for costs to grow year-after-year in the absence of evaluation and reassessment of the value of different tax expenditures, it might be reasonable to use changes in cost as one means of triggering new scrutiny.

## Options for increasing scrutiny of tax expenditures

Even outside of tight fiscal times, institutionalising greater scrutiny of tax expenditures would be a goal worth pursuing. In the current climate, with so many extremely difficult and potentially painful choices to be made on welfare, public services and taxes, it takes on added urgency.

There have been many calls for reform in the past, and many options presented, alongside best practice from abroad, as to how to deliver that increased scrutiny. A non-exhaustive list includes:

- Improving and expanding HMRC's list of tax expenditures, including a greater number of costings and stating the intended purpose of each.[8] The governments of Canada, Australia and New Zealand, at least, produce annual Tax Expenditure Statements. In some cases these include projections over the forecast period, which can later be compared to outturns, and could be accompanied by parliamentary debate.
- Developing a framework for HMRC's own administration and monitoring of tax reliefs and their changing costs.[9]
- Introducing a rolling programme of individual reviews – i.e. the government could regularly look at the effectiveness and value for money of each tax expenditure.[10] In Canada, annual reports focussing on one or two tax expenditures are included in the Tax Expenditure Statement. Alternatively or additionally, new tax expenditures could be subject to sunset clauses, requiring demonstrations of cost-effectiveness if they are to continue beyond their initial period.[11] On value for money, the question in effect is: "if this were a departmental

[7] Outturn and forecast: Budget 2015, DWP

[8] Public Accounts Committee, The effective management of tax reliefs, March 2015

[9] PAC, op cit.; NAO, The effective management of tax reliefs, November 2014

[10] PAC, op cit.

[11] M Johnson, Who will care for Generation Y?, Centre for Policy Studies, June 2015

spending programme – would it survive?”[12]

- Involving other departments in tax expenditure policy. The Public Accounts Committee recommended that “the cost of spending and expenditure on tax reliefs should be considered alongside one another in setting annual departmental budgets so that the true level of financial support to each area of public policy is transparent.”[13] Similarly, the Centre for Policy Studies has suggested that “departmental budgets should be set both gross and net of expenditure on tax reliefs and exemptions”.[14] In the Netherlands, each tax expenditure is reviewed once every five years jointly by the Ministry of Finance and a relevant spending department.[15] At the extreme, departments would be able to freely budget between tax expenditures and regular spending.[16]
- Continued scrutiny by the NAO. Its last review concluded that HMRC and HMT had left “a significant gap in accountability to Parliament”[17] but it was accused by the government of working beyond its remit.[18]
- Creating a joint parliamentary committee on tax policy.[19]
- Expanding the role of the Office for Budget Responsibility (OBR) – which already looks, for example, at policy costings and welfare trends – or the Office of Tax Simplification (OTS), or the creation of a new body to specifically scrutinise tax expenditures.[20]
- More broadly, reviewing the institutions of the Budget, Autumn Statement and Finance Bills, which allow for relatively little consultation,[21] and the relationship between HMT and HMRC.[22]

Perhaps more crudely, the Chancellor might choose to borrow from his own ‘welfare cap’ approach. Under this cap, if the costs of selected benefits rise beyond a level previously set by parliament, the OBR can call out the government. Ultimately, the Chancellor might be required to reduce costs or ask for a higher cap.

If the logic of the welfare cap is accepted as being a good one, then a similar cap for tax expenditure – usefully necessitating more robust and projected costings and categorisation – does not seem inappropriate. In fact, using the NAO categories as above, the two might even be set at a similar level. As with the welfare cap, the role of a tax expenditure cap would be less about absolutely constraining the government and more about creating a drive for efficiency and a lens for scrutiny.

The government, Parliament and political parties therefore have a wide selection of options they could choose from to institutionalise better scrutiny. However, what is lacking is the broader political discussion and drive to make those changes. Many on the left of the political spectrum have sought to focus on increasing tax at the top and talking down tax avoidance; while those on the right have placed greater emphasis on controlling welfare and departmental spending,

[12] J Rutter, *Opening the hidden ringfence: why the next public expenditure round needs to look at the Chancellor’s big “spending” programme*, SMF, March 2015

[13] PAC, op cit.

[14] M Johnson, op cit.; See also N Broughton, *One More Time Repairing the public finances*, SMF, June 2015

[15] J Minarik, *Tax expenditures in OECD countries*, OECD, June 2009; NAO, op cit., November 2014

[16] A Corlett, T Frostick & S O’Brien, op cit.

[17] NAO, op cit., November 2014

[18] The Guardian, *National Audit Office questions government’s lack of tax relief scrutiny*, 27 March 2014

[19] See P Johnson, *Better Budgets: making tax policy work*, IFS, 2013 & *Making Taxes Simpler The final report of a Working Party chaired by Lord Howe of Aberavon*, July 2008

[20] M Johnson, op cit.

[21] For example see G Wilkes & S Westlake, *The end of the Treasury*, Nesta, September 2014

[22] P Johnson, op cit.

alongside permanently locking-in tax cuts and ambitious borrowing targets. Absent from both these approaches have been the relatively simple changes needed to hold government to account on tax expenditure for the long-term.

We have not attempted to make any assessment of the efficacy of these different options for institutional reform, but we are clear that there is a very strong case for greater scrutiny of such a major part of the government's budget.

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