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Unhealthy finances

How to support the economy today and repair the public finances tomorrow

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November 2020

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Executive Summary

Public sector borrowing is heading towards £400 billion this year, an unprecedented peacetime level. What this means for policy makers sharply divides opinion, with some arguing it is entirely unsustainable and requires urgent action, while others see little constraint on government borrowing in an era of low interest rates.

This paper rejects both approaches, recognising the dual tasks facing the Government and fiscal policy: supporting the economy now to avoid a longer-lasting downturn than necessary, while ensuring sustainable public finances so that future governments can do the same in the face of recessions to come. We set out how policy makers can plot a course to achieve both short-term support and longer-term sustainability, while navigating the huge uncertainty about the path of this crisis. Crucially, we do so by jointly considering the Government's macroeconomic objectives and the detailed, bottom up, policies needed to achieve them.

The low interest rate environment means fiscal policy must play a profoundly different role

For those focused exclusively on the significant damage being done to the public finances by this pandemic, the priority is to minimise spending now and to begin reducing the deficit as soon as possible. But such an approach fails to recognise the profound change that the prolonged low interest rate environment implies for fiscal policy. There is widespread recognition now of the

need for fiscal policy to play a much greater role in supporting the economy during the crisis given the constraints on the Bank of England posed by low rates, and the very sectorally-uneven nature of this crisis.

But the rethinking of fiscal policy in the face of low interest rates goes much further than acknowledging the need for a bigger fiscal stimulus in the depth of the crisis. The limited room for manoeuvre faced by policy makers at the Bank of England also requires any fiscal consolidation to start later than would otherwise be the case, and to proceed at a pace that avoids being a bigger drag on the economy than the Bank can offset.

However, the fact that interest rates are close to all-time lows does not imply only that we should have looser fiscal policy, nor does it support the arguments of those who say that there is no need for a consolidation after this crisis. Such arguments ignore the need to repair the fiscal damage done by the structural hit to the economy and, crucially, the greater need to build fiscal space in order to combat future recessions.

To be successful in driving a strong recovery and ensuring the public finances remain sustainable, policy makers must correctly choose the size, timing and nature of the fiscal consolidation.

Size of the consolidation: we estimate around £40 billion may be needed

What matters for the size of the required fiscal consolidation is the extent to which the deficit will remain elevated in the medium term due to economic 'scarring' or permanently higher spending. Based on the OBR's central scenario, which embodies the assumption that coronavirus-related spending ends in the coming months, the economy will be 3 per cent smaller in 2024-25 than was expected before the pandemic. If realised, this structural economic damage would lead to structural fiscal damage, with persistently lower tax receipts and higher spending than would otherwise be the case. Left unchecked, this would put the public finances on a deteriorating path. It is the need to avoid this outcome, rather than the need to 'pay for' the extra spending to combat the health and economic effects

of coronavirus during the crisis itself, that requires a fiscal consolidation in the years ahead.

A conventional approach to a fiscal consolidation would focus on reducing the structural deficit or stabilising public sector net debt. But our view is that two important modifications must be made to this approach to reflect better the economic landscape we find ourselves in.

First, the Government's primary fiscal target should be defined in terms of public sector net worth rather than net debt, so that we take into account the value of the public sector's assets, rather than focusing exclusively on its liabilities. This is particularly important at the moment because of an increase in public sector investment (that was planned before the pandemic hit), the benefits of which are not captured in the traditional focus on net debt.

Second, to achieve genuine fiscal sustainability, targets cannot solely focus on year-to-year improvements in fiscal aggregates, but must also take account of the economic cycle and, in particular, the fiscal costs of fighting future recessions. So we should be aiming to build fiscal space now that will offset the significant downward ratchet effect of future economic crises on net worth (or an upward ratchet on debt). Failure to do so would mean that – at some, very uncertain, point in the future – we could find that fiscal policy would, like monetary policy, be constrained, causing severe hardship and undermining the government's capacity to combat recessions.

Taking both of these factors together, we conclude that planning consolidation measures equivalent to around £40 billion in 2024-25 terms is roughly the right order of magnitude to put the public finances on a sustainable footing, ready to deal with the next economic crisis.

There is, however, considerable uncertainty around this target, with the risks firmly skewed to the downside. For example, to ensure net debt (rather than net worth) does not rise over the economic cycle would require an additional £80 billion of consolidation. And if the economy was 6 per cent smaller after

the crisis, rather than 3 per cent, we would need around another £60 billion. Such uncertainty should be taken into account today; it implies that we need to build flexibility into our consolidation strategy.

Timing of the consolidation: fiscal policy should not tighten until 2023 and, even then, should do so gradually

Most discussions about the impact of monetary policy being out of firepower focus on the need for greater fiscal stimulus during the depths of recessions. But the constraint on monetary policy has wider implications for fiscal policy, including on how consolidations should be conducted. Because fiscal support needs to last longer during the crisis, and not just be bigger, the consolidation must also start later. And when it does start, the pace and design of that consolidation should be constrained by the need to avoid it posing a larger drag on GDP growth than monetary policy can offset. In short, starting consolidation too early – or proceeding too quickly – risks derailing the recovery.

This means that the Government should start the process of consolidation only when it is clear that the economy has recovered from this crisis. Based on the OBR's central scenario, that means consolidation should not start until 2023. In the meantime, more support will be needed to prevent fiscal policy becoming a significant drag on growth. Once the consolidation starts, and given the limits on the Bank of England's ability to offset the consolidation's impact on the economy, our benchmark estimate is that the fiscal stance could tighten by around £20 billion per year without risking the recovery.

Once again, it is important to emphasise the uncertainty here: consolidation may need to start later if the economy is more sluggish than expected. But rather than making a case for avoiding taking decisions today, this uncertainty provides a powerful case for setting out a clear fiscal framework in the near term. This should take the form of a commitment not to start the consolidation until the economy has recovered but then, once it starts, to do what is required to ensure the public finances are sustainable, recognising the greater hit they face

in recessions in a low interest rate environment. To do this, the Government should adopt a balanced current budget rule once GDP returns to its sustainable level (i.e. when the output gap is closed). Some fear that making such an announcement in the near term risks choking off a recovery by signalling an intention to tighten policy. In fact, making such an announcement would reduce policy uncertainty, ease coordination with the Bank of England, reinforce the Government's commitment to generating a rapid recovery, and provide assurance of fiscal sustainability in the longer term.

Nature of the consolidation: economics and history dictate that this consolidation will be principally driven by tax rises

The changed economic environment we face also profoundly affects the choice of instruments through which the consolidation should be achieved. In the past, the choice of how to tighten fiscal policy was largely dictated by different governments' wider policy aims – for example, the overall size of the state – but the constraints placed on the timing and pace of any fiscal tightening by the low interest rate environment mean that we need to choose individual policies carefully so as to minimise the impact on the recovery.

There are two reasons for thinking that this consolidation will, and should, be principally delivered through tax rises. First, there is a consensus that cutting government spending has a larger negative impact on the economy than increasing taxes. For example, the OBR and its US counterpart (the Congressional Budget Office) both assume that the impact of spending changes on the economy are generally larger than those for taxes. This means that a spending-led consolidation would have to proceed slower than a tax-led one if it is to avoid undermining the recovery. Second, the path of previous spending cuts – which have been unprecedented historically, and among the largest seen among advanced economies since they started in 2010 – makes it much less likely that achieving a further large-scale tightening mainly through spending cuts could be achieved, not least given existing signs of deterioration in the quality of some

public services. Some areas of spending will undoubtably be cut or restrained in the years ahead, but both economics and history dictate that tax rises will do the lion's share of the work in this consolidation.

Tax increases of this order of magnitude would be politically challenging but not unprecedented

Our central estimate of the required consolidation – of around £40 billion in 2024-25 terms – is a very substantial sum to raise in taxes, but it is not without precedent. On a comparable basis, the budgets in 1993 increased taxes by around £48 billion, and the budgets of 1974 and 1975 together raised £47 billion. Such an increase would take the tax-to-GDP ratio to over 39 per cent of GDP, the highest since 1983-84. But that would not be particularly unusual by international standards: the UK's tax take is over 1 per cent of GDP below the (pre-coronavirus) OECD average, and over 10 per cent of GDP below some similar countries. And the direct tax burden faced by the typical employee has fallen dramatically over time – with effective tax rates falling from 30 per cent in 1975, to 25 per cent in 1990 and 18 per cent by 2019.

Of course, while not unprecedented, delivering a tax led consolidation on this scale is a significant challenge. Doing so successfully requires far more than simply identifying some taxes to increase. We highlight three guiding principles that will increase the chances of success. First, the burden of tax rises must be shared fairly in the post-pandemic world. In practice, this means those who have gained from the crisis are seen to contribute, and that tax rises reflect who has the broadest shoulders to bear them. It also means ensuring that measures are fair between generations, reflecting long-term changes in the distribution of wealth. Second, consolidation should support the recovery by aiming to reduce, rather than increase, economic distortions, strengthening the weakest links in the tax system, and prioritising those tax rises that have a smaller drag on growth. And third, consolidation must be part of the answer, rather than a hinderance, to some of the broadly-accepted and fundamental challenges we face as a country, including tackling

climate change, updating our system of wealth taxes for the increase in household wealth, and providing for the health and care needs of an aging population.

Taxing those that have prospered during this pandemic is important, but cannot play a major role in the fiscal consolidation…

2020 has been tough for most, but some firms have profited from higher than usual demand, and some individuals have received government support in excess of any income losses. But, contrary to the hopes of some, measures to directly tax those firms and individuals that have done well over the past year will not be able to make major contributions towards repairing the public finances. This is mainly because, by their nature, such measures will be temporary, whereas the need for higher tax revenues is much longer-lasting. However, such measures should still form an essential component of the coming consolidation; indeed, they are a pre-requisite for a consolidation that maintains public support.

We propose two temporary measures that draw on the principles of solidarity and fair burden-sharing. First, we recommend a Pandemic Profit Levy of 10 per cent on windfall profits made by firms during the pandemic, reflecting the fact that such profits in many cases reflect the luck of some firms being presented opportunities by the crisis or not being adversely affected by social distancing restrictions. Second, the self-employed who have seen their incomes actually rise this year while claiming the poorly-targeted Self-Employment Income Support Scheme (SEISS) grants should have their grants partially clawed back. This would narrow the enormous gap in treatment with the self-employed who have seen income falls but been excluded from support, and would raise at least £3 billion.

…and nor can green taxes

Environmental tax changes would be desirable, even in the absence of a large deficit, with a pressing need to get the UK's carbon emissions onto a trajectory consistent with the

commitment to 'net zero'. Unfortunately, they are not a major part of the answer to reducing the deficit. There is scope to reform such taxes to increase revenues, but carbon pricing developments will take a long time to implement. And even where specific proposals can raise substantial sums – such as raising levies on domestic heating – the changes are regressive, and any money raised will be needed for extra spending to support the behavioural change that net zero will require. Moreover, the loss of environmental tax revenue (particularly the £38 billion a year of taxes on road transport) will require policy change, such as a system of road pricing, just to stand still in exchequer terms. Reflecting the fast growth in online shopping during this pandemic, we recommend introducing a Home Delivery Congestion Charge as a pilot for broader road pricing, raising £100 million.

'Easy wins' should be embraced...

No tax rise is completely painless, but some are much easier to introduce than others. For permanent deficit reduction on the scale that is likely to be necessary after this crisis, the Government should look at two options that are relatively easy to implement (or stop) as needed: freezing tax thresholds and raising Corporation Tax (CT).

On the first of these, substantial sums should be raised from Income Tax (IT) threshold freezes. The personal allowance has been £12,500 for the past two years. Keeping it at this level would raise £5 billion a year by 2024-25, and still mean it was 50 per cent higher than if there had simply been consistent inflationary uprating since 2010. Meanwhile the higher rate threshold for IT has been £50,000 for the last two years, where it is helpfully (if coincidentally) aligned with the withdrawal point for child benefit. Keeping it at this level would raise £1 billion a year by 2024-25. Of course, these freezes could be continued beyond 2024-25, or be discontinued earlier, depending on fiscal circumstances; and this flexibility is a key benefit of this approach.

The Corporation Tax rate should also be increased. The UK's rate of 19 per cent is low by international and historical standards

– suggesting headroom for a rise. With each 1p rise potentially raising £3 billion a year, raising the rate to 22 per cent would raise £10 billion a year from profitable companies, while keeping in place two thirds of the 9 percentage point rate cut since 2010-11 and ensuring the UK's headline rate remains below the OECD average.

...as should overdue reforms to wealth related taxes

One of the major challenges facing the UK tax system is that it has not kept pace with changes in the overall amount and distribution of wealth. Over the past four decades, the total amount of household wealth in Britain has grown from three times national income to over seven times, whereas wealth-related tax revenues have stayed roughly constant as a share of GDP. So we propose a package of reforms in this area that rationalise the allowances (including for capital gains) that give those who can choose the form in which they take their income the ability to pay significantly lower taxes, and restricting or abolishing exemptions that are either unjustified or too often abused. We also set out longer-term changes that are desirable in their own right and could be called upon if the scale of necessary consolidation increases.

The immediate package is made up of five elements. First, a reform of Capital Gains Tax (CGT) and taxes on other forms of income to work towards parity of tax treatment between different forms of income, thus raising revenue while improving fairness. Here we propose abolishing Business Asset Disposal (BAD) relief, and ending the step-up in the basis of capital gains upon death, which can incentivise people not to sell or pass on assets before they die. Second, changes to the tax reliefs on income from savings and investments, including merging several tax-free allowances (including for capital gains, dividends and savings income) and the abolition of the Lifetime ISA. Third, a reform of pension tax-free lump sum allowances that in their current state are both highly expensive and highly regressive. Fourth, several reforms to Inheritance Tax (IHT). And fifth, a Council Tax Supplement on properties worth over £2 million

that partly fixes the regressivity of Council Tax. Collectively, these measures would raise £9 billion.

Looking further ahead, there are more fundamental reforms in key areas that are desirable and could be brought in if a larger consolidation is required. IHT could be replaced with a tax that is paid by recipients rather than donors, thus addressing concerns about its high rate, ease of avoidance and the perception that it 'taxes giving'. Property taxes in the UK – notably Council Tax and Stamp Duty Land Tax – are ripe for reform. The former is highly regressive, outdated, and should be overhauled, while the latter reduces the volume of otherwise desirable property transactions and should be cut. Lastly, we look beyond the parameters of the existing wealth tax system towards a new idea that has rapidly gained traction in policy debates both in the UK and USA: taxes on the ownership of net wealth.

We propose the introduction of a 'Health and Social Care Levy' to raise significant revenue, improve our tax system and deliver badly-needed resources for social care

For a consolidation on this scale, it is hard to escape the conclusion that some increase is needed in the marginal rates of income or expenditure taxes. An option that has regularly been turned to historically is to raise the main VAT rate. With each 1p raising £8 billion, this could be a substantial revenue raiser. But this would not be a progressive change and would exacerbate existing distortions between standard-rated and non-standard-rated expenditure. So while acknowledging a strong economic case (though weak in political terms) for broadening the VAT base, we do not think changes to VAT are the answer. Likewise, governments have regularly turned to NI rate rises, but repeating that approach would not be a fair way to raise revenue. NI applies only to working-age earnings, and so those over the state pension age, however well-off, or those receiving other forms of income would not contribute. IT rate rises would be sensible, given its broad base and progressive impact. Increasing every IT rate by 1p would raise £7 billion a year, and more could be raised with larger increases for higher earners. However, a simple IT

rise might be considered a missed opportunity to improve the tax system and to address the challenges faced by the country. Moreover, such a change would explicitly break Conservative manifesto commitments to not raise the rate of IT, VAT or NI.

Given these considerations, we propose that the centre piece of the coming consolidation should be a new Health and Social Care Levy. It would be set at a simple flat rate of 4 per cent, paid above a threshold of £12,500. This would be combined with the abolition of Class 2 NI for the self-employed and a 3p cut in the basic NI rate for employees. The Levy would apply equally across different generations and across different forms of income, including taxable capital gains.

This approach is designed to deliver the bulk of the necessary consolidation in a way that protects those on lower incomes and supports broader national priorities that have been put into stark relief by the pandemic. It would:

- Be highly progressive. Employees earning below £19,500 would be better off.
- Raise significant revenue for social care. Such a tax would raise £17 billion, with £6 billion of that set aside for social care.
- Reduce the tax gaps that heavily incentivise self-employment, with the greater insecurity that can bring. It achieves this by levelling down NI rates for employees to those paid by the self-employed.
- In the longer-run, it would be desirable to go further and completely replace personal NI with the new Health and Social Care Levy.

Summary of our recommendations for raising around £40 billion in 2024-25

Policy recommendations	Revenue raised (2024-25, nominal £bn)
Environmental tax reforms	
Reform Vehicle Excise Duty	1.0
Introduce a Home Delivery Congestion Charge	0.1
Subtotal	**1.1**
Freezing tax thresholds and raising Corporation Tax	
Freeze IT personal allowance at £12,500 (from April 2021)	5.1
Freeze IT higher-rate threshold at £50,000 (from April 2021)	1.0
Freeze IHT thresholds at a combined level of £1m (from April 2021)	0.4
Extend the VAT threshold freeze (from April 2022)	0.2
Raise Corporation Tax rate from 19% to 22%	10.1
Subtotal	**16.8**
Reforming wealth taxes	
Scrap BAD relief and curtail voluntary liquidations CGT loophole	1.0
Remove capital gains uplift on death	2.3
Merge allowances for CGT, dividends, savings income & ISA income	2.2
Scrap Lifetime ISAs	0.6
Cap pension tax-free lump sums at £100,000	0.1
End the tax-free treatment of inherited pensions	0.5
Add a £2.5m cap on business/agricultural property IHT relief	0.6
Introduce a Council Tax Supplement on properties worth over £2 million	1.4
Subtotal	**8.8**
Increasing major tax rates	
Extend VAT to private school fees	1.6
Scrap the IT marriage allowance	0.5
Introduce a 4% Health and Social Care Levy on most income over £12,500: net	11.3
4% Health and Social Care Levy	*31.5*
Cut basic employee NI by 3p & abolish Class 2 NI	*-14.2*
Boost social care spending	*-6.0*
Subtotal	**13.5**
TOTAL	**40.2**

Section 1

Introduction

In the face of a global pandemic and huge recession, policy makers face the challenge of tackling the health crisis and supporting the economy. Both are expensive. Indeed, borrowing looks set in the coming years to reach levels unprecedented in peace time. So this report discusses how best to approach fiscal policy, given this damage to the public finances. At the heart of our approach is a recognition that the low interest rate environment constrains the Bank of England's ability to support the economy, profoundly changing the size, timing and nature of the appropriate steps to repair this damage compared to past recessions.

The immediate priority should be for fiscal policy to provide the absolutely essential support that the economy needs in the short run. While some would argue that the priority should be minimising the damage to the public finances, such an approach is short sighted. This is because fiscal policy has a crucial role in minimising the hardship faced during the crisis, and also because more active fiscal policy today can reduce the size and longevity of the economic hit, which will reduce the need for future fiscal tightening.

Looking further ahead, policy makers must also do what is necessary to ensure sustainable public finances. In this context, there are those who would say that the current low level of borrowing costs means there is little need for future fiscal tightening. But this ignores the need to repair the fiscal damage done by the structural hit to the economy, and build fiscal space ahead of future recessions in order to ensure that policy can respond. This need is real even if interest rates remain at their current historical low.

In this report, we set out how the Government should approach achieving these objectives, considering jointly the macroeconomic objectives and the detailed policies needed to achieve them. In doing so, we wrestle with the reality that any strategy devised today has to be set in the face of vast epidemiological, economic and fiscal uncertainty.

The approach in this report is based on the lessons of the past decade. Most significant here is the need for fiscal policy to play a much greater role than in past recessions in supporting the economy given the constraints placed on monetary policy makers at the Bank of England by the low level of interest rates. This means that we must postpone fiscal consolidation until it is clear that the recovery is sufficiently entrenched to ease the monetary policy constraints. But it also means doing more tightening once the recovery begins to ensure fiscal policy has the space to fight future crises.

This report is focussed on the crucial role that fiscal policy will play over the next few years in the face of an unprecedented health crisis. To be successful, fiscal policy needs both to respond effectively to the current crisis and ensure that the public finances allow us to deal with future ones too.

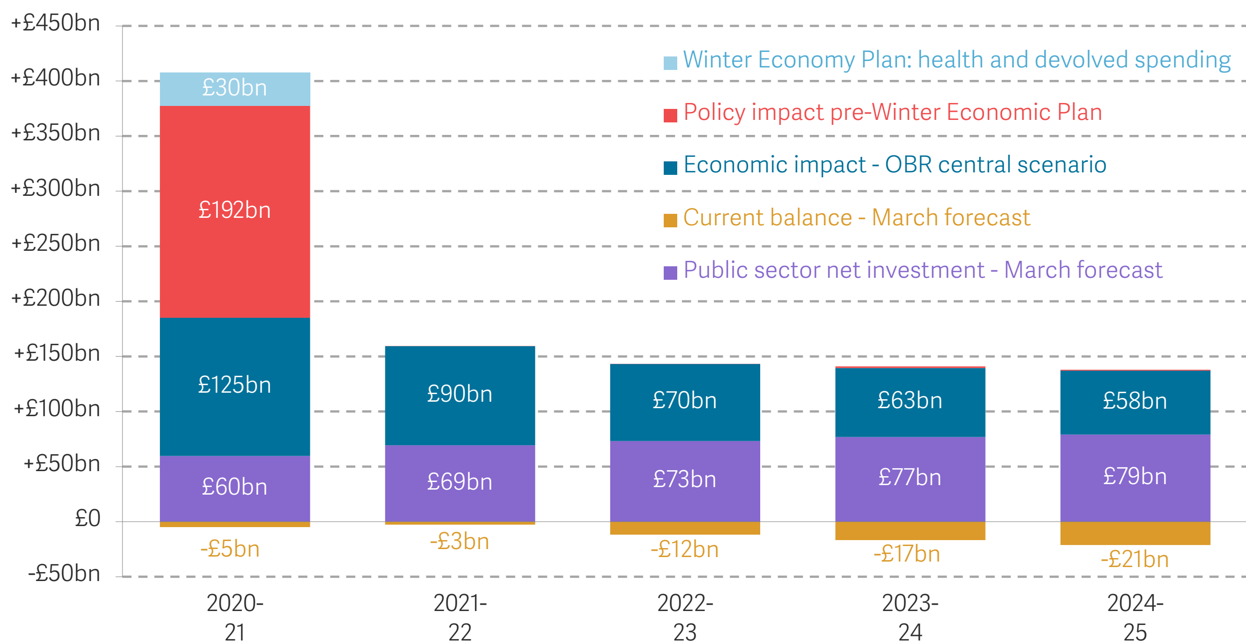
The coronavirus crisis has already led to significant damage to the public finances

What makes this issue all the more pressing is that the pandemic already looks to have inflicted considerable damage to the public finances. A precipitous decline in economic activity combined with substantial support measures means the deficit has risen to a level unprecedented in peace-time. Figure 1 shows OBR fiscal forecasts updated for recent policy announcements.[1] On this basis, it now seems likely that borrowing could rise to £400 billion this year. Around £125 billion of that deficit reflects the deterioration in the economic outlook, but the majority stems from the unprecedented level of support the Government has rightly put in place to address the impact of the crisis, as well as the direct public health costs of fighting the virus.

1 Figure 1 borrowing totals relate to the OBR's most recent projections for borrowing in 2020-21 – based on the central scenario published in the July Fiscal Sustainability Report, plus policy costings from the Summer Economic Update (updated in the OBR's monthly profiling of borrowing on 21 August). Also included in this total are the additional health and devolved spending announced in the Chancellor's Winter Economy Plan, as well as RF's costing of the VAT extension for hospitality. Costings of second wave support schemes subsequently announced have not been included pending a new forecast from the OBR on 25 November, including a reassessment of scarring effects.

FIGURE 1: **Borrowing is projected to reach over £400 billion in 2020-21**

Public sector net borrowing: updated FSR central scenario, including Summer Economic Update and elements of Winter Economy Plan2



NOTES: Forecasts relate to the OBR's central scenario published in the July Fiscal Sustainability Report, plus policy costings from the Summer Economic Update (updated in the OBR's monthly profiling of borrowing on 21 August), and the additional health and devolved spending announced in the Chancellor's Winter Economy Plan, as well as RF's costing of the VAT extension for hospitality. Costings of second wave support schemes subsequently announced have not been included.
SOURCE: RF analysis of OBR, Fiscal Sustainability Report, July 2020; HM Treasury, Winter Economy Plan, September 2020.

The immediate priority for policy makers should be to support the economy – and here the Government will need to do much more

In the near term, policy must focus on the crucial need to support the economy. The damage to the public finances described above, and the new reality of multiple waves of the virus, has led to concerns about the affordability of measures to cushion households and firms from the pandemic's impact and to support a rapid recovery. Indeed, some would argue that support should be withdrawn to minimise the rise in the deficit. But that argument misses the macroeconomic impact of such an approach. A failure to support incomes now will only increase the severity of the downturn, while a failure to put in place measures to generate a rapid recovery risks increasing the longer-term damage to the economy and the public finances. As set out in our previous work, and discussed below, all this means that the short term priority for fiscal policy is to continue its highly accommodative stance, rather than to prematurely embark on fiscal retrenchment.[3]

2 Unless otherwise specified, all charts and data in this report cover the UK.
3 As discussed in: L Gardiner, J Leslie, C Pacitti & J Smith, Easing does it: Economic policy beyond the lockdown, Resolution Foundation, July 2020.

In the medium term, policy makers must prioritise doing what is necessary to repair the damage to the public finances and actively build space to tackle future crises

The reality that fiscal rather than monetary policy is the primary tool of macroeconomic stabilisation in this crisis, and likely future crises, means that fiscal consolidation should start later than has been the case in past recessions, but will ultimately need to go further. In this context, there are those who would say that the low level of borrowing costs means there is little need for future fiscal tightening. The low level of interest rates does indeed help stabilise the public finances, but that does not mean that we can ignore the fiscal damage done by the structural hit to the economy. On top of that, simply returning the public finances to a stable position will not be sufficient. Instead, there is a need for policy tightening to go further than in the past in order to make fiscal space, recognising that fiscal policy will be needed again in future to combat future crises.

Our approach in this report is to illustrate our proposed approach using the OBR's scenarios while recognising the massive uncertainty

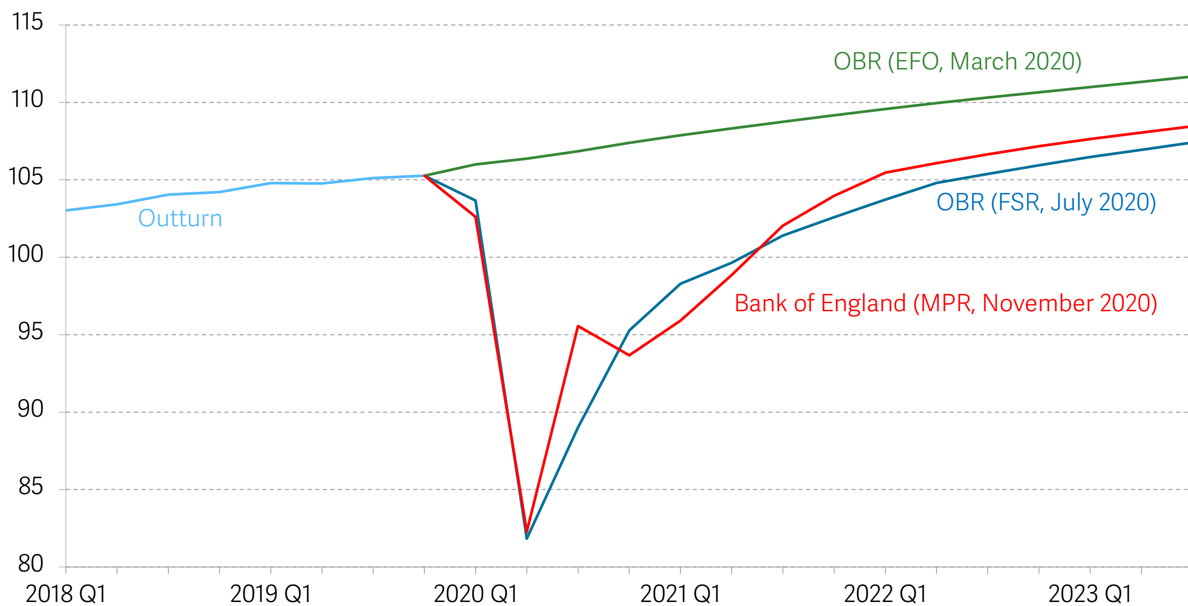
The approach we adopt in this report is to provide an illustration of how the Government can achieve these near-term and medium-term objectives. We consider jointly the macroeconomic aspects of these objectives, as well as providing a detailed set of policy proposals and costings consistent with these top-down considerations. Specifically, we use the OBR's Fiscal Sustainability Report central scenario as a way of framing that analysis. That forecast – made in July – is consistent with a vaccine becoming widely available by the Spring, an assumption that is supported by positive news from developers.[4]

In the weeks after the publication of the FSR, the data pointed to a much more rapid recovery than suggested by the central scenario. This is shown by the speed of the initial recovery in the Bank of England's November Monetary Policy Report (MPR) forecast (Figure 2). But in recent weeks the outlook has deteriorated, following the implementation of new social distancing restrictions in all four nations of the UK. On balance, then, the central scenario provides a reasonable starting point for thinking about the policy issues. This is not least because, as shown in the next section, the near-term profile of GDP – or even the public finances themselves – have little bearing on the future consolidation challenge. Instead that hinges on the longer-term hit to the economy.

4 See BBC, Covid vaccine: First 'milestone' vaccine offers 90% protection, November 2020.

FIGURE 2: **Our approach is based on the OBR's central scenario**

Selected OBR and Bank of England projections for the level of GDP (index, 2016 Q2 = 100)



SOURCE: RF analysis of Bank of England; OBR; ONS.

It is, however, important to stress that any approach will need to evolve as the path of the virus and the economy unfold. In the face of such uncertainty, policy makers must do all they can to avoid adding to the volatility, and instead build confidence in the recovery. This can be achieved by providing clarity around their policy objectives, the strategy they plan to adopt in achieving them, and their reaction function in the face of news about the virus. A key takeaway from this paper, then, is the need to set out a fiscal framework which shapes expectations for future policy – not just a set of planned policies that imply an overly-rigid approach to fiscal policy based on any given current view of the outlook.

The approach in this report is fit for the economic environment we face today

The economic environment has changed significantly over the past decade, meaning that simply adopting a similar policy approach to the one adopted after the financial crisis will not work. The most obvious aspect of this changed environment is the low interest rate environment. This implies that monetary policy makers at the Bank of England will not be able to provide large-scale support to the recovery. During the financial crisis, the lion's share of the support for the economy came from monetary policy, as the Bank of England cut its short-term policy rate by more than 5 percentage points, and implemented quantitative easing (QE) to reduce longer-term interest rates. In the current crisis, with both policy and longer-term interest rates already close to all-time

lows, the scope for the Bank to support the economy is very limited. This means fiscal policy has to do more of the heavy lifting in generating a rapid recovery.

All this means we need to see a different approach from fiscal policy makers. First, it means that fiscal support measures will need to be larger and more long-lasting than those following previous recessions, implying that steps to repair the public finances will start later.[5] Second, there is a need to plan on the basis that the low interest rate environment will be with us for years to come. Low interest rates do help improve the fiscal position by reducing debt-servicing costs, but they also mean that fiscal policy makers need to be more active in improving the fiscal position between recessions in order to ensure that there is capacity to support the economy in future recessions. Third, the pace of the consolidation will need to be set in such a way to not exacerbate the constraints on monetary policy.

The Government's approach boils down to a set of decisions about the size, timing and nature of the future fiscal consolidation

Achieving the Government's near- and medium-term objectives collapses into a set of decisions about the: size, timing and nature of the fiscal consolidation. So the rest of this report focusses on each of these decisions. To that end, this report is structured as follows:

- Section 2 focusses on the question of the size of consolidation that is needed based on an updated version of the OBR's central scenario. The public debate has focused so far on the question of how the Government should 'pay for the measures taken during this crisis', but we argue that the scale of consolidation instead depends on the lasting damage to the economy and the amount of fiscal space the Government needs to build ahead of future crises.

- Section 3 looks at the question of the timing of the consolidation – that is, what is the appropriate starting point and pace of the consolidation based on the central scenario. Here the key consideration is how to put the public finances on a sustainable footing, while avoiding constraining monetary policy further so as to generate a rapid recovery.

- Section 4 looks at the choice between taxes and spending in delivering the required consolidation. In this section we make the case that a well-timed and well-designed package of tax rises offers the best approach to the 2020's consolidation.

- Section 5 builds on this analysis by setting out the historical context for consolidations that are skewed towards tax increases, demonstrating that such an

5 As discussed in: L Gardiner, J Leslie, C Pacitti & J Smith, Easing does it: Economic policy beyond the lockdown, Resolution Foundation, July 2020.

approach has been taken before. We then set out the core principles for how we go about designing a package of tax rises that achieves the aim of repairing the damage to the public finances while minimising the economic impact. At the heart of this is a need to recognise the political economy constraints on what can be achieved.

- Section 6 focuses on whether short-term taxes that recognise that the crisis has been felt unevenly have a major role to play in restoring fiscal sustainability. It considers the scope for taxing coronavirus windfalls, but also the role of such taxes in ensuring the perceived fairness of a consolidation plan.
- Section 7 then looks at tax policies which also meet the objective of improving environmental outcomes and explains why, despite being desirable, they cannot play a significant part in delivering this consolidation.
- Section 8 discusses the extent to which money can be raised in less politically-painful ways, most obviously by freezing tax thresholds – so-called 'fiscal drag'. This element of a consolidation also provides tools for relatively easily varying the scale of retrenchment, which will be important given the uncertainty policy makers face.
- We then consider how much progress can be made by making long-overdue changes to the tax system. Section 9 focusses on the ways in which the tax system can be improved to account for the secular increase in wealth seen in the UK in recent decades.
- A key takeaway from this analysis is that the job of repairing the public finances is larger than can be achieved through these changes. This means there is a need for more substantial reform. So in Section 10 we propose a new Health and Social Care Levy which achieves the combined goals of consolidation, badly needed reforms to our tax system and the priority of properly funding our system of social care post-pandemic.
- Finally, Section 11 sets out our conclusions and summarises our policy recommendations.

Section 2

How much fiscal consolidation is likely to be needed?

The hit to the public finances from the coronavirus crisis is set to be considerable. Borrowing has soared towards £400 billion this year, reflecting both the initial policy response, as well as the economic hit from the crisis. More importantly for considerations of fiscal sustainability, borrowing is also likely to remain elevated into the medium term due to the economic 'scarring' from the pandemic. Given this lasting damage to the public finances, some tightening of policy will be needed. But exactly how much depends on how we think about fiscal sustainability.

A conventional approach to fiscal sustainability generally focuses on reducing the structural deficit or stabilising public sector net debt, but our view is that two important modifications must be made to this approach to reflect better the economic landscape we find ourselves in. First, the Government's primary fiscal targets should be defined in terms of public sector net worth, because this is a more complete measure of the government's balance sheet. This is particularly important at the moment because of a pre-coronavirus shift towards higher public investment spending, the benefits of which are not captured in the traditional focus on net debt. This lowers the amount of consolidation that is required compared to focusing just on public sector net debt. Second, to improve fiscal sustainability over the longer term, targets cannot solely focus on year-to-year improvements in debt or net worth, but must also take account of the economic cycle, and in particular the fiscal costs of recessions. We should therefore aim to build fiscal space to deal with future economic crises; without this, we would experience a 'ratcheting' up of debt (or a 'ratcheting' down in net worth). This increases the amount of consolidation the Government should aim to undertake over the medium term.

Taking both of these factors together, we conclude that planning consolidation measures equivalent to around £40 billion in 2024-25 would be a reasonable approach in order to build enough fiscal space in net worth terms to deal with an average recession over the next decade. There is, however, considerable uncertainty around

this target with the risks firmly skewed to the downside. This is important, because it implies the consolidation strategy will need to be flexible enough to evolve as this uncertainty is resolved.

The size of the fiscal consolidation the Government should aim to undertake will depend on both the total impact of the crisis on the public finances, and the evolution of the economy thereafter. Both are unknowable with certainty today. But because expectations about future fiscal policy influence demand today, it is crucial that policy makers set out their approach to fiscal sustainability in the years ahead. In this section we discuss the key considerations that weigh on the decision of how much fiscal tightening to aim for in the medium term to return the public finances to a sustainable position, taking into account the economic cycle.

The coronavirus crisis has pushed up borrowing through both a weaker economy, and additional policy support measures

The impact of the coronavirus crisis on the public finances has been twofold. Firstly, like all economic downturns, the crisis has meant rising expenditure, for example on welfare spending, coupled with lower tax revenues as the economy weakens. On top of this, the Government has rightly taken the approach of socialising the economic hit of the crisis and supporting the recovery, through support schemes that also add significantly to borrowing – such as the Job Retention Scheme, costed at nearly £40 billion to date.[6] And because this is ultimately a health crisis, the Government has had to incur the direct public health costs of fighting the virus, Figure 1 illustrates the effects of all these factors. A key point to note is that although policy costs make up over two thirds of borrowing in this year, these effects are temporary and drop out of the borrowing forecast thereafter, while economic scarring and persistently lower revenues results in borrowing remaining elevated by two and a half per cent of GDP on top of March Budget forecasts by 2024-25. In 2024-25 without spending cuts or tax rises, the OBR forecasts that GDP will return to its sustainable level. So higher borrowing (than expected pre-crisis) from that point on can be thought of as the permanent, or structural, hit to the public finances as a result of a permanently weaker economy. This amounts to nearly £60 billion in 2024-25 prices.

Ultimately, debates around medium-term fiscal sustainability should be separated from the necessity of providing policy support in the near term. As will be set out below, the exact levels of borrowing reached to fund temporary support measures in 2020-21 have a relatively minor effect on the magnitude of consolidation needed in the future, but the

6 HM Revenue & Customs, Coronavirus Job Retention Scheme statistics: September 2020, 18 September 2020.

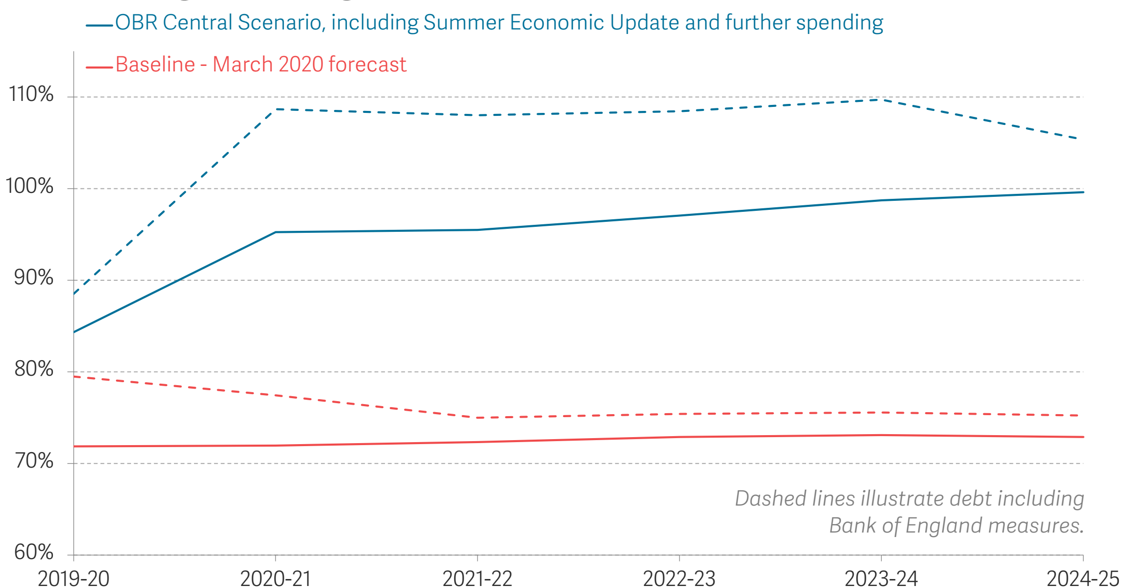
extent of economic scarring significantly increases the consolidation required. Given that spending on support measures in the near term has the potential to reduce economic scarring over the medium term, continuing to spend – even if it means increasing borrowing – while the crisis is ongoing and the economy requires support is the fiscally-prudent approach.

Conventional metrics of fiscal sustainability have generally focussed on year-to-year stabilisation of the debt-to-GDP ratio

A significant structural deterioration forecast of nearly £60 billion in 2024-25 suggests that some consolidation is required, but the exact size of this depends on the definition of fiscal 'sustainability' that is used. Generally, metrics of fiscal sustainability have focused on year-to-year reductions in the debt to GDP ratio, with the aim to place debt stocks relative to the size of the economy on a falling trajectory. As we will come on to discuss, there are important reasons to believe this metric alone is no longer best suited to the economic environment we are now operating in. But debt dynamics are still central to our understanding of how the public finances will shift over the medium to longer term.

FIGURE 3: **Debt looks set to continue to rise in the coming years when the Bank of England is excluded**

Public sector net debt as a proportion of GDP, updated FSR central scenario, including Summer Economic Update and elements of Winter Economy Plan: excluding and including Bank of England measures



NOTES: Forecasts relate to the OBR's central scenario published in the July Fiscal Sustainability Report, plus policy costings from the Summer Economic Update (updated in the OBR's monthly profiling of borrowing on 21 August), and the additional health and devolved spending announced in the Chancellor's Winter Economy Plan, as well as RF's costing of the VAT extension for hospitality. Costings of second wave support schemes subsequently announced have not been included.
SOURCE: RF analysis of OBR, Fiscal Sustainability Report, July 2020; HM Treasury, Winter Economy Plan, September 2020.

Current forecasts suggest that, given the ongoing pressures on the public finances of a weaker economy, debt as a fraction of GDP will continue to rise. This is illustrated in Figure 3, in which the solid lines show the path of public sector debt, excluding the Bank of England measures. The dotted lines show debt including the Bank of England which include falls at the end of the forecast but this merely relates to the unwinding of the Bank of England's Term Funding with additional incentives for SMEs (the TFSME scheme).

The experience of past consolidations reveals a reliance on favourable growth and interest rate dynamics to deliver falls in public sector debt

When the debt-to-GDP ratio is used as the key measure of year-to-year fiscal sustainability, then a natural benchmark is "the level of borrowing that can be maintained while the total debt stock as a proportion of GDP remains stable". Calculating this requires consideration of the dynamics of government debt stocks and the factors that affect them. Besides the level of government borrowing, two key factors are the level of nominal GDP growth and the effective interest rate on government debt. In addition, changes in debt can also result from one-off 'stock-flow' adjustments such as changes to Bank of England schemes, asset sales or revaluations of existing assets.[7]

How each of these different factors has contributed to falls in debt during previous periods of consolidation that followed UK recessions is shown in Figure 4.[8] In particular, these past consolidations illustrate the important role played by growth and interest rates in driving past falls in debt-to-GDP, with nominal GDP growth more than accounting for the overall falls in the debt-to-GDP ratio. For example, holding all else equal, the significant rises in GDP growth would have resulted in 36 and 37 per cent falls in the debt-to-GDP ratio in debt consolidations after the mid-1970s and early-1980s recessions. Periods of reduced borrowing, or running a budget surplus, have also accounted for sizeable falls in the debt-to-GDP ratio in some instances, most obviously following the 1980s and 1990s recessions. But the overall impact is smaller, accounting for almost half as much of the post-Second World War falls in debt as GDP growth.

7 This relationship can be expressed formally in terms of the equation below,

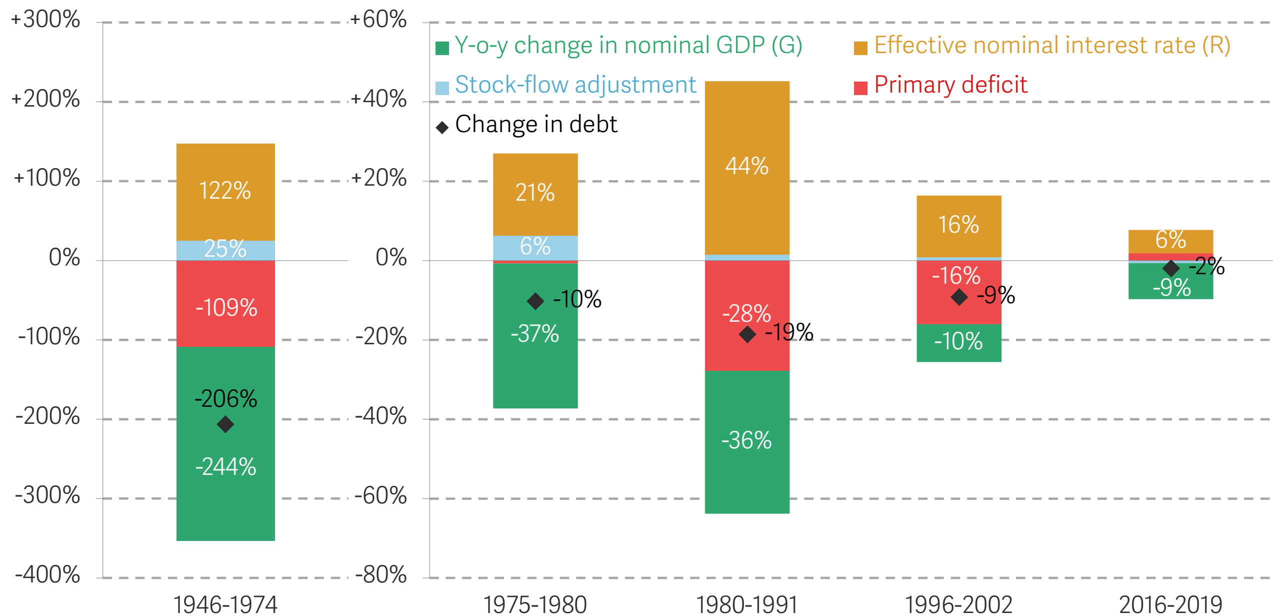
$$d_t - d_{(t-1)} = p_t + s_t + [(R_t - G_t)/(1 + G_t)]\ d_{(t-1)}$$

where the change in public sector net debt (as a proportion of GDP), denoted by d, is equal to: the cumulative primary deficits run over the period (borrowing excluding interest payments), denoted by p; a stock-flow adjustment term, s; and a term reflecting the effect of the difference between effective interest rates, R, and nominal GDP growth, G.

8 This decomposition of contributory factors to debt consolidations uses the equation above, and calculating the impact of its component parts using OBR time series. 'Stock-flow adjustments' are then assumed to be the residual in the calculation.

FIGURE 4: **Growth and interest rates have played a key role in past consolidations**

Peak-to-trough falls in public sector net debt after recessions, by component and as a share of GDP



NOTES: Consolidation periods reflect the peak to trough fall in public sector net debt as a proportion of GDP after a recession period.
SOURCE: RF analysis of OBR and Bank of England.

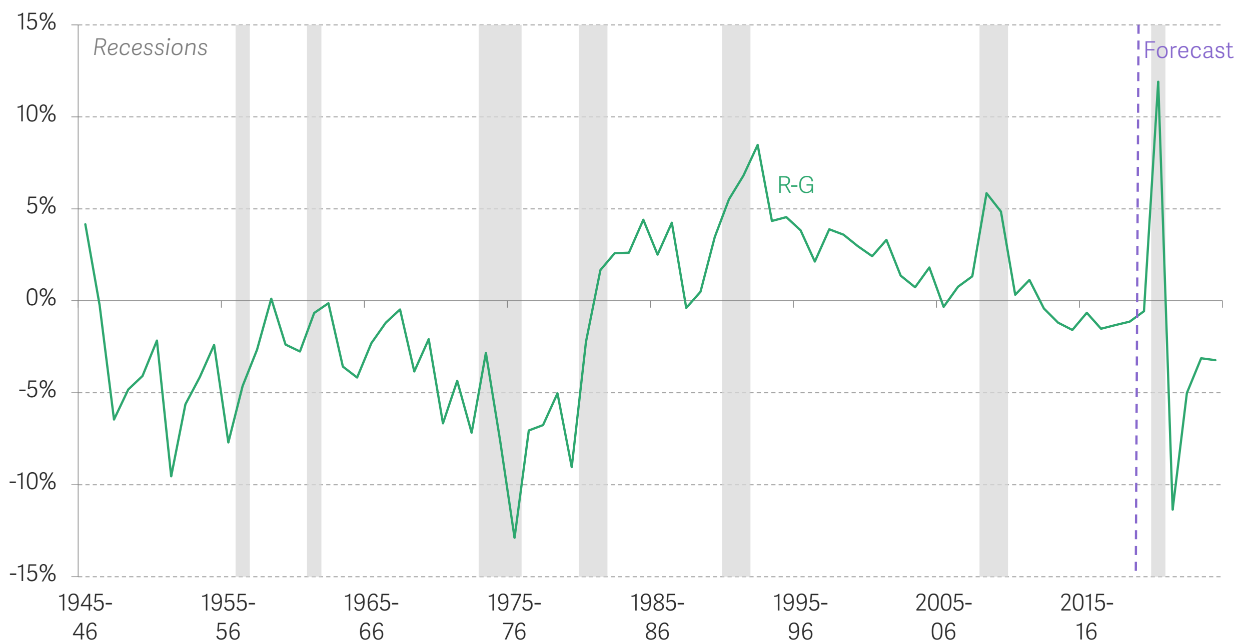
A key factor for debt dynamics is the difference between nominal GDP growth and interest rates. Where interest paid on the debt stock is lower than GDP growth, then total debt as a proportion of GDP tends to fall (subject to the level of additional new borrowing in that time period).[9] To see why this is the case, it is helpful to think of a government that is running a balanced budget excluding interest payments (i.e., its revenues are sufficient to pay for all public services and public investment, but not enough to pay for interest payments). In this world, total debt rises only because of the need to borrow to make the interest payments, so debt growth is equal to the effective interest rate on it. Therefore, when the nominal GDP growth rate is higher than the effective interest rate, the debt-to-GDP ratio naturally falls over time. (It is worth noting that nominal GDP growth depends on both real GDP growth and inflation, and high inflation has driven falls in debt in previous recessions, making up part of the change in nominal GDP bars in Figure 4. However, on the other side of the equation, inflation rises now also have a greater effect on the effective interest rate that the government faces, due to a larger proportion of government debt being held in indexed-linked bonds, meaning a strategy of trying to deliberately 'inflate' away government debt is not fiscally prudent.

9 To put it in terms of the equation in footnote 5, this happens when $R - G < 0$.

Worryingly, GDP growth looks a lot less likely to contribute to falling debt in the coming years than it has done in those previous episodes. Indeed, the OBR estimates the long-term nominal GDP growth rate to be just 3.9 per cent, below its long-run average of 4.3 per cent.[10] However, nominal growth and interest rates are strongly positively associated, with the correlation coefficient between the two series since 1980 at 0.75. Figure 5 shows the difference between interest rates and GDP growth over previous decades, projecting out to 2024-25. Although nominal GDP growth is forecast to be low in future years, the effective interest rate is forecast to be even lower. Therefore, other than in 2020-21 (when GDP is expected to contract sharply), interest rates are expected to stay below nominal growth rates for the foreseeable future. As we discuss in more detail below, this provides a strong 'tailwind' to the fiscal consolidation required to repair the public finances.

FIGURE 5: **Interest rates are expected to remain below nominal growth rates for the foreseeable future**

Difference between the nominal effective interest rate on government debt and nominal GDP growth: outturn and forecast



SOURCE: RF analysis of OBR.

But a key future risk that should inform policy makers' decisions is that the extent to which growth exceeds government borrowing costs may decline. This could happen if public spending 'crowds out' private investment, which would increase the returns to private investment, pushing up interest rates. Indeed, this provides a natural tendency for interest rates to tend back towards the nominal growth rate. Past data shows us that episodes in which the effective rates on government borrowing deviate from the nominal

10 Source: Fiscal Sustainability Report, OBR, July 2020; compared to average nominal GDP growth since 1990.

growth rate can last for a long period.[11] Nevertheless, policy makers should not assume that favourable debt dynamics will continue indefinitely. This is not least because, when adjustment in interest rates back to nominal growth rates does occur, Figure 5 suggests it can happen relatively quickly.

It is possible to stabilise public sector net debt year-to-year while running a significant deficit

The most obvious implication from the above is that favourable debt dynamics currently provide significant assistance in bringing down debt as a proportion of GDP. To see why this is the case, it is helpful to introduce the concept of the 'debt-stabilising primary balance'. That is defined as the fiscal balance, excluding debt interest payments, that is sufficient to stabilise the debt-to-GDP ratio at current levels in the short term (this will be non-zero unless the interest rate equals the nominal growth rate; at a zero fiscal balance, the debt stock is growing by the interest rate and GDP is increasing by the nominal growth rate). When interest rates are below the nominal growth rate, this stabilising primary balance will be a negative (i.e. the state can take on additional borrowing and still see the debt-to-GDP ratio fall). The size of that stabilising balance will be increasing with both the size of the debt stock and the difference between the interest rate and the growth rate.[12]

Based on this, it is possible to back out a primary surplus consistent with stabilising the public finances at the medium-term horizon (taken here as 2024-25). As set out in Figure 6, the 'debt-stabilising primary balance' – that is, excluding interest payment – in 2024-25 is a deficit of 3.4 per cent of GDP, which, after adding interest payments back, would correspond to a deficit of 4.3 per cent of GDP. That is to say that, were the Government to borrow 4.3 per cent of GDP in 2024-25, including interest payments, the debt to GDP ratio would stay stable. Given that borrowing is currently forecast to be 4.6 per cent of GDP in 2024-25, achieving year-to-year debt-stabilisation would require a consolidation of only 0.3 per cent of GDP, or just over £8 billion in 2024-25 prices.

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11 A simple estimate based on a long time series of data suggests that deviations of interest rates from nominal growth half every seven years. This estimate comes from estimating a simple partial adjustment process using data from 1875 to 2016 taken from O Jordà, M Schularick & A M Taylor, 'Macrofinancial history and the new business cycle facts', NBER Macroeconomics Annual, vol. 31, pages 213–263, 2017. Supportive evidence for the conclusion of a slow return to equality between nominal growth rates and interest rates can be found in, for example: N R Mehrotra, 'Debt Sustainability in a low interest rate world', Hutchins Center Working Paper No.32, 2017.

12 In order to calculate the debt-stabilising primary balance (dspb) the equation above is rearranged, with the fall in debt set to zero, resulting in the relationship below:

$$dspb_t = [(R_t - G_t)/(1 + G_t)] \; d_{(t-1)}$$

The stock-flow adjustment term has also been set to zero, meaning the calculations in this section abstract from stock changes such as the unwinding of the Bank of England's TFSME scheme, that cause a level shift in debt in the final year of the forecast.

FIGURE 6: **A deficit of 4.3 per cent of GDP would be debt stabilising in 2024-25**

Debt-stabilising primary balance in 2024-25, and required consolidations including and excluding investment, as a proportion of GDP and £ billion: 2024-25 prices

	% GDP	£bn
a) Debt-stabilising primary balance in 2024-25:	-3.4%	
b) Debt-stabilising balance, including interest payments:	-4.3%	
c) Borrowing forecast in 2024-25 (including investment):	-4.6%	
Consolidation required including investment (c - b)	**0.3%**	**£8.1bn**
d) Borrowing forecast in 2024-25 (excluding investment):	-1.5%	
Consolidation required, excluding investment (d - b)	**-2.8%**	**-£71.9bn**

NOTES: 'R' calculated as interest payments as a proportion of debt stock. Debt stock is taken from the OBR's central scenario in the latest FSR, updated for the Summer Economic Update and elements of the Winter Economy Plan, as above.
SOURCE: RF analysis of OBR, Fiscal Sustainability Report, July 2020.

However, net debt is not the best metric to measure fiscal sustainability against

As set out above, the objectives of fiscal policy are often anchored in the preservation or restoration of a particular level of public debt. However, conceptions and definitions of fiscal sustainability have evolved over time as both the scope of government liabilities and range of assets taken into consideration has expanded, and the cost of government debt itself has declined. The broadest possible definition of fiscal sustainability – public sector net worth (PSNW) – includes all assets and liabilities held by the Government and all the entities it owns or controls. The key building blocks of that measure are summarised in Figure 7. Because incentivising good policy involves taking account of both government assets and liabilities, our view is that fiscal objectives should incorporate a broad view of the public sector balance sheet.[13] This is particularly crucial where public investment levels are high, and the quality of the investment of large portions of public funds matters more. Moreover, there are reasons to believe investment should be excluded in consolidation considerations: it might make sense to avoid borrowing to fund current spending on the basis that this creates a burden for future taxpayers, but borrowing to spend on investment can create durable assets for future taxpayers that can help offset the extra liabilities. A focus on net worth rather than just debt could result in debt rising through investment spending, but recent work from the IMF suggests that a stronger public-sector balance sheet has positive macroeconomic

13 For more a more detailed discussion on this issue, see: R Hughes, Seeking public value: the case for balance sheet targeting in fiscal policy, Resolution Foundation, September 2019.

effects. In particular, economies with strong public-sector balance sheets tend to find it easier to borrow in financial markets, experience less severe recessions, and recover from these more effectively.[14] For these reasons, when defining sustainable public finances, we focus on net worth.

FIGURE 7: **Net worth includes a full assessment of the balance sheet, including assets as well as liabilities**

Coverage of alternative balance sheet metrics

	National Accounts Measures			IFRS Measures
	Public Sector Net Debt (PSND)	Public Sector Net Financial Liabilities (PSNFL)	Public Sector Net Worth (PSNW)	Public Sector Net Worth (PSNW)
Assets			Non-financial assets	Non-financial assets
		Illiquid financial assets*	Illiquid financial assets	Illiquid financial assets
	Liquid financial assets	Liquid financial assets	Liquid financial assets	Liquid financial assets
Liabilities	Government borrowing	Government borrowing	Government borrowing	Government borrowing
		Other financial liabilities*	Other financial liabilities	Other financial liabilities
			Unfunded public sector pensions**	Unfunded public sector pensions
			PFI contracts**	PFI contracts
				Provisions

*Including funded public sector pensions

**Included in IMF GFSM2014 but not ESA2010

SOURCE: RF analysis of HM Treasury, 'Managing Fiscal Risks', July 2018.

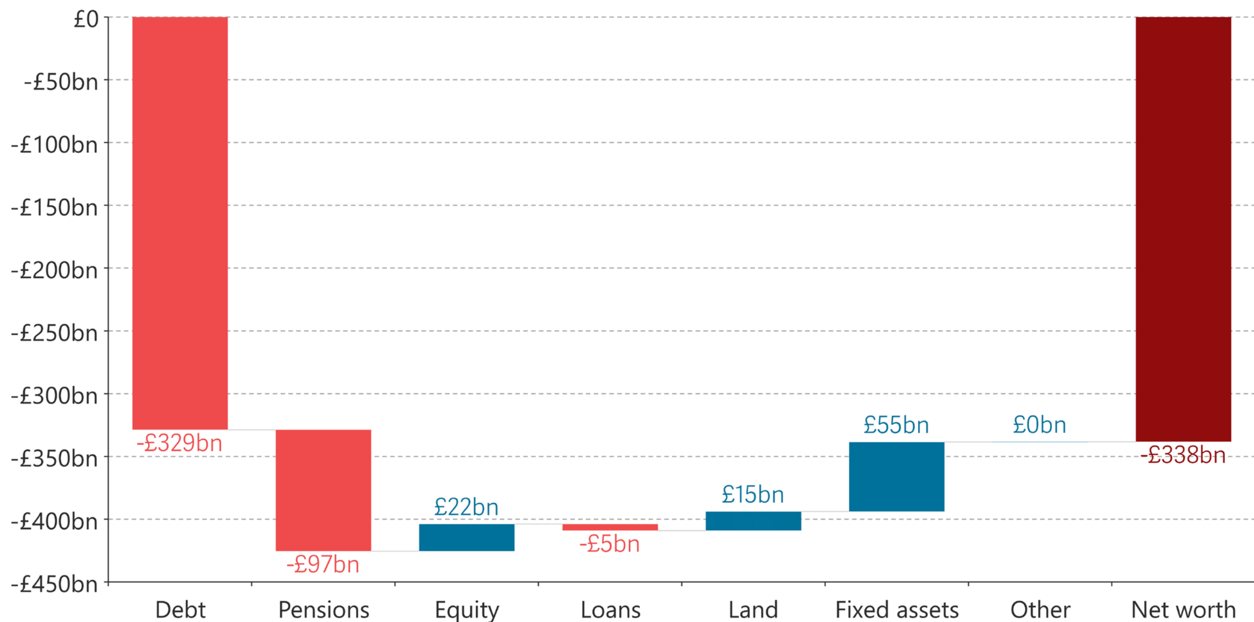
Thus far, in considering the 'debt-stabilising primary balance' we have been working in net debt terms. Two key changes are needed to shift to a corresponding "net worth stabilising" level of borrowing. The first of these is the exclusion of investment spending in our measure of borrowing, meaning that we focus on the current balance. This is because borrowing to invest, while it does increase net debt, does not tend to reduce net worth, as it often creates assets that are equal to, or greater than, spending on this investment, and thus 'nets off' when considering the total balance sheet.[15] The second assumption we make here is that the assets and liabilities on the government balance sheet, other than public sector net debt and assets created by investment, do not change their value over time. This is equivalent to setting the stock-flow adjustment to zero in the calculation of the debt-stabilising primary balance. This is, we admit, a strong assumption. But, as shown in Figure 9, this largely held true in the aftermath of the

14 S. R. Yousefi, Public Sector Balance Sheet Strength and the Macro Economy, International Monetary Fund, 6 August 2019.
15 It is important to caveat that while this holds for the vast majority of investment, there are some forms of investment spending that do not create assets that appear on the public sector balance sheet – such as capital grants to private companies to build e.g. housing, where these ultimate assets are owned by the private sector.

financial crisis, with changes in debt making up the majority of the fall in net worth; the effect of changes to the value of other assets and liabilities within net worth – such as fixed assets, land and equity – largely 'netted out'.[16]

FIGURE 8: **Falls in net worth in the financial crisis were mainly driven by rising public sector debt**

Change in public sector net worth from 2010-11 to 2012-13, decomposed by asset type



NOTES: Net changes in assets and liabilities for each asset type are shown. 'Other' consists of financial derivatives and employee stock options; monetary gold and special drawing rights; inventories and other accounts payable. Debt is here presented in nominal terms in line with national accounts measures, rather than at market value, as in GFSM net worth statistics published by the ONS.
SOURCE: RF analysis of ONS, Public Sector Finances, UK: August 2020.

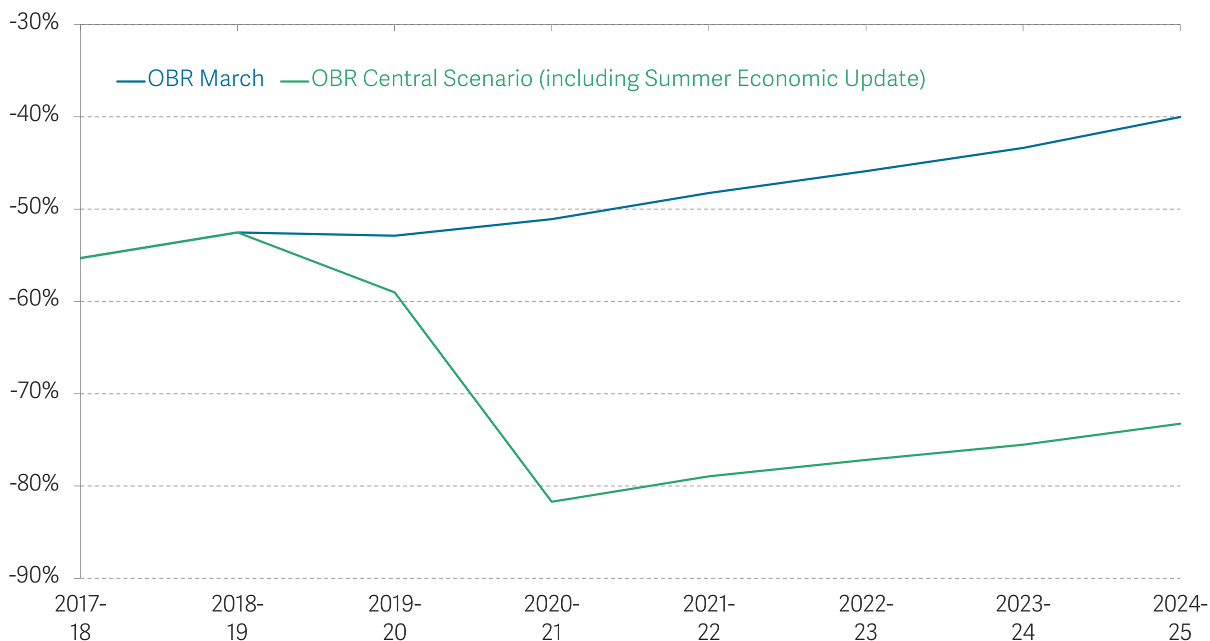
Having made these changes and gone through the same calculations as above, we can show that year-to-year stabilisation of net worth does not require a consolidation relative to the OBR forecast. Based on the two assumptions outlined above, the deficit required to stabilise net worth year-to-year is the same as that for stabilising net debt, but where the deficit is calculated excluding investment spending. In other words, we need to compare the target net-worth stabilising deficit to the current balance, rather than to total borrowing. As shown in Figure 6, the borrowing forecast excluding investment (i.e. the current balance) in 2024-25 is 1.5 per cent of GDP. This is nearly three per cent of GDP (or around £72 billion in 2024-25 prices) below the stabilising level of the current balance in 2024-25. This means, as shown in Figure 9, that net worth is forecast to be rising over the medium term. The key reason for this – and why net worth is much more stable than

16 Significant increases in net public sector pension liabilities over this period relate to valuation changes such as the shift from RPI to CPI indexation from April 2011, as well as the effect of the privatisation of Royal Mail pension schemes from April 2012.

debt – is that the OBR forecasts include government plans for very significant public investment that adds around £80 billion to public sector borrowing in 2024-25 (as shown in Figure 1).

FIGURE 9: **Net worth is forecast to rise over the medium term, after falling sharply in 2020-21 because of the crisis**

Public sector net worth, as a proportion of GDP: outturn and forecast



NOTES: The debt component within net worth is presented here in nominal terms in line with national accounts measures, rather than at market value, as in GFSM net worth statistics published by the ONS.
SOURCE: RF analysis of ONS, Public sector finances, UK: August 2020; OBR, various.

However, our view is that simply stabilising the public finances year-to-year is not sufficient: building future fiscal space should be prioritised

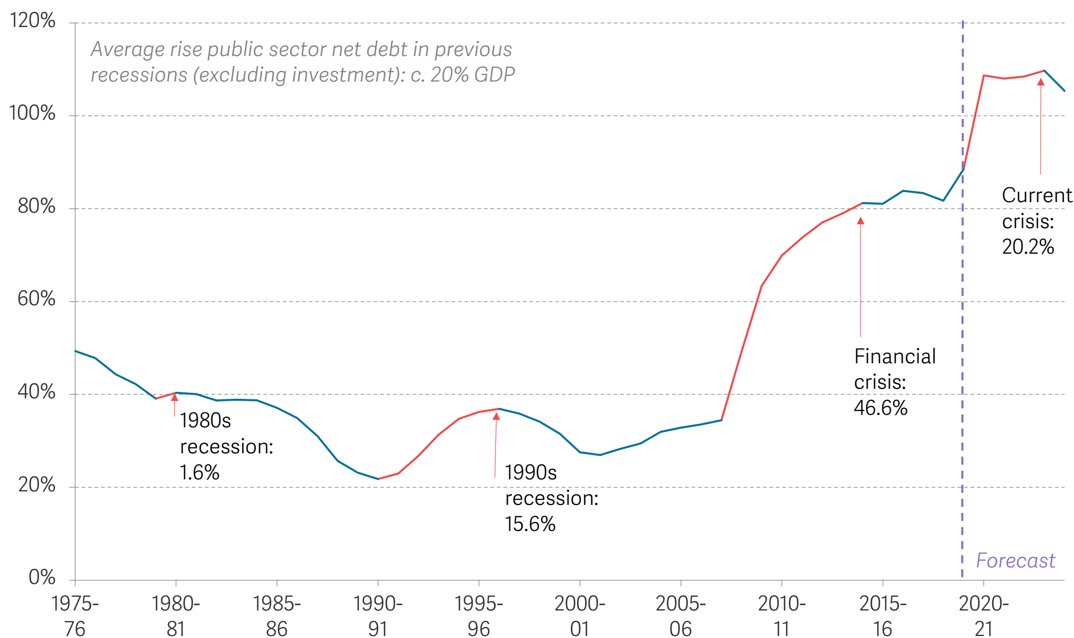
To summarise, it would take a consolidation of around 0.3 per cent of GDP in 2024-25 to stabilise net debt on a year-to-year basis, but no further consolidation would be needed to place net worth on a short-term rising trajectory.

However, an important point to consider is that 'stabilising' the public finances over this metric of year-to-year improvement is unlikely to be sufficient to achieve longer-term fiscal sustainability. In order to deliver net worth rising over the longer term – that is, over a period containing a number of future recessions – the rising trajectory must be enough to offset falls in net worth driven by future economic shocks. As discussed above, the constraints imposed on monetary policy by the low interest rate environment mean that

fiscal policy will need to be used more actively for the foreseeable future during recession periods. This is likely to mean further significant increases in government borrowing in future decades. If the public finances were to continue on a deteriorating path for a prolonged period, it is clear that – at some point – the UK government would no longer be able to borrow in financial markets.

FIGURE 10: **The UK's past four recessions have resulted in an average rise in debt of around 20 per cent of GDP**

Public sector net debt and rises during recession periods excluding investment, as a proportion of GDP



NOTES: 'Recession periods' are defined as the first year of technical recession to the peak in debt – apart from the financial crisis, where significant debt rises in 2007-08 are also included. Totals refer to rises in debt excluding investment.
SOURCE: RF analysis of OBR, various.

The counter argument to this approach is that, so long as there are structural forces driving interest rates down, net worth can be stabilised at a lower level than it is currently – meaning there is capacity for it to decline further. However, while we agree that fiscal sustainability is state-dependent, there is a great deal of uncertainty about where the limit of fiscal space is; crucially, this limit depends on economic circumstances, so it could well bind at levels for fiscal aggregates that have been unproblematic in good times.[17] Therefore, prudent policy demands not just that net worth stocks are stable over the short term. Instead, the objective should be to avoid declining net worth over

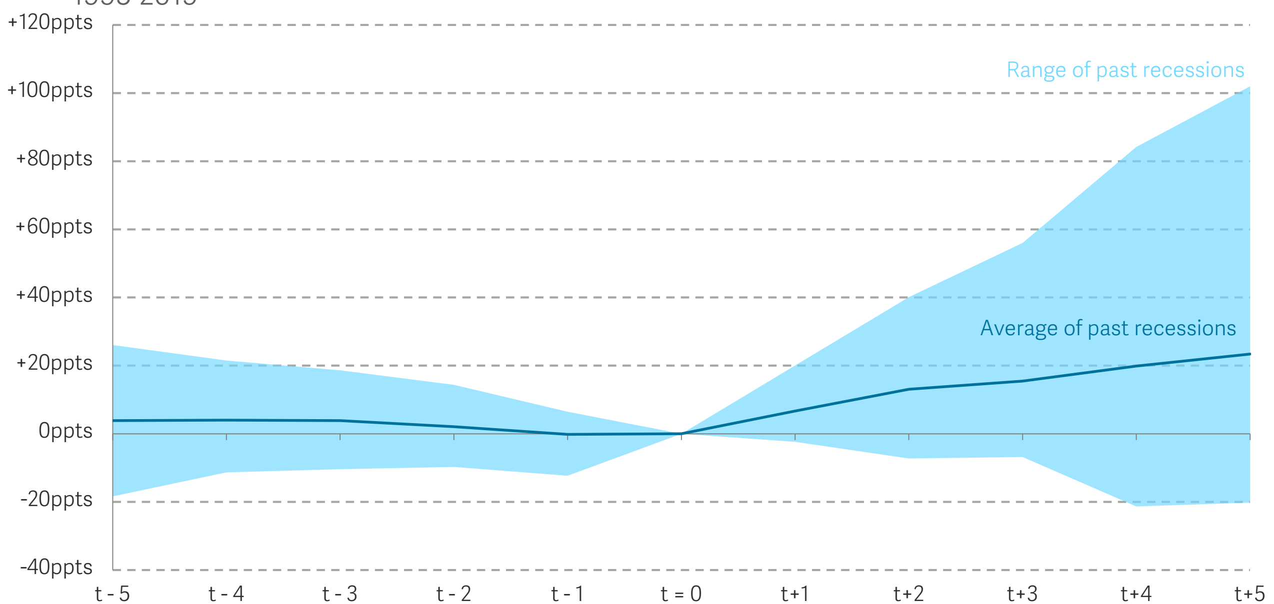
17 For example, a limit for retaining market access of a debt-to-GDP ratio of 90 per cent was proposed in C M Reinhart & K S Rogoff, 'Growth in a Time of Debt', American Economic Review, vol. 100(2), pages 573-578, May 2010. But the methodology employed in this estimate was subsequently subject to substantial challenge (see, for example: R Harding & C Cook, Harvard duo defend the case for austerity, Financial Times, April 2013). Moreover, a number of advanced countries have seen their debt level rise significantly above this level in recent years while continuing to borrow at very low interest rates.

the medium term, which requires that net worth actually rises year-to-year outside of downturns to create the fiscal space to cope with future recessions.

Figure 10 illustrates how debt has changed during past recessions in the UK, showing an average rise of nearly 20 per cent of GDP excluding investment (roughly equivalent to the change in net worth), and with recessions occurring on average once per decade. But a key difficulty in predicting how much fiscal space to build for a future economic shock is the variation in the fiscal effects of past recessions. Some of this relates to policy choices – for example, the small rise in debt in the early-1980s recession was due to fiscal policy tightening during the shock. And this uncertainty is compounded by the varying types of economic shock, with the bailing out of banks during the financial crisis resulting in especially high rises in debt, and the current pandemic having its own unique profile.

FIGURE 11: **The average recession in advanced economies has added around 23 per cent of GDP to government debt**

Change in debt to GDP ratio relative to pre-recession levels, across OECD countries: 1995-2019



NOTES: Sample includes all OECD countries, excluding Columbia, Iceland, South Korea, Mexico, New Zealand and Turkey. Sample covers available data on debt to GDP ratios between 1995 and 2019. A recession is defined as a period starting with a fall in annual per capita GDP growth, denoted as year t+1. Where multiple years of negative GDP growth fall within a five-year period, the first negative year is treated as the start of the recession. Debt is defined as general government debt.
SOURCE: RF analysis of OECD; the World Bank.

Taken together, this suggests that the average recession could add around 20 per cent of GDP to the debt stock, excluding investment, so would lower net worth by around the same magnitude. This magnitude of rise in debt is also largely in line with the average rises in debt during recession periods in other advanced economies. As Figure 11

illustrates, while the experiences of advanced economies vary significantly – on average, five years after a recession, the rise in general government debt across OECD countries has been just over 23 per cent of GDP.

However, even if we thought that past average was informative about future recessions, we also need to consider the fact that the constraints on monetary policy mean that fiscal policy will in future need to provide more support to the economy. As a rule of thumb, the Bank of England has cut interest rates by an average of around 5 percentage points during recessions. Based on the Bank's own estimates of the impact of monetary policy on the economy and the OBR's estimates for the impact of fiscal policy, then we would need to see an additional increase in government spending of further 5 per cent of GDP to make up for the lack of a stimulus provided by lower interest rate.[18] So adding a further 5 per cent of GDP to the target for fiscal space is likely to be closer to the magnitude needed to offset a future recession.

Therefore, it would appear prudent to aim to build around 25 per cent of GDP in fiscal space in net worth terms to account for the average future recession. As discussed below, however, it is important to recognise that there is a significant risk that more fiscal space will be required, either because the recession will be larger or because more policy support will be needed. In terms of the time scale to build this fiscal space, history suggests that an economic shock occurs around once per decade,[19] and starting consolidation around four years into this decade leaves around six years to build fiscal space before the next crisis is likely to hit.

Overall this points to a consolidation of around £40 billion in 2024-25 terms to stabilise net worth and build future fiscal space

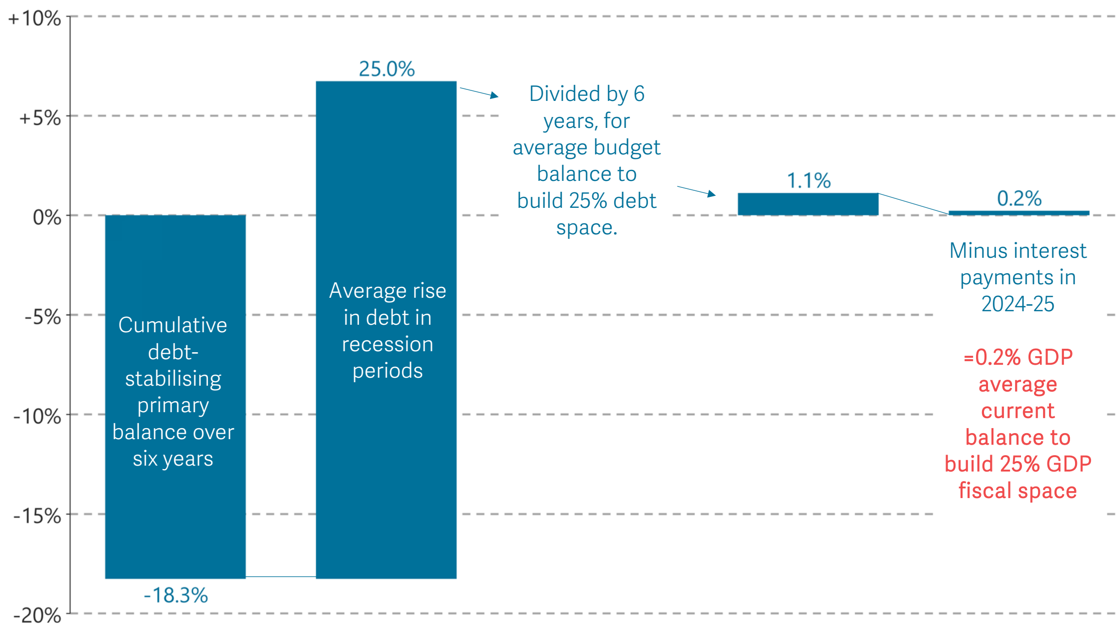
Calculating the level of borrowing consistent with building around 25 per cent of GDP in fiscal space over six years depends on the same debt-stabilising equation that we used above. In this case, we are looking to stabilise net worth over the whole decade, then adding a rise of 25 per cent of GDP on top of this. Figure 12 sets out this calculation. It starts from the basis that cumulative borrowing over six years could amount to around 18 per cent of GDP (excluding interest payments), while the net worth-to-GDP ratio remains flat. Adding on top of this the 25 per cent of GDP in fiscal space (necessary to offset the economic shock expected at the end of the decade) results in a cumulative primary surplus figure of 6.7 per cent of GDP. To hit this would require averaging around a 1 per cent primary surplus in each year of the six years of a consolidation cycle. Finally, accounting for interest payments in 2024-25 means that we would require averaging

18 See Footnote 29 in L Gardiner et al., Easing does it: Economic policy beyond the lockdown, Resolution Foundation, July 2020.
19 See J Smith, J Leslie, C Pacitti & F Rahman, Recession ready?: Assessing the UK's macroeconomic framework, Resolution Foundation, September 2019

a current balance of 0.2 per cent of GDP (essentially, a balanced budget excluding investment spending). This is at the centre of the range of the current balance target set out in previous work as part of a model fiscal framework, as detailed further in Section 3.[20]

FIGURE 12: **Averaging around budget balance for 6 years would build 25 per cent of fiscal space**

Breakdown of calculation of average budget balance to build 25 per cent of GDP in fiscal space: proportion of GDP



SOURCE: RF analysis of OBR.

Given the forecast current deficit for 2024-25 in the OBR's central scenario is around 1.5 per cent of GDP, converting this to a 0.2 per cent surplus would require a consolidation of around £40 billion in 2024-25 prices.[21]

Policy recommendation: Subject to the pace of recovery, the Government should aim to undertake a £40 billion consolidation in 2024-25, to reach close to a balanced current budget. In order to build sufficient fiscal space against net worth to offset a future economic shock, the Government should aim to continue to average around current balance over the period until the next recession.

20 R Hughes et al, Totally (net) worth it: The next generation of UK fiscal rules, Resolution Foundation, Oct 2019.

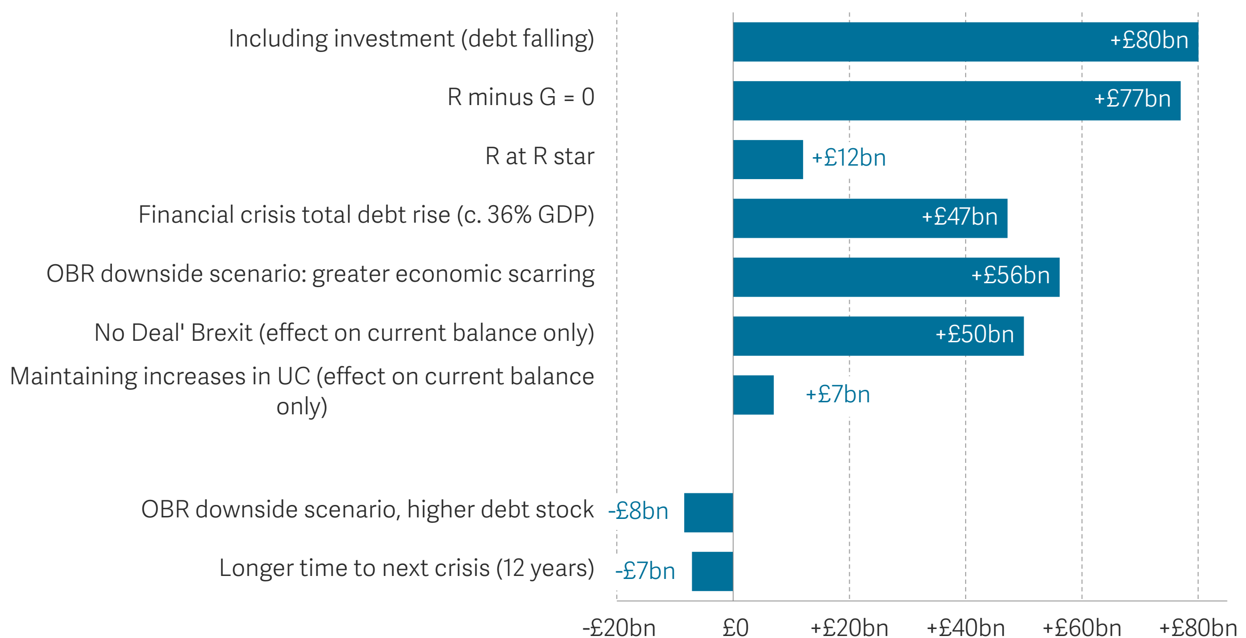
21 In general, we would expect governments aiming to average close to a current balance over the parts of the cycle outside of downturns to run deficits in the early years, with more significant surpluses being built up over later years (ahead of the next recession). However, when considering a level of consolidation for 2024-25, these considerations need to be balanced against the significant downside risks to this estimate of consolidation required set out below.

But there is significant uncertainty around a £40 billion target, with the risk that there will need to be a larger consolidation

It is worth bearing in mind that this £40 billion target is very uncertain. There are a number of ways in which it could shift, particularly towards requiring a larger consolidation. Figure 13 sets out quantitative scenarios for some of the key uncertainties detailed below.

FIGURE 13: **There are several factors that could substantially raise the annual amount of consolidation required**

Additional consolidation required, by scenario: £ billion, 2024-25 prices



SOURCE: RF analysis of OBR, various.

The following factors would tend to push up on the required consolidation:

- Focussing on net debt rather than net worth: Perhaps the most important factor that would increase the amount of consolidation required would be a decision to focus on building fiscal space against public sector net debt rather than net worth. This would require near to an absolute budget balance in 2024-25, including investment spending. This equates to a further £80 billion in consolidation, or a total of £120 billion overall. Because of this, it is hard to avoid the conclusion that a net debt fiscal target would be accompanied by significant cuts in investment spending. In an era requiring significant investment, not least to deliver a net zero transition, net worth is a far more appropriate (although far from perfect) fiscal target.
- Interest rates are higher or growth lower: Because the debt-stabilising primary

balance depends on the difference between effective interest rates and GDP growth, then, if this ratio changes (because interest rates are higher or growth lower) then debt dynamics would deteriorate, requiring deeper consolidations for the same fiscal objectives. But a key point here is that, as we showed in Figure 5, these are not independent risks: a rise in growth is likely to be accompanied also by rise in interest rates. However, there is also evidence of 'mean reversion' in the difference between these rates, i.e. a likelihood that their difference tends to zero. While mean reversion is unlikely in the medium-term, were interest rates and GDP growth to become equal then this could add nearly £80 billion to the required consolidation. A more realistic risk is that interest rate growth could increase marginally, returning to the natural rate of interest, often referred to as 'r star'.[22] On current estimates of r star, this would add around £12 billion to the consolidation required.

- The required fiscal space is greater than 25 per cent of GDP: A key assumption underlying the £40 billion consolidation figure is that 25 per cent of GDP in fiscal space is sufficient, on average, to offset the fiscal impact of future recessions. If future economic shocks have an average impact on debt in line with the financial crisis (a rise in debt of 36 per cent of GDP, rather than the average of 25 per cent for recent recessions) this could add nearly £50 billion to the required consolidation.
- Increased economic scarring: A greater structural hit to the economy as a result of the pandemic could significantly raise consolidation estimates, given the impact on projected current deficits by the end of the forecast. An amount of scarring close to that forecast in the OBR's 'downside scenario' would add around £56 billion to the consolidation. Estimates from the Institute for Fiscal Studies also assume higher levels of scarring than the OBR's central scenario: as a result, they estimate that it would take a 2.1 per cent of GDP consolidation just to keep debt flat on a year-to-year basis from 2024-25 (compared to the 0.3 per cent consolidation we set out above).[23] The risks and likelihood of further recession scarring are discussed in Box 1 below, a more pressing concern than it was at the time of the OBR's FSR, given we now face a second wave of the virus.
- Policy choices: Although, as set out above, near-term spending on policies designed to support incomes through the pandemic are likely to have negligible effects on borrowing by 2024-25, there are other, significant policy choices that could affect the current balance over the medium term. The most significant of these would be a 'No Deal' Brexit, which previous work suggested could create scarring effects amounting to a £60 billion per year deterioration in the current balance by 2024-

22 Estimates of r star are taken from the latest data from the Federal Reserve Bank of New York.
23 C. Emmerson and I. Stockton, 'Outlook for the public finances' in Institute for Fiscal Studies, Green Budget 2020, October 2020.

25.[24] A very different policy choice that could also affect the level of consolidation required would be to make permanent the current increases in the generosity of Universal Credit: this would add around £7 billion to the current deficit by 2024-25.[25]

BOX 1: Prospects for economic 'scarring'

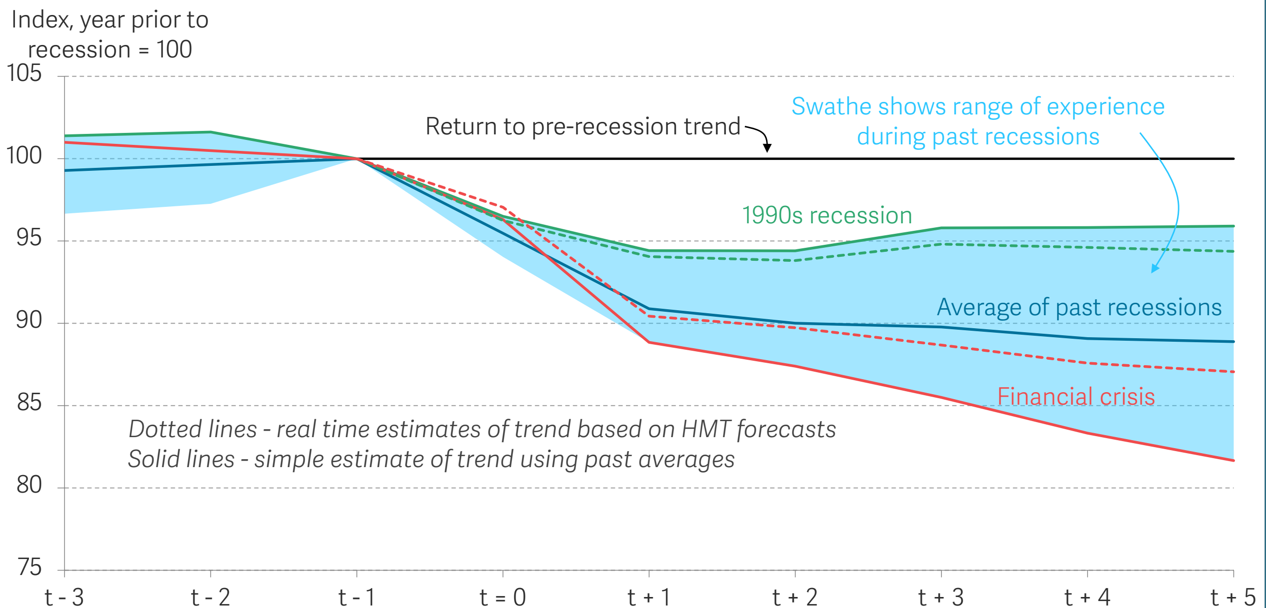
In the initial phase of this crisis, GDP fell by unprecedented amounts in a very short period of time. But what matters for the public finances is the extent of the lasting damage on the economy – often referred to hysteresis, or economic 'scarring'. In this box we consider what history and international experience can tell us about the prospects for scarring. We conclude that, although past experience tells us that scarring is often larger than the 3 per cent assumed in the OBR central scenario, many of the ways in which scarring affects the economy can be reduced if policy makers can deliver a rapid recovery. In the context of coronavirus, an effective vaccine could provide a particularly effective way to deliver a rapid recovery.

Past recessions in the UK appear to have had a large, persistent impact on the size of the economy. As shown in Figure 14, during post-war recessions, GDP has fallen persistently relative to the path that the economy was on prior to the recession. On average, GDP is around 11 per cent below a continuation of its pre-recession trend after five years. The definition of 'trend' here is potentially important, however. So in Figure 14 we compare the simple five-average growth rate, five years prior to the recession used in the calculation of that average, with estimates of trend made in the run up to the 1990s recession and the financial crisis by HM Treasury (forecasts are not available for earlier recessions).[26] Those real-time estimates provide some comfort that our simple average provides a reasonable sense of trend.

24 R Hughes, J Leslie, C Pacitti & J Smith, Dealing with no deal: Understanding the policy response to leaving the EU without a formal agreement, Resolution Foundation, September 2019.
25 Cost of increase in weekly universal credit and weekly working tax credit by £20 in 2020-21, from OBR, Coronavirus policy monitoring database, updated 14 July 2020. This cost would of course be lower if there were fewer benefit claimants as is likely to be the case by 2024-25. For example, the Institute for Fiscal Studies estimates that, in the long-run, this policy change would cost around £6.6 billion per year in 2020/21 prices.
26 Source: Historical forecast database, OBR, March 2020.

FIGURE 14: **Falls in GDP during past recessions persisted even after the recessions were over**

The level of real GDP relative to pre-recession trend following during past recessions (year prior to recession = 100)

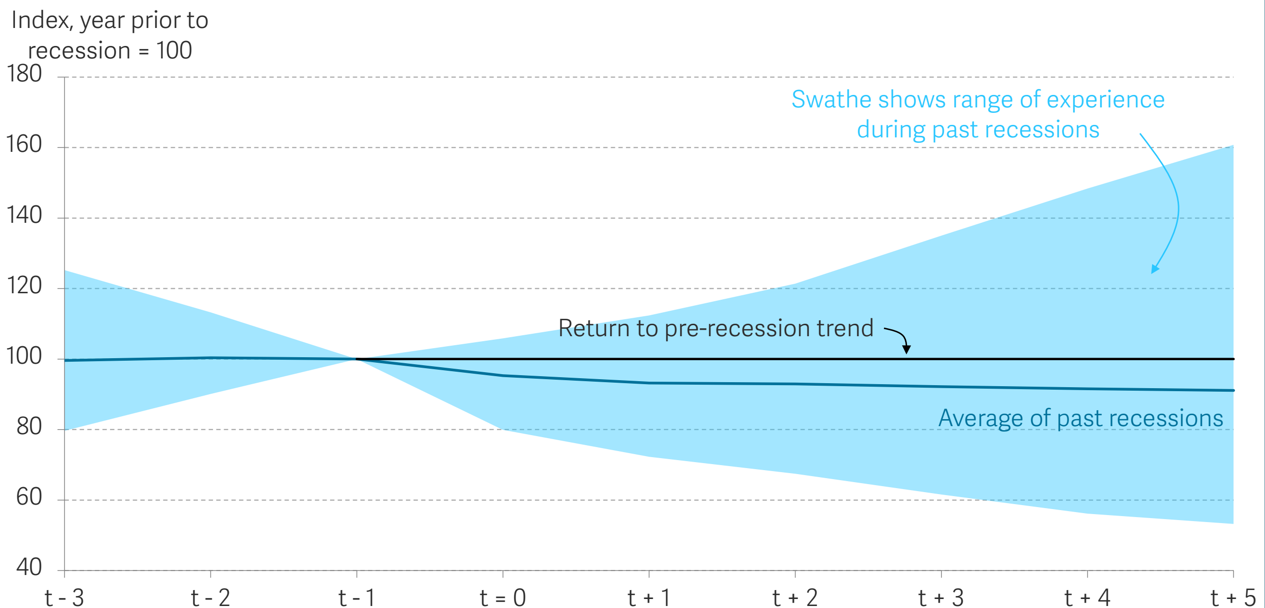


NOTES: t = 0 is the year of the recession (first year that GDP growth is negative); swathe includes 1970s, 1980s, 1990s and financial crisis recessions. In the solid line (and in the swathe) trend is estimated to be the average growth rate over five years, five years prior to the start of the recession. The dotted lines show deviation from pre-recession, real time HM Treasury forecasts included in the OBR's historical forecast database.
SOURCES: RF analysis of ONS; OBR, Historical Forecast Database.

A similar picture emerges if we look at past recessions in other advanced economies: see Figure 15. The variation in recession experience is much larger than for the UK, with many economies recovering very strongly and others continuing to shrink for a number of years: this reflects that we are looking at around 150 recessions. Nonetheless, we find that, on average, GDP is around 9 per cent below a continuation of its pre-recession average growth rate five years afterwards, close to the 11 per cent figure for the UK.

FIGURE 15: **A strikingly similar picture emerges from looking at recessions in advanced economies since 1960**

The level of real GDP relative to pre-recession trend following during past recessions (year prior to recession = 100)



NOTES: t = 0 is the year of the recession (first year that GDP growth is negative); swathe includes all recessions in advanced economies (based on the IMF definition) since 1970. As in Figure 14, the definition of trend is estimated to be the average growth rate over five years, five years prior to the start of the recession.
SOURCES: RF analysis of World Bank.

This historical evidence suggests that the longer-term impact of the coronavirus crisis could be much larger than in the OBR's central scenario. Indeed, if the UK economy was around the 10 per cent or so smaller that is suggested by the historical evidence relative to its pre-coronavirus crisis path, that would suggest a much greater need to tighten fiscal policy in future.

But the ways in which such scarring is thought to happen suggest that an effective policy response could mean that there is a smaller longer-term impact this time.

Scarring effects can happen in four main ways. First and most obviously, workers who are made unemployed may end up taking early retirement, see their skills degrade over time, or end up having to move to other industries where their skills are not as well suited. This can be particularly problematic if unemployment remains elevated for a prolonged period after a recession, as it did after the early-1980s and early-1990s recessions.[27] Second,

27 Recent work has suggested that the process of people becoming unemployed can lead to an inefficient period during which workers try to find a job to which their skills are a close match, see: R E Hall & M Kudlyak, 'Why Has the US Economy Recovered So Consistently from Every Recession in the Past 70 Years?', NBER Working Papers 27234.

business insolvencies can lead to a loss in physical capital, as well as a loss in workers' job-specific skills. Third, a prolonged recession and weak recovery could also discourage businesses to invest in new physical capital, or increasing the number of workers employed. And fourth, weak growth can lead to a slowing in the pace of technological advancement, reducing the incentives for firms and workers to increase their productivity. These third and fourth mechanisms can result in an extended period of low productivity growth and stagnant incomes as was the case following the financial crisis.

In all cases, however, an effective policy response that minimises uncertainty and reduces the depth of the recession will tend to reduce the size of these effects. If policy makers can generate a rapid recovery, then this reduces unemployment – particularly long-term unemployment – minimises insolvencies, and incentivises firms to hire more workers and invest in increasing productivity. Indeed, there is plenty of evidence that policy makers who provide greater support for the economy tend to see shallower and less long-lasting recessions.[28] This means that policy makers seeking to return aggregate demand to its long-term sustainable level will need to avoid limiting their policy response on the basis of assumed structural hits to the economy. This is important because – for the reasons mentioned above – a weak policy response could directly cause a more persistent period of low growth. If such an outcome becomes entrenched as a fall in the sustainable level of output of the economy, there is a risk that such an assumption becomes self-fulfilling.

Taken together, then, our view is that, although there are downside risks to the OBR's estimate of the long-term impact on the economy, policy makers should be pushing actively for a rapid recovery to minimise these effects.

However, there are also some factors that would tend to push down on the required consolidation. These include the possibilities that:

- The crisis is larger and the rise in debt is greater: Perhaps counter-intuitively, it is easier to stabilise the debt-to-GDP ratio at higher values. This because the higher the debt, the larger the deficit that can be run while maintaining a stable debt-to-GDP ratio (as shown by the equation in footnote 12). Reaching the debt stock forecast in the OBR's 'downside' scenario (around 10 per cent of GDP higher than the central scenario) would actually reduce the required consolidation by £8 billion. However, a higher rise in debt would also be likely to occur alongside greater long-

28 For example, see: C D Romer & D H Romer, 'Fiscal Space and the Aftermath of Financial Crises: How It Matters and Why', NBER Working Papers 25768, 2019; and, V Cerra, A Fatas & S C Saxena, 'Hysteresis and Business Cycles', IMF Working Papers 20/73, International Monetary Fund, 2020.

term scarring to the economy, meaning that the OBR's 'downside' scenario ends up requiring a larger consolidation by around £43 billion. This clearly shows the merits of avoiding longer-term economic scarring, even if this comes at the cost of higher spending on near-term support through the crisis period, and a higher total debt stock.

- There is more time to implement fiscal consolidations between recessions: The £40 billion consolidation figure, or averaging around current balance, aims to build 25 per cent of GDP in fiscal space over six years– using an assumption of a decade between recessions on average. Were policy makers to allow themselves to assume an average gap between future recessions to be longer, such as the twelve years from the early 1990s recession closing and the financial crisis, then this would reduce the consolidation required by around £7 billion.

Our view is that there is very considerable uncertainty around any estimate of the size of the required consolidation, but that the risks point firmly towards the possibility of having to do more consolidation than discussed in our policy package below. This also suggests that, although our target is based off an average of current balance over the next six years, it makes sense to aim for that target in 2024-25, given the likelihood that more significant consolidation could be required afterwards. More broadly, the range of possible sensitivities in this analysis underlines the importance of flexibility in the approach to repairing the damage to the public finances. It is sensible to have a broad strategy, but that strategy will need to adjust as uncertainty is resolved. There is, therefore, a premium on plans that can be 'scaled up' in the event that one of the downside risks discussed above crystallises. That is a key element of the approach described below.

Taken together, this suggests a prudent initial target for fiscal consolidation in net worth terms is around £40 billion in 2024-25. However, the realisation of this target is also dependent on the practicalities of consolidating in the aftermath of a crisis. The time-scale over which a consolidation can begin, and the pace at which it can take place without damaging the economic recovery, are crucial economic judgments; the next section addresses these in detail.

Section 3

When should consolidation start and how quickly should it proceed?

How large the eventual fiscal tightening should be is clearly a key question to address, but so too is the question of its timing. Here, once again, the shift into a low interest rate environment over the past decade means that a profoundly different approach is needed. Most discussions focus exclusively on the need for greater fiscal stimulus during the peak of recessions, on the grounds that monetary policy has little capacity to stimulate the economy. But the constraints on monetary policy have wider implications for fiscal policy, and specifically on how consolidations should be conducted. Because fiscal support needs to last longer, not just be bigger, consolidation must start later. And when it does start, the pace and design of that consolidation should be limited by the need to maintain monetary policy space by avoiding too large a drag on GDP. In short, starting consolidation too early – or proceeding too quickly – risks derailing the recovery.

In practice, this means that the Government should only start the process of consolidation when it is clear that the economy has recovered from this crisis. Based on the OBR's central scenario, it looks like the absolute earliest fiscal consolidation can possibly start is 2023. In the meantime, more support will be needed to prevent fiscal policy becoming a significant drag on growth. Once the consolidation starts, our benchmark estimate is that the fiscal stance could tighten by around £20 billion per year without forcing the Bank of England to loosen monetary policy to boost the economy.

It is important to emphasise the uncertainty here: it is certainly possible that the consolidation may need to start later. But honesty about that uncertainty strengthens the case for setting out a clear framework now. Indeed, while the Government does not currently face any financing difficulties, showing a commitment to repairing the public finances when the time is right will minimise the risks that any such difficulties

emerge. It will also ease decision-taking for policy makers at the Bank of England given the inevitably more coordinated natures of fiscal and monetary policy during this pandemic than in previous recessions.

Changes to the economic environment mean that fiscal policy must play a different role to that in past recessions

As we have highlighted already, a key difference in this crisis compared to other recessions is that monetary policy is constrained, so fiscal policy has to play a more active role in stabilising the economy. In a typical UK post-war recession, the Bank of England has cut interest rates by more than 5 percentage points.[29] During this crisis, the Bank has only cut interest rates by 0.65 percentage points and added £450 billion to its purchases of government bonds and other assets (known as QE). Although the Bank could conduct further stimulus – for example, cutting interest rates into negative territory, expanding QE further, publishing interest rates expectations or other more novel approaches – in practice the Bank has little firepower left to stimulate the economy directly.[30] This means that fiscal policy has to do the heavy lifting in supporting the economy during this crisis.

So far fiscal policy has done just that, but under current plans fiscal policy is likely to become a drag on growth next year. As discussed above, government spending since the onset of the pandemic has been driven by the requirements of the health crisis and the need to support the incomes of those affected by social distancing restrictions. This has provided a huge boost to the economy and protected the living standards of many.[31] But these measures have been targeted at the immediate crisis, and there are no current plans to continue support in the medium term. The most recently announced fiscal support measures, such as maintaining the full furlough scheme, have also all been time-limited and targeted at the immediate health restrictions. On current plans, there is a substantial risk that fiscal support will be withdrawn too quickly, leading to higher unemployment.

29 See: J Smith, J Leslie, C Pacitti & F Rahman, Recession ready? Assessing the UK's macroeconomic framework, Resolution Foundation, September 2019.
30 There are increasing signs that the Bank will cut interest further but the stimulatory effective is unlikely to be substantial. See G Vlieghe, (2020), Assessing the Health of the Economy, Bank of England, Speech, October 2020.
31 See L Gardiner, J Leslie, C Pacitti & J Smith, Easing does it: Economic policy beyond the lockdown, Resolution Foundation, July 2020; and D Tomlinson, A Corlett, K Handscomb, C McCurdy & M Brewer, The Living Standards Audit 2020, Resolution Foundation, July 2020.

Figure 16 shows our estimate of the effect of macroeconomic policies (both fiscal and monetary) on quarterly GDP growth.[32] Fiscal support so far during this crisis has been far larger than the equivalent support during the financial crisis, and monetary policy has done much less. Looking ahead, as shown in Figure 16, the current expected path of fiscal policy, which assumes large falls in government spending post-crisis (as shown in Figure 1), would become a drag on GDP growth in the second quarter of 2021. The OBR expects the unemployment rate to be 10.5 per cent in its central scenario in the second quarter of 2021, 2 percentage points higher than the peak unemployment rate during the financial crisis, with other forecasters expecting a lower, but still significant, unemployment peak. It would clearly be undesirable for fiscal policy to become contractionary at a time when unemployment remains high. This means that the Government will need to provide greater support next year than is currently envisaged.

The results in Figure 16 come with a great deal of uncertainty, both in the estimation and because the health crisis continues to develop. In particular, it is hard to know what effect some of the various government support measures will have on GDP: the JRS and the SEISS, for example, are both transfers of money to households, but they may not have the typical economic effect of these transfers.[33] We have attempted to account for this mechanism by splitting government spending and tax changes into those which are 'typical' support measures – shown in the solid bars – and those which might be 'atypical', such as the JRS – shown in the striped bars. This effectively provides a range within which the impact of fiscal policy is likely to lie next year. Even in the best-case scenario, where we discount the likelihood that these policies become a drag on growth once withdrawn, we can see that fiscal policy is expected to become contractionary in 2021.[34]

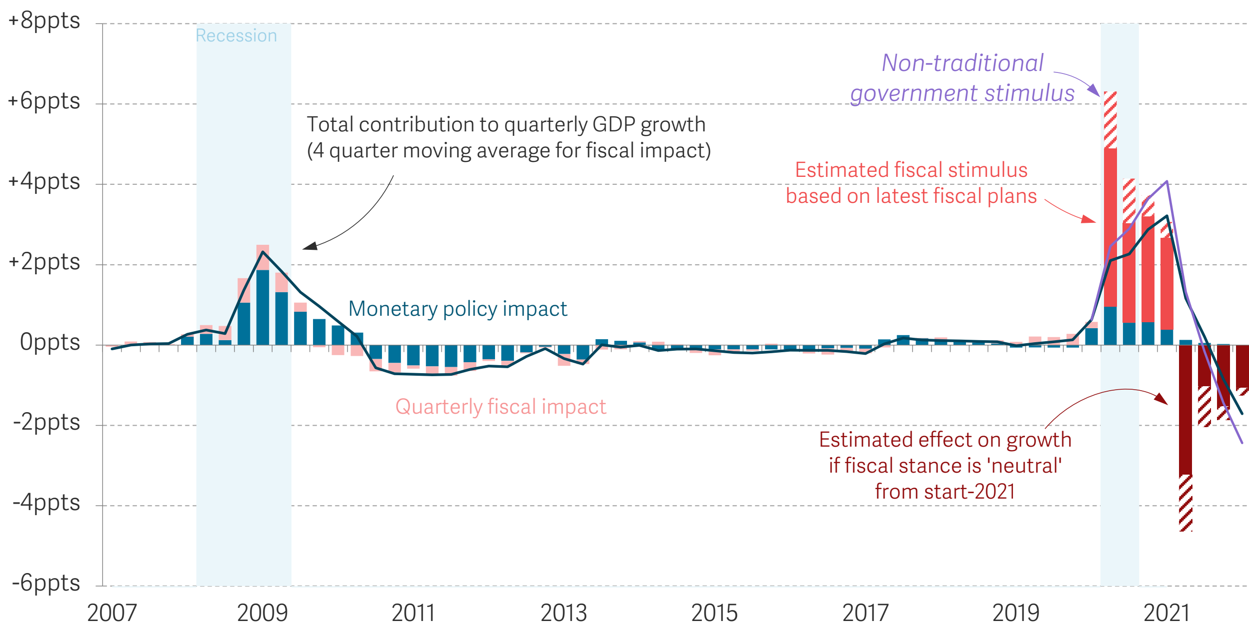
32 This is based on an adapted version of the Hutchins Center Fiscal Impact Measure, using the OBR's UK-specific fiscal multipliers. We allocate government fiscal policy into four groups: consumption, transfers, taxes on households and taxes on businesses. We calculate the difference between the actual and expected value for spending in each category in each quarter relative to their value if they had they grown in line with the size of the real economy. This provides an amount of fiscal stimulus from the contemporaneous spending and tax stance. This fiscal stimulus is translated into GDP growth estimates using the OBR's estimates of the economic impact of additional spending, transfers and taxes.

33 Outside of a pandemic, if a household receives additional money from the government it is likely that they would spend a portion of it – leading to an increase in the level of GDP – and save the rest. GDP would also rise in the future, partially as a result of the higher savings, but this effect would fall over time. Thus, we would estimate that GDP *growth* initially rises as a result of the transfer but the impact of the transfer on growth becomes negative after some time. This may not be how these specific schemes affect GDP, because they are designed to replace income which is no longer received during the crisis (e.g. as a result of halted economic activity). In the simplest case, someone who was furloughed, had their employer top-up their wage to the normal level and expected to go back to their job might continue to consume exactly as they were before. This would mean the JRS provided a strong boost to GDP growth during the crisis (directly offsetting the fall in consumption that would otherwise result from unemployment), but would have no contractionary impact from its withdrawal.

34 There are other ways of measuring the stance of fiscal policy. For example, the change in the cyclically-adjusted budget deficit is a common metric. Alternative measures are, however, hard to interpret with respect to the effect on GDP, and do not provide as useful a tool in understanding how fiscal policy should respond in practice.

FIGURE 16: **Fiscal policy is on track to become a drag on growth in 2021**

Estimated impact of macroeconomic policies on quarterly GDP growth, history and forecast



NOTES: Monetary policy impact is calculated using estimates from P Bunn, A Pugh & C Yeates, 'The distributional impact of monetary policy easing in the UK between 2008 and 2014', Bank of England Working Papers no.720, Bank of England, March 2018. This covers the Bank of England stimulus during the financial crisis. Subsequent changes in Bank rate and quantitative easing purchases are incorporated using equivalent scaling factors between policy changes and GDP. The fiscal policy impact is calculated based on a UK version of the Hutchins Center Fiscal Impact Measure, adjusted for the OBR's estimate of fiscal multipliers. The values for 2020 and 2021 are based on assuming Bank rate is held at 0.1 per cent and the OBR's central scenario, beyond that spending is assumed to grow in line with nominal GDP. The 'non-traditional government stimulus' is the part of government spending (both consumption and transfers) which may not align with standard multipliers, including the JRS and SEISS. The OBR estimates of fiscal multipliers are not based on estimates consistent with monetary policy being at the effective lower bound; some evidence suggests that taking this into account would raise the fiscal multipliers which would increase the size of the positive and negative fiscal impact bars (see W. Miyamoto, T L Nguyen, and D. Sergeyev, 'Government Spending Multipliers under the Zero Lower Bound: Evidence from Japan', American Economic Journal, Vol. 10, No. 3, July 2018. The effect of the most recent round of fiscal measures, for example the extended full furlough scheme, have not been included in this chart as the OBR is yet to publish an estimated cost.
SOURCE: RF analysis of ONS; OBR; Bank of England.

It is important for the Government to set out its fiscal strategy

In general, governments face incentives to run fiscal policy overly loose. Although it is in a government's long-term interest to keep borrowing and debt at sustainable levels, taxing less or spending more can secure short-term political gains. The traditional worry about the existence of such 'deficit bias' is that it creates a risk that markets lose confidence in the government's fiscal position.[35] This would result in higher financing costs for the government (i.e. the interest rate on government debt would rise), as gilt

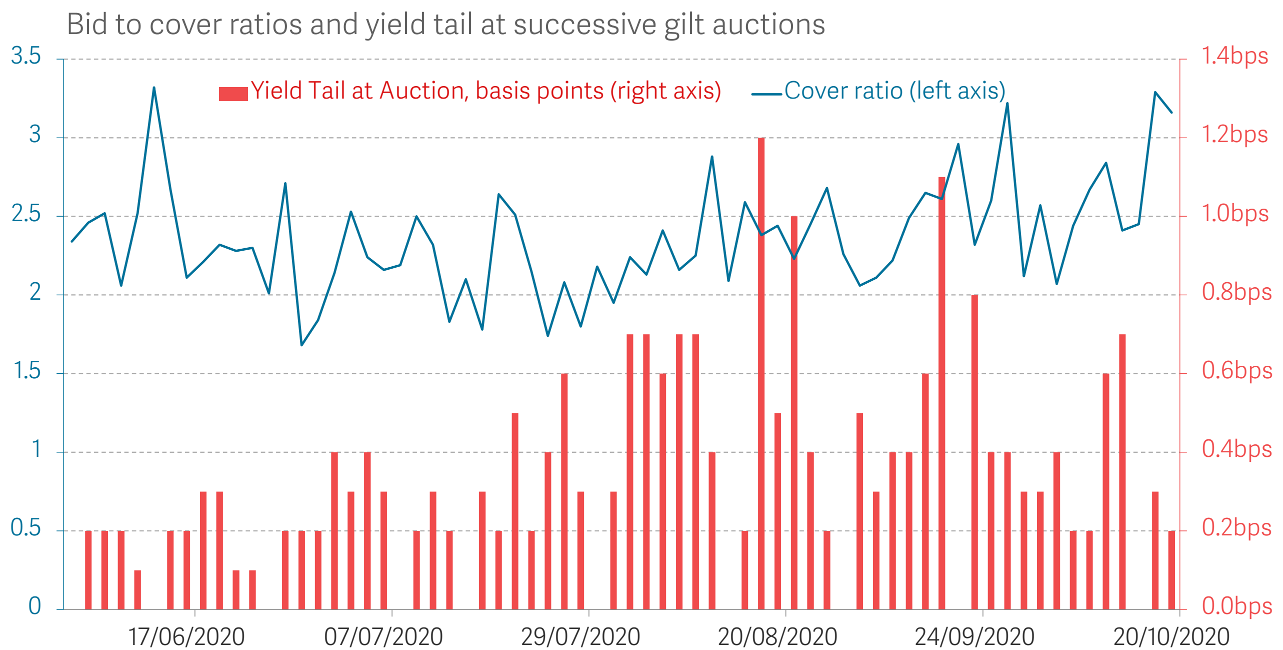
35 This is exacerbated by the fact that perceptions of fiscal sustainability and the cost of government borrowing feedback on each other. This means that fiscal crises can take hold quickly and unpredictably. For a discussion of these issues, see: H L Cole & T J Kehoe, 'Self-Fulfilling Debt Crises', Review of Economic Studies, vol. 67(1), pages 91-116, 2000.

market participants would only purchase government debt at a premium to reflect the perceived risk of default (or higher inflation) in the future.[36]

There is no evidence of financing constraints at present. Between April and August 2020, the Government successfully raised £280 billion at gilt market operations, more than twice the amount for the entire previous financial year. Measures of market confidence remain positive. Figure 17 shows two key measures of market stability: the bid to cover ratio (which measures the ratio of bids for newly issued government debt relative to the amount on offer to the market), and the yield tail (a measure of the spread of prices accepted for the gilts on offer). Both remain within normal levels; in fact, the average cover ratio is slightly higher than before the crisis, suggesting there remains considerable capacity for additional gilt issuance.

FIGURE 17: **Despite record debt issuance, markets remain stable**

Bid to cover ratios and yield tail at successive gilt auctions



NOTES: Yield tail is not available for indexed linked auctions.
SOURCE: Debt Management Office.

This is encouraging, but it is not unexpected. We are still at a relatively early stage in the crisis, with the borrowing to date mainly funding the immediate income support measures. And it is important to remember that the Bank of England has very substantially increased its QE purchases, which in turn have reduced the net increase

36 In practise, an actual sovereign default of UK debt is probably a relatively low risk. However, as government finances become worse there is an increasing incentive for a government to reduce the real value of government debt by raising the level of inflation. Therefore, interest rates on non-index linked debt, which makes up the majority of outstanding government debt, would rise to reflect the perceived increase in risk of higher inflation in the future.

in outstanding government debt held outside of the public sector. This expansion of the Bank's asset purchases is expected (and welcome) given the depth of the recession, supporting fiscal policy as the primary tool for stimulating the economy by reducing costs of borrowing in financial markets.[37]

But it is not guaranteed that the Government will continue to find it so easy to sell gilts in future. The risk of a deterioration in market conditions appears low at the moment but, were interest rates to rise due to perceived fears about future fiscal sustainability, then this could result in material increases in the proportion of government spending going towards debt interest payments; this in turn could lead to a forced tightening of the fiscal stance before it was desirable.

There is also another risk that fiscal policy tightens prematurely, and this is exacerbated by the electoral cycle. Evidence suggests that the sudden and unpredictable way in which concerns about a country's fiscal position can develop in financial markets means that the policy makers face an incentive to respond pre-emptively to that risk.[38] In the past, this has led to fiscal policy being tightened too quickly in the aftermath of recessions, and so leading to slow recoveries. This risk is exacerbated in the UK by political economy considerations. With the current Government close to the start of its term, there may be an incentive to tighten fiscal policy sooner in an effort to avoid such tightening coming in the run up to the next election (due in May 2024).

Our key insight is that, to address the risk of being forced to tighten policy too early, the Government should set out its long-term fiscal strategy now. This has two clear benefits. First, a credible long-term fiscal plan will ensure that financial market participants understand how the Government will approach fiscal consolidation in the future, building confidence in its approach. Second, setting out a plan now that makes it explicit that government support will be in place as long as is necessary will help the wider economy by dampening uncertainty and boosting household and business confidence. In short, setting out a framework now would help stop the premature withdrawal of fiscal support while laying the path for the necessary consolidation to come.

Below we set out what that framework should look like, examining the right time to start to consolidate and how to define the appropriate fiscal strategy in the longer-term. Again, we rely on the OBR's central scenario to frame this decision, while recognising the huge uncertainty over how the health crisis and economic recovery will evolve. Crucially, the Government's approach needs to be contingent on these developments.

37 For more discussion on the supporting role that the Bank of England is playing in this crisis, see: J Smith & T Yates, Helicopters on standby?: With rates at all-time lows, the Bank of England needs a different playbook for this crisis, Resolution Foundation, March 2020.

38 For recent evidence, see: C D Romer & D H Romer, 'Fiscal Space and the Aftermath of Financial Crises: How It Matters and Why', NBER Working Papers No. 25768, 2019.

The stance of fiscal policy should be adjusted in a way that is analogous to monetary policy

With monetary policy constrained, fiscal policy has to function as the primary tool of macroeconomic stabilisation. This point is widely understood in theory, but the practical implications are rarely fully appreciated.[39] In practice, this means that the objectives of fiscal policy should be the same as those of monetary policy: having inflation at its 2 per cent target for the Consumer Prices Index (CPI) inflation in the medium term and having GDP at its sustainable level (i.e. the output gap is closed). In the current climate this would mean delivering a rapid recovery over the next two years or so.[40] The appropriate fiscal strategy is therefore easy to define in theory: fiscal consolidation should only start when the output gap has closed, which should be consistent with inflation being at target in the medium term.

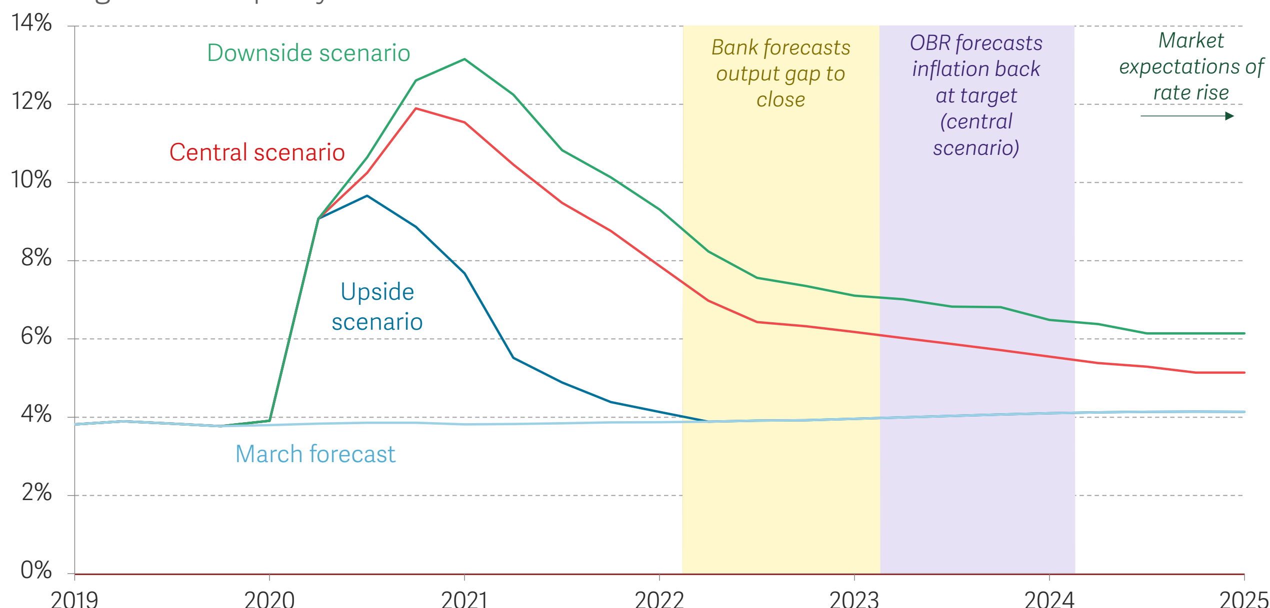
We can use the OBR's central scenario to assess what such an approach means for the timing of any tightening in fiscal policy. In particular, the OBR currently expects inflation to be back at target in 2023-24 with the output gap closed at the end of their forecast horizon (2024-25). This would suggest that consolidation should start in 2023-24.[41] As Figure 18 shows, unemployment would still be elevated at this point, with the central scenario suggesting the unemployment rate would be around 6 per cent.[42] The fact that unemployment is elevated while inflation is back at target reflects the scarring effects of the crisis on potential economic output.

It is also useful to consider other forecaster's expectations. The Bank of England is currently more optimistic than the OBR and forecasts the output gap to be closed by 2022 Q4 and inflation to be back at target before the end of 2021. Other central banks are less bullish on the pace of recovery – both the European Central Bank and the Federal Reserve expect inflation to rise more slowly in the euro area and US respectively, despite smaller average GDP losses in those economies.[43]. Similarly, market expectations for interest rates suggest that monetary policy will not tighten until 2025 at the earliest, suggesting that market expectations are for a more persistent output gap than official forecasts. This is important because the Bank of England would tend to start tightening policy in advance of the output gap closing, suggesting that a rise in interest rates is a necessary precursor to the output gap being closed.

39 One exception is the proposed unified monetary and fiscal policy rule – broadly analogous to a Taylor rule – set out in W Carlin & D Soskic, 'Macroeconomics: Institutions, Instability, and the Financial System', Oxford University Press, 2015.
40 The recovery will be dependent on the development of the health crisis. As stated, current expectations suggest an effective vaccine will be rolled out in the first half of 2021 allowing for a rapid recovery in subsequent months.
41 The OBR has not published a full updated forecast for the output gap since March 2020.
42 The Australian Government has set out its approach to fiscal consolidation in their 2020-21 Budget. This states that "once the unemployment rate is comfortably below 6 per cent and on a path toward previous levels, the focus will shift towards stabilising and then reducing debt as a share of GDP, while still allowing for flexibility in response to changing economic conditions." This is broadly consistent with the approach outlined here.
43 See: ECB, ECB staff macroeconomic projections for the euro area, September 2020, September 2020 and Federal Reserve, Chair's FOMC Press Conference Projections Materials, June 10, 2020, June 2020.

FIGURE 18: **The OBR expects inflation to reach target in 2023-24**

OBR forecasts of unemployment and implications for when it might be appropriate to tighten fiscal policy



SOURCE: RF analysis of OBR; Bank of England.

There are, of course, risks that starting consolidation in 2023-24 could end up being too late or too early. For example, if the recovery is more rapid than expected, then starting to consolidate at the point the output gap is estimated to have closed could lead to an inflation overshoot. This is because there is a lag between implementing policy and the effect on the economy, and there are practical issues with changing fiscal policy quickly outside of the standard Budget process.[44] Conversely, there is a risk that fiscal policy could tighten too soon. Estimates of the output gap are imperfect and often revised, and inflation can easily temporarily rise above target without being driven by a positive output gap (for example, as a result of an exchange rate deprecation). Crucially, these risks are not symmetric: the cost of tightening fiscal policy during a weak recovery is much more harmful than an inflation overshoot.[45] This suggests a cautious approach of waiting until there is clear evidence that the output gap has closed; in practice, this should be interpreted as basing fiscal consolidation decisions on the OBR's contemporaneous output gap estimate – rather than their forecast output gap – being at zero.

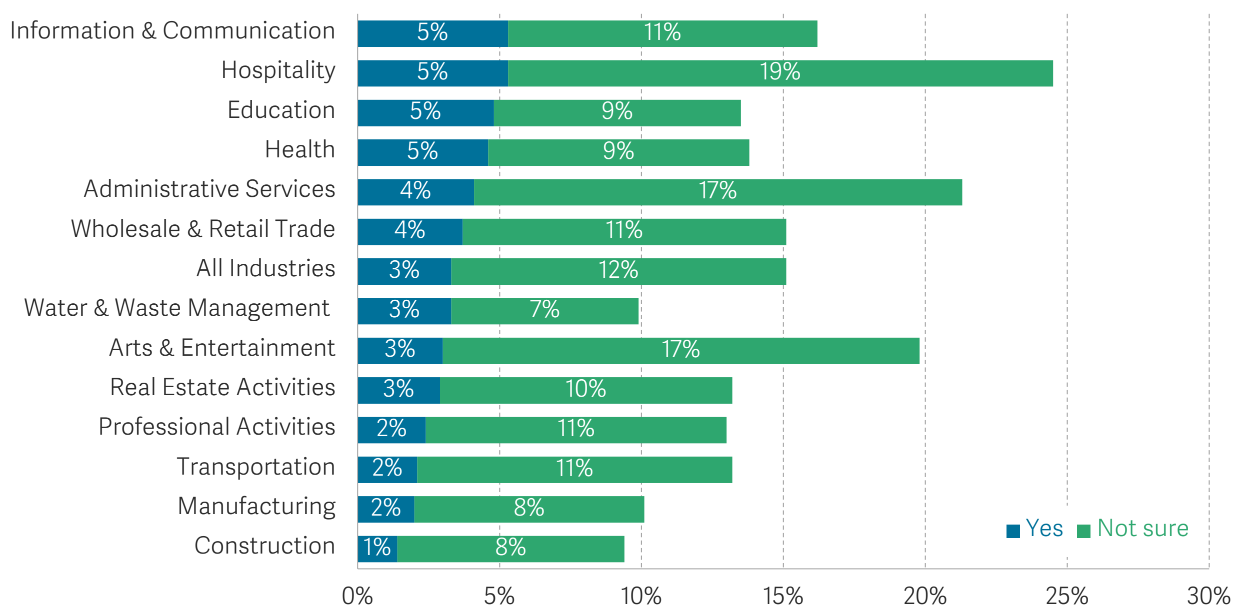
44 For a discussion of this in the UK context, see: S Burgess, E Fernandez-Corugedo, C Groth, R Harrison, F Monti, K Theodoridis & M Waldron, 'The Bank of England's forecasting platform: COMPASS, MAPS, EASE and the suite of models', Bank of England Working Paper No. 471, 2013.

45 Indeed, some argue that an inflation overshoot would itself be beneficial. This is now the Federal Reserve approach and is under consideration by the ECB. For a discussion of the conceptual case for this, see: C Evans, J Fisher, F Gourio & S Krane, 'Risk Management for Monetary Policy Near the Zero Lower Bound', Brookings Papers on Economic Activity, vol. 46(1 (Spring), pages 141-219, 2015.

Furthermore, estimates of the output gap are harder to produce now than in normal times. An important feature of the current crisis is that efforts to control the spread of the virus have reduced economic demand and simultaneously created matching temporary supply restrictions. Identifying the difference between what is a temporary supply shock – for example, the temporary closure of an arts venue – and a permanent component – for example, the permanent closure of a business that would not have closed had there been no pandemic– is difficult. Government support measures are not sufficient to replace all the losses businesses are facing, and this means more of the temporary supply constraints will become permanent as the crisis persists, as indicated by Figure 19.

FIGURE 19: **Businesses are expecting to reduce capacity in the coming months**

Proportion of businesses reporting intentions to permanently close any business sites in the coming three months, by sector: UK, 7 to 20 September 2020



SOURCE: ONS, Business Impact of COVID-19 Survey.

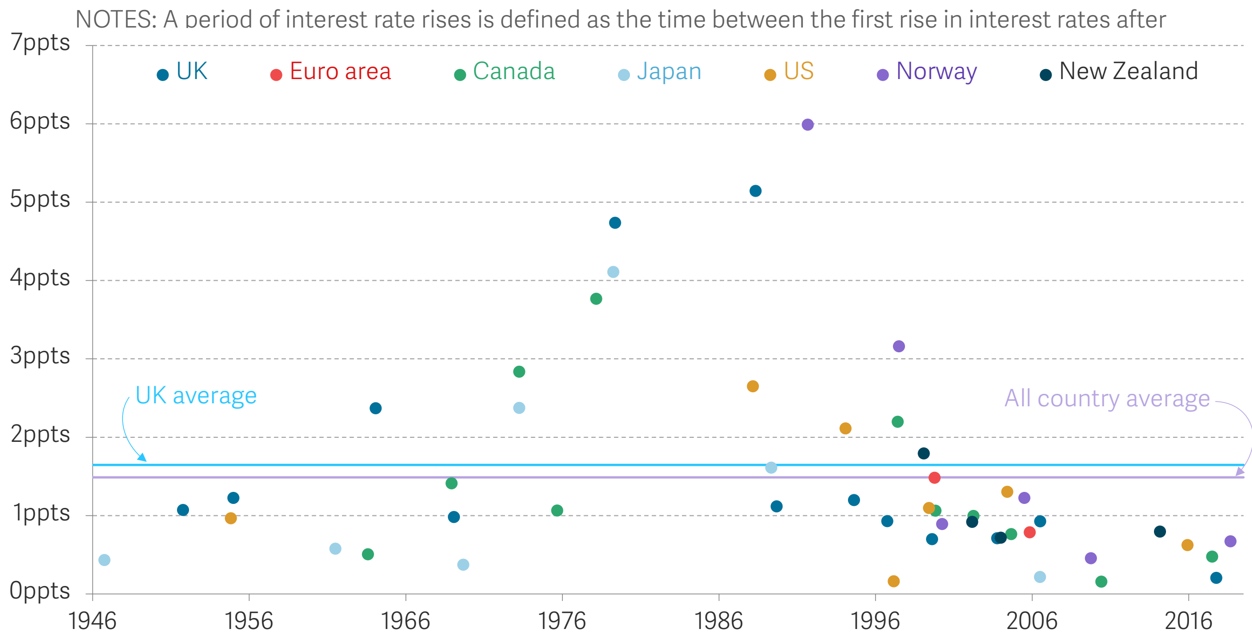
The pace of fiscal consolidation, once started, should be cautious

The point at which consolidation can start is only one part of the timing consideration; the speed at which the government increases taxes or reduces spending is also vitally important. It is generally understood that constrained monetary policy necessitates a bigger fiscal stimulus but it also means that the fiscal stimulus needs to be withdrawn more slowly. Extending our approach above leads us to conclude that a sensible rule would be to consolidate at a pace consistent with maintaining macroeconomic stability – inflation at target and unemployment falling back towards pre-crisis levels. We can think about this as the speed at which monetary policy would have tightened had fiscal policy

remained fully accommodative.

FIGURE 20: **Rate-rising cycles have slowed**

Average annual pace of increases in official central bank policy rates for individual periods of rising interest rates, by date of the first increase in interest rates



NOTES: A period of interest rate rises is defined as the time between the first rise in interest rates after an interest rate cut until the next rate cut. The total increase in rates over each period is divided by the number of years (calculated using daily data) between the first rise in interest rates and the first cut in rates. Periods lasting less than 1 year are excluded.
SOURCE: RF analysis of Bank of England, ECB, Federal Reserve Board, BIS.

The speed at which monetary policy has been able to tighten following previous recessions has varied widely, both in the UK and internationally. In the UK, there have been two periods of post-recession steady increases in nominal interest rates: 1975-79 and 1994-1998. In these two cases, interest rates rose by an average of 1.2 percentage points per year. Taking these as a benchmark, then, we can translate these rate rises into an amount of fiscal consolidation that can be achieved without harming the macroeconomy. Our benchmark estimate is that the fiscal stance could tighten by

around £20 billion per year without causing the output gap to reopen.[46] This suggests that it might be possible to achieve the level of consolidation that Section 2 suggested was necessary over the course of two years.[47]

But the recovery may be slower than historic examples. Figure 20 shows the average pace-per-year that interest rates have risen during rate-rising cycles across some major advanced economies. One striking conclusion from this chart is that the pace of monetary policy tightening has varied widely over time. Interest rates have, on average, increased more slowly during rate rising cycles in recent years suggesting that the consolidation may also need to be slower in order to prevent unemployment rising or inflation falling below target.

Monetary policy needs to account for the path of fiscal consolidation

The interaction of monetary and fiscal policy will be a major challenge for macroeconomic policy makers during the recovery.[48] The Bank of England's remit requires monetary policy tightening to be enacted if the Monetary Policy Committee thinks inflation will rise above target; therefore, without a clear path for fiscal consolidation set out by the Government, the Bank will react to a closing output gap and raise interest rates.[49] Monetary policy tightening would then limit the pace of fiscal consolidation that would be possible without harming the economy. Therefore, the Government should set out its fiscal plans upfront to ensure that the Bank can take this into account when setting monetary policy.[50]

Policy recommendation: The Government should set out its medium-term fiscal framework as early as possible. It should include: (i) a commitment to maintaining economic support for the crisis and recovery, (ii) a plan to consolidate finances so as to achieve long-term fiscal sustainability, (iii) the consolidation should start when the OBR estimates the contemporaneous output gap has closed, and (iv) the speed at which consolidation should happen should be in line with keeping the output gap closed and

46 The path of interest rate increases in these two periods was not independent from changes in fiscal policy. During 1974-79, simple measures of the fiscal stance suggest that fiscal policy was not particularly variable: public sector net borrowing fell from 5.7 per cent of GDP in 1974-75 to 4.5 per cent in 1979-80 (averaging 5.1 per cent over the full period). Suggesting that the change in interest rates in this period is a good estimate of the total pace of macroeconomic policy tightening (i.e. including fiscal and monetary policy). But, there was significant fiscal consolidation between 1994 and 1998: public sector net borrowing fell from 5.3 per cent of GDP to a 0.1 per cent surplus, and the cyclically adjusted current budget deficit fell from 3.8 per cent to 0.7 per cent. This means that we might be underestimating the pace of possible consolidation because the changes in interest rates during the 1994-98 period only partially capture the underlying speed of recovery in the economy.

47 The central estimate of necessary fiscal consolidation is around £40 billion in 2024-25. If the recovery is slower and consolidation starts at a later date, the total amount of consolidation would likely be larger.

48 For a fuller discussion of monetary and fiscal policy coordination, see J Smith, J Leslie, C Pacitti, & F Rahman, Recession ready? Assessing the UK's macroeconomic framework, Resolution Foundation, September 2019.

49 For more discussion of the Bank of England's remit see: J Smith, J Leslie, C Pacitti, & F Rahman, Recession ready? Assessing the UK's macroeconomic framework, Resolution Foundation, September 2019.

50 An additional challenge here though is where the Bank of England's assessment of the economy diverges from the Government's, and in practise the OBR's, view: specifically, under our proposal, if the OBR thinks there is a persistent output gap but the Bank believes the output gap has closed, then policy coordination becomes more difficult. Were this to become an issue, the Government should also take into account the Bank's view, particularly were it to consider starting to raise interest rates.

inflation at target.

The final plank of the Government's approach to fiscal consolidation should be a transition to a set of fiscal rules which can guide fiscal policy after both the recovery and the initial period of consolidation. Resolution Foundation analysis from 2019 provided the foundation for a set of fiscal rules which could ensure long-term fiscal sustainability while facilitating the key economic reforms the Government intends to pursue, such as the levelling-up agenda.[51] This crisis has not changed the analysis which underlay the proposed fiscal rules, and so those proposals remain a well-founded sensible approach for this and future governments to take.

Policy recommendation: The Government should set out the fiscal rules which will inform policy making after the economy recovers from the crisis. These should be:

- **A Net Worth Objective: to deliver an improvement in public sector net worth as a share of GDP over five years. This would incentivise prudent investment decisions to address the long-term challenges facing the UK.**
- **A Structural Current Balance Target: to achieve a cyclically-adjusted public sector current balance of 1 per cent of GDP (and no less than -1 per cent) over five years. This requires the government to keep receipts and day-to-day spending in broad balance but would also allow it the to borrow to invest;**
- **A Debt Interest Ceiling: to ensure the proportion of revenue spent on debt interest does not exceed 10 per cent. This would ensure that the overall debt burden remains sustainable at all times by taking account of not only the level of debt but also what it costs to service; and,**
- **An 'escape clause': to recognise the need for more active fiscal policy given the constraints on monetary policy, the net worth and structural current balance targets would be suspended if the economic outlook deteriorates significantly.**

Maintaining macroeconomic stability is now a primary responsibility of fiscal policy. This means re-evaluating how fiscal policy should be conducted – stimulus needs to be larger and consolidation slower. But it isn't just about the size or pace or fiscal stimulus and consolidation; the nature of fiscal measures (the mix of tax and spending measures) – plays a vital role in the impact of fiscal decisions on households and businesses and the distributional effects are no less important. The following sections set out our analysis of how fiscal consolidation should be done to minimise any welfare costs and provides concrete policy proposals for government taxes and spending.

51 R Hughes, J Leslie, C Pacitti & J Smith, Totally (net) worth it: The next generation of UK fiscal rules, Resolution Foundation, October 2019.

Section 4

How to consolidate

Even if a fiscal consolidation is well designed in its size and timing, there is still an important question about whether to focus on tax or spending measures in order to achieve the desired tightening. This matters because a poorly designed approach can slow the recovery and adversely affect living standards.

Our view is that this consolidation should be principally made up of tax rises. This is for two key reasons. First, there is a consensus that spending cuts have a larger impact on the economy. This may not have mattered historically when the impact of fiscal tightening could be offset by an easing of monetary policy. But the very real constraints on the pace of consolidation from lack of monetary policy space requires consolidation design to pay careful attention to minimising its impact on GDP. Second, the path of previous spending cuts over the past decade makes it much less likely that achieving a further large-scale tightening mainly through spending costs is feasible. Such an approach would be unprecedented historically, and would lead to further worrying declines in the quality of public services.

The choice between consolidating through spending less or taxing more should depend on the impact on the recovery

The approach to the consolidation must reflect the lessons of the past decade. As discussed in Section 3, the low interest rate environment means that the pace of consolidation is limited by the constraints facing monetary policy makers. In this environment, successfully repairing the damage to the public finances means choosing a broad strategy that minimises the impact on the recovery. Whereas the approach to past consolidations has been dictated by debates about the size of the state, taking such an approach in the coming years runs the risk of weakening the economy by more than can be accommodated by the Bank of England. If that was the case, it would make the consolidation much more prolonged and, ultimately, difficult to achieve.

So in this section we focus on the question of whether consolidating mainly through spending cuts or tax rises is likely to do more damage to the recovery. As Box 2 suggests, other methods of reducing deficits are possible, but they have significant downsides and we do not consider them further. Instead, the key consideration is the impact on the economy. Prioritising growth is important not just to minimise the short- and longer-term impact on living standards, but also to bring down the debt-to-GDP ratio more rapidly (as discussed in Section 2, a large majority of the falls in debt-to-GDP have been achieved through relatively rapid growth). To inform the choice of whether we should concentrate on tax or spending measures when building more resilient public finances, we discuss below the likely economic impact of each strategy. We start with a brief review of what previous research has to say about the impact of each, before looking at some of the factors that are likely to affect their impact.

BOX 2: **Approaches to reducing debt**

Higher taxes and lower spending are the most obvious ways to bring down debt, but there are – at least in principle – other ways this can be achieved. These include: defaulting on the debt; acting to reduce interest payments (so-called 'financial repression'); or forcing the central bank to engineer a surprise increase in inflation (often referred to as 'fiscal dominance').

In practice, however, these other approaches are counterproductive because they lead to sharp and lasting increases in the cost of borrowing. In the case of attempting to inflate away the debt, the high share of inflation-protected (or index-linked) gilts in the overall stock means that such a strategy would have little benefit for the UK.[52] Another radical option – permanent money-financed government spending – should also be avoided for similar reasons.

There is a consensus that the near-term impact of tax changes on the economy is smaller than that for spending

In looking at what economic research has to say about how to consolidate, we focus on the near-term economic impact. As discussed in Section 3, this is important because of the limits on the pace of the consolidation stemming from the constraints on monetary

52 Based on the OBR's 'ready reckoners' for the impact of higher inflation on the cost of servicing index linked gilts, a 1 percentage point increase inflation for a year will cost around £6.4 billion. This will, however, be an underestimate for the size of this cost because the amount of index-linked gilts in circulation has increased since this multiplier was published.

policy. In the low interest rate environment we currently face, consolidation should avoid posing a bigger drag on growth than monetary tightening would have provided absent the fiscal consolidation. In the aftermath of past recessions such a consideration was less important because monetary policy makers had more room to offset the economic impact of fiscal tightening. As a result, policy makers need to think not just about the size of the consolidation, but also its design, because it is the combination of the two that determines the impact on GDP. So this section focuses on the short-term impacts of consolidation measures, without delving into wider questions about the impact of tax or spending policies over the longer-term.

Coming to an answer on whether taxes or spending have a smaller economic impact is clouded by the difficulties in measuring the impact of fiscal policy. Simply looking at the correlation between changes in fiscal policy and overall GDP is not likely to be informative. This is because policy change is both a cause of GDP changes, but also a response to them. Indeed, fiscal policy tends to be loosened in recessions and tightened when the economy is strong. Simply looking at the co-movement between GDP and fiscal policy would tend to imply a negative relationship. So, in order to estimate the extent to which looser fiscal policy boosts the economy, researchers need to find ways to control for the state of the economy.

In assessing the impact of changes in fiscal policy, economists typically focus on the impact on GDP of changing different types of fiscal instruments by 1 per cent of GDP – so called 'fiscal multipliers'. In Figure 21, we show a range of estimates for the size of fiscal multipliers. They include OBR estimates for different types of tax and spending multiplier, which vary between 1 per cent in the case of cuts to capital spending, and 0.3 per cent for income tax and NICs changes.[53] It also shows a range of estimates from the Congressional Budget Office – the US equivalent of the OBR.[54] An obvious point here is that there is a wide range of estimates for the size of fiscal multipliers.

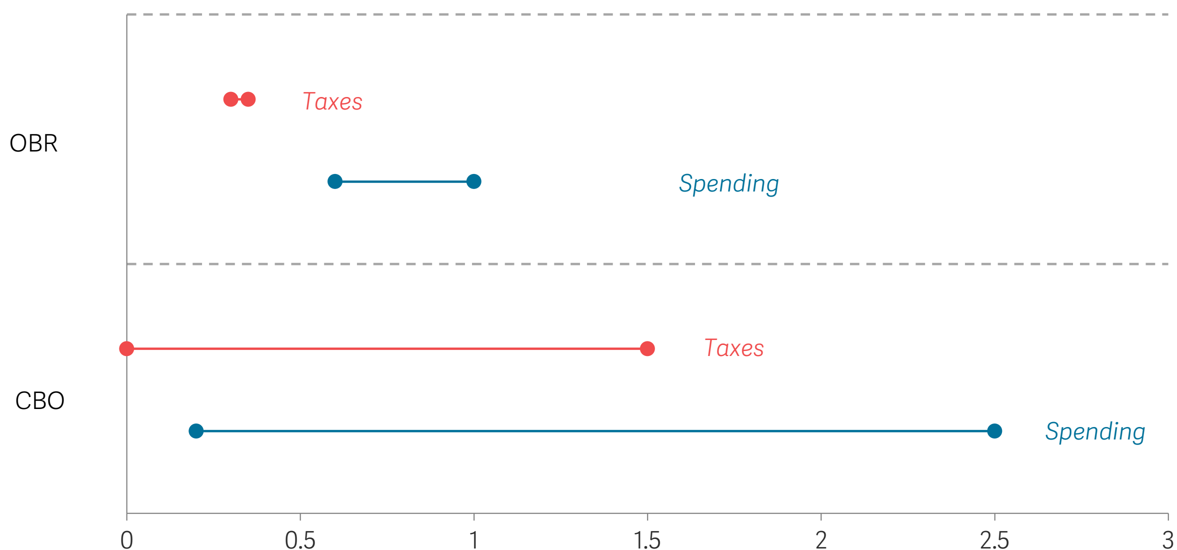
Rather than take a stand on the precise level of any particular fiscal multipliers, we focus on the narrower question of whether tax or spending measures are likely to pose a greater drag on the recovery.[55] If one of these strategies tends to have a smaller impact on the economy, then it is likely to be better suited to repairing the damage to the public finances caused by the coronavirus crisis in an era of low interest rates. Here, despite the significant uncertainty over the point estimates of multipliers, there is a consensus that spending multipliers tend to be larger, suggesting that consolidation through higher taxes may be less damaging to the recovery, at least in the short term. Here, the CBO

53 See: Fiscal policy and growth, Box 2.2, Forecast evaluation report, OBR, October 2017.
54 C J Whalen & F Reichling, 'The Fiscal Multiplier and Economic Policy Analysis In The United States', Congressional Budget Office Working Paper 2015-02, 2015.
55 To simplify the argument in this section we have largely abstracted from different categories of spending. In almost all cases the spending multipliers refer to current government spending; on the tax side, most estimates focus on changes to income taxes.

estimates in Figure 21 are reasonably representative: while the range is wide for both taxes and spending, tax multipliers tend to be smaller.[56] A similar pattern is evident for the OBR's estimates. Indeed, the fact that OBR and CBO estimates both have tax multipliers smaller than spending multipliers points to something of a consensus that spending multipliers are generally greater in size than those for tax. That said, there are a wide range of views among economists about the impact of tax and spending measures on the economy.[57] This, again, highlights the need for a flexible approach to the consolidation, adjusting the approach as necessary in light of incoming data about the strength of the economy.

FIGURE 21: **Studies produce a range of different estimates for fiscal multipliers**

Range of estimated fiscal multipliers for discretionary changes in taxes and spending



NOTES: A spending or tax multiplier is defined here as the percentage impact on GDP of an increase in spending (or cut in taxes) worth 1 per cent of GDP; for the CBO estimates the chart shows a range of values found for either taxes or spending, for the OBR the range shows the variation in multipliers for different types of tax and spending policy.
SOURCE: 'Fiscal policy and growth', Box 2.2, Forecast evaluation report, OBR, October 2017; C J Whalen & F Reichling, 'The Fiscal Multiplier And Economic Policy Analysis In The United States', Congressional Budget Office Working Paper 2015-02, 2015.

56 C J Whalen & F Reichling, 'The Fiscal Multiplier and Economic Policy Analysis In The United States', Congressional Budget Office Working Paper 2015-02, 2015.

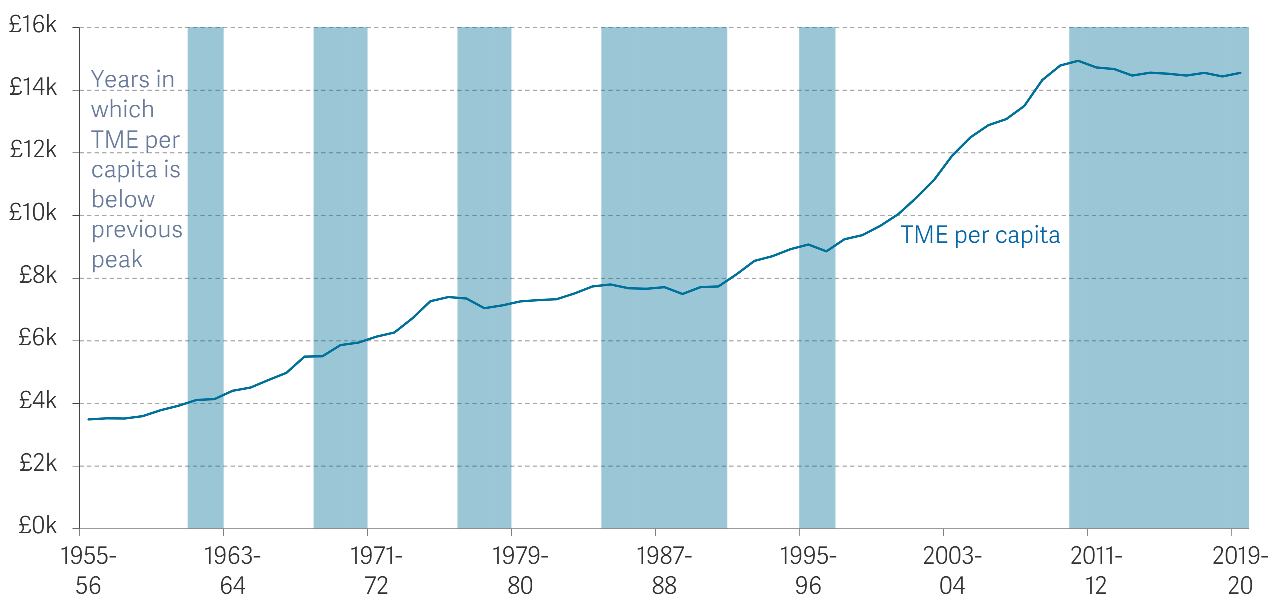
57 For example, A Alesina, C Favero & F Giavazzi, Austerity: when it works and when it doesn't, Princeton University Press, 2019, present evidence that, in some settings, the impact of changes to taxes can have a larger impact on the economy than spending cuts. Such arguments support the idea that designing fiscal consolidation measures to minimise the economic impact is crucial. More generally, average rates of taxation across economies are found to be uncorrelated with growth performance, see, for example: N Jaimovich & S Rebelo, 'Nonlinear Effects of Taxation on Growth', Journal of Political Economy, vol. 125(1), pages 265-291, 2017.

Continued spending cuts would be historically unprecedented

Looking beyond the size of fiscal multipliers, it is important to remember the UK's own recent fiscal history, and in particular the deep cuts to public spending implemented over the past decade. In the run up to the coronavirus crisis, the UK had already experienced an unprecedented decade in which per capita government spending fell in real terms (Figure 22). This raises the question whether a consolidation driven by spending cuts could be achieved; it would certainly be totally without parallel in modern UK economic policy.

FIGURE 22: **The UK has experienced a historically unprecedented decade of cuts to spending**

Total managed expenditure per capita: UK, 2018-19 terms (GDP-deflator)

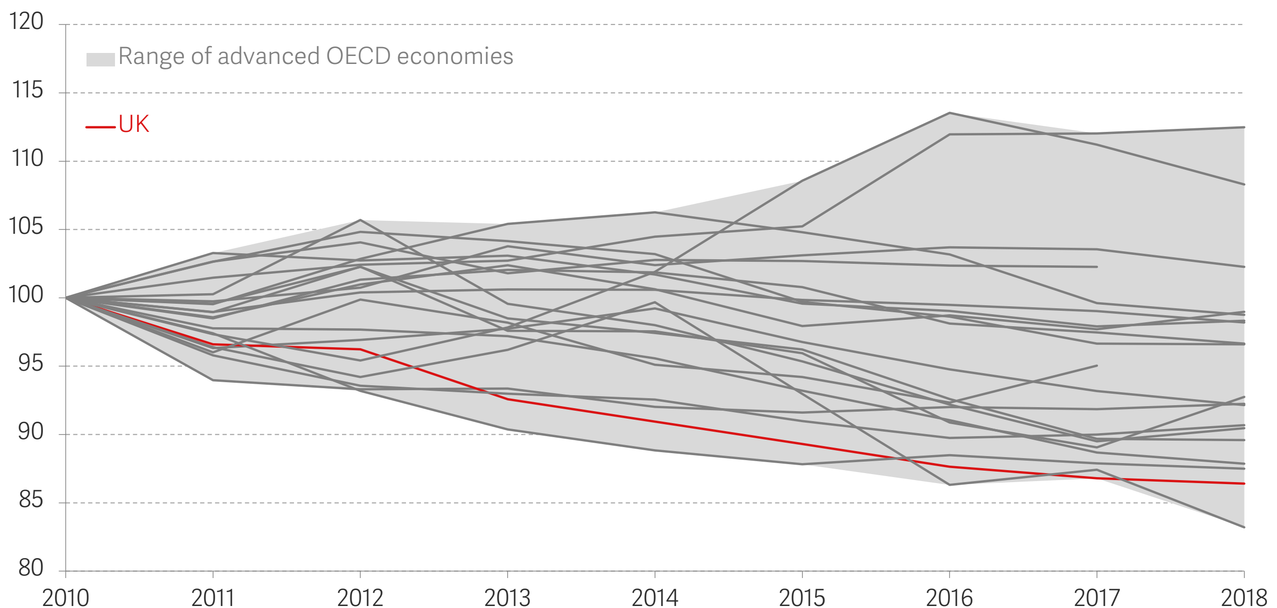


SOURCE: RF analysis of OBR, Public Finances Databank.

Moreover, any further spending restraint would come on the back of spending cuts that have been very large even by the standards of the huge falls in spending seen in a number of countries. Figure 23 below shows how spending has evolved across OECD advanced economies since 2010. Over this period there have been large spending cuts across a number of countries, reflecting attempts to reduce deficits in the aftermath of the financial crisis. But, over this period, the only country that has experienced larger spending cuts on the basis of comparable OECD data is Portugal. Again, this illustrates the importance of taking the exceptionally weak recent path of spending into account when choosing an approach to future consolidation.

FIGURE 23: **UK spending cuts have been among the largest in advanced OECD economies since 2010**

Index of general government spending as a proportion of GDP (2010 = 100)



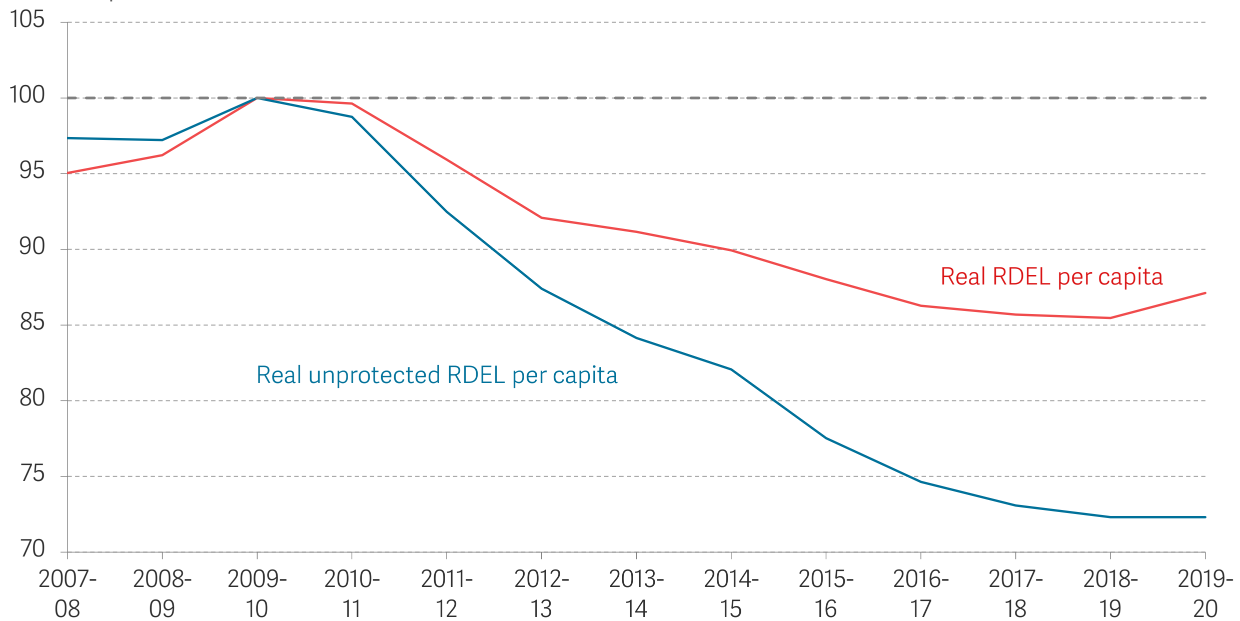
SOURCE: RF Analysis of OECD.

Spending cuts over the past decade have led to significant falls in the quality of public services

Cuts in the budgets of some government departments have been extremely large over the past decade. Removing those departments with protected expenditure limits – that is, Defence, International Development and Health and Social Care – from total expenditure – as done in Figure 24 – illustrates the size of cuts to the budgets of unprotected departments. Indeed, the budget of the Department of Health and Social Care (DHSC) in particular now accounts for almost £4 in every £10 of spending by government departments (or RDEL), up from £3 in every £10 in 2007-08. In 2019-20, real spending per capita was 72 per cent of its 2009-10 level excluding health spending.

FIGURE 24: **There have been massive cuts in departmental spending, particularly outside healthcare**

Indices of real (GDP-deflator adjusted) per-capita departmental spending (resource departmental expenditure limits, 2009-10=100), all departments and 'protected' departments

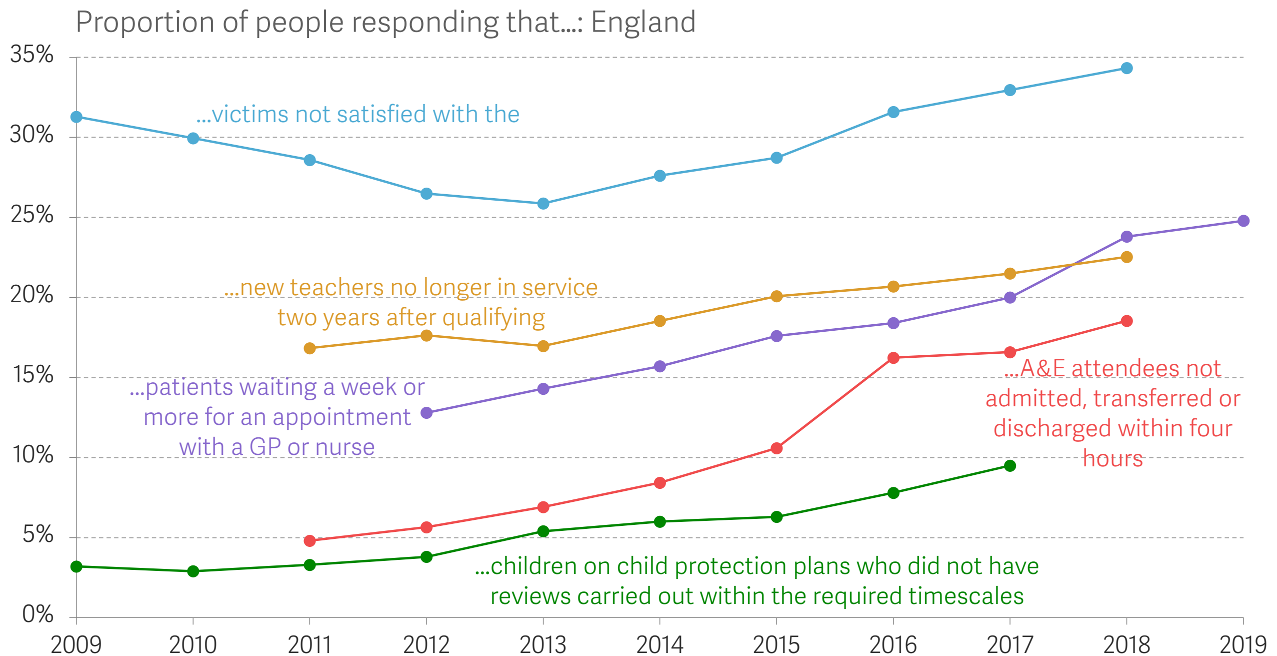


NOTES: Resource departmental expenditure limit totals adjusted for public service pension adjustment (see OBR, Economic and Fiscal Outlook, October 2018); protected departments are Defence, International Development and Health and Social Care.
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2020.

These cuts in spending have been associated with falls in the quality of many government services. As shown in Figure 25, a range of indicators suggests that many public services have deteriorated in recent years. For example, the proportion of crime victims declaring themselves dissatisfied with the police increased from 26 per cent in 2013-14 to 34 per cent in 2018-19. Likewise, the proportion of new teachers leaving the profession within two years of qualifying increased from 17 per cent in 2011 to 23 per cent in 2018. And, despite protection for health spending, the proportion of patients waiting a week or more for a GP or general practice nurse appointment increased from 13 per cent in 2012 to 25 per cent in 2019. The Ministry of Justice has been particularly badly affected with a number of very worrying developments in the health and safety of prisoners: the number of deaths, self-harm incidents and assaults in prisons has increased, particularly over the past five years.

FIGURE 25: **There has been a marked deterioration in the quality of public services**

Proportion of people responding that...: England



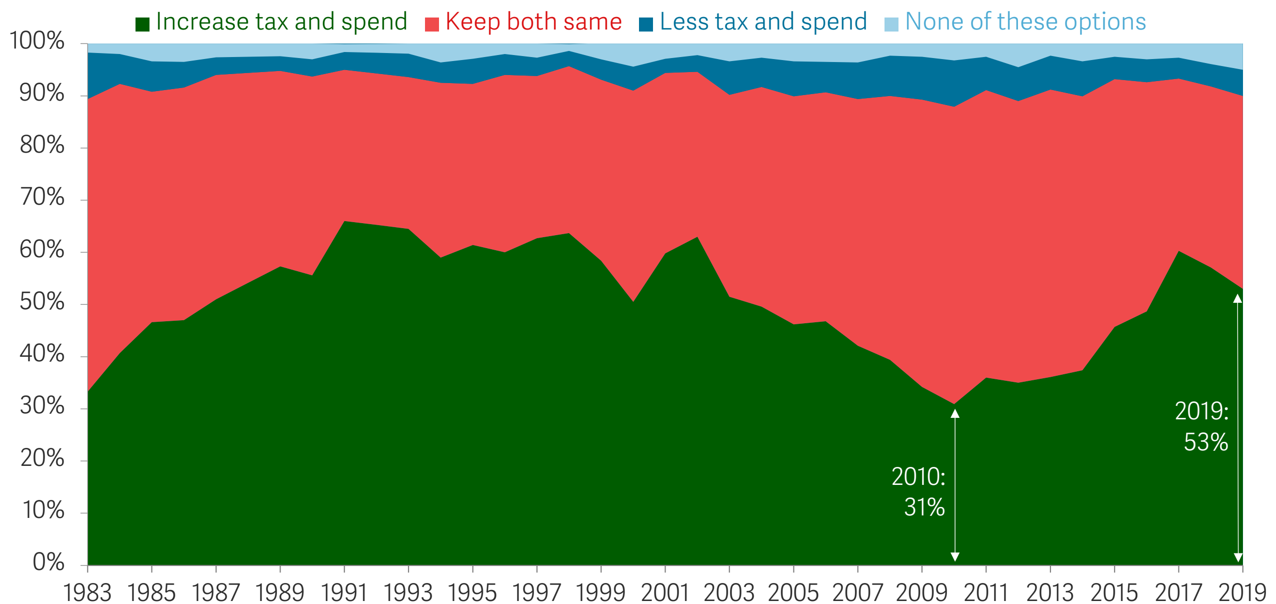
NOTES: Data on victims not satisfied with the police covers England and Wales. Victims not satisfied with the police and child protection figures are for financial years. A&E figures are 12-month averages for Type 1 attendances.
SOURCE: Institute for Government, Performance Tracker.

Public support for further spending cuts is low, making it difficult to see how such a strategy could be politically feasible

All this has contributed to a drop in public support for spending cuts. A key source of data on such sentiment is the British Social Attitudes Survey, which provides a long time series of public sentiment towards tax and spending policies. The striking result from that survey is that, although support for increases in spending (paid for by taxation) has fallen back slightly over the past couple of years, it remains close to the 20-year high reached in 2017, with around 53 per cent of adults in 2019 favouring increasing taxes in order to pay for higher spending. Indeed, as shown in Figure 26, the level of support for 'tax and spend' has been significantly higher in recent years than in 2010, when just 30 per cent of adults were supportive of such an approach.

FIGURE 26: **Support for increases in spending and taxation is near record highs**

Proportion of adults in favour of various options in relation to tax and spend: GB



SOURCE: RF analysis of Centre for Comparative European Survey Data; NatCen, British Social Attitudes Survey.

Other polling evidence shows some support for tax rises. A survey conducted by Demos, which asked respondents to think about tax rises in 'normal times' after the current crisis, found that 47 per cent of people supported a small rise in income taxes, while this was opposed by only 25 per cent. Respondents were generally more positive about more progressive tax increases: for example, 58 per cent of people supported a larger rise in income taxes which would only affect those above incomes of £20,000, while only 17 per cent opposed the proposal.[58] Similar results were found in a survey conducted by Ipsos MORI for Tax Justice UK: 48 per cent of UK adults agreed that they were personally prepared to pay more taxes in order to fund public services, while 24 per cent disagreed.[59] Evidence from these types of surveys tend to find that support for increases in taxes is conditional on maintaining or improving public services, and ensuring that government spending is used efficiently. This supports the proposal in this paper that increases in taxes are tied closely to the purpose of funding health and social care services.

Taken together, then, our view is that achieving much of the required fiscal consolidation through increases in taxes, rather than cuts in spending, is the best approach. To be clear, that doesn't mean ruling out spending cuts altogether: indeed, some elements of spending will be lower than they otherwise would have been as a result of the economic hit from coronavirus (such as spending commitments that are fixed as a proportion of GDP, including the targets to keep defence spending at 2 per cent of GDP and foreign aid

58 See: B Glover & C Seaford, A People's Budget: How the public would raise taxes, Demos, September 2020.
59 See Tax Justice UK, Talking tax: How to win support for taxing wealth, Tax Justice UK, September 2020.

spending at 0.7 per cent). But our overall conclusion is that it would be difficult to achieve substantial falls in spending as a proportion of GDP. So below we discuss the design of an implementable tax package that delivers the required consolidation outlined in Section 2, to the timetable in Section 3, but which also minimises the economic impact.

Section 5

Delivering substantial tax rises

Previous sections have shown that post-recovery fiscal consolidation will be needed, and that tax rises should do most of the heavy lifting. The scale of consolidation required is uncertain, but our analysis suggests planning for around £40 billion – or 1.6 per cent of GDP. This is a lot, posing significant economic policy and political challenges. But it is not without precedent: in today's terms, the budgets of 1993 raised £48 billion; and the budgets of 1974 and 1975 together raised £47 billion. Such a consolidation would also take the tax-to-GDP ratio to over 39 per cent of GDP, its highest level since 1983-84. But taxes in the UK are relatively low by international standards: with the UK's tax take over 1 per cent of GDP below the (pre-coronavirus) OECD average, and over 10 per cent of GDP below some countries. And if we look at the tax burden for individuals, rather than the national accounts, we see that direct taxes on the typical employee have fallen dramatically over time, with effective tax rates falling from 30 per cent in 1975, to 25 per cent in 1990 and 18 per cent in 2019. Taken together, while such consolidation would be challenging – particularly politically – our view is that it looks far from impossible in a historical context.

A huge range of options for raising taxes exist. While technical considerations of optimal tax policy design are important, a successful consolidation must be rooted in a broader view of how it helps to build a better country. Large increases in tax will be impossible if they lack a compelling purpose that builds consensus. We therefore approach the choices between tax measures with three guiding principles. First, fair burden sharing. This means that political economy considerations – and particularly the distributional impact of the pandemic – must be at the heart of the proposed approach. Second, tax changes should support the recovery by reducing economic distortions, as well as being designed to minimise the impacts on GDP. And third, a tax-driven consolidation must be part of, rather than an alternative too, making progress on some of the big changes and challenges facing our country: ageing; the growing role of wealth; insecure work; and climate change.

Raising something in the order of £40 billion in tax revenue is very challenging; but it is possible

The conclusion of the previous sections is that significant tax rises will be needed in the coming years. There is very considerable uncertainty about just how much, but our starting point is a consolidation of around £40 billion in (net) tax rises. Below we discuss how to respond to that uncertainty. But first we look at what historical and international experience has to tell about how difficult such an increase in taxes would be to achieve. We provide three metrics to gauge this by.

1. A £40 billion increase in taxes would be large by historical standards but far from unprecedented

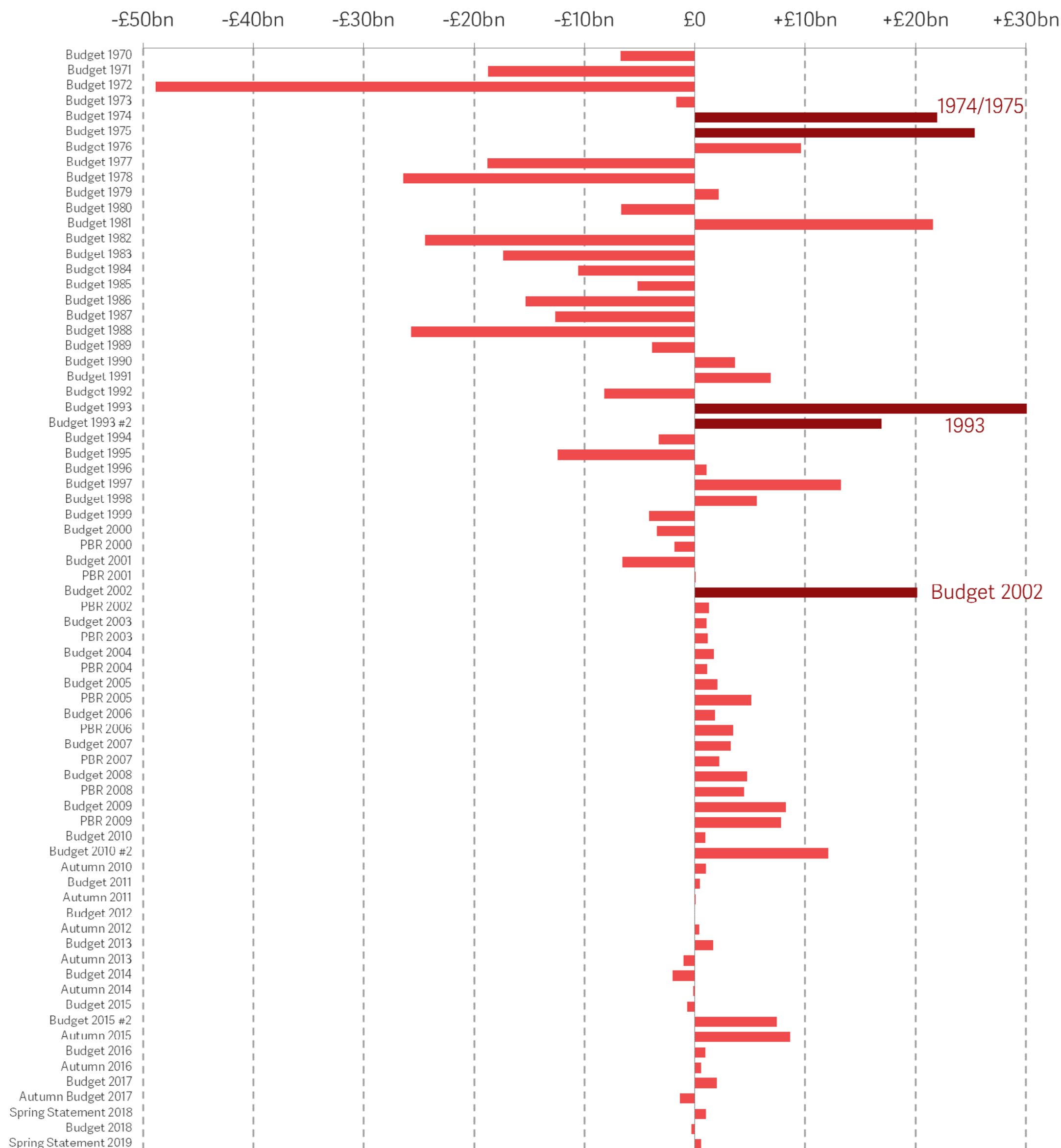
To begin, we can look for reassurance from previous decades. Figure 27 shows the net long-term impact of tax policy announcements at each fiscal event since 1970. To improve comparability with the £40 billion figure, these are in 2024-25 prices that account for inflation and economic growth.

The most any single fiscal event has attempted to raise was around £30 billion in the March 1993 Budget. Of course, a tax consolidation is generally not all announced in a single fiscal event or even year, so it makes sense to take some events together. In particular, the two Budgets of 1993 together raised £48 billion (if projected out to 2024-25), while the Budgets of 1974 and 1975 combined raised a similar £47 billion. More recently, the Budget of 2002 raised £20 billion a year to boost spending on the NHS, and the period from 2007 to 2010 announced a total of £45 billion in net tax rises.

History does not show that large tax rises are politically easy, though the political impacts of some of these historic tax packages has varied a lot. But it does show that governments are at least capable of announcing around £40 billion tax rises (over time).

FIGURE 27: **The Budgets of 1993 or of the mid-1970s (combined) raised the equivalent of over £40 billion, while the 2002 Budget raised the equivalent of £20 billion**

Net long-term tax policy announcements at each fiscal event, 2024-25 nominal GDP terms



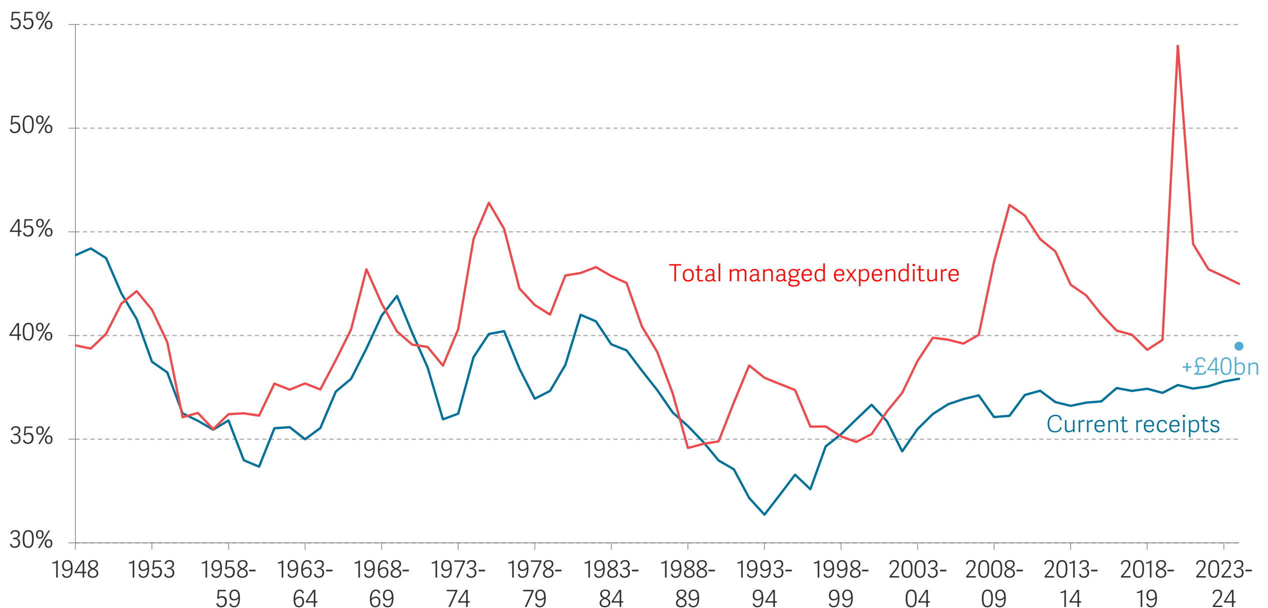
NOTES: Based on forecasts from the time (actual impacts on tax revenue may have differed).
SOURCE: RF analysis of OBR, Policy measures database.

2. A tax-led consolidation would mean the tax-to-GDP ratio rising to its highest level in nearly forty years, but it wouldn't be particularly high by earlier standards and needs to be interpreted carefully

Tax rises of 1.6 per cent of GDP would take the tax forecast to over 39 per cent of GDP, which would be the highest since 1983-84, but certainly not an unprecedented level in the UK.

FIGURE 28: **An extra £40 billion in revenue would take the forecast tax take to over 39 per cent of GDP, but this level would not be unprecedented in the UK**

Current receipts and total managed expenditure relative to GDP



NOTES: OBR forecasts.
SOURCE: RF analysis of OBR, Public finances databank and OBR, Fiscal Sustainability Report, June 2020.

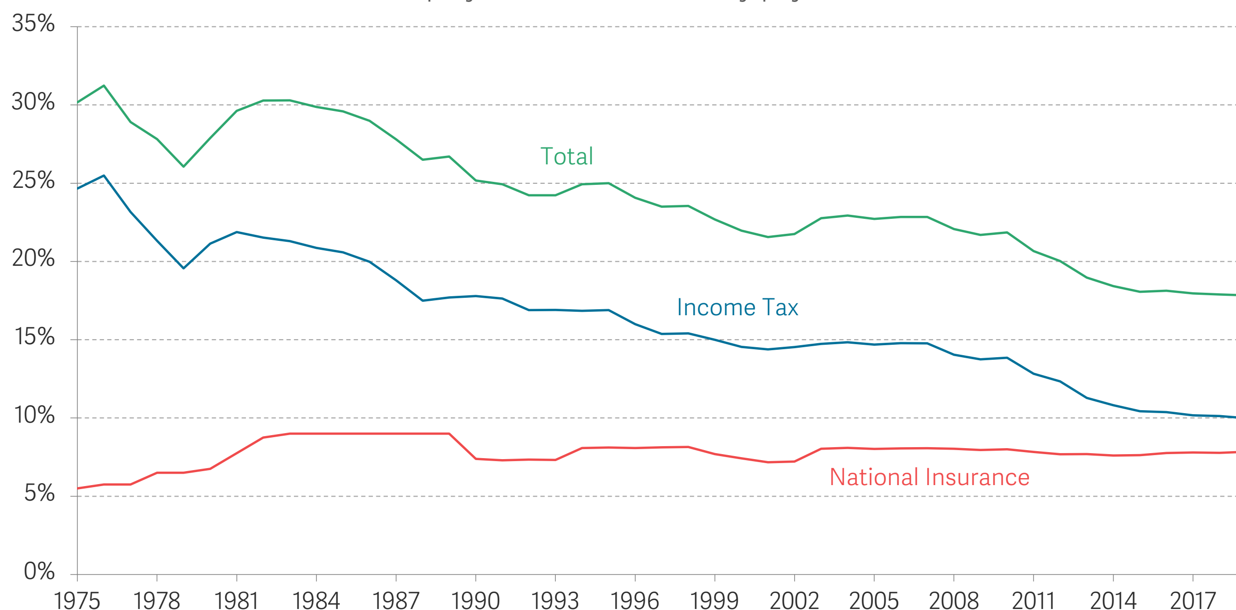
Given big shifts in the structure of the economy over long periods, we need to be careful in interpreting the tax-to-GDP ratio as a proxy for the tax burden on typical households. In part this is because different forms of economic activity and income are taxed to different degrees – with, for example, a rising labour share of income (highly taxed), and declining business investment (little taxed), both having boosted the tax take. Similarly, increases in earnings inequality have increased tax revenue as a higher share of income flows to more highly-taxed people, even while tax rates at most points in the income distribution have remained unchanged or actually fallen.[60]

If we look at direct taxes on the typical salary (in the form of Income Tax and National Insurance) we see that effective tax rates have fallen dramatically over time (Figure 29). The effective tax rate for the typical employee fell from 30 per cent in 1975, to 25 per cent in 1990 and 18 per cent in 2019. If taxes were as high as in 1990, the typical employee would therefore have paid over £1,800 a year more than they did in 2019.[61]

60 See: A Corlett, The shifting shape of UK tax, Resolution Foundation, November 2019.
61 See: A Corlett, The shifting shape of UK tax, Resolution Foundation, November 2019.

FIGURE 29: **Direct tax rates have never been lower for the typical employee**

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. Originally published in A Corlett, The shifting shape of UK tax, Resolution Foundation, November 2019.

3. A £40 billion tax-led consolidation would not leave the UK tax take particularly high by international standards

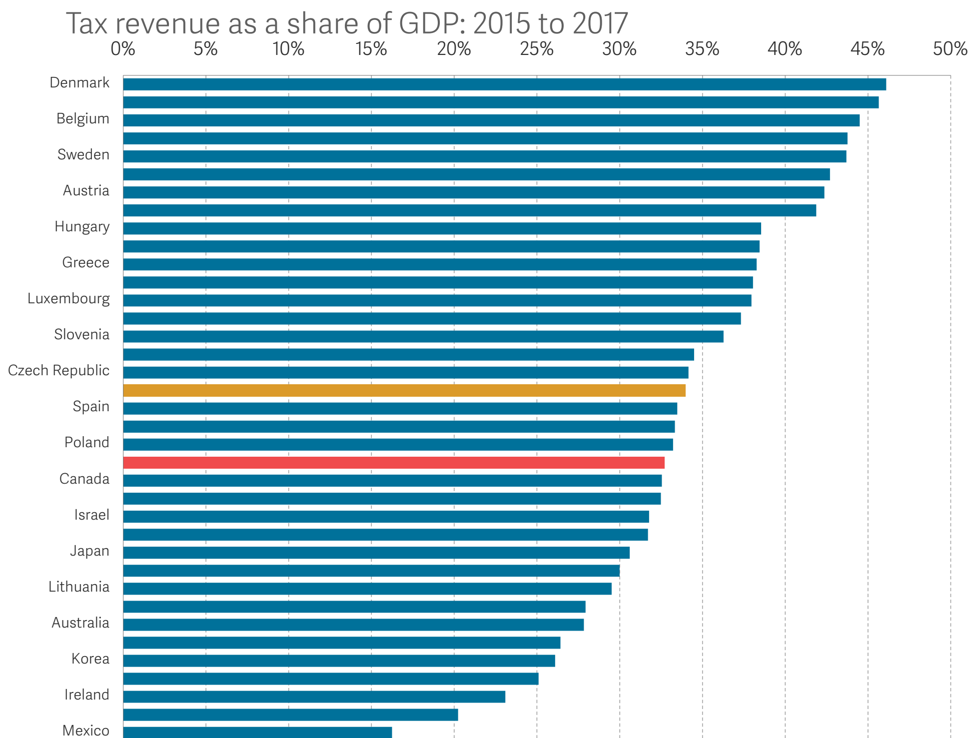
It is true that a tax take of over 39 per cent would be higher than the UK has been used to over the past four decades. But UK taxes are relatively low by international standards, with the UK's tax take over 1 per cent of GDP below the (pre-coronavirus) OECD average, and over 10 per cent of GDP below some countries.[62]

Overall, then, our view is that there are no obvious political or economic barriers that mean that taxes simply cannot be raised, if that is the what choices about fiscal targets and spending require. Moreover, the feasibility of raising taxes can of course be increased if the tax rises in question are chosen well. That is the issue we turn to next.

62 See: A Corlett, The shifting shape of UK tax, Resolution Foundation, November 2019.

FIGURE 30: **The UK's tax to GDP ratio is below the OECD average**

Tax revenue as a share of GDP: 2015 to 2017



NOTES: Three year average.
SOURCE: OECD.

A number of principles should guide the choice of tax rises

The rest of this report is dominated by the question of which tax measures to choose in order to best raise that tax revenue. With almost 40p in every £1 of economic activity taken in taxes, the design of those taxes matters a great deal for economic efficiency and incentives; administrative burdens; and levels of inequality.

A successful tax-led consolidation needs to recognise the breadth of these impacts. Technical considerations of optimal tax policy design are crucial, and we also recognise that political reality requires taking into account this Government's manifesto.[63] Although that manifesto preceded this crisis, and this report is certainly not at all bound by it, we imagine that the Government would no doubt rather stick to its specific manifesto promises if it can.

But a successful consolidation must be rooted in a broader view of how it helps to build a better country. A compelling purpose for change, that goes beyond the importance of sustainable public finances, will be essential if sufficient consensus is to be built.

Sections 6 to 10 will set out our thinking on individual tax options, but our broad approach might be described by the three guiding principles below.

63 The Conservative and Unionist Party Manifesto 2019.

1. Fair burden sharing in a post-pandemic world

All consolidations involve losses for some households. These can be difficult to perceive during spending-led consolidations – when the consolidation reduces the quality or quantity of public services – but they tend to be crystal clear when it comes to tax rises, when losses are directly financial. Public support therefore requires that fair burden sharing is visibly taking place. There are two particularly important aspects to this in the context of this specific consolidation.

First, there are aspects of fairness arising from the coronavirus crisis itself. It is not an exaggeration to note that, while some have lost their lives, jobs or businesses – or risked their health to continue working – others have worked comfortably from home, built up savings, and in some cases seen profits rise during the crisis. Here policy must be seen to ensure that those who have gained from the crisis contribute more. As we have discussed in previous work, the crisis has disproportionately affected low earners and the young.[64] For those groups to be asked to pay more in tax it will be important for those who have been less affected – or even benefited – to be demonstrably taking on more of the tax burden.

The second aspect of fairness concerns the ever-present broad principle that those with the broadest shoulders should take more of the burden. This is evidenced by the polling results in Section 4 above. The income distribution in the UK is very unequal, and 2018-19 (the latest year of data) was one of the most unequal on record.[65] The UK is also regionally unequal, while the state should play a role in ensuring that the luckiness or unluckiness of different generations is partly cushioned.[66]

But it is also *economically* crucial that changes to the tax system where possible protect those on lower incomes. This is because different groups will respond to different degrees if their taxes rise, as propensities to consume are higher for lower-income (and lower-wealth) households.[67]

2. Supporting the recovery by reducing rather than increasing economic distortions, and strengthening the weakest links in the tax system

The size of the economy is a key determinant of the fiscal outlook. More broadly, taxes can impact on well-being and economic efficiency by artificially distorting people's decision-making. So, although this report does not aim to reinvent or recite the literature on optimal taxation, we must consider the potential behavioural impacts of taxes.

64 M Brewer, N Cominetti, K Henehan, C McCurdy, R Sehmi & H Slaughter, Jobs, jobs, jobs: Evaluating the effects of the current economic crisis on the UK labour market, Resolution Foundation, October 2020.
65 M Brewer, A Corlett, K Handscomb, C McCurdy & D Tomlinson, The Living Standards Audit 2020, Resolution Foundation, July 2020.
66 A New Generational Contract: The final report of the Intergenerational Commission, May 2018.
67 K Drescher, P Fessler & Peter Lindnerc, Helicopter money in Europe: New evidence on the marginal propensity to consume across European households, July 2020.

In this context, some forms of taxation are generally preferable to others. The OECD notes that "recurrent taxes on immovable property [are] the least harmful tax", for example.[68] And taxes on externalities – particularly greenhouse gas emissions and other pollution – should be favoured, as altering behaviours is part of the point of these taxes.

In many areas, our proposals take some inspiration from the influential 'Mirrlees Review', which presented one possible coherent, efficiency-improving tax system for the UK.[69] For example, like that review, we tend to maintain "a presumption against all kinds of transactions taxes [such as stamp duties], input taxes, and turnover taxes", which "are in general grossly inefficient and have no place in a good tax system."

More proactively, a key goal with our proposals is to reduce distortions between similar forms of economic activity. Arbitrary differences in tax treatment provide opportunities for tax avoidance, and so strengthening the weakest links of the tax system in particular is a sensible approach to maximise revenue. These distortions also lead to inefficient or damaging economic choices, often for no good reason. They waste people's time on tax-minimisation exercises, and the government's time in trying to prevent the abuses that many tax breaks invite.

3. Supporting progress on broadly-accepted and fundamental challenges we face as a country

A successful tax-led consolidation will not just be about sustainable public finances, nor just a concern of the Treasury while the rest of government gets on with making progress on our other national priorities. Instead, if it is to secure lasting public support, it must be embedded within and supportive of broader attempts to make progress on the some of the big goals and challenges our country faces. This will guide not just which policies are pursued, but also which are rejected. Particularly salient changes and challenges for this consolidation include:[70]

1. An ageing population means more revenue will be needed over time just to provide existing standards of pensions and health care, and to address the national disgrace of our system of social care.

2. Wealth taxes have not kept pace with the secular changes in the importance of household wealth. Overall household wealth has increased from three times GDP in the 1980s to almost seven times today, but revenue from the UK's existing wealth-related taxes has barely increased as a share of GDP.[71]

68 OECD, Tax Policy Reform and Economic Growth, November 2010.
69 J Mirrlees et al., Tax by design, IFS, September 2011.
70 For a discussion of these challenges, see: A Corlett, The shifting shape of UK tax, Resolution Foundation, November 2019.
71 G Bangham & J Leslie, Rainy days: An audit of household wealth and the initial effects of the coronavirus crisis on saving and spending in Great Britain, Resolution Foundation, June 2020.

3. Our tax system currently builds in widespread incentives for people to adopt more insecure working patterns by reclassifying themselves as self-employed – or incorporating – to reduce their tax bill. As has been very clearly exposed during the pandemic, the under-taxation of self-employed labour through National Insurance, or of some income through companies, can result in both reduced tax revenue for the state and reduced labour market security for the individuals.[72]

4. Tackling climate change and air pollution. This will require the tax system to play a role in driving change, while also dealing with fiscal pressures from the loss of fossil fuel-related tax revenues.

In short, a successful consolidation improves the tax system and the country, at the same time as raising revenue

Raising £40 billion a year through tax policy changes is certainly not politically simple. But nor is it impossible, and subsequent sections show that it is feasible to simultaneously raise revenue, make the tax system fairer and less distortionary, and also make progress on some of the fundamental challenges we face as a country. We break our exploration of the extent to which tax choices based on the principles above can achieve the required consolidation into five parts:

- Taxing windfall gains from the coronavirus crisis;
- The role of taxes in aiding efforts to tackle climate change;
- Politically expedient changes to tax thresholds and the Corporation Tax rate;
- Improving the UK's wealth-related taxes, focussing on reducing arbitrary distortions and tax-avoidance opportunities; and
- A proposal to raise substantially more revenue to fund the challenges faced by health and social care.

Finally, the conclusions section (Section 11) summaries the full list of our tax recommendations. People may very reasonably come to alternative conclusions about what policy mix would be ideal, and there are always trade-offs with large tax rises. But if substantial fiscal consolidation is to happen, difficult choices will need to be made, and many of the proposals we recommend are likely to be needed.

The following sections now turn to setting out our specific tax policy recommendations in the order set out above.

72 M Brewer, N Cominetti, K Henehan, C McCurdy, R Sehmi & H Slaughter, Jobs, jobs, jobs: Evaluating the effects of the current economic crisis on the UK labour market, Resolution Foundation, October 2020.

Section 6

Taxing windfall gains from the coronavirus crisis

The impact of the coronavirus crisis so far has been highly uneven, both for companies and households. While 2020 has been tough for most, some firms have profited from higher demand, and some individuals have received government support in excess of any income losses. Most have not been so lucky – with the young and low-paid disproportionately likely to have lost their jobs. This rightly raises questions of how post-pandemic policy, including tax rises, should reflect the uneven burden that this crisis has placed across society and the economy. Some have suggested that windfall taxes on those that have prospered during this pandemic could play a major role in the fiscal consolidation to come. This section examines the potential for this.

Measures to directly tax those firms and individuals that have done well over the past year will not be able to make major contributions towards repairing the public finances. This is mainly because, by their nature, such measures will be temporary, whereas the need for higher tax revenues is more long lasting. It also reflects the relatively small revenues likely to be raised. However, such policies should still be pursued as part of a broader consolidation plan. Indeed, they are an essential component of building public support for that plan.

We propose two temporary measures that draw on the principles of solidarity and fair burden-sharing. First, we recommend a Pandemic Profits Levy: a Corporation Tax surcharge of 10 per cent on windfall profits made during the pandemic, reflecting the fact that such profits in many cases reflect the luck of some firms being presented opportunities by the crisis and not being adversely affected by social distancing restrictions (such as supermarkets, whose competitors may have had to close). This would raise approximately £130 million and be time-limited to 2020-21. Second, self-employed workers who have seen their incomes actually rise this year while claiming poorly-targeted Self-Employment Income Support Scheme (SEISS) grants should have their grants partially clawed back. The SEISS Clawback would narrow the enormous gap in treatment with the self-employed who have been excluded from support, and

raise at least £3 billion across the four rounds of the scheme.

Measures that tax windfall gains during this crisis are necessary, but very far from sufficient, in ensuring that a consolidation plan has public consent in the years ahead. Broader questions of how the impact of this crisis on different groups should impact on the nature of the consolidation to come will be addressed in subsequent sections on more permanent tax increases.

The economic impact of the pandemic has been uneven for firms as well as for workers

Although the coronavirus crisis has meant uniformly bad news for the public finances, it has had very different impacts across families and firms. While most companies, and many households, have experienced difficulties, some have been offered economic opportunities by a crisis that has directly created demand for particular products while also changing patterns of consumption. The rough-and-ready nature of some government support schemes has also created markedly different outcomes. Some of those hit hardest by the crisis have fallen through the cracks, while others have actually found themselves better off in 2020 as a result of poorly-targeted support. This has prompted discussions about how such uneven outcomes should inform the fiscal consolidation to come, with some arguing that windfall taxes on such corporate or household gains could play a major part in repairing our public finances.[73]

To assess the potential role of such windfall taxes, in this section we focus on two issues. First, business windfalls. Here, some businesses have gained from shifts in economic activity led either by the virus directly or by the social distancing restrictions its control has required. Spending has shifted towards goods and away from services,[74] while the shift of retail spending from the high street to the internet has been turbo-charged.[75] Firms lucky enough to be able to swiftly satisfy surging demand for face masks, PPE, and hand sanitiser have had a good crisis. So we consider how we might go about taxing such gains from happy circumstance.

Second, this crisis has seen unprecedented levels of government support for households. Programmes like the JRS and the SEISS, designed to insure individuals against very large income losses from the crisis, were rightly created quickly in the early stages of the crisis. But the need for speed, and the lack of existing mechanisms for

73 See for example: J Rutterford, Taxing financial winners from coronavirus to pay for the crisis – lessons from WWI, The Conversation, October 2020.
74 Service industry activity in August 2020 remained further below its February 2020 level than production industry activity. See: ONS, Coronavirus and the impact on output in the UK economy: August 2020, October 2020.
75 In September 2020, online sales in Great Britain accounted for 27.5 per cent of retail sales, compared to 20.1 per cent in February. See: ONS, Retail sales, Great Britain: September 2020, October 2020.

making such payments, has led to very poor targeting of support in some cases. This is more egregious in the case of the self-employed, where some have been excluded from support entirely while others have received very large grants despite seeing little hit to their earnings.[76] So we consider the role of taxation in reducing these unjustifiable disparities by clawing back excessive payments.

More generally, the uneven impact of this crisis is clear, with the young and low earners much more likely to have lost their jobs.[77] While income falls have been more evenly shared across the income distribution, they do not tell the full picture of the pandemic's impact on family finances. Many higher-income households have seen their financial situation improve with incomes holding steady while their spending has fallen considerably. Meanwhile, those on lower incomes have been more likely to borrow to make ends meet during the crisis.[78] Even if these impacts are less susceptible to forms of windfall taxation (and it would be less fair to tax extra savings if people chose to make them for precautionary reasons), they form important context to our policy considerations in the chapters to come, including in Section 9 where we discuss the issue of taxing the wealth that some families have acquired during this crisis.

A Pandemic Profits Levy could share the proceeds of corporate windfalls

Most firms have seen their revenues and profits fall significantly during this crisis, with 44.9 per cent reporting lower turnover in early October even after many social distancing restrictions had been lifted.[79] In particular, 23 per cent have seen very significant revenue falls of over 20 per cent. But some firms have bucked this trend. For example, supermarket giant Tesco has seen a boost to sales and profits, with underlying UK retail profits in the first half of 2020-21 up 4.2 per cent on a year earlier (in real terms), as a consequence of rising food sales.[80] Seeing profits increase is particularly noteworthy given that even firms doing well have incurred significant pandemic-related costs. In Tesco's case, that has meant £533 million spent adjusting to doing business in this very different era, though this was partly offset by business rates relief worth £249 million. While supermarkets have been able to continue trading throughout the crisis, they have benefited from the closure of non-food retail stores during the initial lockdown, and then again during November (in England), that they would normally compete with.

76 See: M Brewer, N Cominetti, K Henehan, C McCurdy, R Sehmi & H Slaughter, Jobs, jobs, jobs: Evaluating the effects of the current economic crisis on the UK labour market, Resolution Foundation, October 2020.
77 Resolution Foundation data for September 2020 suggests that 20 per cent of 18-24 year-olds were unemployed, while 30 per cent of those in the bottom pay quintile back in February had lost their job, lost hours or lost pay since February. See: M Brewer, N Cominetti, K Henehan, C McCurdy, R Sehmi & H Slaughter, Jobs, jobs, jobs: Evaluating the effects of the current economic crisis on the UK labour market, Resolution Foundation, October 2020.
78 See: G Bangham & J Leslie, Rainy days: An audit of household wealth and the initial effects of the coronavirus crisis on saving and spending in Great Britain, Resolution Foundation, June 2020.
79 ONS, Business Impact of COVID-19 Survey (BICS) Wave 16 results: 5 to 18 October 2020, November 2020.
80 Tesco PLC, Interim Results 2020/21, October 2020.

Other firms too have benefited from higher demand, in some cases alongside restrictions in their competitors' ability to trade. Revenues at online supermarket Ocado rose 27 per cent year-on-year, for example, in the first half of 2020, while revenue at private services contractor Serco (which has played a significant role in the UK's Test and Trace programme among many other such contracts) saw growth of 15 per cent.[81]

Overall, approximately one in ten firms recorded turnover that was higher than usual in the summer and autumn of 2020, while 7 per cent of businesses still trading had profits higher than usual.[82] Unusually high profits were concentrated among larger firms (with 250 or more employees) and in specific sectors, particularly 'Wholesale and Retail Trade', among which 14 per cent of firms reported higher-than-usual profits in September 2020.[83] These results are consistent with the greater ability of larger firms to absorb the costs of adjustment to the pandemic, and the relative shift in consumer spending from face-to-face services towards certain goods.

It is noteworthy that most government support for businesses has not been tied directly to the scale of hit the pandemic has inflicted. The Job Retention Scheme has been available to all firms, while £10 billion of business rates relief and £12.4 billion of business grants have been paid out on the basis of previous business rates (with some simple sectoral targeting in the latter scheme) rather than revenue falls.[84] Given this context, it is right that those who have prospered – whether due to government support, higher demand for their products or the luck of avoiding restrictions on trade – should share the proceeds of that luck.

Survey evidence from the early months of the pandemic suggests there would be substantial public support for an 'excess profits tax' on company profits that rose significantly above normal levels during the pandemic.[85] This model has been employed in several countries in major wars, whereby corporate profits in excess of previous years would be taxed at a high rate, and in cases when particular sectors have made high profits, as Box 3 explains.[86] In some cases, the policy has not been targeted, and simply imposed across all firms making any profits.

81 Ocado Group PLC, Interim results for the 26 weeks ended 31 May 2020, July 2020; Serco Group PLC, 2020 half year results, August 2020.
82 ONS, Business Impact of COVID-19 Survey (BICS) Wave 16 results: 5 to 18 October 2020, November 2020.
83 ONS analysis of ONS, Business Impact of Coronavirus (COVID-19) Survey (BICS), 7 to 20 September 2020.
84 MHCLG, Business to receive almost £10 billion in rates relief, April 2020; K Ogden and D Phillips, COVID-19 support through the business rates system: how does the pattern of support vary across England?, Institute for Fiscal Studies, June 2020.
85 YouGov / NEON survey results, May 2020.
86 R S Avi-Yonah, Taxes in the Coronavirus: Is it time to revive the Excess Profits Tax?, University of Michigan Law Research Paper 671, May 2020.

BOX 3: Excess profit taxes, or corporation tax surcharges, have often followed major wars or national events

Corporate profits taxes have often risen during and in the aftermath of wars and natural disasters. They come in two main forms: surcharges imposed on all corporate profits, and special charges on the portion of firms' profits that exceed their average profits from previous years. Some examples follow.

- Excess Profits Duty in WWI. This was introduced in 1915, initially at a rate of 50 per cent on any profits that exceeded a firm's pre-war average (with an allowance for a 6 per cent rate of return on capital investment).[87] The tax continued until 1921, with its rate varying over time between 40 and 80 per cent. A similar tax was reintroduced just in the September 1939 Budget, after the outbreak of the Second World War, at a rate of 60 per cent, with the rate rising to 100 per cent in 1942.
- 1981 Budget levy on bank deposits.[88] In the landmark 1981 Budget a 2.5 per cent one-off levy was imposed on non-interest bearing bank deposits. This was justified by the fact that bank profits were higher than usual not due to any changes in their business, but rather to government policy for higher interest rates.
- 2011 Japanese earthquake tax. A recent precedent for a tax of this type is the 10 per cent surcharge on corporation tax for all firms imposed in Japan after the 2011 earthquake, which remained in force for three years from April 2012.[89] Rather than targeting super-normal profits, this amounted simply to a 10 percentage point increase in the rate of corporate income tax for all firms.

We recommend the introduction of a Pandemic Profits Levy. Companies which record higher real-terms profits during 2020-21 than they averaged in the two fiscal years before the pandemic should pay a 10 per cent surcharge in addition to their usual Corporation Tax bill for that year, on the part of their profits that exceeds the previous years' average. This would be a simple way to tax corporate windfalls received during the pandemic period, and would help to achieve fairness between firms hit hard by the pandemic (who would not pay tax on their zero profits) and those whose business has benefited. An investment return allowance could be considered. Anti-avoidance measures for the tax

87 M Billings and L Oates, Innovation and pragmatism in tax design: Excess Profits Duty in the UK during the First World War, Accounting History Review 24, 2014.
88 Margaret Thatcher Foundation, The 1981 Budget - background & documents.
89 P Aldrick, It's time for pandemic winners to show solidarity with everyone else, The Times, 10 October 2020.

would also need to be carefully calibrated, particularly to prevent firms pushing profits into subsequent fiscal years, and could include automatic investigation of firms whose revenue increased in 2020-21 even if reported profits did not.

A windfall tax on corporate profits would not be uncontroversial. A key argument against it is that it might penalise firms which make higher profits in 2020-21 for reasons unrelated to the pandemic, such as young firms in a fast-growth phase of expansion. Since 2015 there have been no reductions in Corporation Tax rate, or marginal reliefs, for smaller firms. Certainly, some firms will be caught in this way, but the particular sectoral nature of the main trends in corporate revenues and profits since March 2020 suggests that firms' fortunes have been correlated with the course of the pandemic: higher profits are concentrated among retailers and large firms. In any case, many new firms will pay no Corporation Tax at all in their early years if they are not making any profit: Ocado Group, for example, was founded in 2000 but did not become profitable until 2014.[90]

We estimate that a 10 per cent Pandemic Profits Levy in 2020-21 would raise around £130 million. We draw on the central scenario in the latest OBR onshore corporation tax receipts forecast (issued in July 2020), and we estimate the proportion of the forecast 2020-21 CT receipts that are made up by 'excess profits' using findings from the ONS Business Impact of Coronavirus survey on the proportion of businesses recording higher-than-usual profits in September 2020.[91]

Policy recommendation: Apply an extra 10 per cent Pandemic Profits Levy on corporate profits in 2020-21 in excess of pre-coronavirus profits (raising a one-off £130 million)

Pandemic payments to the self-employed should be partially clawed back where they have not been needed

Like in the corporate world, government support for different parts of the labour market during the early months of the pandemic was – rightly – broad and relatively generous. And support was particularly generous for the self-employed, in the form of the SEISS. Recent Resolution Foundation analysis showed that up to the end of August, the average self-employed worker benefitting from support via the Self-Employment Income Support Scheme (SEISS) had received twice as much in government support (£2,500) as the average furloughed employee (£1,300).[92] In total, the first two tranches of the SEISS paid out £7.8 billion to 2.7 million people and then £5.9 billion to 2.3 million people between May and October 2020, a total of £13.7 billion in support.[93] The third and fourth tranches

90 Ocado Group PLC, Annual Report and Accounts for the 52 weeks ending 30 November 2014, February 2015.
91 Office for Budget Responsibility, Fiscal Sustainability Report – July 2020, July 2020; ONS, Business Impact of Coronavirus (COVID-19) Survey (BICS), 7 to 20 September 2020.
92 M Brewer, N Cominetti, K Henehan, C McCurdy, R Sehmi & H Slaughter, Jobs, jobs, jobs: Evaluating the effects of the current economic crisis on the UK labour market, Resolution Foundation, October 2020.
93 HMRC coronavirus (COVID-19) statistics.

were announced in November 2020 (although the generosity of the fourth tranche is not yet known), each covering a further three-month period.

Despite its generosity, the support provided to self-employed workers was poorly targeted. Many received payments even when their earnings did not fall materially: one-in-six people (17 per cent) who received a SEISS grant did not see their earnings fall in any of the first seven months of the pandemic (March to September).[94] Others fell through the gaps in the policy, with three-fifths of self-employed workers whose earnings fell to zero receiving no SEISS support.

These findings prompted us to call for future rounds of self-employment support to avoid being repeats of the SEISS system, not least by offering support to many of those excluded from help to date, advice which has not yet been taken on board.[95] But very significant payments have already been made in the support available to self-employed workers. The huge inequities of these risk undermining support for the unprecedented collective action taken during this crisis. We recommend that the Government proactively tackle this, by partially clawing-back SEISS payments made to self-employed workers where receipt of the grant pushed their incomes in 2020-21 above their average income in the previous three tax years (or their income in 2019-20 only, if this is higher than the three-year average). This could be achieved via Income Tax self-assessment, through which SEISS grants are already liable for Income Tax and NI.

Specifically, our recommendation is that recipients of SEISS grants in 2020-21 should be required to repay two-thirds of any portion of their grant that made their income exceed their average income from fiscal years 2017-18 to 2019-20 (or fiscal year 2019-20 alone, if this is higher than the three-year average). This would mean that if a self-employed person's income is down on previous years, they would pay Income Tax and National Insurance on their SEISS grant as usual. If their income including the SEISS was higher than previous years, then two-thirds of the increase in income would be clawed back, with the claw-back capped at two-thirds of the size of the original SEISS grant.

Considering the first round of the SEISS alone, we estimate that 435,000 people claimed grants and then did not experience any fall in their earnings, implying that around £1.3 billion in unnecessary grants was claimed in this way.[96] Clawing-back two-thirds of these payments, for example, could raise £840 million. It is difficult to estimate the amount that would be clawed back if this policy was repeated across all four rounds of the

94 M Brewer, N Cominetti, K Henehan, C McCurdy, R Sehmi & H Slaughter, Jobs, jobs, jobs: Evaluating the effects of the current economic crisis on the UK labour market, Resolution Foundation, October 2020.

95 Resolution Foundation, Self-Employment Support Scheme pays out over £1.3 billion to thriving businesses, but nothing to 500,000 left without work, October 2020.

96 Calculation assumes that workers not experiencing an earnings fall each received the average amount paid to recipients of the first round of the SEISS (£2,900). For details see Section 4 in M Brewer, N Cominetti, K Henehan, C McCurdy, R Sehmi & H Slaughter, Jobs, jobs, jobs: Evaluating the effects of the current economic crisis on the UK labour market, Resolution Foundation, October 2020.

SEISS announced so far, since this requires estimates of the proportion of recipients whose earnings in each round dropped by less than the amount their received in grant money. However, with a conservative methodology we estimate that a two-thirds SEISS Clawback would bring in at least £3 billion in revenue.[97]

The main critique of a claw-back of some people's SEISS grants is simple: it is a form of retrospective taxation. Recipients were not told that this would happen when they claimed the grants, and so may not have the money available. This is not a compelling critique, however, for three reasons. First, the original eligibility criteria for the SEISS schemes made clear that they were for people whose trading had been impacted by the coronavirus. So the claw-back could be seen as a form of enforcement for people who did not experience an impact to ensure that grants have been properly used (and it is certainly a cheaper and more reasonable approach than pursuing enforcement via HMRC prosecutions for fraud, which would not apply for the cases this policy is designed for). Second, we propose only clawing back a fraction of the relevant grants, in acknowledgement of the fact that recipients were not told at the start of the scheme. Third, any cash-flow problems for recipients could be mitigated by HRMC giving them an extended period of time over which to make repayments.

This approach will not be welcome news to some of those that have received SEISS grants, but it will only impact those whose income in 2020-21 ended up higher than in previous years – and even then it will only claw back some of the excess grant. It is important that the state steps in during this crisis to offer unprecedented income protection and fiscal stimulus, but it also remains important that public money is well spent. And, crucially, it must be seen to be well spent, if we are to ask taxpayers to accept significant tax rises in the years ahead.

Policy recommendation: Require partial repayment of SEISS grants, where these pushed income above pre-crisis levels (raising around £3 billion across the four rounds of grants)

Taxes on pandemic gains are not the answer to the fiscal challenge but do have an important role to play in a successful consolidation

Sometimes these types of taxes on windfall gains during the crisis are held out as a significant way to repair the public finances. These proposals show that even significant

97 This estimate is necessarily very approximate, since there are considerable uncertainties around the proportion of SEISS grants that will take recipients' earnings above their previous level. We assume that the proportion of recipients whose earnings did not fall stays the same throughout each round of the scheme, and that the number of participants does not fall in the later rounds. We do not include people in our estimate whose earnings dropped, but by less than the amount of their grant (meaning that two-thirds of part of their grant would be clawed back).

measures in this regard will not be able to make major contributions towards repairing the public finances.

Most importantly this is because they are, by their nature of focusing on windfalls in a particular year, temporary, and this means they can have no lasting impact on reducing the deficit. It is also the case that these one-off taxes will not make much dent in the overall stock of debt, given the relatively small amount of revenue they would raise. This reflects the fact that 2020 has been a bad year for most individuals and firms – there are not many windfalls out there – and the practical challenges of effectively taxing them. On the latter point, for example, we conclude that it is not practical to directly tax the excess savings that many, particularly higher income, households have built up this year.

However, although taxes on windfall gains cannot play a major role in restoring the sustainability of the public finances, they should still be pursued and seen as an important part of a broader consolidation plan. As well as raising some revenue and ensuring some elements of crisis spending provide value for money, these taxes on pandemic windfalls are an essential component of building public support for that plan.

After considering another revenue source that is often touted as the silver bullet to fiscal problems (environmental taxes) in the next section, the remainder of the report then moves on to other areas of tax reform that could build on the fairness embedded in the Pandemic Profits Levy and SEISS Clawback, while raising more substantial revenue into the longer term.

Section 7

Environmental tax options

With a pressing need to get the UK's greenhouse gas emissions onto the right trajectory, this section explores whether tax reform could help achieve this goal while also playing a significant role in fiscal consolidation.

The UK Emissions Trading Scheme (currently expected to take over from the EU equivalent on 1 January 2021) will tax emissions from many parts of the economy. This could be reformed to drive change and raise more revenue, but we assume that significant reforms – such as a carbon border adjustment, reduced allowances, and an extension to shipping – are unlikely to happen rapidly enough to be a part of consolidation in this parliament. There is also a strong argument for rectifying the situation whereby domestic fossil fuel heating faces no carbon pricing (unlike electricity production), and benefits from a reduced rate of VAT. Extending emissions trading (or an equivalent) to gas, oil and coal destined for home heating would raise around £1 billion given current carbon prices, and perhaps triple this by 2030. But this a relatively regressive revenue-raiser; green regulation will be more important than tax signals in driving change; and any money raised in this way should be ringfenced for home subsidies to reduce fuel costs and emissions rather than boosting the public finances.

Road transport already faces high taxes in the form of Fuel Duty. The fiscal outlook assumes this rises in line with RPI inflation each year, and so the immediate question is simply whether this goes ahead, or whether there are further fuel duty freezes, which would cost an additional £3 billion in 2024-25 if continued for another four years. We do not recommend such a tax cut. As we move towards net zero, there are other policy levers that may ultimately be more important than pricing (not least the ban on new petrol and diesel cars). But one area where significant additional revenue could be raised is in the reform of Vehicle Excise Duty. Reform that places higher taxes per additional g/km of emissions for new vehicles could plausibly raise £1 billion a year while hastening the switch to cleaner vehicles.

Environmental taxes, then, can play a role in reducing the deficit and achieving

environmental ends, but are not a silver bullet for either problem. Indeed, in the longer-term, the loss of environmental tax revenue (particularly £38 billion of vehicle taxes) will require a replacement system of road pricing – which we suggest begins with a new GPS-based Home Delivery Congestion Charge for delivery vehicles. This would also help tax a sector that has done very well from the coronavirus crisis.

Green taxes can raise some extra revenue, but are not a silver bullet for the deficit (nor the climate)

The UK has rightly committed to reducing net greenhouse gas emissions to zero (or negative) by 2050.[98] With the adoption of the net zero target in 2019, the hosting of the 'COP26' climate conference in 2021, and a commitment to 'build back better' after this crisis, future fiscal events will need to help clarify how policy will get the UK on track to reach net zero. Relatedly, there are very good reasons to reduce outdoor and indoor air pollution, with the former linked to 40,000 UK deaths per year,[99] and with air pollution potentially being linked to over 6,000 coronavirus-related deaths in the UK so far.[100] So it is a particularly good time to consider whether tax policy that might contribute to greening the economy can also raise revenue.[101]

Some have suggested that green taxes should sit at the centre of the consolidation to come. However, as with the windfall tax ideas discussed in the previous section, it is easy to overstate the potential for large, sustainable revenue increases here. Changes in green levies would not necessarily be quick, politically easy or progressive, and in many cases might not contribute to deficit reduction overall even if they are desirable for reducing emissions. In the rest of this section we explore some of the options that could raise extra revenue, but our key point is that we cannot rely on an assumption that carbon taxes are likely to raise – for example – the £25[102] or £77 billion a year[103] that some have claimed.

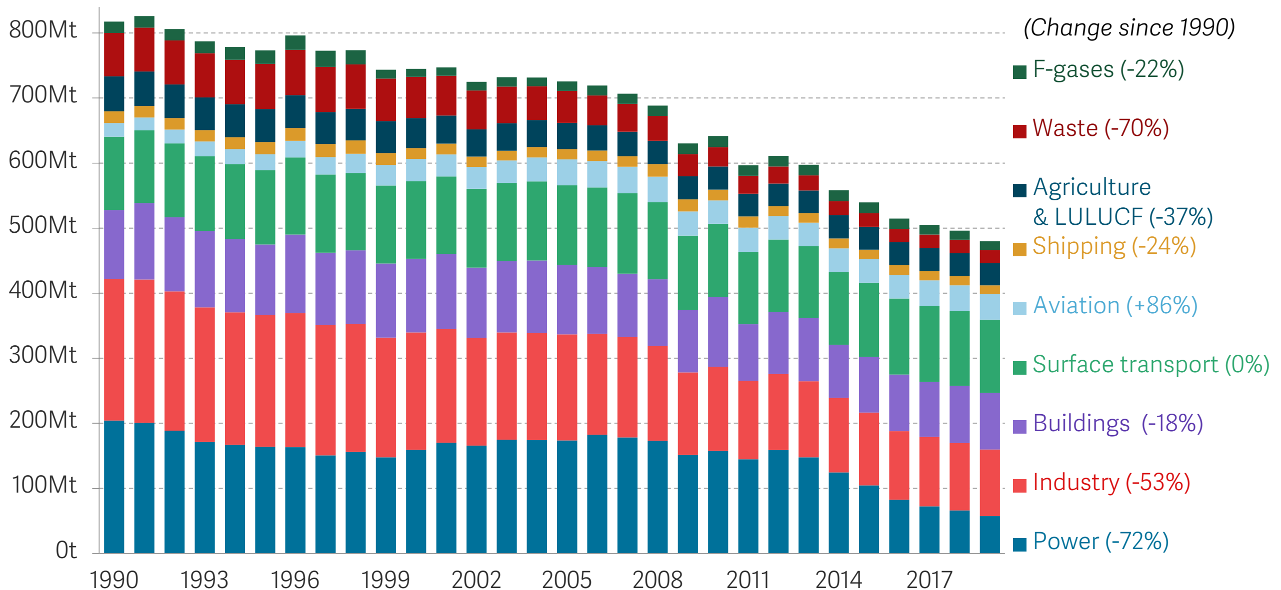
For context, Figure 31 presents the sectoral break-down and history of UK greenhouse gas emissions. There has been notable success in reducing emissions from power generation (down 72 per cent since 1990, even before coronavirus), industry (down 53 per cent), and waste (down 70 per cent). But in some parts of the economy there has been less progress, with zero change in overall surface transport emissions, for example.

98 Scotland has committed to reaching net-zero greenhouse gas emissions by 2045.
99 Royal College of Physicians, Every breath we take: the lifelong impact of air pollution, February 2016.
100 A Pozzer et al., Regional and global contributions of air pollution to risk of death from COVID-19, Cardiovascular Research, October 2020.
101 The OECD argues that "A central priority [once recovery is locked in] should be to accelerate environmental tax reform. Today, taxes on polluting fuels are nowhere near the levels needed to encourage a shift towards clean energy." OECD, Tax Policy Reforms 2020: The role of tax systems in responding to COVID-19, September 2020.
102 Reuters, Sunak plans carbon emissions tax to help rebuild economy, October 2020.
103 Green Party Manifesto 2019.

Although some emissions might be offset in future by various modes of CO2 capture, emissions in most sectors – and especially surface transport and buildings – will need to fall to zero in under 30 years.

FIGURE 31: **The UK has made progress in reducing territorial emissions, but there is a long way to go and some sectors have made no progress**

UK greenhouse gas emissions by sector (CO2 equivalent)



NOTES: Territorial basis. LULUCF = Land use, land-use change, and forestry.
SOURCE: Climate Change Committee analysis of BEIS data.

In considering what extra revenue could be raised, it is important to stress that the UK does have a carbon price already: the EU Emissions Trading Scheme. At the time of writing, it is unclear what exactly will replace this on 1 January 2021, but the Government's stated preference has been for a similar (and potentially EU-linked) UK Emissions Trading Scheme (UK ETS).[104] An alternative to this cap-and-trade approach is a more straightforward carbon tax,[105] and we do not take a view in this report on the relative merits of these approaches.

Based on current policies, UK government receipts from the sale of carbon permits were projected to be over £1 billion a year.[106] There are a number of factors that shape this, and that will determine how much revenue the UK can raise from carbon pricing in future. First, there is the price per tonne of CO2 (or equivalents), which is driven by supply and demand, and/or direct price setting by government. The current EU ETS price in

104 HM Government, The future of UK carbon pricing: UK Government and Devolved Administrations' response, June 2020.
105 e.g. E Birkett, The Future of UK-EU Energy Cooperation: Policies to strengthen UK-EU energy and climate cooperation in the Future Relationship, Policy Exchange, September 2020.
106 OBR, Economic and Fiscal Outlook, March 2020.

November 2020 is around £23 per tonne of CO_2,[107] but future prices may be considerably higher. Government guidance (which is not a prediction of future prices but does give some indication) points to a price of £59-£178 by 2035, and perhaps over £200 or £300 by 2050.[108] And they arguably do need to be higher: with the Grantham Institute calling for a price of at least £75 by 2030.[109] But alongside the price, the number of free permits distributed and the scope of the trading system are both key in determining how much revenue can be raised.

A sector-by-sector look shows that there are opportunities for raising extra green revenue, but also good reasons why this has not already happened

So how much potential is there for raising revenue in each of the sectors shown in Figure 31? We explore surface transport separately further below, but first we must take a whistle-stop tour through power; industry; aviation; shipping; agriculture; and buildings.

1. Raising revenue from electricity generation

This sector is already covered by the ETS, as well as an additional 'Carbon Price Support' of £18 per tonne. The reduction in UK emissions from electricity generation is partly due to this carbon pricing contributing to the rapid phase-out of coal power. But if this price-elasticity continues it would mean that further carbon price increases may lead to further emissions reductions (e.g. less use of unabated gas power) rather than increased revenue.

2. Raising revenue from industry

This is also covered by the ETS. However, a large number of permits are currently distributed for free. In 2020, the government gave out permits equivalent to 48Mt of CO_2,[110] or around £1.2 billion's worth, to companies including producers of steel, oil, cement and fertilisers. One way to increase revenue, then, would be to reduce these free allowances. But the policy of free allowances is designed to help avoid the offshoring of production – which might lead to the UK importing carbon-intensive goods but no carbon price being paid, benefiting neither the climate nor the Treasury.

One answer, as many have suggested, is a carbon border adjustment: whereby imports of specific goods into the UK would have to pay an equivalent carbon price if this had not already been levied in their country of origin. Such a tariff would enforce a level playing

107 See ember-climate.org/data/carbon-price-viewer/, 6 November 2020.
108 BEIS, Green Book supplementary guidance: valuation of energy use and greenhouse gas emissions for appraisal, March 2020.
109 J Burke, R Byrnes & S Fankhauser, How to price carbon to reach net-zero emissions in the UK, Grantham Institute, May 2019.
110 BEIS, UK National Allocation Table: Phase III National Allocation including changes: April 2020.

field between domestically produced and imported goods. The EU is in the process of drawing up proposals for a carbon border adjustment "for selected sectors, to reduce the risk of carbon leakage".[111] The border tariff itself might not necessarily raise substantial sums: indeed, part of the point is to incentivise other countries to implement their own carbon pricing (and therefore become exempt from the border adjustment).[112] But it would allow a reduction in the distribution of free allowances which – as indicated above – could raise substantial revenue. Indeed, the EU has explicitly presented the carbon border adjustment as an alternative to the allocation of free allowances. However, there are many questions that remain to be answered about how a carbon border adjustment would work such as: what goods it would apply to; what the exact mechanism would be; and – not least – how it can be delivered in a way that does not breach WTO rules. It should therefore not be banked as a possible revenue raiser for this parliament.

3. Raising revenue from aviation

The question of what taxes and carbon pricing should apply to aviation is complex, with a number of current and potential mechanisms for taxing flying:

- The (likely) UK ETS proposes to cover flights within the UK, Gibraltar, EEA and Switzerland. The number of free allowances allocated to airlines and airports could be reduced from its current level, and the European Commission has suggested the same for the EU ETS.[113]
- The Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA) is an international measure requiring offsets against any (route-based) emissions growth above 2019 levels. It therefore does not price all aviation emissions, and the coronavirus crisis will render it weak in the short-term, but it may at least be a starting point for a comprehensive global solution.
- Fuel Duty is not applied, based on the 1944 Chicago Convention, though there is no legal impediment to applying it to domestic flights.[114]
- Air Passenger Duty is a per-passenger tax on flights departing from (most) UK airports, based on the length of the flight (though divided into only two bands), and the density of seating. The Treasury had been reviewing APD, prior to coronavirus, but had not published or consulted on any proposals.[115]
- VAT is not levied on most flights. For international flights, this is part of an international consensus. Domestic flights with 10 or more seats do not attract VAT

111 European Commission, The European Green Deal, December 2019.
112 Dieter Helm on The Green Alliance Podcast, June 2020.
113 European Commission, The European Green Deal, December 2019.
114 Transport & Environment, Domestic aviation fuel tax in the EU, January 2019.
115 HM Treasury, Budget 2020, March 2020.

in the UK, but smaller aircraft do.

- A frequent flyer levy has been proposed as a tax that progressively increases based on an individual's number of flights, with one tax-free return flight per year.[116]

Higher taxes on aviation emissions would therefore be possible in some forms, and would be broadly progressive. However, the coronavirus crisis has taken a very large toll on the industry and large numbers of jobs have been lost, meaning that now is not the time for significant tax rises.

4) Raising revenue from shipping

Shipping is not included in the EU ETS, though some Fuel Duty is paid.[117] But the European Commission has proposed extending the ETS to include the maritime sector, and the UK ETS should do the same. However, there are outstanding questions such as exactly what voyages would be covered which, alongside the fact that the UK ETS does not yet exist, mean it may be some years until this could be implemented and begin raising revenue.

5) Raising revenue from agriculture and land use

Agriculture is not currently included in the EU ETS, and estimating emissions (or sequestration) for specific pieces and uses of land is challenging. There have been specific proposals to introduce a carbon tax for food producers,[118] or higher taxes on meat.[119] But all such proposals face considerable political challenges – even if they would be part of a consistent carbon pricing framework. And comprehensive revenue-raising reform here is unlikely on a timeline consistent with the necessary consolidation, not least because the first order of business for Government regarding this sector is reforming agricultural subsidies post-Brexit.

6) Raising revenue from buildings

Direct fossil fuel heating of domestic and non-domestic buildings is not currently included in the ETS. And there is a pressing need to encourage better insulation and green heating options. But there are also reasons why little revenue might or should be raised here.

Taking non-domestic buildings first, the UK ETS could be extended to the supply of fossil

116 See afreeride.org.
117 Ending the 'red diesel' Fuel Duty rate for the fishing industry could be considered as a green revenue-raiser, in the absence of including smaller ships within the ETS.
118 UK Health Alliance on Climate Change, All-consuming: building a healthier food system for people and planet, November 2020.
119 BBC News, Climate change: German MPs want higher meat tax, August 2019.

fuels (primarily gas) for the heating of these. But non-residential gas and electricity use is already charged via the Climate Change Levy (raising around £2 billion a year). The Levy's charge on gas of 0.465p/KWh in 2021-22 does equate to roughly £21 per tonne of CO2 – and therefore similar to the short-term carbon prices discussed above.[120] Assuming that the carbon price rises in future, trying to align the Climate Change Levy with that rate – or replacing the Levy entirely – could raise substantial extra revenue and encourage decarbonisation. However, this approach would point to removing the Climate Change Levy from non-residential electricity use, given that electricity production is already covered by the ETS (and Carbon Price Support). Indeed, not only is electricity currently double taxed in this way but the Climate Change Levy rate for electricity is (at 0.775p/KWh) higher than that for gas use. Moving from the Climate Change Levy to consistent carbon pricing seems sensible to promote the electrification of non-residential heating and industrial processes. However, the net impact of such a change would not necessarily raise revenue.

Decarbonising home heating (and cooking) is a key challenge in decarbonising the UK, yet domestic gas, oil and coal do not have any carbon price applied and also benefit from a reduced (5 per cent) rate of VAT. Meanwhile, the carbon impact of electricity use – such as for heat pumps – is taxed via the ETS and Carbon Price Floor (and via various levies on electricity bills). This is a perverse state of affairs.

For environmental and efficiency reasons, consistent carbon pricing could be extended to gas, heating oil and solid fuel destined for residential use.[121] Given a carbon price of around £25 per tonne of CO2, that might raise around £1 billion a year (while adding around £70 a year to gas bills).[122] If the carbon price rose to £75 per tonne of CO2 by 2030, that would triple to a £3 billion gain (and £200 a year impact on gas bills). An alternative would be to raise VAT on fossil fuel use from 5 per cent up to the standard VAT rate of 20 per cent. This would also raise around £2-3 billion a year (and the policies are not strictly mutually exclusive). However, of the two options, up-stream carbon pricing seems a better choice: it is a less obvious tax, better matches the treatment of other emissions, and focuses on emissions, whereas VAT would also tax administration costs (which might be difficult to disentangle in the case of dual-fuel billing) and any greener additions to the gas supply such as biogas or hydrogen.[123]

However, there are two significant sets of concerns around raising the price of domestic

120 Assuming average emissions of 220 gCO2eq/kWh. See: Parliamentary Office for Science and Technology, Carbon Footprint of Heat Generation, May 2016.
121 We do not focus in this report on whether extensions of carbon pricing should mean 1) extending trading with an increase in the overall cap; 2) extending trading without any change in the cap; or 3) applying a shadow carbon price (either roughly or precisely matching the market rate) to new sectors via other mechanisms.
122 RF calculation based on typical gas usage of 12,000kWh per year, typical boiler emissions of 220gCO2/kWh, and a carbon price of around £25/tCO2.
123 W Lytton & R Shorthouse, Pressure in the pipeline: Decarbonising the UK's gas, Bright Blue, February 2019.

fossil fuel heating, whether through carbon pricing or higher VAT.

First, consumers may not be very responsive to higher fuel prices, given that insulation improvements and the replacement of gas boilers with other heating arrangements often require substantial financing, knowledge, long-termism, and disruption. In addition, renters have no control over their home heating arrangements (short of moving). So pricing must not be the only policy tool used to tackle this problem. The UK is banning gas in new-build homes by 2025; raising insulation standards for private rented homes;[124] and subsidising (or, in some cases, entirely funding) some retrofitting and heat pumps through schemes such as the Green Homes Grants and upcoming Clean Heat Grants. Further regulation, such as the banning of new oil-fired boilers, new gas hobs, and (in time) new gas boilers may also be needed.[125] Such measures will have a greater impact on greenhouse gas emissions than marginal changes in the price of fuel.

The second concern with raising heating costs is the potential distributional impact. Spending on gas and other home fuel use is relatively flat across the household income distribution – though slightly higher in the top half of the distribution. As a share of total household budgets (or incomes) then, fuel use is higher for lower-income households, making any extra levy a relatively regressive source of revenue.

If rapid progress is to be made in decarbonising heating, difficult choices will be needed. But given these considerations, any revenue raised from higher levies on residential fuel use should be recycled in ways that support the net zero transition for homes, particularly those of lower income households. This would include further subsidies for new insulation and heat pumps. This would help alleviate the distributional concerns above and it would (figuratively) double the environmental impact by providing both 'stick' and 'carrot'. But it also means that this policy area should not aim to contribute significantly to consolidation.

In sum...

There are options to raise more revenue by increasing emissions-related taxes in the six broad sectors above. However, many improvements will take some time to plan and implement. First the UK must decide for certain what will replace the EU ETS. And even if the answer is a similar UK ETS, the Government's suggestion is that it would not implement any major improvements until 2026,[126] giving an indication of the pace of reform here – particularly for the most complicated options such as a carbon border adjustment.

And discussion of carbon pricing in the abstract can obscure hard political choices:

124 BEIS, Improving the energy performance of privately rented homes, September 2020.
125 CBI, Net-zero: the road to low-carbon heat, July 2020.
126 HM Government, The future of UK carbon pricing: UK Government and Devolved Administrations' response, June 2020.

the potential revenue, for example, is to some extent simply a function of how high and rapidly politicians are willing to raise the price of gas, certain foods or plane tickets. This is also the case for road transport taxes, which are explored in the rest of this section.

Transforming road transport is key but, realistically, the immediate tax goal should be simply to avoid cutting Fuel Duty

Surface transport (dominated by road transport) is a key consideration given its size and the total lack of overall emissions progress made between 1990 and 2019.

But it's also a notable sector because of the potential for a rapid transition. Electric vehicles have room to improve, but there is already relatively high certainty about what is the future of road transport (excluding long-distance freight). Electric vehicles are already roughly price-competitive on a lifetime basis, and are expected to become cheaper up-front (even without subsidy) as the scale and experience of the industry grows.[127]

Road transport is also crucial from a fiscal perspective, with Fuel Duty projected to raise £31 billion in 2024-25 (with Vehicle Excise Duty raising another £8 billion). For the foreseeable future, then, Fuel Duty is considerably more important for the public finances than explicit carbon pricing is likely to be.

Fuel Duty is 57.95p per litre of diesel or petrol, and has been since March 2011, following repeated freezes. Despite this, for public finance forecast purposes the duty is still assumed to rise each year in line with inflation.[128] Any new freeze would therefore worsen the fiscal outlook, as well as act to increase greenhouse gas emissions and slow down progress in electrifying the sector. Specifically, as Figure 32 shows, continuing the freeze for a further four years would cost £3 billion in 2024-25, relative to the default policy.

We do not look here at what the optimal level of Fuel Duty is. In theory, it should combine a carbon price with taxes on air pollution, safety risks, noise and – above all – congestion.[129] But – fundamentally – this is a sector that has potential for significant change over the 2020s; where price makes some difference to behaviour (the freezes so far have likely increased emissions);[130] where small changes can help tip the balance towards electric vehicles; and where inflationary increases are already included in the fiscal outlook.

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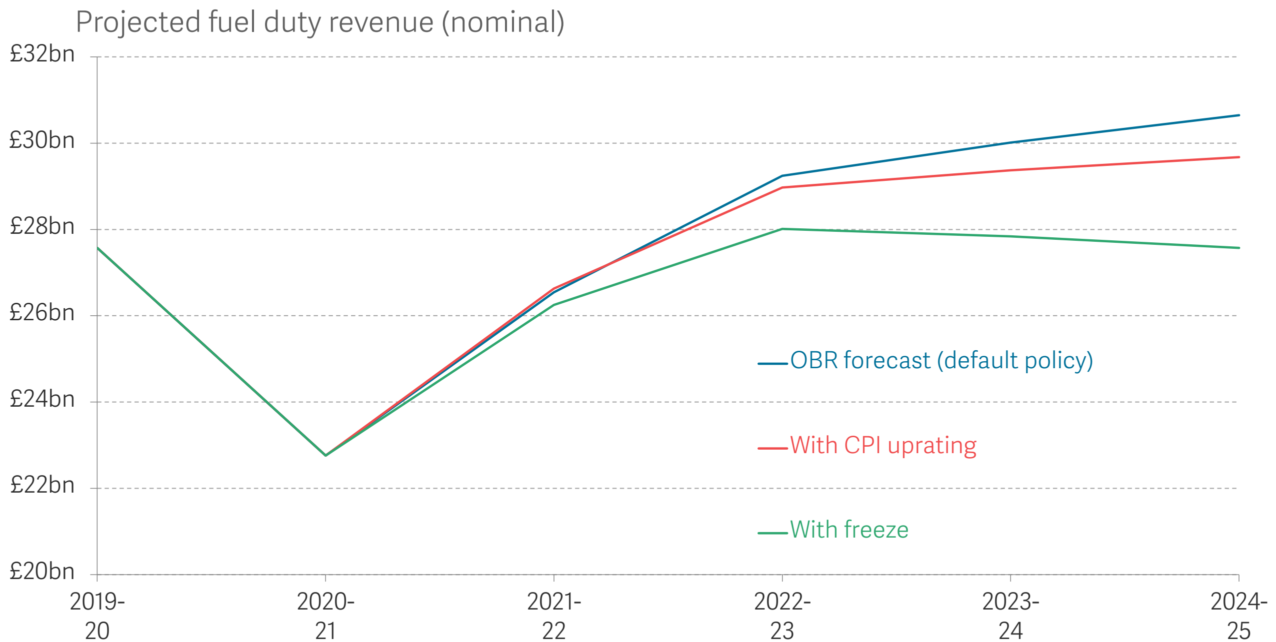
127 Committee on Climate Change, Net Zero – Technical Report, May 2019.
128 A Seely, Taxation of road fuels, House of Commons Library, October 2019 notes that "When uprating road fuel duties [...] the measure of inflation used is the projected annual change in the Retail Prices Index (RPI) in the year to the third quarter, following the respective Budget."
129 S Adam & R Stroud, A road map for motoring taxation, IFS, October 2019.
130 See: S Adam & R Stroud, A road map for motoring taxation, IFS, October 2019 – "Estimates suggest that a 10% rise in the petrol price cuts the amount of petrol consumed by 2.5% in the short term and by 6% in the long term"; and Carbon Brief, Analysis: Fuel-duty freeze has increased UK CO2 emissions by up to 5%, March 2020.

FIGURE 32: **Another four years of Fuel Duty freezes would cost £3 billion a year – which would need to be found elsewhere or worsen the deficit**

Projected fuel duty revenue (nominal)



SOURCE: RF analysis of OBR, Fiscal Sustainability Report, July 2020.

Given the inability of successive Conservative Chancellors since 2010 even to maintain the real value of Fuel Duty, we do not consider here the option of above-inflation increases (despite rumours of a 5p rise)[131], or somehow adding a specific carbon price onto the existing Fuel Duty.[132] A good outcome from a deficit-reducing perspective is simply that the scheduled inflationary rises go ahead. And April 2021 may be a relatively good time to break the Fuel Duty freeze habit, given low fuel costs and low inflation.

Policy recommendation: implement the planned inflationary uprating of Fuel Duty throughout this Parliament and beyond (raising zero revenue, relative to the existing fiscal outlook)

As with home heating, however, there are good reasons to not rely only on fuel taxation to achieve environmental goals. Regulations around car sales will be key, and the taxation of vehicles – rather than vehicle use – may also have an important role to play in encouraging change and raising revenue.

131 The Sun, Rishi Sunak could increase fuel duty by 5p to pay for coronavirus crisis – costing drivers hundreds of pounds, August 2020.

132 There may be a case longer-term for a more considered approach to Fuel Duty or carbon trading for long-range freight and other users (some of whom benefit from red diesel), including agricultural vehicles. The European Commission will consider extending emissions trading to road transport.

First-year VED should be a key tool to change car purchases, and also raise revenue

The Government is (at the time of writing) considering ending the sale of new petrol and diesel cars in the UK in 2030. It is also reportedly considering requiring that a growing share of car sales are electric even before then.[133] However, Vehicle Excise Duty (VED) can also contribute to this goal while raising revenue.

VED must be paid annually by all cars on the road, but a special rate is paid in the first year, and this effectively increases the up-front 'on-the-road' price of cars. At present, the first VED payment varies by CO2 emissions – from £0 for emissions-free cars to £2,175 for the most polluting, with 13 bands in total. After the first year, VED does not vary with emissions (though it did prior to 2017 reforms).

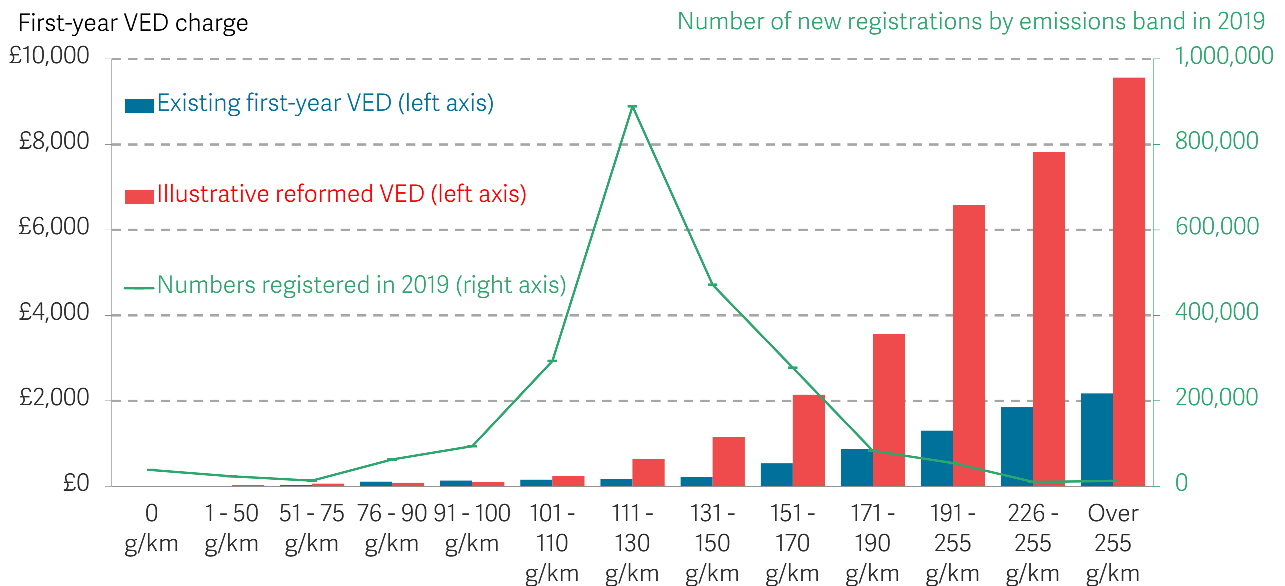
To maximise the impact on purchasing decisions – i.e. to encourage the purchase of electric vehicles, or at least lower-pollution cars – the emphasis should be on the VED paid when registering a vehicle for the first time. The Treasury has issued a call for evidence regarding a 'granular' system that would do away with bands and instead calculate VED based on the exact level of emissions: providing an incentive for every little improvement.[134] Such a system might also mean considerably higher taxes on the most polluting cars, which would bring the UK closer into line with countries like Norway, the Netherlands and France.[135]

There are many ways such a tax could be designed. But in Figure 33 we show an illustrative policy that (arbitrarily) taxes emissions at: £1 per gram (of CO2/km) plus £25 for every gram over 100g plus £45 for every gram over 150g (and these are additive). Relative to the existing system, that would mean typical tax rises of over £1,000 for cars in the top five bands currently, although these bands only account for around a fifth of car registrations. Given that the UK is rightly banning the sale of all new petrol and diesel cars, large tax rises for the most polluting new vehicles in advance of that seems reasonable; and a policy such as this could easily raise £1 billion a year.[136]

133 The Times, Manufacturers may be forced to sell electric cars in drive towards zero emissions, October 2020.
134 HM Treasury, Vehicle Excise Duty: call for evidence, March 2020.
135 S Wappelhorst, P Mock & Z Yang, Using vehicle taxation policy to lower transport emissions: An overview for passenger cars in Europe, ICCT, December 2018.
136 Our modelling in fact suggests £2 billion based on 2019 registrations, but there are good reasons to think car sales will green over the next few years, and that this policy change would (deliberately) produce a large behavioural response.

FIGURE 33: **In advance of banning the sale of petrol and diesel cars, high taxes could be levied on the most polluting models**

Current and illustrative VED, and new car registrations by emissions band



NOTES: For the illustrative new system, which would not use bands, figures are based on band averages.
SOURCE: RF analysis using DfT Vehicle Licensing Statistics.

There are other ways more money could be raised from VED, which currently raises around £8 billion a year.[137] Rates could simply be increased within the existing band structure; rates beyond the first year could be relinked to emissions, as the call for evidence suggests; and rates for motorbikes could now be linked to emissions (rather than engine capacity), also discussed in the call for evidence. The odd VED exemption for cars that are more than 40 years old (which costs £100 million a year) should also be revisited. At the very least, the exemption could be frozen at its current extent, i.e. cars from 1980 or earlier.

Of course, many of these options would not raise revenue in the long-run, as the sale of petrol and diesel cars will end. But VED can play a role in limiting the deficit in the 2020s while encouraging the transition to greener vehicles. The Treasury should also consider that the more this encouragement is delivered via tax rises (for more polluting vehicles), the less will need to be done via tax cuts and grants (for cleaner vehicles and charge points).

Policy recommendation: reform VED (based on unbanded emissions) to strongly discourage the purchase of new high-pollution cars and motorbikes (raising £1 billion)

137 Note that this has been ringfenced for road investment in recent years.

For the longer-term, road pricing is needed, and in the short-term this can be used to tax the big winners of the coronavirus crisis

While Fuel Duty and VED should work to hasten the decarbonisation of road transport, they would also be victims of any such success. By 2050 at the latest, it is likely that greenhouse gas emissions from cars would need to be zero, and thus Fuel Duty and VED revenue would also be zero. As noted above, these two taxes are expected to raise £38 billion in 2024-25: around 1.5 per cent of GDP, and 4 per cent of total receipts. Replacing this revenue with higher Income Tax, for example, would require a 5p increase in every Income Tax rate. Or, all of the tax rises proposed in this paper might be needed simply to replace the loss of these revenue sources, in the absence of policy change.

Given the expected commitment to end the sale of new fossil fuel cars from around 2030, it is time for the UK to start thinking seriously about this fiscal challenge. It would be possible to change VED so that it is paid by electric vehicles, or perhaps increase taxes on the electricity used to charge them. But it would be better to specifically tax the externalities that are produced by all car use, regardless of how they are powered. This predominantly means congestion, but also any remaining particulate pollution (from tyres), noise pollution, accidents, and the requirement for road construction and maintenance.

There are many examples of road pricing in the world, including London's Congestion Charge. Ideally, road pricing would be more fine-grained than this and would charge road users based on their precise location, the day and time, and the size (and perhaps weight) of the vehicle. This may require a primarily GPS-based approach, as opposed to the barriers or number plate recognition often used on toll roads and in congestion zones. Ideally, road pricing would use as little physical infrastructure as possible (some infrastructure – or policing – may be needed for enforcement) and instead build on the now-prevalent digital infrastructure, in which apps often already track the exact location of vehicles. The growth of mileage-based insurance fees also provides some real-world experience.

A national road pricing system will take time to design, and there are a myriad of practical and political issues to be debated (such as the privacy implications). But, a specific form of road pricing should be implemented in the shorter-term, for a broader set of reasons. Online shopping and home deliveries have ballooned during this crisis, with many of the relevant firms being among the big winners from the coronavirus crisis. There are many proposals for higher taxes on such firms, but a sensible approach would be to focus on the home delivery process itself, given concerns about congestion,[138] air pollution and CO2 emissions. A small 'Home Delivery Congestion Charge' – averaging perhaps as low

138 G Topham, How London got rid of private cars – and grew more congested than ever, The Guardian, February 2020.

as 3p per delivery – could begin to alleviate these concerns. (To further encourage the greening of delivery fleets, electric vehicles could also be excluded from this for the short-term.)

Policy recommendation: introduce a GPS-based Home Delivery Congestion Charge for delivery vehicles (raising £100 million)

Such a levy for delivery vehicles could eventually be built out into a broader road pricing system: in effect piloting what will become necessary for all vehicles in coming years.

Environmental taxation therefore provides some opportunity for extra revenue, but will not be a major part of a tax-led consolidation

Although there is potential for environmental taxes to raise additional revenue, digging into the details shows that that potential is lower than might first be expected, with our specific proposals raising around £1 billion a year overall in the short-term. Some parts of the economy that might warrant explicit carbon pricing already face related taxes (such as the Climate Change Levy and Fuel Duty). And where there is a strong case for new taxes to be levied to increase prices and drive behavioural change – most notably, domestic fuel use – there is also a strong case for recycling that revenue. There are also strong political pressures, with one of the unavoidable central questions being simply how high and how rapidly policymakers are willing to raise the cost of oil for cars and fossil fuels for homes. And carbon pricing is not always the right answer, with the UK rightly also opting for strong regulation (and incentives) in many cases. Finally, some existing environmental taxes pose substantial fiscal risks. To deliver very substantial (and more permanent) revenue increases then, we must turn to other parts of the tax system.

Section 8

The ‘easy’ options: freezing tax thresholds and raising Corporation Tax

No tax rises are politically easy, but some are much easier than others. For permanent deficit reduction on the scale that is likely to be necessary after this crisis, the Government should look at two options that are politically relatively easy and also straightforward to implement (and stop or reverse as needed): freezing tax thresholds and raising Corporation Tax (CT).

The official fiscal forecasts assume that some tax thresholds go up in line with inflation each year. For the Treasury then, simply keeping tax thresholds unchanged is a way to improve the fiscal outlook without generating uproar. In the case of National Insurance (NI), £2 billion could be raised by freezing the starting point for employer NI at around £8,800 a year until 2024-25; and a further £2 billion by freezing the personal threshold at £9,500. In the case of the former though, this would mean increasing taxes on employment, which would not be advisable in the short-term. And in the case of the latter, the Conservative manifesto expressed an “ultimate ambition” to raise this threshold to £12,500. We recommend that this ambition go unfulfilled in this parliament – as it would cost an additional £7 billion – but it means that a freeze in this threshold might not be the Government’s preferred choice.

Substantial sums should be raised from Income Tax (IT) threshold freezes, however. The personal allowance has been £12,500 for the last two years. Keeping it at this level would raise £5 billion a year by 2024-25, and still leave the personal allowance 50 per cent higher than if there had simply been consistent inflationary uprating since 2010-11. Meanwhile, the higher-rate threshold for IT has been £50,000 for the last two years, where it is helpfully aligned with the withdrawal point for child benefit. Keeping it at this level would raise £1 billion a year by 2024-25.

Many other thresholds in the tax system (such as the £100,000 and £150,000 IT thresholds) are already frozen by default. However, significant revenue could also be raised by freezing Inheritance Tax thresholds – which together now allow £1 million

to be inherited tax-free (raising £400 million by 2024-25); and from the £85,000 VAT threshold, which is already frozen next year (but continuing beyond 2021-22 could raise £200 million in 2024-25). Any of these freezes could be continued beyond 2024-25, or be discontinued earlier, depending on fiscal circumstances, and this flexibility is a key benefit of this approach.

The other relatively politically easy option is to raise the CT rate: it is not a tax rate that most voters directly encounter; businesses are less focused on the headline rate of CT than some politicians; and the UK's rate of 19 per cent is low by international and historical standards, giving headroom for a rise. Raising the rate to 22 per cent would raise £10 billion a year from profitable companies, while keeping in place two thirds of the 9 percentage point rate cut since 2010-11.

Given that raising taxes will be difficult, options with relatively high political deliverability should be grasped

As we showed in Sections 6 and 7, crisis-specific and environmental tax options will not raise significant long-term revenue. The following sections will look at tax proposals that would improve the tax system and raise revenue fairly, but are not without political challenges. But there are two sets of policies that should be particularly high on the Treasury's shortlist due to the combination of their relative political ease, extremely simple implementation and ability to make large inroads into the required £40 billion consolidation: freezing tax thresholds and raising the headline rate of CT.

We judge freezes to tax thresholds to be relatively politically easy because most people would not consider a tax threshold remaining unchanged to be a tax rise. However, if nominal incomes are rising but tax thresholds are unchanged, then this would imply a rise in effective tax rates (known as 'fiscal drag'). Because of this, some tax thresholds are assumed to rise in line with inflation each year – and indeed in some cases there are legal requirements for this to happen[139] – and the OBR includes such assumptions in its fiscal forecasts.[140] From the perspective of the Treasury and OBR, then, the government can 'raise' revenue by freezing certain tax thresholds. But from a layperson's perspective, not increasing a tax threshold is harder to portray as a scandalous tax rise than the increasing of tax rates, for example.

139 See Annex A (Indexation in the public finance forecast baseline) in HM Treasury, Budget 2020: policy costings, March 2020.
140 Indeed, beyond the five-year detailed forecasting period, the OBR assumes tax thresholds and benefits rise in line with average earnings.

In the case of National Insurance thresholds, the first priority is avoiding long-term tax cuts

We begin by considering the National Insurance (NI) thresholds, as this is an area where the 2019 Conservative manifesto has something specific to say. The most relevant thresholds here are the starting points for employer NI, employee NI, and self-employed NI.

Employer NI (with a flat tax rate of 13.8 per cent) currently kicks in at pay of around £8,800 a year. By default, this threshold increases in line with CPI inflation each year, and might reach around £9,300 by 2024-25. Freezing the threshold for four years instead might raise around £2 billion. However, in the current circumstances we do not think that employer NI should be increased in any way (in this case by around £70 a year per employee), given that this is more likely than other tax changes to impact on employment in the short-term.[141]

For employees and the self-employed, NI begins at £9,500. This 2020-21 level represents a significant increase on the year before (as shown in Figure 34) – as the Conservative manifesto promised such an increase and professed an "ambition" to raise the threshold to £12,500, to match the current level of the Income Tax (IT) personal allowance (£12,500), with the manifesto saying "our ultimate ambition is to ensure that the first £12,500 you earn is completely free of tax".

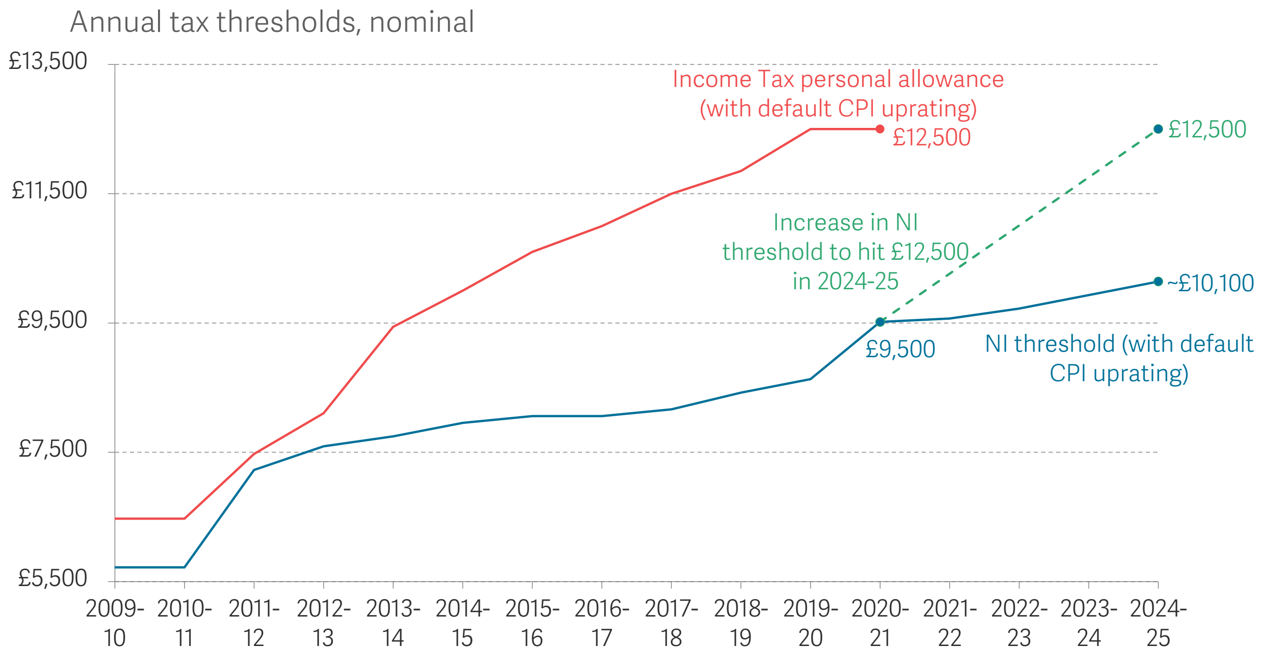
As Figure 34 shows, the default approach of inflation-uprating is projected to take the personal NI threshold only up to around £10,000 by 2024-25. Increasing the threshold to £12,500 by the end of this parliament – a tax cut of roughly £300 per employee – would therefore be very expensive: costing around £7 billion in 2024-25.

It almost goes without saying, then, that this "ultimate ambition" should be shelved for now. Indeed, in retrospect (at least), one strange element of the 2010s was that there were very large tax cuts at a time when the government was attempting to engineer a consolidation of the public finances: most notably, increases in the IT threshold; Fuel Duty freezes; and CT rate cuts. Unless there is a very good case for doing so, the Government should avoid making its fiscal job even harder by implementing permanent tax cuts.

141 There is a strong argument that in the long-run such taxes are incident on wages, with no theoretical difference between employer-based and employee-based taxes; but we should care about the short-run distinction. This is particularly true when overall nominal wage growth is expected to be weak, and when the minimum wage is being increased. As will be discussed in Section 10, we also care about reducing the tax differential between employee income and other forms of income: the prime cause of which is employer NI.

FIGURE 34: **The Conservative manifesto aspired to raise the NI threshold to £12,500, but that idea should be shelved for this parliament**

Annual tax thresholds, nominal



NOTES: All figures beyond 2020-21 are projections or scenarios.
SOURCE: RF analysis.

That said, the Government's "ambition" may mean that it would rather avoid freezing the personal NI threshold (even though doing so would raise around £2 billion); and it might see annual inflationary uprating – taking the threshold to around £10,000 by 2024-25 – as steps on the way to an eventual £12,500 threshold.

Policy recommendation: Do not try to deliver a £12,500 NI threshold in this parliament (raising zero, relative to the existing fiscal outlook)

Freezing Income Tax thresholds would be a significant down payment

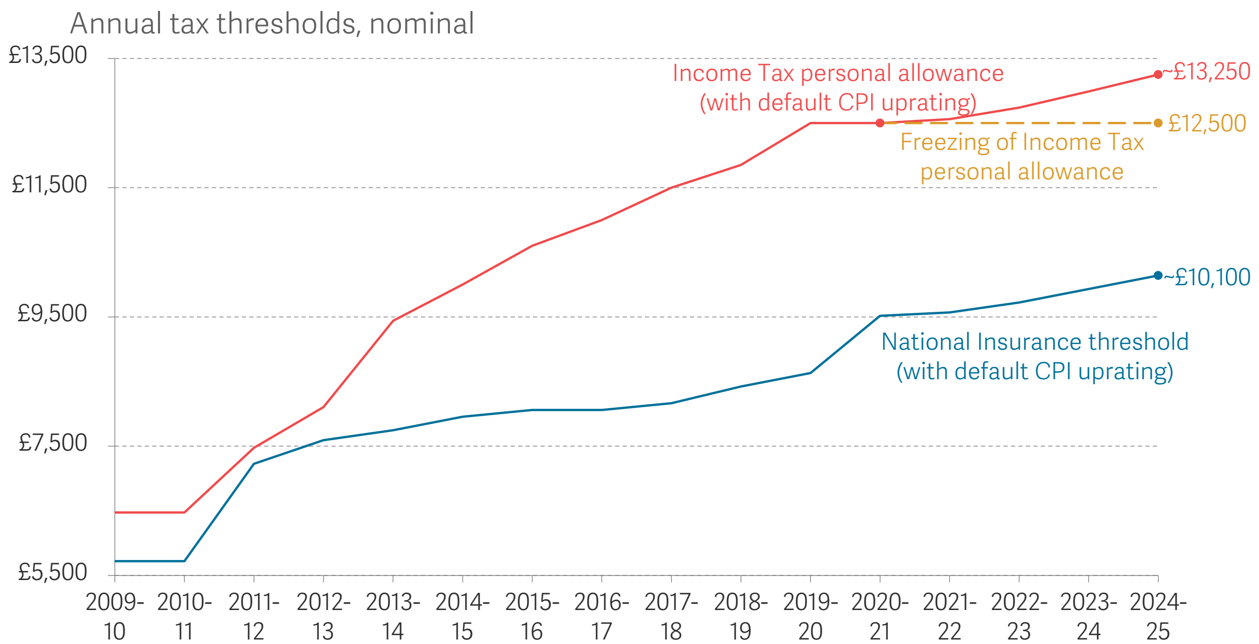
While the Conservative manifesto might make it slightly awkward to freeze NI thresholds, that is not true of IT thresholds. And, as the UK's most significant tax, changes in IT policy can raise substantial sums.

As indicated above, the starting point – or personal allowance – for IT is £12,500 in 2020-21. This is unchanged from the year before, but this followed rapid increases over the preceding nine years: with a total (nominal) rise of over £6,000 (or 93 per cent) since 2010-11, as can be seen in Figure 35. One consequence of this rise was to increase the gap between the starting point for NI and that of IT.

As with NI, the assumption used in the fiscal forecasts is that the personal allowance rises in line with CPI inflation each year. Based on current inflation forecasts, that suggests a personal allowance of around £13,250 by 2024-25. But given the manifesto ambition to eventually raise the NI threshold to £12,500 and "ensure that the first £12,500 you earn is completely free of tax", the Government could reasonably argue that maintaining the IT threshold at £12,500 is very much in keeping with this goal, and doing so would allow the NI threshold to close the gap with its IT equivalent.[142] Moreover, even with a four-year freeze, the personal allowance would still be £4,000 (and almost 50 per cent) higher than if there had been consistent CPI-uprating – rather than large tax cuts – since 2010-11.

FIGURE 35: **Keeping the Income Tax allowance at £12,500 would help the National Insurance threshold catch up**

Annual tax thresholds, nominal



NOTES: All figures beyond 2020-21 are projections or scenarios.
SOURCE: RF analysis.

The case is equally strong for maintaining the higher-rate threshold at £50,000 – its 2020-21 and 2019-20 level.[143],[144] Indeed, it might seem unfair to continue to freeze the threshold for basic-rate tax but not that for higher-rate tax, particularly given that higher earners' incomes have been relatively unaffected by the coronavirus crisis.[145]

142 Note that the marriage tax allowance is set at 10 per cent of the personal allowance: i.e. currently £1,250. Freezing the latter would mean freezing the former. The existence of the marriage tax allowance is discussed further in Section 10.
143 This threshold is devolved to Scotland, where it is currently £43,430.
144 The IT higher rate threshold is technically separate from the higher NI threshold (the upper earnings limit / upper profit limit). But they have been aligned (at least outside Scotland) since 2009. So we assume they remain so. This means extra forecast IT from a higher rate threshold freeze is partially offset by lower NI.
145 M Brewer & L Gardiner, Return to spender: Findings on family incomes and spending from the Resolution Foundation's coronavirus survey, Resolution Foundation, June 2020.

Keeping this threshold at £50,000 – rather than £50,000 and a bit (if uprated) – has some small advantages in complementing other thresholds in the tax system. The additional rate of IT kicks in at £150,000 (not linked to inflation), and the personal allowance is withdrawn once incomes reach £100,000 (ditto). What's more, Child Benefit begins to be withdrawn at a non-inflation-indexed threshold of £50,000 (via the High Income Child Benefit Charge); meaning that raising the higher rate threshold above that point would mean partially removing Child Benefit from some basic-rate taxpayers, which might be politically controversial.

Freezing the personal allowance and higher-rate threshold can raise significant sums. If their current levels were maintained for a further four years, that would raise an estimated £6.1 billion in 2024-25: £5.1 billion from the personal allowance, and £1 billion from the higher-rate threshold. As Figure 36 shows, the revenue would, of course, build up over time. This is an advantage of a consolidation via threshold freezes: they have a gradual roll-out rather than rapid introduction, and they can be continued or discontinued depending on future fiscal circumstances. As Figure 36 also shows, if such freezes were to continue into the next parliament, the revenue total could rise to £11 billion by 2026-27.

It should be noted that maintaining the thresholds at £12,500 and £50,000 would mean gross tax increases not just by the end of the parliament but also in 2021-22, relative to the current fiscal forecast. Indeed, to be implemented in time for the start of the next financial year, the thresholds will likely need to be announced in late 2020 or very early 2021.[146] As discussed in Section 3, April 2021 is certainly not the time to implement overall tax rises. But there are four reasons why continued threshold freezes might be justifiable.

First, the scale of the tax rise in 2021-22 would be minimal. These tax thresholds are by default increased in line with September CPI inflation, which was 0.5 per cent. Cancelling the personal allowance rise would mean a £12 tax rise over the whole year.[147] In 2021-22, a freeze of both thresholds would save (only) around £400 million. Second, while the overall stance of fiscal policy should still be expansionary, there is scope for tax rises within that. That £400 million raised by freezing the thresholds could – and should – easily be redirected towards temporary stimulus (or indeed to help avoid the currently scheduled benefit cuts)[148]. Third, as set out above, there are good reasons to keep these tax thresholds at £12,500 and £50,000 specifically. If the thresholds are allowed to diverge from these figures, it may be politically harder to later implement a new freeze. And

146 For comparison, the increase in the NI threshold in April 2020 was laid before parliament in January 2020 – relatively late, but ahead of the March Budget.

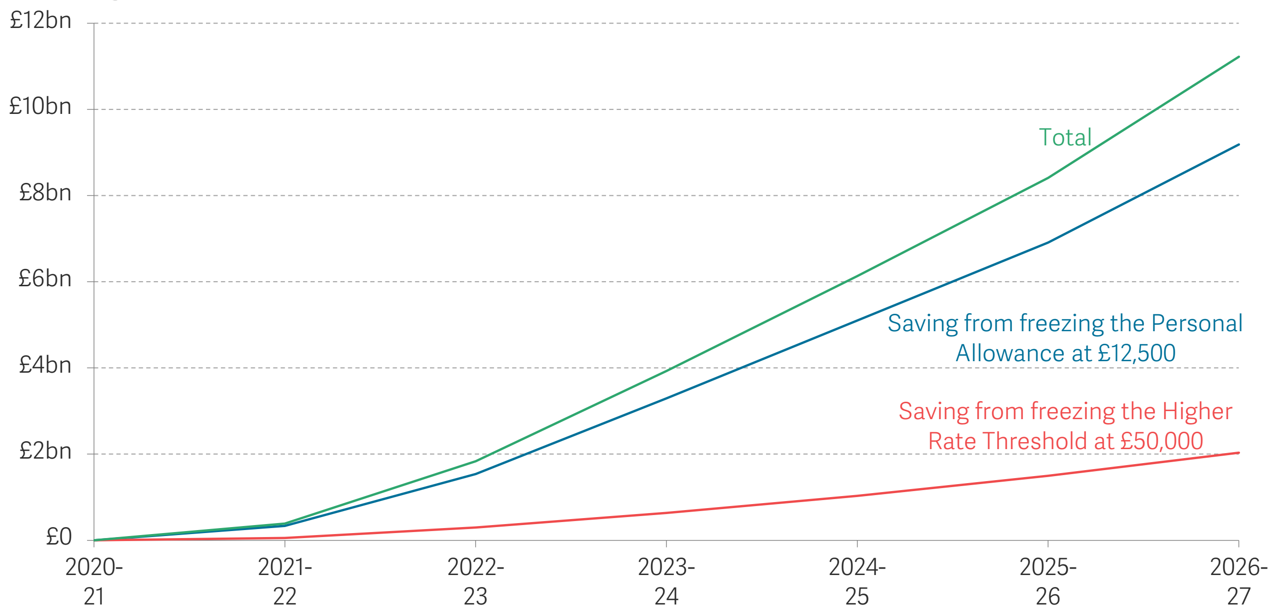
147 For those on Universal Credit, any gain from direct tax cuts is reduced by means-testing: which would reduce this number to £4.40 (a year).

148 T Bell, A Corlett & K Handscomb, Death by £1000 cuts? The history, economics and politics of cutting benefits for millions of households next April, Resolution Foundation, October 2020.

fourth, the length of the freeze determines how much it will raise in future, so delaying the beginning of a freeze means delaying the point at which a given annual yield is realised (which is not the case for many other tax policies).

FIGURE 36: **Freezing Income Tax thresholds would raise more and more over time, with a total of £6 billion in 2024-25**

Nominal in-year revenue increases from sustained Income Tax threshold freezes (if begun in 2021-22)



NOTES: Projections beyond 2024-25 come with extra uncertainty as they are beyond the current OBR forecasting period.
SOURCE: RF analysis of DWP, Family Resources Survey, using the IPPR tax-benefit model.

Announcing, then, that these thresholds will remain at their current levels for the next four years would be a good way to take a meaningful chunk out of the consolidation challenge. It would show some fiscal resolve and reduce the scale of tax rises needed elsewhere. And it would likely do so without too much uproar.

Policy recommendation: Keep the personal allowance frozen at £12,500 and the higher-rate threshold at £50,000, for at least four more years (raising £6.1 billion),[149] so long as fiscal policy provides a net stimulus in the short-term

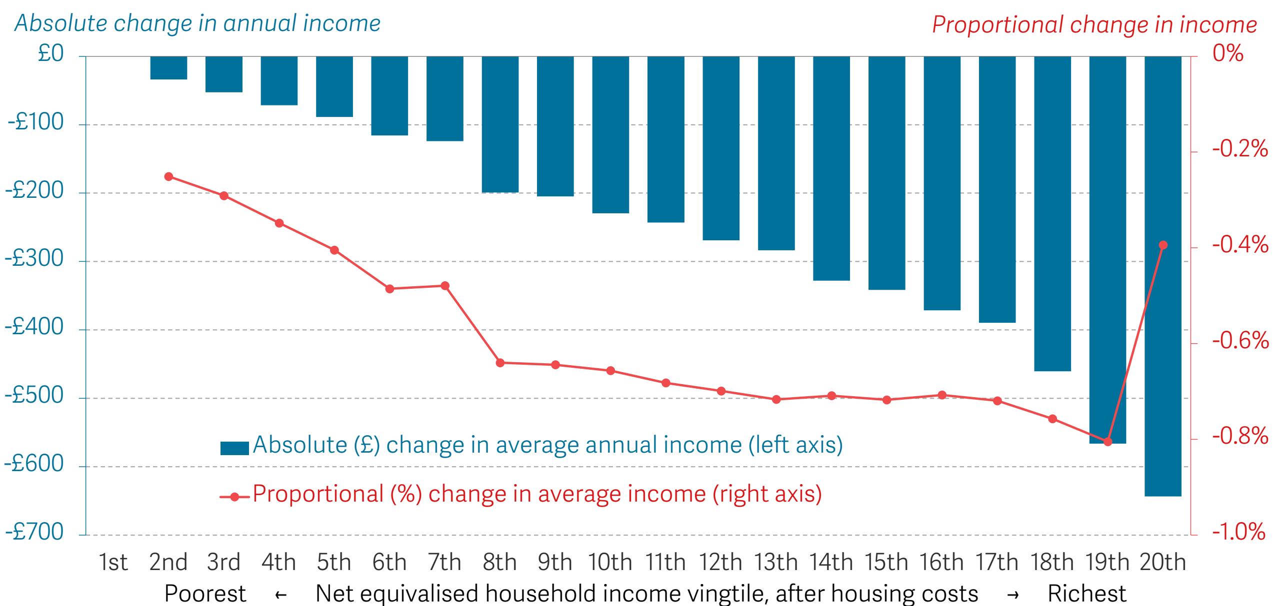
The household-level distributional impacts of such a freeze are shown in Figure 37. The average household income in 2024-25 would be reduced by around £250; though a single basic-rate taxpayer would lose only around £150. Average cash losses would be largest for the highest income households, and proportional losses would rise progressively with income, other than in the top 5 per cent, both because their incomes are so high (while

149 All costings for our policy recommendations are for 2024-25 specifically, unless stated otherwise.

the maximum cash loss is limited) and because those with incomes above £125,000 do not get a personal allowance and so would be unaffected by that freeze (Section 11 shows the combined distributional impact of more of the tax policies proposed in this report).

FIGURE 37: **Freezing Income Tax thresholds would be progressive overall, with the exception of the top 5 per cent**

Impact on average household income by vingtile of freezing Income Tax thresholds for four years, 2024-25



Notes: We exclude the bottom 5 per cent, due to concerns about the reliability of data for this group.
Source: RF analysis of DWP, Family Resources Survey, using the IPPR tax-benefit model.

The Inheritance Tax threshold should be kept at £1 million

Many thresholds in the tax system do not rise in line with inflation (or anything else) by default.[150] Keeping these unchanged would therefore not 'raise' any revenue compared with the OBR's baseline. This includes the £100,000 and £150,000 IT thresholds discussed above, and many minor tax allowances. But there are a few more notable thresholds that can be frozen. (We will explore the Capital Gains Tax allowance, and touch on the pensions lifetime allowance and ISA annual contribution limit, in Section 9.)

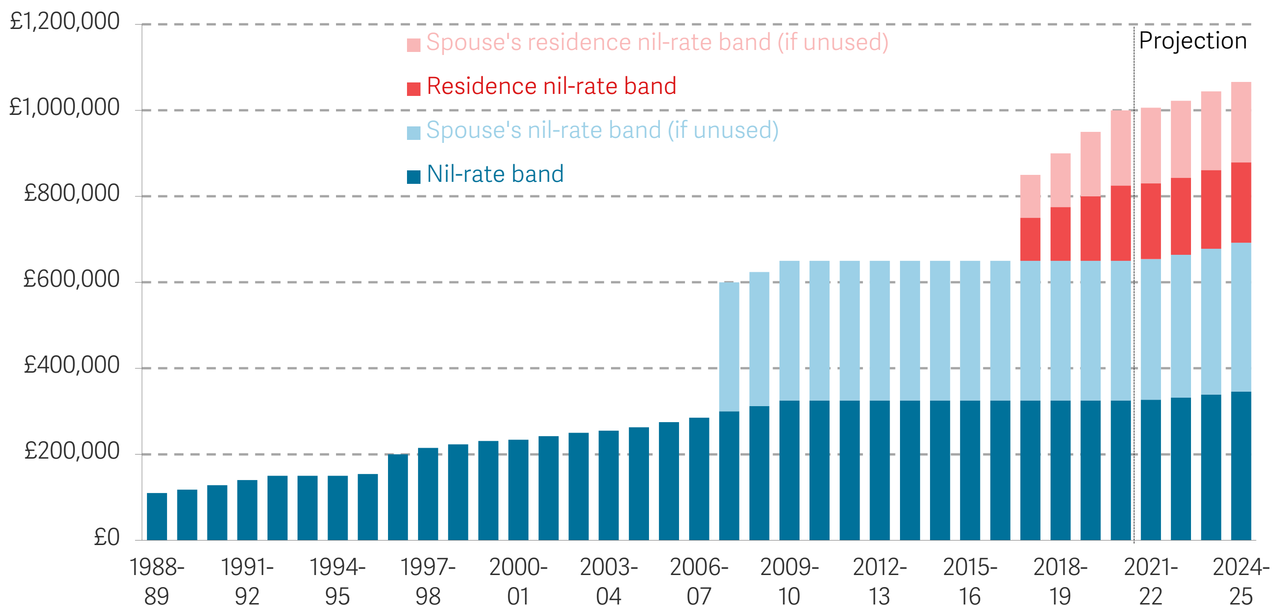
By default, Inheritance Tax (IHT) thresholds rise in line with CPI inflation each year. For the last 11 years, however, the 'nil-rate band' has been frozen at £325,000. This is the amount that can be passed on tax-free, and spouses can transfer any unused allowance at death, allowing £650,000 to be passed on tax-free. On the other hand, a separate 'residence

150 See Annex A (Indexation in the public finance forecast baseline) in HM Treasury, Budget 2020: policy costings, March 2020.

nil-rate band' – specifically for main residences – has been gradually introduced over the past four years, as Figure 38 shows. This has taken the total amount of wealth that can be bequeathed tax-free to £1 million.

FIGURE 38: **In 2020-21, £1 million can be inherited tax-free**

Inheritance Tax thresholds, nominal



NOTES: All figures beyond 2020-21 are projections.
SOURCE: RF analysis.

Inflationary uprating might take this total threshold to around £1.07 million by 2024-25. But a £1 million tax threshold for inherited wealth is more than generous enough, given that for many people this is equivalent to an entire lifetime's earnings.[151] For further comparison, the median household net wealth is around £290,000.[152]

As discussed in Section 5, the argument for progressive tax rises is not just a normative one, but also a macroeconomic argument. In this case, raising more revenue from large transfers of wealth seems particularly unlikely to impact on short-term aggregate demand. That is, someone receiving an inheritance of over £1 million would have been unlikely to spend that income in the next few years anyway, so a marginal tax rise – even in April 2021 – would not present a meaningful drag on aggregate spending.

In Section 9, we explore the case for removing unnecessary distortions in the IHT system, including replacing it entirely. But maintaining a £1 million threshold seems a reasonable first step, and a fair way to raise revenue.

151 A Corlett, Passing on: options for reforming inheritance taxation, Resolution Foundation, May 2018.
152 ONS, Total wealth in Great Britain: April 2016 to March 2018, December 2019.

Policy recommendation: Freeze Inheritance Tax thresholds for at least four years (raising £400 million)

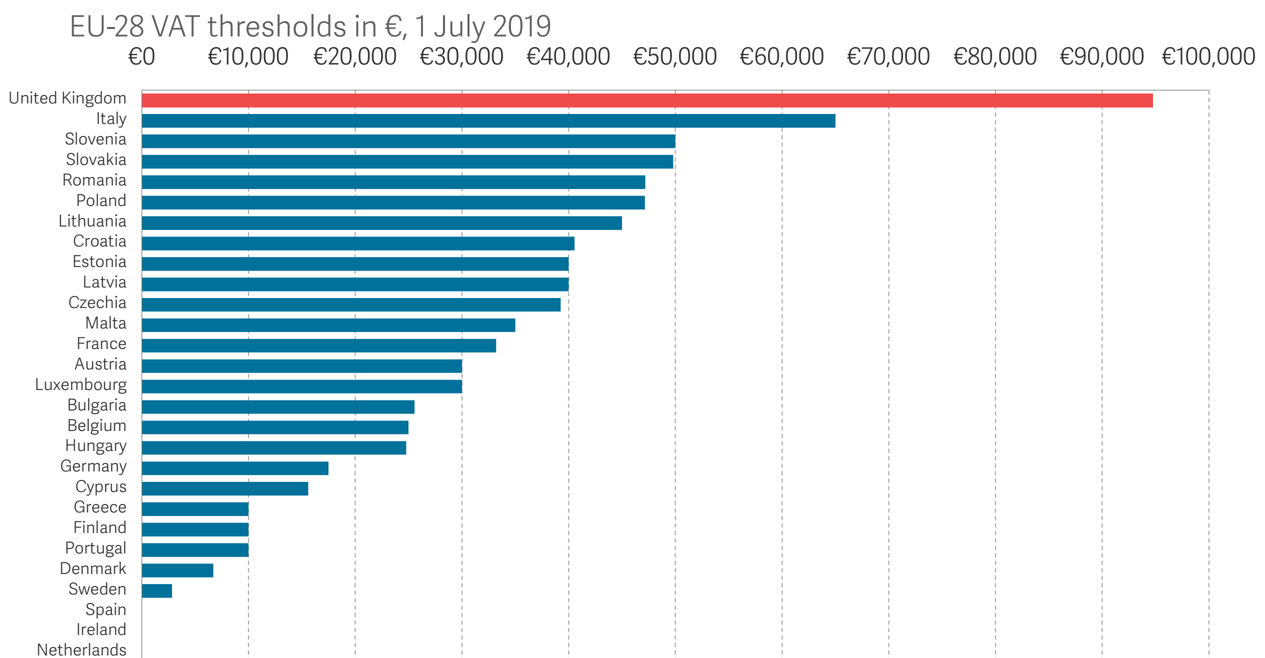
And the VAT threshold should be frozen again

Another notable threshold that could be frozen is the VAT threshold. This is a level of annual turnover beyond which businesses or charities must register for VAT: they must then charge customers any relevant VAT, but also reclaim any VAT on inputs. The Government has already frozen this threshold at £85,000 until 2021-22, and continuing this freeze would raise additional revenue.

As Figure 39 shows, this threshold (equating to around €95,000 in 2019) is very high by international standards, at over three times the EU average (and above a planned EU maximum of €85,000). The UK threshold is in fact the highest in the OECD.[153]

FIGURE 39: **The UK has a considerably higher VAT threshold than any EU country**

EU-28 VAT thresholds in €, 1 July 2019



NOTES: Based on Euro foreign exchange rates as published by the European Central Bank for 1 July 2019.
SOURCE: European Commission.

As the Office of Tax Simplification (OTS) has noted, such a high threshold does reduce the number of businesses that need to register for VAT, although some may voluntarily register in order to reclaim VAT on inputs. But the OTS also stresses that "there is clear evidence [...] that the high level of the threshold is having a distortionary impact on

153 Office of Tax Simplification, Value added tax: routes to simplification, November 2017.

business growth and activity", with businesses – either legally or illegally – keeping their reported turnover just below the threshold. It also means that business models such as those of taxi-cab operators, where each driver can be a separate entity for VAT purposes, are favoured over a corporate structure with employees.

There is therefore a strong case for significantly reducing the VAT threshold. Roughly halving the threshold could raise £1-1.5 billion.[154] There may also be options to 'smooth' the financial and administrative impact of becoming VAT-registered – potentially while raising revenue too.[155]

In 2018, the Government considered this issue but decided to implement a further freeze rather than a cut. So, given the considerable new disruption of coronavirus and Brexit, this may not be the time for a large reduction in the threshold: a continuation of the freeze is certainly a politically easier option, though it might make sense to explicitly remove inflationary uprating permanently.

Maintaining the threshold at £85,000 for another three years beyond 2021-22 would raise around £200 million by 2024-25,[156] and more in the long run if maintained further.

Policy recommendation: Continue the VAT threshold freeze for at least another three years after 2021-22 (raising £200 million)

The Corporation Tax rate should be increased

Like threshold freezes, the CT rate should also be considered as a revenue-raising lever because of the relative political ease with which it can be changed. CT ultimately affects household incomes in a complicated way through eventual impacts on wages, prices or investment returns (although we can assume the overall impact is progressive), but most voters will neither know nor strongly care about the particular rate of CT.[157] For demonstration, the Conservative manifesto promised not to raise the rates of IT, NI or VAT (as will be explored further in Section 10), but did not include CT in this promise, and instead used the cancellation of a CT rate cut as a revenue raiser. Business leaders also focus less on the headline rate of CT than some politicians of both main parties have historically done, instead focusing on their overall tax bills.

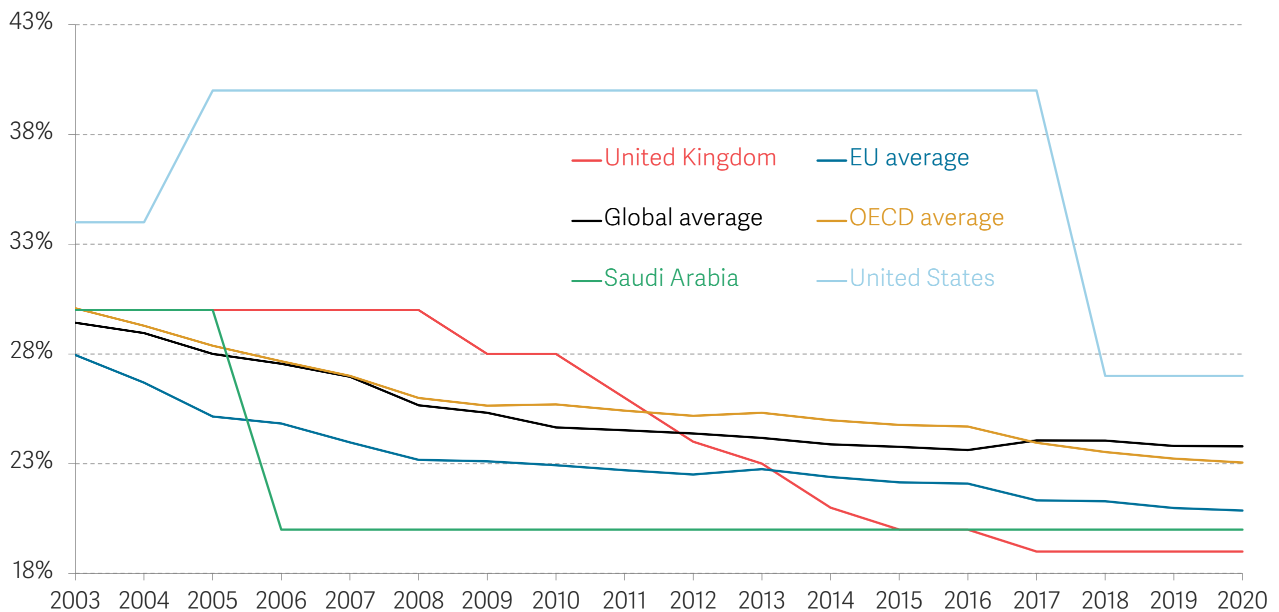
The potential for a CT rise has also been made easier by the pre-coronavirus trend of successive falls in the CT rate. The UK's headline rate of CT has fallen from 28 per cent to

154 Office of Tax Simplification, Value added tax: routes to simplification, November 2017.
155 Office of Tax Simplification, Value added tax: routes to simplification, November 2017.
156 The 2017 measure to freeze the threshold in 2018-19 and 2019-20 was forecast to raise £170 million a year (HM Treasury, Autumn Budget 2017: policy costings, November 2017). The 2018 measure to freeze the threshold in 2020-21 and 2021-22 was forecast to raise £150 million a year (HM Treasury, Budget 2018: policy costings, October 2018). Very crudely, then, a three-year freeze might (conservatively) be expected to raise around £225 million a year.
157 See, for example, support for a 25 per cent CT rate in: The Independent, Brits in favour of higher income tax on country's wealthiest, poll finds, March 2017.

19 per cent since 2010, as Figure 40 shows. It also shows that the UK now has a headline CT rate notably below the global, OECD or EU averages. Indeed, OECD statistics for 2019 show that the UK had the joint fourth-lowest headline CT rate in the OECD: only Hungary, Ireland and Lithuania have lower rates.[158] We should also note that many other countries will be in a similar position to the UK in seeking to raise taxes in years to come,[159] perhaps providing even more space for the UK to move.

FIGURE 40: **In the past decade the UK's Corporation Tax rate has fallen from above the OECD average to one of the lowest in the OECD**

Headline corporation tax rates, selected countries and groups of countries



Every 1p increase in the UK CT rate, from its current level of 19 per cent, would raise an estimated £3 billion a year (after making an allowance for any behavioural effects).[160] Although there is something to be said for the symmetry of having the basic rate of IT, the standard VAT rate, and the CT rate at 20 per cent; given the current fiscal outlook we recommend a rate of 22 per cent. This would keep the CT rate lower than it was in 2013-14 and earlier years, and would keep in place two thirds of the rate reduction since 2010-11. For comparison, there has been reported speculation of a return to a 24 per cent rate,[161] while the last Labour manifesto proposed a 26 per cent main rate.[162]

Policy recommendation: increase the headline rate of Corporation Tax from 19 per cent to 22 per cent (raising £10 billion)

158 OECD.Stat, Table II.1. Statutory corporate income tax rate.
159 President-Elect Biden, for example, proposed to raise the US federal CT rate by 7 percentage points.
160 HMRC, Direct effects of illustrative tax changes, May 2020.
161 Reuters, UK's Sunak considers sweeping tax hikes to plug COVID-19 hole, newspapers say, August 2020.
162 Labour Party manifesto 2019.

A higher rate of CT would also (along with other policies in this paper, and ongoing changes to 'IR35' rules) reduce the ability for some workers to pay less tax by setting up personal service companies, which has been a growing and expensive problem for the Treasury.[163]

There are arguments that a slightly higher CT rate would reduce investment, both within and into the UK. But the role of marginal tax rates in determining investment levels is often overstated, with other factors such as certainty about demand and policy considerably more important. And even within the tax system, the opportunity cost of keeping the headline CT rate low must be compared to other possibilities, such as increasing investment allowances or reforming Business Rates.[164] Indeed, capital allowances for CT are relatively ungenerous in the UK, pushing up effective CT rates and showing that marginal rates are far from the only important consideration.[165]

These policies could together raise around £17 billion a year – and this should be considered 'low-hanging fruit'

Together, the policy recommendations in this section would raise a significant £17 billion a year by 2024-25, with further sums possible if threshold freezes were continued beyond 2024-25 or if any NI thresholds were frozen too.

Given the difficult political economy of tax rises, this is a sensible starting point for reducing the deficit by tens of billions. In the case of the personal allowance and CT rate, these tax rises could simply be presented as reversing a fraction of the tax cuts implemented in the 2010s, which seems particularly reasonable given the change in circumstances. And all of the thresholds we have discussed (with the exception of the residential nil-rate band, which was being phased in) were already frozen in 2020-21, demonstrating the political plausibility of such freezes. This is not to say that such tax rises do not have an impact on household incomes, nor that they would be politically pain-free. But to not pick these relatively low-hanging fruit would make the job of raising revenue significantly harder.

Beyond the question of deficit reduction, however, it is not immediately obvious whether, for example, an IT allowance of £12,500 is 'better' in terms of tax design than one of £13,250 (though there is something to be said for memorable round numbers); or that a CT rate of 22 per cent is fundamentally more equitable than a 19 per cent rate. But in the next section we turn to reforms that do aim to really improve the tax system at the same time as raising new revenue: reforms that reduce unwanted behavioural distortions and arbitrary inequities.

163 A Corlett, The shifting shape of UK tax, Resolution Foundation, November 2019.
164 See, for example, proposals in: S Bowman & S Westlake, Reviving Economic Thinking on the Right, September 2019; CPS, A Framework for the Future: Reforming the UK Tax System, October 2020.
165 H Miller, What's been happening to corporation tax?, IFS, May 2017.

Section 9

Reforming wealth taxes

One of the major challenges facing the UK tax system is that it has not kept pace with changes in the overall amount and distribution of wealth. Indeed, over the past four decades, the total amount of wealth in Britain has growth from three times national income to over seven times, whereas wealth-related tax revenues have stayed roughly constant as a share of GDP. So we propose a package of reforms in this area, including specific tax reforms that can contribute to consolidation in the short-term by reducing loop holes and distortions, as well as longer-term changes that are desirable in their own right and could be called upon if the scale of necessary consolidation increases.

The short-term package is made up of five elements. First, a reform of Capital Gains Tax (CGT) and taxes on other forms of income, to raise revenue while improving fairness and work towards parity of tax treatment between different forms of income. Here we propose two initial measures: abolishing Business Asset Disposal (BAD) relief, and ending the step-up in basis of capital gains upon death, which can incentivise people not to sell or pass on assets before they die. Second, changes to the tax reliefs on income from savings and investments, including merging several tax-free allowances (including returns from ISAs) and the abolition of the Lifetime ISA. Third, a reform of pension tax-free lump-sum allowances, both during the lifetime and at death, that are both highly expensive and highly regressive. Fourth, some reforms to Inheritance Tax (IHT). And fifth, a Council Tax Supplement for high-value properties that partly fixes the regressivity of current local property taxes. Collectively these measures would raise £9 billion.

Looking further ahead, we discuss reform in a number of key areas that could be brought in if the consolidation needs to be larger. IHT could be replaced with a tax that is paid by recipients rather than donors – to address concerns about its high rate, ease of avoidance and the perception it 'taxes giving'. Property taxes in the UK – notably Council Tax and Stamp Duty Land Tax – are ripe for reform: the former is highly regressive and outdated, while the latter reduces the volume of otherwise-desirable

property transactions. But in the short-term we make one firm proposal here, for a new Council Tax Supplement of 1 per cent on the value of properties above £2 million that could raise £1.4 billion in 2024-25. Lastly, we look beyond the parameters of the existing wealth tax system towards a new idea that has rapidly gained traction in policy debates in many countries: taxes on the ownership of net wealth.

Taxes related to wealth have particular room for improvement in the UK

The case for reform of the UK's wealth-related taxes – those for which tax liability is assessed in relation to people's ownership of, or income from, wealth – existed even before the pandemic.[166] Since the 1970s, the total stock of household wealth has risen from around three times GDP to over seven times.[167] The majority of the recent growth in household wealth has come not from 'active' investment or saving behaviour, but undertaxed 'passive' windfall gains or reclassified labour income, growth which has accrued most to particular cohorts (those born in the 1950s above all) and regions.[168] Over this period of time, revenues from wealth-related taxes have stayed flat as a fraction of national income, and there is a broad recognition that the tax system has not kept up with the underlying economic changes represented by the rise in household wealth, with the 2019 Conservative manifesto saying that we should "redesign the tax system so that it … limits arbitrary tax advantages for the wealthiest in society".

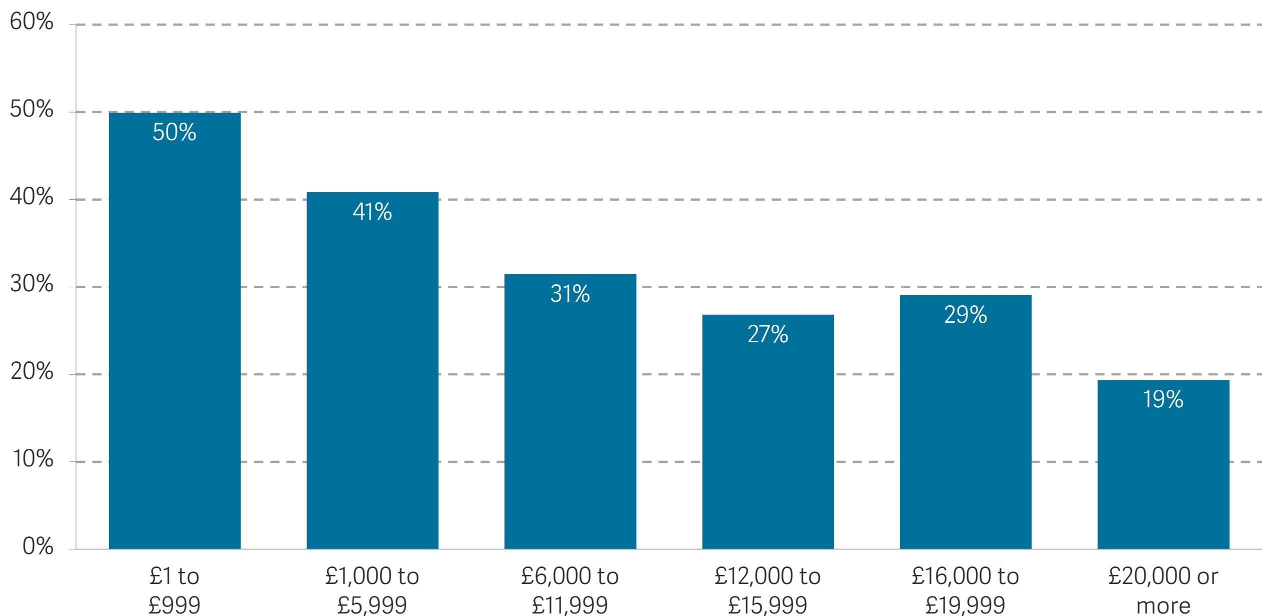
There is also mounting evidence that wealth gaps may have widened during the early months of the coronavirus pandemic, between families who entered the crisis with healthy balance sheets, and those who did not. One-third of families in the top income quintile saved more than usual in the first two months of the pandemic, whereas lower income families were more likely to have taken on additional debt.[169] Between March and September, people with lower family savings in February were more likely to have used savings to cover everyday living costs, as Figure 41 shows. If the longer-term impact of the pandemic does turn out to be higher stocks of savings among high-income and high-wealth families, and the opposite among the less prosperous and wealthy, then this would put in sharper relief the existing distortions and anomalies in the taxation of wealth (even though savings are only a small part of the wider stock of wealth that

166 D Willetts, Baby boomers are going to have to pay more tax on their wealth to fund health and social care, Resolution Foundation, March 2018.
167 G Bangham & J Leslie, Who owns all the pie? The size and distribution of Britain's £14.6 trillion of wealth, Resolution Foundation, December 2019.
168 Resolution Foundation, A new generational contract: The final report of the Intergenerational Commission, May 2018; G Bangham & J Leslie, Rainy Days: An audit of household wealth and the initial effects of the coronavirus crisis on saving and spending in Great Britain, Resolution Foundation, June 2020.
169 G Bangham & J Leslie, Rainy Days: An audit of household wealth and the initial effects of the coronavirus crisis on saving and spending in Great Britain, Resolution Foundation, June 2020.

can provide people with incomes). Tax allowances let significant income from wealth be taken tax-free, and the same income may be taxed in different ways for different people, depending on their ability to classify it in different ways for tax purposes.[170]

FIGURE 41: **People with lower levels of family savings were more likely to use savings to cover everyday expenses, during the early pandemic**

Percentage of respondents who used their savings for everyday spending during the crisis, by level of savings before the crisis



NOTES: Base = all UK adults aged 18-65 with any savings in February (n=3,703). Those with no savings, or who did not respond to savings in February question are excluded. Sample size for the subgroups are as follows: £1 to £999, 596; £1,000 to £5,999, 934; £6,000 to £11,999, 500; £12,000 to £15,999, 222; £16,000 to £19,999, 144; £20,000 and more, 1,307. These figures have been analysed independently by the Resolution Foundation.
SOURCE: RF analysis of YouGov, UK Adults Age 18 to 65 and The Coronavirus (Covid-19) –September wave.

The remainder of this section addresses a number of wealth-related taxes in turn:

- Capital Gains Tax
- ISAs and other tax-free saving
- Pension taxes
- Inheritance taxes
- Property taxes

170 The final point is discussed in A Corlett, A Advani & A Summers, Who gains? The importance of accounting for capital gains, Resolution Foundation, May 2020.

Capital Gains Tax is the weakest link in the taxation of income, and should certainly be strengthened

Capital Gains Tax (CGT) was introduced in 1965 to correct the inconsistency whereby people with appropriate advice could, as the then-Chancellor said, "turn what is really taxable income into tax-free capital gains".[171] This was justified by the assertion that "there is little dispute nowadays that capital gains confer much the same kind of benefit on the recipient as taxed earnings more hardly won". Both statements remain valid in 2020. Although capital gains do nowadays incur tax, CGT's flaws continue to lead to big gaps in the tax rates paid by different groups of high-income people. It remains the weakest link in income taxation.[172]

This is for two reasons. First, capital gains are taxed at lower rates than other income, as Figure 42 shows. This is particularly problematic at very high levels of income.[173] And second, there are many reliefs associated with CGT. Some help reduce its administrative burden, by avoiding the need for tax returns for small capital gains. But others are less desirable, since they result in otherwise-similar people with the same income paying very different amounts of tax. For example, Business Asset Disposal (BAD) relief (formerly known as Entrepreneurs' Relief) allows a 10 per cent tax rate to be paid on gains of up to £1 million that qualify for it, far lower than the 40 or 45 per cent marginal rate that would likely apply if the money was taken as earnings.[174] The rules for BAD relief are themselves complex and inconsistent and it is not clear that they achieve the policy objective of encouraging entrepreneurs.

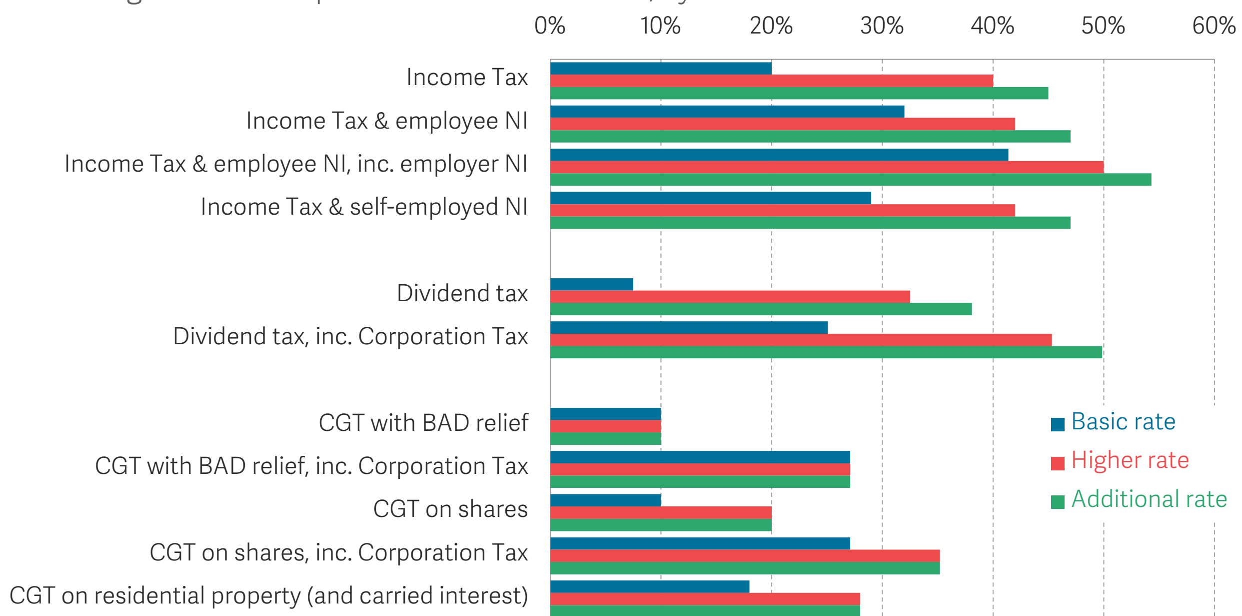
A popular proposed solution to the complexity of CGT, and the horizontal inequities it introduces into the taxation of income, is to fully align CGT rates with the structure and rates of Income Tax. We think this is the right direction for policy to move in over the medium-term, although we do not wish to downplay the political challenge of such an approach (given for example the critiques that higher CGT might discourage future investment and penalise past saving). Some consideration would also need to be given to how inflationary gains, as opposed to real gains, would be taxed. In the short-term however, we favour immediate action to close some of the least defensible loopholes and reliefs in the CGT system: doing so would raise revenue and simplify the system quickly, while setting a clear direction of travel towards fuller alignment of income tax and CGT (taking into account inflation) in due course. This would also bolster the wider credibility

171 J Callaghan, Budget Statement, HC Deb 6 April 1965 vol 710, col 245.
172 A Corlett, A Advani & A Summers, Who gains? The importance of accounting for capital gains, Resolution Foundation, May 2020.
173 The difference in the average tax rate between normal income and the equivalent sum taken as capital gains is substantial. Incomes of £1 million or more attract average income tax of 40 per cent, but, if the income is taken as capital gains, it attracts an average tax rate of less than 15 per cent. See: HM Revenue & Customs, Capital Gains Tax statistical tables Table 1: Estimated taxpayer numbers, gains and tax accruals by year of disposal, August 2020.
174 As the Mirrlees review noted in 2011, "the result [of CGT exemptions and reliefs] has been a great deal of tax planning focused around capital gains".

of the tax system by making it harder for similar individuals to take income in different legal forms. Given the distortions that CGT rates and reliefs bring about, it is not too surprising that recent surveys have consistently shown public support for equalising the rates of tax paid on labour income and capital income. Our proposals therefore focus on three sets of reforms.

FIGURE 42: **CGT greatly expands (downwards) the range of marginal tax rates that high incomes can attract**

Marginal tax rates paid under different taxes, by tax rate band



Source: RF analysis.

Abolishing Business Asset Disposal (BAD) relief and changing the taxation of voluntarily liquidated companies

Business Asset Disposal (BAD) relief has received considerable attention in recent years. Its maximum generosity was rightly reduced at Budget 2020, but this did not address the fundamental problem that it continues to give some people the option of paying just 10 per cent tax on gains of up to £1 million.[175] We therefore favour going further and abolishing the BAD relief altogether, a move which could raise approximately £1 billion.[176]

175 For an outline of BAD's problems in its previous guise as Entrepreneurs Relief, see A Corlett, Entrepreneurs' Relief has cost £22 billion over the past 10 years. Was it worth it?, Resolution Foundation, August 2018.

176 We estimate this yield from the HMRC estimate of the cost of BAD, less the HM Treasury estimate of the yield from capping BAD relief at Budget 2020. See: HMRC, Estimated cost of non-structural tax reliefs, October 2020; HM Treasury, Budget 2020: policy costings, March 2020.

On top of this, the scope of what business income counts as a capital gain by HMRC should be revisited. Members' Voluntary Liquidations (MVLs) are undertaken by around 10,000 businesses per year.[177] They involve the owner(s) of a still-solvent business winding up the company and dividing its assets into cash amounts for shareholders. Crucially, funds extracted via MVLs are taxed as capital gains, so they are taxed more lightly than they would be if treated as normal income or dividends. There is no good reason to tax someone receiving business income via a MVL more lightly than someone taking it via dividends, so we recommend that any income taken via MVLs should always be taxed as dividends, rather than capital gains. The proceeds of MVLs would then be taxed at the dividend rates of 7.5, 32.5 or 38.1 per cent, instead of 20 per cent CGT (or 10 per cent under BAD relief). We estimate that this reform would yield around £100 million per year.

Policy recommendation: Abolish Business Assets Disposal relief, and additionally change the tax treatment of funds extracted from wound-up companies via Members' Voluntary Liquidations so that they are taxed as dividends rather than as capital gains (together raising around £1 billion).

Ending the forgiveness of CGT at death

Under the present CGT regime, if someone sells – or gives away – an asset one day before they die, the normal CGT liability is incurred for any capital gains.[178] Yet if they retain the asset until death such tax liabilities are wiped clean, with CGT being assessed on the asset's value at the date of death (the so-called CGT 'uplift'). This means that those inherited assets that are exempt from IHT can be transferred or sold on by their recipients without any IHT or CGT being paid.

This rule is distortionary, discouraging people from passing on assets like private trading businesses while they are alive. It is also regressive, since it benefits the recipients of unearned wealth, and particularly those inheriting assets whose value has inflated in recent decades. Even the argument that it averts double-taxation with Inheritance Tax is not valid: this can still happen in the case of assets like investments or second homes gifted to children less than seven years before death.[179] And there is no principled reason why CGT and IHT should not be levied on the same assets, since the two taxes have distinct and valid policy aims.

We propose replacing CGT uplift at death with a 'no gain, no loss' system.[180] An asset transferred at death would be free from CGT, but full CGT would be charged if it was sold in future, on the capital gain from the historic base cost at which the donor originally

177 A Corlett, A Advani & A Summers, Who gains? The importance of accounting for capital gains, Resolution Foundation, May 2020.
178 Although in effect they may then be subject to IHT on the net amount after payment of CGT.
179 Office of Tax Simplification, OTS Inheritance Tax review: Simplifying the design of the tax, July 2019.
180 The alternative – which should also be considered – would be to treat death as a disposal, with CGT being paid at that point.

acquired the asset. This system helps deal with the liquidity problems that might arise with large tax liabilities at the point of inheritance, but ensures that the proper sum of CGT is collected in due course. In 2015-16 it could have yielded £1.3 billion per year, across 55,000 estates – although the short-term revenue when the policy was introduced would be lower.[181] Uprating this figure by the OBR's forecast for total CGT receipts suggests that it could yield as much as £2.3 billion by 2024-25. For simplicity, we propose that any IHT should be charged as usual when a 'no gain, no loss' transfer is made, despite the potential future CGT liability.

Policy recommendation: Replace CGT uplift at death with a 'no gain, no loss' system (raising £2.3 billion)

Reducing the Annual Exempt Amount

Anyone receiving a capital gain is entitled to have some of that entirely free of tax – this is known as the Annual Exempt Amount (AEA), and is the largest CGT relief. At £12,300 per annum, it is also far too generous, and allows people who have the flexibility to take their income in different forms to greatly reduce the total tax they pay. This horizontal inequity is exacerbated in cases where people also use their (separate) dividend allowance and personal savings allowance, or split their gains with a spouse, and is compounded over time if they can 'drip feed' capital gains across several years. With 260,000 people (plus trusts) currently paying some CGT each year, a reduction in the AEA from £12,300 to £2,000 could raise approximately £600 million in revenue.[182] But we propose going further, given that the AEA is not the only additional investment income allowance.

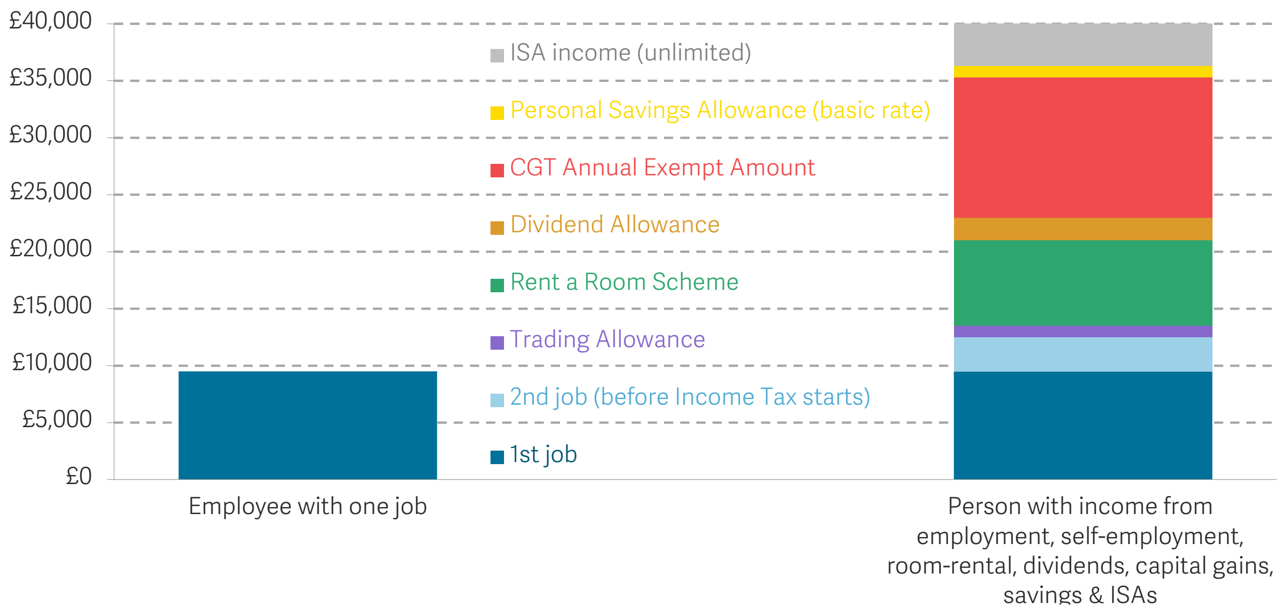
Investment income taxation could be significantly simplified, while those with the highest savings should contribute to consolidation

As well as the AEA, there are several other tax-free allowances for different types of income. Although these act somewhat to reduce administrative burdens for individuals and HMRC, the resulting system is complex, and adds significant horizontal distortions. As Figure 43 shows, it is possible (though we do not know if anyone has done this) to receive more than £36,000 a year tax-free through the use of multiple allowances. This compares to the less than £9,500 of entirely tax-free income a typical employee would have (given that National Insurance is due above this threshold).

181 This yield would be increased somewhat if the CGT Annual Exempt Amountwas lowered, as we recommend (by perhaps around £110 million).
182 This is a conservative estimate. HMRC costings suggest reducing the threshold to £2,500 would raise £835 million in 2021-22. See: Office of Tax Simplification, Capital Gains Tax review – first report: simplifying by design, November 2020.

FIGURE 43: **Given the UK's array of different tax allowances, it is possible to receive over £35,000 a year tax-free**

Total value of reliefs from Income Tax and Capital Gains Tax available to an employee with one job, and a person using every available relief: UK, 2019-20



Source: RF analysis.

This effect is compounded by the existence of ISAs, one of the most widespread forms of tax-advantaged saving, which disproportionately benefit higher-income and higher-wealth individuals who have more money to set aside in savings and would otherwise be paying higher marginal income tax rates on that income. In so doing, they risk exacerbating the inequalities in saving patterns that have emerged during the coronavirus pandemic, with significant extra savings by higher-income households flowing into ISAs and other tax-advantaged accounts. They were already unequally-distributed before the crisis, with two-thirds of people aged 16 plus holding no ISA wealth in 2016-18.

We propose merging the following into a single, £2,000 a year tax-free allowance, creating a system more like the German single annual investment income allowance of €801:

- The £12,300 AEA for capital gains;
- The £2,000 Dividend Allowance;
- The Personal Savings Allowance, which is £1,000 for basic rate taxpayers, £500 for higher rate taxpayers, and £0 for additional rate taxpayers; and
- A new annual tax-free limit for income within ISAs.

To understand the consequences of this policy, it is helpful to consider first what would be raised if each of the allowances were first set at £2,000, before then considering the impact of combining them.

Capping tax-free returns in ISAs at £2,000 a year would raise an estimated £1.6 billion – based on conservative assumptions about future rates of return. It would have no impact on most ISA savers, only affecting individuals with high levels of personal savings (for example, at the average rate of return for a two-year fixed-rate cash ISA in September 2020 (0.64 per cent), investment income would only breach this limit if someone held more than £312,500 in their accounts).

Replacing the Personal Savings Allowance with a flat £2,000 allowance would be a tax cut for some, since currently only the first £1,000 of interest from any savings account is tax-free to basic-rate payers; a reform would also remove the cliff-edges that currently exist where people's allowances are reduced when they become higher or additional rate taxpayers.[183] It would also raise taxes significantly for some individuals who do genuinely have a range of sources of income – as opposed to having structured their income specifically to take advantage of reliefs – though it is not clear why someone whose income happens to come from a range of sources should therefore pay a lower rate of tax than someone with only one source.

Combining these allowances into a broader 'Personal Investment Income Allowance' would then yield even more than lowering the separate limits, including the at least £600 million raised by lowering the CGT allowance.

Policy recommendation: Merge the CGT Annual Exempt Allowance, Personal Saving Allowance and Dividend Allowance, and cap tax-free ISA income, to create a new Personal Investment Income Allowance of £2,000 a year (raising £2.2 billion)

Relatedly, the Lifetime ISA should also be scrapped

The Lifetime ISA (LISA) provides an even more generous subsidy to saving.[184] Introduced in April 2017, it lets individuals aged 18 to 40 contribute up to £4,000 per year to a ringfenced savings fund (to be spent on a first home or after age 60), to which the government contributes an extra 25 per cent. Up to £33,000 can be received overall, but take-up has been low.[185] MPs on the Treasury Select Committee criticised its complexity and 'perverse incentives' and called for its abolition, concluding that it was too complex

183 See also: P Lewis, Close the ISA tax haven, Paul Lewis Money, June 2017. At present the best rates available for easy-access cash ISAs are in the range of 0.8-0.91 per cent, and the best rate available for a 5-year fixed rate cash ISA is 1.4 per cent, so that even someone using their full £20,000 ISA allowance in one year would not receive enough interest from it to exceed their Personal Savings Allowance (unless they paid income tax at the additional rate).

184 This is a spending measure, but we include it here given the overlap with the tax treatment of savings and pensions.

185 Approximately 1.2 per cent of adults in the qualifying age range (223,000 people) opened accounts in the scheme's second year of operation (2018-19). RF calculation using HMRC, Individual Savings Account (ISA) Statistics, June 2020; Office for National Statistics, Population estimates for the UK, England and Wales, Scotland and Northern Ireland: mid-2019, June 2020.

for wider take-up, and hence unpopular with savers.[186] Other problems include its partial goal of tempting people to use it rather than enrolling in a pension, which is problematic since it does not receive employer contributions; and concerns over the quality of advice that account-holders will receive. It is also rather perverse that holdings of a LISA can disqualify recipients from receiving means-tested benefits like Universal Credit, whereas saving in a personal pension (which would be the obvious alternative to a LISA) do not.

We recommend the LISA scheme should be abolished, with no more accounts created and no more bonuses paid.

Policy recommendation: scrap the Lifetime ISA (raising £600 million)

Pension wealth is highly tax-advantaged, not all of it for defensible reasons

Pension wealth matters. With a total value of £6.1 trillion in 2016-18, it accounts for 42 per cent of total household wealth, and plays a vital role in determining people's living standards in later life. It is right that saving in a pension has its own rules in the tax system: these ensure that money passing through pensions is mostly taxed only once, and provide some tax incentives to save in a pension. But the tax treatment of pensions leaves classes of income which escape taxation at any stage in people's lives, and some very poorly-targeted incentives to save.

Pension saving is tax advantaged in a number of distinct ways, the most expensive of which is the relief on income tax provided for employer and employee contributions to pensions and NI relief on employer contributions. These had gross costs in 2017-18 of £37.2 billion for income tax and £16.5 billion for National Insurance.[187] A desirable policy reform would be to move all pension contributions to the same rate of income tax relief, at the basic rate of income tax.[188] This would mean halving the rate of tax relief provided to higher-rate tax payers (and more than halving that for additional rate payers), raising revenue of around £11 billion. It would mean substantial losses of private pension savings for people who pay higher-rate income tax for much of their working lives, but since very few pensioners pay higher-rate income tax it would not lead to double taxation in many cases.[189]

The implementation of this change would be relatively straightforward for DC pensions, but much more complicated for DB pensions, where the tax system would need to know

186 A Zafar, MPs call for abolition of Lifetime ISA, FT Adviser, July 2018.
187 HMRC, Table 6: Cost of Pension Tax and NICs Relief, 2012-13 to 2017-18, September 2019.
188 For previous Resolution Foundation research in this area see: A Corlett and M Whittaker, Save it for another day: pension tax relief and options for reform, Resolution Foundation, March 2016.
189 I.e. someone would be taxed twice on some of their income if they received tax relief on contributions at basic rate, but paid Income Tax at the higher rate in retirement. Yet this only happens in a small number of cases.

the effective change in the value of a DB pension in each year.[190] It would therefore be sensible to roll out flat-rate relief differently for some DB pensions schemes. For funded DB schemes, employer and employee contributions could be taxed in the usual way, and an equivalent charge could be introduced for unfunded public sector pension schemes; this avoids the need for a scheme valuation every year in order to calculate exact tax liability.

There are major challenges involved in rolling out flat-rate pension contribution tax relief. We are in favour of it – it would be a desirable change to the taxation of wealth in the UK – but we do not rely on it for setting out concrete plans for a consolidation in 2024-25. But the Government should keep the option on the table, particularly as we learn more about the extent of fiscal consolidation that may be needed in future years.

The tax-free lump sum should be capped more tightly

Pension savers approaching retirement have the option to withdraw up to 25 per cent of their pension pot's value tax-free, in many cases. This means that this portion of their pension is untaxed at any stage of contribution, investment or payment. The lump-sum is an old part of the pension system, dating back more than a century, but also a contentious and expensive one, with a cost in 2019-20 of around £4 billion in foregone Income Tax. Its cost has led to several attempts to rein it in: it was first capped in the 1947 budget, and Nigel Lawson tried to scrap it in the 1980s, describing it as an 'anomalous but much-loved' payment.[191]

Lump-sum withdrawals are significant in scale, and their tax benefits flow mainly to people with substantial pension pots. In 2016-18, withdrawals totalled £23.8 billion per year. Nine per cent of lump sum withdrawals in 2016-18 were of sums of £100,000 or more, but these sums accounted for 43 per cent of the total value of withdrawals. The average household net annual income and median net household wealth of people making such large lump-sum withdrawals in 2016-18 were £70,000 and £2 million respectively, compared to only £38,000 and £730,000 among those making withdrawals smaller than £100,000. By contrast, the scheme is of less benefit to pensioners paying standard rate income tax in retirement, and of no benefit to many of the one-in-four pensioners with incomes too low to pay any Income Tax (although some of them may have had incomes high enough to pay Income Tax had they not taken a lump-sum).

Our proposal is to cap total tax-free lump sum withdrawals at £100,000, or the existing cap of 25 per cent of pension pot value if this is lower (which, together with the Lifetime Allowance, effectively imposes a cap of around £270,000 at present). This would only affect people with pension pots of £400,000 or more, or 9 per cent of those currently

190 M Echalier, J Adams, D Redwood & C Curry, Tax relief for pension saving in the UK, Pensions Policy Institute, 2013.
191 N Lawson, Budget Statement, HC Deb 19 March 1985 vol 75 cc790-2.

making lump-sum withdrawals. We choose this limit over a lower percentage cap partly to allay concerns about the phase-in of the policy: since this cap would impact less than a tenth of current withdrawals, it would be feasible to introduce it immediately.

The revenue from this policy would take time to build, since its short-term effect would be to reduce the number of lump-sum withdrawals over £100,000, leaving more money in pension pots which will then be taxed in the normal way as it is withdrawn. Initially, we estimate it would raise little more than around £100 million. But in the steady state, as people draw as taxable income the money they could otherwise have taken as tax-free lump-sums, it should raise approximately £500 million per year.[192]

Policy recommendation: Cap tax-free lump sum withdrawals from pensions at £100,000 over the lifetime (raising £100 million in the short-term and £500 million in the long-term)

Inheritance Tax is unpopular for some good reasons: it needs fewer exemptions and a simpler structure

Inheritance Tax (IHT) consistently ranks as the most unpopular of all taxes. It is easy to see why: it has a high headline rate (40 per cent), it is complicated to administer despite few estates actually having to pay it due to the high threshold, and there are several reliefs which can be exploited by the very wealthy.

In fact, research by the Office of Tax Simplification has shown that the average effective rate of IHT paid by estates whose value exceeds around £9 million is substantially lower than that paid by estates with a value between £2 and £9 million.[193] Estates worth £10 million or more pay an average IHT rate of around 10 per cent, while those worth between £2 and £10 million pay an average rate around twice as high.

A full overhaul of IHT is difficult. The Resolution Foundation has previously advocated its replacement with a Lifetime Receipts Tax, whereby liability is shifted from donor to recipient (with a lower tax rate and a lifetime allowance of, say, £125,000).[194] This should be the medium-term goal of public policy, but in the short-term we propose more limited restrictions of some of the least defensible exemptions from the tax base for IHT. Removing these exemptions would both improve the fairness of the tax and raise additional revenue. We concentrate on three exemptions: pension pots, agricultural property and business property.

192 This assumes that the current annual flow of lump-sums over £100,000 is eventually taxed at a 20 per cent marginal rate, although this yield will take a number of years to reach. If a £100,000 threshold is retained over time then fiscal drag would increase the yield, as would nominal-terms reductions in the cap in future.

193 Office of Tax Simplification, Inheritance Tax Review – first report: Overview of the tax and dealing with administration, November 2018.

194 A Corlett, Passing On: Options for reforming inheritance taxation, Resolution Foundation, May 2018.

1. Inherited pensions should attract IHT like other types of assets

Unannuitised pension pots have always sat outside the scope of IHT. This exemption is of greater fiscal consequence since the introduction of pension freedoms in 2015. Now that pensions do not need to be annuitised when people retire, it has become possible for a growing number of pensioners to keep large amounts of money in pension pots and then to bequeath them to others free from IHT. It has three key adverse consequences.

First, it produces horizontal inequity between pensioners with a higher proportion of their savings in non-pension assets, and those with most of their savings in a pension, since the latter have the option of shielding much more wealth from IHT. Second, it produces a behavioural distortion that undermines the policy objective of pensions, since holders of funded pensions are incentivised to spend all other assets before reaching in to their pension. Third, it is an increasingly expensive tax relief, given that the number of pensioners entering retirement with Defined Contribution (DC) pensions rather than Defined Benefit (DB) pensions will increase over coming years (in 1997, 47 per cent of employees contributed to a DB pension, compared to 29 per cent in 2016).[195]

We recommend charging full Inheritance Tax on unannuitised pension savings.[196] We expect that this would raise at least £600 million by 2024-25, and would improve fairness and reduce distortions in the current system. This figure is estimated using data from the latest Wealth and Assets Survey (for 2016-18) on people's DC pension holdings, applying cohort life expectancy rates from the latest ONS estimates for 2017-19, and then charging full IHT (apart from allowances) on the pension wealth of the proportion of people of each single year of age who would be expected to die in a given year. In a related reform, it would also be desirable to fix the anomaly whereby no Income Tax is paid on income from pensions inherited from people who died before age 75, but we do not estimate the yield from this reform here.

Policy recommendation: Remove the exemption of all pension pots from Inheritance Tax, and the exemption of pension pots inherited on deaths before 75 from Income Tax (raising £500 million)

2. IHT reliefs on agricultural and business property are too generous

Two major reliefs from Inheritance Tax, Agricultural Property Relief and Business Property Relief, are also due for reform. In 2019-20, the former cost the exchequer £475 million

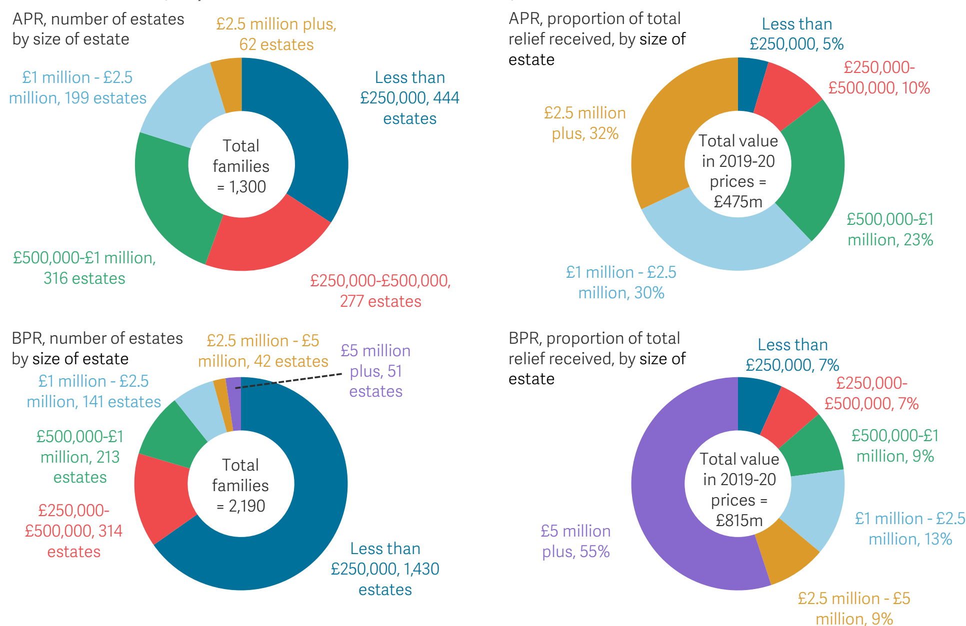
195 D Finch & L Gardiner, As Good as It Gets? The adequacy of retirement income for current and future generations of pensioners, Resolution Foundation, November 2017. DC pensions exist as pots of money that can relatively easily be bequeathed if they are not annuitized, whereas DB pensions exist in most cases only as accrued rights to income, hence are difficult to pass on as cash lump sums.

196 A related policy that should be considered is levying Income Tax on income from pensions inherited from people dying before age 75.

in foregone revenue, while the latter cost an estimated £815 million.[197] The rationale for these reliefs is to avoid family farms and businesses having to be broken up and sold when inheritance tax becomes due. Yet they greatly increase the complexity of the tax and are widely used for purposes well beyond this objective, raising concerns about its fairness.[198] As Figure 44 shows, a mere 61 estates, with a value of £2.5 million or more, received almost one-third (32 per cent) of all APR by value in 2015-16. BPR was even more concentrated in the hands of a few families: 93 estates with a value of £2.5 million or more received almost two-thirds (64 per cent) of all BPR in the same year, worth a combined £1 billion.

FIGURE 44: **In 2015-16, 51 estates accounted for the majority of Business Property Relief**

Agricultural Property Relief and Business Property Relief received, number of estates and value of reliefs, by banded value of estate, 2015-16



SOURCE: RF analysis of HMRC distributional statistics on estates above nil rate band claiming APR or BPR, released by FOI request to Tax Justice UK.199

We propose that APR and BPR should each be capped at £2.5 million per estate, with the part of agricultural and business assets worth in excess of this cap subject to normal IHT at the 40 per cent rate. This could yield as much as £600 million in additional revenue by 2024-25.[200] Potential extensions would be to make APR subject to a 'farmer test', as used

197 HMRC, Estimated cost of non-structural tax reliefs, October 2020.
198 On complexities caused by these reliefs see Office of Tax Simplification, Inheritance Tax Review – second report: Simplifying the design of Inheritance Tax, July 2019.
199 P Hebden, R Palmer & T Tyldesley, In Stark Relief: How inheritance tax breaks favour the well off, Tax Justice UK, June 2019.
200 We apply the distribution of reliefs received in 2015-16 to the latest (2019-20) estimates of the total cost of APR and BPR. We estimate this cap would yield £110 million from APR, and £490 million from BPR.

in Ireland and France, where the beneficiary of the relief must hold assets (including the inheritance) of which at least 80 per cent are agricultural, and BPR subject to a similar 'family business test', in which the inheritor must have a demonstrable working relationship with the company, and must be given at least 25 per cent of its value.[201] To keep our revenue estimate conservative we do not include these additional tests in our modelling of the policy's yield, though their implications would be substantial. Given their complex impacts, they would also need to be carefully reviewed before implementation.

Policy recommendation: Limit Agricultural Property Relief and Business Property Relief to the first £2.5 million of assets (raising £600 million in 2024-25)

Property tax reforms could contribute to tax revenues in future, but the need for long-term reform make them less suitable for a near-term consolidation

Property taxes in the UK – notably Council Tax and Stamp Duty Land Tax – are widely accepted to be overdue for reform. The former is highly regressive, and the latter reduces the volume of otherwise-desirable property transactions (although it is highly progressive). Previous Resolution Foundation research has produced detailed recommendations for reform in this area, so we provide here a brief summary.

Council Tax in England should be replaced entirely by a new progressive property tax based on up-to-date valuations, with a tax-free allowance equivalent to the tenth percentile of property values in a region.[202] Similar policies could be implemented in Scotland, Wales and Northern Ireland, to which the power to vary existing Council Tax (or domestic rates in Northern Ireland) is already devolved. We have also previously proposed halving the rate of Stamp Duty, which raises considerable revenue at the cost of impeding house moves for desirable reasons such as job matching and right-sizing between properties.

Both these property tax reforms would significantly improve the UK's tax system, but they would also take time to implement and should not necessarily be used to raise revenue at first (given the political difficulty even of Council Tax revaluation, a revenue-neutral package of reforms may be desirable). A better approach is therefore to focus first on more straightforward reform of our existing property taxes, while laying the groundwork for a stronger and more progressive tax system in the long term.

We recommend that the Government introduces a new solidarity tax on high-value properties, the Council Tax Supplement, at a rate of 1 per cent on the value of properties

201 See A Corlett, Passing on: Options for reforming inheritance taxation, Resolution Foundation, May 2018.
202 For details see Resolution Foundation, A new generational contract: The final report of the Intergenerational Commission, May 2018.

above £2 million.[203] This would raise £1.4 billion in 2024-25. Recent Resolution Foundation research has highlighted how space at home, housing quality and other related conditions have been key determinants of the experience of the pandemic lockdown for different groups.[204] It would be more effective than simply adding extra bands to Council Tax, and is also a relatively economically-efficient tax, in that it taxes economic rents rather than values dependent on individual effort, and it offers limited opportunities for avoidance due to the immovable nature of real estate. Potential (though often exaggerated) problems for asset-rich but comparatively income-poor households could be addressed with a deferral or equity payment system.

Policy recommendation: Introduce a new Council Tax Supplement, payable on properties worth over £2 million (raising £1.4 billion)

BOX 4: Net wealth taxes are the subject of rising public interest

The UK's wealth-related taxes are generally related to the returns to wealth (e.g. income tax, CGT), or to transfers (e.g. IHT).[205] A third category of taxes – levied on the total wealth that someone owns – have been much-discussed in recent years, though they are not used in the UK. Net wealth taxes, the more novel version of this third category, differ from currently-existing UK taxes in being levied on all categories of wealth, and on net rather than gross holdings. A broad tax base reduces the distortionary impact of the tax, since all asset classes are equally treated, while taxing net rather than gross wealth is fairer to people with high debts (for example mortgagors with low equity). Net wealth taxes are not without real-world precedent: at present they are levied in some form in Switzerland, Norway, Belgium and Spain, although several other countries have also introduced and then repealed them.[206]

Several types of net wealth tax have been proposed during the coronavirus pandemic. They include a one-off solidarity tax of 3 per cent on the net wealth of the upper half of UK households, or a tax on the net worth of

203 For further details and rationale see A Corlett & L Gardiner, Home affairs: Options for reforming property taxation, Resolution Foundation, March 2018.
204 Department for Communities and Local Government, English Housing Survey 2014: Housing and Well-being Report, July 2016; A Clair & A Hughes, Housing and health: new evidence using biomarker data, Journal of Epidemiology and Community Health, May 2019; L Judge & F Rahman, Lockdown living: Housing quality across the generations, Resolution Foundation, July 2020.
205 J Hills, F Bastagli, F Cowell, H Glennerster, E Karagiannaki & A McKnight, Wealth in the UK: Distribution, Accumulation, and Policy, Oxford: Oxford University Press, 2013.
206 S Perret, The Role and Design of Net Wealth Taxes in the OECD, OECD Tax Policy Studies, April 2018; S Perret, Why did other wealth taxes fail and is this time different?, Wealth and Policy, Working Paper 106, October 2020.

the richest 1 per cent of individuals.[207] Another option is for a medium-term time-limited tax, such as a 10-year wealth tax of 1-3 per cent on the net worth of the richest 1 per cent across Europe.[208] There is some evidence they may be popular with the public[209]: a YouGov survey in May found majority support across almost all demographics for a tax on net worth over £750,000, excluding pensions and main home, including 61 per cent of the general population and 51 per cent of 2019 Conservative voters.[210]

The key design decisions to be made by policy makers considering introducing net wealth taxes are:

- Tax base. This may exclude primary properties and pensions, particularly since the latter have their own complex tax treatment, though exclusions produce distortions and the possibility of avoidance.[211]
- Threshold.[212] A net wealth tax only levied on the top 1 per cent or similar, as debated in the US Democratic party, is unlikely to raise enough revenue in the UK to make it worth the political challenge of introducing it.
- Rate structure. Net wealth taxes tend to be levied at very low rates, for example as low as 0.3 per cent in some Swiss cantons.[213]
- Tax unit. The effects of the tax would vary depending on whether wealth is assessed at the individuals, family or household level.[214] At present the tax system tends to work on an individual level, while many benefits are assessed at the family level. Trusts would have to be considered carefully.
- Interaction with other taxes: would a net wealth tax be deductible against any other taxes, and/or could it replace them?[215]
- Valuation. A key challenge is how people's wealth is valued.[216] Net wealth taxes ideally need regular 'mark-to-market' (MTM) valuations, rather than waiting for assets to be sold and hence assigned a market price (which is the way taxes like CGT and SDLT operate today). But MTM valuations are hard for assets that rarely change hands, so other

207 N O'Donovan, Paying for the Pandemic, Future Economies Research and Policy Paper 8, Manchester Metropolitan University, April 2020; S Machin & L Elliott Major, Covid-19 and Social Mobility, LSE Centre for Economic Performance, May 2020.
208 C Landais, E Saez & G Zucman, A progressive European wealth tax to fund the European COVID response, VoxEU, April 2020.
209 For an overview of public opinion see K Rowlingson, A Sood and T Tu, Public attitudes to a wealth tax, Wealth and Policy, Working Paper 102, October 2020.
210 YouGov survey for NEON, 7-11 May 2020. The question was "To what extent, if at all, would you support a tax on wealth where individuals are taxed a percentage of their net worth over £750,000, excluding any personal pension savings and their main home?"
211 For a detailed discussion, see: E Chamberlain, Defining the tax base: Design issues, Wealth and Policy, Working Paper 108, October 2020.
212 Ibid.
213 M Sandbu, The Swiss town that taxes its wealthy without scaring them away, Financial Times, February 2019.
214 See: E Chamberlain, Defining the tax base: Design issues, Wealth and Policy, Working Paper 108, October 2020.
215 For a discussion see: A Summers, Ways of taxing wealth: Alternatives and interactions, Wealth and Policy, Working Paper 104, October 2020.
216 S Daly & G Loutenhizer, Valuation, Wealth and Policy, Working Paper 109, October 2020.

approaches have been proposed.[217] One solution is to have fixed tax bills for broad bands of total net wealth value, as currently used in the UK's Annual Tax on Enveloped Dwellings.[218]

The political challenge of introducing net wealth taxes should not be underestimated. They can create vocal and powerful losers, who may protest against horizontal equity problems if the tax base is restricted or double taxation arises. There are also economic challenges, including behavioural responses like capital flight (although there is limited evidence of this in practice) or forestalling, especially if a tax was time-limited or lacked cross-party support.[219] Administrative challenges include valuations and making allowances for potential liquidity problems among large asset-owners with little income.[220] In short, policy makers should note the considerable revenue-raising potential from net wealth taxes, while being realistic about the significant challenge that introducing any such new tax would pose.

These proposed changes to wealth-related taxes could raise £9 billion, and lay the groundwork for further-reaching reform in future

This section has shown that there is substantial scope for reform of the UK's wealth-related taxes, that could both reduce their complexity, improve their efficiency and raise additional revenue in a progressive way that fairly reflects the differing burden of the coronavirus crisis so far on households across the country. This would make considerable progress in improving the extent to which the UK tax system has responded to the increase in wealth seen in recent decades.

217 See for example: E Posner & EG Weyl, Radical Markets: Uprooting Capitalism and Democracy for a Just Society, Princeton: Princeton University Press, 2018.
218 E Troup, J Barnett & K Bullock, The administration of a wealth tax, Wealth and Policy, Working Paper 111, October 2020.
219 A Advani and H Tarrant, Behavioural responses to a wealth tax, Wealth and Policy, Working Paper 105, October 2020.
220 For a discussion of liquidity issues in wealth-related taxes, see: G Loutzenhiser and E Mann, Liquidity issues: Solutions for the asset-rich-cash-poor, Wealth and Policy, Working Paper 110, October 2020.

Section 10

A proposal for a new Health and Social Care Levy

The previous sections have shown that there are ways to raise significant revenue from freezing tax thresholds and raising Corporation Tax, and from targeted improvements to wealth-related taxes. But these are not enough to repair the public finances, so some increases will be needed in the rates of broad income or expenditure taxation. In this section, we discuss how this might be achieved given the post-pandemic political reality and the challenges facing the country.

The main VAT rate could be raised – as was done in 2011 – with each 1p raising £8 billion, but this would not be as progressive as income-based taxes, and would exacerbate existing distortions between standard-rated and non-standard-rated expenditure. There is, though, a strong economic case for broadening the VAT base, and we propose a rise for private school fees, but delivering wholesale reform in a progressive and politically-sellable way is well-known to be challenging.

Likewise, raising NI rate rises would not be a fair way to raise revenue. That is because it only applies only to working-age earnings, with those over state pension age not contributing. IT rate rises, however, would be sensible, as income tax has a broad base and increases in IT have a progressive impact. Increasing every rate by 1p would raise £7 billion a year, and more could be raised with larger increases for higher earners. However, a simple IT rise might be considered a missed opportunity to improve the tax system and to address the challenges faced by the country. Moreover, such a change would break explicit Conservative manifesto commitments to not raise the rate of IT, VAT or NI.

Given these considerations, we propose that the centre piece of the coming consolidation should be a simple Health and Social Care Levy. It would have a flat rate of 4 per cent (above a threshold of £12,500), and be accompanied by the abolition of Class 2 NI for the self-employed, and a 3p cut in the basic NI rate for employees. This design would help reduce the gap in the tax treatment of employees and the self-employed, something that was flagged by the Chancellor when he announced the SEISS. The new tax would work in a similar way to IT, but also extend to taxable capital

gains. Such a tax would raise £17 billion – although employees earning below £19,500 would end up paying less tax – with £6 billion of that set aside for new social care spending. In the longer-run, it would be desirable to go further and completely replace personal NI with the new Health and Social Care Levy. This approach would deliver a large fraction of the necessary consolidation in a highly progressive way, and support broader national challenges that have been put into stark relief by the pandemic: the social care crisis and the dangers of a tax system that heavily incentivises self-employment, with the greater insecurity for many that brings.

For substantial revenue, rates may need to rise for at least some of the largest three taxes

The medium-term recommendations set out in this report thus far total around £27 billion a year: £1 billion from environmental tax reforms; £17 billion from threshold freezes and a CT rate rise; and £9 billion from reforming the UK's wealth taxes. More could be raised by continuing freezes for longer, or being bolder on wealth or environmental taxes, but this seems politically unlikely for now. So, given the need to raise around £40 billion, it is hard to avoid the conclusion that changes are needed in the major rates of tax on income or expenditure. Income Tax (IT), National Insurance (NI) and Value Added Tax (VAT) together raise over half of all government receipts, and have (relatively) broad bases that mean even small increases in tax rates would raise significant revenue.

Our conclusion is that a substantial new Health and Social Care Levy should be introduced – to ultimately replace National Insurance – but first we explore VAT, NI and IT in turn.

Increasing VAT again is not desirable

VAT is the third-largest source of government revenue after IT and NI. A small change in its standard rate can raise a lot of revenue, despite there being numerous exemptions. HMRC estimate that a 1p change would yield £7.6 billion for the Exchequer. When compared internationally there is scope for rate rises, given that the current 20 per cent standard rate is in the middle of the pack among comparable countries, and lower than the majority of EU-27 countries.[221] In 2011, VAT was a significant contributor to fiscal consolidation – with the standard rate rising from 17.5 per cent to 20 per cent. On the other hand, the Conservative manifesto said "We promise not to raise the rates of Income Tax, National Insurance or VAT. This is a tax guarantee that will protect the incomes of hard-working families across the next Parliament." The current crisis is another

221 See: A Corlett, The shifting shape of UK tax, Resolution Foundation, November 2019.

example of why such promises are unwise, but the Government may wish to keep to its guarantees if it can.

However, there are two more principled arguments against raising VAT again.

First, and most importantly, VAT rate rises compare poorly to income-based tax rate increases (explored below) in terms of progressivity. A rise in IT rates results in a pattern of losses as a fraction of income that increase with household income (partly due to the presence of the tax-free allowance).[222] But relative to income, VAT rises are slightly regressive – they impose greater costs on lower-income households as a proportion of income – because lower-income households consume a greater proportion of their income and save less. This regressive outcome is partly illusory because higher-income households' higher savings represent future consumption, which will attract VAT when the money is spent. But even relative to expenditure – and taking into account the fact that most essentials do not attract standard-rate VAT – the distributional impact of higher VAT is neutral rather than progressive.

Second, increasing the standard VAT rate alone would increase the already considerable distortion to consumer behaviour from the way in which some goods attract a low or zero rate of VAT. At present, the UK's VAT system stands out among comparable rich countries in having a large number of exemptions and reduced or zero-rated products, as a proportion of total consumer spending. The impact of this narrow tax base on revenue is measured by the VAT revenue ratio, which equals actual VAT revenue divided by total potential VAT revenue (if all consumption was fully and successfully taxed). In the latest OECD statistics, for 2016, the UK's VAT revenue ratio stood at 0.44, far lower than the OECD average of 0.56.[223] (Note that our proposal in Section 8 to freeze the VAT threshold would marginally broaden the UK's base.)

Having different tax rates for different forms of expenditure is inefficient; is (theoretically) a poor way of achieving distributional goals; and adds complexity. As just one example, there is the well-known price differential between cakes and biscuits, with HMRC charging zero VAT on cakes but standard VAT on biscuits –leading to important questions such as whether Jaffa Cakes are really cakes or biscuits.[224]

However, a look at some of the categories that could be added to standard VAT shows the political difficulty of broadening the base. Most food receives a zero-rating for the tax, at a cost of £19 billion in foregone revenue in 2019-20; while the zero-rating of children's clothing costs £2 billion. There is a strong green argument for extending VAT to domestic

222 For a comparison of the distributional impacts of IT and VAT changes, see: S Adam & T Waters, Options for raising taxes, Resolution Foundation, October 2018.
223 OECD, Consumption Tax Trends 2018 – United Kingdom.
224 HMRC Internal Manual: Excepted items: Confectionery: The bounds of confectionery, sweets, chocolates, chocolate biscuits, cakes and biscuits: The borderline between cakes and biscuits, 2020.

gas and electricity bills (particularly the former, though – as discussed in Section 7 – carbon pricing may be a better green priority). It is quite possible to design combinations of VAT rises and cash payments that would protect lower-income households from any extension of the VAT base – and consideration could be given to flat VAT 'rebates' for all to make this combination explicit and permanent.[225] But past VAT increases have not been accompanied by such offsets (other than via any impact that a VAT rise has on inflation and therefore annual changes to social security payments and tax allowances), while the politics of increasing taxes on children's clothing, for example, are tricky, to say the least.

Indeed, the public debate around VAT has often pointed in the opposite direction. When the Brexit Transition Period finishes on 31 December, the UK will have further powers to offer VAT exemptions. The Government has already announced that the 5 per cent VAT rate on sanitary products – the so-called 'tampon tax' – will change to a zero rate when the Brexit Transition Period finishes on 31 December;[226] and e-books have become zero-rated (to match physical books). The pre-Brexit referendum campaign also included proposals to reduce the rates charged on domestic energy to zero.[227] Resisting calls from every sector for special VAT treatment will be a central post-Brexit task for the Treasury.

Although most existing VAT exemptions are broadly progressive (even if not cost-effectively so), there are some that are neither efficient nor progressive: most notably, the exemption of private school fees from VAT.[228] Removing this exemption would not have the political difficulties associated with removing other exemptions, with even a majority of Conservative voters in favour.[229] Broadening the VAT base to include private school fees would be progressive, since private schools are attended on a fee-paying basis only by children from households with significant means. The average annual fee for a private day school in 2019-2020 is around £15,000, higher than the entire after-housing costs income of one-in-four households in the same time period.[230]

Policy recommendation: Extend VAT to private school fees (raising £1.6 billion)

National Insurance should not be increased

National Insurance is the UK's second largest tax, raising a projected £167 billion in 2024-25. And it has been a common tool for tax rises: with the basic rate for employees having been repeatedly hiked by 1p: in 1994, 2003 and 2011; while over this same period, the basic rate of IT has fallen from 25 per cent to 20 per cent.

225 See: A Corlett, Poorly targeted: reforming the taxation of low income families; CPS, A Framework for the Future: Reforming the UK Tax System, October 2020.
226 P Collinson, Budget 2020: chancellor plans to finally end tampon tax, The Guardian, March 2020.
227 BBC News, EU Referendum: Vote Leave wants power to axe fuel VAT, May 2016.
228 Others include domestic flights (discussed briefly in Section 7) and private healthcare.
229 B Glover & C Seaford, A People's Budget: How the public would raise taxes, Demos, September 2020.
230 Independent Schools Council. ISC Annual Census 2020, April 2020.

Increasing employer NI in this parliament would not be wise, for the reasons we argued in Section 8. Increasing NI by 1p for employees and the self-employed would raise around £6 billion a year, and would be progressive overall. But the tax base for personal NI means that such a tax rise (at least in isolation) would be unfair in other ways.

First, NI is not currently paid by those over the state pension age. There is no good reason why efforts to improve the public finances after this crisis should only tax the incomes of the working-age population, especially given that pensioners are now less likely to have low incomes than the rest of the population.[231]

Second (and relatedly), NI is only levied on earnings. Increasing it would mean a higher tax bill for employees and the self-employed, but not for those with private pension income, dividends, capital gains, rental income, interest or other investment income, royalties, and so on.

Finally, there are smaller inequities in the NI system. It is per-job (rather than per-person) basis means that those with multiple sources of earnings are favoured (as they benefit from multiple tax-free allowances). Its non-annual nature means that you can earn less than £10,000 in a year but still pay NI – if that income is not spread out over the year – penalising those with volatile incomes or who, for example, become unemployed. On the other hand, those with highly volatile incomes, such as those receiving large bonuses, can benefit from the non-annual system (due to NI's regressive structure). And it is levied on employee but not employer pension contributions (favouring salary sacrifice).

An increase in NI rates would make all of these inequities and distortions worse.

These problems could be fixed and revenue raised by, for example, extending NI to any earnings of those over state pension age, and indeed pension income, or moving NI to an annual per person basis. But we return to these issues below with a proposal to achieve all of this in a comprehensive rather than piecemeal way.

Income Tax rises would be sensible, but may have been ruled out by the Conservative manifesto

IT does not suffer from the same problems as NI, and rate rises would also have a progressive impact. Overall, it is a sensible way to raise further revenue. Indeed, some of the proposals we have set out thus far – such as capping the pension tax-free lump sum, consolidating tax allowances, and reducing the attractiveness of converting 'income' into 'capital gains' – would make IT an even broader tax.

231 M Brewer, A Corlett, K Handscomb, C McCurdy & D Tomlinson, The Living Standards Audit 2020, Resolution Foundation, July 2020.

As a brief aside, we also believe the 'Marriage Allowance', which allows spouses to transfer any unused Personal Allowance, should be abolished. This policy clearly penalises unmarried couples (civil partnerships are included); adds complexity and has incomplete take-up; reduces work incentives for second earners; and has a cliff-edge, with the transferable allowance being available for those earning £50,000 but not those earning £50,001 (or £43,430 and £43,431 in Scotland). Abolishing it would be relatively regressive – as one of the couple must have a low income to benefit. But in the spirit of horizontal equity, and raising £500 million a year, it should be abolished.

Policy recommendation: Scrap the Marriage Allowance (raising £500 million)

Given its broad base (and even ignoring our proposals for freezing thresholds), a 1p rise in every rate of IT would raise around £7 billion a year – and more progressive rate rises could be considered (as we do below).

However, the manifesto promise not to raise IT should be noted. And politicians have not managed to increase the basic rate of IT since 1975 (and that was short-lived), often opting for NI increases instead. And, although IT rate rises would not worsen the tax system, they would not in themselves do much to improve its structure. So, although we do think IT rate rises would be a sensible way to raise significant extra revenue, there is an alternative option to raise revenue while simultaneously dealing with some of the distortions and unfairness caused by NI, as we set out below.

A new Health and Social Care Levy would be an appropriate response to the separate public health, social care and fiscal crises

Our conclusion so far is that an IT rise is a broadly sensible way to raise revenue. There is also – as partly discussed above – a strong case for replacing (or starting to replace) personal NI, which is the source of many problems in the existing direct tax system.

At the same time, there is a long-running debate over how to better fund social care. After the Prime Minister announced in 2019 that "we will fix the crisis in social care once and for all",[232] there is an expectation that some significant reform will happen. Independent assessments suggest that simply maintaining recent standards of care (and improving pay) would, given an ageing population, require an additional £2-12 billion in England alone.[233] Further sums would be needed to provide added insurance, though some of this could come from beneficiaries with significant assets. We do not take a view in this report on what the exact funding need is, but instead take as a starting the point the idea that an additional £6 billion a year in taxes (UK-wide) will be needed to go a long way towards fixing the crisis.

232 Boris Johnson's first speech as Prime Minister: 24 July 2019, gov.uk.
233 O Idriss, C Tallack & N Shembavnekar, Social care funding gap: Our estimates of what it would cost to stabilise and improve adult social care in England, The Health Foundation, October 2020. Figures are 2023-24 projections in 2020-21 prices.

Clearly, trying to find an additional £6 billion a year on top of the £40 billion needed for fiscal consolidation is extremely challenging, and this leads us to consider the need for a new tax that makes clear its relationship with increasing social care funding. We therefore set out below a comprehensive proposal for a 'Health and Social Care Levy' that would simultaneously:

- raise substantial revenue for fiscal consolidation;
- additionally raise £6 billion for social care;
- close the gap in personal tax treatment between the self-employed and employees – something that was flagged as a priority by the Chancellor when he announced the SEISS – and begin to replace personal NI entirely, improving the tax system in a variety of ways; and
- not breach the Conservative party's manifesto promise.

Given the complexity of these considerations, we explore the idea step-by-step.

1. The idea of an additional tax on incomes

In its most basic form, our proposal involves a 1 percentage point marginal tax rate rise for basic rate employees (above £12,500 – where the IT personal allowance would also be in 2024-25 under our proposals) and a 4 percentage point rate rise for higher and additional rate payers.[234]

But – as with increasing IT – simply using a new tax to achieve this would represent a missed opportunity to improve the tax system by tackling some of the flaws of NI. We therefore propose to combine the basic gist of this tax rise with NI reform.

2. Closing the personal NI gap between employees and the self-employed, aided by a 4 per cent Health and Social Care Levy

Any new tax should not discriminate between employment income and self-employment income. But existing personal NI does treat these differently: on top of the huge additional distortion of employer NI, which is explored in Box 5. Basic rate employees have a marginal personal NI rate of 12 per cent, while the self-employed pay only 9 per cent – but do pay a separate £3 per week in 'Class 2' NI.

There is no good justification for this difference.[235] Philip Hammond tried in April 2017 to raise the self-employed rate to 11 per cent (before backing down), saying "Historically, the differences in NICs between those in employment and the self-employed reflected

234 Note that the latter would be equivalent to reversing most of – but not all – the 2013-14 cut in the top rate of IT, and so is within the bounds of even recent history.
235 See for example: J Freedman & H Miller, Tax and employment status: myths that are endangering sensible tax reform, July 2020.

differences in state pensions and contributory welfare benefits. But with the introduction of the new state pension, these differences have been very substantially reduced." And Rishi Sunak has publicly stated that "there's currently an inconsistency in contributions between self-employed and employed" and that "[the coronavirus support does] throw into light the question of consistency and whether that is fair to everybody going forward." In addition, this crisis has shown the danger of artificially encouraging more people into relatively insecure work (i.e. self-employment) – with the low-earning self-employed particularly badly hit by private income falls.[236]

One way to reduce these tax differences would be to increase the basic NI rate for the self-employed to 12 per cent. If Class 2 NI were abolished at the same time, this would raise a net £400 million. This change would be a significant improvement, and a narrowing of the tax treatments between employees and the self-employed should certainly be part of the consolidation in some form (in this paper we focus on gaps created by different rates of personal NI, but Box 5 discusses the broader question of employer NI). But our proposal for a new tax presents the opportunity to achieve fairness between employees and self-employed in a different manner from the straightforward rate rise that Philip Hammond attempted.

BOX 5: **Employer NI and the self-employed**

The proposals in this section include removing the gap in personal NI between employees and the self-employed. However, this does not address the fact that employment is also taxed via employer NI. Indeed, while closing the personal NI gap for the self-employed would raise £400 million (net), the total self-employment NI tax break was estimated to be worth £5.85 billion in 2019-20.[237]

This inconsistency in tax treatment leads to firms being incentivised to use self-employed labour rather than directly employed workers, thereby avoiding responsibility for employer NI (as well as pension contributions and a requirement to pay the National Living Wage).

One partial solution might be an Australian-style extension of employer NI to contractors, where contractors work for a business for a prolonged

236 M Brewer, N Cominetti, K Henehan, C McCurdy, R Sehmi & H Slaughter, Jobs, jobs, jobs: Evaluating the effects of the current economic crisis on the UK labour market, Resolution Foundation, October 2020.
237 HMRC, Estimated cost of tax reliefs, October 2020.

period.[238] But this only covers a limited proportion of the self-employed, with others – such as many taxi drivers, hairdressers or cleaners – working (on paper) for many individual customers, even if another business is responsible for co-ordinating their activity.

A comprehensive solution might require the self-employed to pay employer NI themselves on their profits, but this would be a very large change.

In the long run, the same goal might be achieved by reducing employer NI while increasing the Health and Social Care Levy (or other taxes), applying more equal taxation to different forms of income. However, the changes we suggest – via personal NI, the Health and Social Care Levy, CGT, dividend taxes, and the VAT threshold – would go some way to reducing the biases in the UK tax system.

Given this background we propose to take the proposal discussed above – for a new tax with a 1 per cent basic rate and 4 per cent higher rate – but to implement it as a flat 4 per cent tax accompanied by a reduction in the basic employee NI rate from 12 per cent to 9 per cent, and the scrapping of Class 2 NI for the self-employed. The net change for basic-rate employees, then, would only be a 1 per cent tax rise. This combination of rate changes (though without the removal of the flat Class 2 payment) is shown in Figure 45.

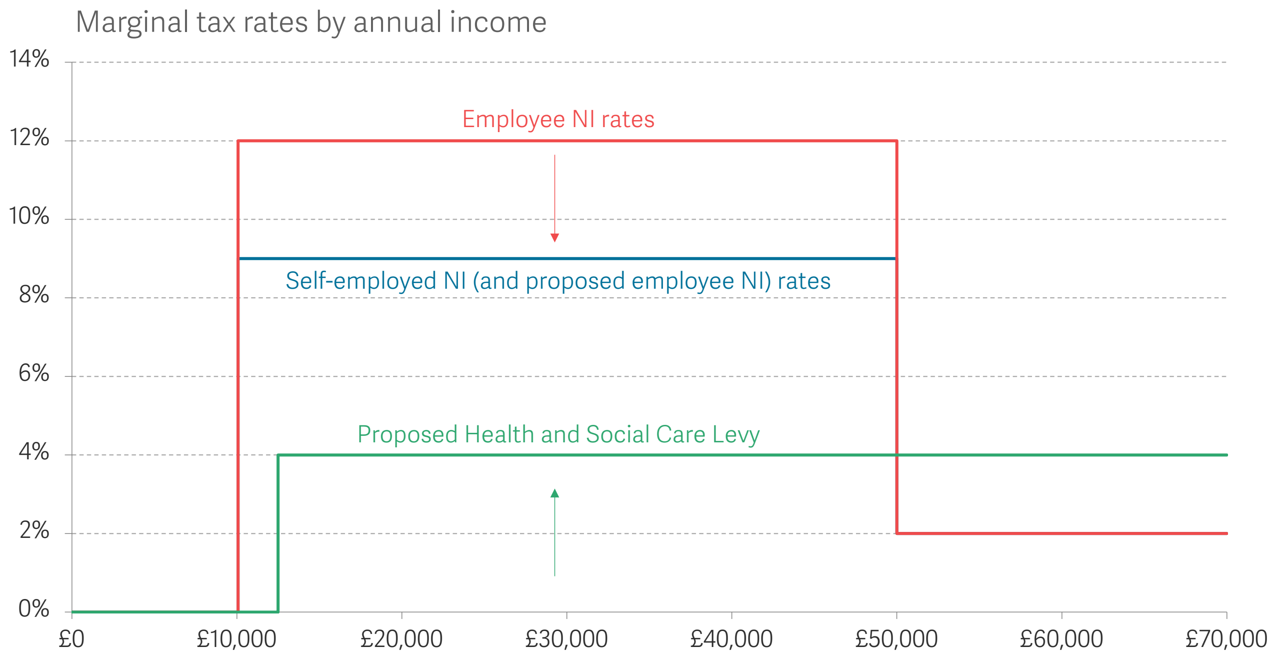
Our central proposal then is a new, UK-wide 4 per cent tax on all income above £12,500, which we refer to as a 'Health and Social Care Levy',[239] but coupled with this levelling-down of NI rates for employees to match those paid by the self-employed.

Policy recommendation: Introduce a new Health and Social Care Levy, at a flat rate of 4 per cent of (broadly-defined) income above a £12,500 threshold, alongside a 3p reduction in the basic rate of employee NI and the abolition of Class 2 NI for the self-employed (raising £17 billion, with £6 billion going directly to higher social care spending).

238 See for example: Queensland Government, Payroll tax on payments to contractors.
239 This is modelled as a UK-wide tax. We do not explore here the important potential for devolution of this Levy. NI is not devolved, but there is devolution of IT (to varying degrees).

FIGURE 45: **A new Health and Social Care Levy would have a flat rate of 4 per cent, compared to the regressive structure of employee and self-employed NI**

Marginal tax rates by annual income



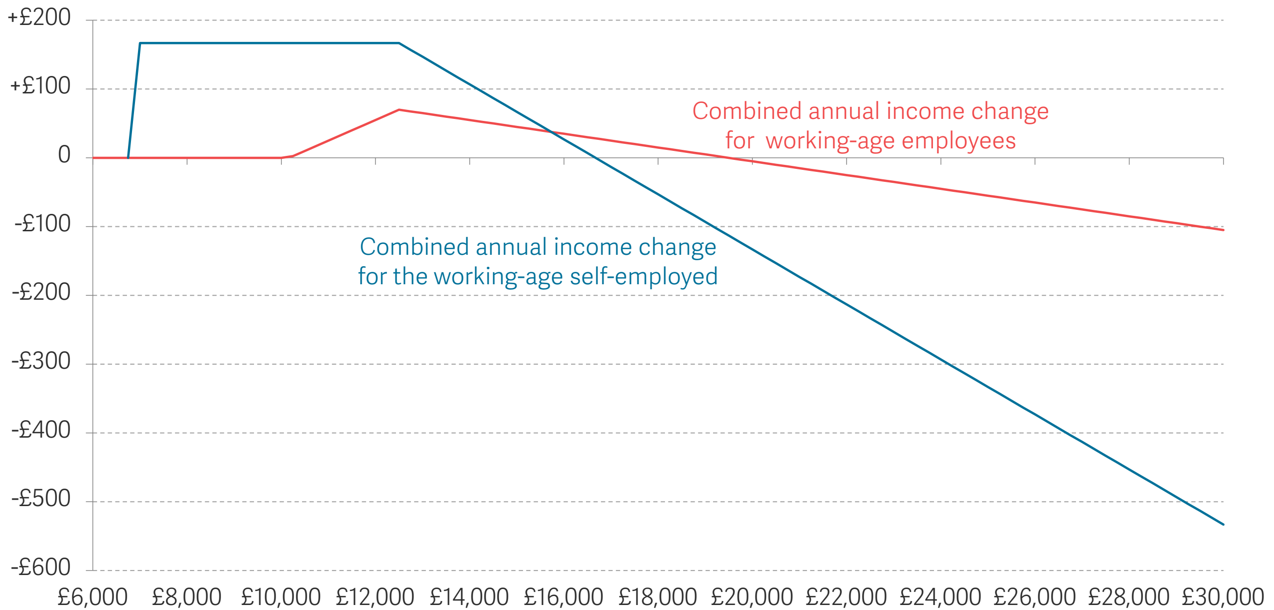
NOTES: NI thresholds based on projections for 2024-25, including a freeze in the higher-rate threshold.
SOURCE: RF analysis.

Given that we propose a starting point of £12,500 for this Levy, rather than the expected NI starting point of around £10,100, the combination of the new Levy with a NI cut would actually mean working-age employees earning less than £19,500 would be slightly better off as a result of this new policy. And among the self-employed, the combination of the Levy and the abolition of Class 2 NI would mean that all of those with incomes below around £17,000 a year – which is the majority of the self-employed – would also be better off. These impacts are shown in Figure 46.

Closing the personal NI gap between the self-employed and employees is not the only tax improvement the Health and Social Care Levy would aim to bring about. The tax would also reduce the distortions and inequities that come from many forms of income attracting zero personal NI.

FIGURE 46: **Employees earning below £19,500, and a majority of the self-employed, would be better off from this combination of policies**

Annual income change from reducing Class 4 NI, abolishing Class 2 NI, and introducing a new Health and Social Care Levy, by annual income



SOURCE: RF analysis.

3. Including all age groups and most income within the scope of the Health and Social Care Levy

- **Any new tax should not have age limits, so should tax earnings above State Pension Age too**

As noted above, one unfairness in the personal NI system is that it does not extend beyond the State Pension Age (currently 66). Given that personal NI is essentially just another income tax, this is hard to justify. We note, for example, that at least 58 MPs (9 per cent) are currently above State Pension Age and therefore pay no employee NI on their salaries (saving around £5,500 a year on the basic MP salary).[240] As with the self-employed tax difference, this could be fixed within the existing system, and we have previously estimated that extending personal NI to the earnings of workers over the State Pension Age could raise £900 million a year.[241]

A 4 per cent tax would raise less than full NI (at 12 or 9 per cent) for working pensioners would but, by the same token, it would be easier to bring in without causing large income falls. And as everyone would begin paying the new tax at the same time, and at a flat rate,

240 Wikipedia, List of United Kingdom MPs by seniority (2019–present).
241 IC report, based on 2020. Note that employer NI is already paid on these employee earnings.

it may be less at risk of being viewed as specifically targeting working pensioners (and other groups) for extra revenue.[242]

However, any new tax should not only cover all earnings equally, but also cover other forms of income.

- **Any new tax should apply to capital income and capital gains, unlike NI…**

NI is a tax on earnings only, so all forms of income other than employment income and self-employment income are excluded.

A Health and Social Care Levy should not follow that approach, and so should extend at least to all of the other forms of income covered by Income Tax, including: dividends, rental income, royalties and savings interest. To avoid exaggerating existing challenges created by capital gains attracting lower rates of tax, the Health and Social Care Levy should be applied to capital gains as well.

As such, the new tax would reduce tax differences between different forms of income, with employment income being somewhat less penalised than at present, thanks to the proposed NI reductions. Certainly, a new tax should not worsen the existing biases by applying only to earned income.

- **…and this includes pension income, and private pension lump sums**

The 4 per cent Health and Social Care Levy should also apply to private pension income. As we discuss below, and in Section 9, an ideal system of pension taxation might exempt all pension contributions but treat pension receipts just like earned income. Today's pension wealth did not attract a Health and Social Care Levy when the contributions were first made and nor, for the most part, will it have attracted NI. It is, therefore, not unreasonable for pensioners to pay tax on their income, particularly when that tax is to support and improve health and social care services for (primarily) older people.

A 4p increase in marginal tax rates above £12,500 for pensioners is not something to be taken at all lightly. However, it should be noted that with the projected typical personal income of retirees being less than £14,000, the majority would pay less than £50 a year, and around 44 per cent would pay nothing.[243] And for most of those with incomes over £12,500, the increase in average tax rate would be considerably less than 4 percentage points. Those above State Pension Age would continue to pay lower tax rates than those below it. Under these proposals the marginal tax rate for a working-age employee earning £20,000 would be 33 per cent, compared to 24 per cent tax rate for pensioners. And any

242 G Tetlow, J Rutter, J Marshall & T Pope, How to be a tax-reforming chancellor, Institute for Government, December 2019.
243 RF analysis of DWP, Family Resources Survey, using the IPPR tax-benefit model. We assume that the Health and Social Care Levy follows the approach of Income Tax and taxes the State Pension in theory but – given its threshold – the basic State Pension would de facto be tax-free.

new tax rise for all age groups – like this – would fall most on younger generations, given they will be paying it for a longer period.

As discussed in Section 9, there are significant value-for-money and fairness concerns about tax-free pension lump sums. And there is no need for bad elements of existing IT policy to be replicated in any new tax. The Health and Social Care Levy should therefore apply to those lump sums.

- **The best option for any new tax may be to apply full tax relief to pension contributions, but this is a major decision**

At the same time as considering how pension receipts should be taxed, we must consider how pension contributions should be taxed.

IT exempts contributions from tax (through 'pension tax relief') but treats pension receipts just like earned income, with the exception of tax-free lump sums.

Personal NI takes an inconsistent approach, with employee pension contributions taxed via NI, but neither employer contributions nor the later pension income from these taxed at all. Our proposal to cut personal NI from 12 per cent to 9 per cent would therefore mean a boost to basic rate employee pension contributions, and a narrowing of the (unwelcome) NI difference between employee and employer pension contributions.

The question of how a new Health and Social Care Levy should treat pension contributions is an important one. It could apply to all pension contributions, or none, or some. We take the view that it is best to aim for a consistent approach of exempting contributions and instead levying tax in retirement (as above). But, as we discuss below, this becomes more challenging if the goal were to entirely replace personal NI.

- **Any new tax should be based on annual income, and aggregated across income sources, unlike NI**

As well as the scope of a new tax, it is worth briefly discussing its basis. IT is based on a person's total annual income (with the exception of capital gains and the various allowances discussed in Section 9). But, as noted above, NI is based on weekly or monthly pay, and is calculated on a per-job basis.

There have been efforts to look at moving NI to an annual and aggregate basis.[244] Looking only at aggregating NI across jobs, we estimated that such a change would raise £360 million in 2014-15.[245] This would obviously lead to those with multiple jobs paying more tax. But when those with fluctuating incomes or who are in work for only part of the year

244 Office of Tax Simplification, Closer alignment of income tax and national insurance contributions, March 2016.
245 A Corlett & D Finch, Double take: workers with multiple jobs and reforms to National Insurance, Resolution Foundation, October 2016.

are also considered, those with lower incomes are more likely to be winners than losers; and higher earners are more likely to lose out.[246]

A partial shift from personal NI to a 4 per cent Health and Social Care Levy would reduce these horizontal (and vertical) inequities, without producing very large income losses overnight or making particular groups such as those with multiple jobs feel targeted. But this aspect of personal NI is also another reason to want to replace it entirely.

4. Replacing personal NI with a 13 per cent Health and Social Care Levy (in the longer-term)

As noted, a partial shift from personal NI to a new Health and Social Care Levy could help tackle a number of problems in the tax system. But it is true that this would mean adding another income-based tax on top of NI and IT. To simplify things, and treat all income even more equally, could personal NI be replaced entirely?[247]

For basic rate employees and the self-employed, it might make sense to have a 13 per cent Health and Social Care Levy, rather than a 4 per cent rate plus 9 per cent NI. However, there are two main sets of problems with proposing a 13 per cent Health and Social Care Levy for all.

The first problem (as shown in Figure 45) is that NI has a regressive structure: employees earning less than £50,000 currently face a marginal rate of 12 per cent while those earning more have a 2 per cent tax rate. Replacing this with a flat 13 per cent tax would therefore mean a very large 11 percentage point tax rise for higher earners. Alternatively, NI's regressive structure could be matched in a new Health and Social Care Levy (e.g. with a 13 per cent rate for lower earners but 6 per cent for higher earners), but we do not think that is very desirable.[248] A third option is that IT rates for higher earners could be reduced alongside a flat-rate Health and Social Care Levy replacing personal NI, with the 40 per cent rate being cut to 33 per cent and the 45 per cent rate falling to 38 per cent.

The second set of problems is about the scale of change. The Health and Social Care Levy proposals above in some cases mean changing from zero tax – for those not paying NI – to 4 per cent. That is a substantial tax rise, but arguably achievable. But full replacement of personal NI might mean going from 0 per cent to 13 per cent for some forms of income. Most importantly, that would be the situation for those over State Pension Age, who currently pay no NI. An alternative to 13 percentage point tax rises

246 A Corlett & D Finch, Double take: workers with multiple jobs and reforms to National Insurance, Resolution Foundation, October 2016.

247 We do not dwell here on the existence of the National Insurance Fund nor NI contribution records. These are minor administrative problems in comparison to the big policy design questions.

248 One benefit of replacing NI's regressive structure with a flat rate is that the Scottish tax oddity whereby total tax rates are regressive for part of the income distribution would disappear. (The oddity stems from Scotland having the same NI thresholds as the rest of the UK but a lower starting point for the higher rate of IT.)

would be to introduce different Health and Social Care Levy rates or thresholds for different groups, but that would add complexity and undermine the principle of reducing horizontal inequities.

So we think it would be desirable in the long-run to entirely replace personal NI (a flawed tax on working-age earned income only) with a Health and Social Care Levy levied on almost all forms of private income. But a 4 per cent Health and Social Care Levy appears a more realistic measure for the medium-term than a 'big bang' approach. Fully replacing personal NI would require careful consideration, with a particularly big decision to be made about whether the long-term goal of pension tax policy should be to move to a (more) consistent approach of exempting pension contributions but taxing pension income at the same rates as earned income.

The Health and Social Care Levy could raise £17 billion, and £6 billion of this could be set aside for additional social care funding

A 4 per cent Health and Social Care Levy would clearly be a major policy, and is a major part of our proposals in terms of revenue. It would bring in an estimated £32 billion a year (which could be subject to hard or soft hypothecation for health and social care spending), though this would be offset by £14 billion of NI cuts (leaving £17 billion) and a direct £6 billion boost in social care funding.

As we've noted, increasing IT rates would in some ways be a simpler alternative to the challenge of raising such large sums. But our proposal combines that with building a better tax system and building a better country. It reduces the incentives in our tax system for people to move into insecure self-employment, and it delivers on a key social policy goal by funding the social care system, the failings of which have been tragically exposed by this crisis. Given that the proximate cause of the fiscal crisis has been a public health crisis, and that health and social care needs remain long-term pressures on tax requirements, it seems appropriate that a key part of the solution should be a Health and Social Care Levy.

Section 11

Conclusions: a fiscal strategy for today and tomorrow

In the near-term, more support for the economy will be needed

In this report we have discussed how the Government can go about supporting the economy in the near term, and ensure the public finances remain on a sustainable footing in the longer term. Developing a strategy that meets both objectives coherently involves jointly considering the top-down objectives of policy, as well as the bottom-up policy measures that would be necessary to successfully deliver those macro objectives.

There can be no doubt that the near-term priority is addressing the health crisis and supporting a rapid recovery. This is best done by controlling the spread of the virus and supporting the incomes of those hit by the recession this pandemic has caused. And with monetary policy space severely curtailed by the low level of interest rates, fiscal policy must take on the role of ensuring that the economy returns quickly to its sustainable level of activity. In practice this means three things. First, the Government will need to provide more short-term support for the economy in 2021 than currently planned. Second, fiscal policy should remain supportive until the economy has recovered. Based on the OBR's central scenario, this means 2023. Third, once tightening starts it must proceed cautiously, so as not to weaken the economy by more than the Bank of England can offset. We estimate that this means a pace of consolidation of £20 billion per year.

To build confidence in a strong economic recovery, the Government should set out its fiscal framework

Some would say now is not the time for a new fiscal framework. The objection to one is that, with the economy operating way below normal levels, announcing a new set of fiscal rules would tie the hands of policy makers amid huge uncertainty, or hit demand by telling the public that tax rises or spending cuts may be to come.

Such a critique misses the key reason for setting out a new fiscal framework: to build confidence in the Government's approach and dampen uncertainty. By setting out a clear framework for supporting a rapid recovery and then keeping the public finances on a sustainable path, uncertainty is dampened and confidence is built. Failing to do that merely adds unwelcome policy uncertainty to an already highly uncertain environment.

The way sustainable public finances have been targeted in the past is with an objective for public sector net debt to be stable year-to-year. But such an approach fails to recognise the necessary shift towards additional investment spending in the face of the twin challenges of levelling-up and moving towards net zero. Yet it would also miss the need to build fiscal policy space for future crises. Instead, governments should target public sector net worth and aim to ensure it improves sufficiently between recessions so as to be genuinely sustainable. This approach would see the Government planning for a fiscal consolidation of around £40 billion in 2024-25 terms. But given elevated uncertainty and the risk that the fiscal outlook could deteriorate, the consolidation strategy should be flexible, including measures that can be scaled up if more is needed.

The Government should be prepared to meet this challenge with a carefully designed package of tax rises

Tax rises will do the lion's share of the heavy lifting in this consolidation. Such an approach is likely to minimise the impact on the economy. But it also takes into account the path that the public finances have been on, where cuts to public spending since 2010 have been historically unprecedented and among the largest of any advanced economy. While individual areas of policy will be reduced or constrained, it is unlikely that major reductions in spending as a share of GDP are feasible.

Such a large rise in taxes is clearly challenging, but it is not without precedent. On a comparable basis, the budget of 1993 raised £48 billion; and the budgets of 1974 and 1975 together raised £47 billion. Some worry that this would mean the tax take is simply too high. And while the tax-to-GDP ratio would rise to over 39 per cent, its highest level since 1983-84, that would not be unusual by international standards, and the tax burden on typical workers has fallen significantly in recent decades.

A significant tax-led consolidation will only be successful if it is underpinned by a compelling national purpose, that goes beyond the question of sustainable public finances. Our approach is therefore driven by three guiding principles. First, large increases in tax will be impossible if they lack a compelling purpose that builds consensus. This means that political economy considerations – and particularly the distributional impact of the pandemic – must be at the heart of the proposed approach. Second, tax changes should reduce economic distortions. And third, where possible, tax

changes should aim to make progress on the four big challenges facing the country and the tax system: ageing, the under-taxation of wealth, the over-incentive to be classified as self-employed, and climate change.

Table 1 gives the full list of our medium-term revenue-raising proposals. These 18 measures range from relatively small revenue-raisers designed in part to remedy horizontal inequities, to the huge additional £17 billion a year (net) that could be raised by a new Health and Social Care Levy.

TABLE 1: **Our recommendations would raise a net £40 billion in 2024-25, including £6 billion extra for social care**

Policy recommendations	Revenue raised (2024-25, nominal £bn)
Environmental tax reforms	
Reform Vehicle Excise Duty	1.0
Introduce a Home Delivery Congestion Charge	0.1
Subtotal	**1.1**
Freezing tax thresholds and raising Corporation Tax	
Freeze IT personal allowance at £12,500 (from April 2021)	5.1
Freeze IT higher-rate threshold at £50,000 (from April 2021)	1.0
Freeze IHT thresholds at a combined level of £1m (from April 2021)	0.4
Extend the VAT threshold freeze (from April 2022)	0.2
Raise Corporation Tax rate from 19% to 22%	10.1
Subtotal	**16.8**
Reforming wealth taxes	
Scrap BAD relief and curtail voluntary liquidations CGT loophole	1.0
Remove capital gains uplift on death	2.3
Merge allowances for CGT, dividends, savings income & ISA income	2.2
Scrap Lifetime ISAs	0.6
Cap pension tax-free lump sums at £100,000	0.1
End the tax-free treatment of inherited pensions	0.5
Add a £2.5m cap on business/agricultural property IHT relief	0.6
Introduce a Council Tax Supplement on properties worth over £2 million	1.4
Subtotal	**8.8**
Increasing major tax rates	
Extend VAT to private school fees	1.6
Scrap the IT marriage allowance	0.5
Introduce a 4% Health and Social Care Levy on most income over £12,500: net	11.3
4% Health and Social Care Levy	*31.5*
Cut basic employee NI by 3p & abolish Class 2 NI	*-14.2*
Boost social care spending	*-6.0*
Subtotal	**13.5**
TOTAL	**40.2**

NOTES: See earlier sections of this report for more details. Total does not include tax cuts avoided. Health and Social Care Levy, NI, Corporation Tax and VED proposals include estimates of behavioural impacts.
SOURCE: Various RF analysis, including use of the IPPR tax-benefit model.

These proposals also vary in how soon they could – or should – be announced and delivered. These are certainly not proposals for a single Budget. As discussed in Section 8, although fiscal policy overall should be expansionary right now, we think it would be sensible to keep key tax thresholds at their current levels in April 2021. For some policies, the direction of travel could be announced in advance, while for others the risks of forestalling tax avoidance would make that unwise. And some policies – including the Health and Social Care Levy proposal – would take some time to plan and implement.

Certainly, the timing and scale of consolidation will depend on what happens with the coronavirus and the economy. So the Government's approach should be a flexible one: threshold freezes could be extended or ended as developments show is necessary, some policies may not be needed, or additional ones may be required – which is why we have also discussed longer-term reforms for wealth-related taxes in particular.

But it would be wrong to plan on the basis that no tax rises will be needed. And in many cases our proposals would be good tax reforms even if raising revenues was not a priority: removing harmful or unfair distortions, improving progressivity, and simplifying the tax system.

This policy package would be progressive and help redistribute some of the good and bad luck from this crisis

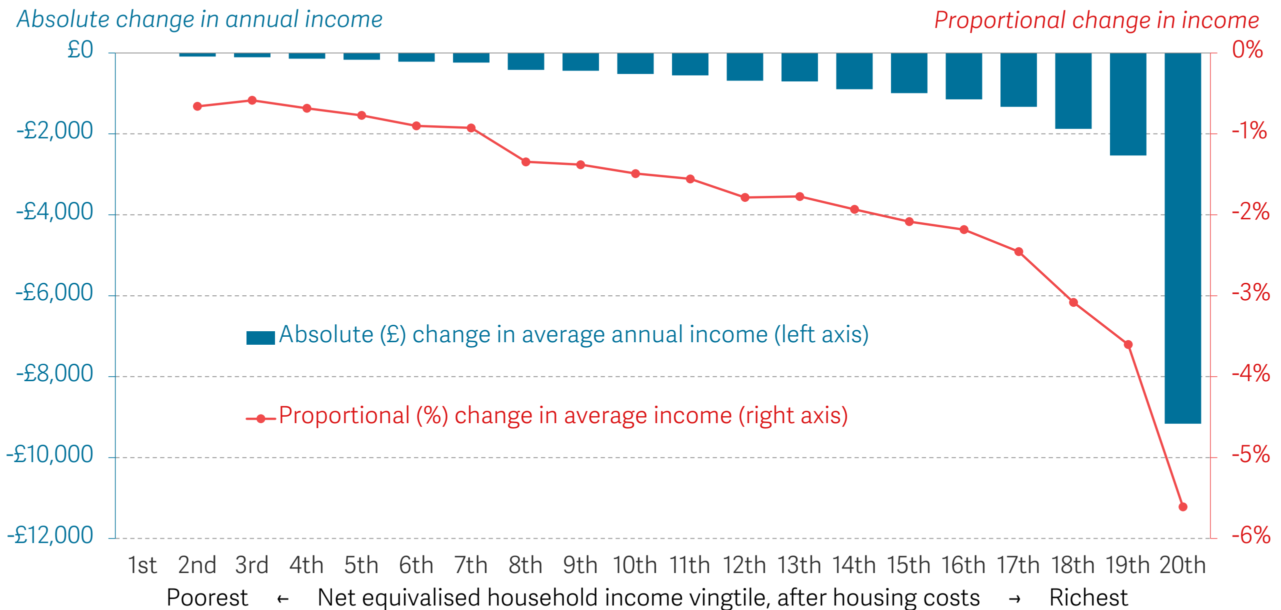
The consolidation overall should be progressive, reflecting the fact that different income groups have very different capacities to contribute, and that the struggles of this crisis have not been (and will not be) spread equally. In our proposals, those who would contribute most would also be those likely to have experienced the least hardship during the crisis: high earners, high savers and profitable companies.

Looking at those proposals with obvious and broadly-felt distributional impacts (i.e. changes to IT, NI and our Health and Social Care Levy), contributions would clearly be progressive, with tax rises of under 1 per cent of disposable income for the poorest third on average (partly due to Universal Credit cushioning any tax rise by giving back 63p for every £1 fall in income) but over 2 per cent for the top third. These proposals would in fact lower the UK's Gini coefficient by around 0.6 percentage points – a significant, if not vast, change – and reduce inequalities between the UK's regions and nations.[249]

249 RF analysis of DWP, Family Resources Survey, using the IPPR tax-benefit model.

FIGURE 47: **Our proposals would raise most from those with the highest incomes**

Impact on average household income by vingtile of our Income Tax, National Insurance and Health and Social Care Levy proposals, 2024-25



Notes: We exclude the bottom 5 per cent, due to concerns about the reliability and volatility of data for this group. We do not include the impact of the Health and Social Care Levy proposal on pension tax-free lump sums or capital gains, as these are not included as income in the survey data.
Source: RF analysis of DWP, Family Resources Survey, using the IPPR tax-benefit model.

Significant tax rises are never easy, but they are required and can play a part in building a better country

No-one thinks that raising significant tax revenues is easy, but nor can it be avoided in the years ahead. This paper sets out how considerations of macroeconomic policy should be integrated with the microeconomic proposals that make them a reality. Neither should be considered in isolation, not least given the crucial role that fiscal policy plays in stabilising our economy, and the reality that policy makers considering how to put the public finances back on a sustainable footing also need concrete suggestions for doing so. The proposals we set out would not only deliver on that fiscal objective, but do so while helping the country address some of the key challenges that we face in the years ahead.

Resolution Foundation

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

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

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