Changing Tax

Pressing reset on the UK's tax policy

Matt Whittaker

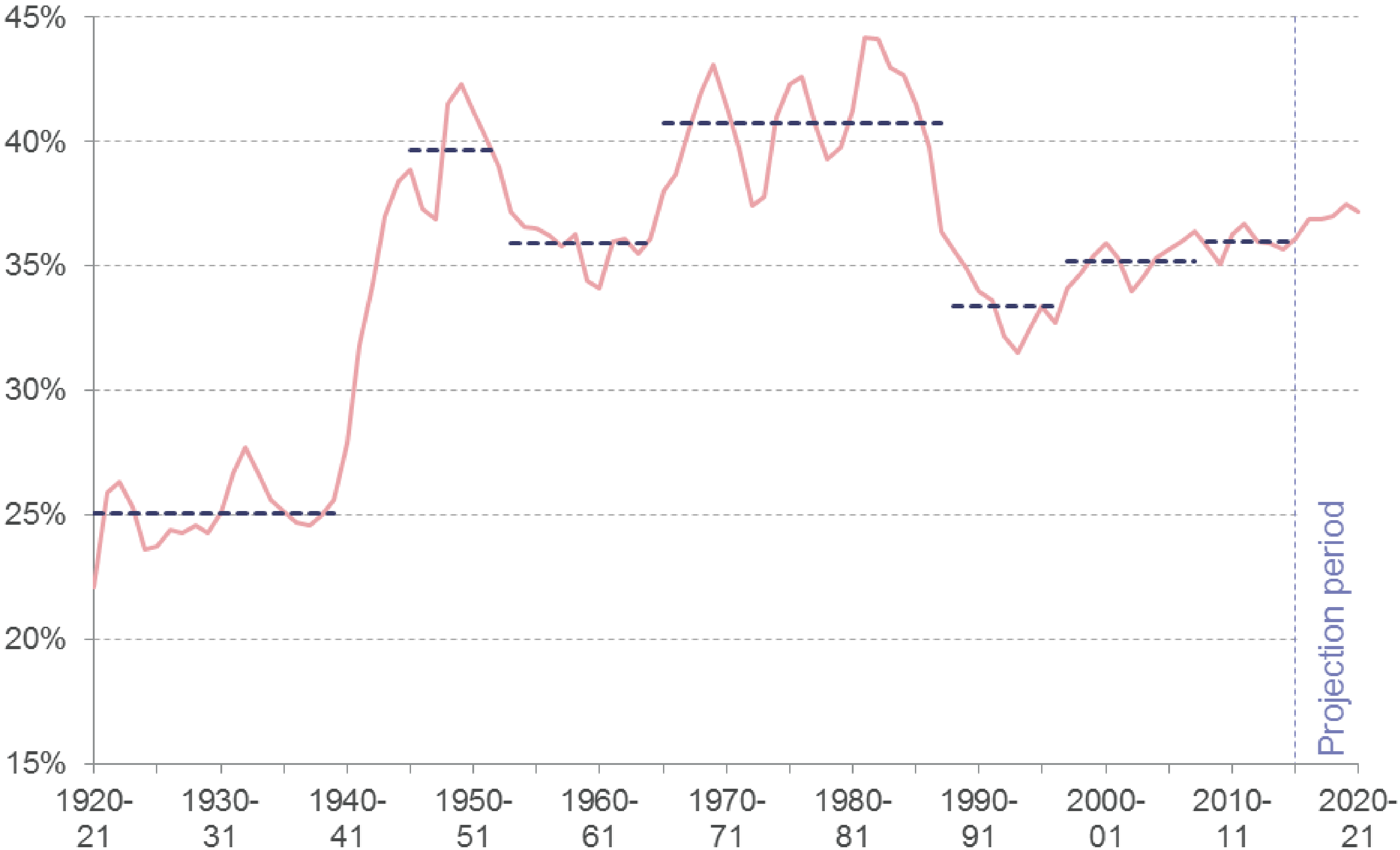
November 2016

WHAT GOES DOWN…

Following record falls in 2008 and 2009, recovery in government receipts has disappointed

Ahead of the Autumn Statement, OBR projections suggest that receipts are set to reach their highest level as a share of GDP in 33 years

Government receipts as a share of GDP



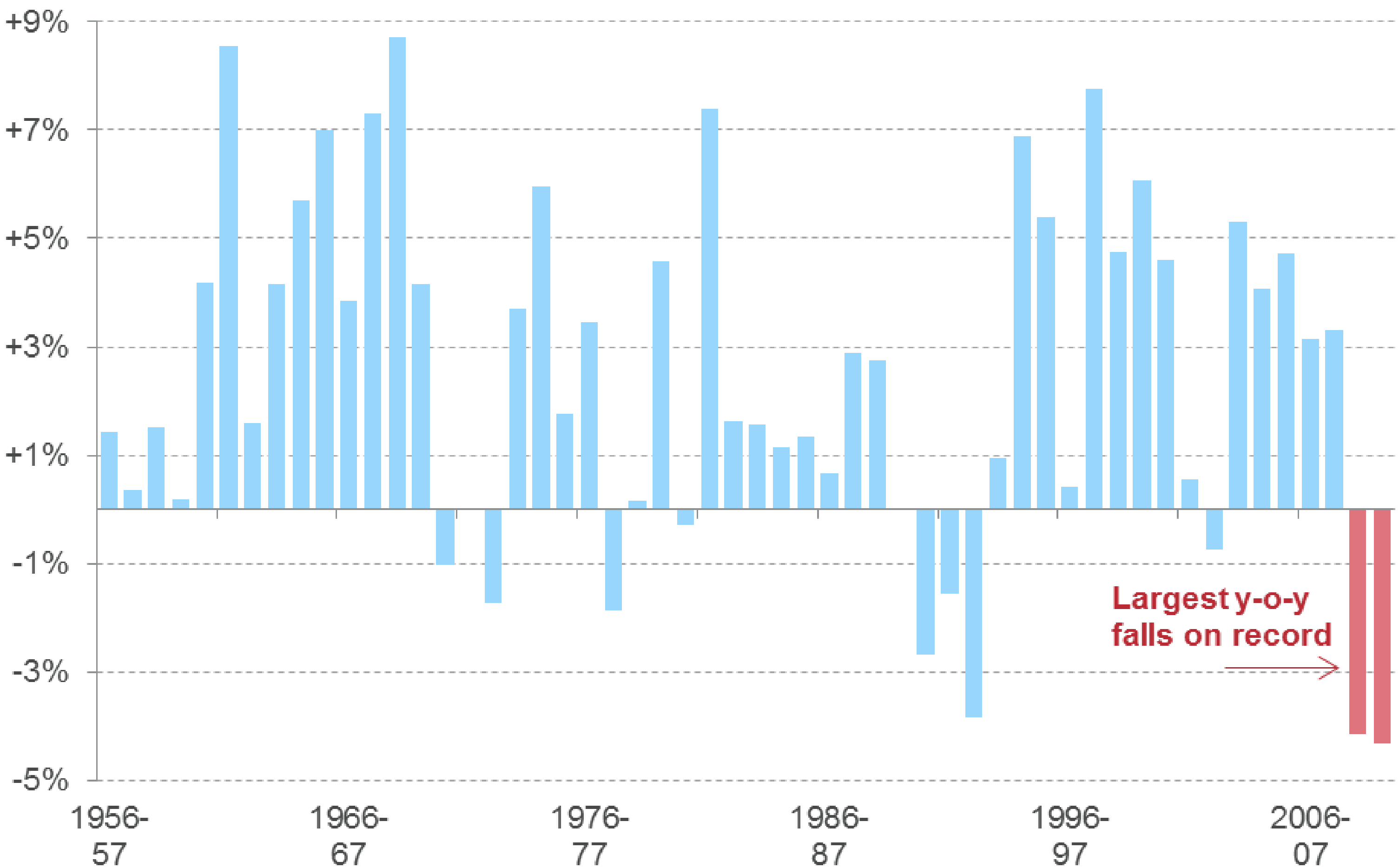
Notes: Projection total for 2020-21 is adjusted to remove the effects of a one-off £3.6 billion (nominal) boost to Corporation Tax in that year that occurs due to bringing forward large firms' payments.
Source: OBR

Having fallen sharply over the course of the 1980s and averaging just 33.4% of GDP between 1988 and 1997, government revenues trended upwards over the 21st century

By 2019, they are projected to reach 37.5% of GDP

That projection follows the sharpest fall in real-terms government receipts in 50 years in the wake of the financial crisis

Year-on-year change in real-terms government receipts

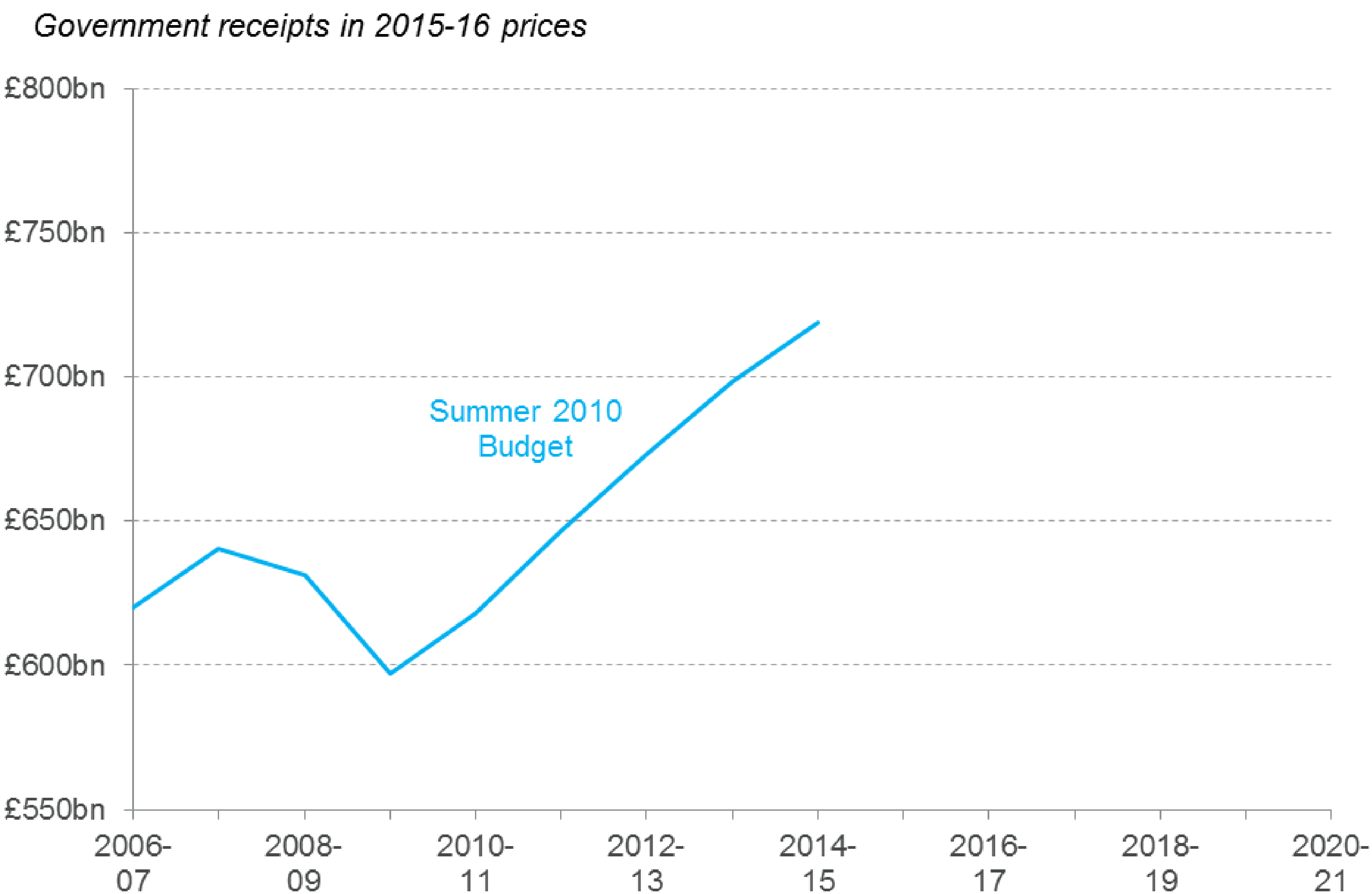


Source: OBR

Receipts fell by 4.2% in 2008 and 4.3% in 2009

That was sharper than at any other time since 1956, and was equivalent to a cumulative drop of £53bn in 2015 prices

But there is a note of caution: receipts have a history of disappointing in recent years



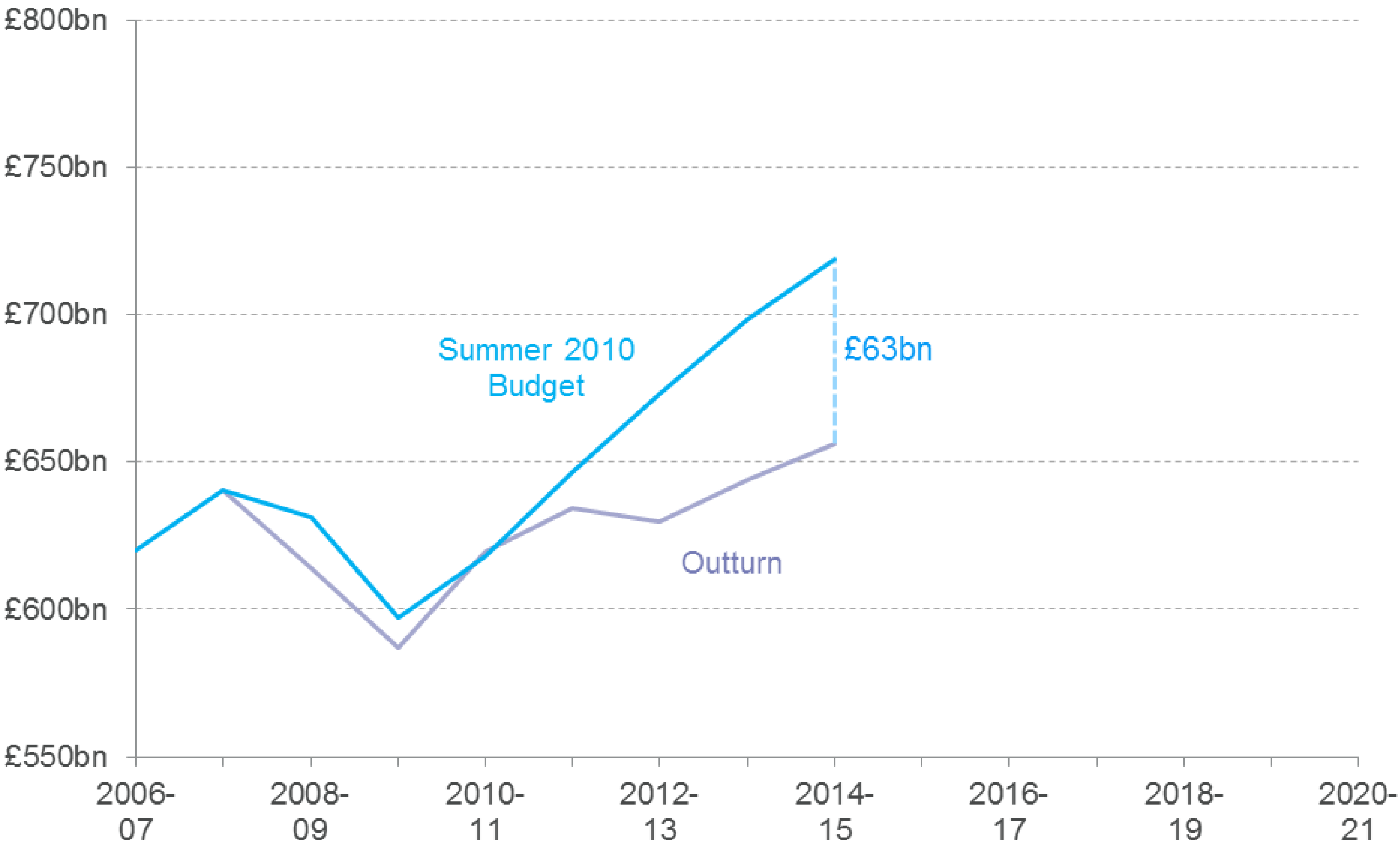
Source: OBR, ONS & HMT

The OBR's *Economic and Fiscal Outlook 2010* implied average annual real-terms growth in receipts of roughly 3.8% over the first four years of the last parliament

Receipts came in £63 billion lower in 2014 than the £720bn projection that the OBR had set out in its 2010 forecast

RF

Government receipts in 2015-16 prices

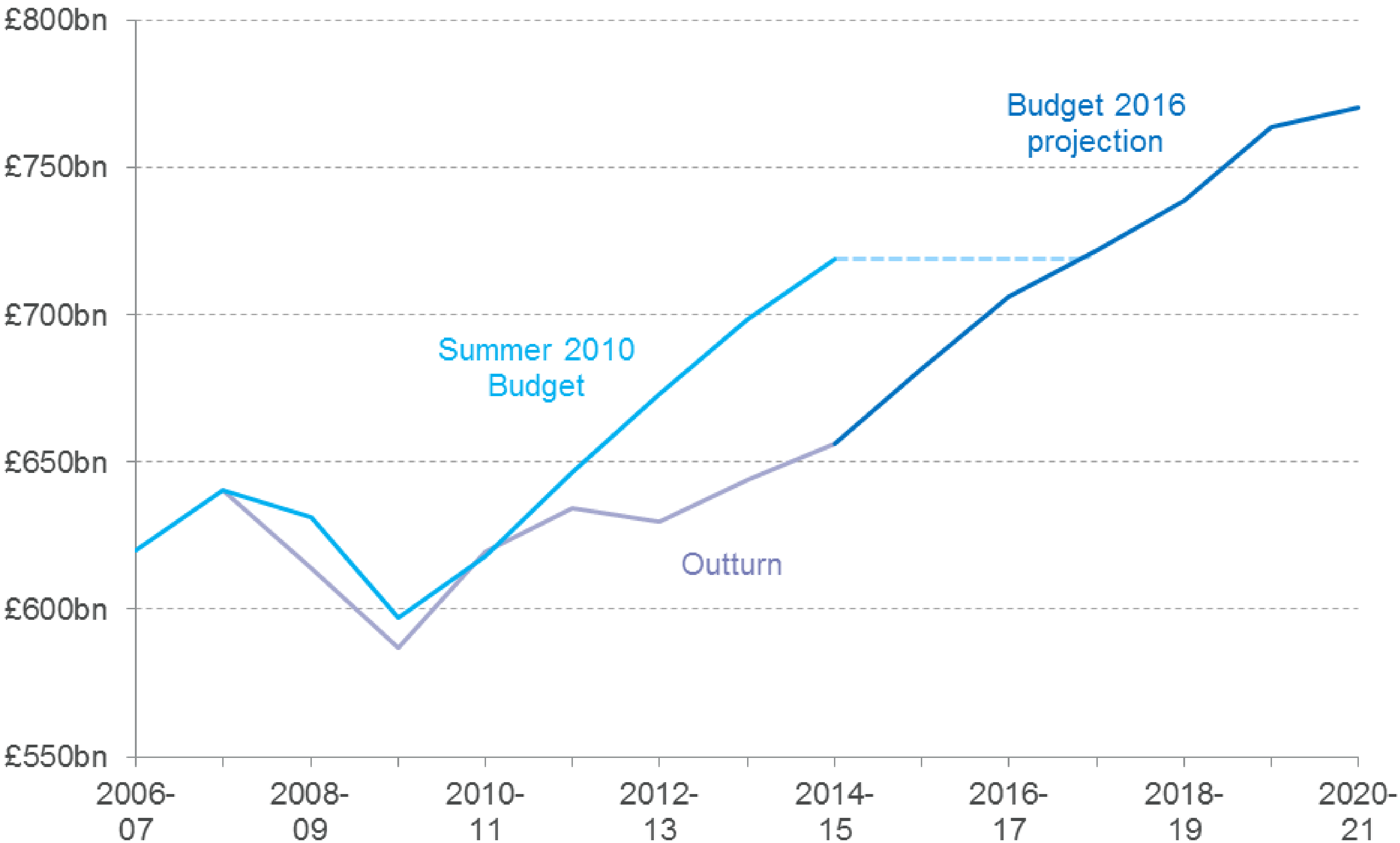


Source: OBR, ONS & HMT

Average growth was instead around 1.5% a year, resulting in a cumulative shortfall in receipts of around £170bn

The March 2016 projections implied the old £720 billion figure would arrive in 2017 instead, three years behind schedule

Government receipts in 2015-16 prices



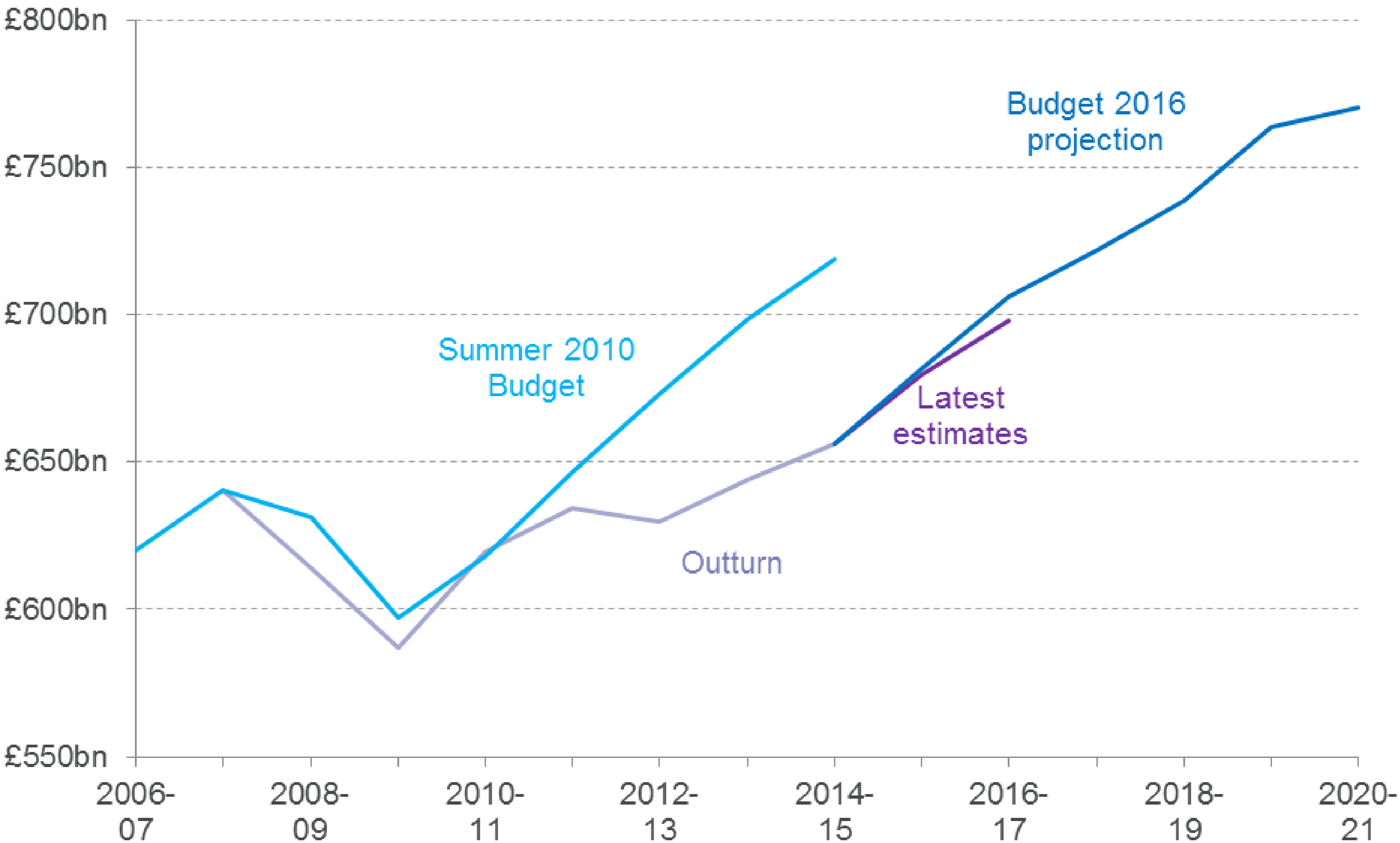
Source: OBR, ONS & HMT

The OBR's last assessment forecast real-terms receipt growth of 2.5% a year in this parliament – roughly halfway between the optimism of 2010 and the eventual outturn in the last parliament

But already these numbers are looking too optimistic: 2015 came in lower and the first half of 2016 has been disappointing

RF

Government receipts in 2015-16 prices

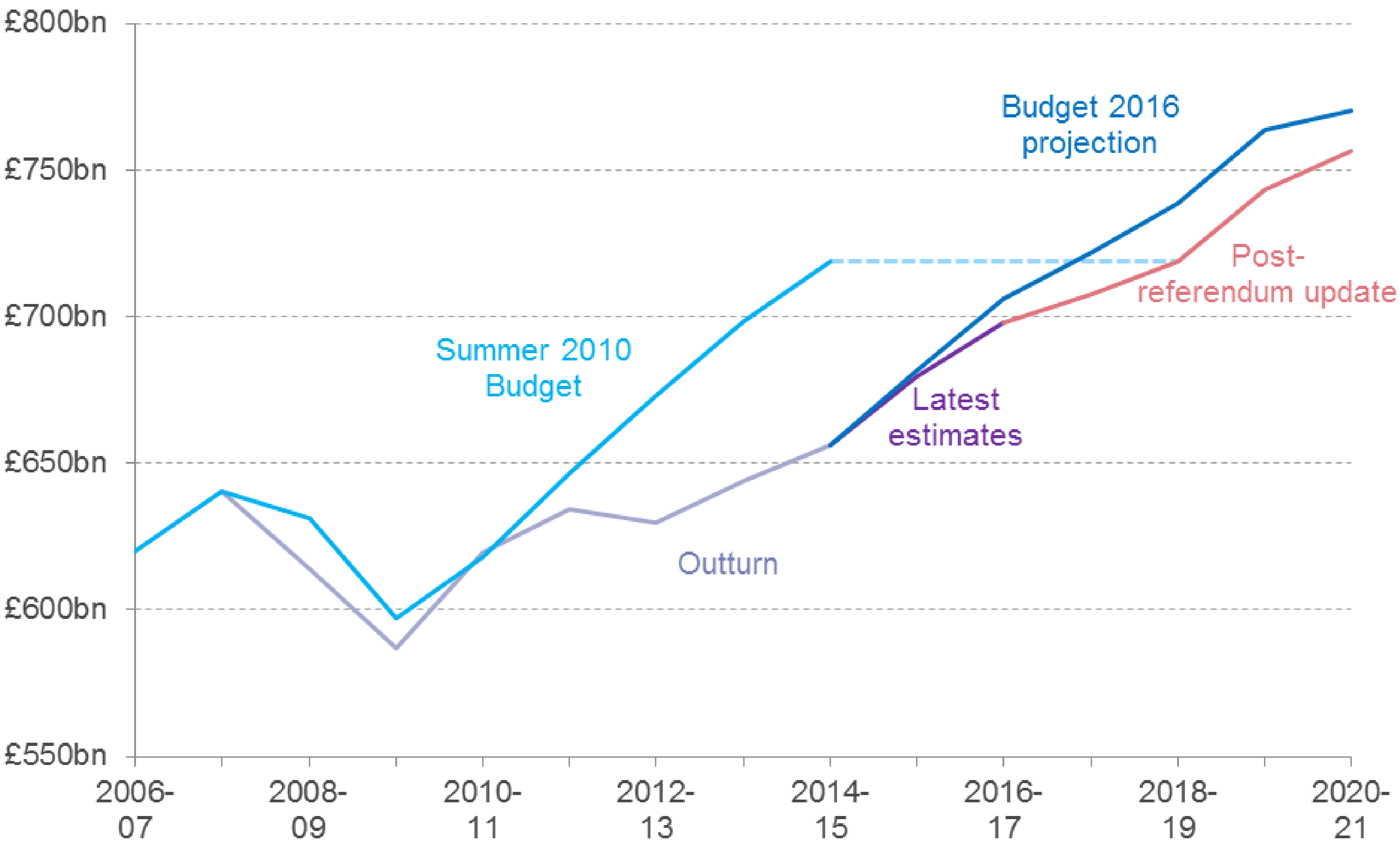


The 2015 estimate proved to be £2bn too high, while the under-performance of PAYE and NICs in the first six months of 2016 imply a potential shortfall approaching £10bn this year

Notes: 'Post-referendum' update lowers 2016-17 figure with reference to ONS data on the first six months of the financial year. Subsequent years are adjusted in line with independent forecasts reported by HM Treasury.
Source: OBR, ONS & HMT

Expectations for slower economic growth following the EU referendum mean the £720bn total now looks like arriving four years late, in 2018

Government receipts in 2015-16 prices



Looking across a range of independent forecasters, expectations of slower GDP growth post-referendum imply receipts coming in £14bn lower than previously projected in 2020 and £75bn lower over the parliament

Notes: 'Post-referendum' update lowers 2016-17 figure with reference to ONS data on the first six months of the financial year. Subsequent years are adjusted in line with independent forecasts reported by HM Treasury.
Source: OBR, ONS & HMT

TAX CUTS IN AN ERA OF FISCAL TIGHTENING

Some of the revenue 'disappointment' of recent years is actually the result of deliberate policy choices

'Receipts' comprise a number of different elements, but taxes dominate

RF

Government receipts

£655bn in 2014-15

HMRC taxes

£515bn

includes:

Income tax

NICs

VAT

Corporation tax

Duties & levies

Other taxes

£82bn

includes:

Council tax

Business rates

VED

Scottish taxes

Other revenues

£58bn

includes:

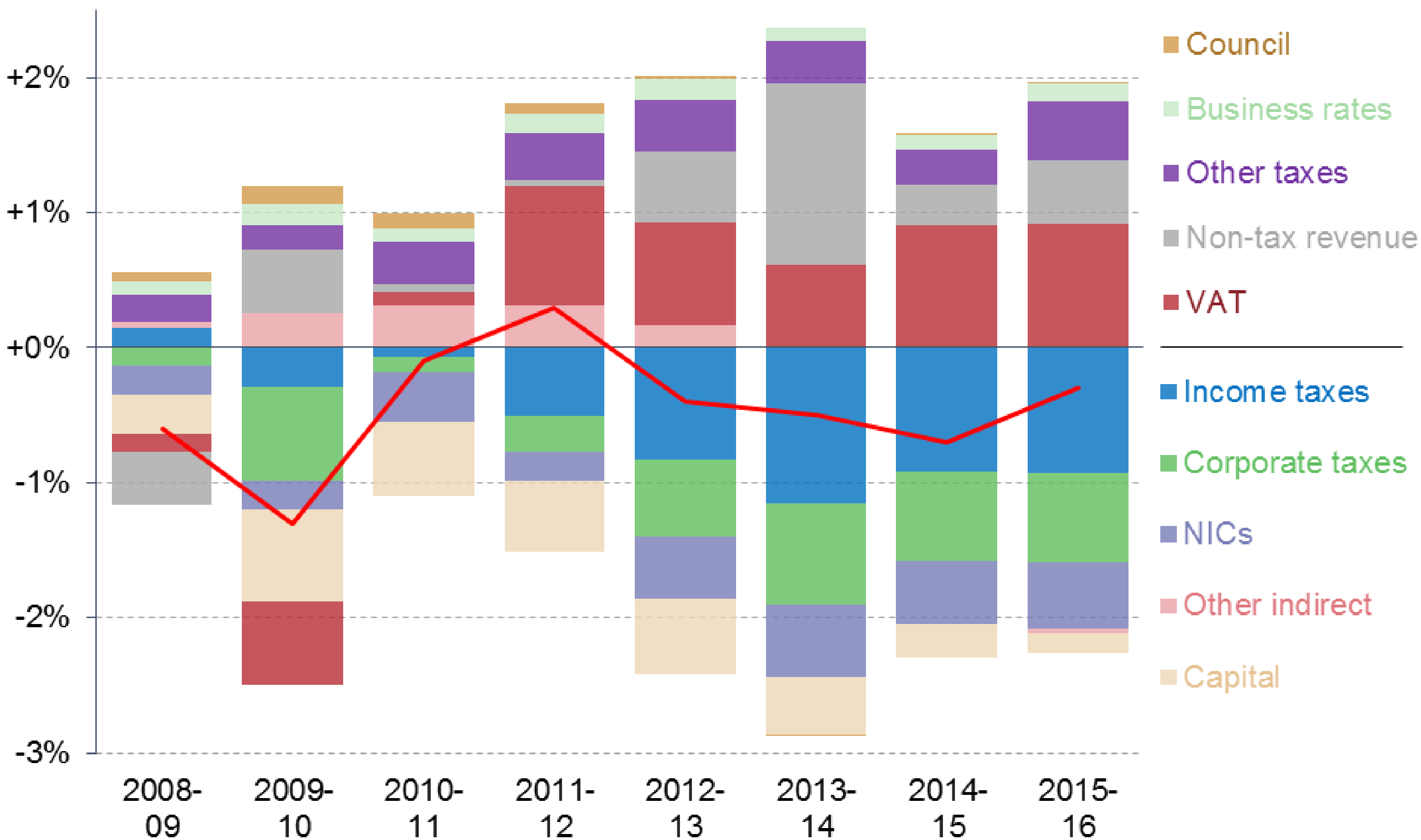
Gross operating surplus

Interest and dividends

TV licences

The biggest drags on receipts since 2007 have come from income and corporation taxes, with VAT providing the biggest boost

Contribution to cumulative change in receipts as a share of GDP since 2007-08 baseline



In cumulative terms, receipts as a share of GDP have fallen by 0.3ppts post-crisis

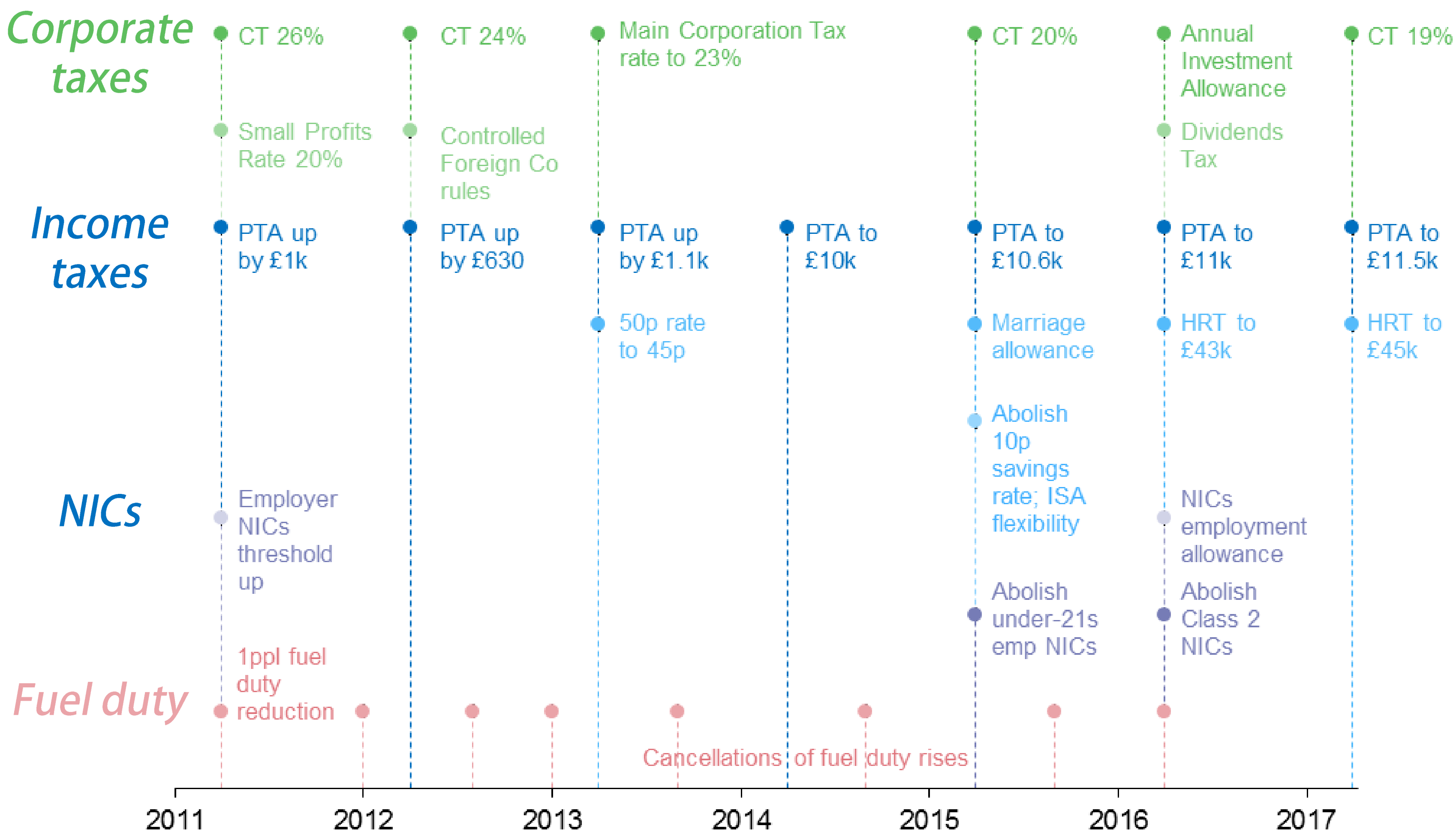
Drags from income taxes (-0.9ppts) and corporation taxes (-0.7ppts) have been offset by boosts from VAT (+0.9ppts) and non-tax revenues (+0.5ppts)

Notes: See Appendix for details of the taxes sitting in each category. 2015-16 figures relate to OBR estimate at the March 2016 Budget.

Source: OBR & HMRC

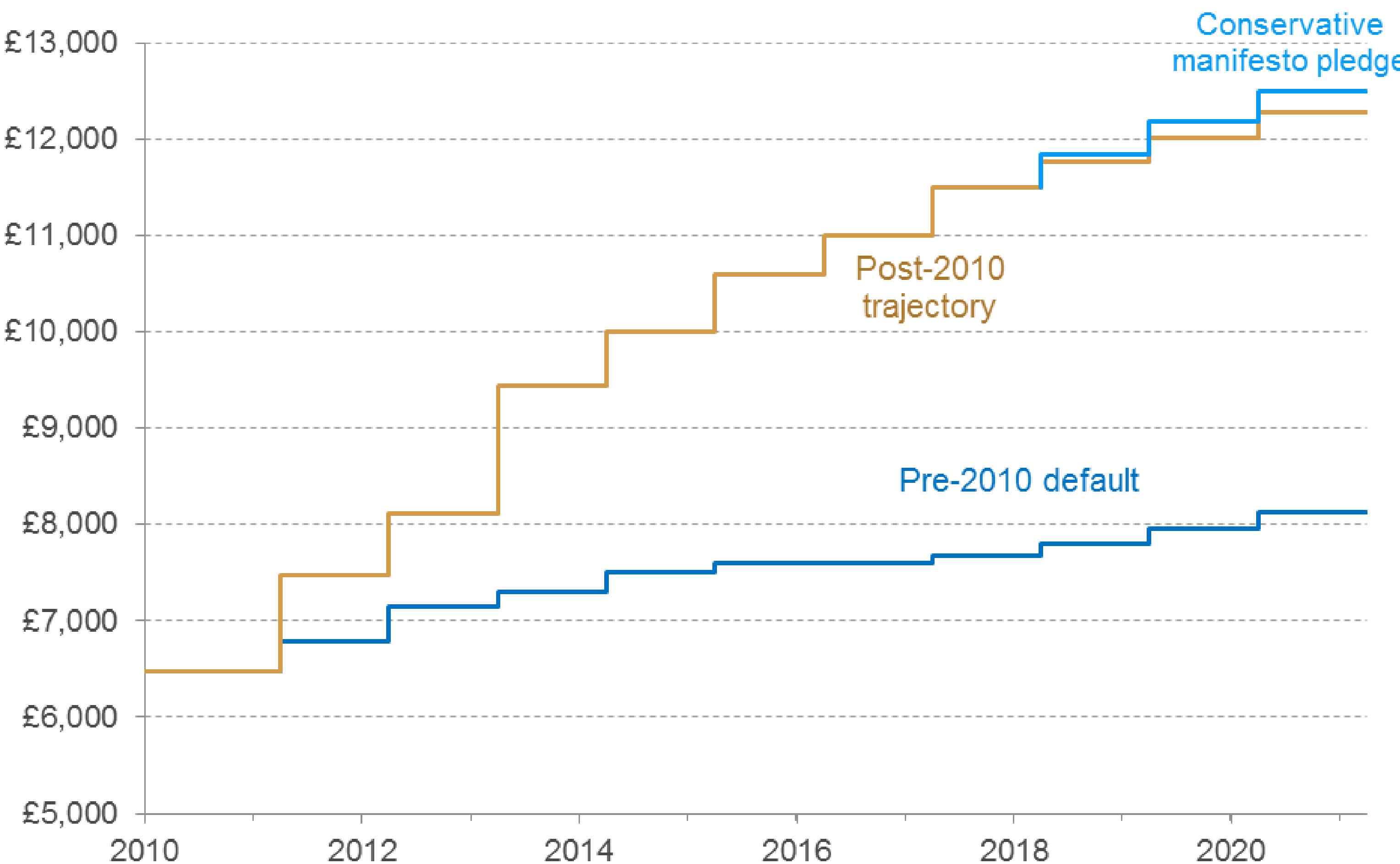
In part this reflects the state of the economy, but it is also the product of a multitude of tax cuts introduced since June 2010

Timeline of selected tax cuts announced since Summer 2010



Above-inflation increases in the personal allowance have raised the tax-free portion of income by around £3,800 relative to the default policy

Income tax personal allowance under different scenarios



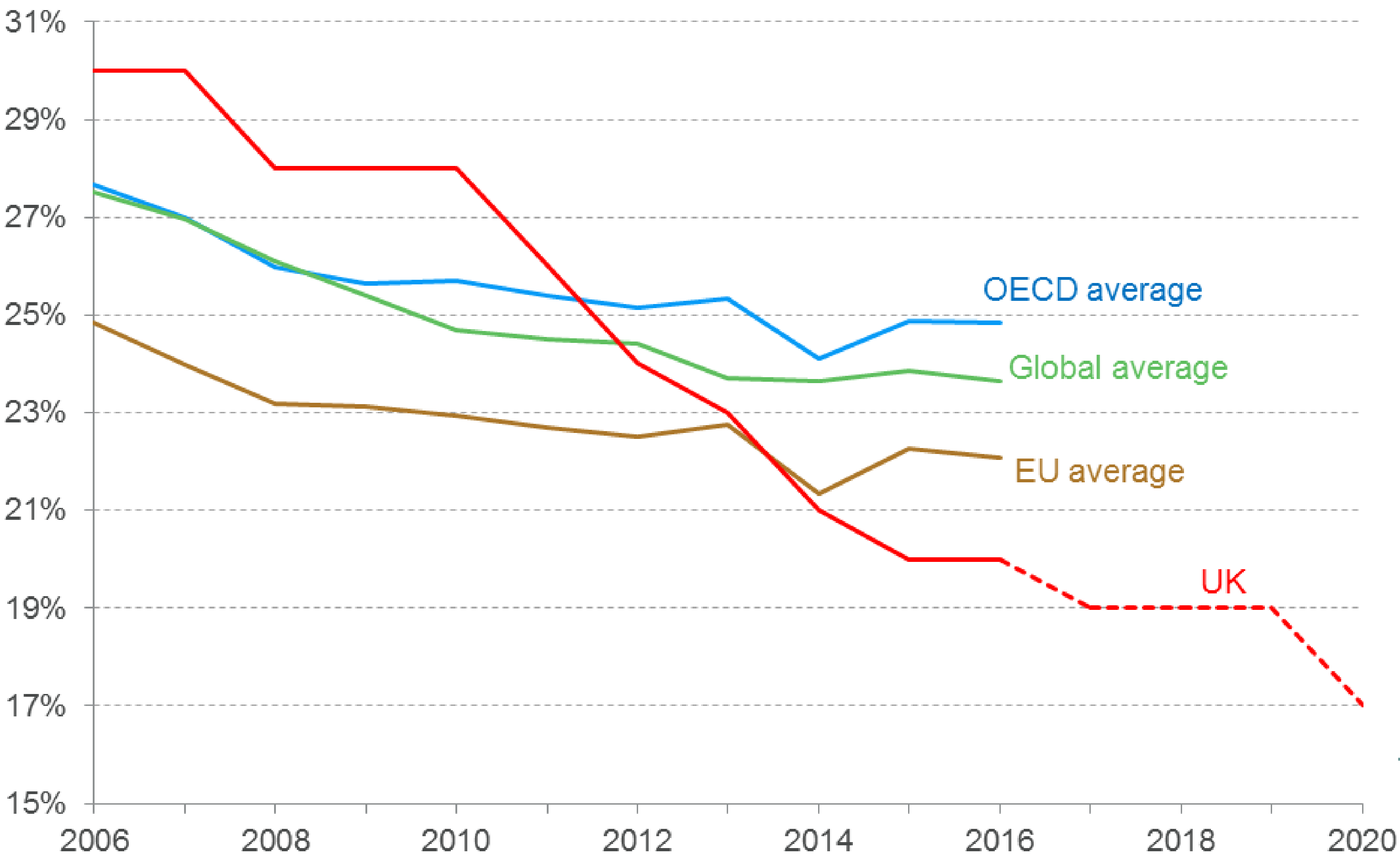
Notes: Default assumption is that the PTA rises with RPI in 2011 and CPI thereafter, reflecting the change in direct tax uprating introduced at this point.

At £11.5k, the income tax personal allowance is set to be around £3,800 higher than it's pre-2010 default would have delivered

The Conservative manifesto pledged a threshold of £12.5k (and £50k for the higher rate) by the end of the parliament

Corporation tax has also been cut sharply since 2010, with the main rate dropping from 28% to a proposed 17%

Headline corporation tax rate in selected countries



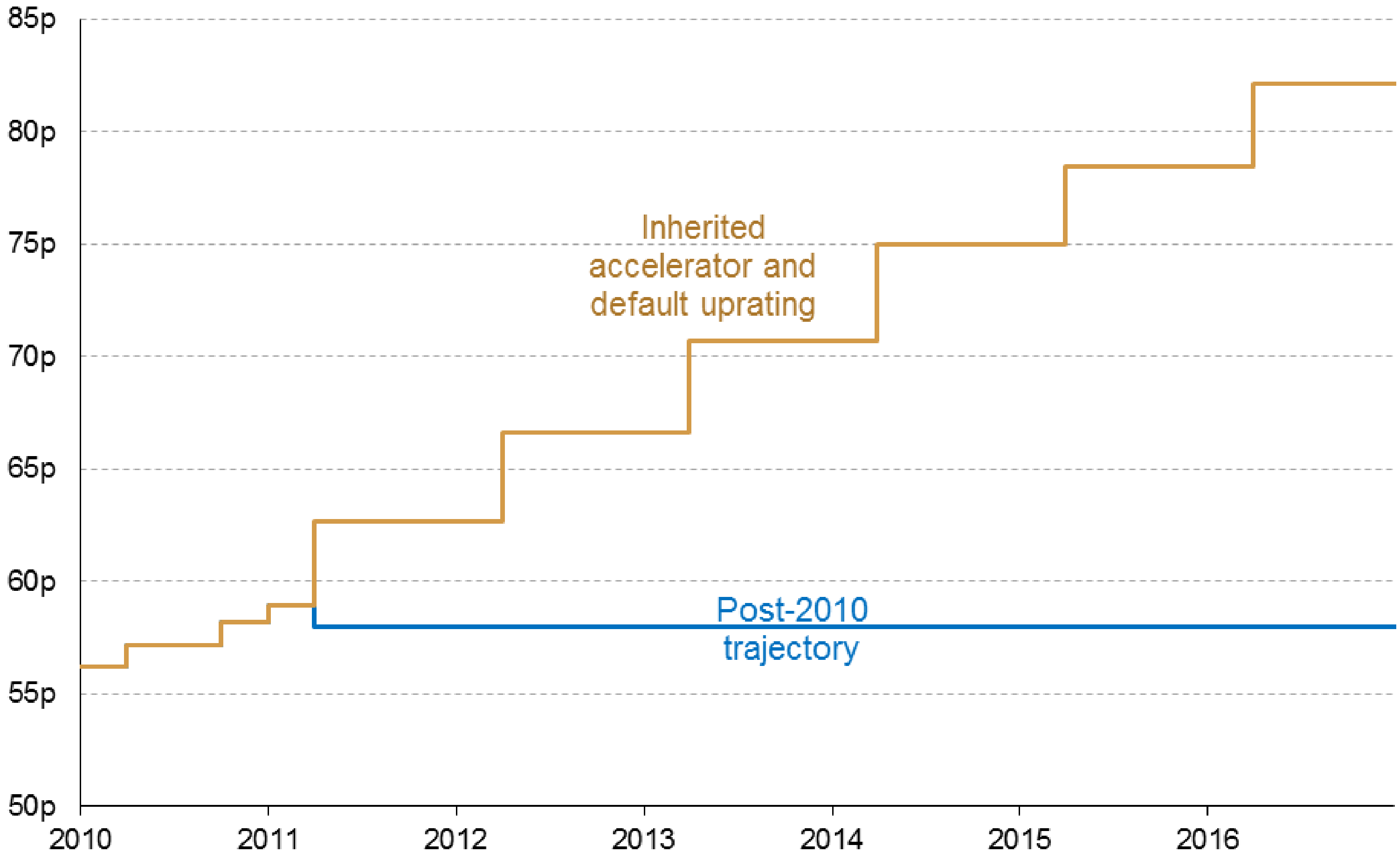
Source: OECD & PWC

Alongside cuts in the main rate of corporation tax, recent reforms have removed the small profits rate, introduced a 10% rate for income derived from patents and increased the amount of investment firms can deduct from their profits for tax purposes

The third major tax cut relates to fuel duty, where both the inherited 'accelerator' and the default index-link have been abandoned

RF

Fuel duty (unleaded petrol and diesel) under different scenarios, pence per litre

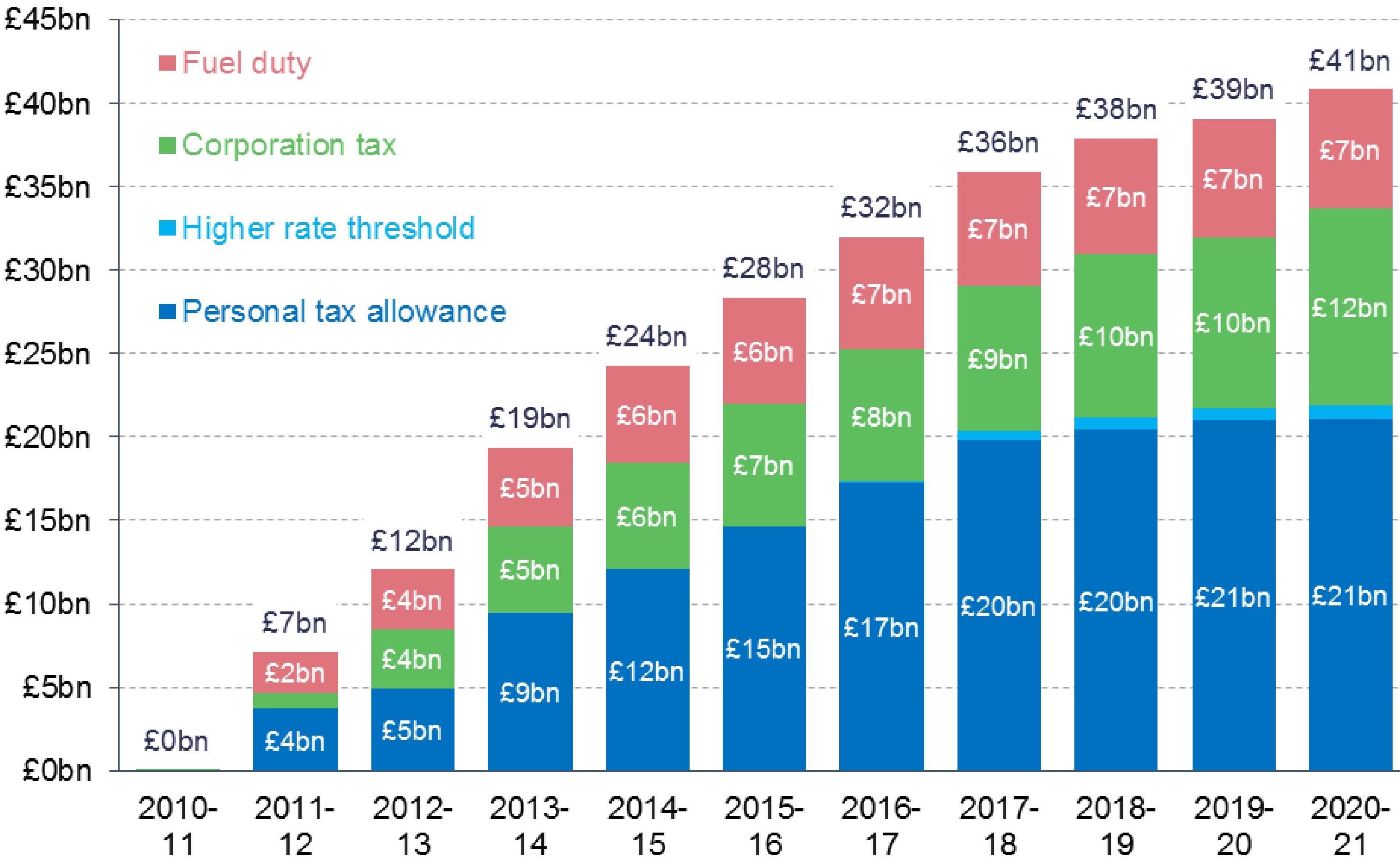


The Labour government had established an 'accelerator' whereby duty was due to rise by 1ppl bove RPI inflation etween April 2011 and April 2014

Instead, fuel duty was lowered by 1ppl in 2011 and then frozen. From 2017 it is set to rise with RPI again

These big giveaways – on income tax, corporation tax and fuel duty – were expected to cost roughly £40bn by the end of this parliament

Annual cost of selected tax cuts introduced since June 2010, 2015-16 prices



Notes: Costings based on those published at the time of the policy announcement.
Source: OBR

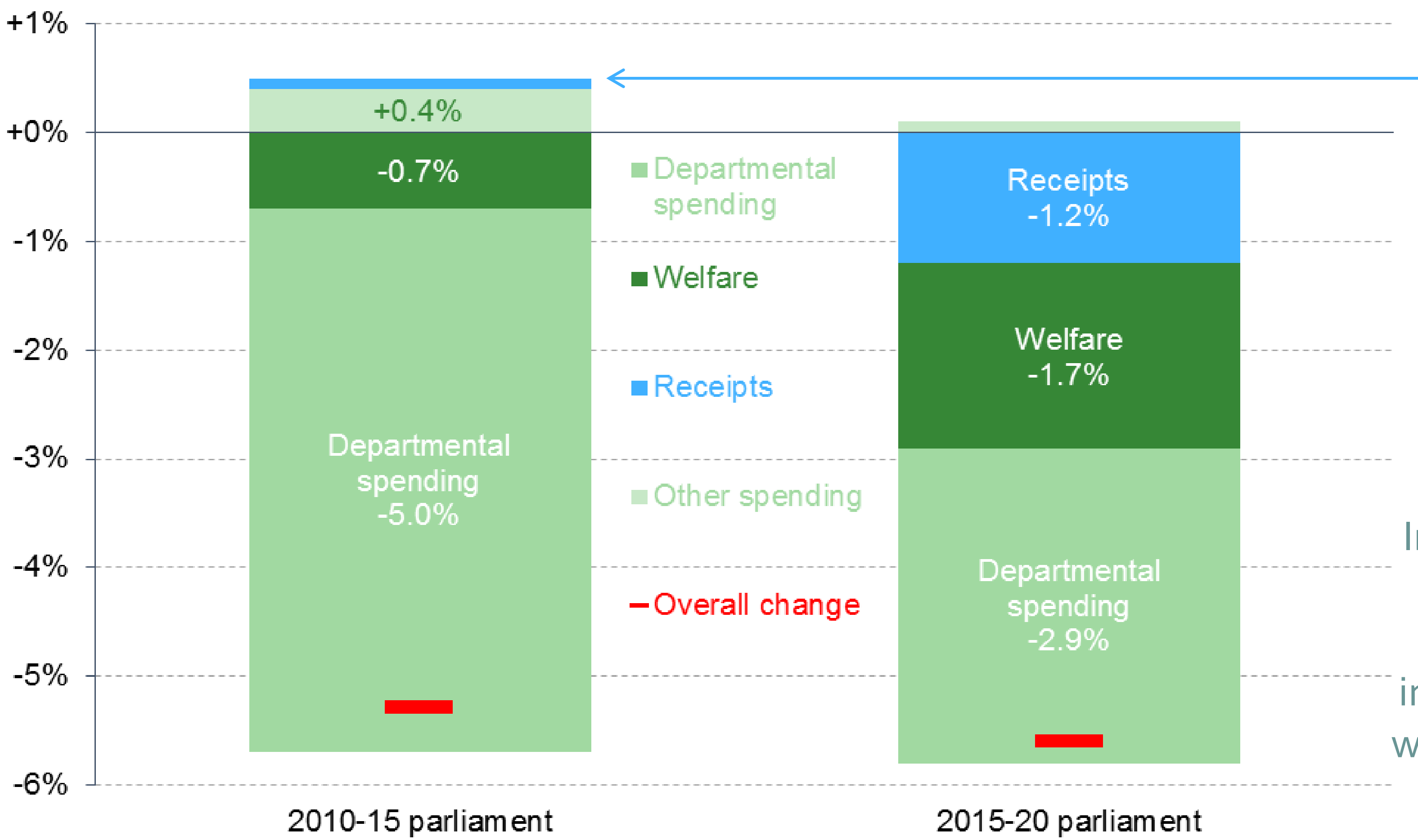
OBR estimates put the cost of the personal allowance policy at £21bn in 2020, with increases in the higher rate threshold costing a further £0.8bn

The various corporation tax reforms amount to £12bn by the end of the parliament and fuel duty comes in at £7bn

These tax cuts are one of the reasons why overall tax policy has played a minority role in the process of fiscal consolidation

RF

Contributions to change in public sector net borrowing as a share of GDP



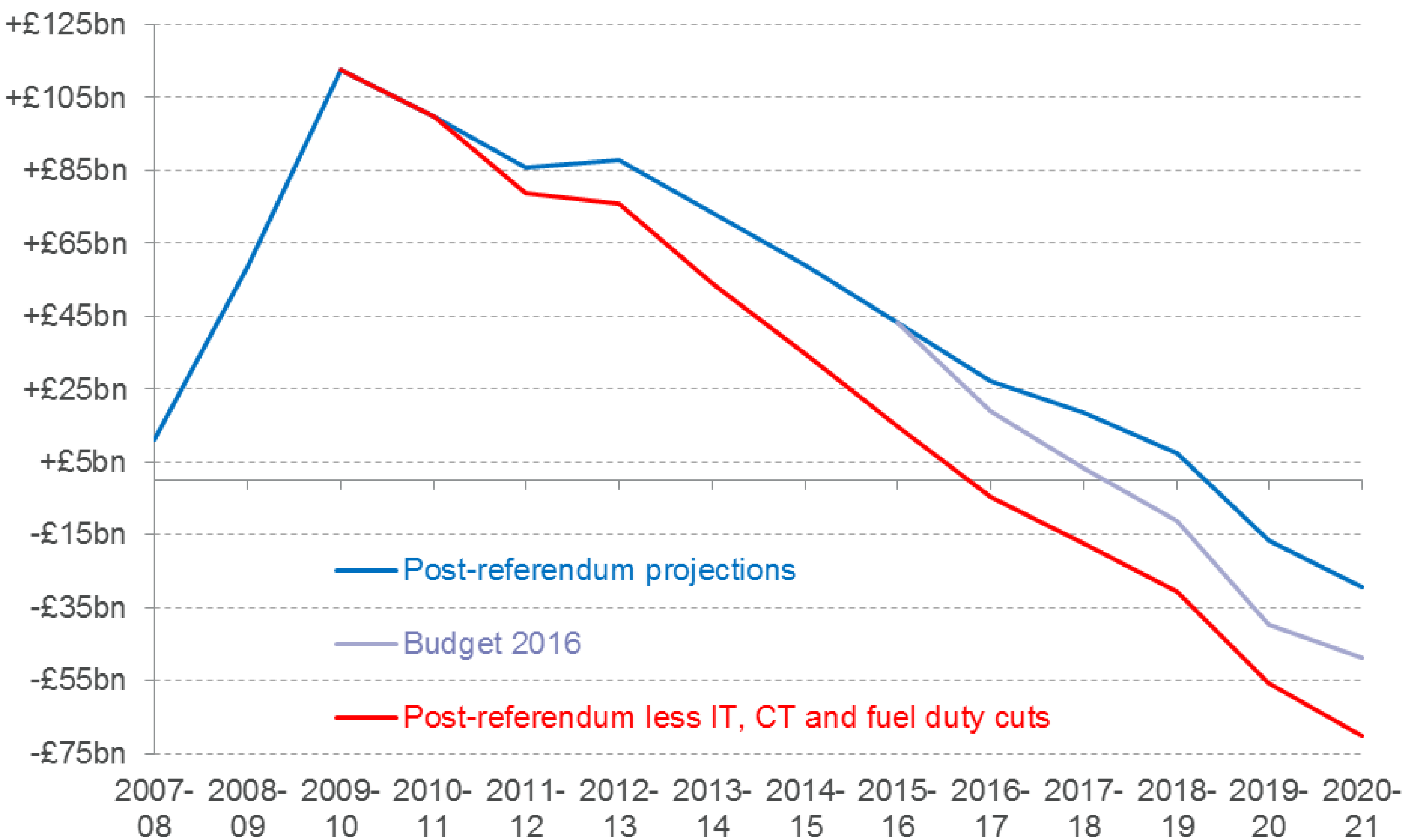
Over the last parliament, the net effect of all tax policy changes was to *increase* government borrowing (by 0.1% of GDP)

Initial projections for this parliament implied tax policy would account for one-fifth of the discretionary consolidation

Notes: The '2015-20 parliament' figures are OBR projections at the time of the 2015 Autumn Statement.
Source: OBR Economic and Fiscal Outlook November 2015

In the absence of these major tax cuts, the new Chancellor might have been able to point to a current budget surplus this year

Current budget deficit, 2015-16 prices



By borrowing £32bn less in 2016, the government would be able to report a £5bn current budget surplus rather than an expected £27bn deficit

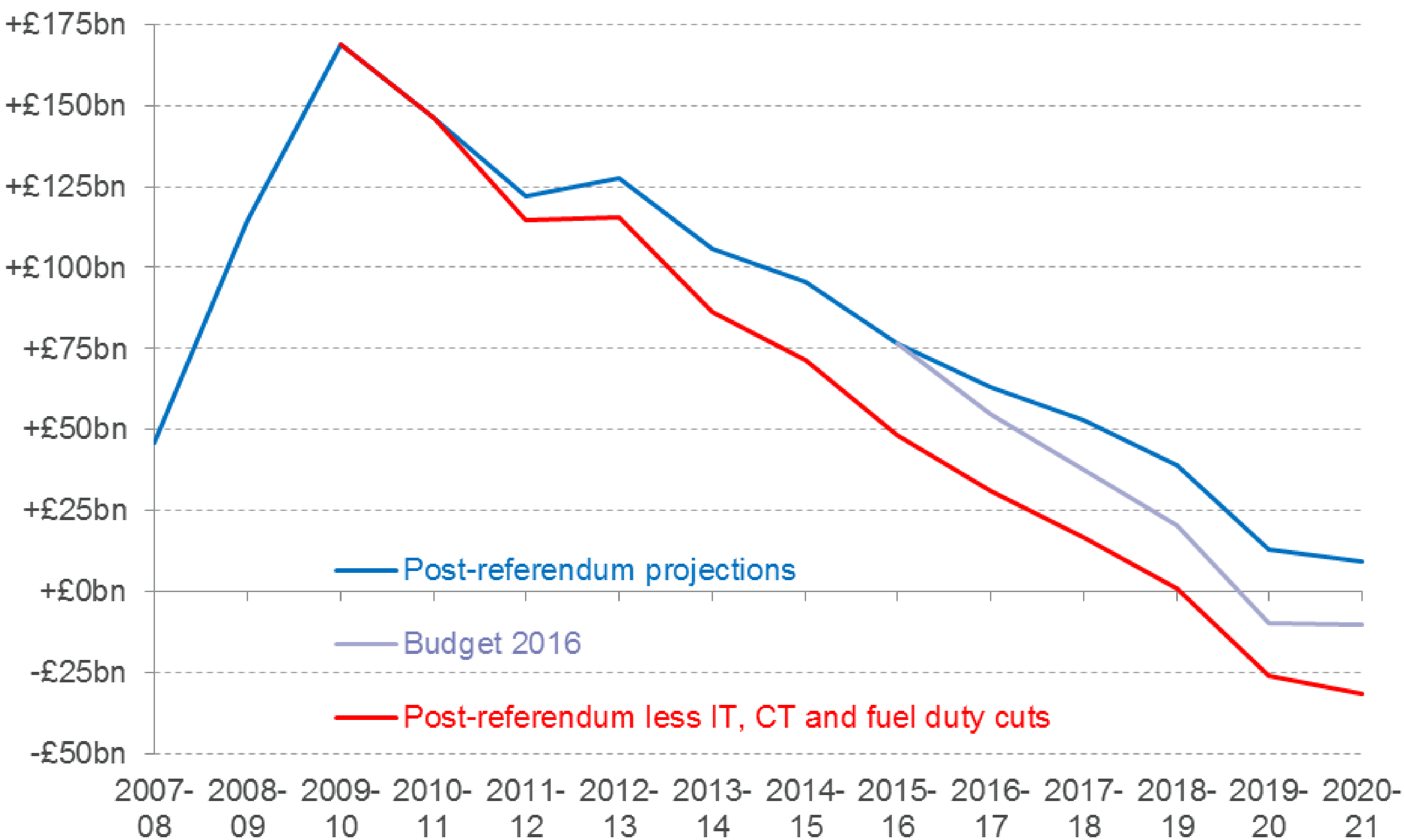
In cumulative terms, the government would have borrowed £123bn less by today

Notes: This simple exercise assumes no dynamic or behavioural effects associated with the tax cuts
Source: RF modelling using HMT & OBR data

@resfoundation

He would also remain on course to deliver an *overall* budget surplus in this parliament, as targeted by his predecessor

Public sector net borrowing, 2015-16 prices



In *Pressing the reset button* we showed how the £10bn surplus in 2019 that was anticipated at the March Budget was set to be replaced by a £13bn *deficit*

But removing the major tax cuts discussed here brings the point of budget balance into 2018

Notes: This simple exercise assumes no dynamic or behavioural effects associated with the tax cuts
Source: RF modelling using HMT & OBR data

And the income tax policy is set to cost more still because of both changed circumstances and the need to deliver on pre-election pledges

RF

- Employment has tended to come in higher and inflation lower than anticipated at the time of each income tax policy announcement. The result is both that more people have been affected and that each uplift has represented a bigger increase relative to the index-linked default than previously thought

  → Our estimate is that the true cost of the policy is likely to come in around £5bn higher than suggested by the original OBR costings

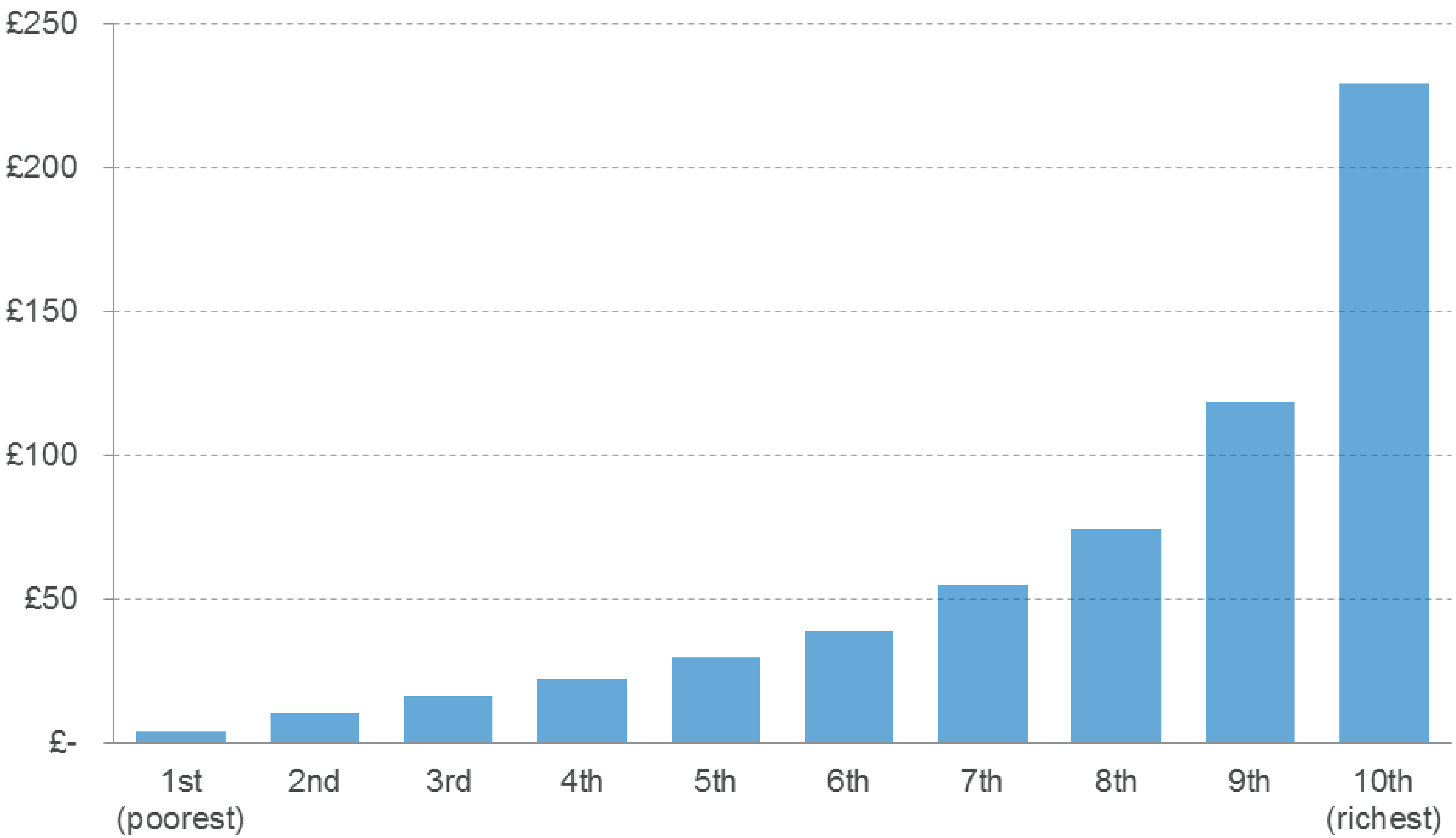
- While the already announced policy measures take the personal allowance to £11.5k in 2017 and the higher rate threshold to £45k, the manifesto pledges of £12.5k and £50k by the end of the parliament require further above-inflation increases

  → Our estimate is that delivering on these pledges would cost an additional £2bn in 2020, less than previously expected due to higher inflation

- Going forward, the government has linked the personal allowance to the equivalent of 30 hours a week on the National Minimum Wage. This level is determined by the Low Pay Commission's recommendations, but likely approximates to an average earnings link and therefore represents a significant increase in the pace of uprating and an end to fiscal drag

With the overwhelming majority of the gains from further tax cuts in this parliament going to households in the top half of the income distribution

Average increase in net income as a result of increasing the PTA to £12.5k and the HRT to £50k in 2020-21 (2015-16 prices)



Source: RF modelling using the IPPR tax benefit model

Of the estimated additional £2bn cost associated with going beyond existing income tax policy in order to deliver on the manifesto pledge, roughly £1.7bn would be targeted at the richest half of households

The top 10% alone would account for £0.8bn

BROAD SHOULDERS: NARROW BASE

Policy changes have shifted the composition of government receipts, and who pays

The tax base has altered in two distinct and important ways in recent years

1. The relative importance of different taxes has shifted, with the contribution of corporate taxes and non-VAT indirect taxes (such as fuel duty) falling in recent years and the arrival of a number of new, very small taxes

   → *the manner in which this has occurred raises questions over the coherence of the government's overall tax strategy*

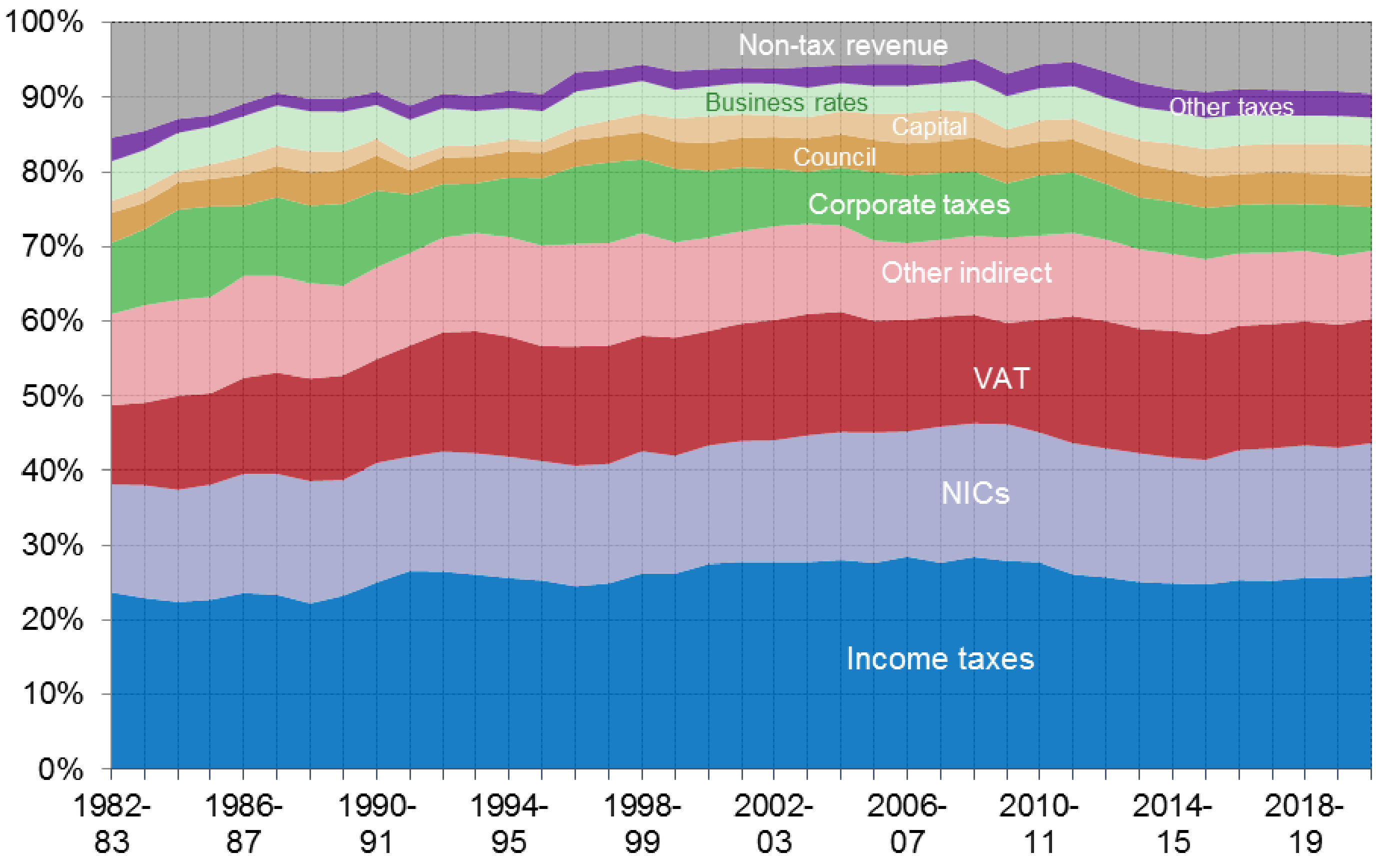
2. The incidence of the largest tax – income – has become increasingly concentrated on the highest earners thanks both to rising income inequality and government policy

   → *has implications for the stability of tax revenues over the economic cycle*

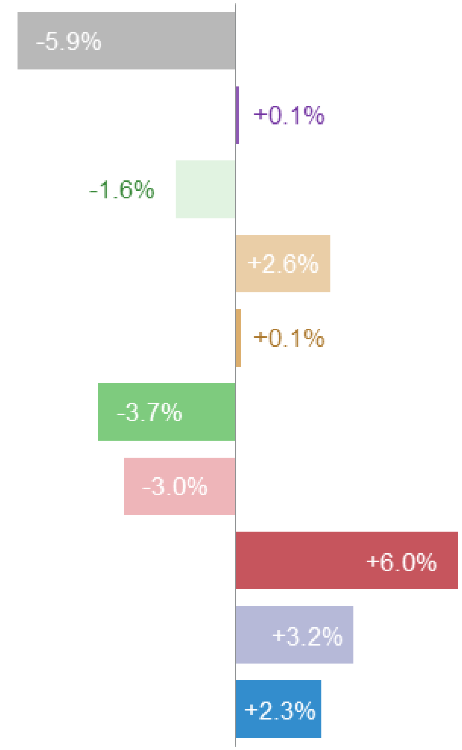
A combination of economic factors and politics has fed into a longer-term change in the composition of UK receipts

RF

Composition of government receipts



Percentage point change, 1982-2020



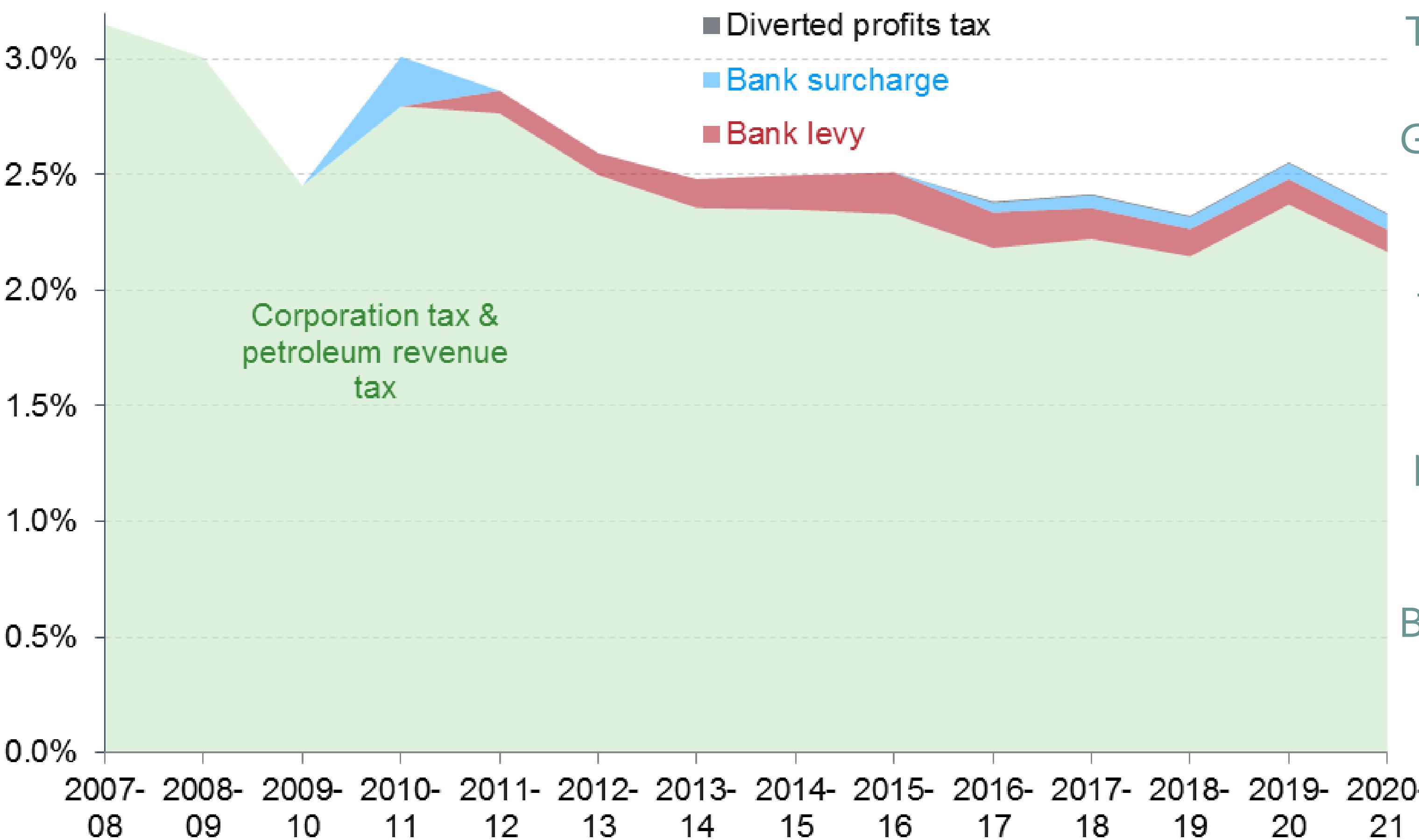
Notes: See Appendix for details of the taxes sitting in each category.
Source: OBR, HMRC& IFS

@resfoundation

The post-crisis drop in corporate tax receipts would be starker still in the absence of the arrival of a selection of new taxes

RF

Corporate taxes as a share of GDP: outturn and projection



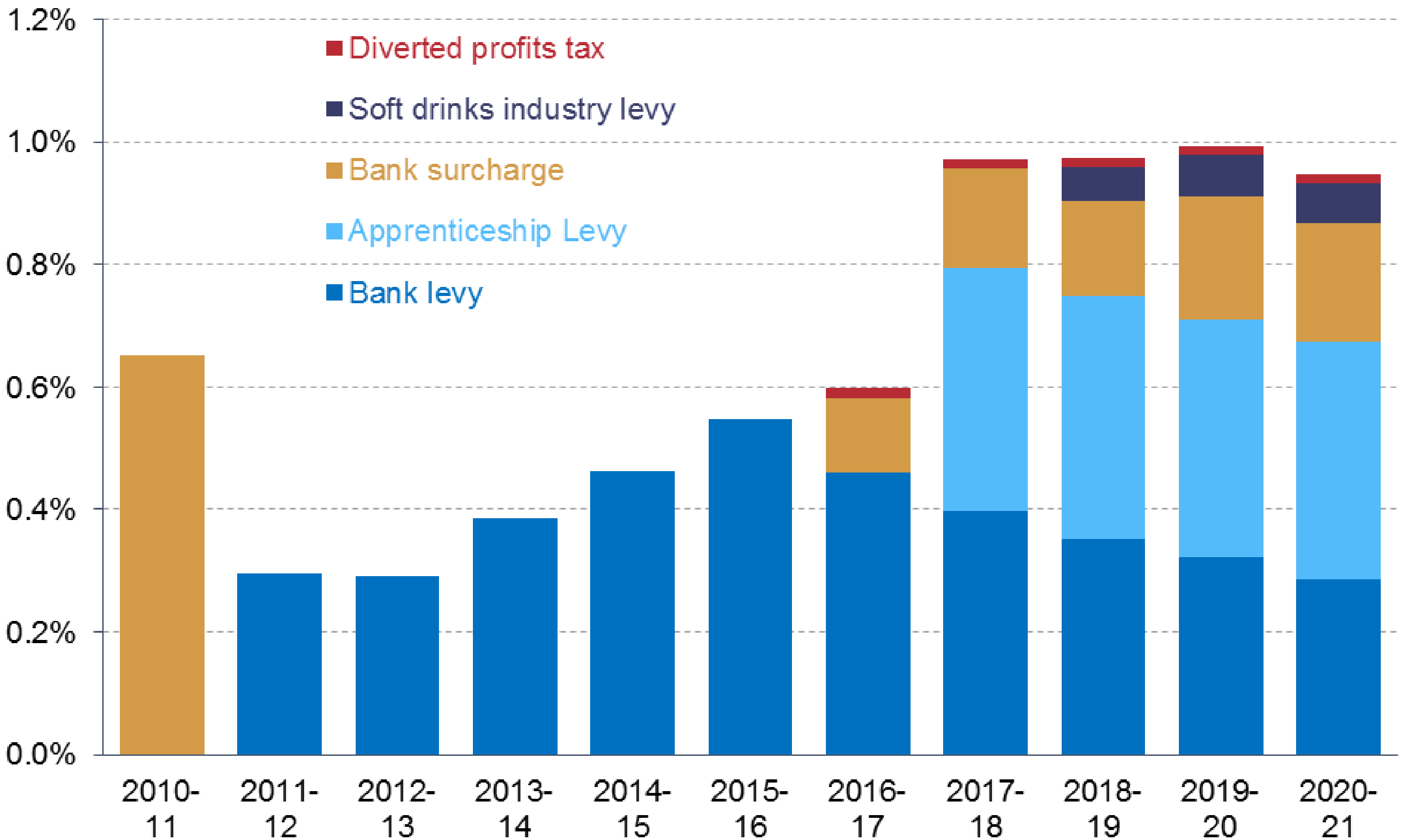
Source: OBR & HMRC

The fall in corporate taxes as a share of GDP is driven in part by economic effects, with the financial sector and North Sea Oil revenues faring particularly badly in recent years

But sharp cuts in the main CT rate mean that structural reduction is also taking place

In combination with other taxes introduced since 2010, these new measures are set to comprise a small but growing share of the overall tax take

Share of all UK taxes accounted for by 'new' taxes

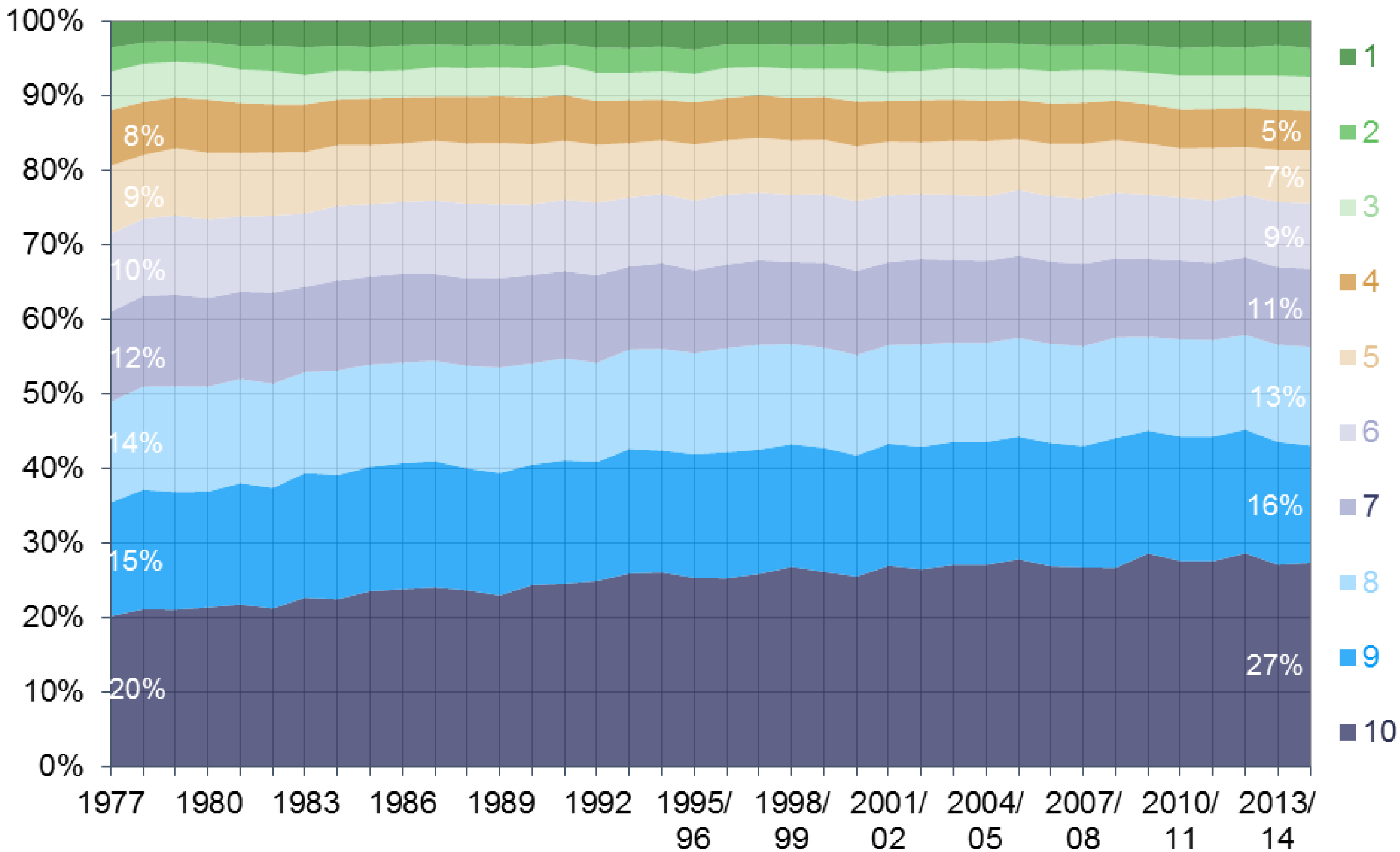


Source: OBR & HMRC

Increased diversity of revenue sources can provide some insurance against economic shocks, but the increased use of such small taxes can pose challenges around efficiency and compliance

As well as a shift in the number and scale of different taxes, the make-up of *who* pays has also changed substantially

Incidence of all direct and indirect taxes by household income decile (1 = poorest 10%)

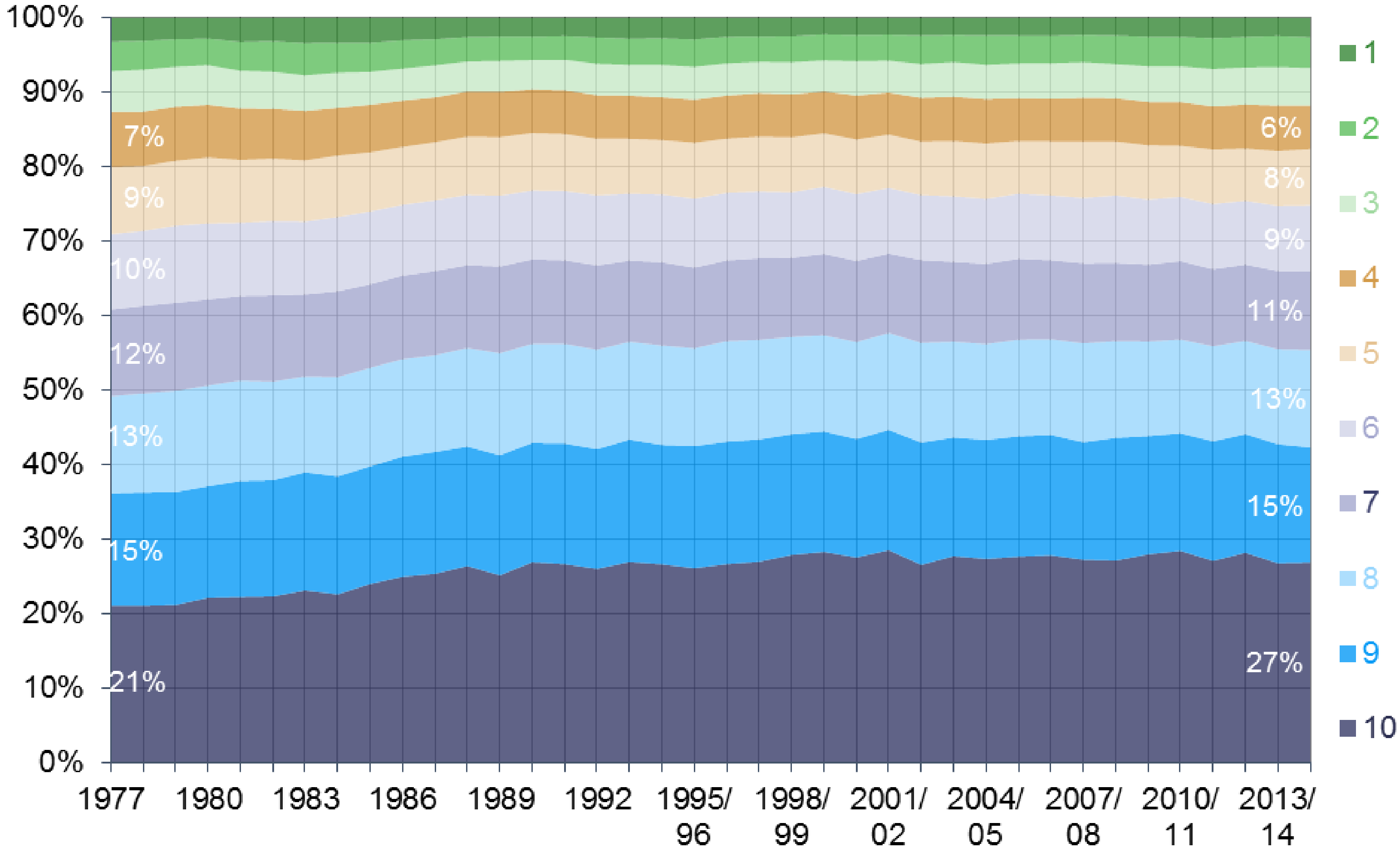


Focusing on taxes charged to individuals or payable via price effects, the proportion accounted for by the richest 10% of households increased from 20% to 27% in the three and a half decades after 1977

Source: ONS, Effects of Taxes and Benefits on Household Incomes

This broadly matches the sharp increases in inequality of pre-tax income recorded in the 1980s

Share of total pre-tax income by household income decile (1 = poorest 10%)

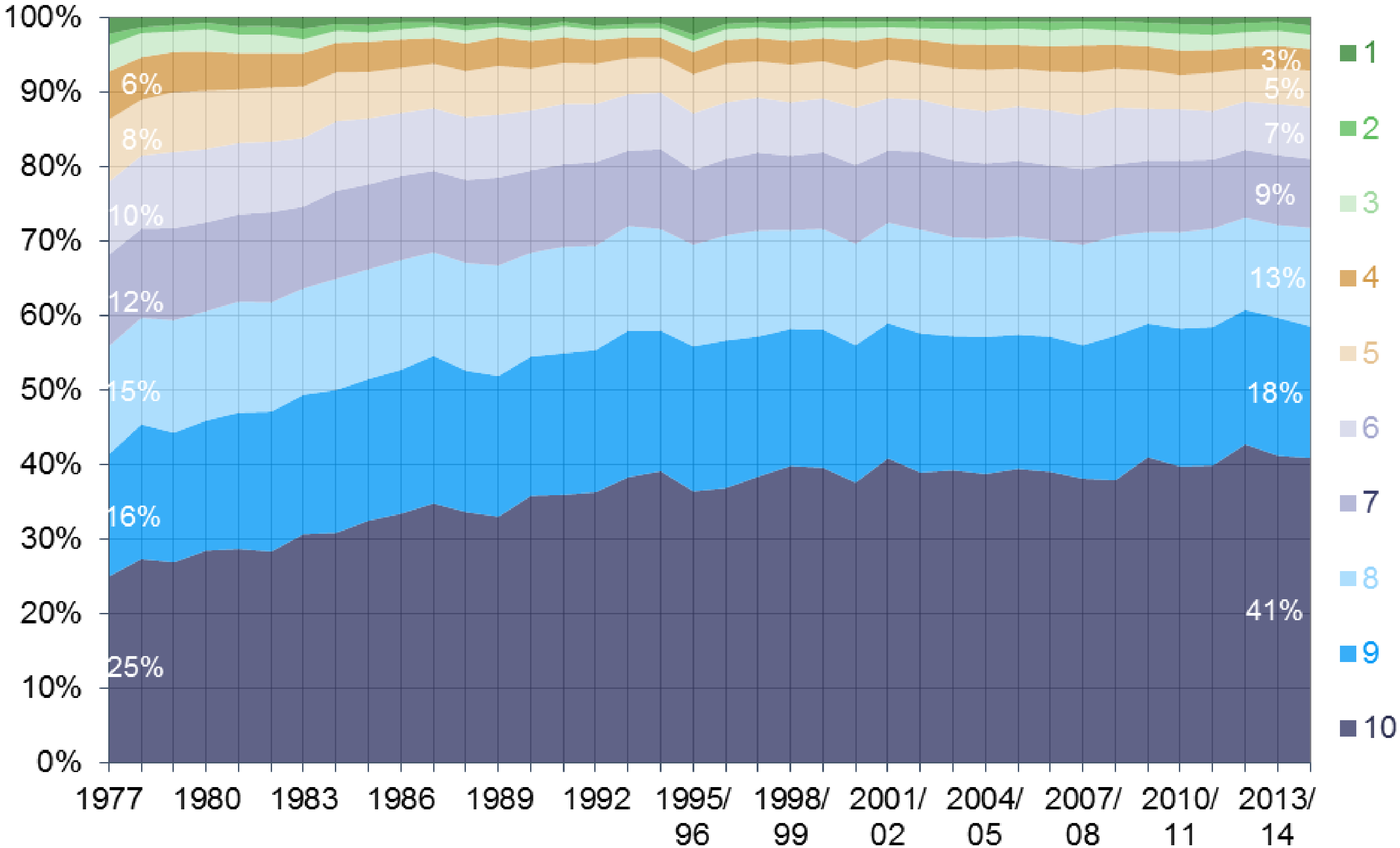


The increasing dominance of the top half of the income distribution in the tax take reflects the sharp increases in pre-tax income inequality over the course of the 1980s

Source: ONS, Effects of Taxes and Benefits on Household Incomes

Focusing on income tax, we see that the richest 10 per cent of households account for roughly 40p of every £1 collected – up from 25p in 1977

Incidence of income tax by household income decile (1 = poorest 10%)



Source: ONS, Effects of Taxes and Benefits on Household Incomes

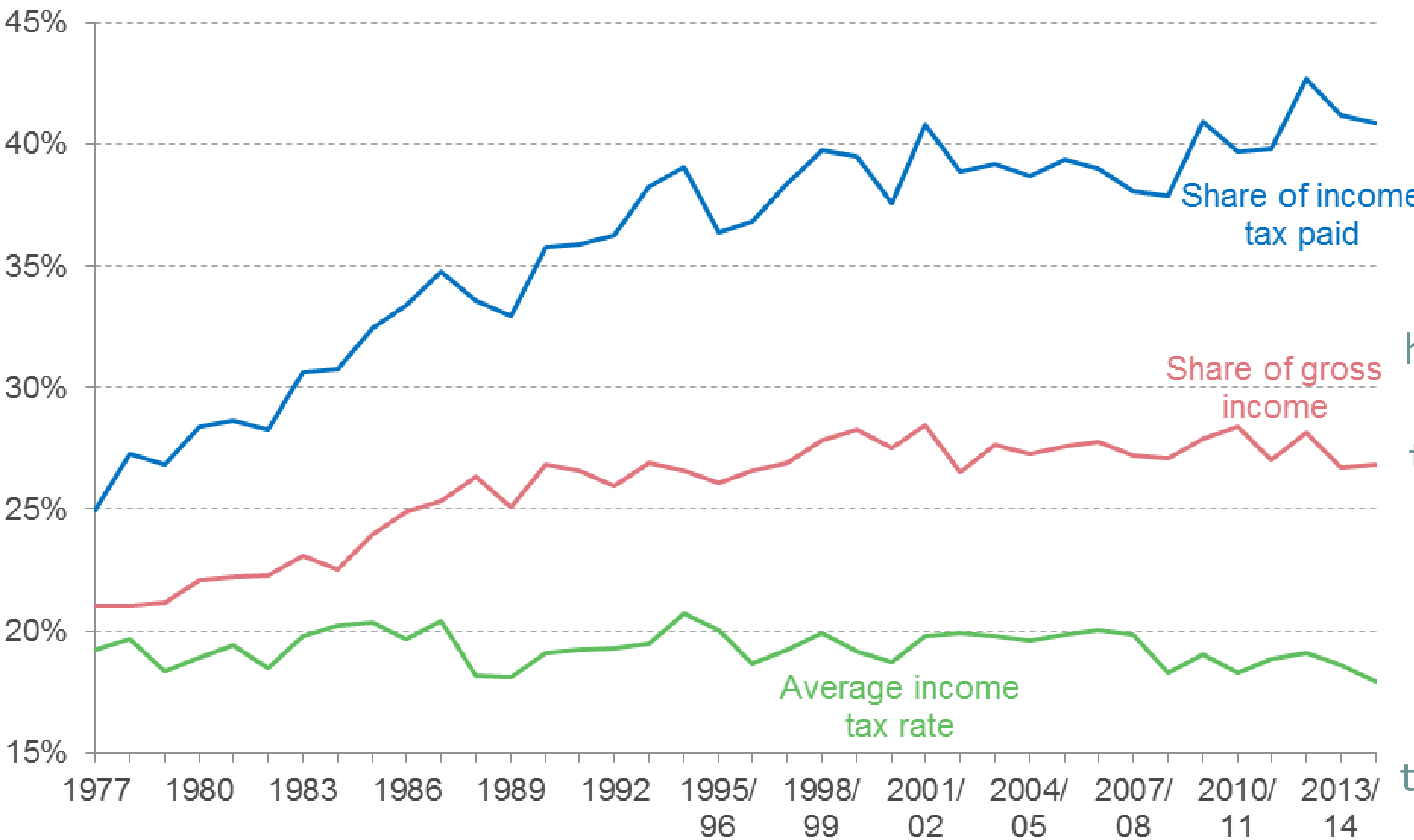
Taken together, households in the top half of the income distribution account for 88% of income tax, up from 78% in 1977

That increase comes despite *falling* shares among households in deciles 6-8

Again this matches growing income inequality during the 1980s, but more recent changes owe something to policy as well

RF

Share of income and income tax and average tax rate (tax paid divided by income) among the richest 10% of households



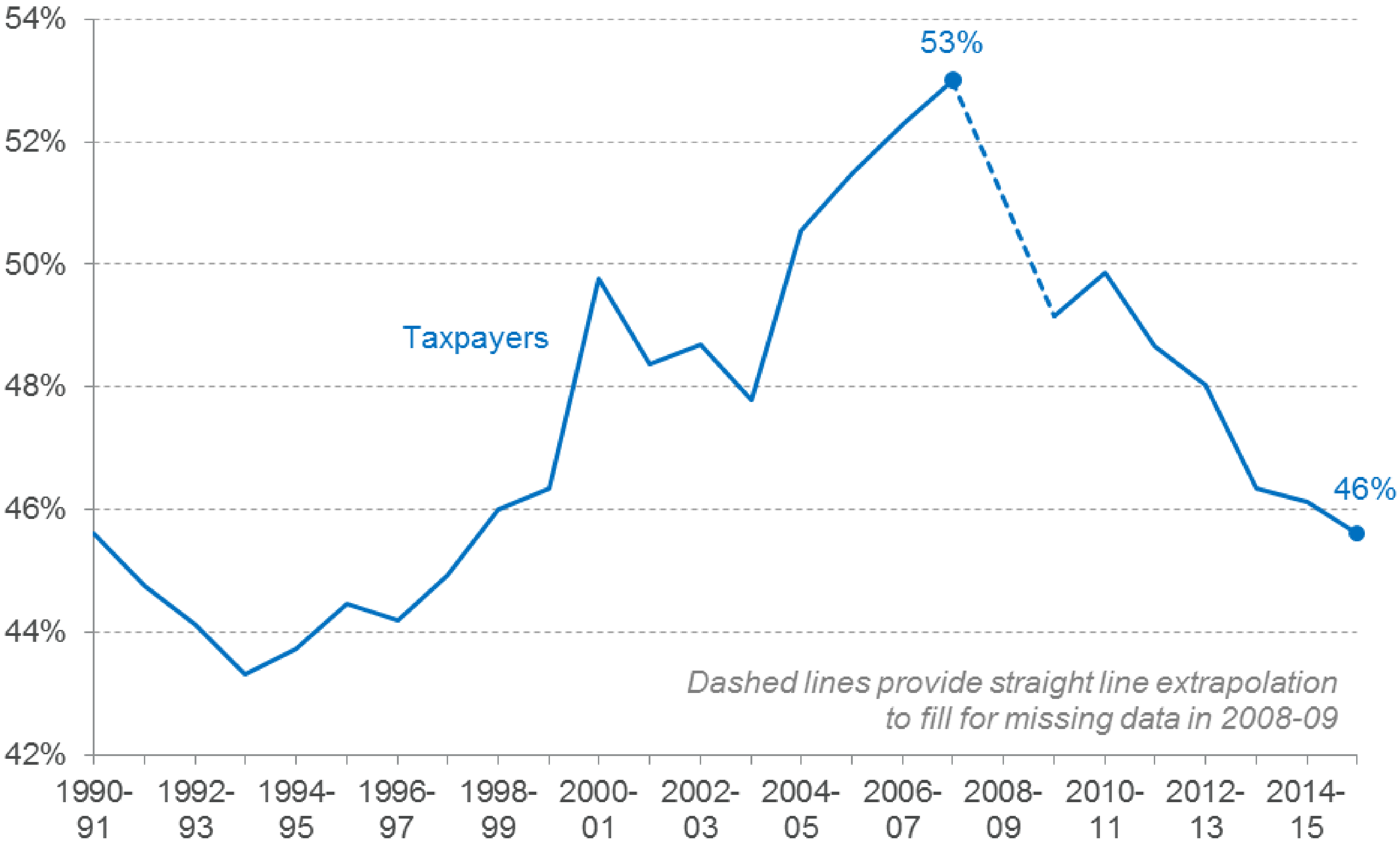
Source: ONS, Effects of Taxes and Benefits on Household Incomes

The top 10% of households have accounted for a rising share of income tax post-crisis, even as their share of income has flat-lined. A flat average tax rate in the group suggests that this is the product of a narrowing base rather than a heavier burden – though the average rate *has* increased at the very top

Revenues have become more concentrated post-crisis partly because an increasing share of the population has paid *no* income tax

RF

Proportion of total UK population

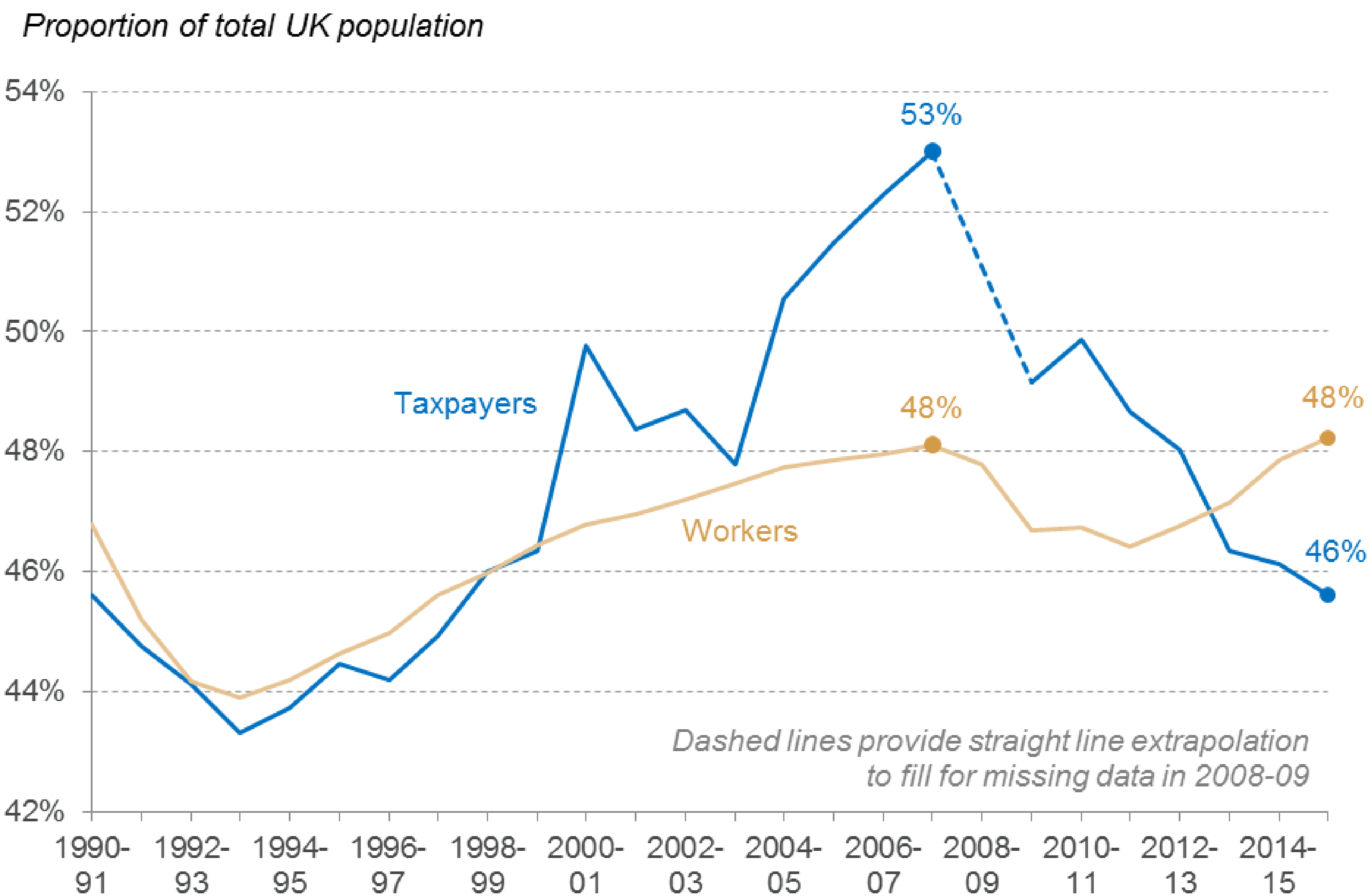


Pre-crisis, the share of the UK population paying income tax climbed, peaking at 53% in 2007

But it has fallen rapidly since. At 46% in 2015, it is roughly back to its 1998 level

Notes: Break in the series in 2008-09 due to missing data.
Source: HMRC, Survey of Personal Incomes

With this fall coming even as the share of the population in work has returned to its pre-crisis level

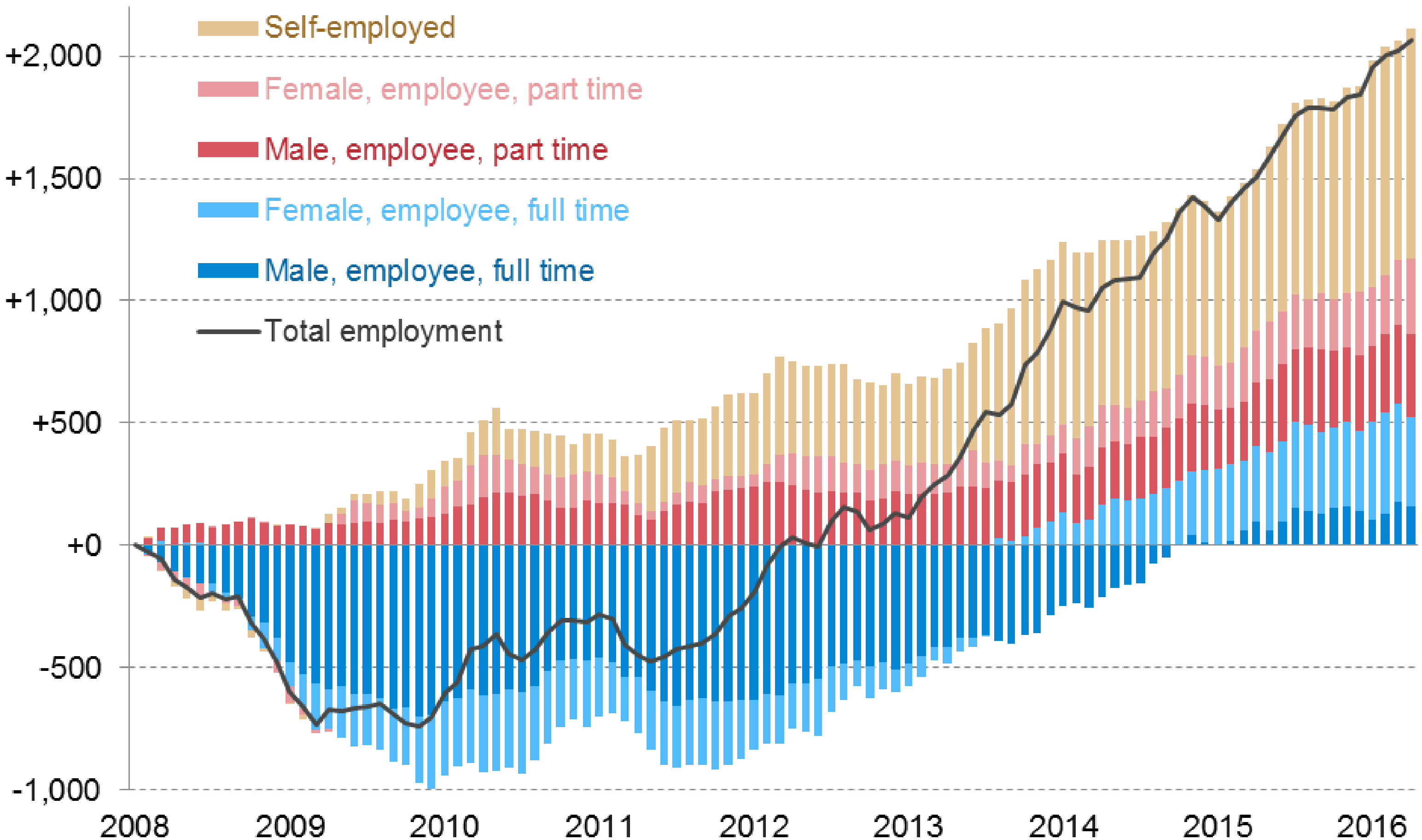


While the biggest drop in the income tax base came as employment fell at the start of the crisis, its sustained decline contrasts markedly with the strong recovery in employment

Notes: Break in the series in 2008-09 due to missing data.
Source: HMRC, Survey of Personal Incomes

In part, this shift is associated with a change in the type of employment held by workers since the crisis

Change in employees and self-employment since May 2008 (thousands)



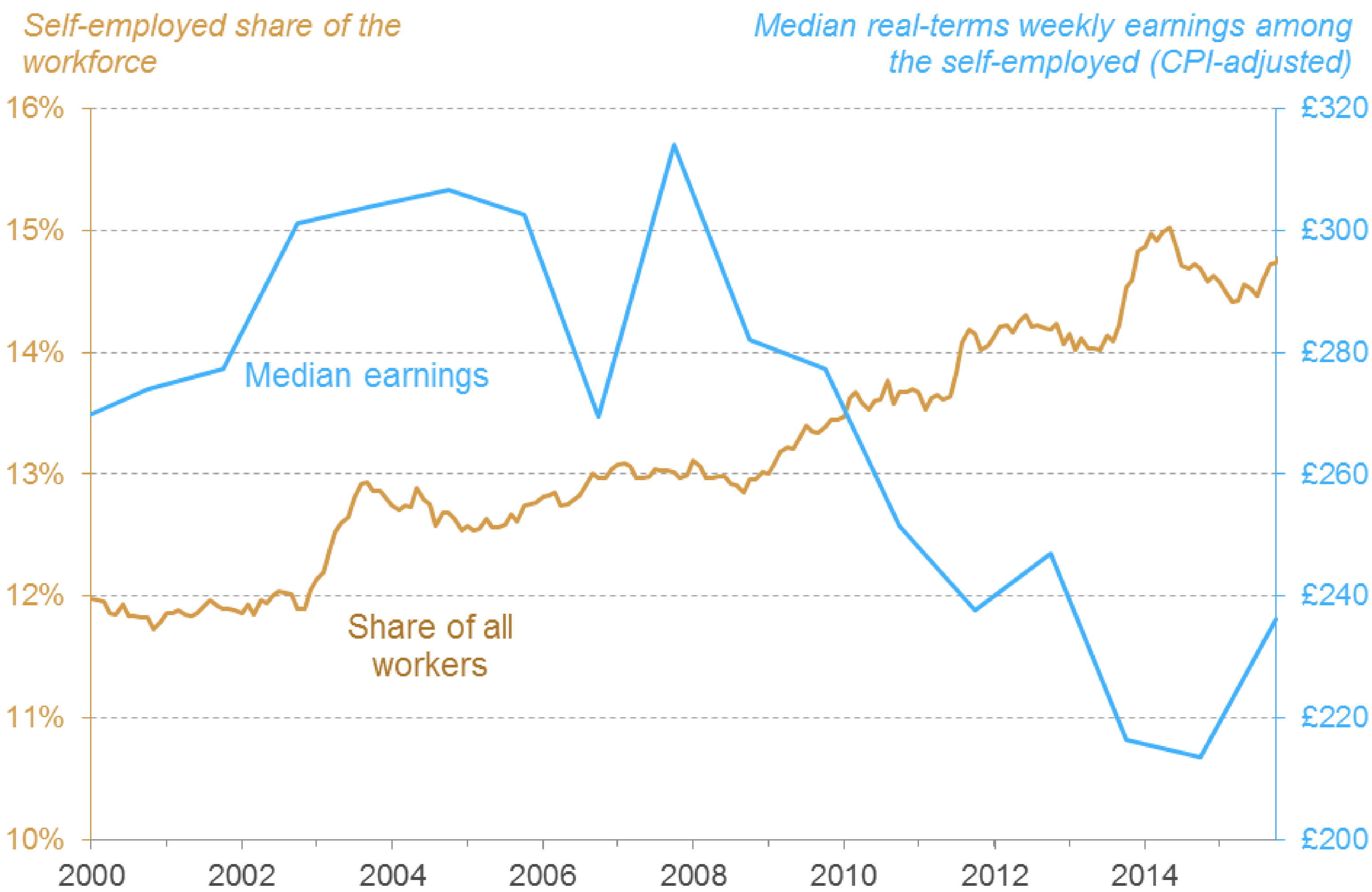
Job losses post-crisis were concentrated among full-time employees, with part-time work and self-employment faring better

Of the 2.1m extra jobs created since May 2008, just 0.5m are in full-time employee jobs

Source: ONS

With the growth in self-employment in particular likely to be affecting the income tax take

RF



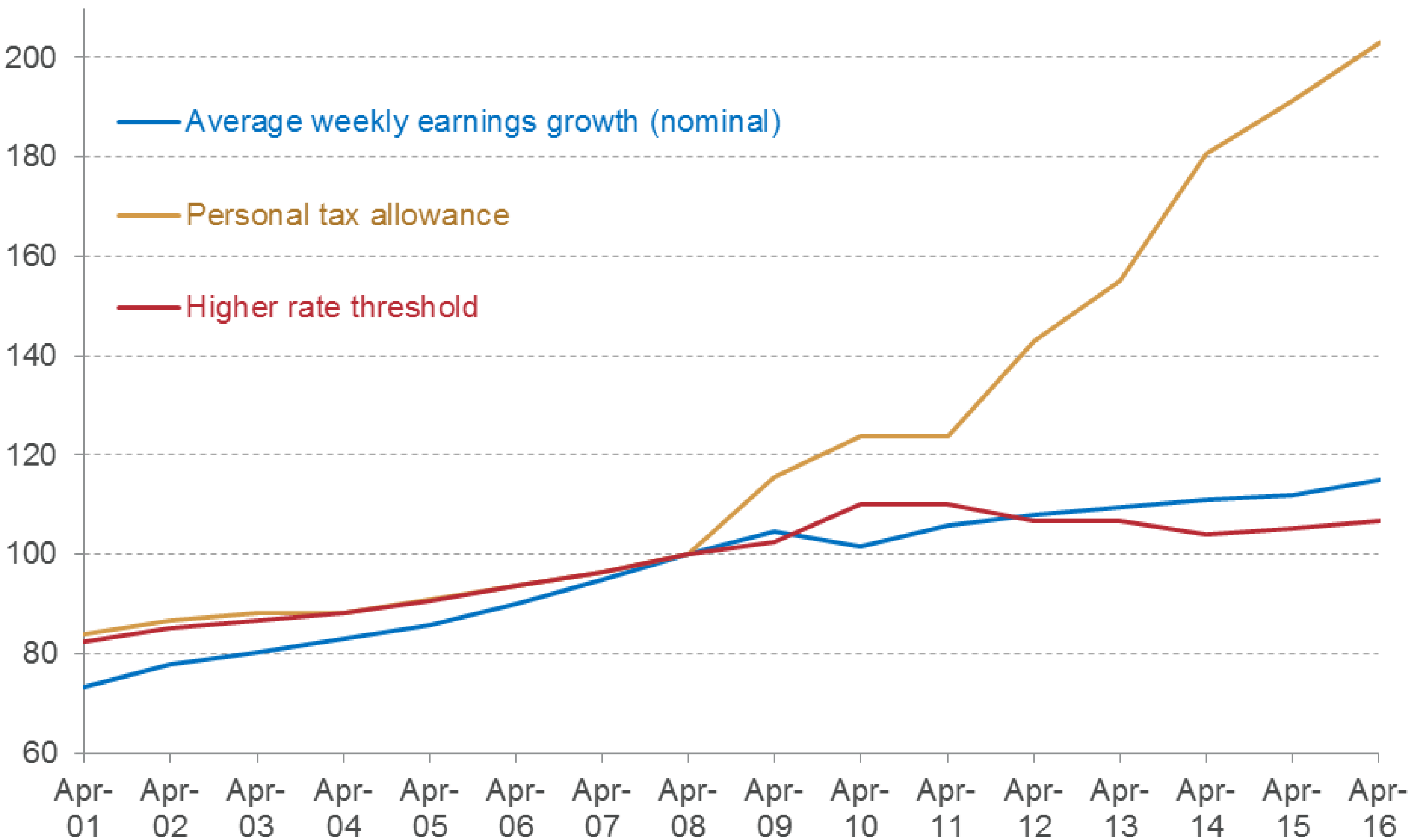
Source: ONS, Labour Market Statistics

Median self-employment incomes are only just above the personal allowance, meaning close to half are outside of income tax

An even higher share of part-time workers pay no income tax, with close to 60% earning too little

But the declining tax base is also a product of increases in the tax threshold that have rapidly outpaced earnings growth

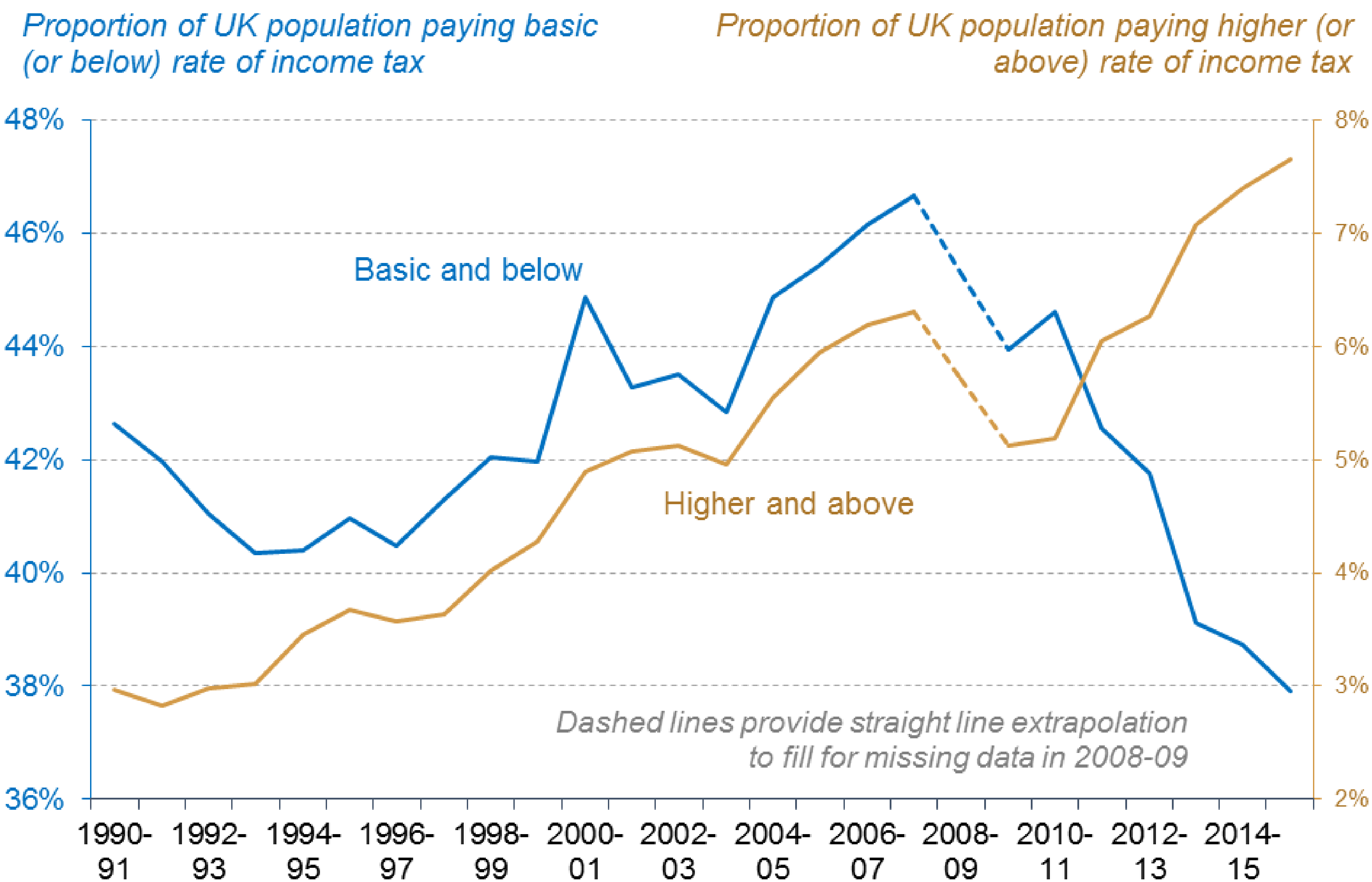
Indices of average earnings and income tax thresholds (April 2008 = 100)



Announcing the April 2017 increase in the personal allowance at Budget 2016, George Osborne estimated that it would lift a further 1.3 million out of income tax

Notes: Average weekly earnings cover basic pay and bonuses and are three month averages ending in April each year.
Source: ONS, Labour Market Statistics

While the overall share of the population paying income tax has fallen, the share paying higher rate and above has increased



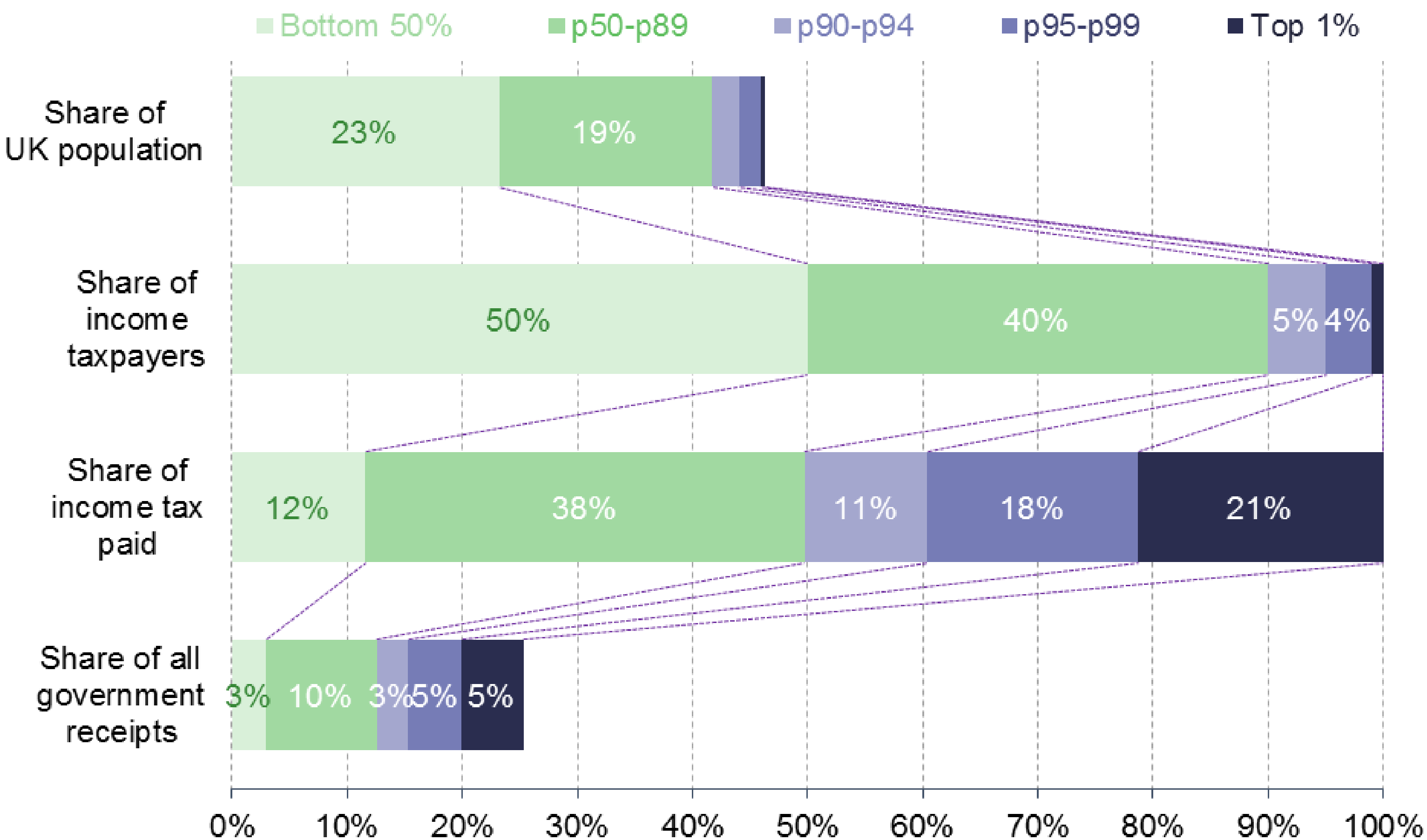
The share of the total population paying basic rate tax or lower peaked at 47% in 2007, but has now fallen to just 38%

Despite the overall decline in the tax base, the share paying higher rate and above is higher than ever, approaching 8%

Notes: Break in the series in 2008-09 due to missing data.
Source: HMRC, Survey of Personal Incomes

The result is that an increasing share of income tax comes from a relatively small group of higher earners

*Size and contribution of different parts of the income taxpaying population: **1999-00***



In 1999, the top 1% of income tax payers comprised 0.5% of the UK population and paid 21% of all income tax

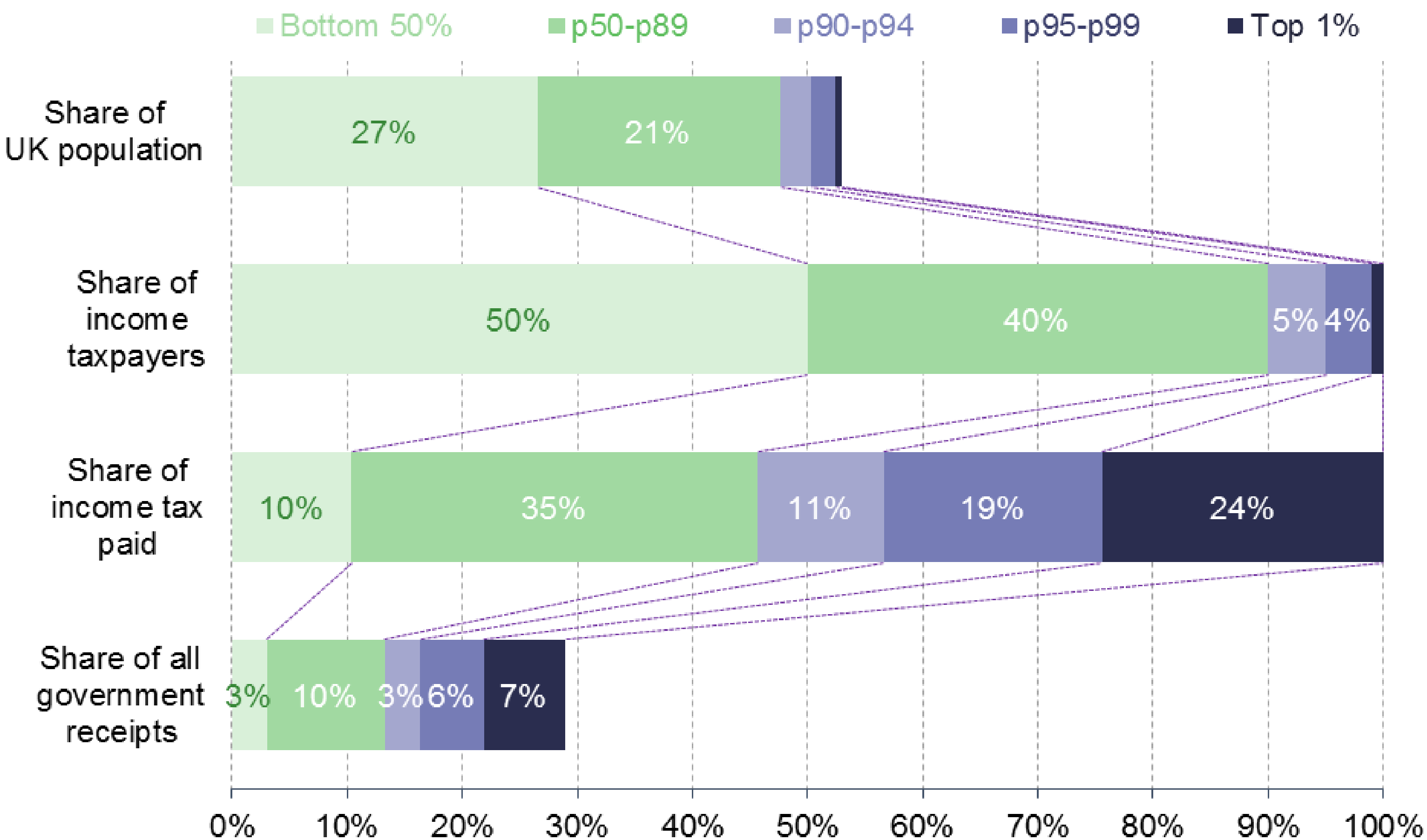
This was equivalent to 5% of all government receipts

Source: HMRC, Survey of Personal Incomes

The result is that an increasing share of income tax comes from a relatively small group of higher earners

RF

Size and contribution of different parts of the income taxpaying population: ***2007-08***



By 2007, the top 1% of taxpayers comprised a marginally larger part of the population, but now contributed 24% of all income tax

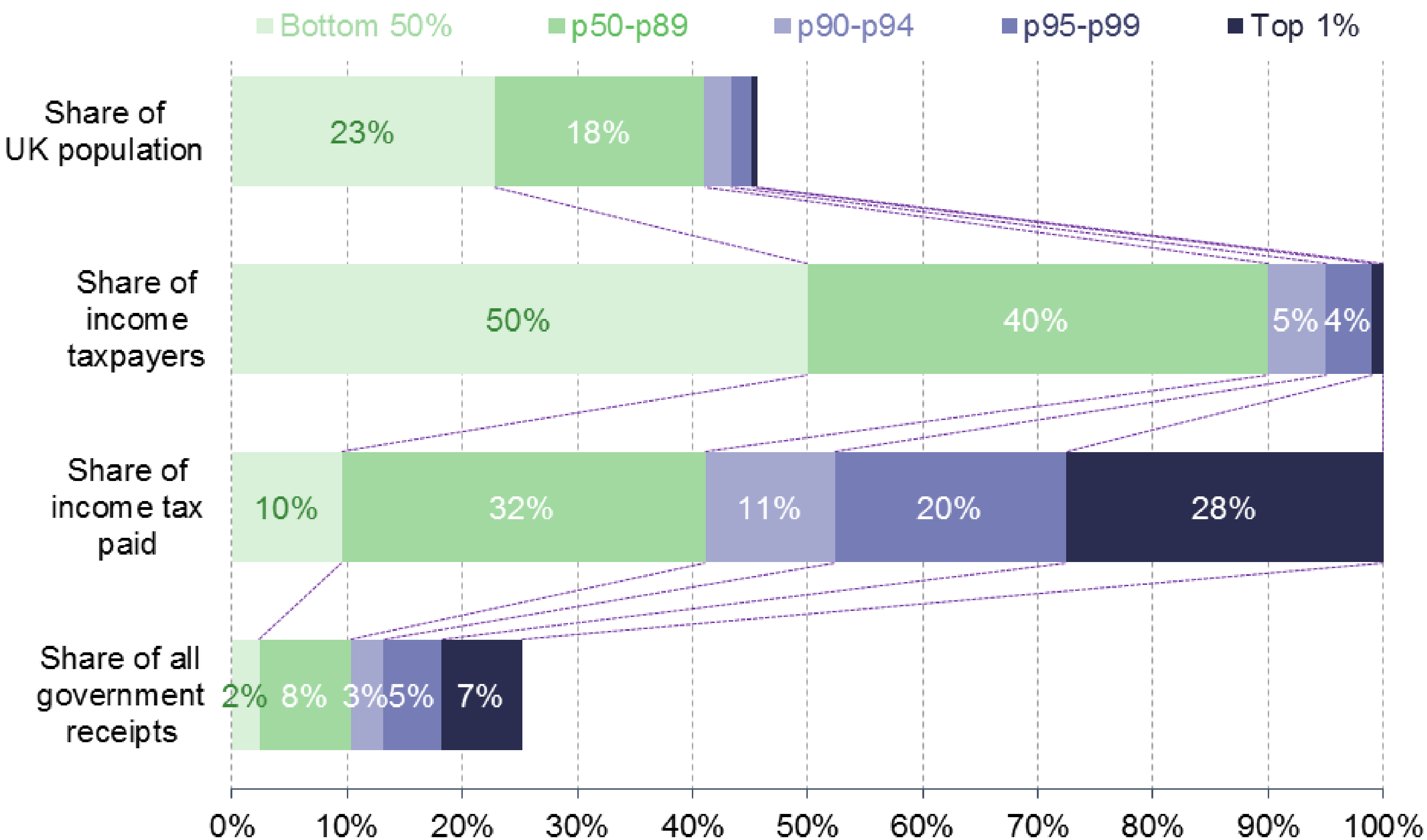
That now accounted for 7% of all government receipts

Source: HMRC, Survey of Personal Incomes

The result is that an increasing share of income tax comes from a relatively small group of higher earners

RF

Size and contribution of different parts of the income taxpaying population: ***2015-16***



In 2015, the contribution made by the top 1% of income tax payers jumped to 28% , despite little change in their population share

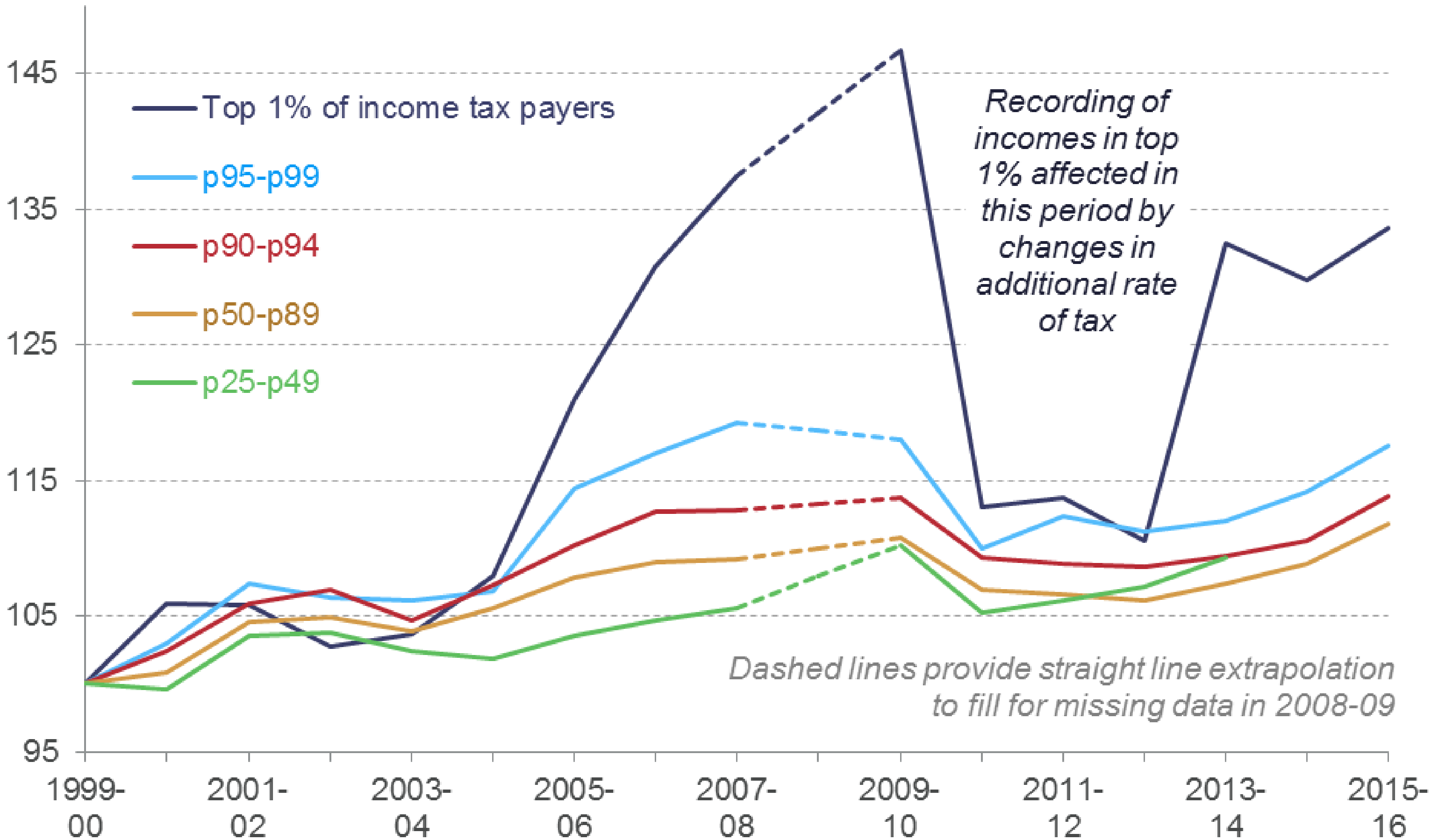
However, this still amounted to 7% of government receipts due to the reduced importance of income tax

Source: HMRC, Survey of Personal Incomes

Which brings (upside and downside) risks due to the volatility of top incomes across the economic cycle

RF

Indices of real-terms average incomes (before tax) by income tax payer group: 1999-00 = 100 (RPIJ-adjusted)



Average gross incomes among the top 1% of income tax payers jumped by nearly £150k (in 2015 prices) in the decade from 1999

But they then fell by £53k between 2009 and 2014

Notes: Break in the series in 2008-09 due to missing data. The raised personal allowance has a compositional impact on income growth at the lower end of the taxpayer population.

Source: HMRC, Survey of Personal Incomes

CHANGING TAX

The new Chancellor has the opportunity to reprioritise tax and spending in the Autumn Statement

The size and shape of the UK's tax base – and the extent to which these have shifted in recent years – matter for revenue levels, equity and sustainability

RF

- Deficit reduction has been a dominant economic policy goal since 2010. Tax receipts, despite being half the story of the public finances, have played a marginal role in achieving that goal to date. Despite some large tax increases delivered in this period, very significant tax cuts have pulled in the opposite direction meaning that the bulk of fiscal consolidation has been achieved via spending cuts.
- Significant and repeated cuts to income tax, corporation tax and fuel duty stand out as structural shifts that, combined, have been sufficient to stop the government meeting its fiscal targets. But it is not just tax receipt levels that matter, the *shape* of the tax base is also an important consideration from the perspective of both equity and public finance sustainability.
- The erosion of significant elements of the tax take in recent years has been compensated for in part by the introduction of a plethora of small taxes. Alongside the apparently indefinite delaying of default fuel duty rises, this has given a sense of an ad hoc approach to policy. There may be merit in diversifying away from the big three of income tax, NICs and VAT – and the new taxes may be desirable for other reasons – but there are potential trade-offs in terms of efficiency and equity which have been under-explored.
- The UK tax base has also shifted over recent decades as a result of growing income inequality which, when combined with tax policy decisions, has increased reliance on a smaller group of taxpayers without sufficient discussion of the trade-offs involved.

In pressing the fiscal 'reset' the Chancellor should abandon his predecessor's pursuit of narrowing the tax base

RF

- The new Chancellor has an important opportunity to rethink tax strategy in his first autumn Statement. He should:

    1. given the changed circumstances, move away from further expensive plans to raise the personal allowance to £12,500 and the higher rate threshold to £50,000 by 2020 costing roughly £2bn at a time when the public finances are already facing a deterioration of £20bn annually by the end of the Parliament. Given that the gains from this policy flow overwhelmingly to the top half of the income distribution, it represents an expensive and poorly targeted measure.

    2. drop plans for further cuts to corporation tax that are not necessary for the UK to maintain a highly competitive tax regime.

- If the Chancellor wants to do more to target 'just managing families' then options are available for better-targeting support at this group which we will discuss next week, in the third of our pre-Autumn Statement reports.

ANNEX

Tax measures split by the categories used in this report

RF

Income taxes
- Pay as you earn
- Self-assessment
- Temporary bank payroll tax

NICs
- National Insurance Contributions

Council
- Council tax
- Community charge
- Domestic rates

Capital
- Capital gains tax
- Inheritance tax
- Stamp duty land tax
- Stamp taxes on shares

VAT
- Value Added Tax

Corporate taxes
- Onshore corporation tax
- Offshore corporation tax
- Windfall tax
- Petroleum revenue tax
- Supplementary petroleum duty
- Bank levy
- Oil royalties
- Bank surcharge
- Diverted profits tax

Business rates
- Business rates

Other indirect taxes
- Fuel duties
- Tobacco duties
- Spirits duties
- Wine duties
- Beer and cider duties
- Betting and gaming duties
- Car tax
- Air passenger duty
- Insurance premium tax
- Landfill tax
- Climate change levy
- Aggregates levy
- Customs duties and levies
- Vehicle excise duties
- Soft drinks industry levy

Other taxes
- Apprenticeship levy
- VAT refunds
- EU ETS Auction Receipts
- Scottish taxes
- National Lottery Distribution Fund
- Rail franchise premia
- Environmental levies

Non-tax revenues
- Gross operating surplus
- Interest and dividends (ex APF)
- TV licences
- Business rate payments by LAs
- Accruals adjustments

Bibliography

- *DWP, Family Resources Survey*
- *HMRC, Income tax statistics*
- *HMRC, Survey of Personal Incomes*
- *HMT, Forecasts for the UK economy*
- *IFS, revenue composition spreadsheet*
- *OBR, Economic and fiscal outlook*
- *OBR, Public finances databank*
- *OECD Stat*
- *ONS, Annual Survey of Hours and Earnings*
- *ONS, The Effect of Taxes and Benefits on Households Incomes*
- *ONS, Labour market statistics*

Changing Tax

Pressing reset on the UK's tax policy

Matt Whittaker

November 2016