SPENDING CHOICES AFTER 2015

Part 5: Taxing Matters

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One of the key priorities for the next Government will be to reduce the deficit. All three main parties have committed to doing so by the end of the next term, although as set out in *A Deficit of Growth II*, the parties differ in the extent of their ambitions. The Chancellor's Autumn Statement in December 2014 implied that overall departmental spending is set to fall in real terms by about 14% after 2015-16. But all three main parties have some room to ease up on these cuts and still meet their respective deficit reduction targets, with Labour having the most room, and the Conservatives having the least.

Since 2010, the current Government has focused primarily on reducing the deficit by cutting spending; but the net effect of its overall package of tax changes has nevertheless been to increase taxes by £16.4 billion since 2010-11.[1] The way in which the next Government plans to collect tax revenues will determine its spending options, whilst also fulfilling the commitment to cutting the deficit. The different parties differ on their appetite for tax rises in the next Parliament. Indeed, there are even promises of tax cuts, such as increases in the Personal Allowance that would reduce income tax. Unless such promises are offset by tax rises elsewhere, that could mean that even more spending cuts are needed, or that the commitment to reducing the deficit will not be met.

However, the effect of tax policy on Government finances goes further than this. An important element of the overall stability of Government finances is the volatility in tax revenues. Recent trends in tax policy have, in some cases, reduced the size of the tax base – the numbers of people or businesses paying tax. The Government has, for instance, estimated that 3.2 million fewer people are paying Income Tax in 2015 as compared to 2010. There is evidence that a smaller and less diverse tax base is linked to increased volatility in tax revenues.

In this paper, we assess the extent to which instability in tax revenues risks becoming an increasing problem due to the types of policies that the main parties are proposing. This could have significant consequences for future borrowing and public spending.

This briefing note:

- Sets out the main sources of the UK's tax revenue; recent trends in Government tax policy; and what is known of the plans of the three main parties for tax policy following the 2015 General Election.
- Highlights how recent trends in tax policy, and some of the proposals on tax being made for the next Government, contribute towards a reduction in the tax base; and demonstrates how a small or concentrated tax base can create problems for volatility in Government tax revenues. Given that the main parties

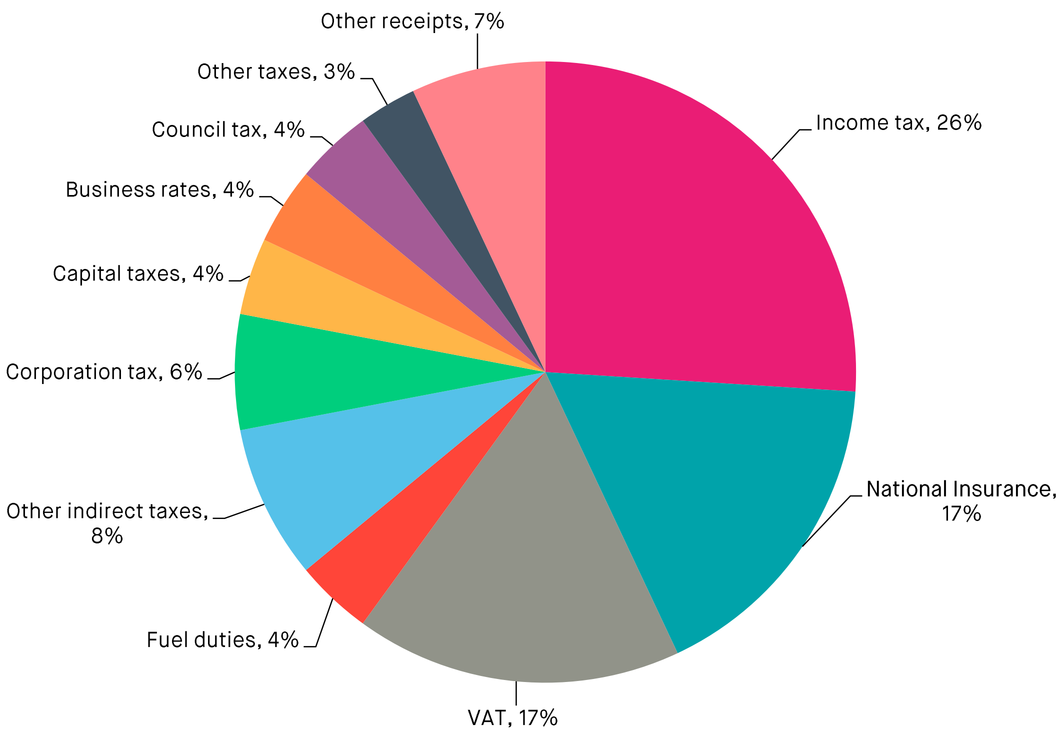
are all committed to reducing the deficit, a stable stream of revenue should be a priority.

- Demonstrates the connection between a reduced tax base for personal taxation such as Income Tax and National Insurance, and debates over those that 'contribute' to society, including those on low pay and migrants.
- Recommends maintaining the current levels of the Personal Allowance and National Insurance thresholds; and advises against further business tax reliefs and exemptions. Further increases in these thresholds and exemptions would reduce the tax base further, not only decreasing much needed tax revenues in the short term, but in the long term would put the UK in a poor position to deal with another economic downturn. If a future Government – faced with improved public finances – wished to cut taxes, reductions in overall tax rates would be better than tax giveaways through exemptions and higher thresholds. This would retain a wide tax base and reduced volatility, and also strengthen work incentives.

GOVERNMENT TAX REVENUE

Tax revenue is dominated by the 'big three' taxes: Income Tax, National Insurance Contributions (NICs), and Value Added Tax (VAT), which together make up three fifths of UK Government revenue, as shown in Figure 1.[2] In addition to employers' National Insurance contributions, businesses contribute to two other taxes that make up a large proportion of revenues – corporation tax and business rates.

Figure 1: Composition of UK Government Revenue, 2015-16



Source(s): IFS Green Budget 2015; Office for Budget Responsibility[3]

Currently, some of the taxes that generate substantial Government revenues are highly concentrated on a small number of individuals and companies. Of more than a million companies eligible for corporation tax, nearly of quarter of receipts are paid by just 70 companies.[4] The UK has a large number of small businesses by international standards; exemptions and reliefs from corporation tax and business rates often mean that many of these small businesses are ineligible for these taxes – they are not included in the tax base. Around half of Income Tax revenues come from 3% of adults.[5] In recent years some policies have been making this concentration even more acute. For instance, increases in the Personal Allowance for Income Tax have reduced the numbers of people eligible to pay it. In 2014-15 there were fewer working age people paying Income Tax than there were in 2000-01. Some of the policy proposals for the 2015 General Election are likely to increase this concentration, and reduce the size of the tax base, even further.

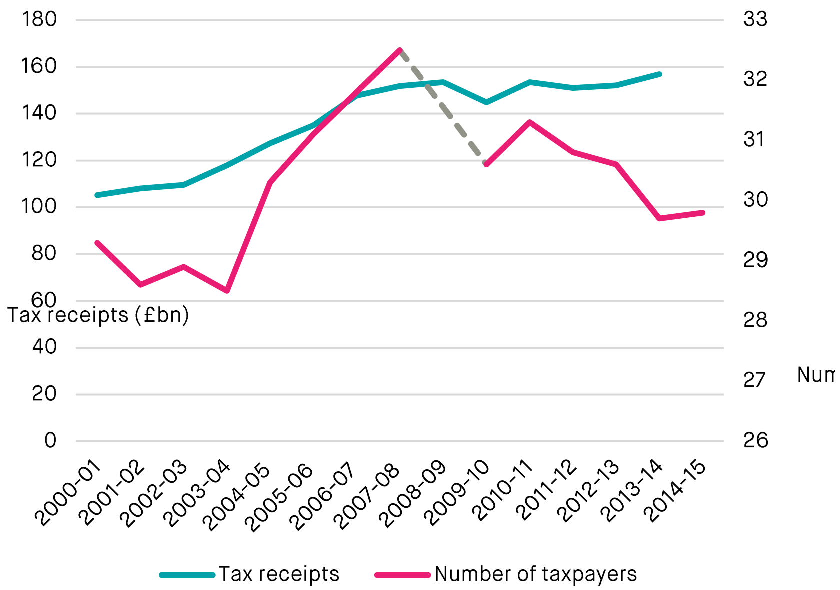
Although there may be good reasons for concentrating taxes on those most able to pay, there are two implications of a small tax base that rarely receive enough attention in political debate. First, there is evidence that a broader and more diverse tax base is associated with less volatile tax revenues.[6] This can be particularly important in times of economic downturn, when revenues that are highly concentrated on a small number of individuals or companies can fall far faster than reductions in GDP. There have been examples of this problem in the UK in recent years: Government tax revenues suffered greatly during the financial crisis as a result of reduced corporation tax income from financial institutions. If the next Government wishes to create a predictable and reliable tax and spending plan, it would be beneficial to have low tax revenue volatility.

Second, with regard to personal taxation, these issues raise important questions about the interaction between a reliance for revenue on a smaller tax base, and the notion that it is important for those receiving state benefits and services to contribute. This could have implications for public attitudes towards those claiming out-of-work benefits, and for attitudes towards immigrants. A poll by Lord Ashcroft found the biggest concern about immigrants was towards them 'claiming benefits and using public services when they've contributed nothing in return'.[7] This concern may be reflected in David Cameron's proposal to attempt to restrict migrants' access to benefits until they have been resident for four years. It also has resonances of debates in the United States, with Mitt Romney claiming 47% of Americans 'pay no income tax', and are 'dependent on government'. These – often overlooked – issues need to be borne in mind when considering recent trends in taxation, and the overall impact of the next Government's tax policies.

REFORMS HAVE MEANT FEWER PEOPLE ARE PAYING INCOME TAX AND NICs

Since 2010 the Coalition has changed the taxes that individuals pay in several important ways. The most publicised has been an increase in the Income Tax Personal Allowance – from £6,475 in 2010/11 to £10,000 in 2014/15, and with a further increase to £10,600 planned for 2015/16. The effect of this has been to reduce the numbers of people paying Income Tax: the Government estimated that 3.2 million fewer people would be paying Income Tax in 2015 as compared to 2010. As shown in Figure 2, whilst income tax revenues have continued to increase (albeit modestly), the number of people paying tax has fallen – implying a larger contribution per head from a smaller number of people. Due to an increase in the numbers of (relatively affluent) pensioners now paying income tax, if one considers only working-age people the trend is even more stark: there are now fewer working-age people paying income tax than there were in 2000/01.

Figure 2: Number of taxpayers and total Government tax receipts



Source(s): HMRC; Survey of Personal Incomes. Data on the number of taxpayers are missing for 2008-09

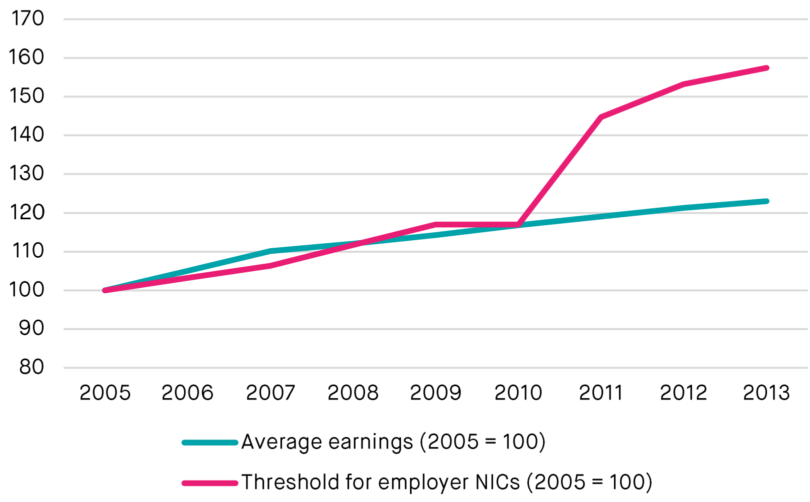
If one considers National Insurance Contributions (NICs), they too have over time seen an increase in the numbers of people not contributing. In 1999, the earnings level at which workers earned National Insurance entitlements was decoupled from the level at which they actually paid contributions. This was to enable the Government to raise the threshold below which contributions were not paid; but at the same time to ensure a group of people, previously making contributions, were kept within the scheme.[8] In the context of wage increases for much of the 2000s, these changes did not substantially reduce the tax base. However, since 2010, the payment threshold increased faster than average wages, meaning that people on low incomes, who were previously paying NICs, were not any longer.

Arguments in favour of increasing the Personal Allowance and threshold for NICs often focus on helping those on low incomes who have less ability to pay. But much of the benefit of raising these thresholds goes to those on middle and higher incomes. For instance, raising the Personal Allowance to £12,500 would give more to middle and higher earners than it gives to the bottom quarter.[9] The lowest income 17% of workers already pay no Income Tax, and so would not benefit at all.[10]

BUSINESS TAXES ARE CONCENTRATED ON A SMALL TAX BASE

Businesses make a substantial contribution to Government revenues through employers' National Insurance contributions. In 2015-16, National Insurance is expected to make up around 17% of overall tax revenue (see Figure 1 above); and employers' National Insurance contributions are expected to comprise around half of this.[11] Changes in the tax base for employers' contributions have followed a similar pattern to contributions from employees. Since 2011, in particular, the wage threshold at which employers are required to make NICs contributions has risen far above increases in average wages, as shown in Figure 3. This means that employers no longer have to make contributions on behalf of a group of relatively low-paid workers.

Figure 3: Average earnings growth, and growth in threshold for employers' NICs



Source(s): OECD data on (nominal) average incomes; IFS Fiscal Facts data on NICs thresholds

The business tax that makes the second biggest contribution to overall Government tax revenues is corporation tax. Corporation tax contributions are highly concentrated amongst a small number of companies, although there has been no discernible trend towards this concentration increasing in recent years. More than half a million companies have no corporation tax liabilities at all.[12]

There are more than a million companies with corporation tax liabilities. But amongst those companies, receipts are highly concentrated. Just 30 companies with the highest tax liabilities contribute more than 15% of Government receipts; and just 70 companies contribute nearly a quarter of receipts. The top 6% of companies with corporation tax liabilities make up over 60% of revenues.[13]

Revenues from business rates are also concentrated on a relatively small number of companies. Business rates are levied based on the 'rateable value' of non-residential property, such as shops, offices, warehouses and factories. The 'rateable value' is calculated using an official estimate of the market value of the rent for a given property. In addition, there is a system of reduced rates for businesses occupying properties with low rateable values; and those businesses with the lowest rateable values are exempt altogether. Additional exemptions apply for certain types of business, including charities, and agricultural businesses.[14] Revenues are therefore concentrated towards both larger and more property-intensive businesses; and very small businesses, those that have very low usage of property, and exempt businesses such as charities, are removed from the tax base altogether.

In this context, then, what are each of the main parties planning if they form the next Government?

GENERAL ELECTION PLEDGES ON TAX

The three main parties have not revealed the exact details of their tax reforms if they form the next Government. However, from what we know so far, the following pledges have been made.

Raising the Income Tax Personal Allowance:

- The Conservatives and Liberal Democrats have both proposed to raise the Personal Allowance from £10,600 to £12,500. The extent to which this affects the tax base depends on the extent to which wages rise for those on relatively low incomes. There are also suggestions that the Personal Allowance may rise further even earlier than planned – possibly to £11,000 as early as April 2015.[15]
- For the Income Tax base not to be reduced even further, wages will have to grow substantially during the next Parliament. The policy is also likely to be expensive, with an estimated cost of £5.6 billion.
- The OBR currently has a projection of (nominal) wage growth of around 3.5% per year until 2020. In this scenario, someone on an income of £10,600 in 2015-16 would earn around £12,500 in 2020 so, all else being equal, the tax base would not change (assuming low income wages grew at the same rate as the average).[16] However, this is in the context of a big reduction in the tax base in recent years. Under the Conservative and Liberal Democrat policy, the tax base would only begin increasing again if wage growth was greater than 3.5% per year. In the event it is lower that 3.5%, the tax base would shrink even further.
- Labour have not announced plans to increase the Personal Allowance further, but have instead proposed to introduce a new 10p rate of tax for low earners. The effect of this policy on the size of the tax base depends on the income band within which the 10p rate applies. If the 10p rate starts at the current level of the Personal Allowance, this would not reduce the numbers of people paying tax, but would reduce the tax liabilities of those on relatively low incomes, thereby having a small effect of concentrating tax revenues slightly more towards those on higher incomes. However, if the 10p rate starts at a lower level, it has the potential to increase the tax base. Given the Labour Party has pledged to increase taxes as well as cutting spending, this is a policy that may be favoured.

Corporation Tax and Business Rates:

- The Labour Party has planned to cancel the reduction in the main rate of corporation tax from 21% to 20% - currently due in April 2015. This money – estimated to be around £1.5 billion annually – would be used to pay for a reduction in business rates.[17] This may have the effect of decreasing the business tax base, but whether this is true depends on whether the money is spent on increasing business rate exemptions, or reducing rates overall. If it is spent on further exemptions, the tax base is likely to get smaller; but if it is spent on reducing overall rates, it should not have an impact on the tax base.
- The Coalition Government have announced that a revaluation of business rates will be delayed until 2017. Any effects of this revaluation on the tax base will therefore not be known until after the General Election.

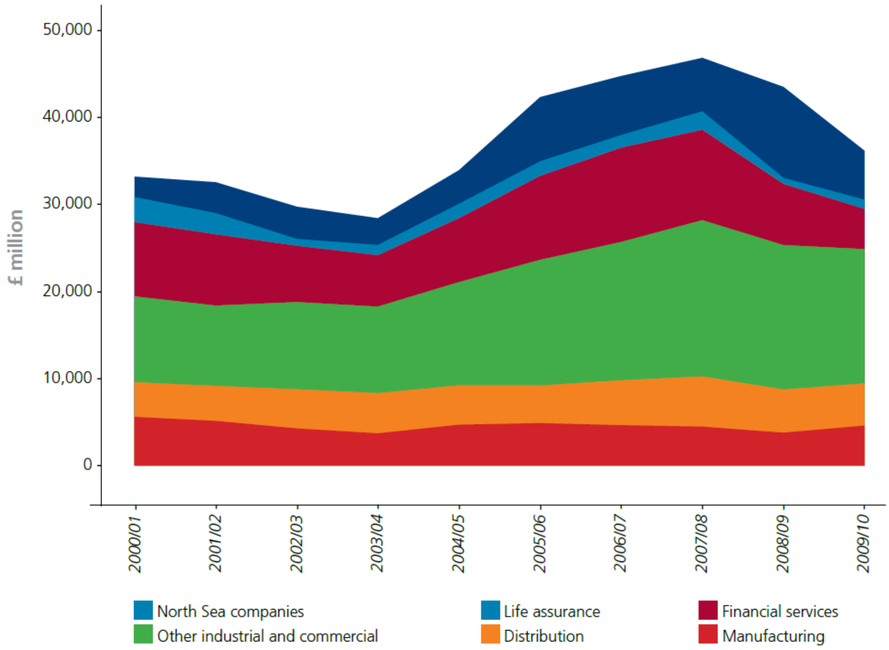
A SMALLER AND LESS DIVERSE TAX BASE MAY CREATE MORE VOLATILE REVENUES

There is a body of evidence, much of it from the US, that smaller or less diverse tax bases are associated with more volatile tax revenues.[18] This can be particularly pronounced during economic downturns, where a dependence on a small number of individuals or companies for tax revenue can result in more severe reductions in revenue, compared to a dependence on a large number of individuals and companies with different circumstances. Volatility can be problematic for governments aiming to plan their tax receipts and spending in a predictable manner.[19]

The UK's corporation tax revenue was badly affected during the 2008 economic downturn, due in large part to a dependence on the financial sector for a significant proportion of revenue (see Figure 4). Real corporation tax revenue fell 20% between 2008-09 and 2009-10, far outpacing falls in GDP. Income tax receipts have also been below the levels anticipated by the Government, affected in particular by weak wage growth and a higher Personal Allowance. If the predictions the OBR has made in different years for 2014-15 Income Tax and NICs revenues are compared, Income Tax and NICs receipts are now expected to be only 14.9% of GDP, but in 2010 were projected as 18.5% of GDP by this point in time.[20]

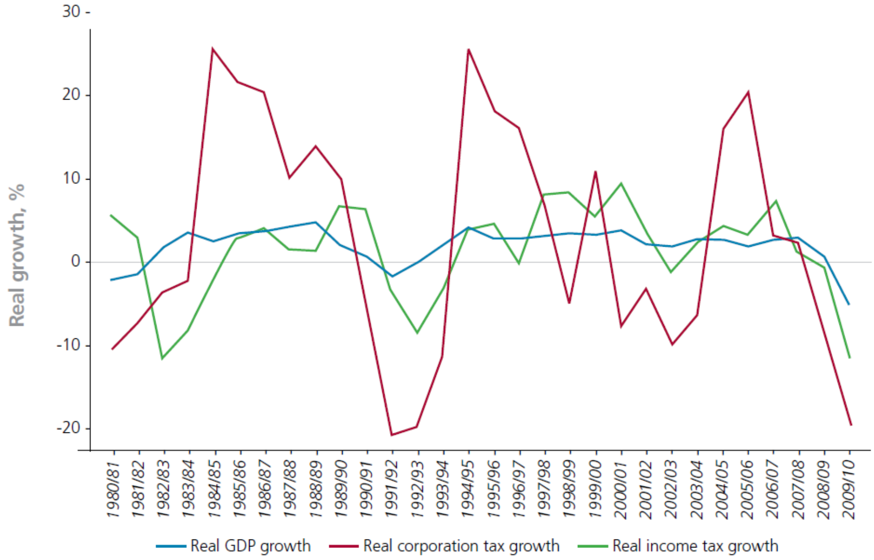
It is clear from Figure 5 that revenue from income tax, and particularly corporation tax, is much more volatile than overall GDP. A dependence on the largest companies for corporation tax, and on a small proportion of workers for a large proportion of income tax, may be especially problematic in the event of another economic downturn, as receipts fall faster than the level of contraction of the economy. Figure 5 also shows that receipts increase faster than GDP in the good times. In theory, this additional revenue could be saved in order to pay for decreased revenue when receipts fall. In practice, however, the amount it would be necessary to save is uncertain; and there is the political risk that surpluses will be spent – or given away in tax cuts – rather than saved for the next downturn.

Figure 4: Net UK corporation tax receipts



Source(s): Corporation Tax in the United Kingdom, Oxford University Centre for Business Taxation

Figure 5: Real growth in GDP, corporation tax and income tax revenues



Source(s): Corporation Tax in the United Kingdom, Oxford University Centre for Business Taxation

FEWER PEOPLE PAYING INCOME TAX AND NICS PRESENTS A CHALLENGE TO THE 'CONTRIBUTORY PRINCIPLE'

Both in the media, and in statements from politicians, one can find a view of two distinct groups of society: those that work hard, pay their taxes, and get nothing from the state; and those that take from the state through benefits and services, and give nothing back. George Osborne, for example, argued in 2013 that:

> *"Two groups need to be satisfied with our welfare system. Those who need it – who are old, who are vulnerable, who are disabled, or have lost their job and who we as a compassionate society want to support. And there's a second group. The people who pay for this welfare system: who go out to work, who pay their taxes and expect it to be fair on them too."*[21]

A similar view can be found in the US, for example with statements such as Mitt Romney's assertion that there are:

> *"47% who will vote for the President no matter what ... who are dependent on government, who believe that they are victims, who believe that they are entitled to health care, to food, to housing, you name it."*[22]

These views do not take into account the changing nature of people's lives: the fact that most people on out-of-work benefits are not out of work for very long; and the fact that, over the lifecycle, most people contribute in taxes and national insurance contributions. But they may reflect a common public concern that in order to get something from the state it is right that someone should contribute.

These views may interact with trends towards reducing the tax base for Income Tax and NICs. If an increasing proportion of workers are taken out of tax and NICs altogether, an oppositional 'us' and 'them' attitude may become even more prevalent with regard to those in low paid or insecure work. This is despite the fact that, under other aspects of the Coalition's tax and benefit reforms those on lower incomes have been paying more to the exchequer – for instance, through the increased rate of VAT, which disproportionately affects those on low incomes.[23] To the extent that the 'contributory principle' is fundamentally linked to contributions paid through work, however, these additional taxes paid by those on low incomes may not be recognised.

Opinion polls support the notion that 'contributing to society' entails working and paying taxes. Demos demonstrate how those who believe current benefit recipients will contribute to society through work in the future are much more likely to think benefits should be made more generous. Those believing current benefit recipients will not contribute in the future are highly likely to want benefit levels reduced.[24] A YouGov poll in 2012 found only 15% of people were in support of the idea that anyone – including the foreign born – legally living in Britain should be able to claim benefits if they are entitled to them. When asked about whether foreign-born people should be entitled to benefits if they became citizens, support was no higher. Support only increased – to 53% - when respondents were asked whether foreign-born residents should be able to claim benefits if they had a record of working and contributing.[25] The polling suggests that a contributory work record is extremely important in respondents' perceptions of whether eligibility for benefits is justified.

WHAT SHOULD THE NEXT GOVERNMENT DO?

A key priority for all parties in the next term is to reduce the deficit. The parties differ on how they plan to do this, with the Conservatives intending to do it all through spending cuts, and Labour through a mixture of spending cuts and tax increases. But the Conservatives and Liberal Democrats are also proposing tax cuts, with a raise in the Personal Allowance and, for the Conservatives, a raise in the higher rate tax threshold.

The commitment to avoiding tax increases in many areas, and in others even implementing tax cuts, puts even more pressure on the Conservatives to make savings in public spending, as we set out in *A Deficit of Growth II*. But we have focused in this briefing on another, less publicised, issue that has the potential to undermine the stability of Government tax revenues.

Given recent trends in tax policy, and some of the proposals on the table for after the General Election, the next Government will also need to take into account the effect of its actions on the size of the tax base. The tax base is already highly concentrated on a small number of large companies and a small number of individuals. Some of the proposals being made for the next term are likely to reduce the size of the tax base even further. This is problematic given that a narrow and concentrated tax base is likely to create more volatile tax revenues.

We therefore recommend that the next Government does not decrease the size of the tax base any further. It would be best for the Personal Allowance and National Insurance thresholds to remain where they currently are, and to allow the tax base to increase gradually as wages rise. We also advise against further exemptions and reliefs from business rates and corporation tax.

Given the pressing need to reduce the deficit, maximising tax revenues is a sensible strategy; and given that raising the Personal Allowance and National Insurance thresholds is extremely expensive, it is not recommended. Moreover, in the long term reducing the size of the tax base any further creates a risk of substantially reduced tax revenues in the event of another economic downturn. It is best to maximise revenues in the short term to shore up public finances; and to keep the tax base as wide as possible to ensure stability of revenues in the long term.

A wide tax base also has the beneficial effect of supporting the ‘contributory principle’. There is reason to think that reducing the tax base for Income Tax and NICs interacts with public perceptions of those that contribute to society and those that do not. It may be particularly important to consider attitudes towards two groups in particular: those of working age claiming out-of-work benefits; and immigrants working in the UK in low paid or insecure employment.

If political parties wished to reduce taxes once the public finances have improved, there are stronger arguments in favour of reducing overall tax rates, as compared to tax giveaways through increasing thresholds, exemptions and reliefs. In addition to retaining a wide tax base and reduced volatility, this would also reduce overall marginal deduction rates, creating greater work incentives. And a large part of the benefit for increases in the Personal Allowance and National Insurance thresholds goes to people on middle and higher incomes, with the lowest earners not benefiting at all. If one is concerned about the incomes of those at the bottom of the distribution, there are better and much less expensive ways of helping them.

ABOUT THE BRIEFING

This paper forms part of a wider project the SMF is conducting in collaboration with PwC, which looks at the challenges and opportunities for the 2015 Spending Review and has included a series of roundtable discussion events.

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ENDNOTES

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