A matter of tax

Pre-election briefing on the main parties’ tax policies

Adam Corlett
May 2017
Summary

There is much that is unusual about the 2017 general election, from its surprise announcement to the dominance of a single issue – Brexit – on which the parties themselves remain split. Particularly remarkable is the extent to which the tax debate has so far focused more on options for tax rises rather than tax cuts.

The backdrop for this debate is the multitude of tax policies delivered over the last seven years – a mix of tax rises, tax cuts and some limited tax reforms. These related in part to deficit reduction, but political determination to lower income and corporation taxes has also been key, with most tax increases funding tax cuts elsewhere.

Ahead of the 2015 election, all the major parties called for income tax cuts, despite the deficit. But two years on, the ground appears to have shifted. A smaller but still significant budget deficit remains, with elevated debt and looming demographic pressures sharpening the case for a continued focus on the public finances. There is evidence that public opinion has moved on too, and of course those earlier promises have reduced the scope for more tax cuts in the years to come. Add in continued uncertainty about the costs and opportunities that leaving the EU will present – and the altered focus of the tax debate appears understandable.

In this paper – part of our pre-election series – we look at the range of policies which have emerged in this pre-election campaign to date. Some of our analysis is necessarily speculative at this stage but a lot has already been revealed (not least through a full scale leak of the Labour manifesto).

The tax take is both little altered and much changed

In the first of our series of pre-election notes, we looked at the potential shape of the main parties’ approaches to government borrowing and debt. As we noted, over the past seven years the deficit has fallen considerably due to a combination of a recovering economy and active fiscal consolidation. Much of that fiscal tightening – and much of the debate it has sparked – comprised discretionary spending cuts. But tax increases have played a role too.

In 2017-18, government receipts are forecast to be 36.7 per cent of GDP: a small increase on the 36.4 per cent of a decade earlier when the financial crisis started to bite. As Figure 1 shows, this proportion has been much more stable over the past ten years than that of spending. Whereas spending is relatively fixed in cash terms in the short-term and therefore shifts as a share of GDP when the economy experiences a shock, tax receipts move more naturally with the size of the economy. Both processes are important automatic stabilisers.
Over the next four years however, receipts are forecast to rise by 0.5 per cent of GDP while current spending is forecast to fall by 2 per cent of GDP. Taking a longer-term view, such an outcome – in which receipts outweigh current spending – looks relatively unusual. The UK has achieved such a position in just seven of the past 40 years.

Underneath the apparently steady picture on tax in the last few turbulent years though, much has been going on. Most notably, there has been a significant churn in the make-up of our taxes. Figure 2 presents a non-exhaustive selection of some of the biggest tax rises (together raising £49 billion) and biggest tax cuts (together costing £48 billion) introduced since 2010.

It is difficult to identify any overarching strategy in this series of changes. On the one hand, a shift away from taxing corporate and (low to middle) personal income towards consumption and targeted tax rises might be argued as being consistent with OECD advice about what taxes are most economically harmful. On the other – more sceptical – hand, some very high profile and politically popular tax cuts (to income tax, fuel duty and the headline corporation tax rate) might be presented as having been funded by a myriad of less transparent, small tax rises (with the exception of the 2011 VAT rise).

[2] These sums are based on estimates from the time of each policy announcement and may not reflect more recent outturn figures and forecasts.

The debate over tax increases may have shifted too

In 2017, the pre-election debate so far has – perhaps remarkably for a pre-election period – focused more on policies to raise taxes more than on promises of tax cuts. There may be several reasons for this.

One is the way in which the Chancellor had his fingers burned at the Spring Budget over the matter of National Insurance. While his attempt to narrow the gap between the self-employed and employees had much to merit it, he found himself running up against his party’s 2015 ‘tax lock’ promise not to increase any of the major rates of tax (which partly explains the above proliferation of smaller taxes). Hopefully such broad and inflexible promises will not be repeated this time around.

A second reason for a renewed focus on tax rises – or at least the absence of promises on tax cuts – is likely to relate to the outlook for public finances. While the deficit has fallen back towards levels that governments have been comfortable with in past decades, the large post-referendum upwards revision in the borrowing forecast and current economic uncertainty mean that the parties are likely to be understandably nervous about expensive tax promises.

Third there is public opinion. After years of departmental and welfare spending cuts, attitudes appear to be shifting. Figure 3 shows that the proportion of adults supporting tax and spending increases troughed in 2010 (perhaps reflecting people’s concerns about their personal finances at the time as well as about the state of public spending), but has since risen again. Only 4 per cent claim to want reduced taxes and lower spending: the lowest level since 2002.
Prudent politicians may also have one eye on demographic forecasts. As the fiscal forecasting horizon stretches further – moving out to 2022-23 in the next Autumn Budget – the government will have to pencil in reactions to more of the demographic changes due in the 2020s. To give a sense of scale, the OBR has estimated that between 2021-22 and 2025-26, an ageing population (including health and pensions cost pressures) will force up health spending by 0.6 per cent of GDP, care spending by a further 0.1 per cent, and state pension spending by 0.3 per cent (with no state pension age increases likely over this period). In the absence of any correction from government, the deficit would rise – under the OBR’s assumptions – from 0.7 per cent of GDP in 2021-22 to 1.8 per cent in 2025-26.[4]

Increasing rates of self-employment, and – within that – of incorporation, have also hurt the fiscal outlook and will continue to do so if not stemmed by policy reforms. Similarly, ‘sin tax’ revenues are expected to continue to be affected by shifts towards cleaner cars and less tobacco smoking. These known trends, together with economic uncertainties and intentions to further reduce the deficit, call for caution in the parties’ promises.

We’re yet to get the full array of manifestos, but much is becoming clear on tax – thanks to a combination of trials, leaks and speeches. Ahead of knowing all the details, we offer some assessment below of the potential positions adopted by the main parties, and what this might mean for living standards.

The Conservative Party has the opportunity to change course

Faced with the challenges set out above, the Conservative leadership has sought to give itself more flexibility than in the last election. Sensibly, the party appears unlikely to repeat the ‘tax lock’ that ruled out headline increases in the rates of income tax, National Insurance (NI) or VAT. However, the Prime Minister has ruled out increases in the rate of VAT, and indicated that the party has no plans at present for broad tax increases. Given how much can change over a potential five year term of government, not imposing a tax straight-jacket is good policy.

The tax lock is particularly germane given its involvement in the U-turn on raising NI for the self-employed. After announcing a tax increase at the Spring Budget, Philip Hammond backed down, citing a need to be compliant with “the spirit” of previous manifesto commitments. At the same time however, he was clear that he continued to believe in the principle behind the change:

“The current differences in benefit entitlement no longer justify the scale of difference in the level of total NICs paid in respect of employees and the self-employed. [...] The measures I announced in the Budget sought to reflect more fairly the differences in entitlement in the contributions made by the self-employed. The Government continue to believe that addressing this unfairness is the right approach.”

While he promised that there would be “no increases in NICs rates in this parliament”, a new manifesto and the early arrival of a new parliament may offer a second chance for reform. Indeed, given that the increase was cancelled only after the Budget had been published and costed, the U-turn currently leaves a £500 million a year hole in the public finances.

There is certainly a pressing need to pursue reform in this area, in order to stem the fiscal losses from taxing different forms of work at different rates. And it should be noted that raising personal NI rates, while important, would still leave a large difference through the lack of employer NI for the self-employed – so there is potential to go even further than the Chancellor previously aimed for. It is also likely that any reform proposed by the Conservative Party could include some welcome new benefits for the self-employed, such as entitlements to parental pay and nudges to encourage pension saving, as well as a response to the forthcoming Taylor review. These are all good reasons to think that an NI rate increase for the self-employed – as part of a broader package – should be expected from a new Conservative government.

Alongside installing new tax rises, the party also has an opportunity to rethink some of its major tax giveaways from the 2015 election. Last time it promised that “during the next Parliament, we will increase the tax-free Personal Allowance to £12,500 and the higher rate threshold to £50,000, so you keep more of your hard-earned money.” At present, the Personal Tax Allowance (PTA) is £11,500 and the Higher Rate Threshold is £45,000. But the government hasn’t yet set out plans to take the final steps towards its pre-election pledge, raising the question of what the new manifesto will promise.

On current forecasts, achieving these goals by 2020-21 (our previous assumption) would come with a significant price tag. Raising the PTA to £12,500 and HRT to £50,000 in 2020-21 would together cost £1.3 billion. Achieving those goals in 2019-20 or earlier would be even more costly.

[5] The policy in the last manifesto of linking the Personal Tax Allowance to the National Minimum Wage was also – sensibly – dropped some time ago.


[9] OBR, Economic and Fiscal Outlook, March 2017
The gains would also flow mostly to richer households, as Figure 4 shows.

Figure 4: Raising the Personal Tax Allowance to £12,500 and Higher Rate Threshold to £50,000 in April 2020 would mostly benefit higher income families

At a time of continued deficit reduction and huge welfare cuts, the Conservative Party would do well to reconsider this expensive tax cut. And, given that these are nominal goals and that tax thresholds by default rise with CPI inflation each year anyway, the key question is not if they will rise to those levels but when. Even with inflation-only uprating, the PTA is currently forecast to exceed £12,500 in 2021-22, and the HRT exceed £50,000 by 2022-23 – both within the next parliament. These may therefore give the Conservatives an opportunity to hit their targets but at a lower – or zero – cost. If inflation forecasts are revised up then those dates could move even closer.

As shown earlier, income tax cuts (originally a Liberal Democrat policy and adopted by the coalition government) have, together with corporation tax and fuel duty cuts over the same period, become extremely expensive: together costing an estimated £45 billion in 2021-22. Some of these changes have already happened and reversals now appear unlikely. But changing future course, by cancelling the planned further cut in corporation tax from 19 per cent to 17 per cent in 2020-21 for example, has the potential to save significant sums relative to existing plans.

The UK already has the lowest corporation tax rate in the G20, and one that is significantly below the OECD average as Figure 5 shows. It is therefore fair to question just how much additional competitive advantage the country can gain from going further still. (And note that Northern Ireland’s rate may separately be lowered to 12.5 per cent – in line with the Republic of Ireland’s – as soon as April 2018.)
Maintaining the headline corporation tax rate at 19 per cent rather than cutting it further would raise an estimated £5.2 billion in 2020-21; returning to the rate of 20 per cent that prevailed until this year would raise £7.8 billion.\(^{[10]}\)

Sizeable though these numbers are, supporters of the cut might point to other aspects of the corporation tax system – such as capital allowances – on which the UK looks less generous: an issue when considering the country’s low investment and low productivity growth.\(^{[11]}\)

One effective tax cut which hasn’t appeared in past Conservative manifestos but which has been consistently delivered relates to **fuel duty**. In theory, the level of this duty should rise in line with RPI inflation each April – and public finance forecasts are based on such an assumption. But in practice there have been no increases (and one cut) since 1 January 2011. If the Conservative Party wants to keep fuel duty at its current level, it should set out its plans ahead of the election – and establish how the cost might be met from elsewhere. Indeed, given government expectations\(^{[12]}\) of a shift to zero emissions vehicles and the rise of driverless cars, there may be a stronger case than ever for broad reform of road taxes. But simply maintaining the notion of a default increase only to introduce annual ‘one-off’ freezes is not good policy.

---

\(^{[10]}\) HMRC, Direct effects of illustrative tax changes

\(^{[11]}\) R Collier and G Maffini, The UK International Tax Agenda for Business and the impact of the OECD BEPS project, September 2015

Labour’s manifesto will propose many tax changes, with a focus on the richest

Thanks to pre-manifesto briefings as well as a leaked draft, we have a good idea of the tax policies that will be in the Labour manifesto. They are substantial, in terms of raising revenue at least.

On corporation tax, the party has promised not only to cancel the planned cut from 19 per cent to 17 per cent discussed above, but also to raise the rate to 26 per cent by 2020-21. As Figure 6 shows, this would take the rate back to where it was in 2011-12. At 26 per cent, the UK would still have the second lowest headline rate in the G7 (after Italy), and the party would reintroduce a lower rate (of 21 per cent) for smaller companies with profits below £300,000.

Figure 6: Labour would raise the corporation tax rate by 9 percentage points relative to current plans, taking the rate back to where it was in 2011-12

![Diagram showing headline corporate tax rate over time]

Source: KPMG, with UK rates and Labour policy for 2017-2020 added

This would be a major change, raising £19 billion in 2021-22 according to the party. This revenue has been earmarked for boosting schools spending by £6 billion, abolishing tuition fees and other education pledges. However, concerns about the impact of corporation tax on investment and forms of financing, as well its incidence (whether that be on shareholders – including pensions – wages or prices) are not academic. There are clear dangers in moving too far in either direction, but a rapid reversal all the way to 26 per cent would clearly be unwelcome for many businesses at a time of significant uncertainty surrounding Brexit.

On other business taxes, the party would exclude new investment in machinery from business rates valuations – a substantial and sensible tax cut – “while reviewing the entire business rates system in the longer run”.[14] And they have promised to extend stamp duty to a wider range of financial instruments and no longer exempt financial intermediaries, changes which they claim will raise at least a further £4.7 billion a year.

In addition, Labour has also said it will reverse cuts to Capital Gains Tax (rates were cut from 18 and 28 per cent to 10 and 20 per cent in Budget 2016), to pay for additional police officers.[15] This could be expected to raise around £800 million in 2021-22.

The party would also “increase the rate of Insurance Premium Tax to 20 per cent for private healthcare insurance products” in order to fund free hospital parking in England,[16] and fund free school meals for all primary school children by charging VAT on private school fees.[17] It has also indicated that it does not support previously announced inheritance tax cuts – such as the new allowance for main residences which will cost a further £1 billion in 2021-22.[18]

Perhaps most high profile, though with less detail, is a plan to raise income tax for those earning above £80,000 and an (unwise) pledge not to raise income tax or personal NI (or VAT) for those earning below £80,000 under any circumstances. To give some context for the tax rise, Figure 7 shows the individual income distribution. Only 3 per cent of adults (and 5 per cent of in-work adults) are expected to have incomes greater than £80,000 in 2018-19. Note that statistics based on the number of taxpayers – such as those published by HMRC – exclude those earning too little to pay income tax.

[14] According to the leaked draft manifesto
A matter of tax: pre-election briefing on the main parties’ tax policies

The details of the tax increase for those earning £80,000 have not yet been announced, though it has been suggested that it would raise around £6 billion to spend on the NHS. We consider an illustrative policy in which the top rate (for those earning above £150,000) is raised from 45p to 50p, and a new 45p tax band is introduced between £80,000 and £150,000.

Figure 8 sets out the marginal tax rates that face people in the current system and with this example policy. One notable feature is the interaction with the withdrawal of the personal allowance, which occurs above £100,000. At present this – together with the 40p rate – gives an effective marginal income tax rate of 60 per cent, plus 2 per cent National Insurance. With the illustrative tax increase considered here, those earning between £100,000 and around £124,000 would face a marginal rate of 69.5 per cent. As now, this group would have higher marginal rates than those earning more – a serious oddity of our tax system.

Figure 7: Only 3 per cent of adults have incomes above £80,000

Note: Work status and population size based on 2014-15 Family Resources Survey. The y-axis has been cut off at 2 million, but a total of 7.5 million adults have no taxable income.

Source: RF analysis using the IPPR tax-benefit model

The details of the tax increase for those earning £80,000 have not yet been announced, though it has been suggested that it would raise around £6 billion to spend on the NHS. We consider an illustrative policy in which the top rate (for those earning above £150,000) is raised from 45p to 50p, and a new 45p tax band is introduced between £80,000 and £150,000.

Figure 8 sets out the marginal tax rates that face people in the current system and with this example policy. One notable feature is the interaction with the withdrawal of the personal allowance, which occurs above £100,000. At present this – together with the 40p rate – gives an effective marginal income tax rate of 60 per cent, plus 2 per cent National Insurance. With the illustrative tax increase considered here, those earning between £100,000 and around £124,000 would face a marginal rate of 69.5 per cent. As now, this group would have higher marginal rates than those earning more – a serious oddity of our tax system.
Someone earning £80,000 would be unaffected. Someone earning £100,000 would pay £1,000 more (5 per cent of £20,000) in tax and someone earning £180,000 would pay £5,000 more (5 per cent of £100,000).

Given the amounts involved and the impact on marginal tax rates, distributional analysis is rendered somewhat uncertain. Clearly though such a policy would have no effect on the vast majority of households. Ignoring any potential behavioural effects, Figure 9 shows that only the richest tenth of households would record any notable average income change. Within this decile, we can expect a similarly top-heavy distribution of impact.
Incidentally, in 2015 the SNP proposed raising the top rate of tax from 45p to 50p. It has been speculated that it will do so again. Such a policy would of course be concentrated on an even smaller share of the population than the Labour approach, while raising less money.

Modelling the impact of the Labour change on a static basis – i.e. not predicting any behavioural response – suggests the policy might raise £6.9 billion in 2018-19. However, HMRC assumes very large behavioural responses to income tax changes for the richest, which reduces the amount of money a tax rise might be expected to raise. There is therefore a great deal of uncertainty about any such figures but the above might be considered upper bounds on the potential impacts and revenue gains from this example tax increase.

One report on changes in the very top rate of tax concludes that “avoidance responds to changes in tax rates, for example, shifting income between tax years and income types” (while the level of work hardly responds) and so “making avoidance harder” should be a key compliment to rate increases.\[19\] No doubt with this in mind, Labour have also called for more resources for HMRC to fight tax evasion, action on tax havens and for those earning over £1 million a year to publicly publish their tax returns.

The Liberal Democrats would raise income tax rates and reverse some tax cuts

Perhaps unusually in politics, the Liberal Democrats have set out a large, transparent tax increase. They have said they would raise the rates of income tax by 1 percentage point (i.e. from 20 per cent to 21 per cent, etc.) to fund additional health and social care spending. HMRC figures suggest this would raise around £6.5 billion a year by the end of the decade (including parallel increases to dividend and savings income tax rates). This would be the first increase in the basic or higher rates of income tax since 1975-76 – though less visible National Insurance or VAT have often risen instead – but a basic rate of 21 per cent would still be lower than in 2007-08 (when it was 22 per cent) or earlier.

Figure 10: Any rise in the basic or higher rates of income tax would be the first since 1975-76

While raising all rates – basic, higher and additional – would be more broadly felt than Labour proposals focused on only those with incomes over £80,000, the impact remains highly progressive. Half the revenue raised would come from the richest 10 per cent of households, and 95 per cent from the richer half of the population. These impacts are shown in Figure 11.
The party has also said that in the longer term they would “bring together” spending on health and social care and introduce a **dedicated Health and Care Tax** to transparently fund this. Previous documents suggest that this tax could be based on – i.e. perhaps replace – the current National Insurance system.\(^{[20]}\) Such broad reform would affect revenues and spending of over £100 billion and so be of great significance. But the income tax boost is the more immediate and clear policy.

It should be noted that the nature of income tax in the UK is not quite as simple as it once was. Scotland now has control over its own income tax rates (and higher and additional rate thresholds). The policy would therefore not apply there, though complex devolution rules could mean a small knock-on boost from the tax change.

Also notable is how the new Universal Credit system, which applies means-testing on a post-tax basis, will cushion anyone on it from any tax increase – to the tune of 63 per cent of any loss. While this is a reasonable feature, the slow roll-out of UC means that any income tax change in the short-term will have different effects on those families and those parts of the country which have moved from the older benefits systems to UC than to those that have not. In 2017-18, someone earning £21,500 – £10,000 above the personal allowance – would pay an additional £100 in income tax if the basic rate rose by 1 per cent and they were either not on means-tested support or still on tax credits. But if they were on UC, the tax increase would be only £37. Though perhaps unavoidable, this is one of the oddities of the continued rollout of UC whereby two welfare systems are expected to be operating in parallel for the next few years.

\(^{[20]}\) **Health and Social Care - delivering a secure funding future: An interim report**, 2015
In contrast to Labour’s proposed large increase in the corporation tax rate and the Conservatives’ further cuts – both policies too extreme – the Liberal Democrats have said they would reverse “the latest round of corporation tax cuts”. They would also scrap the Marriage Tax Allowance which cost £425 million last year (and had a take-up rate of less than 25 per cent)\(^\text{21}\), both to boost education spending.\(^\text{22}\) Finally, it should be noted that in both 2010 and 2015 the party had a headline tax policy of raising the income tax PTA – a policy also adopted by the Conservatives in 2015 as discussed earlier. A change of focus away from this expensive policy and towards tax increases would be noteworthy, and a sign of the broader shift in the debate.

There is a need – and opportunity – for boldness

We do not have to wait long for the manifestos of these three parties – or of the Green Party, SNP, Plaid and UKIP whom we have not covered. But it is to be hoped that the next five years will feature bold but considered tax reform. These must aim to support growth (by reducing negative distortions and making the tax system easier to use), improve the long-term sustainability of the public finances, and help low and middle income households especially.

Three challenges for the next five years stand out.

- **There is a pressing need to create a flatter tax playing field between different forms of labour, making the tax system fit for the 21st century world of work.** Rising self-employment and incorporation are causing substantial, growing losses to the Exchequer. The Conservative policy of raising personal NI for the self-employed could now make a comeback, along with some new benefits for the self-employed. But even the previous proposals would only go part of the way to taxing all work equally.

- **The tax base has also faced erosion through an international decline in corporate taxes.** Neither further cuts nor huge increases in the UK’s low headline rate seem sensible at present. But reforms to fight ‘base erosion and profit shifting’ – as the OECD calls it – remain necessary, at the same time as trying to boost the UK’s levels of business investment.

- **The UK’s housing market problems and wealth inequalities** are not helped by its property taxes. Council tax (in England especially) is disproportional to property values and is still based on valuations from 1991 – a fact that will become yet more absurd if no action is taken in the next five years.\(^\text{23}\) There are also real concerns that young people’s prospects for home ownership and savings will depend increasingly on their parents’ wealth. Reforming the taxation of domestic property, inheritance and pensions can play a role in averting this, but these issues have not yet made appearances in the 2017 election.

There are also a few political reasons to think change is possible.

First, if polls are to be believed then a large Conservative majority is the most probable result of the election, making reform easier for the government to pass. Second, although an early election has been called, the expectation remains that the subsequent election would not be for another five years, giving substantial time for reform – and Chancellors have a habit of announcing tax increases in fiscal statements that follow general elections.

Third, tax changes are likely to require less parliamentary time than other reforms (for better or worse) – at a time when Brexit-related legislation will dominate parliament’s timetable. Finally, leaving the EU will itself likely change what is possible in UK tax law (such as on VAT and tariffs) and the government has suggested it could also use aggressive tax competition as a negotiating tool.


\(^\text{22}\) [http://www.huffingtonpost.co.uk/tim-farron/lib-dems-education-brexit_b_16531698.html](http://www.huffingtonpost.co.uk/tim-farron/lib-dems-education-brexit_b_16531698.html)

\(^\text{23}\) Values in Wales were updated in 2005, and Scotland, Wales and Northern Ireland all have more proportionate systems than England.
But it is also important to consider not just the tax system as a whole but also the complementary welfare system. Giving with one hand through tax cuts while taking away through welfare cuts would not be progress, for example. Despite the Prime Minister’s rhetorical focus on those who are just about managing, and delivering “a country that works for everyone, not just the privileged few”, the context of the next few years is very likely to be one of rising inequality and falling incomes for the poorest, in large part due to welfare cuts inherited from the Cameron administration. We will explore welfare policies in a separate note, but if there is no reversal in the huge welfare cuts then a progressive – and pro-growth – tax strategy becomes all the more important.
Resolution Foundation

Resolution Foundation is an independent research and policy organisation. Our goal is to improve the lives of people with low to middle incomes by delivering change in areas where they are currently disadvantaged. We do this by:

» undertaking research and economic analysis to understand the challenges facing people on a low to middle income;
» developing practical and effective policy proposals; and
» engaging with policy makers and stakeholders to influence decision-making and bring about change.

For more information on this report, contact:

Adam Corlett
Economic Analyst
adam.corlett@resolutionfoundation.org
020 3372 2983