Resolution Foundation

Talking tax

What's been said and what's gone unsaid in the Conservative leadership election

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Torsten Bell & Adam Corlett

Elections are rarely entirely about a single issue, but there are exceptions. Brexit in the 2019 general election stands out, and today tax cuts totally dominate the 2022 Conservative leadership election. Judging by last night's TV debate, the contest is staying that way, with little discussion of the huge questions facing the country, from the NHS, to net zero and the cost of living. Instead both Liz Truss and Rishi Sunak are content to focus on tax cuts, or more specifically the "when to cut taxes" dividing line that's shaped the election.

This is unfortunate given record NHS waiting lists and energy bills surging to over £3,000 will fill the in-tray of whoever next moves into 10 Downing Street. But it's at least partially understandable. National Insurance (NI) payments have just gone up (for some); Corporation Tax is set to rise significantly next April; and tax thresholds are set to be frozen for the next three years. The result is that taxes are forecast to rise to 35.5 per cent of GDP in 2022-23 – the highest since 1950-51 – and 36.3 per cent by 2026-27. While this is not high by international standards, most Conservative members live in the UK, so it is our history rather than our neighbours' tax/spend choices that may be front of mind.

But if we're going to talk so much about tax cuts, we may as well do it properly. Despite the exclusive focus on them to date, a lot of what's important about tax cuts is going unsaid. So here are five lessons about what proposed tax cuts will, and won't achieve – and the wider economic and fiscal context they sit within.

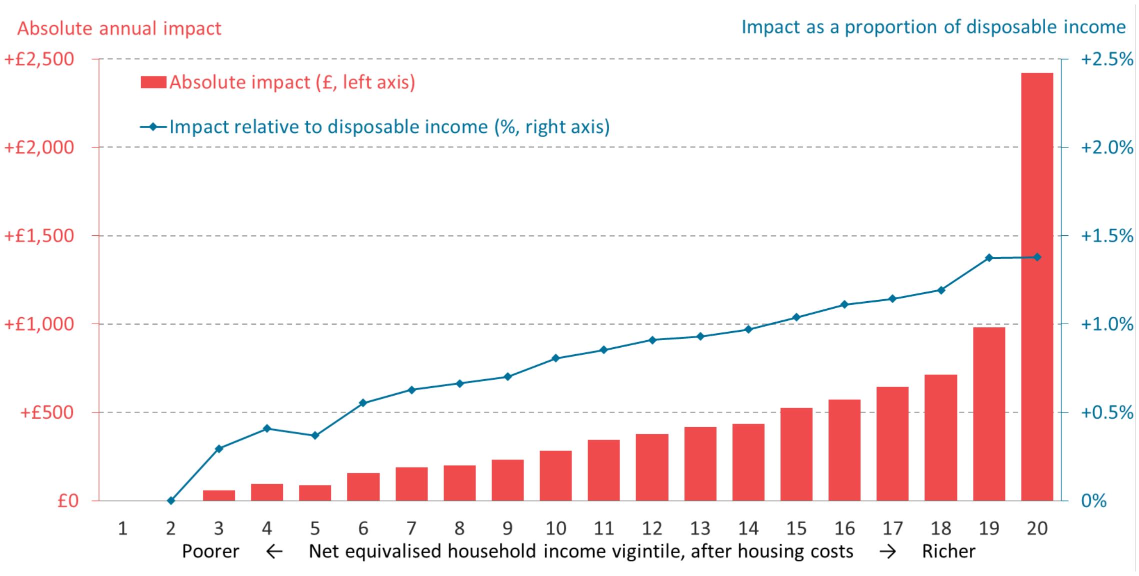
1. These tax cuts are big but cannot be the answer to the cost of living crisis

The tax policies under discussion are big. Liz Truss proposes a £30 billion package of immediate tax cuts made up of cancelling the forthcoming Corporation Tax rise (costing up to £19 billion in 2024-25), scrapping the recent NI rate rise for employees and the self-employed (£8 billion a year, or around double that if the plan is to do the same for employers) and reversing the corresponding dividend tax rise (around £1 billion).[1] Rishi Sunak has criticised these plans as unaffordable, but as Chancellor was exploring options to provide lower corporate taxes for firms that invest (likely to cost several billion pounds), pre-announced a cut to the basic rate of Income Tax for 2024 at a cost of £6 billion and suggested (again) last night that he'll "go further when the time is right".

Whatever the merits of these proposals – and debate about the right level of taxation is a perfectly normal part of politics – they are not a serious answer for the current crisis. While their price tags are high, they do little to target those hardest hit by the rise in the cost of living, due to the focus on rates of personal income taxes.[2] Rising energy bills will bite hardest for low- and middle-income households this winter, but only 15 per cent of the cost of scrapping the NI rise would go to the poorer half of the population, while 28 per cent would go to the top twentieth (Figure 1). And – despite both candidates recommitting to levelling up in last night's debate and despite energy bill rises being fairly evenly spread across our nations and regions – the change would widen rather than narrow regional divides. The average income boost in the North East, Yorkshire & the Humber and Wales would be £290 a year (0.8 per cent of disposable income), while in London it would be over twice as large at £640 (1.2 per cent).

Figure 1 **Only 15 per cent of the cost of scrapping the National Insurance rise would go to the poorer half of the population**

Impact on average disposable household incomes (after housing costs) of cancelling the personal National Insurance rate rise, by income vigintile, 2023-24: UK



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.

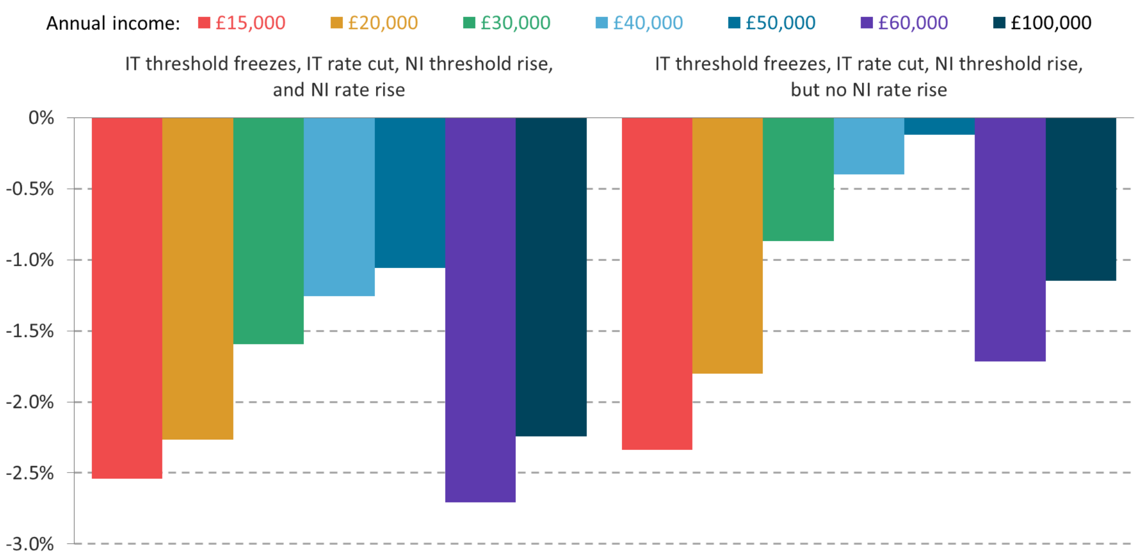
2. A debate about tax cuts ignores the underlying realities: taxes will be going up under either candidate and planned changes are a total mess

The tax cuts being promised here will not take place in a vacuum. The backdrop here is a complex and largely indefensible approach to raising personal taxes between this year and the middle of this decade, only one aspect of which Liz Truss proposes to reverse. More focus on how taxes are actually being raised, rather than just how much candidates would like to cut them, is badly needed. The Government's current plan is to combine an Income Tax threshold freeze over the next few years (i.e. a very large tax rise) with a cut to the basic rate of Income Tax (i.e. a smaller tax cut). Before you interpret this as a tax strategy intentionally aimed at widening the tax base and lowering marginal rates, note the exact opposite approach is being taken to NI – with an increase in rates partially offset by a large increase in the threshold. This isn't a strategy, it's a dog's dinner.

No-one would have designed this combination intentionally. It leads to lower earners being disproportionately affected: someone with an income of £15,000 is being asked to pay twice as much as a share of their income (particularly via the Income Tax threshold freeze) as someone on £50,000 (thanks to the basic rate cut), with losses of 2.5 per cent and 1.1 per cent of pay respectively. Note that cancelling the NI rise (or another basic rate cut) would make the package more regressive across earners as the right-hand chart in Figure 2 illustrates.

Figure 2 **With or without the National Insurance rate rise for workers, direct taxes are going up – and disproportionately so for lower earners**

Combined impact (loss) from Income Tax and personal National Insurance policies for an employee, as a share of pay, 2025-26: UK



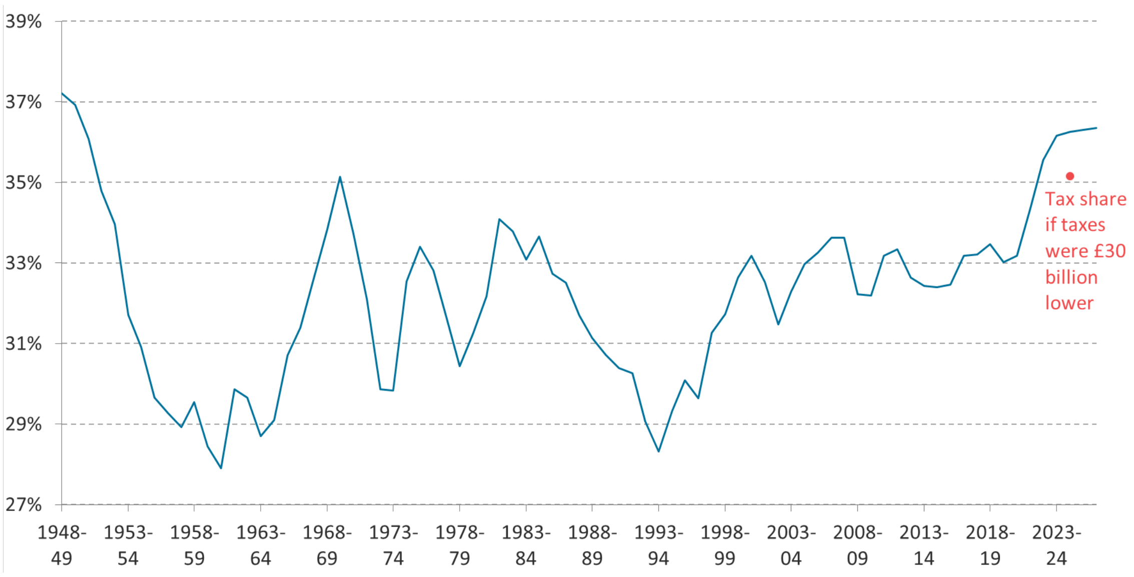
Notes: Impact of employer NI rise not included.
Source: RF analysis.

The mess of this package, which the next PM will be implementing, is largely being ignored in this election. That's not surprising for Rishi Sunak given he created it. Liz Truss is also not raising it, presumably because doing so means admitting that, even under her plans, direct income taxes are going up not down, especially for some lower earners (note some of those earning too little to pay income tax have benefited from the higher NI threshold).

But acknowledging this is important for a host of reasons. Firstly, because this mess needs sorting out. The overall package could be simplified and its fairness increased by ending the ludicrous approach of telling people it's an economic necessity to freeze their Income Tax thresholds for four years when the past two years are just paying for the cut to the basic rate of Income Tax. Secondly, it points to the dangers of an economic strategy for the 2020s built almost entirely on the hope that tax cuts will unleash growth, given that under either candidate income taxes are rising (reflecting pressures on public spending that won't be wished away) and that the big row about corporate taxes is whether they should be held at their current level (which we've learnt is perfectly consistent with a very slow growing economy) or increased significantly. Saying you're a tax cutter is all well and good, actually cutting them in the 2020s is another thing entirely, given long-term structural pressures. As Figure 3 shows, even with £30 billion a year of tax cuts, tax as a share of GDP would still be higher in 2024-25 than in 2019-20 and indeed still the highest since 1950-51.

Figure 3 **Overall taxes are likely to remain high by historical standards regardless of who the next Prime Minister is**

Outturn and projected national account taxes relative to GDP: UK



Source: OBR, Economic and Fiscal Outlook, March 2022.

3. Thatcher is being praised but her legacy misunderstood: personal taxes are rising, but they're historically very low

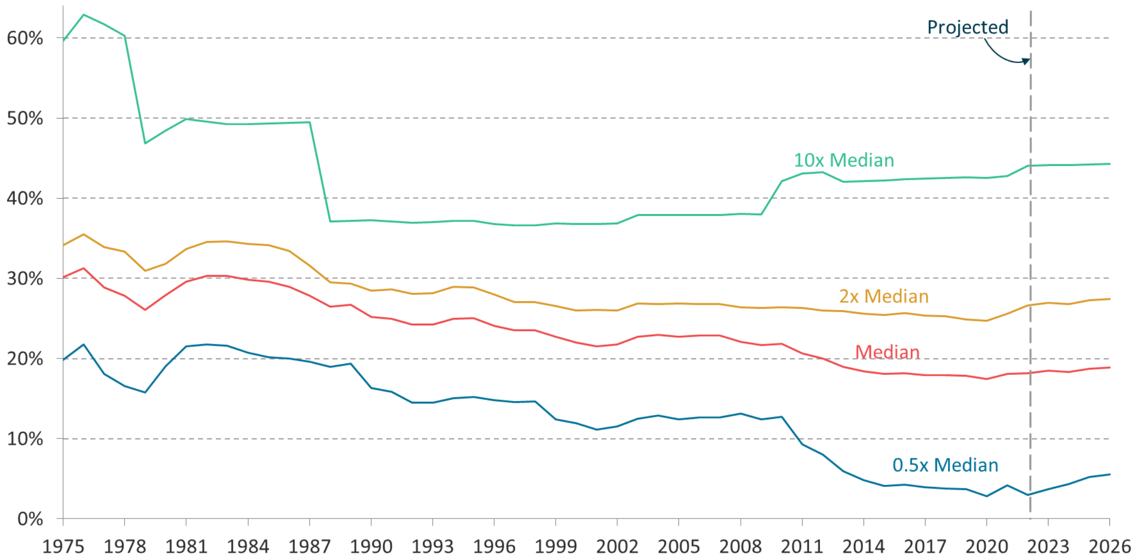
There is better news for low tax Conservatives if they look backwards rather than forwards. It is very popular to laud Margaret Thatcher during this contest, but not to do her the credit of understanding that we're still living with the tax system she created in many ways. In particular, you'd think from the debate that the British are suffering under the yoke of incredibly high direct income taxes, when the reality is that Thatcher set us on a path towards historically low rates of such taxes, as our next chart shows. She focused on reducing tax rates for higher earners, while her successors have reduced them for those on middle and lower incomes, as

Figure 4 shows.

Even accounting for the planned tax rises currently in train, in 2026-27 the typical employee is projected to pay 19 per cent of their salary in Income Tax, employee National Insurance and the Health and Social Care Levy. Compare that to around 30 per cent when Thatcher was in Downing Street. So real Thatcherites who worry about the incentive effects of high marginal tax rates should be focused beyond the headline rates of NI and Income Tax – it's the likes of our benefits system and student loan repayments that mean some groups face high effective tax rates today, although neither is being mentioned this summer.

Figure 4 **For most workers, personal National Insurance and Income Tax will remain historically low overall even with tax rises**

Effective tax rates for employees on different levels of weekly pay: UK



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. Projections include threshold freezes and the planned reduction in the basic rate of Income Tax.
Source: RF analysis using median earnings figures from ASHE/NESPD and tax history from HMRC and IFS.

The high rate of taxes as a share of GDP can be reconciled with these low effective direct tax rates in two ways. Firstly other taxes, which are absent from today's tax debates, have increased – with VAT rising to record highs relative to GDP (though still lower than in most European countries), and payroll taxes being routinely increased. And secondly, complicated, compositional shifts raise the tax take even if tax rates remain unchanged. For example, higher wage inequality has pushed up tax revenues as more of our GDP goes to those on higher incomes who pay higher tax rates.

4. The economic context: it's the Bank of England, not the "Treasury orthodoxy", that means tax cuts won't boost growth in the short term

A big positive of this contest so far is both candidates – in stark contrast to the current Prime Minister – being open that the UK has a serious growth problem, as we set out in recent work on the UK's low growth, high inequality stagnation. Keir Starmer did likewise yesterday. Recognising the problem is a necessary, albeit far from sufficient, condition for addressing it.

With tax cuts dominating the context, they are also playing an outsize role in claims about which candidate would best support growth. Liz Truss argues that her immediate large tax cut plans would reject the "Treasury orthodoxy", boost growth and avoid a recession, while Rishi Sunak says additional borrowing now would crater the economy. Both are probably overdoing the short-term effect on growth of their different positions, not because of the Treasury but the Bank of England.

The central bank has now raised rates at five successive meetings for the first time since independence in 1997, reflecting the view that we cannot have more growth at present without further pushing up on inflation (already running at 9.4 per cent in June) because the supply side of the economy is struggling to keep up with demand. Markets generally agree, and whether or not the next Prime Minister does is largely irrelevant given central bank independence. Assuming Liz Truss is not about to remove that independence (doing so amid high inflation and with the Bank of England holding a lot of government debt would be incredibly unwise), the central bank will respond to any significant immediate tax cuts with higher interest rates to offset the short-term boost to demand.[3] To get a rough sense of scale here, the £30 billion of tax cuts being discussed might see the Bank of England raise rates by a further 1 percentage point relative to where they would otherwise have been, based on its standard multipliers.

This doesn't mean there aren't genuine choices to be made about the balance between fiscal and monetary policy. Providing cash support to low- and middle-income households is crucial to us getting through the winter ahead without widespread destitution, but will also mean upward pressure on interest rates which will reduce other people's incomes. Short-term debates about the fiscal/monetary mix are therefore largely ones of distribution rather than growth so the focus should be on whether the distributional priorities are the right ones. Large tax cuts for the highest earners do not seem to fit that description.

In the longer-term, fiscal policy changes can affect growth, for example if they encourage more business investment. And there's a strong case for reforming Corporation Tax to try to do that, ideally within a wider strategy that recognises that the UK's disastrously low levels of business investment have much more to do with our unstable economic policy making environment than tax.

5. The fiscal context: there are big choices ahead but not easy ones

An important enabler of this tax cut debate is the fact that the Government has around £30 billion of headroom against its binding fiscal rule to have debt falling on the basis of the Office for Budget Responsibility's (OBR's) March forecast. It is whether that headroom should be used up now, rather than more nebulous arguments about how long we should take to pay back public debt incurred during the pandemic (which neither candidate is really proposing to do), that separates Liz Truss and Rishi Sunak's approaches.

Is it essential to maintain exactly this much fiscal headroom? Clearly not, with the amount of headroom resting on a judgement about how much is necessary to reduce the chances of counter-cyclical lurches in fiscal policy being required at future fiscal events – we want to avoid having to tighten fiscal policy in the face of a slowing economy. The planned headroom of around 1 per cent of GDP against fiscal targets is near the top of the range of what Conservative Chancellors since 2010 have maintained, so Rishi Sunak is wrong to say that any additional borrowing is somehow a big departure from previous practice. Indeed it is clear he would like to use some of that headroom up for additional tax cuts in the years ahead. But he is right that Liz Truss's proposal to have no headroom at all is unwise and in practice comes close to being relaxed about missing the fiscal rules that both candidates (and indeed the Labour Party) are publicly committed to.

More importantly Liz Truss has made other commitments, beyond the headline £30 billion of tax cuts, that will very likely breach the debt rule. The proposal to raise defence spending to 2.5 per cent of GDP in 2026-27 may cost a further £10 billion while moving some green levies from energy bills and into public spending will require further borrowing. Potentially allowing partners to share their tax allowances would also require billions of pounds more borrowing. Promises on this scale are not consistent with wanting any material reduction in debt in the years ahead.

Candidates (and incidentally the Labour Party, which also aims to use up the available fiscal headroom, albeit for capital spending on net zero rather than tax cuts) should also be aware that there is a significant chance that the headroom available will shrink when the OBR updates its forecasts in the autumn. The OBR's previous forecast of growth of 1.8 per cent for 2023 now looks very rosy, compared to the Bank of England's projection of -0.2 per cent, while the idea that no further spending will be required in response to higher inflation given the extra costs to public services, both direct (e.g. school energy bills) and indirect (a need to raise pay) veers towards wishful thinking.

More generally, these technical discussions of how much fiscal headroom is available for tax cuts risk losing sight of why taxes are going up in the first place under a Conservative government: very real pressures for a larger state. The NI rise was, after all, explicitly introduced to bolster an NHS wrestling with the awful legacy of the pandemic and provide new protection for some from the catastrophic costs of adult social care. Liz Truss is also not the only Conservative to want to see much higher defence spending. It is far from clear that there is a plausible route to a materially smaller state in the 2020s.

The summer ahead

In practice it is very unlikely that cutting taxes will play as big a part in the next Prime Ministers time in office as their route to that position. That means it's unfortunate that wider questions are not being debated in this leadership election.

But debates about the right level, and type, of taxation are important parts of politics and the democratic process. Given we are going to spend this summer talking tax, it's in everyone's interest that we do it properly. On that front there's plenty of room of greater recognition of how our taxes have changed in years past, and the context within which politicians will seek to deliver promises of major tax cuts in the years ahead.

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[1] It is not clear whether Liz Truss's proposals include reversing the employer National Insurance rise, but she has said that "My plans do not exceed the headroom. I'm very clear that they are about £30 billion worth of costings, and those are affordable within our current headroom" which – when taken with her defence spending proposal – might suggest that the employer rise would remain in place. Reversing the employer rise would cost up to £10 billion a year – or less if the compensation that public sector employers received were removed and/or if there was a positive impact on wages.

[2] It is assumed that Truss proposes to reverse the National Insurance rate rise, but not to reverse the offsetting threshold increase that was implemented this month. If both changes were reversed, the impact would be to raise taxes for most workers, with only higher earners getting a net tax cut.

[3] Note this means higher than they would otherwise be, with many other factors – most importantly labour market developments – also key drivers of how large interest rate rises in the months ahead are likely to be.