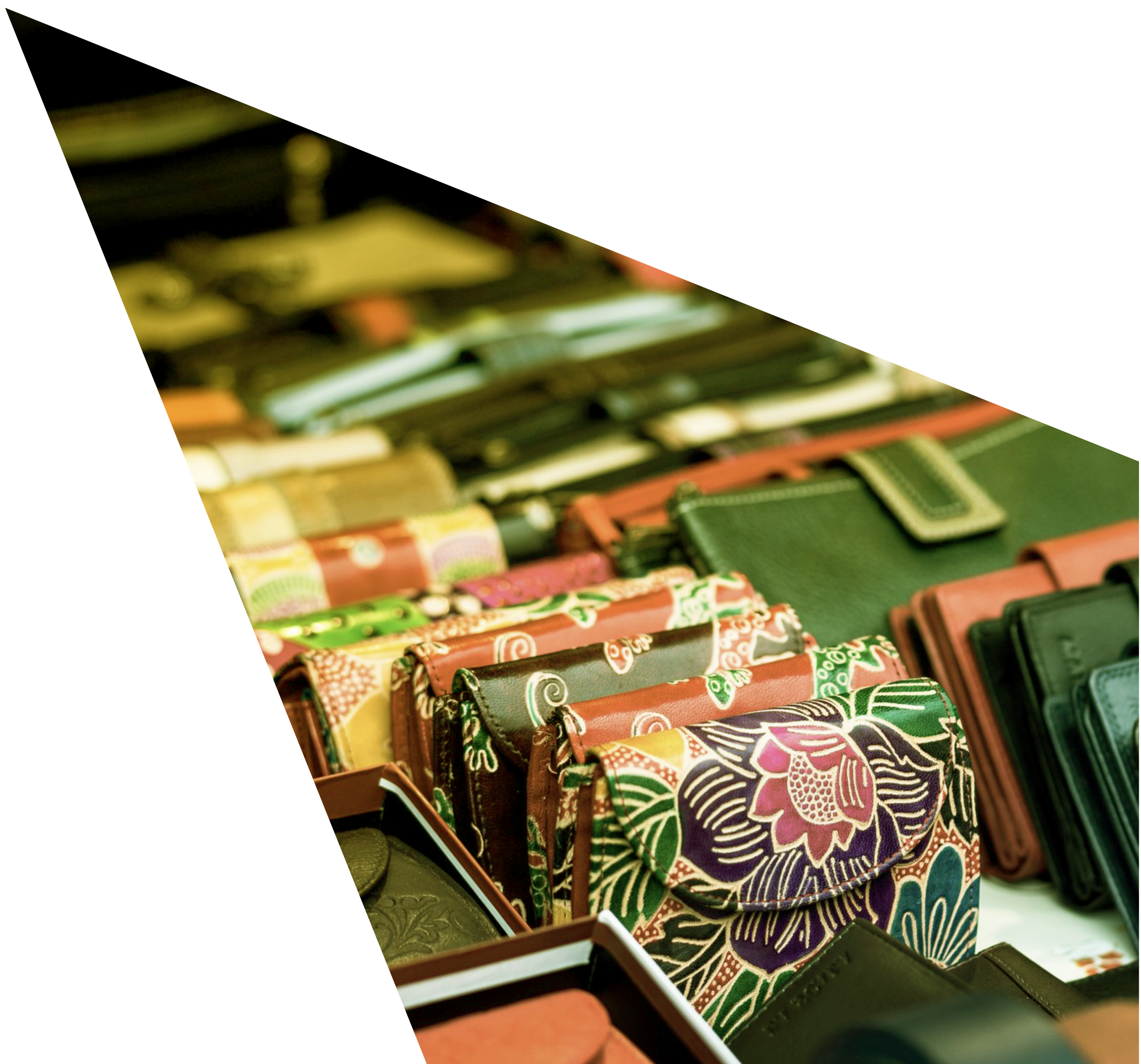
Resolution Foundation

The shifting shape of UK tax

Charting the changing size and shape of the UK tax system

Adam Corlett

November 2019



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Executive Summary

Ahead of the upcoming election, the two biggest parties are taking very different approaches to tax policy: one is proposing large tax rises to fund new spending; while the other is likely to offer large tax cuts funded from higher borrowing. Indeed, this is arguably the largest political divide between the parties on taxation since at least 1992. Beyond exploring the likely array of manifesto commitments – this paper takes a step back to look also at how the tax system has changed over a period of decades, and at the structural challenges the next government is likely to face, whatever the election result.

In doing so, we build on a previous report that assessed the size and shape of the state. A subsequent report will complete our pre-election trilogy with a look at the state of, and challenges facing, the social security system.

UK taxes as a share of GDP are relatively high by historical standards, but low internationally

Tax receipts currently amount to around 37 per cent of GDP. This is a substantial proportion of the economy as a whole. Should we consider this level of taxation to be high or low? Looking historically, it is around the post-war average of 37.1 per cent. But, with a rise projected to 2023-24, it is on track to hit its highest level since 1985-86.

Changes in tax receipts as a share of the economy may not always give a meaningful picture of how high taxes feel for real households, however. This is because this measure is influenced by the make-up of the economy, and not just by tax policy choices made by successive governments. Indeed, a number

factors mean we might expect a higher tax to GDP ratio even without any change in tax policy, including:

- Privatisations since the 1980s have reduced non-tax receipts, increasing the need for governments to raise money through taxes.
- Workers' earnings are relatively highly taxed compared to other shares of the economy. This means that the increased share of labour income seen since the 1990s has acted to boost taxes as a share of GDP.
- In addition, reductions in (low-tax) business investment and (untaxed) imputed rental income are likely to have also boosted tax revenue.
- And within the labour share, a rise in earnings inequality buoyed tax receipts as higher-tax groups received larger shares of total income.

Internationally, the UK raises relatively low levels of tax as a share of GDP – though again this comparison is not always straightforward (for example the UK is relatively reliant on public, rather than private, healthcare). The UK raises particularly little from local government taxes and from social security schemes by international standards. Indeed, direct taxes on typical earners are relatively low; the standard VAT rate is below the European average; and corporation tax is now significantly below average.

For most people, tax rates appear to have fallen

We must also look beyond aggregate measures and consider *what* taxes have changed, and for *whom*. Although the tax system has in some respects been remarkably stable since the 1990s, there has been a steady shift away from so-called 'sin taxes', and towards VAT. There has also been a shift away from income tax towards narrower National Insurance. And there has been a rise in the share of GDP raised through stamp duty land tax, among other changes. Looking at the distributional impact of all taxes together, one result is that the range of taxes that are important to low-and-middle income household finances has

only grown over time. This is in contrast to the all-too-frequent myopic focus on income tax alone, which is what matters most for higher income households.

While which taxes people pay varies significantly, when considered together they are remarkably flat as a proportion of gross income across the income distribution, with effective rates of between 27 and 36 per cent for all income groups.

We can also see that for households across the income distribution, total tax rates (including most taxes) have, if anything, fallen over time, from an overall rate of around 37 per cent in the late 1970s to 34 per cent recently. Although these data come with their own caveats, this further warns against too a narrow focus on the rising tax to GDP ratio as a measure of the tax burden on UK households.

Declines in taxes are particularly stark if we look at the income tax and (employee) National Insurance paid by employees on a typical wage over time. In 1975, their combined effective tax rate would have been 30 per cent. But, by 1990, that had fallen to 25 per cent, and in 2019 it was 18 per cent. If these taxes were as high now as in 1990, the typical employee would pay over £1,800 more than they do under the 2019 schedule. And for low earners the decline has been even starker, with personal allowance increases reducing their income tax bill to zero. Very high earners, by contrast, have experienced a slight increase in combined income tax and employee National Insurance over the past decade.

So it's not clear that *average* tax rates should be a great concern at present. And if we turn to *marginal* rates of tax – including the crucial role played by the benefit system – we find that the highest rates are concentrated in the bottom half of the household income distribution, with very high marginal deduction rates of 63 or even 75 per cent common.

There are many reasons to think tax reforms are needed

In some senses it is surprising how little major change to the tax system there has been in recent years. But the world is changing, and taxes will need to adapt. As we see it, the big challenges for the Treasury include:

1. An ageing population means more revenue will be needed over time just to provide existing standards of pensions, health and social care. This might mean tax rises of around 1 per cent of GDP every five years simply to keep pace with these spending areas. Any other election promises, such as on education, will be additional to that.
2. The relative importance of household wealth has grown relative to income, increasing from three times GDP in the 1980s to almost seven times today. But the UK's existing wealth-related taxes – like inheritance tax, council tax, stamp duty, pension taxation and capital gains tax - have not kept pace with wealth's growth relative to the size of the economy and are riddled with problems.
3. Our tax system currently builds in widespread incentives for people to change how they classify otherwise identical work to reduce their tax bill. The under taxing of self-employed labour through National Insurance, or of some income through companies, can result in both reduced tax revenue and reduced labour market security.
4. Tackling climate change and air pollution will require the tax system to play a role in driving change, but reform will also be required to avoid declining revenue. Unless there are policy changes, the necessary shift to electric vehicles will mean a potential loss to the Treasury of £35 billion a year in fuel duty and Vehicle Excise Duty by 2050 (at the very latest). And the decline in tobacco revenue is also expected to continue, with a further £9 billion ultimately at risk. That is £44 billion of tax rises needed just to maintain revenue.

A further prospective change comes in the form of the UK's new potential trading relationship with the EU. This may create new policy freedoms in VAT (though with possible divergence in Northern Ireland), but will also require more work on the possible fiscal and distributional impacts of new UK tariff policies. And to restore faith in the taxation of big multinational companies, the slow process of creating new shared international systems – as proposed by the OECD at the request of the G20 nations – must continue.

The Resolution Foundation has proposed a number of ways in which the tax system should be changed to help keep pace with broader changes. These include major reforms to: council tax, stamp duty, inheritance tax and pension taxation. The unfair tax differentials between employment statuses should also be narrowed. This would help fund the public services that all generations expect, while doing so in a fair manner and reducing economic distortions in the process. There are also many smaller changes that could be made to increase revenue and close loopholes, even in the absence of wholesale reform.

It is also not clear that very large cuts to corporation tax rates, and increases to income tax allowances, have helped overcome the challenges facing our economy in recent years. Some of the former should be reversed and further increases in the latter avoided.

But how (if at all) are the political parties proposing to address these tax challenges?

The main political parties are proposing quite different visions of the future tax system

In advance of the party manifestos, we must base our assumptions on what the parties have said so far. While some of these will inevitably prove to be wrong, in the case of both Labour and the Liberal Democrats, policies from the 2017 election are likely to be a good guide. And the Conservatives have dropped plenty of hints about their intentions.

From what we know, Labour, the Liberal Democrats and the SNP are likely to offer net tax increases, while the Conservatives and Brexit Party are likely to want net tax cuts. In fact, the divergence between Labour and the Conservatives may be of the order of a total £50 billion a year tax rise versus a £10 billion a year cut.

Among many other policies, Labour wants to raise income tax rates for the minority of people with incomes over £80,000. Their changes would raise around £6 billion a year from richer households. If elected, they would do well to implement such

changes quickly in order to limit income shifting between years, and to look at capital gains too, to limit shifting between forms of income. In raising top taxes Labour might have at least partial support from the SNP, who have already raised the top Scottish rate following devolution, as well as the Liberal Democrats who want to raise all rates of income tax by 1p (raising around £7 billion).

The Conservatives are widely rumoured to favour raising the starting point for paying National Insurance. If this were aligned with the income tax allowance by 2023-24, it would give most workers a tax cut of £480, at a cost of £11 billion. But, beyond simply borrowing more, it is not yet clear how this might be funded. It would be a sensible tax cut in comparison to further income tax cuts, but would still overall favour richer households over poorer ones. One reason is that those in work but on Universal Credit – particularly parents and disabled adults – would have their Universal Credit payments reduced by £300 a year as a result of a £480 tax cut. To ensure that a National Insurance threshold increase benefits workers on Universal Credit as much as those in richer households, the Conservatives must increase work allowances £1-for-£1 with any tax cut (for example, a £40 per month National Insurance cut and £40 per month work allowance increase). This would increase the policy cost by around 8 per cent, but make it progressive.

In addition to this divergence on personal taxes, there is great disagreement about the future of corporation tax. The Conservatives want the rate to fall next year, while every other major party has suggested cancelling that £6 billion cut and potentially reversing earlier years' cuts too. Labour has proposed a rate of 26 per cent, in contrast to the planned 17 per cent rate.

Overall, then, parties are offering very different tax prospectuses for the parliament ahead. But all of them could do more to recognise the challenges facing the tax system, and to be honest with voters about the reforms that are likely to be needed in the much-delayed Budget, and beyond into the 2020s.

Section 1

Introduction

'Budget deficit'

There is a lot of politics about at the moment, not least as our third general election in five years approaches. But there's also not enough – with 2019 looking set to be the first calendar year since at least the 19th century in which the government hasn't presented a Budget.[1] And that follows on from the postponement of the full multi-year Spending Review that had been scheduled for the autumn (replaced instead with a one year 'Spending Round' stop gap).

That means the election debate is being played out against the backdrop of economic and fiscal forecasts that are eight months old, and so are out of date. Throw the uncertainty surrounding Brexit into the mix and it's clear that commentators and voters alike are likely to have a harder than usual time working out just how to judge the various election pledges set out in the different parties' manifestos.

This is particularly pertinent given some major changes to the public finances. Indeed, as we explored in *The shape of things to come*, we have seen nearly a decade of austerity that has changed what the UK state does in some profound ways.[2] And, looking ahead, coming demographic headwinds will present further challenges. That makes it all the more important for parties to be clear not just about what they want to spend money on in the coming years, but also how they intend to fund their promises.

This paper explores the journey our tax system has been on in recent decades, its current state, the forces that will shape it in future, and what policies might be adopted in response.

These issues are all the more important for the imminent election given that voters are likely to be offered very different prospectuses on tax, with the gap between the two main parties arguably the largest for a generation.

1 House of Commons Information Office, Budgets and Financial Documents Factsheet, August 2010
2 M Whittaker, The shape of things to come: charting the changing size and shape of the UK state, Resolution Foundation, November 2019

This report is set out as follows:

- Section 2 looks at the size of the tax system and how this compares historically and to other nations;
- Section 3 then explores in more detail how the make-up of the tax system has changed, and for whom;
- Section 4 presents some of the key challenges facing the tax system from different directions, and some of the proposals Resolution Foundation has put forward to tackle these;
- Section 5 sets out the policies that the political parties have suggested so far ahead of the election and final manifestos, and what their impacts might be;
- And Section 6 concludes.

A subsequent paper will look at trends and challenges in the benefits system, completing our trio of pre-election assessments of the state of UK tax and spending.

Section 2

About the size of it

Here we explore the UK's overall tax take compared to the size of the economy and to international peers. Total revenue as a share of GDP has risen to its highest level since 1985-86 but remains very close to its post-war average of 37 per cent. Tax revenue excluding other receipts has hit its highest share of GDP since 1981-82. But this is not the same thing as saying, as many do, that we are paying the highest rates of tax in decades. Indeed the tax to GDP ratio is a complex function not just of tax rates but also of economic changes – including levels of investment, the labour share, levels of inequality and the degree to which wealth is owned by the public sector. What is clear, however, is that taxes are below average when compared with other OECD countries. This is particularly true in terms of social security funds and local taxes – though, again, there are big differences in how countries fund health or pension saving, for example, and in what assets the state owns. As ever, if voters want high-quality, publicly funded services and social security, in a country with negative public sector net worth, levels of taxation will need to keep up.

Receipts have risen slightly, but are typical by historical standards

This financial year (2019-20), the state is forecast to collect revenue equivalent to around 37.4 per cent of GDP.[3] So for every £1 of goods and services produced, 37p is collected in taxes or other state receipts. The scale of taxes required to fund a modern state should tell us that the design of the tax system matters. It doesn't, however, tell us whether taxes are 'too high' or 'too low': that is an intensely political choice about whether some marginal spending is worth some marginal tax change.

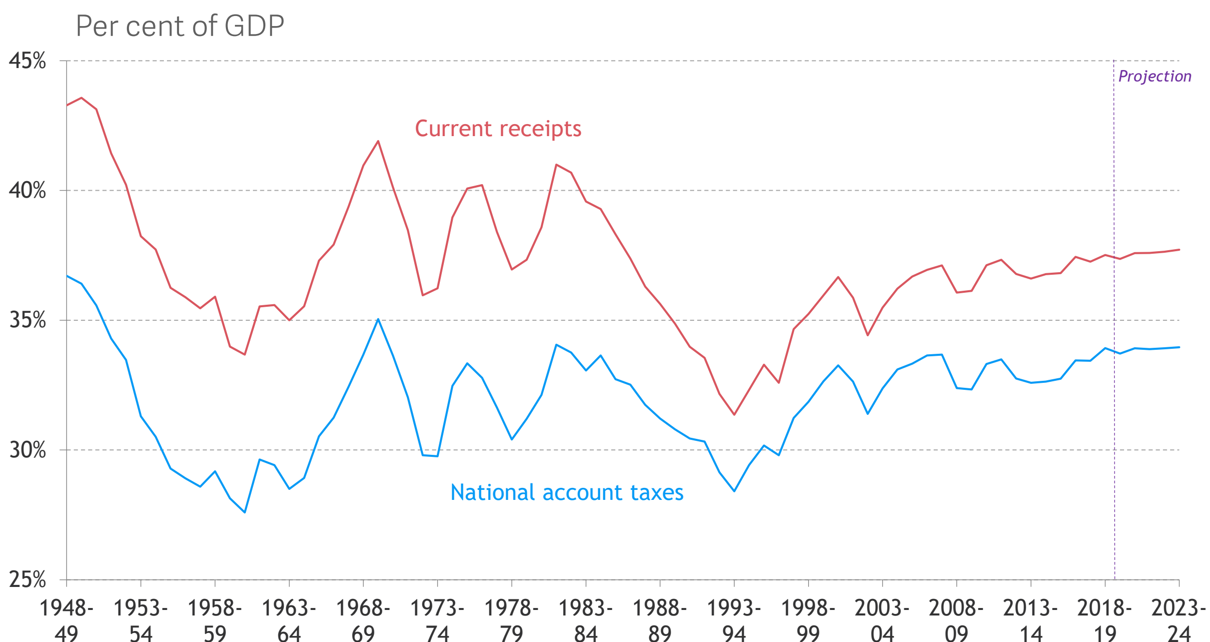
But we can compare the past, present and projected size of the tax system, as Figure 1 does. The present figure for receipts as a share of GDP is, in fact, very similar to the average over the past 72 years (i.e. since 1948) of 37.1 per cent. However, that share has

3 We use the latest Office for Budget Responsibility revenue data from September 2019, but adjust their GDP figures to account for ONS Blue Book 2019 revisions. Note that revenue figures going back to 2008 have also been revised since March to remove a double-counting error in Corporation Tax receipts.

fluctuated significantly over time, going as high as 43.6 per cent in 1949-50, and as low as 31.4 per cent in 1993-94.

While the future tax take will depend both on political choices (discussed further in Section 5) and the size of the economy, on current projections tax as a share of GDP looks set to rise slightly to 37.7 per cent by 2023-24, which would be its highest since 1985-86.

FIGURE 1: **Government receipts as a share of GDP are projected to hit their highest since the mid-1980s**

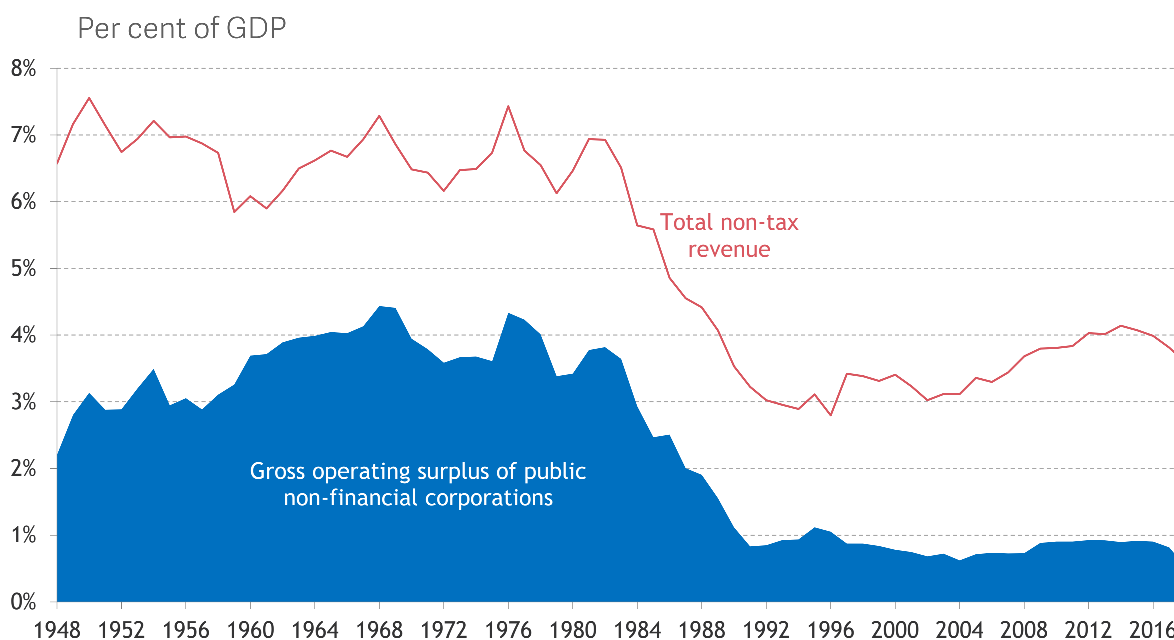


NOTES: This combines the latest OBR revenue figures with revised ONS GDP figures. OBR growth forecasts from March are then used for the projection period.
SOURCE: OBR *Public Sector Finances Databank*, September 2019; and ONS

The difference between 'current receipts' and 'national account taxes' is also highlighted by Figure 1. The gap between these measures relates to government receipts that are not taxes, including public sector gross operating surpluses; accrued interest on student loans; other interest and dividends from state-owned investments; and TV licence fees. The key component in explaining the historic trend in non-tax receipts is the gross operating surplus of public sector non-financial corporations (largely nationalised industries), as Figure 2 shows. In 1976, for example, this accounted for 4.5 per cent of GDP, while in 2018 this was only 0.5 per cent. All else equal, this would require a 4 per cent of GDP increase in taxes to maintain the same level of state spending. And it is important to recognise that these assets – like British Gas, BAE, British Airways, BT – are now ultimately owned by individuals who may pay income tax for example, which the state previously did not. Privatisations all else equal, then, should push down non-tax receipts

but push up the tax to GDP ratio. The fact that they did not in the 1980s reflects the combination of privatisations with large tax cuts.

FIGURE 2: **Non-tax government receipts fell dramatically in the 1980s, driven by privatisation**



SOURCE: RF analysis of OBR and ONS

Both the 'current receipts' and 'national account taxes' measures are useful, but it is the current receipts measure that is most relevant for comparison with total expenditure (and therefore the 'size of the state') or net borrowing. After all, if the government owned a major share of natural or corporate assets, it could potentially charge lower taxes (as in Alaska or Singapore, for example) but it would not exactly be a 'small state'.

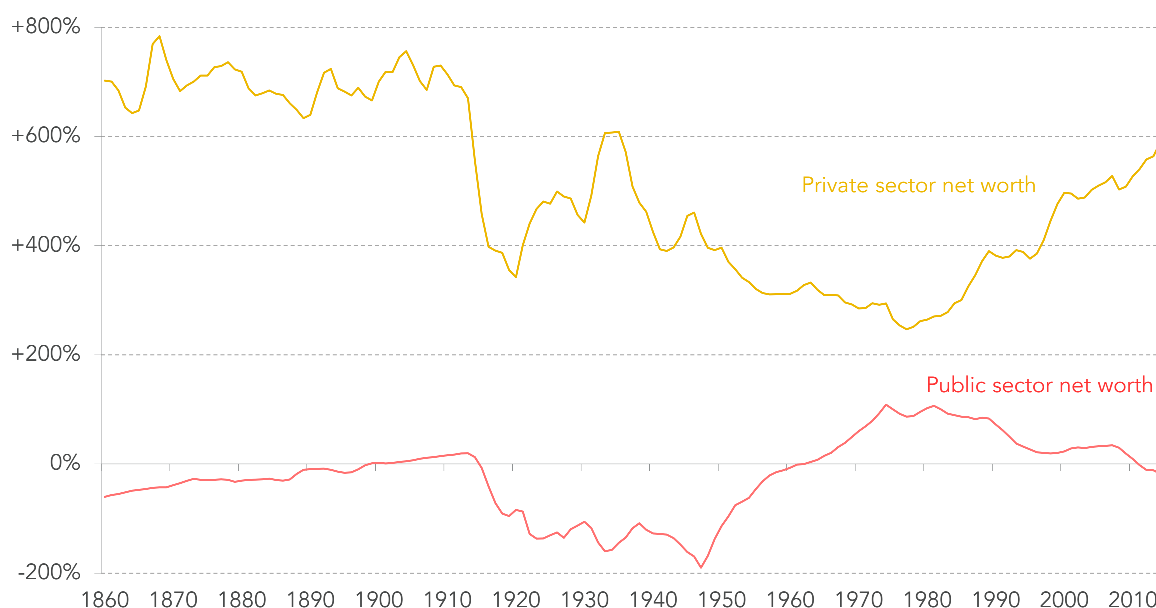
This distinction helps explain why national account taxes are now around 2 per cent of GDP higher than in the 1970s, while current receipts are around 1 per cent of GDP lower.

Figure 3 shows that the combination of (often discounted) state asset sales, without offsetting investment, has meant public sector net worth has fallen considerably from the 1970s and 1980s, when it was roughly equal to annual GDP, to now being negative.[4] As a result, and assuming there was some return on state assets, the government would need higher taxes than in the past to maintain the same levels of public spending.

4 For more on public sector net worth, see: R Hughes, Seeking public value, Resolution Foundation, September 2019

FIGURE 3: **In earlier decades, the state's net worth was positive, requiring slightly less reliance on taxing the private sector (all else equal)**

Net private and public sector net worth as a share of net national income



NOTES: These figures may differ from ONS aggregates.
SOURCE: World Wealth & Income Database

The difference between current receipts and national account taxes shows that there is not a perfectly clear boundary between what is or is not a 'tax'. As another example, many former students now pay 9 per cent of their income (above a threshold) to the government to help cover the cost of university tuition. While this is not technically a tax, a near identical 9 per cent levy on graduate income could be.

The tax ratio is not just a function of tax policy

When considering tax as a share of GDP, there are further conceptual issues to bear in mind. Tax as a share of GDP may change not only because of changes in the tax system itself, but also because of changes in the make-up of the economy.[5] As the illustrative Office for Budget Responsibility (OBR) numbers in Figure 4 show, labour income is taxed at a much higher rate than corporate profits, for example, while the effective tax rate on business investment is negative because it can register as a (tax-deductible) expense.

5 As a further example, money received from pensions is taxed but this drawdown of wealth does not count as income in the national accounts (rather pension contributions do), and occupational pension income has risen faster than GDP. But – acting in the opposite direction – largely untaxed pension contributions have also risen.

FIGURE 4: **Different forms of economic activity face different tax rates**

Selected components of GDP and associated effective tax rates

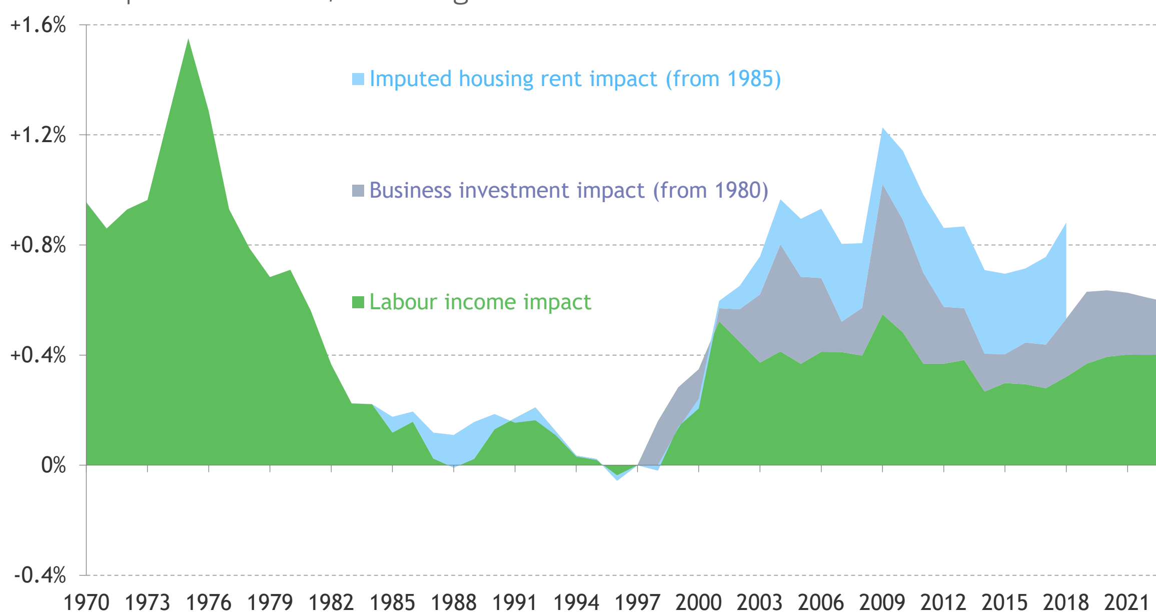
NOTES: Components do not need to add up to 100 per cent.
SOURCE: OBR, Fiscal risks report 2019 (except imputed rent)

These components of GDP have changed in importance over time. Business investment has fallen from 10 per cent of GDP in 1997 to 9 per cent in 2018 – which will increase the tax to GDP ratio in the short term. The labour share rose rapidly in the late 1990s, reversing the declines of the 1980s. And in the 1990s, imputed rent (which is a part of GDP) was relatively high – mirroring the small size of the private rented sector. With the growth of actual rents (which are taxed) since then, imputed rent (which is not taxed) has shrunk as a share of GDP.

Figure 5 presents a thought experiment using these figures and the rates in Figure 4. With a simplistic assumption that tax differences between different components of GDP have remained the same over time, this shows that changes in the make-up of the economy can likely explain some changes in the tax to GDP ratio. In particular, the rise in labour share since the 1990s appears very likely to have played an important role, even though tax rates for individual workers did not necessarily rise (as discussed further in Section 3).

FIGURE 5: **Since the 1990s, business investment has fallen, the labour share risen, and imputed rent fallen, all helping to push up the overall tax take**

Modelled change in tax as a share of GDP relative to 1997 due to changes in the composition of GDP, assuming constant tax rates



NOTES: Illustrative model based on the difference between the recent tax rates for these activities (from Figure 4) versus the tax rate for corporate profits.
SOURCE: RF analysis based on OBR and ONS

In addition to these three factors (though there may be other trends at play), there have been important changes within the labour share. Changes in the distribution of earnings also affect the tax take, even if rates remain the same for each income group. The substantial increase in wage inequality in the 1980s and 1990s will also have pushed up the tax to GDP ratio (all else equal). This is explored further in Section 3.

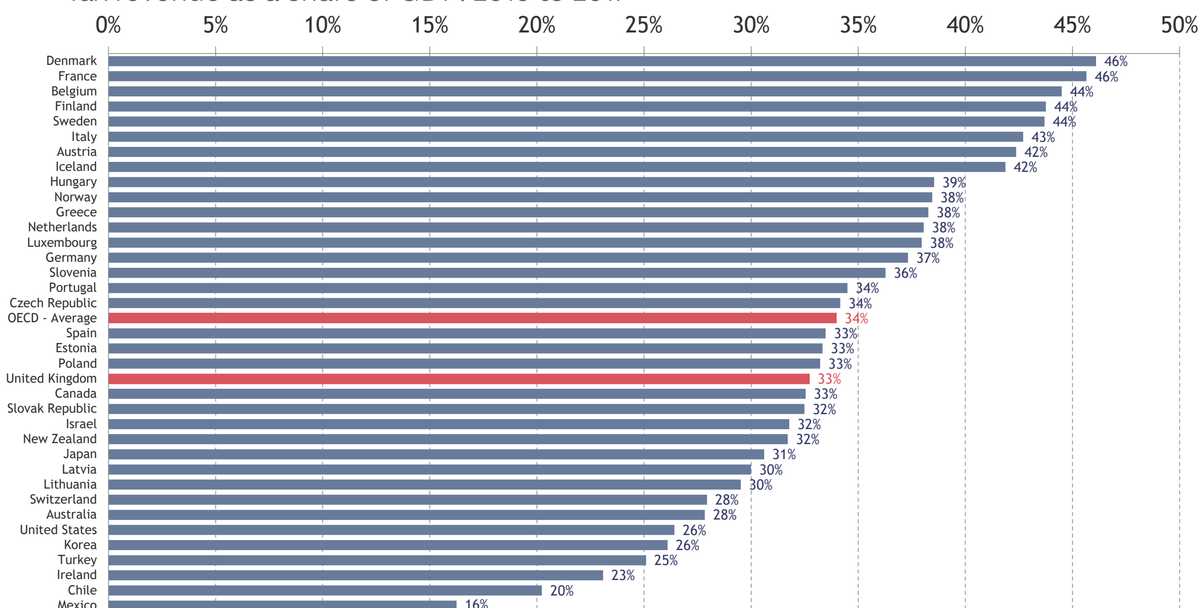
Clearly, then, changes in tax relative to GDP, while useful, should not be taken to purely reflect changes in tax rates and thresholds.

By international standards, taxes are below average overall

While historical comparisons are more complex than is often acknowledged, we can also compare the UK to other countries. Ignoring non-tax revenues for now, the UK's average tax take over the past few years is 33 per cent, versus an OECD average of 34 per cent, using comparable figures. But, as Figure 6 shows, there is a huge range within the OECD, from 16 per cent of GDP in Mexico to 46 per cent in Denmark.

FIGURE 6: **The UK tax share is somewhat below average by international standards**

Tax revenue as a share of GDP: 2015 to 2017



NOTES: Three year average.
SOURCE: OECD

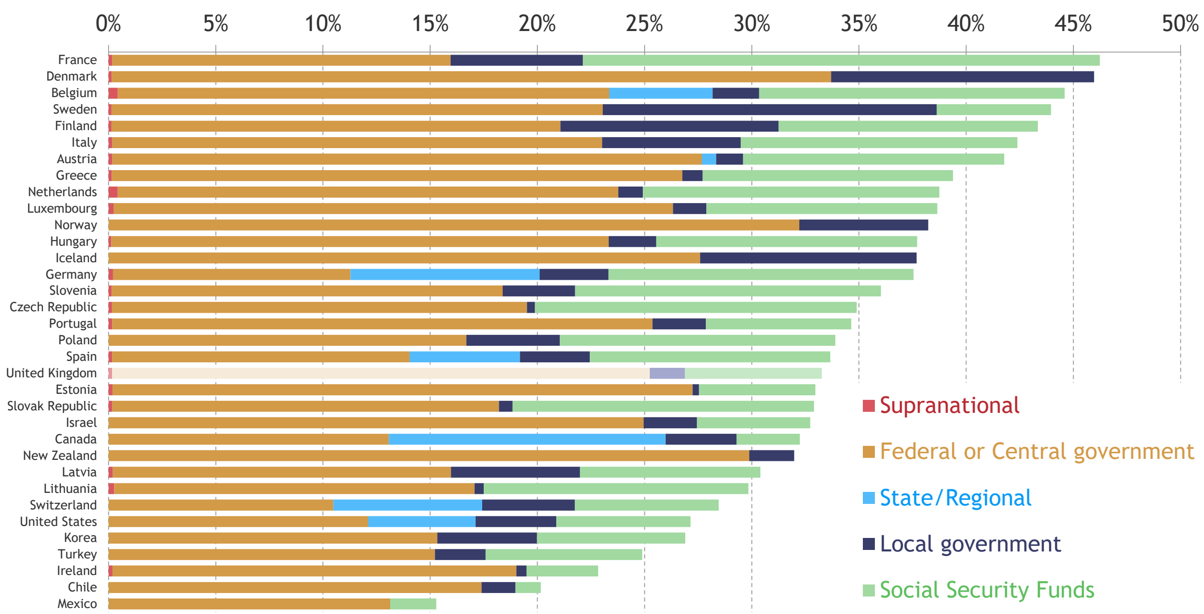
Breaking down that tax revenue into different administrative categories, in Figure 7, most OECD countries that raise more tax than the UK tend to raise more at the local (or state/regional) government level and/or through 'social security funds'. In the UK, the latter would be National Insurance, which technically operates through its own National Insurance Fund, though in practice the distinction between this and other taxation is inconsequential and most entitlements do not depend on the level of past contributions. This is quite different from many other countries' social security contribution systems.

Of course, different nations have made very different choices about public spending, which helps explain variations in tax levels. The UK is more reliant on public (rather than private) healthcare, for example, with 79 per cent of health care expenditure being taxpayer funded.[6] Based on other OECD countries, if that was the only thing one knew about the UK, one might expect the country's tax to GDP ratio to be 4 percentage points higher than it actually is. The UK also tends to account for household circumstances through the benefits system rather than through family taxation (e.g. child benefits rather than child tax allowances), unlike some other countries, also pushing up the tax to GDP ratio. But, on the other hand, public state pension spending is somewhat below average due to relatively well-developed private pension saving.[7]

6 ONS, How does UK healthcare spending compare with other countries?, August 2019
7 OECD, Pension spending, 2019

FIGURE 7: **Compared to other countries, the UK raises particularly little from local government taxes and social security taxes**

Tax revenue as a share of GDP: 2017

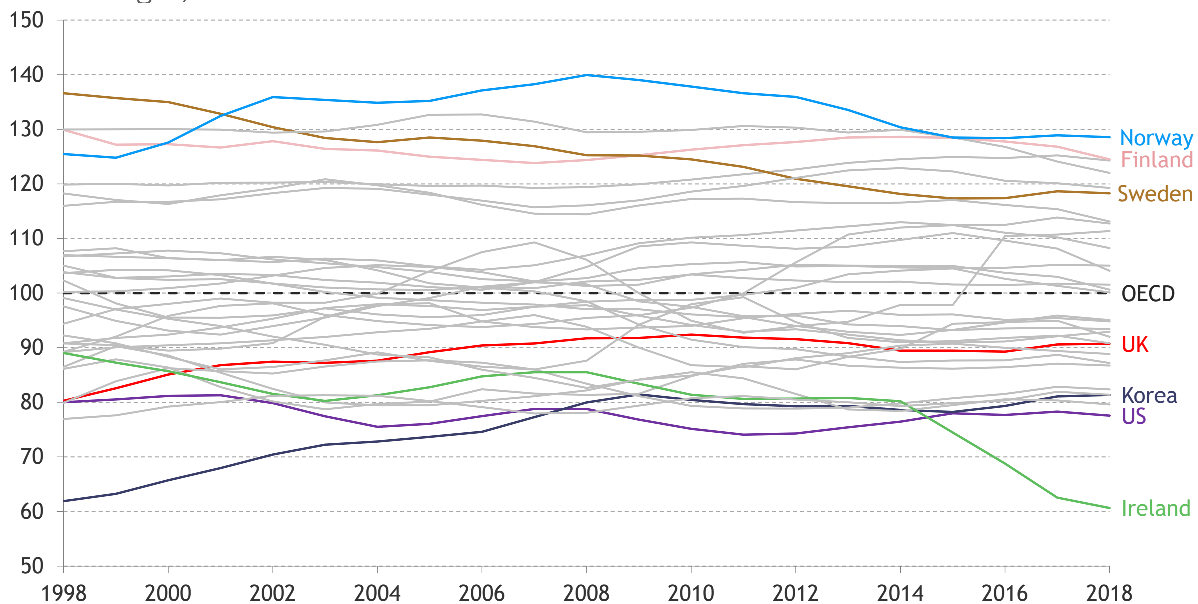


SOURCE: OECD

The importance of non-tax revenues, discussed above, also varies a lot between countries. But adding in this revenue (e.g. from the Norwegian state energy industry) the big picture is again one of UK revenues being somewhat below the OECD average relative to GDP.

FIGURE 8: **Total UK receipts have remained below the OECD average**

Indices (OECD average = 100) of government receipts as a share of GDP (three-year averages)



SOURCE: RF analysis of OECD, *General Government Accounts*

As Figure 8 shows, this has been fairly consistent over time, though there was a steady convergence prior to 2010.

So although comparability over time and space is not entirely straightforward, we can say that the UK tax system is not quite as large as in many other countries but is slightly larger than it has been for some time. But it is also important to consider, as the next section does, how the task of raising revenue is distributed between different types of tax and between people, and how tax rates have changed for actual households and individuals rather than the economy as a whole.

Section 3

How the nature of the tax system has changed, and for whom

It is not just the size of the tax system that matters: its form and distribution are crucial. In this section we explore some of the shifts that have happened, such as a decline in so-called 'sin taxes', a rise in VAT, and a shift towards National Insurance and away from broad-based income tax. Distributional analysis also shows that the range of taxes affecting households is large and varied. Income tax, which dominates political discussions of taxation, is now only a small part of the tax contribution made by low to middle income, non-retired households. But a wider view, accounting for most taxes, shows that rates are surprisingly flat across the income distribution.

In contrast to the rising tax to GDP ratio, household tax rates appear to have fallen or remained flat over time, although these data are imperfect. Individual effective tax rates have also certainly fallen for low and middle income employees. And we show that the benefit system is key in determining the levels and progressivity (or regressivity) of marginal rates. Internationally, the UK now has particularly low tax bills for typical earners, while VAT rates are not high compared to our peers, helping explain our below-average tax take overall.

The make-up of the tax system has shifted

For the efficiency and distribution of taxes it matters not just how much tax is raised, but in what way. Figure 9 breaks down tax levels since 1990 into broad categories.[8] Throughout this period, the great bulk is raised by income tax; National Insurance; corporation tax; business rates & council tax; VAT; and other consumption taxes.

Overall, there have been no dramatic shifts in this make-up, with the exception of the (very dramatic) introduction and swift replacement of the poll tax in the early 1990s. But there have been some slower yet still significant shifts:

8 This uses OECD rather than OBR figures.

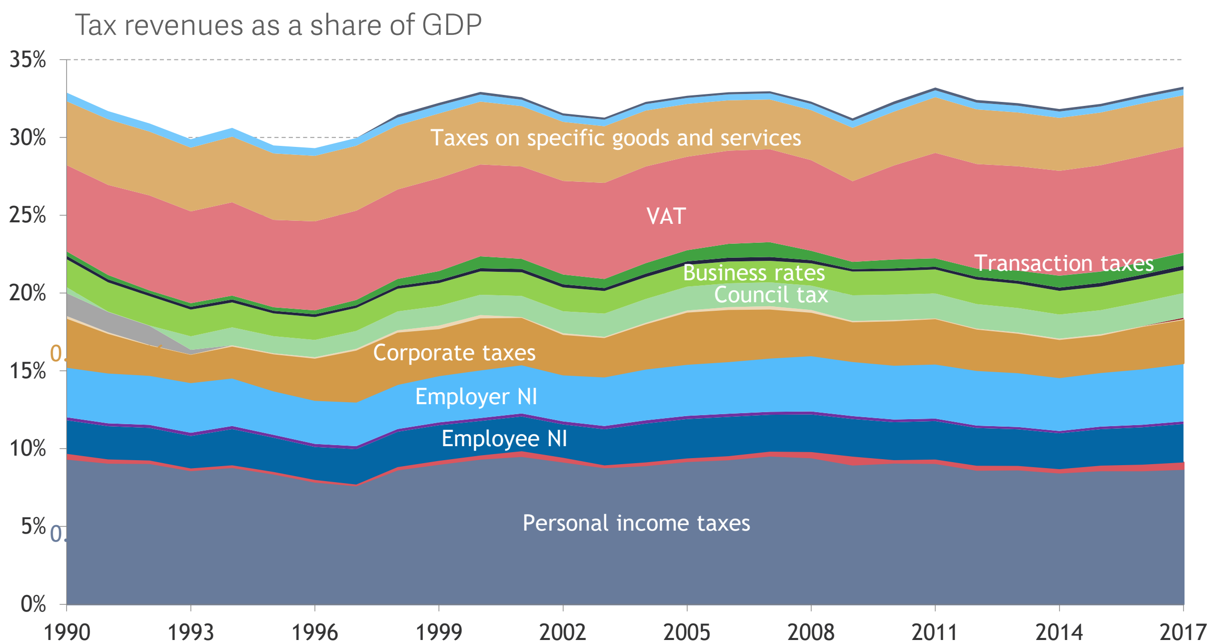
There has been a slight decline in the importance of income tax and a rise in the importance of National Insurance.

There has been a significant decline in the importance of specific consumption taxes – including tobacco and alcohol duties – which have fallen from 14 per cent of tax revenue in 1995 to 10 per cent in 2017. But this has been offset by a rise in the importance of general consumption tax (i.e. VAT).

There has also been a rise in transaction taxes, such as stamp duty land tax.

FIGURE 9: **One shift in the tax system has been away from specific goods taxes and towards general VAT**

Tax revenues as a share of GDP

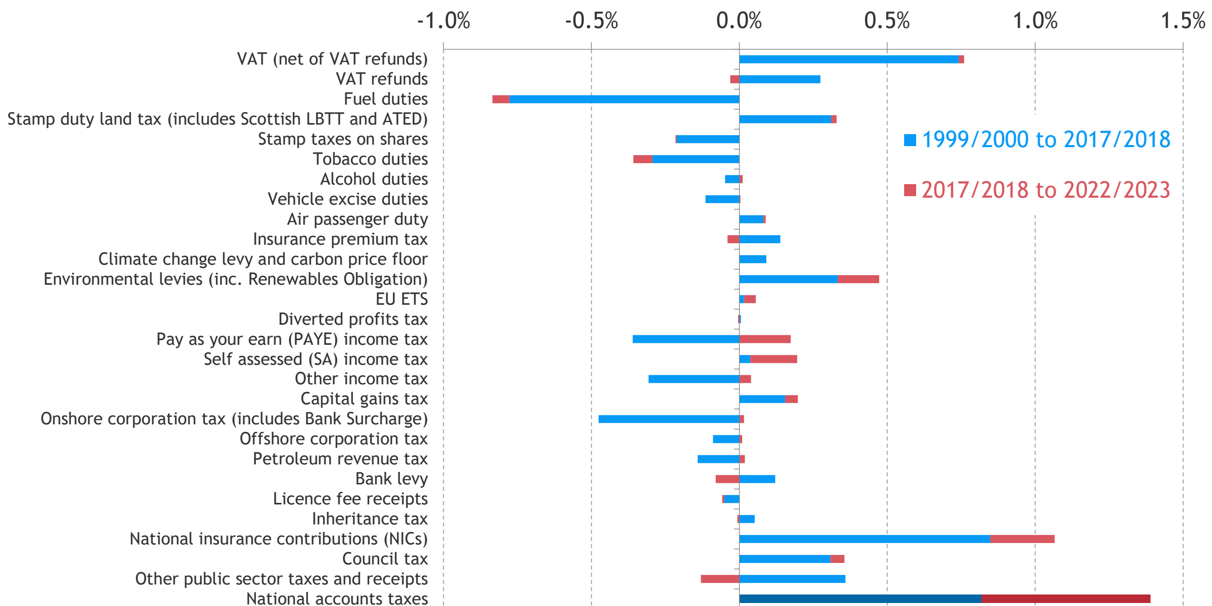


NOTES: These are figures designed for international consistency and may not match OBR totals.
SOURCE: OECD

This is backed up by OBR data, set out in Figure 10. The key trends since the turn of the millennium include a rise in VAT as a share of GDP; a fall in tobacco, alcohol and fuel duties (projected to continue); a shift from income tax to National Insurance; a fall in corporation tax receipts; a rise in stamp duty land tax and council tax; and a rise in non-vehicle green levies.

FIGURE 10: **Although overall tax receipts have risen, some taxes have shrunk relative to GDP**

Percentage point changes in tax receipts as a share of GDP



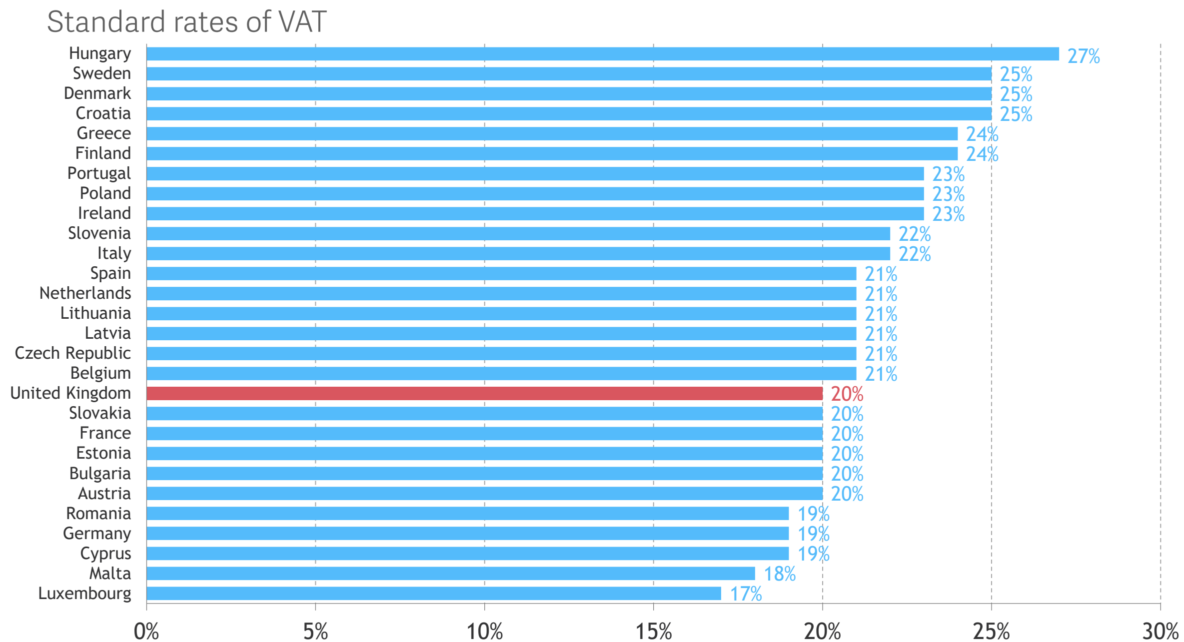
NOTES: Compares averages of two financial years.
SOURCE: OBR

In large part the increase in the VAT take will simply reflect the increase in the standard rate from 17.5 per cent (where it had largely remained unchanged since 1991)[9] to 20 per cent in 2011. But, despite this increase, the UK's standard VAT rate is not particularly high by international standards, as Figure 11 shows. The UK system also has a broader range of exemptions and reduced rates than most.

9 The rate was lowered to 15 per cent for 13 months following the financial crisis.

FIGURE 11: **The majority of EU-28 countries have a higher standard VAT rate than the UK**

Standard rates of VAT



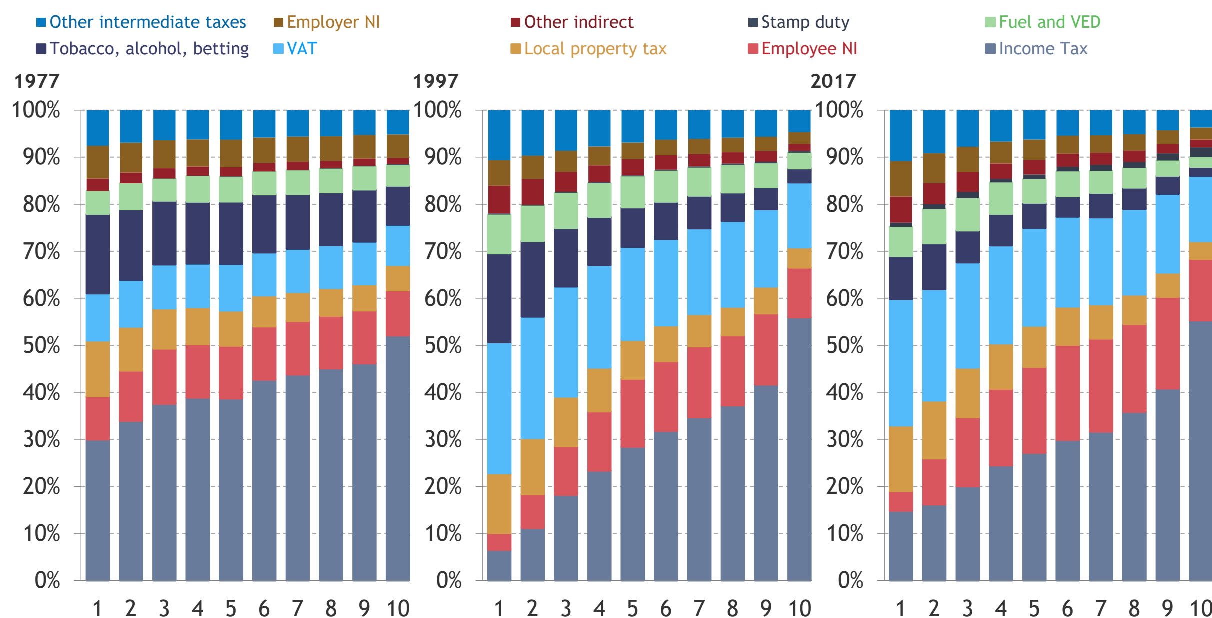
NOTES: Situation at 1 January 2019.
SOURCE: European Commission

Richer and poorer households pay different taxes

Changes in the make-up of the tax system particularly matter because some taxes affect different parts of the income distribution more than others. The composition of total taxation for each income decile, and how this has changed over time, is shown in Figure 12. Back in 1977, the composition of taxation was relatively equal across the income distribution (partly reflecting lower income inequality). But by 1997 the taxes that were most important for the poorest were very different from those for the richest. Among the lowest income decile, VAT and tobacco/alcohol/betting duties were 47 per cent of total taxes, with income tax just 7 per cent; whereas in the top decile income tax accounted for 56 per cent, and those consumption taxes only 17 per cent. In keeping with the overall revenue figures above, the key further shifts by 2017 included a decline in those duties and a rise in National Insurance.

FIGURE 12: **There are now large differences in the relative importance of different taxes for poorer and richer households**

Make-up of total taxes paid by equivalised household income decile, non-retired households only



SOURCE: RF analysis of ONS, *Effects of taxes and benefits on household income*

However, these data come with some significant caveats: top incomes are known to be significantly under-estimated (although there are plans to correct this);[10] benefit income is also under-reported;[11] a growing share of expenditure appears to be missing relative to the National Accounts;[12] and alternative assumptions can be made about the distributions of some taxes.[13] People will also move between these deciles over their lives (and save income to be spent later), ultimately flattening out the experience of the tax system. But it is nonetheless safe to say, for example, that income tax is very far from being the only tax that matters, particularly for lower income households. This is despite the fact that income tax is often discussed in isolation, at least in part because it is relatively easy for HMRC to analyse.[14]

Overall tax rates are surprisingly similar across households and across time

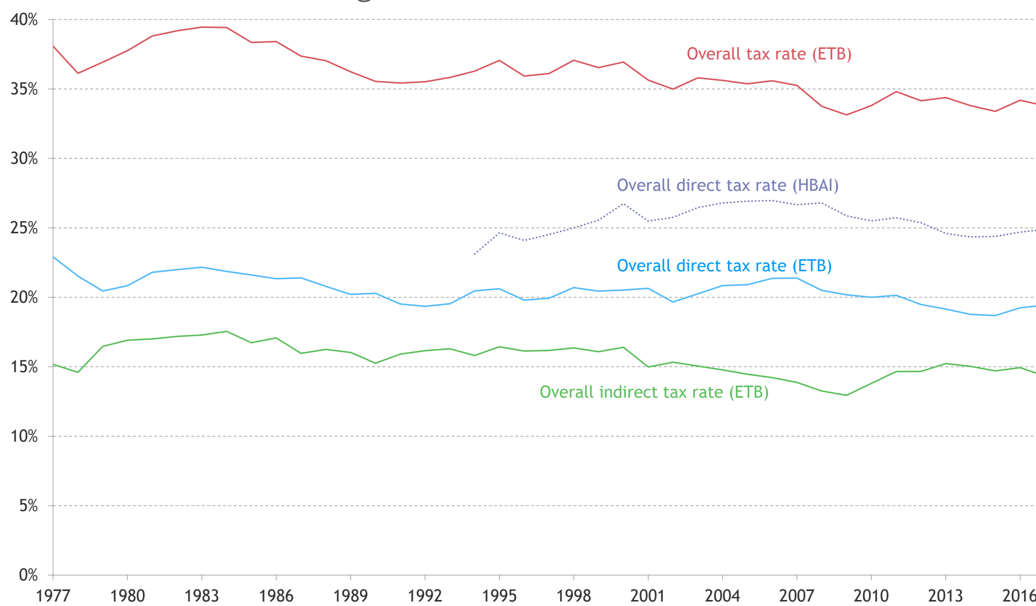
While the previous chapter focused on tax as a share of GDP, we can also examine how taxes relative to household incomes have changed over time. Incorporating all of the

10 A Corlett, Unequal results: improving and reconciling the UK's household income statistics, Resolution Foundation, December 2017
11 A Corlett, S Clarke, C D'Arcy & J Wood, The Living Standards Audit 2018, Resolution Foundation, July 2018
12 L Gardiner et al., Consuming forces: generational living standards measured through household consumption, Resolution Foundation, September 2017
13 P Bourquin & T Waters, The effect of taxes and benefits on UK inequality, Institute for Fiscal Studies, May 2019
14 A Corlett, What share of tax do the top 1 per cent pay? Less than you might have heard, Resolution Foundation Comment, May 2018

taxes above, the overall tax rate on households appears to have fallen from around 37 per cent in the late 1970s to 34 per cent in 2017-18 (using a three year average), shown in Figure 13. This fall is more pronounced for direct taxes than for indirect ones, but neither has risen in this data. Alternative data going back to 1994-95 (which more fully captures top incomes) also shows little change in the overall direct tax rate, and a downward trend over the past decade. There is little here to suggest that household tax levels are particularly burdensome at present by historical standards.

FIGURE 13: **ONS data suggests flat or falling tax rates**

Total tax as a share of total gross income



NOTES: Direct taxes includes income tax, National Insurance and council tax / domestic rates / poll tax. HBAI data includes a top-income correction that ETB does not (yet).
SOURCE: RF analysis of ONS, *Effects of taxes and benefits on household income (ETB); DWP, Households Below Average Income* (HBAI)

These data also allow us to see how overall tax rates differ across the income distribution, and how this has changed over time. The results in Figure 14 tell us a number of things.

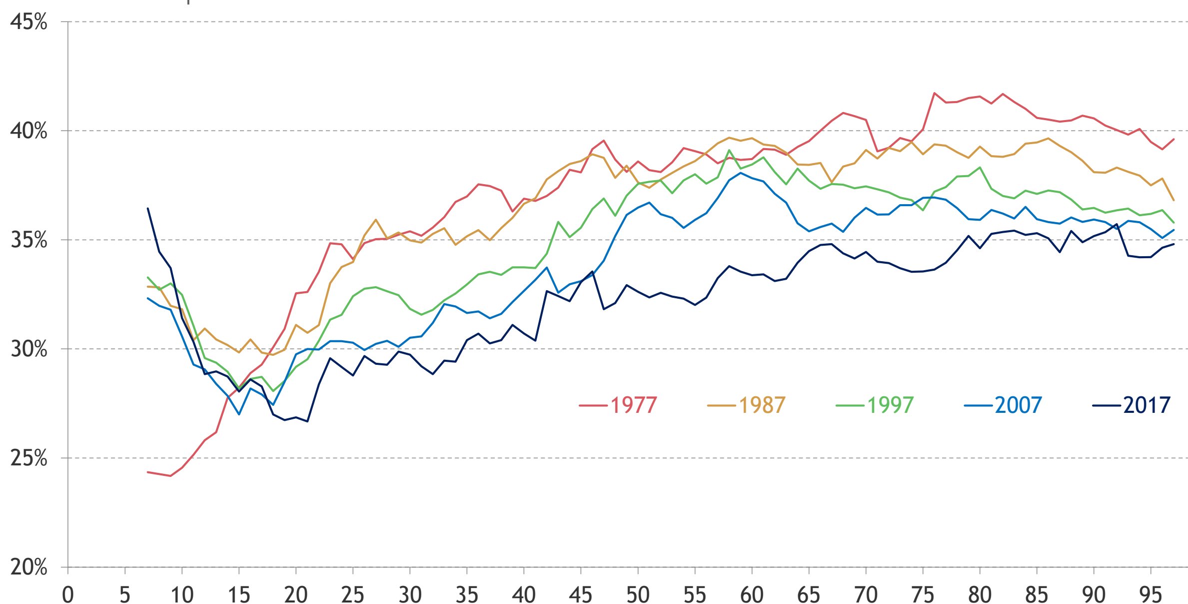
First, overall tax rates are remarkably flat across the income distribution, with rates of between 27 and 36 per cent for all income groups in 2017. That is, when all taxes are considered, tax is paid roughly in proportion to total income (including benefits).[15] There is a tick up at the bottom of the income distribution, but this is likely the result of under-reported incomes or households with only temporarily low incomes spending more (and therefore paying more indirect tax) than their income would suggest.[16]

15 A Corlett, What share of tax do the top 1 per cent pay? Less than you might have heard, Resolution Foundation Comment, May 2018
16 A Corlett, No, the poorest don't pay higher taxes than the richest, Resolution Foundation Comment, June 2018

We can also see that tax rates have generally fallen right across the income distribution but for different groups at different times. Top income households saw tax rates fall in the 1980s, while it has been middle and upper middle income households that have seen the biggest total tax rate reductions in the past decade.

FIGURE 14: **ONS data suggests tax rates are relatively flat across the distribution once all taxes are accounted for, and that taxes have generally fallen**

Average total tax as a share of gross income, by equivalised household disposable income percentile



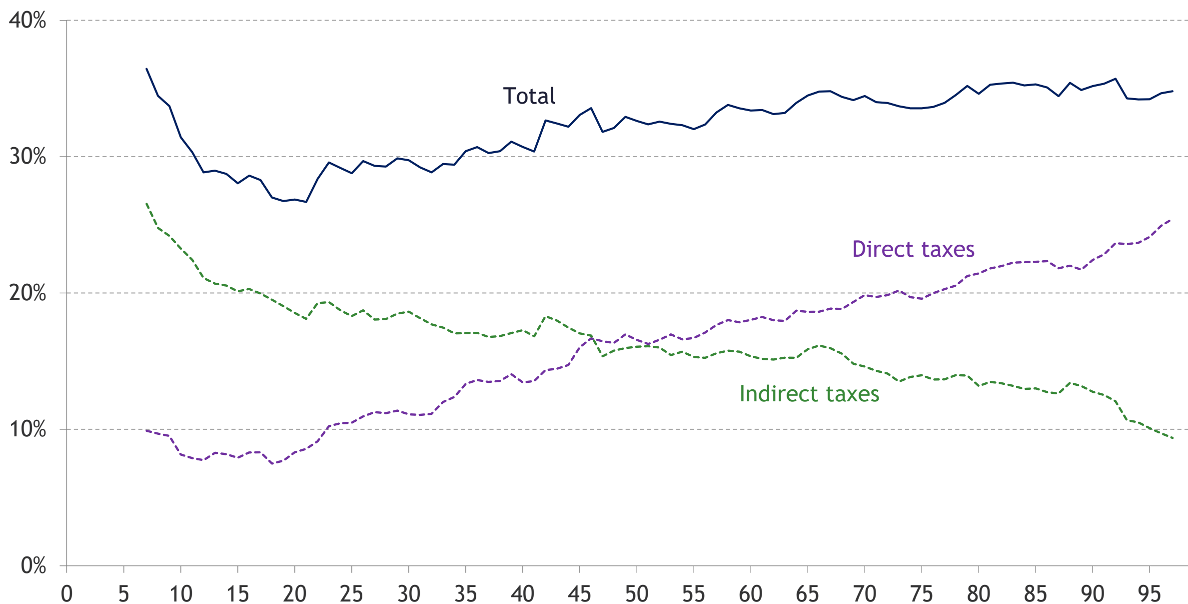
NOTES: Gross income is market income plus benefits.
SOURCE: RF analysis of ONS, *Effects of taxes and benefits on household income*

The surprising flatness of household tax rates can be seen, in Figure 15, as a combination of progressive direct taxation (income tax, National Insurance and council tax) and regressive indirect taxation when compared to income (though results differ considerably when comparing these to expenditure)[17].

17 P Bourquin & T Waters, The effect of taxes and benefits on UK inequality, Institute for Fiscal Studies, May 2019

FIGURE 15: **Total household tax rates are much flatter than if we were to look only at direct taxes, as indirect taxes are regressive as a share of income**

Average taxes as a share of gross income, by equivalised household disposable income percentile



NOTES: Gross income is market income plus benefits.
SOURCE: RF analysis of ONS, *Effects of taxes and benefits on household income*

Again, these data are not perfect, and revisions to top incomes and levels of expenditure might bring these results closer to the story told by National Accounts taxes. But there are other reasons to think that tax levels have fallen for many, at least.

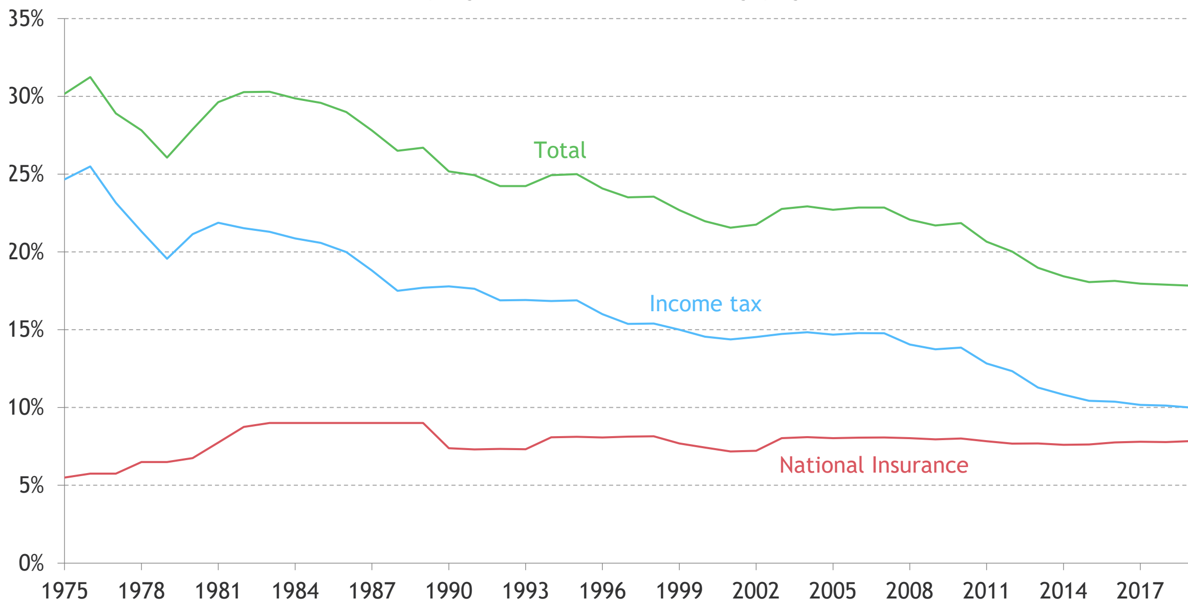
Income tax rates have especially fallen

We can say with more certainty that typical workers now face lower taxes on their wages than in the past.

Income tax and National Insurance are the workhorses of the tax system, accounting for 42 per cent of current receipts. Bringing together historic rates and thresholds for these two taxes, as well as historic pay levels, we model the effective tax rate a median employee would have paid in each year, shown in Figure 16. In 1975, their combined income tax and employee National Insurance rate would have been 30 per cent. By 1990 that had fallen to 25 per cent, and in 2019 it was just 18 per cent. If taxes were only as high as in 1990, they would now pay over £1,800 more than they do under the 2019 schedule. And if we look at income tax alone, the decline has been even starker.

FIGURE 16: **Effective tax rates for the typical employee have repeatedly fallen over time, though within this National Insurance has not fallen**

Effective tax rate for an employee on median weekly pay

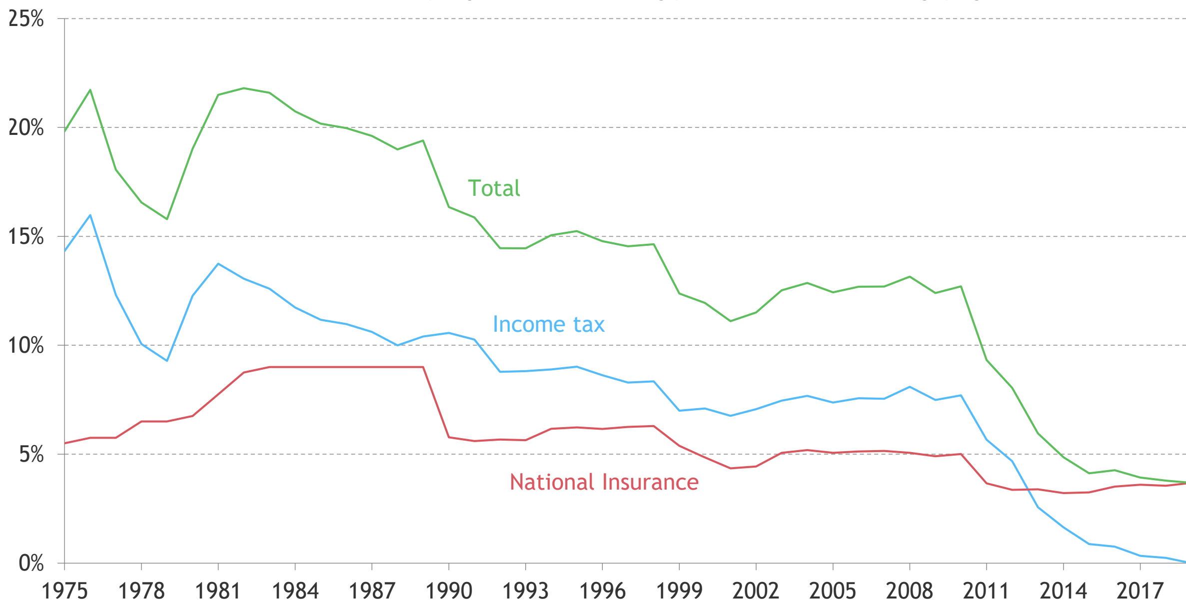


NOTES: Includes Income Tax and Employee (but not Employer) National Insurance. For consistency, tax rates are for unmarried employees under 65 with non-volatile earnings. Recent divergences in Scotland are not included.
SOURCE: RF analysis using median earnings figures from ASHE/NESPD and tax history from HMRC and IFS.

While the story for an employee with typical pay is one of falling effective tax rates, the decline in effective tax rates for a low paid employee (at half the median wage) has been even greater, as Figure 17 shows. Due to the policy of raising the starting point for income tax over the past decade, such an employee now pays zero income tax, down from 14 per cent of earnings in 1975. And National Insurance for them has fallen a little (also due to threshold increases), now taking 4 per cent of earnings.

FIGURE 17: **An employee on low pay now pays no income tax, and National Insurance has also fallen over time**

Effective tax rate for an employee on half of typical median weekly pay

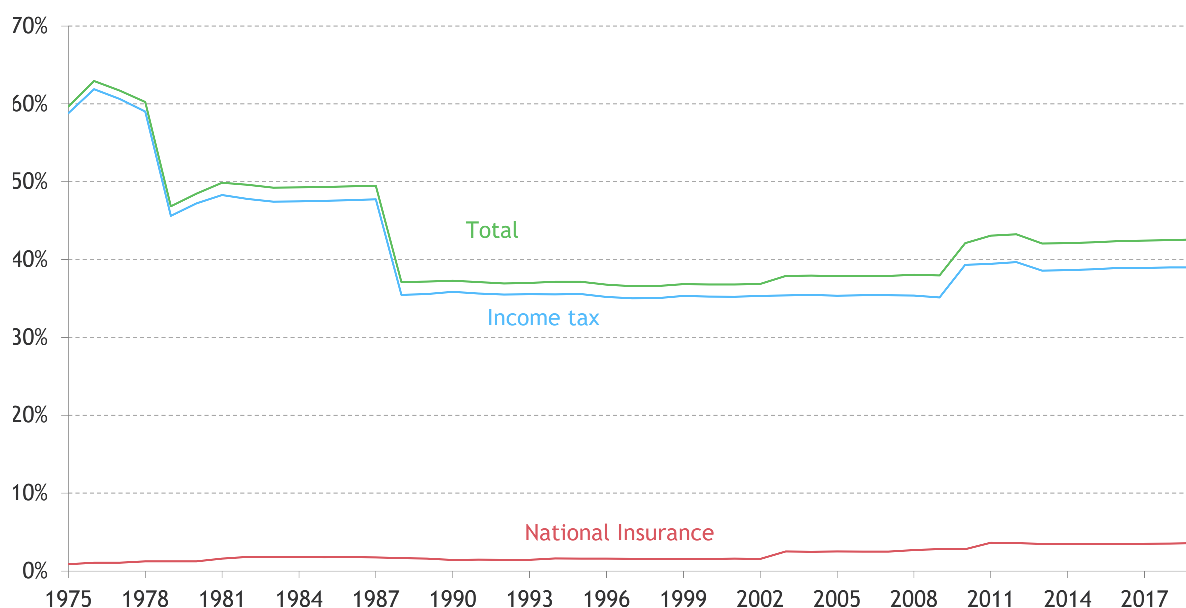


NOTES: Includes Income Tax and Employee (but not Employer) National Insurance. For consistency, tax rates are for unmarried employees under 65 with non-volatile earnings. Recent divergences in Scotland are not included.
SOURCE: RF analysis using median earnings figures from ASHE/NESPD and tax history from HMRC and IFS.

Those on very high earnings – 10 times the median (so around £250,000 in 2019) – have seen a more stable picture after initial big falls, as Figure 18 shows. Closely matching the history of top income tax rates, effective tax rates in this case fell substantially between 1978 and 1988. They were then extremely stable until the introduction of the 50p rate in 2010 and the fall back to 45p in 2013.

FIGURE 18: **Average tax rates for very high earners are largely a function of top tax rates, which fell in the 1980s especially, and rose a little post-crisis**

Effective tax rate for an employee on ten times median weekly pay



NOTES: Includes Income Tax and Employee (but not Employer) National Insurance. For consistency, tax rates are for unmarried employees under 65 with non-volatile earnings. Recent divergences in Scotland are not included.
SOURCE: RF analysis using median earnings figures from ASHE/NESPD and tax history from HMRC and IFS.

Going beyond those three examples, we can also look – in Figure 19 - at tax rates for all levels of earnings. To allow a fair comparison across time, incomes are adjusted in line with historical earnings growth.

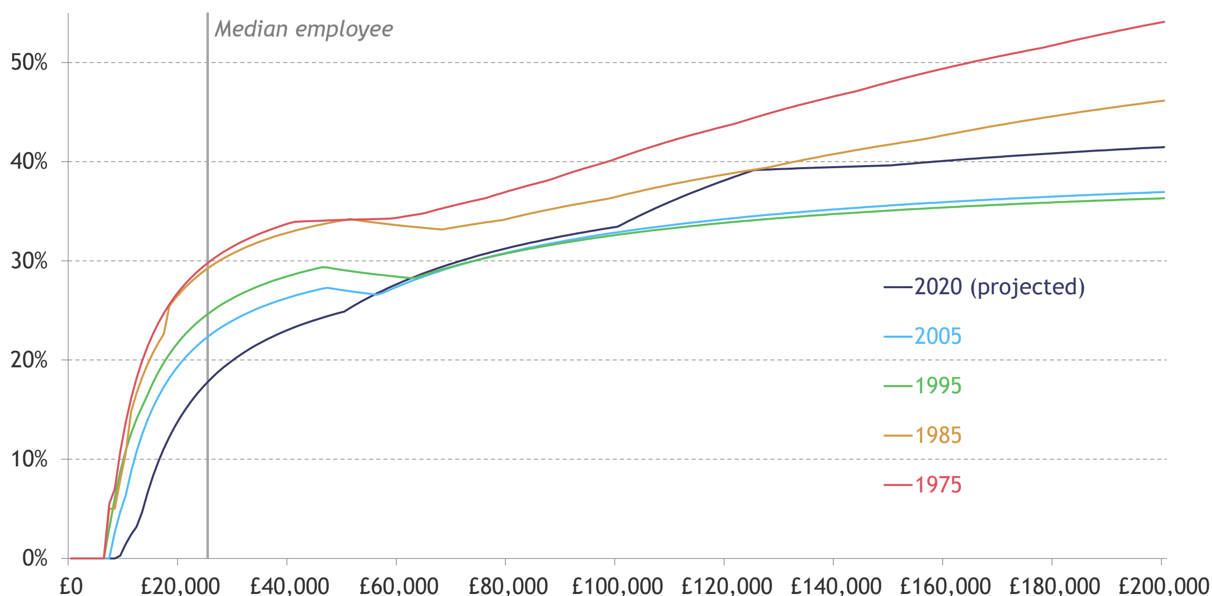
Between 1975 and 1985, effective tax rates on wages particularly fell for higher earners; whereas tax rates dropped across the income range by 1995. Between 1995 and 2005 there was little change for higher earners but rates fell for low to middle earning employees. More recently, rates of wage taxes for lower earners have fallen dramatically further while tax rates above £100,000 increased.[18]

Given these historic falls in effective tax rates for most, it is perhaps surprising that income tax and National Insurance revenues have remained buoyant. Partly this is due to increases in employer National Insurance. Partly it is due to an increase in the labour share since the mid-1990s, as explored in Section 2. And partly it relates to changes in inequality. Figure 19 gives effective tax rates by income (normalised to the median), but if a higher share of total income goes to high earners and less to low and middle earners, that will push up tax receipts independently of any tax policy changes.

18 Since 2010 the personal income tax allowance has been withdrawn from higher earners, beginning at £100,000.

FIGURE 19: **For most employees, effective tax rates on earnings have fallen considerably over time**

Effective tax rates (Income Tax and Employee National Insurance) by annual earnings, adjusted for growth in median pay



NOTES: Includes Income Tax and Employee (but not Employer) National Insurance. For consistency, tax rates are for unmarried employees under 65 with non-volatile earnings. Recent divergences in Scotland are not included. 2020 projected using default uprating assumptions and recent earnings growth.
SOURCE: RF analysis using median earnings figures from ASHE/NESPD and tax history from HMRC and IFS.

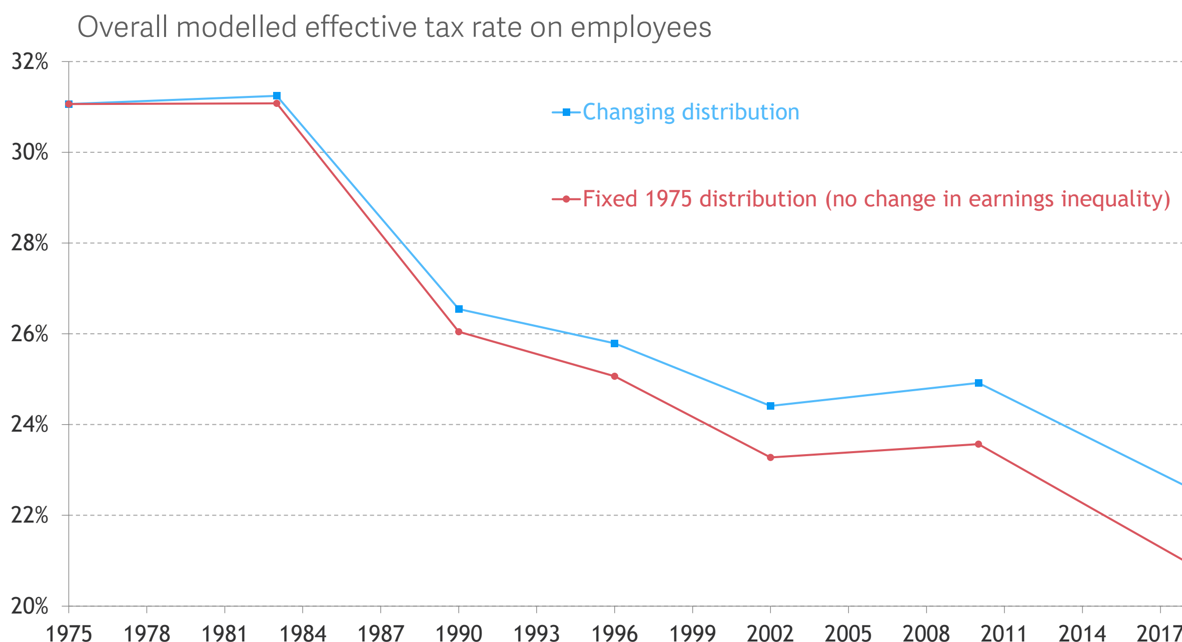
As a thought experiment, Figure 20 shows how the average employee tax rate has changed since 1975, and how it would have changed if earnings inequality had remained permanently at its 1975 level rather than rising (as it did until around 2002).[19] This shows that an increase in earnings inequality has to some extent supported tax receipts from wages.

Finally, looking internationally, separate analysis from the Institute for Fiscal Studies has shown that tax rates on a median earner would be higher if we imported a tax system from other rich nations.[20] The biggest difference though is in the level of employer social security contributions (not included above), where UK contributions (employer National Insurance) are considerably lower than most.

19 See Figure 3 in: C D'Arcy, Low Pay Britain 2018, Resolution Foundation, May 2018
20 H Miller, Cutting taxes on income would make UK more unusual relative to other countries, Institute for Fiscal Studies, July 2019

FIGURE 20: **Increases in earnings inequality have helped to prop up overall wage tax rates despite tax cuts**

Overall modelled effective tax rate on employees



NOTES: Includes Income Tax and Employee (but not Employer) National Insurance. For consistency, tax rates are for unmarried employees under 65 with non-volatile earnings. Recent divergences in Scotland are not included.
SOURCE: RF analysis using median and distributional earnings figures from ASHE/NESPD and tax history from HMRC and IFS.

If we care about high marginal rates, we need to look at benefits too

The charts above refer to average tax rates (total tax as a share of income), but we also care about marginal tax rates (the tax you pay on an additional £1 of income) and their impact on incentives. And here it is essential to consider the benefits system as well as income tax and National Insurance. We will look at the welfare system as a whole in a separate paper, but in terms of work incentives it is the combined impact of taxes and benefits that matters.[21]

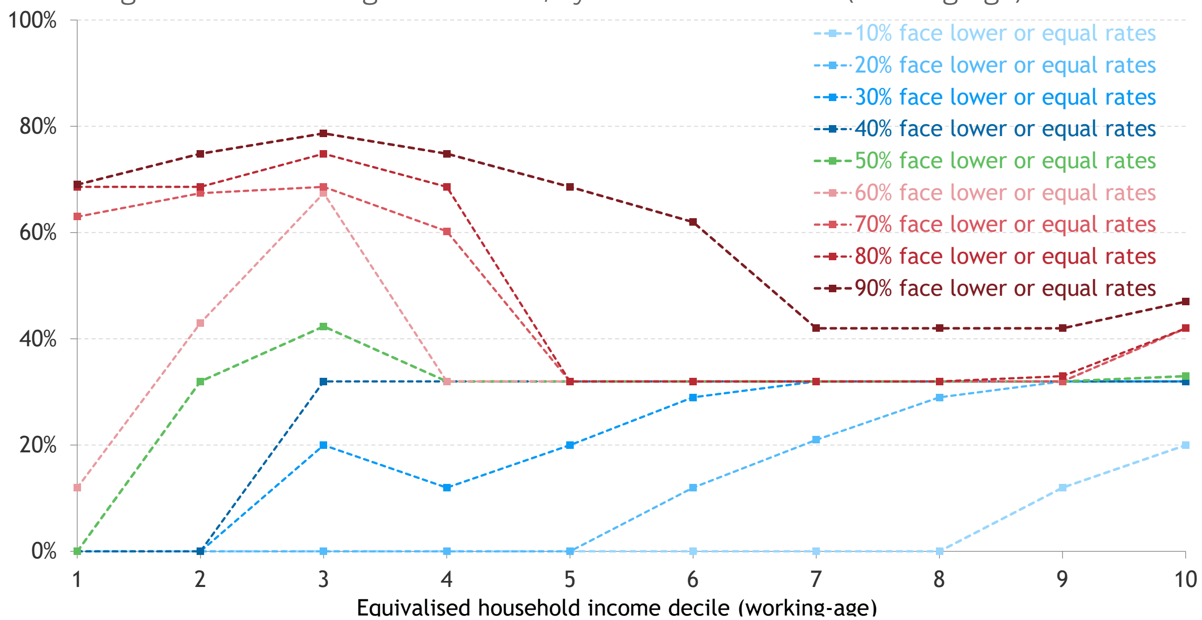
Figure 21 shows modelled effective marginal deduction rates in 2020-21 for the working-age population. It shows the range of deduction rates paid by individuals at each tenth of the household income distribution. In most parts of the living standards distribution, the median deduction rate is 32 per cent (basic rate income tax and employee National Insurance). But there are big differences across the income distribution – and not in the way many might assume. While some in the top deciles pay 42 or 47 per cent, the highest deduction rates are amongst lower income households. Indeed, many in the bottom six deciles face marginal deduction rates of 63 per cent or more. This is the Universal Credit

21 Ultimately, it is the tax and benefit system as a whole that also matters for distributional analysis and average tax rates; and the two might be considered one. For example, if we count tax credits as negative taxes, then HMRC statistics show that tax rates for some low earners have been going up recently. See HMRC, Income tax (net of tax credits) as a per cent of gross earnings for specimen families, 1990-91 to 2019-20. But the tax system and benefit system are both so large as to require separate scrutiny.

taper rate (we assume full roll-out of UC). Where this combines with National Insurance or income tax, rates may be 67 per cent or 75 per cent, and withdrawal of Council Tax Support (with its own separate taper) may also push up rates. Higher up the income distribution, the withdrawal of both child benefit and the personal allowance may also be a concern in terms of marginal rates.[22]

FIGURE 21: **Accounting for both the tax and benefit systems, many adults in low to middle income households have marginal deduction rates of 63 per cent or more**

Range of effective marginal tax rates, by household income (working-age)



NOTES: Modelled tax and benefit payments, with full take-up. Assumes UC rolled out. Calculations for 2020-21.
SOURCE: RF analysis of FRS using IPPR tax-benefit model

So although the income tax schedule is progressive, when we look at household incomes and the full array of rates, marginal rates are actually higher (but also more diverse) in the bottom half of the income distribution.

Such high marginal rates are not always a significant problem in practice: primary earners with children may be quite likely to stay in work regardless of rates, and the benefit system relies on conditionality to offset some work disincentives. But some other groups such as second earners and single parents are known to be more responsive to marginal rates.

Overall then, when focusing on tax as a share of household income it is far from clear that high tax burdens are a particularly big problem at the moment. Effective tax rates are low by historical and international standards; top tax rates have been considerably

22 A Corlett, CB40: Happy 40th birthday to child benefit! But will it last another twenty?, Resolution Foundation Comment, April 2019

higher; and any concern about the highest marginal tax rates should focus more on the benefits system. But there are certainly changes happening that require a response from the tax system. The next section looks at some of these.

Section 4

How the world is changing

As society and the economy change, so the tax system needs to change to reflect that. Otherwise, it risks significant losses of revenue and potentially harmful distortions. In this section, we explore four sets of challenges. First, demographic pressures are pushing up the need for revenue, even before considering expansions in the breadth of public services. Second, the tax system has not kept up with the growing importance of wealth and trying to fund a growing state through flawed taxes like council tax is not sustainable. Third, the tax system has created great distortions as to what form of economic activity and remuneration should be used. This has pushed people away from employment and reduced revenue. And fourth, the necessary wholesale switch to non-fossil-fuel vehicles will – on current policy – lose the Treasury £35 billion a year, while the £9 billion of tobacco revenue may also be at risk, and there will be no repeat of past North Sea tax booms. The tax system must be used to support green changes while also ultimately replacing the lost revenue. This section also summarises the tax changes that the Resolution Foundation has previously proposed to help address these pressures.

Taxes will need to rise to fund the state the public wants

In the previous two sections we have explored how the size and shape of the tax system have changed over recent decades, and have put that in an international context. But the fiscal challenges and tax options available will change over time. So next we look at why tax revenue may need to rise in the 2020s and what forms of taxation could and should take that strain.

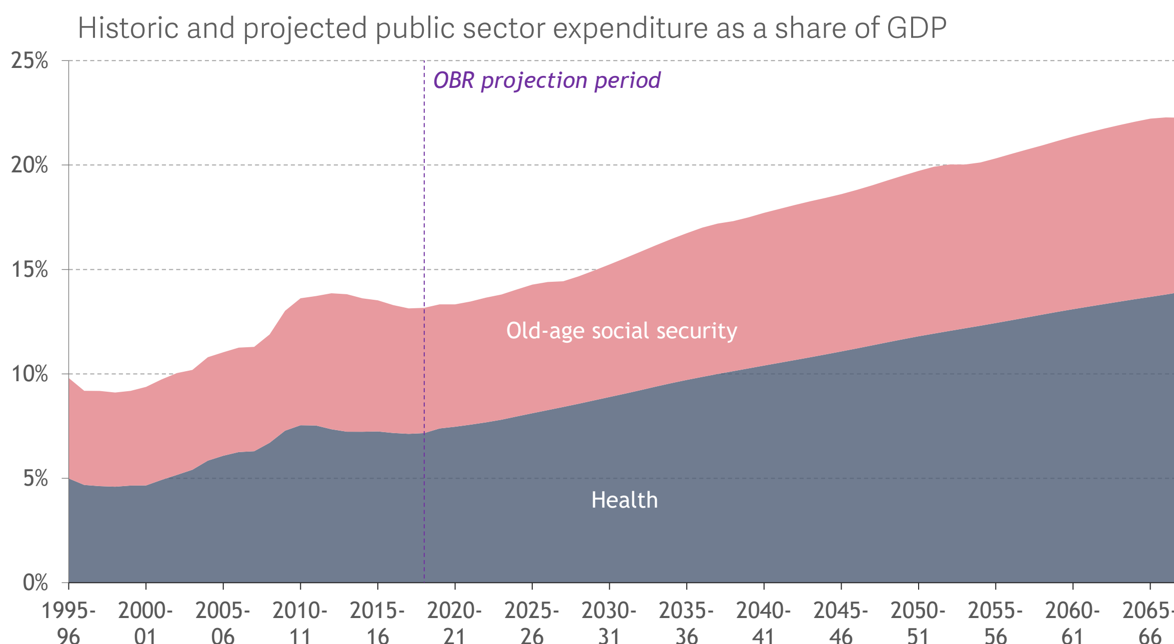
Clearly, the extent and quality of public services, and the tax levels required to fund those, are intensely political choices. But underlying trends will push up the cost of providing existing levels of services and social security. As explored in *The shape of things to come: charting the changing size and shape of the UK state*, rising life expectancy, past variation in the birth rate, and rising healthcare costs mean health and old-age social

security costs must grow faster than GDP simply to provide the same level of service that we have today.

As Figure 22 shows, these parts of public spending are projected to grow from 13 per cent of GDP now, to 15 per cent in ten years' time, and perhaps 20 per cent by the middle of the century. This is despite the state pension age rising to 66 by 2020 and to 68 by 2046.

FIGURE 22: **Health and old-age spending needs will put upward pressure on the size of the state**

Historic and projected public sector expenditure as a share of GDP



NOTES: For more details see Resolution Foundation, *The shape of things to come: charting the changing size and shape of the UK state*
SOURCE: RF analysis of HMT, PESA (various) and ONS, ESA Table 11; OBR Fiscal Sustainability Report 2018; ONS, Public sector finances

In the past, a declining defence budget as a share of GDP has helped to fund increased old-age spending,[23] but that will not always be an option. Cutting education spending as a share of GDP would not be desirable. And cutting working-age social security further would increase poverty again. Other parts of the state have already endured years of cuts, and in the general election so far it is clear the order of the day is more spending rather than less. And although the two main parties have loosened their fiscal rules,[24] there remains a shared goal to keep the current budget balanced.

This creates a clear need for state revenue to rise. Based purely on the health and old-age projections in Figure 22, taxes would need to rise by around 1 per cent of GDP every

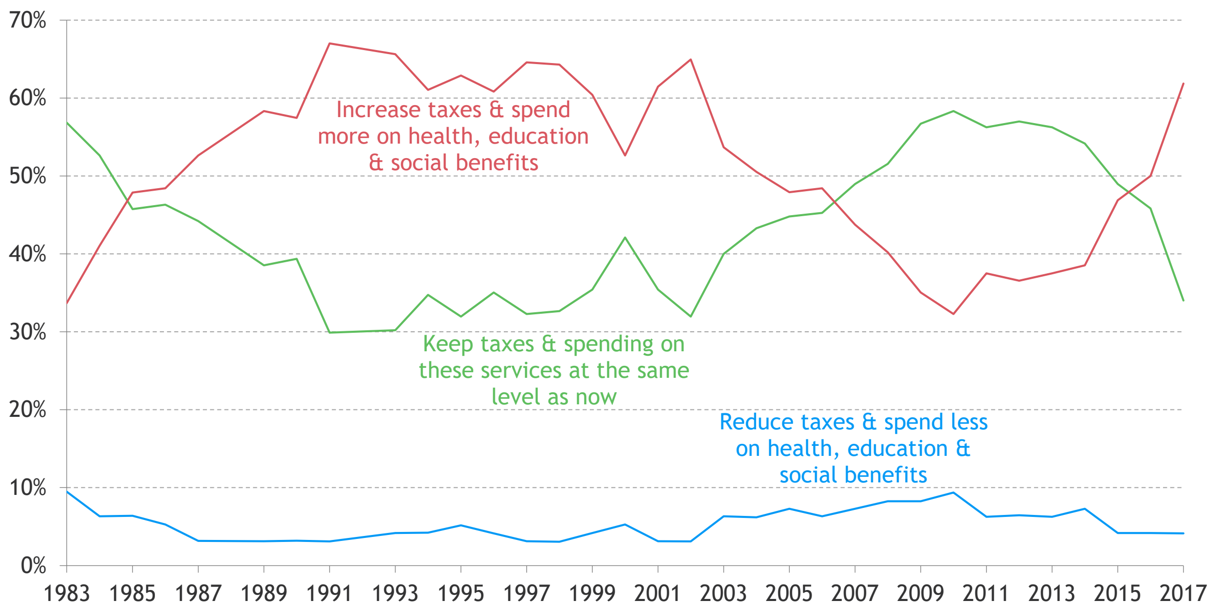
23 For a discussion, see: S Adam, R Crawford, J Cribb, C Emmerson, P Johnson & R Joyce, Let's talk about six big economic challenges that need addressing, Institute for Fiscal Studies, November 2019
24 For a discussion of recent changes to the fiscal rules, see: T Bell, J Leslie, C Pacitti & Matt Whittaker, Rewriting the rules, Resolution Foundation, November 2019

five years. This scale of increase may well be achievable, but is likely to involve difficult choices for policy makers.

But, perhaps reflecting the pressures on public services, surveys show that a clear majority of people (62 per cent in 2017) favour increasing taxes to increase spending, the highest proportion since the early 2000s. In contrast, favouring actual tax cuts and lower spending on health, education and social benefits has always been a minority view.

FIGURE 23: **Surveys suggest a clear majority in favour of increasing taxes to pay for higher spending**

Proportion of adults favouring each option when asked "Suppose the government had to choose between three options. Which do you think it should choose?"



NOTES: Excludes 'don't knows'
SOURCE: British Social Attitudes survey

Of course, voters may not always be consistent when it comes to assessing whether any specific tax (especially their own) should go up.

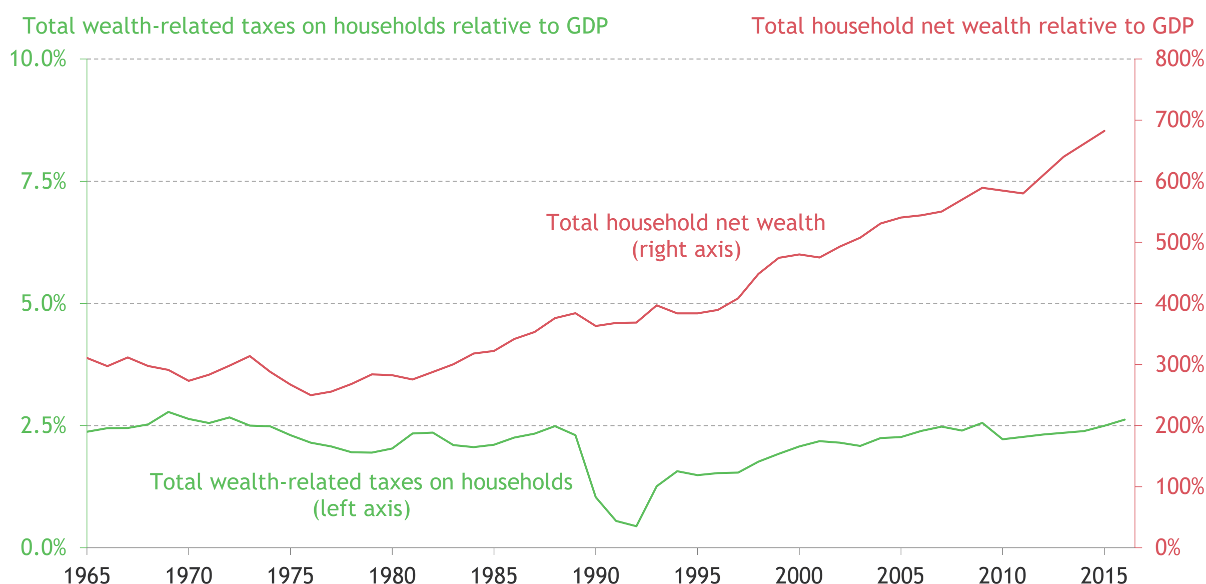
Increases in wealth suggest a strong case for increasing and reforming wealth taxes

If higher taxes are needed, we should also look to how the world has changed when considering which sources of revenue to consider. As Figure 24 shows, household wealth has risen far faster than national income, going from around 280 per cent of GDP in 1980 to 680 per cent of GDP in 2015. Previous work has explored this trend in detail, including changes in home ownership, the house-price windfalls of the 2000s, and increases in private pension wealth (including through life expectancy changes).[25]

25 C D'Arcy & L Gardiner, The generation of wealth: asset accumulation across and within cohorts, Resolution Foundation, June 2017

FIGURE 24: **Levels of wealth have risen far faster than national income, but wealth taxes have not caught up**

Proportion of GDP



NOTES: Total household net wealth covers Great Britain; tax and GDP data cover the UK.
SOURCE: RF analysis of ONS, *Wealth in Great Britain*; ISER, *British Household Panel Survey*; ONS, *UK National Accounts*; D Blake & J Orszag, 'Annual estimates of personal wealth holdings in the United Kingdom since 1948', *Applied Financial Economics*, 9, 1999; OECD.Stat

This large stock of wealth is also leading increasingly to large flows of wealth. The total value of inheritances has more than doubled over the past 20 years, with £127 billion of gifts and inheritances in 2015-16. And it is expected to double again over the next 20 years.[26] Realised capital gains have also ballooned in recent years.[27]

But taxes on wealth (broadly defined) have not kept up with those rises, as Figure 24 shows, and nor are they expected to keep up in future.[28] Council tax is more like the Poll Tax than a genuine property tax. Although stamp duty is linked to wealth transfers, it is economically a poor form of tax as it discourages housing transactions. Inheritance tax is unpopular, partly due to design flaws that reduce bills for the very wealthy in particular. The hugely important pension tax system is overly generous (yet still causes problems due to its complexity), and pensioners are also favoured in the tax system despite the closing of living standards gaps between them and non-pensioners. Meanwhile, at the top, capital gains tax and its loopholes allow the richest to pay lower tax rates than others, while significantly distorting behaviour (see below).

Such problems might be fairly tolerable in a world of low private wealth, but with growing stocks and flows, poorly designed taxes cause large inefficiencies, an over-dependence

26 A Corlett, Passing on: options for reforming inheritance taxation, Resolution Foundation, May 2018
27 S Nanda & H Parkes, Just Tax: reforming the taxation of income from wealth and work, Institute for Public Policy Research, September 2019
28 See for example: A Corlett, Passing on: options for reforming inheritance taxation, Resolution Foundation, May 2018

on taxing earned income, and risks of tax avoidance opportunities.

The case for change is also shown in the way that levels of Council Tax are now rising rapidly, with 4 per cent per year increases including an "adult social care tax". With Council Tax being a relatively regressive part of the tax system, for a number of reasons,[29] this is increasingly loading the cost of social care on to all households, with little regard for ability to pay, while still providing insufficient revenue.[30] More radical and progressive tax policy change is needed.

There is a very strong case for taxing different forms of income more equally

As well as the growing role of wealth, employee income has also diminished in relative importance due to a rise in self-employment and other forms of remuneration. In the early 2000s only 12 per cent of workers were self-employed but in 2019 that figure now stands at 15 per cent.[31] And there has been a particularly large rise in owner-managers of one-director companies.[32] So although a large number of self-employed workers might broadly be characterised as 'precarious' – on low to middle incomes in transport, care, hairdressing and construction, for example – there has been very strong growth in sectors like advertising, public administration and banking; adding to the numbers of relatively 'privileged' self-employed workers in health, legal services and consultancy.[33]

This matters a lot for the tax system. As noted in Section 3, National Insurance Contributions have grown as a share of GDP, with the employer National Insurance rate having gone up in 1999, 2003 and 2011 as more revenue was needed. Employment has also attracted the apprenticeship levy since 2017, and is used for auto-enrolment into pension saving (including employer contributions); as well as a wide range of worker rights. Taxing employment income is also relatively simple in practice through the PAYE system (recently supplemented by the Real Time Information system). But this employment-focused model for taxes and rights does not hold up if companies (or workers) decide to shift away from employment towards other ways of commissioning labour.

Self-employment does not attract employer National Insurance, or any equivalent. And for the self-employed themselves, the basic rate of National Insurance is only 9 per cent, rather than the 12 per cent paid by employees. As Figure 25 shows, this creates big tax differences.

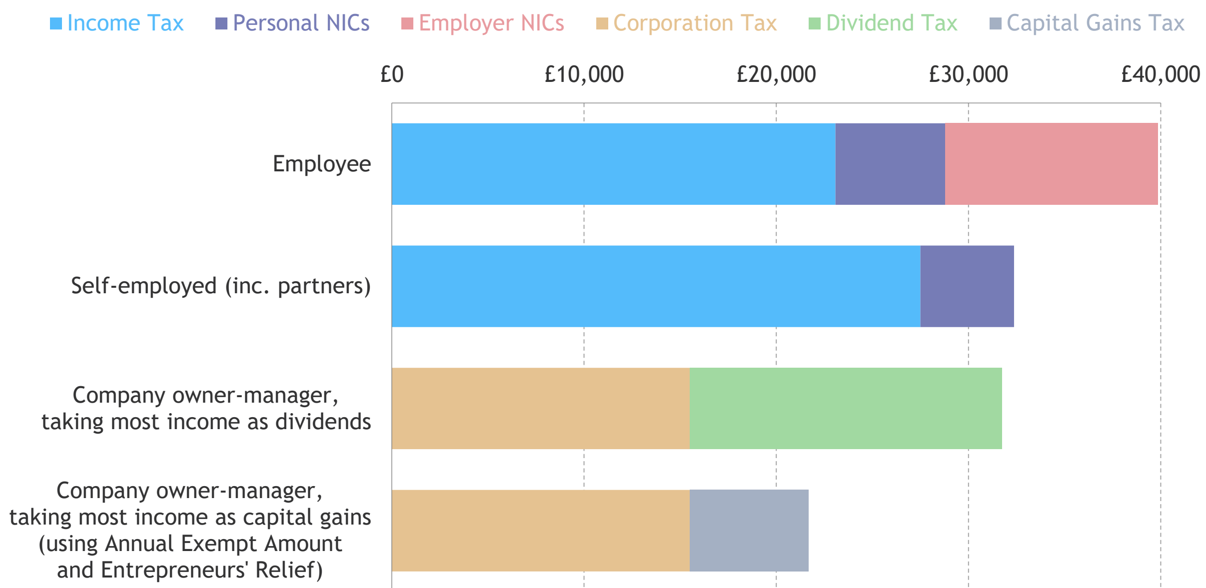
29 A Corlett and L Gardiner, Home affairs: options for reforming property taxation, Resolution Foundation, March 2018
30 D Phillips, The outlook for councils' funding: is austerity over?, Institute for Fiscal Studies, November 2019
31 RF analysis of ONS, Labour Market Statistics
32 J Cribb, H Miller & T Pope, Who are business owners and what are they doing?, Institute for Fiscal Studies, June 2019
33 D Tomlinson & A Corlett, The nature of self-employment in 21st Century Britain and policy implications, Resolution Foundation, February 2017

Individuals can potentially further reduce their tax bill by incorporating. Although they may then wish to pay themselves a small (potentially tax-free) salary, they can choose to take most of their money as dividends and pay corporation tax and dividend tax instead. And for those who can afford to delay dipping into their profits, it is possible to effectively receive income as capital gains. Particularly thanks to Entrepreneurs' Relief – which allows up to £10 million of gains to be taxed at only 10 per cent – tax bills can be reduced still further.

So while someone generating £100,000 of value as an employee would attract a total tax bill of £40,000 in 2020-21, someone providing similar services through a one-person company and taking advantage of Entrepreneurs' Relief may pay only £22,000.

FIGURE 25: **There are huge tax inequalities between different forms of income, inevitably distorting individual and corporate behaviour**

Tax paid on £100,000 of market income, by legal form



NOTES: Based on estimated 2020-21 tax system, on default policy (including 17 per cent corporation tax rate). Employee salary is £89,000 after employer NICs. Example company owner-managers pay themselves a salary equal to the NICs threshold (tax-free) and in both cases take advantage of the dividend allowance.
SOURCE: RF analysis

Those taking their income as dividends or capital gains also have much more flexibility about the timing of that income, allowing optimal use of annual allowances and making it easier to take advantage of changes in tax policy (e.g. waiting for tax cuts). In addition, a whopping 26 per cent of self-assessed tax-payers under-declared their tax liabilities in 2015-16.[34]

34 HM Revenue & Customs, Measuring tax gaps 2019 edition Tax gap estimates for 2017-18, June 2019

Tax is not the only reason why self-employment and incorporation have become more common. But for the Treasury, artificial distortions between different ways of doing business are both a bad thing in themselves and an open door for further revenue losses.

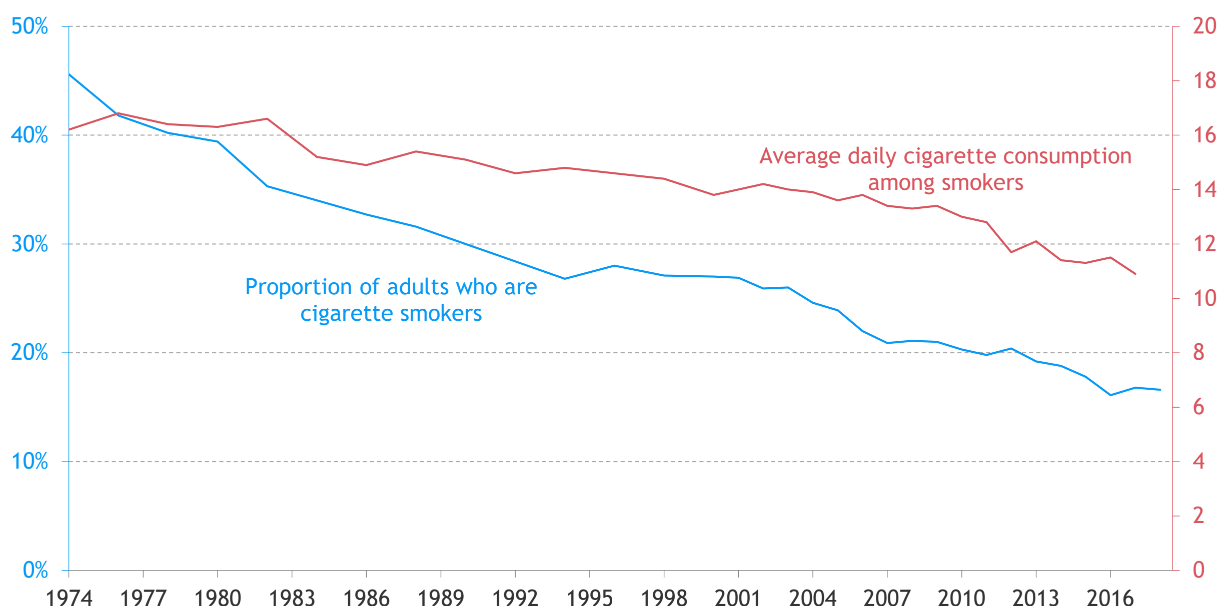
Taxes can help phase out damaging activities, but new sources of revenue must then be found

The employment status issues above are an example of a tax differential that might unintentionally drive behavioural changes. But the Treasury must also contend with reductions in revenue that stem from welcome changes.

For example, tobacco duties still raise £9 billion a year. But, even with a duty escalator of RPI plus 2 per cent each year, the continued decline in cigarette consumption shown in Figure 26 is expected to weigh on this source of revenue. Going further, the government has suggested "an ambition to go 'smoke-free' in England by 2030… with smokers quitting or moving to reduced risk products like e-cigarettes."[35] But, if successful, that would be £9 billion (UK-wide) that would need to be raised elsewhere.

FIGURE 26: **Heavily-taxed cigarette consumption has been declining**

Proportion of adults who smoke and average consumption among smokers



NOTES: GB. Data are unweighted prior to 2000, and refer to fiscal years prior to 2005.
SOURCE: ONS, *Adult smoking habits in Great Britain*

Even more significantly, fuel duty and vehicle excise duty (VED) together raise £35 billion – equivalent to 1.6 per cent of GDP each year, or roughly the combined budgets of the Home Office, Department for Transport and Department for International Development.

35 Department of Health & Social Care, Advancing our health: prevention in the 2020s – consultation document, July 2019

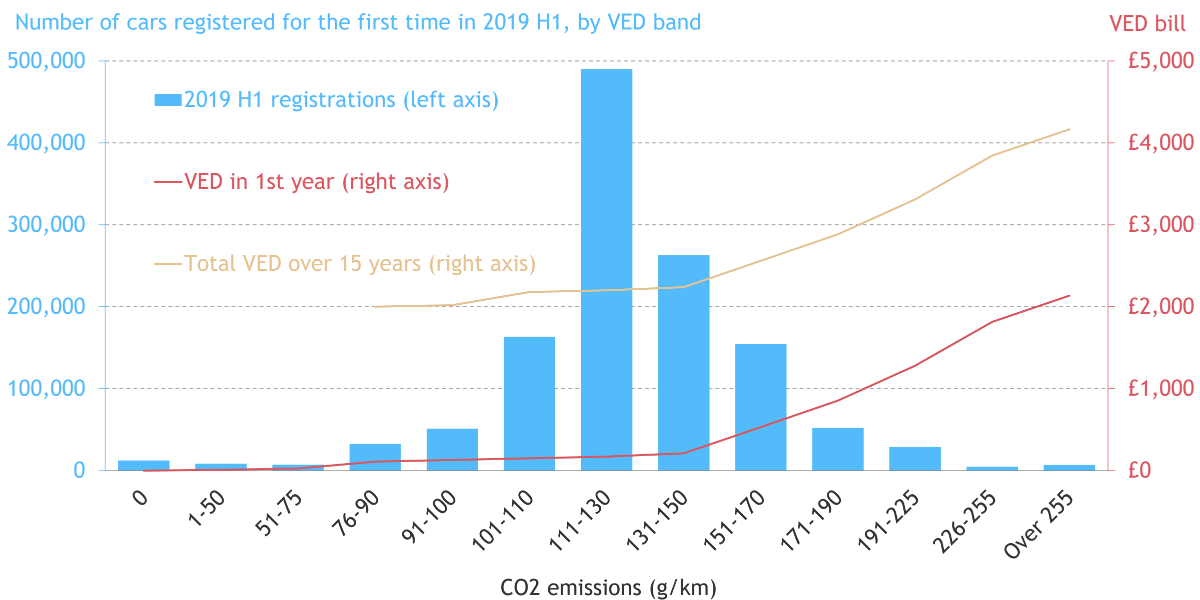
Given the current design of these taxes, delivering net zero greenhouse gas emissions will essentially drive these revenues to zero. Yet these taxes may also have a very important role in encouraging the decarbonisation of transport.

The Committee on Climate Change has called for all new cars and vans to be electric by 2030, or 2035 at the very latest.[36] Government policy is already for 2040 (though this would only be a partial ban), with the Scottish government saying 2032, while Labour and the Liberal Democrats have called for a 2030 ban. In all cases, petrol and diesel vehicles would need to have been entirely phased out by 2050.

This is an opportunity and a problem for the tax system. VED is somewhat proportional to emissions for new cars, as set out in Figure 27, but not after the first year. But electric vehicles (except those costing over £40,000) pay zero each year. To encourage the decarbonisation of transport and reduction in air pollution, VED could be made still more proportional to emissions, while recognising that even if more revenue were raised in the short-term, it could fall to zero as early as 2030.

FIGURE 27: **Despite the VED system's mild incentives, low-emission cars are at present still a small minority of new sales**

Number of cars registered for first time in 2019 H1, by VED band



NOTES: Total VED figures are for petrol or diesel cars, except for the 76-100g/km ranges which show figures for hybrids.
SOURCE: Department for Transport

A continued rise in electric vehicle sales would affect fuel duty revenues more slowly than VED revenues, as the stock of all cars will change more slowly than the flow of

36 Committee on Climate Change, Net Zero – the UK's contribution to stopping global warming, May 2019

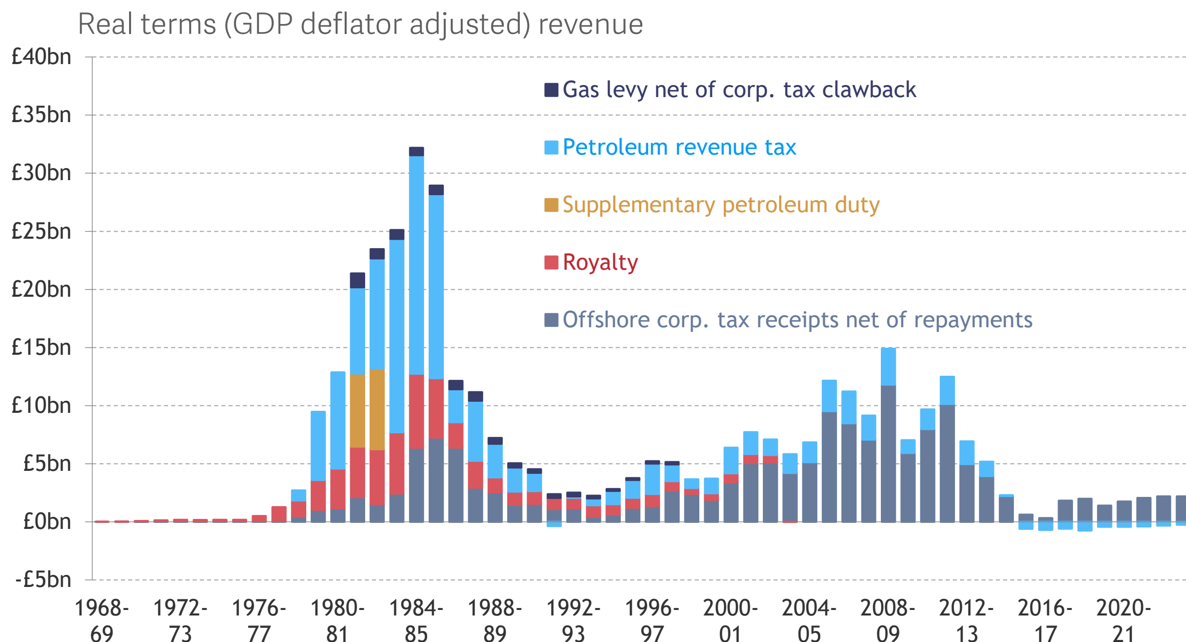
new cars. But, given fuel duty's importance, this is still a huge challenge for the Treasury. Labour, for example, have an ambition for two thirds of the UK car fleet to be electric by 2030,[37] which might be expected to reduce fuel duty revenue by around two thirds, or around £20 billion.

Fuel duty could be increased to drive electrification and buoy revenues (short-term), but the recent norm has instead been to cut fuel duty in real terms. As others (such as the Institute for Fiscal Studies and Committee on Climate Change) have suggested, the best solution may be replace fuel duty (and VED) in the long-term with road pricing, to link taxes with actual road use and congestion.[38] So fuel duty, VED and road pricing look set to be key UK tax policy issues throughout the 2020s. Other green policies such as changes to the carbon price or VAT may depend on what happens with Brexit (discussed further in Section 5).

As if a £44 billion revenue loss from tobacco and vehicles taxes were not enough, it should also be noted that the tax system has at previous times been buoyed by oil and gas revenue. As shown in Figure 28, in 1984-85 this revenue peaked at £32 billion (in today's money, but not adjusted for the size of the economy), and this was not unrelated to the personal tax cuts discussed earlier. In the 2000s it averaged around £9 billion a year. But in two recent years this revenue has in fact been negative (partly due to decommissioning costs) and is now forecast to remain under £2 billion. The public services funded by earlier windfalls must now be funded through other taxes.

37 The Guardian, Labour to commit to big increase in charging points for electric cars, September 2019
38 See S Adam & R Stroud, A road map for motoring taxation, Institute for Fiscal Studies, October 2019; and Letter from Lord Deben to Simon Clarke MP, October 2019

FIGURE 28: **The UK will have to get by without the oil and gas production tax revenues of the 1980s or 2000s**



NOTES: Projected from 2019-20 onwards
SOURCE: HMRC outturn and OBR projection

The Resolution Foundation has made a range of prescriptions to help address these challenges

Bearing in mind these trends and challenges, the Resolution Foundation has suggested a number of tax policy changes. These range from small short-term changes to complete overhauls, and are set out in more detail in other publications, but they can be summarised as follows:

- Cancel (at least) 1p of the 2p corporation tax cut planned for April 2020.
- Completely replace council tax with a progressive property tax – including a tax-free allowance – based on up-to-date values (and allow local authorities to raise additional money to build new homes via a property tax building precept).
- Cut residential stamp duty, except for the purchase of additional properties.
- Support further progress on occupational pension saving among low- and middle-earners during a period of rising minimum pension contributions by providing a flat rate of income tax relief; and exempting employee pension contributions from employee National Insurance, funded by capping tax-relieved lump sums drawn at retirement to £40,000.
- Introduce a new 'NHS levy'. This would include charging employee and self-employed National Insurance contributions on the earnings of workers over the

State Pension age. It would also place a charge that mirrors employee National Insurance contributions on private occupational pension income, but initially at half the main rate and with a higher starting threshold.[39]

- Abolish inheritance tax and replace it with a lifetime receipts tax with lower rates and fewer exemptions. This should be levied on recipients, with a tax-free allowance to encourage broadly shared inheritances. The existing system could alternatively be tightened by freezing its thresholds, focusing reliefs, removing the normal gifts exemption, and closing pension inheritance loopholes.[40]
- Scrap forgiveness of Capital Gains Tax upon death, at least for additional residential properties and assets qualifying for Business Property Relief or Agricultural Relief.
- Scrap Entrepreneurs' Relief, or potentially lower its threshold from £10 million to £1 million.
- More broadly, improve the governance of tax expenditures by treating them more like departmental spending.
- Equalise self-employed and employee NICs by raising Class 4 NICs.[41]
- Levy employer NICs or an equivalent tax on PAYE-registered companies that use self-employed labour (including owner-managers).
- Abolish the marriage tax allowance.[42]
- Abolish Lifetime and Help to Buy ISAs (though technically these are spending measures).

On top of those suggestions, other areas of policy might be considered. As above, VED, fuel duty and road pricing need action, with scope for wider tax reforms driven by a decarbonisation agenda. Business rates and corporation tax could potentially be changed to better encourage investment, while capital gains tax needs greater reform. And the fiscal challenges set out above are likely to ultimately require broad increases in income taxes during the 2020s.

Clearly, a lot of reform is warranted. In the next section we look at what the major political parties have suggested they would do over the next five years.

39 A New Generational Contract: The final report of the Intergenerational Commission, Resolution Foundation, May 2018
40 T Bell & A Corlett, How wealth taxes can raise billions more without scaring any horses, Resolution Foundation, January 2019
41 Work in Brexit Britain: reshaping the nation's labour market, edited by S Clarke, Resolution Foundation, July 2017
42 D Finch, Making the most of UC, Resolution Foundation, June 2015

Section 5

What the parties are proposing

This section explores what tax policies the parties may propose ahead of the election. There is plenty for voters to absorb, and some very big differences between the parties, with a particularly large gap between Labour – who want to raise perhaps £50 billion for new spending – and the Conservatives – who may propose multi-billion pound tax cuts largely funded through increased borrowing. We explore some of the key areas that are likely to be debated, from income tax and National Insurance, to corporation tax, the future of inheritance tax, and indeed the desirability of post-Brexit tax freedoms.

These are big picture choices, but the details of these policies will matter too, and we offer some suggestions. The Conservatives could make their likely National Insurance cut fairer by ensuring those on Universal Credit receive the full cut. And Labour may need to ensure a top rate rise raises as much revenue as possible by implementing it rapidly and closing off avenues of avoidance.

Finally, we caution that the parties should be honest about some of the difficult decisions that will need to be made about taxes in the years ahead.

There are big differences in the parties' tax policies

At the time of writing, no party manifestos have been released.[43] However, from the 2017 manifestos and subsequent announcements, we have a good idea of what the parties may say. Table 1 lists many of the possible policies that may be announced, for five of the largest parties.[44]

Some aim to raise money for spending promises the parties have made; others to reduce carbon emissions; and many to also achieve distributional goals. Not all will make it into manifestos (and any post-election Budget may, if history is any guide, include additional tax rises). But it is clear there is a lot of tax policy to be discussed at this election. More

43 The Brexit Party says it will not be releasing one, but does list a short policy platform
44 These five parties together account for over 90 per cent of current voting intentions, and over 95 per cent of 2017 MPs.

importantly there is a big fundamental choice between lower taxes (and lower spending) under the Conservatives or Brexit Party and higher taxes (and higher spending) under Labour, the Liberal Democrats or SNP.

TABLE 1: **Based on 2017 manifestos and other statements, a wide range of tax policies may plausibly be on offer at this election**

	Conservatives	**Brexit Party[45]**	**Labour[46]**	**Liberal Democrats**	**SNP**
Income tax / National Insurance	Raise the starting threshold for employee and self-employed National Insurance		Raise income tax rate to 45p above £80,000 and 50p above £125,000. Excessive Pay Levy beyond £330,000. End marriage tax allowance.	1p rise in income tax rates. Flat rate of 25% pension tax relief, and other reforms. End marriage tax allowance. Ultimately replace National Insurance with a Health & Care Tax.	Support raising UK top tax rate to 50p. End marriage tax allowance.
VAT and similar	Cut VAT on energy and sanitary products from 5% to 0% after Brexit	Introduce an online sales tax	VAT on private school fees and increase tax on private medical insurance	Reform Air Passenger Duty	
Corporation tax	Go ahead with cut from 19% to 17% in April 2020		Cancel cut and raise to 26% for large companies. Introduce 'inclusive ownership fund'	Cancel cut and raise to 20%	Cancel cut
Inheritance tax	Cut	Abolish	Potentially reform or replace	Replace with a recipient-based tax	
Capital gains tax	Cut for landlords who sell up		Reverse rate cuts	Complete reform with higher rates but inflation indexing. Abolish CGT forgiveness at death.	
Business rates & commercial SDLT		Reduce business rates to zero for high street retailers and leisure operators outside the M25	Remove business rates exemption for private schools. Exclude new plant and machinery investment.	Replace with land value tax	(Devolved)

45 https://www.thebrexitparty.org/policy-platform/
46 http://labour.org.uk/wp-content/uploads/2017/10/Funding-Britains-Future.pdf

Council tax & domestic SDLT				Cut council tax in lower bands and add new bands at top. Review case for broader reform. Link SDLT to energy efficiency.	(Devolved)
VED & fuel duty	Cut or freeze fuel duty		Waive surcharge on electric vehicles above £40,000 for fleets for two years	Make VED more proportional to fuel efficiency	
Carbon pricing	Leave the EU Emissions Trading Scheme, and replace			Raise the Carbon Price Floor. Remove renewables from Climate Change Levy.	
Other			Extend scope of stamp duty reserve tax. Anti-avoidance programme. Offshore company property levy.	Regulate and tax cannabis trade. Anti-avoidance programme.	

In total, the Labour 2017 manifesto proposed tax rises of £49 billion, and the Liberal Democrats £16 billion (both on their own costings). And the SNP's tax policies refer to increases rather than cuts. In contrast, the Brexit Party proposes a £6 billion tax cut by abolishing inheritance tax. Quite how far the Conservative manifesto will go in promising tax cuts, and whether it will fund these and spending promises through any specific tax rises, remains to be seen; but the Chancellor has said that tax cuts can be afforded under his new fiscal rules, and it seems likely that multi-billion pound tax cuts will be proposed.

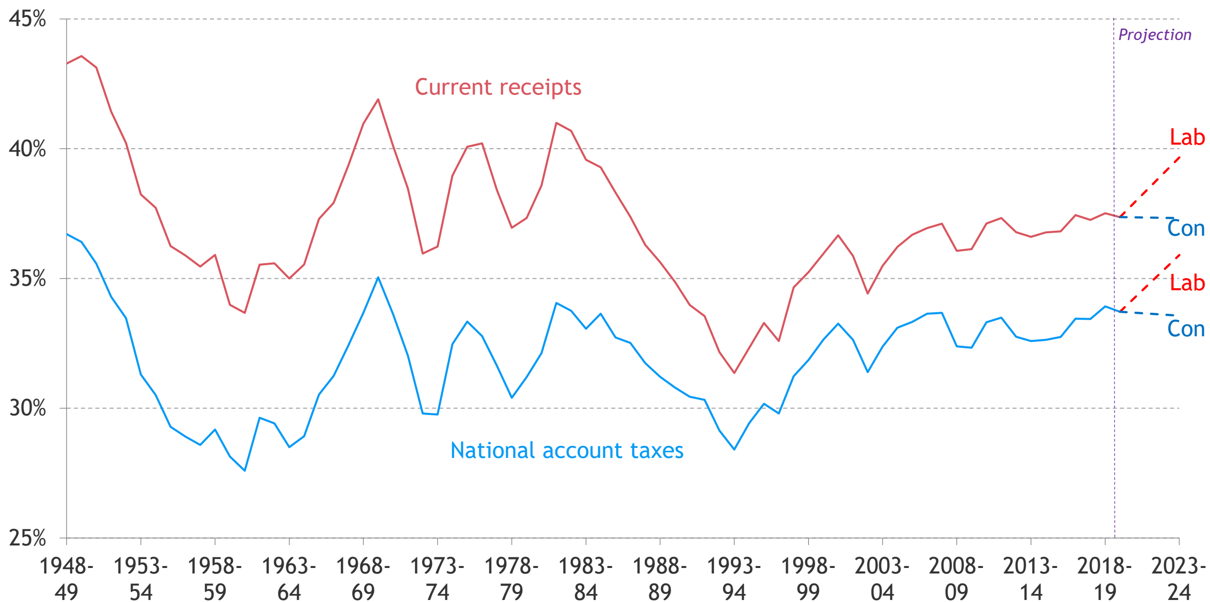
The difference between the two largest parties, in particular, is large by historical standards. From 2010 to 2017, both parties proposed net tax increases as part of deficit reduction programmes. Before that, New Labour was more reluctant to propose headline tax increases in its manifestos. You may need to go back to the 1992 election to find such diverging views, when Labour proposed top tax rate increases and the Conservatives proposed basic rate cuts, among other policies. Or to 1983 and 1987, when Labour proposed new capital taxes while the Conservatives wished to push ahead with income tax rate cuts.

Adding plausible total tax policy costings (+£50 billion for Labour; -£10 billion for the Conservatives) to the OBR forecasts in Figure 1, Labour's plans would clearly mean tax rising as a share of GDP while they might fall marginally under the Conservatives. This amounts to very different policy platforms, with the gap between the two equating to

over 2 per cent of GDP. The Liberal Democrats are likely to fall somewhere between the two, but also with large tax rises overall.

FIGURE 29: **Labour and the Conservatives now have very different visions about the size of the tax system**

Tax as a share of GDP under illustrative scenarios



NOTES: With illustrative tax policy totals of +£50 billion for Labour and -£10 billion for the Conservatives. Baseline combines the latest OBR revenue figures with revised ONS GDP figures, with OBR growth forecasts from March applied for the projection period. No policy adjustment is made to GDP or to non-tax receipts.
SOURCE: OBR *Public Sector Finances Databank*, September 2019; and ONS; plus RF policy scenarios.

Labour and Liberal Democrat income tax plans would most affect richer households...

Looking in more detail at the policies in Table 1, one of the more consequential would be Labour's proposed change to the income tax schedule. This would only affect those with incomes above £80,000 – "the top 5 per cent" as Labour say – with a new tax rate above this of 45 per cent rather than 40 per cent, and a top rate of 50 per cent above around £125,000 (rather than 45 per cent above £150,000 at present). This top rate would be a return to where it stood between 2010 and 2012, albeit starting at a lower level of income.

In 2023-24,[47] we estimate this policy would raise around £6 billion, though tax changes at the top of the income distribution do tend to be more uncertain.[48] Unsurprisingly, this

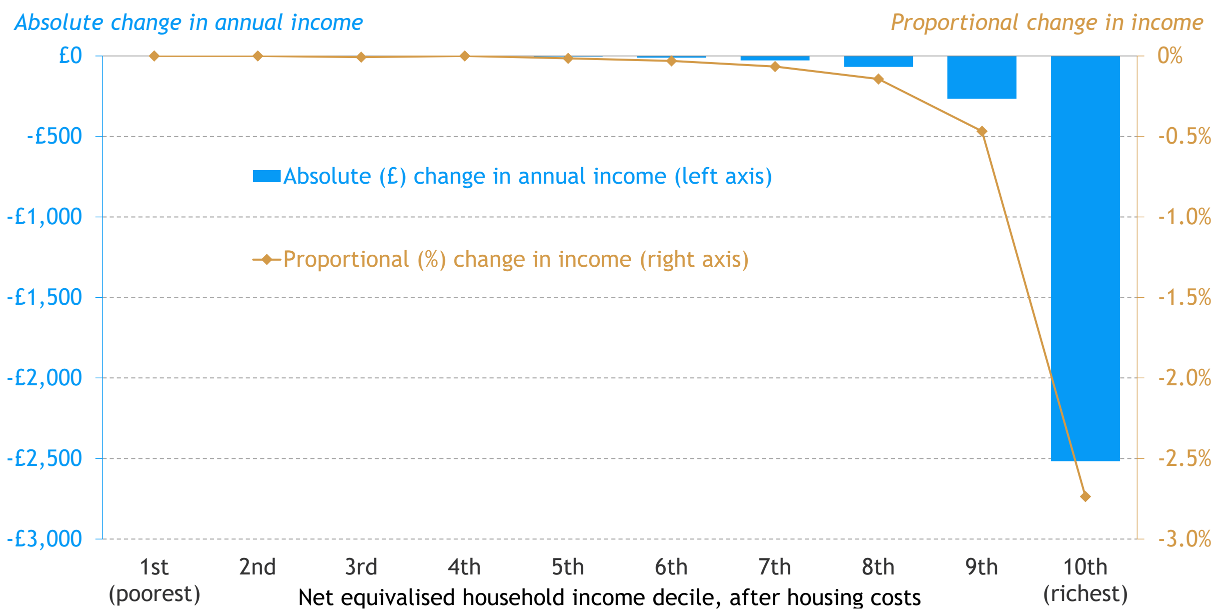
47 The last year of the most recent OBR forecast window, the last full year of the next parliament, and a time by which the roll-out of UC is expected to be largely complete.

48 This costing (and that for the Liberal Democrats) is based on a UK wide policy change. Rates are devolved to Scotland, and now Wales, but for the Westminster government the financial impact would be very similar to a UK-wide change, due to the way the block grant system works.

sum would come almost exclusively from the top ten per cent of the household income distribution, as Figure 30 shows.

FIGURE 30: **Labour's income tax changes would only affect the top of the household income distribution**

Average policy impacts in 2023-24 by household income decile



NOTES: Assumes no behavioural response but uses data that underestimates top incomes. We assume the £80,000 threshold would not have changed with inflation, but that the 50 per cent rate would begin where the personal allowance withdrawal ends. We include changes to dividend tax rates.
SOURCE: RF analysis using the IPPR tax-benefit model

In implementing this policy, Labour can learn some lessons from the top rate changes of 2010 and 2013.[49] First, they would be wise to make the change rapidly – i.e. in April 2020. This would reduce the degree to which dividends especially could be brought forward before the higher rate is introduced, though the tax take in the first year of the new rate would still likely be reduced. Second, incentives to shift profits between forms of income would also need to be reduced. As shown in Figure 25, taking income as capital gains can be lucrative, and would be even more so if top income tax were increased in isolation. So Labour proposals to increase corporation tax and capital gains tax rates would go hand-in-hand with this policy, and the case for reviewing Entrepreneurs' Relief would be made even stronger.

Labour are likely to not be the only party proposing income tax rate rises, as set out in Table 1. The top rate has already been increased to 46 per cent in Scotland, with a higher rate of 41 per cent. So the SNP may well support the top rate in the rest of the UK rising,

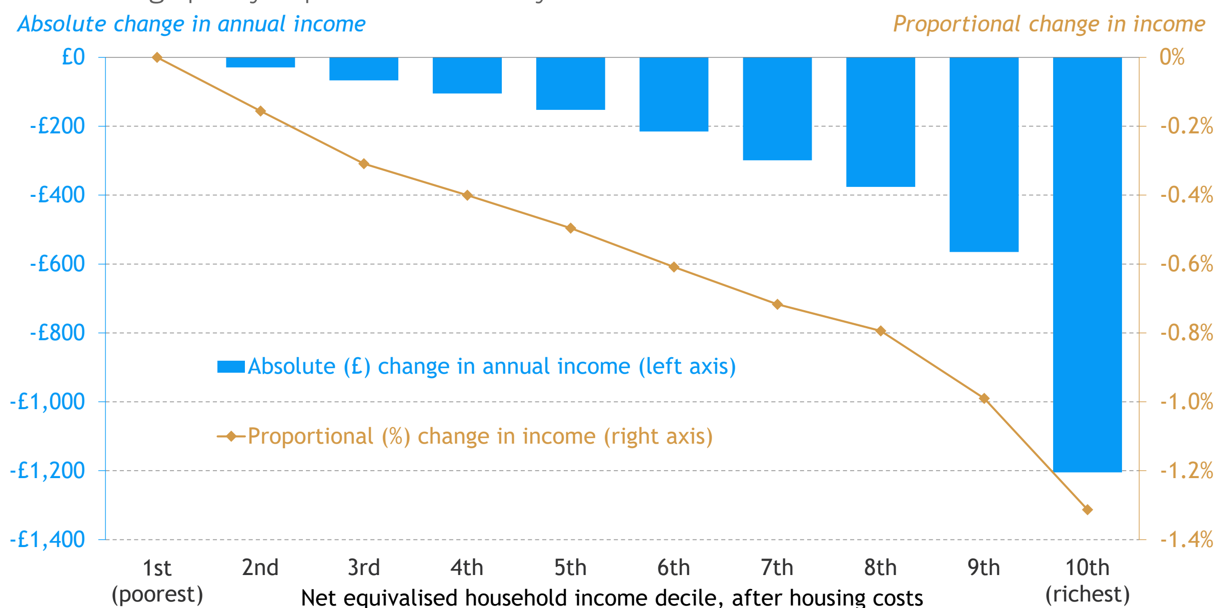
49 See for example: A Manning, Top rate of income tax, LSE, 2015

although to what level is less clear.[50]

The Liberal Democrats have proposed increasing all rates of income tax by 1p, raising around £7 billion in 2023-24. As Figure 31 shows, this would inevitably affect a much broader group of people than Labour's policy, but would still be a very progressive income change, reducing inequality.

FIGURE 31: **The Liberal Democrat plan to increase income tax rates by 1p would be a progressive way to raise revenue**

Average policy impacts in 2023-24 by household income decile



NOTES: Assumes no behavioural response but uses data that underestimates top incomes. We include changes to dividend tax rates.
SOURCE: RF analysis using the IPPR tax-benefit model

...while the Conservatives propose National Insurance cuts

In very stark contrast to these expected tax-raising proposals, it has been widely speculated that the Conservatives will propose at least one substantial tax cut. Given previous statements, they may propose to raise the starting point for National Insurance. At present, this is around £8,600 a year[51] but they might raise it to the level of the income tax allowance, which will be £12,500 in 2020-21 and (rising with inflation) might be around £13,250 by 2023-24. To reduce the cost of the policy, this may apply for employees and the self-employed, but not for employer National Insurance. Given that the basic rate of employee National Insurance is 12 per cent for employees, the change would equate to a tax cut of £480 a year (in 2023-24) for anyone earning above the threshold.[52] Dual-earner

50 Note that Wales now also has control over its income tax rates.
51 Though technically this 'primary threshold' is weekly or monthly for employees
52 For the self-employed the tax cut would be smaller at around £360.

couples would potentially get double this, as would those with two jobs, as National Insurance is calculated per job.[53] Those earnings below threshold – e.g. working under 19 hours per week on the National Living Wage, would not benefit.

This is a fairly reasonable choice of tax cut if you believe lower taxes is the objective: benefiting more lower earners than further personal allowance increases, being far more progressive than rate cuts, and would reduce marginal rates for some. It also has no bearing on future benefit entitlements: paying any National Insurance is not a requirement to build up contribution records.[54]

However, given the fiscal challenges set out in Section 4, it is not clear why further broad tax cuts should be a priority. The cost would be £11 billion in 2023-24, and the Chancellor has hinted that it might be funded by further increases in borrowing.

To strategically try and address the self-employment tax issues discussed in Section 4, the tax cut could apply to employees but not the self-employed, but that would only reduce the cost by around £1 billion and may be unpopular.

And while raising the National Insurance threshold is relatively progressive as tax cuts go, in terms of poverty reduction it would be far better and cost-effective to simply cancel or reverse some or all of the £12 billion of benefit cuts that were announced in 2015. As we have shown previously, even a £5 billion package of focused benefit spending would turn around the worrying outlook for child poverty.[55]

Figure 32 shows the distributional impact of the potential tax cut. In cash terms, it is the top of the income distribution that would benefit most as those households are more likely to have two earners who would each benefit, while poorer households are more likely to have fewer earners and more dependents. But in relative terms, the impacts of the tax would be broader with upper-middle income households benefitting most and most deciles seeing gains of over 1 per cent of disposable income.

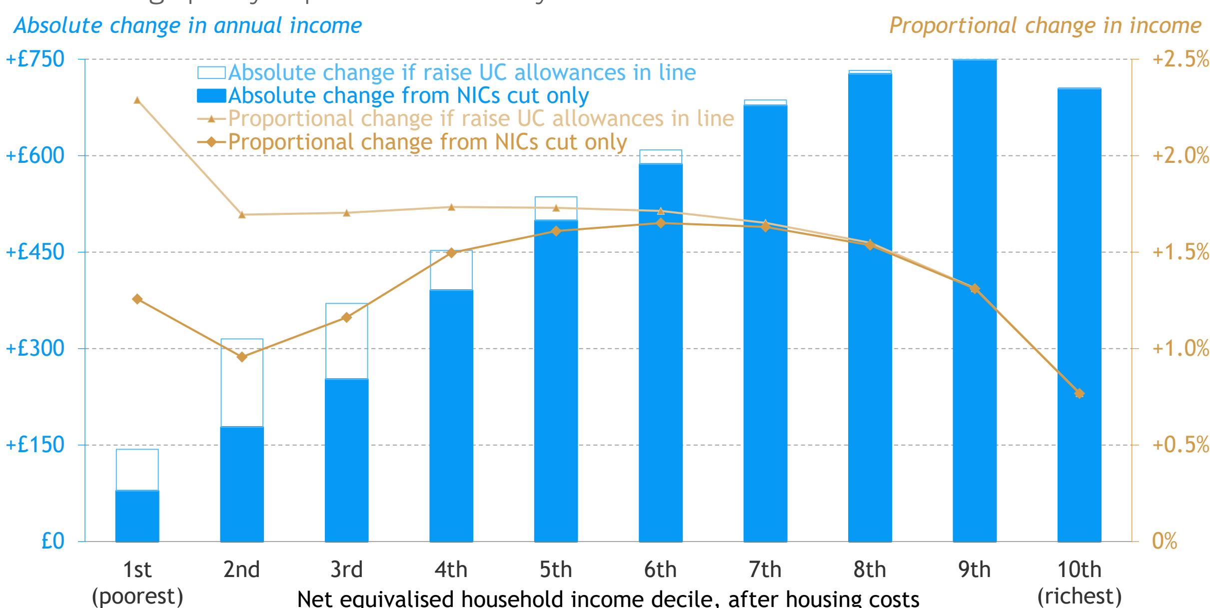
One reason why the policy is not more progressive is that those in lower income households, on Universal Credit, are likely to lose 63 per cent of the tax cut due to means-testing. That is, they may receive a £480 tax cut but their Universal Credit will then immediately be reduced by £300 a year. Given that millions of working-age households will be on Universal Credit, this will affect, for example, the majority of single parents who pay National Insurance, or most parents and disabled adults in in-work poverty. On top of

53 A Corlett & D Finch, Double take: workers with multiple jobs and reforms to National Insurance, Resolution Foundation, October 2016
54 You must earn above the separate Lower Earnings Limit
55 A Corlett, The Living Standards Outlook 2019, Resolution Foundation, February 2019

this, some individuals may see their Council Tax Support payments reduce as a result too, to the extent that some people would actually be left worse off by the tax cut.[56]

FIGURE 32: **Raising the National Insurance threshold would help higher-income (dual-earning) households most, but it could be made more progressive by ensuring Universal Credit claimants get the full benefit**

Average policy impacts in 2023-24 by household income decile



NOTES: Assumes full roll-out of UC, and incomplete take-up of benefits. Includes pensioners, who would not benefit.
SOURCE: RF analysis using the IPPR tax-benefit model

It is not clear why workers in poorer households should be given a smaller income boost than those in richer households. But there is a way to resolve this. If Universal Credit's Work Allowances were increased by the same amount as the tax cut – i.e. £480 a year (£40 a month) – then those on Universal Credit can benefit equally. Increasing the point at which people start paying the 63 per cent Universal Credit taper could be seen as an appropriate parallel to increasing the point at which 12 per cent National Insurance kicks in. For completeness, a second earner work allowance could be added too for couples with children, but the number of couples where both partners earn enough to pay National Insurance but are also on Universal Credit is relatively limited.

Figure 32 also shows that the distributional impact of the policy would be significantly more progressive if those on Universal Credit were allowed to receive the full benefit of the tax cut, with the bottom half then receiving the biggest proportional gains. This policy tweak would raise the cost by (only) 8 per cent – or an extra £800 million – largely recycling the reduction in benefit spending that the tax cut would cause. Alternatively,

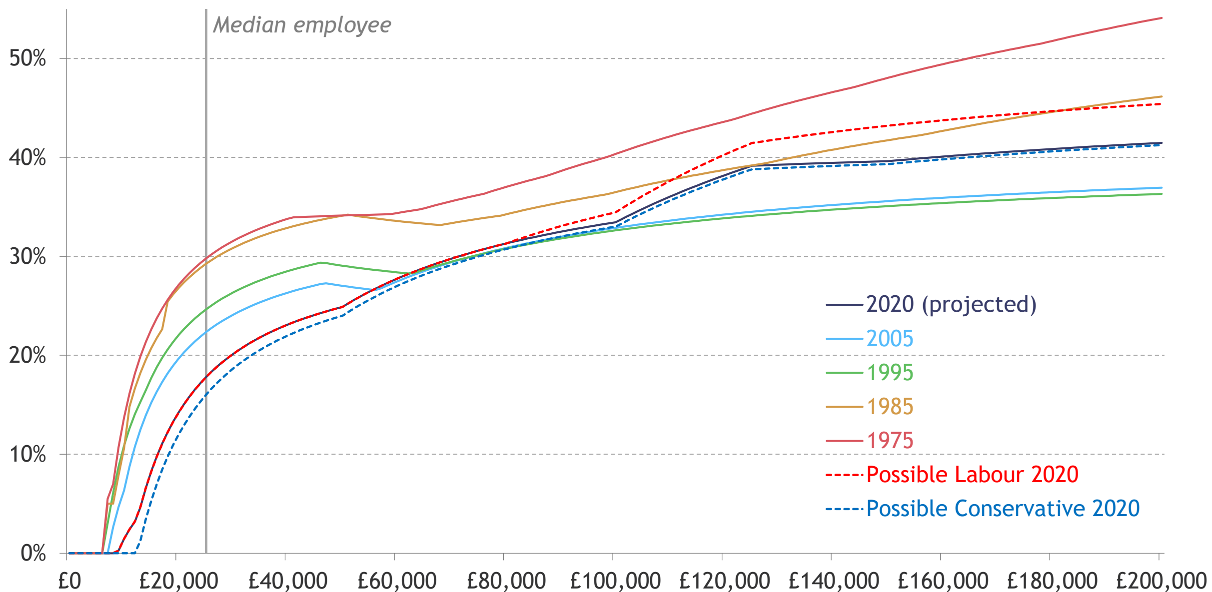
56 R Joyce & X Xu, Options for cutting direct personal taxes and supporting low earners, Institute for Fiscal Studies, October 2019

clearly it would be better to reduce the scale of the National Insurance threshold rise but ensure that those on Universal Credit receive the full benefit.

Stepping back, the divergent approaches of the Conservatives and Labour are also shown in Figure 33. Whereas Labour would build on the increases in average tax rates at the top that have happened relative to 2005, the Conservatives would build on the low to middle income tax reductions that have happened over the same period. In both cases, however, tax rates for low to middle earners would remain low by historical standards while top tax rates would, at most, be comparable to those in the mid-1980s.

FIGURE 33: **For most workers, Labour and Conservative wage tax policies would not be as significant as past changes**

Effective tax rates (Income Tax and employee National Insurance) by annual earnings, adjusted for growth in median pay



NOTES: This assumes the tax cuts/rises take place in 2020. Includes Income Tax and Employee (but not Employer) National Insurance. For consistency, tax rates are for unmarried employees under 65 with non-volatile earnings. Recent divergences in Scotland are not included. 2020 projected using default uprating assumptions and recent earnings growth.
SOURCE: RF analysis using median earnings figures from ASHE/NESPD and tax history from HMRC and IFS.

The parties also disagree about the near future of corporation tax

As well as setting out diverging policies on personal taxation, the parties also differ on corporate taxation. Over the last decade, the corporation tax rate has fallen from 28 per cent to 19 per cent. By default (as it has already been legislated), it will fall further to 17 per cent in April. This will cost around £5.8 billion a year by 2022-23.[57]

57 https://www.gov.uk/government/statistics/direct-effects-of-illustrative-tax-changes

How changes in corporation tax cuts feed through to household incomes – to shareholders, workers and customers – is an ongoing question. But in terms of the distribution among companies, such a cut in 2017-18 would have cost £5.8 billion, with 44 per cent (£2.5 billion) going to 1,050 companies. 38 per cent (£2.2 billion) would have gone to 600 companies, and 19 per cent (£1.1 billion) would have gone to 90 companies (averaging £13 million a year each). The bottom 95 per cent of the 1.5 million companies who pay tax would only receive 21 per cent of the overall cost.

In contrast to the cut from 19 per cent to 17 per cent which would (presumably) happen under the Conservatives, other parties have proposed to at least cancel it. Labour have called for a return to a rate of 26 per cent (with a lower rate for small businesses). The Liberal Democrats have said they would reverse back to 20 per cent. The SNP said at the last election that they would not support further cuts, and the Greens have proposed a 24 per cent rate.

These are big policies and big differences between the parties. The Liberal Democrat policy might be expected to raise £9 billion a year. The size of Labour's proposed increase to 26 per cent makes it harder to estimate the revenue it could raise. Without any dynamic effects, nor taking into account their plans to have a lower rate for smaller businesses, £28 billion would be raised, but that should not be taken as a projection of what revenue would actually come in. However, as Figure 34 shows, higher corporation tax rates than the UK currently has would not be unusual by international or even recent historical standards, although Labour's plans would see the UK jump from well below to significantly above both the OECD and EU averages.

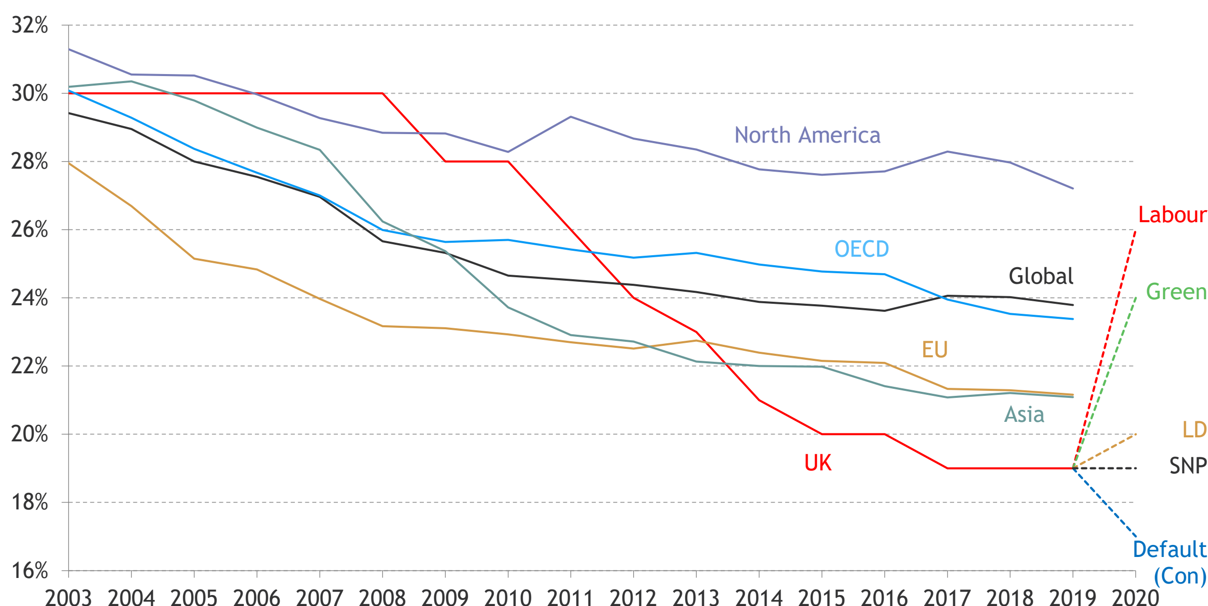
Labour also propose an 'inclusive ownership fund' policy, which – while partly a way to give dividends to workers – would raise an estimated £9 billion a year for the government and create an effective corporation tax rate of 31 per cent for large companies when combined with the rate rises above.[58]

The downsides of corporation tax rate rises in terms of investment or wages are hard to estimate, but in any case it is hard to see why a £6 billion corporation tax cut is a priority in 2020. The 2p cut (or even just half of it) should simply be cancelled.

58 Clifford Chance, Labour's inclusive ownership funds, September 2019

FIGURE 34: **Corporation tax is set to fall again in April 2020**

Headline corporate tax rates



NOTES: Party policies are not necessarily for 2020.
SOURCE: KMPG; plus party policies

Expensive tax cuts that no-one asked for are not in line with the fiscal challenges set out in Section 4, and – in addition – cutting corporation tax increases the problematic tax gap between company owner-managers and other workers, unless offset by other policy changes.

And tax policy is not immune from the Brexit debate

Another area of divergence between the different parties is, of course, on Brexit. While most areas of tax policy may be considered independently from Brexit, there would be some tax implications. Most notably, if the UK were to leave the EU VAT area, it would gain more policy freedom in that respect.

One possible use of that freedom might be to reduce VAT on some goods and services beyond what is allowed inside the EU. In particular, in the referendum campaign, Boris Johnson and others called for VAT on (domestic) energy bills to be cut from 5 per cent to zero.[59] As shown in Figure 35, this would be relatively progressive as tax cuts go, though with the top ten per cent still gaining the most in cash terms.

It would however cost around £1.6 billion a year, and would not be a well-targeted way of helping the poorest, particularly coming on the back of welfare cuts that have certainly reduced the incomes of the poorest. And – while there may be an argument for cutting

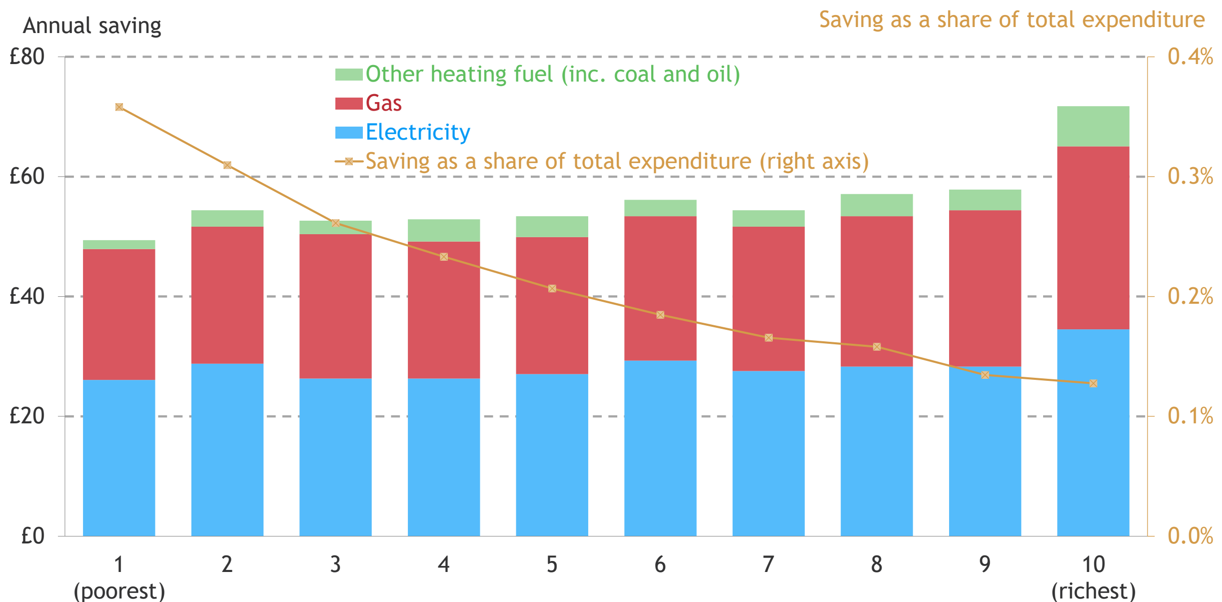
59 Though there are other ways to reduce fuel bills within EU rules. This topic is explored further in A Corlett, After Brexit the UK could cut VAT on energy – but should it?, Resolution Foundation Comment, September 2019

tax on (zero carbon) electricity – it is hard to see how a government committed to eliminating carbon emissions could prioritise cutting taxes on coal, oil and gas heating.

The most striking thing, however, is how small an impact it would have. As it would reduce after-tax prices by only 4.8 per cent (and assuming the change is passed on in full to consumers), the average gain would be only around £60 a year per household. Larger, and more sustainable, savings could be delivered by investing in insulation.

FIGURE 35: **Reducing VAT on domestic energy would be relatively progressive, but would only be a very small boost to household finances**

Impact of removing 5 per cent VAT from domestic electricity, gas and other fuels, by equivalised household income decile



NOTES: Based on 2017-18 figures
SOURCE: RF analysis of ONS, *Effects of taxes and benefits on household income*

Outside the EU VAT area, it is likely that discussion of the 'tampon tax' would also return. But, whatever the merits of reducing this VAT rate from 5 per cent to zero, the aggregate impact of this would only be £12 million a year.[60]

There would likely be less freedom to change VAT policy on goods (but not services) in Northern Ireland, however. The Brexit Protocol on Ireland and Northern Ireland says that "the United Kingdom may apply to supplies of goods taxable in Northern Ireland VAT exemptions and reduced rates that are applicable in Ireland…", and it seems likely that what rates should therefore apply in Northern Ireland may eventually be a potential source of controversy.

60 Based on HMRC, Estimated costs of non-structural tax reliefs, October 2019

Finally, more debate is warranted over what tariffs would apply post-Brexit, not least given the distributional and fiscal questions inherent in tariff changes. But that is not a topic for this paper.

More honesty may be needed about the tax changes required

As set out in Table 1, there may not be shortage of tax policies in the party manifestos. But, returning to the challenges set out in Section 4, it is not clear that the right questions are always being asked:

1. The government announced a five-year spending settlement for the NHS in 2018. Even if that proves sufficient, a new settlement will be needed before the end of the next parliament, while social care reform has been repeatedly kicked into the long grass. So the parties will need to give a better sense of the direction of travel of how health and social care will be funded into the 2020s. Given some of the international experience set out in this paper, the Liberal Democrat suggestion of a dedicated 'Health and Care Tax' in the long-term may be the kind of idea we will hear more of in future.

2. On the taxation of wealth, some party proposals are likely to go in the wrong direction. With inheritances set to play an even more important role in future, inheritance tax cuts – for the 4 per cent of estates that pay anything - risk further reducing social mobility and requiring tax increases elsewhere; though the case for reforming or replacing the inheritance tax is strong. And there has thus far been little discussion of council tax, though this relatively unfair tax (now based on valuations that are almost thirty years old) is being increasingly used as a short-term fix to bolster social care funding.

3. There is unlikely to be much debate about narrowing National Insurance differences between employees and the self-employed, particularly after Philip Hammond was burnt during his attempt to do so as Chancellor. However, Labour and Liberal Democrat plans to reform capital gains tax and cancel the corporation tax cut, might reduce some of the distortionary incentives discussed in Section 4.

4. Policy proposals to boost the electric vehicle market have become more commonplace. But discussion of the opportunities and threats regarding fuel duty, VED and road pricing has not been commensurate to the risk to the Treasury. And, if or when the UK leaves the EU, decisions about VAT and about carbon pricing deserve careful deliberation.

5. Every party should try to be honest about these (and other) big challenges, to prepare the ground for changes that may be unavoidable, and to allow everyone to play a role in determining the future size and shape of the tax system.

Section 6

Conclusion

Voters will have important choices to make on 12 December about the size of state and tax system that they want. Indeed, the range of choices may be greater than it has been for a generation.

But, whatever the result, the Treasury will still face some of the same structural challenges. After the exuberance of the election, the hangover of how to pay for the winning party's promises will arrive in the very delayed Budget. Based on past elections – particularly 2010 and 2015 – we should not be surprised if there are then more tax rises than were mentioned in the campaign. Even then, the Treasury will have much more to do to raise increasing sums of money for an ageing population in a fair way. It will need to do better at closing obvious inequities and avoidance opportunities in the tax system. And it will need to use the tax system to help get the UK on track to hit its emissions goals, while also working out what to do when there's no more pollution left to tax.

Challenges to and cracks in the tax system cannot be papered over indefinitely, regardless of choices about the exact size of the state. Political will and focus will be required to deliver sustainable and economically efficient improvements. And – if or when Brexit takes place – temptations to make expensive policy changes merely to exercise new freedoms should be avoided.

Finally, while the tax choices at this election will have very important distributional consequences, we must also remember that the tax and benefit system work in tandem. We have explored tax separately in this report, but a further report will look at how social security has changed, the pressures it faces and whether the parties have the right policies to reduce poverty.

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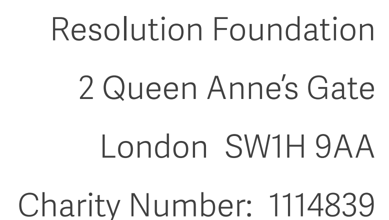
For more information on this report, contact:

Adam Corlett
Senior Economic Analyst
adam.corlett@resolutionfoundation.org



Resolution Foundation
2 Queen Anne's Gate
London SW1H 9AA
Charity Number: 1114839

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