

7. Options for fiscal tightening: tax increases and benefit cuts

Mike Brewer, James Browne, Andrew Leicester and Helen Miller (IFS)

Summary

- This chapter presents options, rather than advocating any of them. Which, if any, to pursue would depend on a government's distributional goals and wider priorities.
- From the big three taxes, 1% of national income (£15.4 billion in 2011–12 terms) could be raised by:
 - a 3 percentage point rise in the basic and higher rates of tax (to 23% and 43%);
 - a 3 percentage point rise in employee and self-employment National Insurance (NI) rates; or
 - a 3.5 percentage point rise in the standard rate of value added tax (VAT) (to 21%).
- These changes would weaken work incentives and hit the rich harder than the poor. The main differences are that the VAT rise would be less progressive than the others (as it would affect poor, non-income-tax-paying households) and that the retired and savers would not be affected by a rise in NI (which only taxes earnings).
- But significant amounts of revenue could also be raised from reforms that would simultaneously remove undesirable distortions in the tax system, such as:
 - charging the full rate of VAT on goods with a zero or reduced rate;
 - a comprehensive carbon tax;
 - increasing NI rates for the self-employed;
 - charging NI on employers' contributions to pension funds;
 - increasing the rate of small companies' corporation tax;
 - increasing the rate and cutting the allowance for capital gains tax.
- If cuts are desired in social security spending, then freezing the value of benefits and tax credits shares the pain over a large number of households. Freezing all benefits in April 2011 for one year would save £4.1 billion a year. A freeze over the next Parliament would save £24.6 billion a year by the fifth year (1.3% of national income in 2014–15), but would increase income inequality and measures of relative poverty.
- Removing benefits from better-off households would be less regressive, but would increase the scope of means-testing. Options include:
 - means-testing child benefit and the family element of the child tax credit (around £6.5 billion);
 - scrapping winter fuel payments and free TV licences and compensating pensioners on the pension credit (£1.4 billion);
 - abolishing carer's allowance (£0.5 billion);
 - time-limiting contributory incapacity benefit (IB) and employment and support allowance (ESA) (up to £2 billion).
- Fewer families could be means-tested by means-testing more aggressively, reversing the direction of reforms since 1999. This could cut £2 billion a year from benefits and tax credits for working-age households, and a similar amount from households with adults aged 60 or over. The impact on incentives would be mixed, but the losers will overwhelmingly be in the poorest half of the income distribution.

7.1 Introduction

The Treasury's plans imply that total public spending is to be broadly flat over the four years from 2011–12 to 2014–15 (inclusive) after economy-wide inflation. As set out in Chapter 8, debt interest spending will rise sharply and, under current policies, spending on social security would also increase, so the total plan for total spending implies deep cuts to spending on public services. If the government – or its successor – wished to keep to the total spending plans, while limiting the detrimental impact on public services, then it might look to implement reforms that would cut spending on social security benefits and tax credits.

Box 7.1. Estimating the effect on government revenues of changes to taxes, social security benefits and tax credits

This chapter mainly uses two methods for estimating the revenue raised by increasing taxes and the savings from cutting social security benefits and tax credits.

Some estimates are based on government publications. For example, the Treasury publishes a document entitled *Tax Ready Reckoner and Structural Reliefs* (henceforth, 'the Ready Reckoner') alongside the Pre-Budget Report.^a This provides estimates of the revenue raised by some of the tax rises we consider. In some cases, however, the Ready Reckoner ignores the possibility that behaviour may change in response to policy reforms. Any such behavioural response would tend to reduce the total amount of revenue raised from tax increases, and so in some cases we make our own estimate of the amount of revenue that would be raised given alternative assumptions about the level of behavioural response. Note that the Ready Reckoner only considers the direct impact of a tax change on the tax base on which the measure is being applied, or closely related bases. For example, this means that estimates of revenue raised by increases in income tax allow the behavioural response to the tax change to reduce the amount of taxable income, and the amount of National Insurance contributions paid, but not the total level of expenditure and indirect tax revenues. Additionally, estimates of the money saved by freezing the cash value of benefits (for example) are based in part upon an estimate of spending on benefits and tax credits in 2011–12; this is detailed in footnote 78.

Other estimates are based on IFS's tax and benefit microsimulation model, TAXBEN, which calculates personal tax revenues and benefit and tax credit spending for 2011–12, and under various hypothetical reform systems. However, it is well known that such models can underestimate tax revenues, perhaps because incomes and expenditures are under-recorded in the underlying data. Similarly, they underestimate spending on some benefits (and therefore the savings from cutting them), perhaps because there are too few low-income households in the underlying data. On the other hand, they can also overestimate spending on other benefits if no adjustment is made for incomplete take-up of benefits or tax credits. The model's estimates do not account for behavioural responses. These might increase the revenue raised if, for example, more people choose to work in response to cuts in out-of-work benefits, and they might reduce it if, for example, people choose to work less in response to higher benefit withdrawal rates.

When costing options, we assume that measures would be implemented in 2011–12, although this may be unrealistic for some of the more substantial changes (such as a carbon tax). In practice, the structural budget deficit need not be closed immediately, and it is likely that any large revenue-raising package will be spread across a number of taxes, as it was in the Conservative Budgets of 1993.

a. The latest version is at http://www.hm-treasury.gov.uk/d/pbr09_taxreadyreckoner.pdf.

This chapter first considers options for raising tax revenues (Section 7.2) and then options for cutting spending on social security and tax credits (Section 7.3). We are presenting options rather than necessarily advocating any of them. In deciding which to include, we have tried to discuss those that have been proposed in policy debate, or that reverse changes made by the current government, or that seem (to the authors) to be obvious measures that ought to be considered. We have also tried to cover most of the main taxes, and most of the main benefits and tax credits, and have tended not to include measures that raise or save only small amounts. But we acknowledge that there is a degree of arbitrariness as to which reforms have been included and which excluded.

Box 7.1 contains some general background on how the costings have been made.

7.2 Options for increasing tax revenue

This section examines ways in which the government could increase tax revenue. For illustrative purposes, we assume that the next government would seek to raise around 1% of national income. Some of the options have previously been discussed in submissions to the Mirrlees Review (see Box 7.2). The section examines the following:

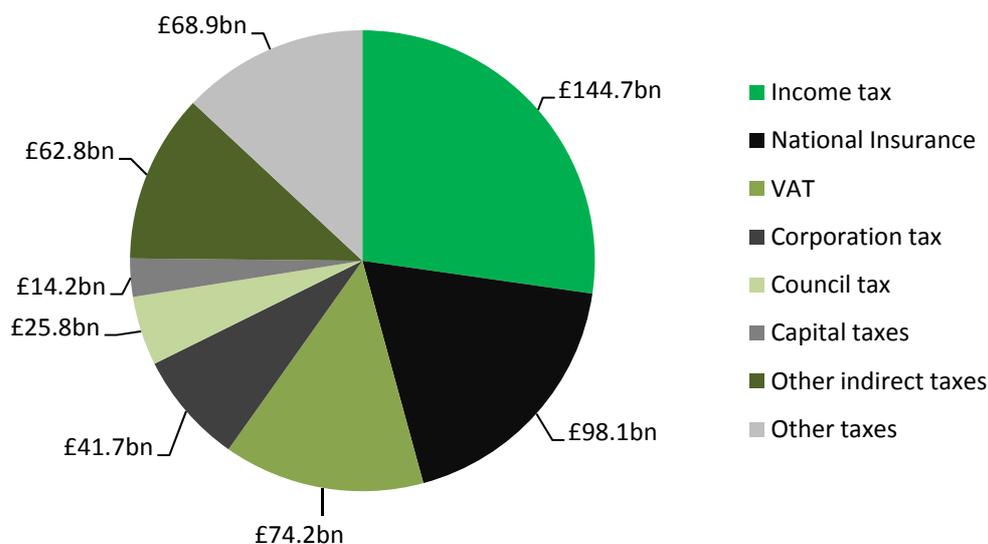
- changes to income tax rates and thresholds (some of which are linked to National Insurance (NI) thresholds);
- changes to the rates, thresholds and base of NI;
- changes to the rates and base of value added tax (VAT);
- changes to the taxation of pension income, contributions to pensions and pensioners;
- changes to the rates of corporation tax;
- environmental tax changes;
- taxation of wealth, including housing, inheritance tax and capital gains tax.

By way of background, Figure 7.1 shows how much revenue the government expects each existing tax to raise in 2010–11. The three largest taxes in terms of revenue raised are income tax, NI and VAT, which together provide three-fifths of all government revenues. Therefore, if the government is looking to raise substantial amounts of revenue, a natural starting point is to examine increasing these taxes.

Box 7.2. The Mirrlees Review

Chaired by Nobel Laureate Sir James Mirrlees, the Mirrlees Review has brought together researchers at IFS with a high-profile group of international experts to identify the characteristics of a good tax system for a developed open economy in the 21st century. It will assess how close the current UK tax system is to these ideals, and suggest reforms to move it in that direction, in a report due to be published later in 2010. In contrast, this chapter merely examines ways in which the existing tax system can be made to increase total government revenues. However, some of the reforms we consider would be desirable in themselves, even if the government did not need to raise extra revenue.

Figure 7.1. Sources of government revenue, 2010–11 projection



Source: Table B10 of HM Treasury, *Pre-Budget Report 2009*, December 2009, http://www.hm-treasury.gov.uk/prebud_pbr09_repindex.htm.

Income tax

Income tax is the largest tax in terms of the revenue raised for the government. In the December 2009 Pre-Budget Report (PBR), the Treasury forecast that it would raise £144.7 billion in 2010–11.¹ In this subsection, we discuss two substantial revenue-raising measures, and a number of smaller reforms. The large reforms are:

- increasing the 20% basic rate and/or 40% higher rate;
- cutting tax thresholds.

The smaller reforms are:

- abolishing the 10p tax rate on savings income (and replacing it with a 20p rate);
- removing additional tax allowances for pensioners (we look at this later, under the heading ‘Taxation of pensions, contributions to pensions and pensioners’).

We do not consider increasing the 50p ‘additional’ tax rate, which will apply above £150,000 from April 2010, as previous research has shown that, at best, very little additional revenue could be expected to be raised from doing so.²

Increasing income tax rates

If the government wished to increase tax revenues by 1% of national income, an obvious way would be to increase the basic rate of income tax. The Ready Reckoner estimates that raising the basic rate of income tax by 1 penny in the pound in April 2010 would raise

¹ Source: Table B10 of HM Treasury, *Pre-Budget Report 2009*, December 2009, http://www.hm-treasury.gov.uk/prebud_pbr09_repindex.htm.

² See M. Brewer and J. Browne, ‘Can more revenue be raised by increasing income tax rates for the very rich?’, Briefing Note 84, Institute for Fiscal Studies, London 2009, <http://www.ifs.org.uk/bns/bn84.pdf>.

£4.05 billion in a full year, or just over 0.25% of national income.³ Therefore, increasing the rate from 20p to 24p (a level last seen in 1996–97) would raise slightly more than 1% of national income.

Alternatively, slightly less than 1% of national income could be raised by increasing both the basic and higher rates of income tax by 3 pence in the pound.⁴ Note that the Ready Reckoner's estimate for the revenue raised from increasing the higher income tax rate does not allow for any behavioural response, despite the fact that this group of taxpayers is likely to have a larger response than taxpayers on average. Assuming a relatively low level of behavioural response (a taxable income elasticity of 0.2⁵) for higher-rate taxpayers whose income is below £150,000, we estimate that raising the higher income tax rate to 43% would raise £2.3 billion in a full year (around 0.15% of national income), less than the £2.85 billion (around 0.18% of national income) the Ready Reckoner suggests.⁶

If the government did not want anyone with an income less than the higher-rate threshold (£43,875 in 2010–11) to be affected at all, it could instead increase the current 40p rate of income tax to match the 50p rate it intends to apply above £150,000. Again assuming a relatively low level of behavioural response (a taxable income elasticity of 0.2) for higher-rate taxpayers whose income is below £150,000, a 50% higher rate of income tax would raise around £7.4 billion (around 0.5% of national income), considerably less than the £9.5 billion (around 0.6% of national income) the Ready Reckoner suggests this would raise under the assumption of no behavioural response.⁷ In these circumstances, the phase-out of the personal allowance from £100,000 (which would create a 75% marginal income tax rate for a small group of high-income individuals) would be even less desirable than it already is, and therefore should be abolished at the same time, reducing the amount of revenue raised to around £5.8 billion. This is around 0.4% of national income.

Figure 7.2 shows the distributional impact of these three measures.

Increasing the basic rate of income tax to 24% would be a fairly progressive tax rise, since higher income decile groups tend to lose proportionately more, but the richest tenth of the population would not lose as big a proportion of their income as those whose incomes are not quite as high. This is because all higher-rate taxpayers would lose the same cash amount (£1,496 per year if introduced in 2010–11) irrespective of how high their income is above the higher-rate threshold. Increasing the higher rate of income tax as well is therefore more progressive, as those with incomes above the higher-rate threshold also

³ This incorporates behavioural response, but any behavioural response is likely to be small – the behaviour of individuals paying the basic rate tends to be fairly insensitive to changes in their marginal tax rate and they may even choose to work more in response to recoup the lost income (economists call this an income effect).

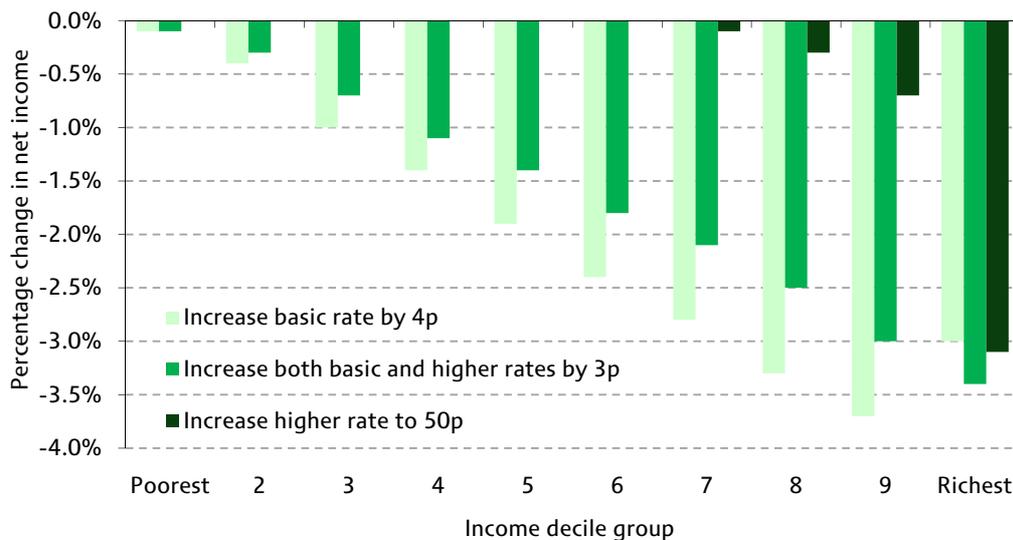
⁴ The Ready Reckoner estimates that increasing the higher rate of income tax would raise £950 million in a full year, but this assumes no behavioural response.

⁵ The taxable income elasticity is a summary parameter which tells us how much taxable income falls when the effective marginal tax rate rises. A taxable income elasticity of 0.2 means that if the net-of-tax rate (one minus the tax rate) falls by 1%, taxable income falls by 0.2%. For example, if the net-of-tax rate was initially 50% and fell by 1% of its original value to 49.5% (i.e. the effective marginal tax rate increased from 50% to 50.5%), taxable income would fall by 0.2% among those affected. This is a considerably lower level of behavioural response than the taxable income elasticity of 0.35 used by the Treasury when calculating the revenue effects of the new 50% income tax rate that will apply above £150,000.

⁶ Source: Authors' calculations using the 2006 Survey of Personal Incomes. The Survey of Personal Incomes is Crown Copyright material and has been used with the permission of the Controller of HMSO and the Queen's Printer for Scotland.

⁷ Source: See footnote 6.

Figure 7.2. Distributional impact of increases in income tax rates



Notes: Income decile groups are derived by dividing all families into 10 equal-sized groups according to disposable income adjusted for family size using the McClements equivalence scale. Decile group 1 contains the poorest tenth of the population, decile group 2 the second poorest, and so on up to decile group 10, which contains the richest tenth.

Source: Authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on the 2006–07 Family Resources Survey.

lose more in cash terms the higher their income is above £43,875. Increasing solely the higher rate of income tax affects only the richest four-tenths of families, and the vast majority of the revenue raised is from the top decile of the income distribution.

Cutting income tax and National Insurance thresholds

The government has already announced that the basic-rate limit in income tax (the amount of income above the personal allowance that is taxed at the basic rate) will be frozen in nominal terms in 2011–12 and the higher-rate threshold (the point at which the 40% rate starts to be paid) will be frozen in nominal terms in 2012–13.⁸ The announcements in the December 2009 PBR will also create the undesirable situation where the thresholds for paying income tax, employee NI and employer NI are close to each other, but all different, as shown in Table 7.1.

Table 7.1. Income tax and National Insurance thresholds, 2011–12

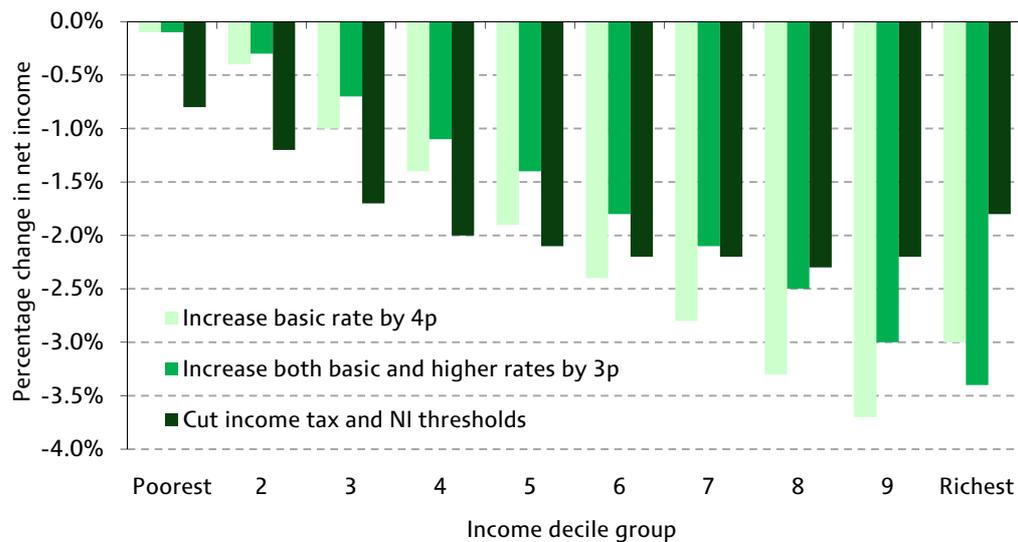
Threshold for paying	Annual amount
Income tax	£6,545
Employee National Insurance contributions	£7,124
Employer National Insurance contributions	£5,876

Note: Assumes 3% RPI inflation in September 2010 in accordance with economic assumptions made in PBR 2009, no further changes to pre-announced policy.

⁸ See table B4 of PBR 2009 and table B5 of PBR 2008. Note that since the higher-rate threshold is the sum of the income tax personal allowance and the basic-rate limit, to freeze the higher-rate threshold in nominal terms while increasing the personal allowance in line with inflation will require a nominal cut in the basic-rate limit in 2012–13. The default is for these thresholds to increase in line with the retail price index (RPI).

To correct this anomaly and raise revenue, the government could lower the income tax and employee NI thresholds to the level of the lower employer NI threshold.⁹ Using TAXBEN, we estimate that this would raise £6.8 billion a year, or around 0.4% of national income. To raise a total of 1% of national income (although not until 2015–16), the government would then need to freeze all three thresholds at this level until 2015–16. We estimate that this would raise almost exactly 1% of national income by 2015–16, around the same as a 4p increase in the basic rate or a 3p increase in both basic and higher rates. However, the distributional effects of these policies are slightly different, as shown in Figure 7.3.

Figure 7.3. Distributional impact of increases in income tax rates and of cut in tax and NI thresholds



Notes: As for Figure 7.2.

Source: As for Figure 7.2.

It is clear that cutting tax thresholds is a less progressive tax increase than increasing income tax rates. This is because all basic-rate income taxpayers lose out by the same cash amount from a reduction in the income tax personal allowance, and all higher-rate taxpayers lose out by twice this amount (the personal allowance is worth twice as much to higher-rate taxpayers because their marginal income tax rate is 40% rather than 20%). Those with incomes greater than £112,870 would not lose out at all, however, as their personal allowance is, from April 2010 onwards, to be reduced to zero at this point. Similarly, all those with incomes above the higher-rate threshold lose out by the same cash amount from a reduction in the higher-rate threshold. Reducing the personal allowance would slightly weaken the incentive to work at all, particularly for low earners, and increasing the basic and higher rates would weaken the incentive for basic- and higher-rate taxpayers to increase their incomes, as well as slightly weakening the incentive to work at all.

If the government did not wish to reduce the personal allowance by so much, an alternative would be to increase it by 1.5 percentage points less than inflation in April 2011 to make up for the fact that the income tax threshold was not reduced in nominal

⁹ In the case of the employee NI threshold, this would in practice mean not going ahead with the increases announced in the PBRs of 2008 and 2009.

terms after inflation was –1.5% in September 2009. (The September RPI inflation figure is used to increase tax thresholds for the following April.) Using TAXBEN, this would raise around £0.6 billion a year. If, in addition to this, the government reversed the £600 increase in the personal allowance announced in May 2008, it could raise £4.5 billion in a full year, around 0.3% of national income. This would realign the income tax personal allowance with the employer NI threshold, but leave the employee NI threshold higher.

Restricting the personal allowance to the basic rate

From 2010–11, the government has announced that the personal allowance will be phased out from those with incomes greater than £100,000. This will create a small band of income in which the marginal income tax rate will be 60%. A way of raising more money by withdrawing the personal allowance from those lower down the income distribution would be to restrict the personal allowance to the basic rate. This policy would essentially involve lowering the point at which the 40p rate starts to be payable from £43,875 to £37,400 (the basic-rate limit in 2010–11). TAXBEN estimates that this would raise £4.1 billion in 2011–12, or approximately 0.25% of national income.

This policy is frequently advocated on the basis that it is ‘unfair’ that the personal allowance is worth twice as much to higher-rate taxpayers as to basic-rate taxpayers because their marginal income tax rate is double that of basic-rate taxpayers.¹⁰ However, this argument is an artefact of the way the tax system is formally described – the point at which the 40p rate starts to be paid (the higher-rate threshold) is formally equal to the personal allowance plus the basic-rate limit. Therefore, a £1 increase in the personal allowance reduces income tax by 40p for a higher-rate taxpayer but only 20p for a basic-rate taxpayer. But this need not be the case – both would only benefit by 20p if the basic-rate limit were reduced by the £1 at the same time, leaving the effective threshold at which the 40p rate becomes payable unchanged. As McCrae (1997) argues,¹¹ the tax system would be much more understandable if the higher-rate threshold itself were specified as a parameter of the tax system, and it would remove this argument in favour of restricting the personal allowance to the 20p basic rate. Furthermore, he argues that describing a policy as restricting an allowance to a particular rate is itself unhelpful and likely to lead to confusion among those with a limited understanding of the tax system. The reform would create a short band of income (between £37,400 and £43,875) where the combined income tax and employee NI rate was 52% and make all those with income between £43,875 and £100,000 worse off by £1,295 each year.

Abolishing the 10p starting rate for savings income

Budget 2007 (in)famously abolished the 10p starting rate for non-savings income. This was a welcome simplification of the income tax system, but the 10p rate remains in place for savings income that falls into the first £2,440 of taxable income, and this is an undesirable complication to the structure of income tax (though see Box 7.3).¹² The Ready Reckoner estimates that increasing this rate to 20% would raise £0.1 billion in 2011–12, although the amount raised would increase if interest rates rose from their

¹⁰ See, for example, T. Horton and J. Gregory, *The Solidarity Society*, Fabian Society, London, 2009.

¹¹ J. McCrae, ‘Simplifying the formal structure of UK income tax’, *Fiscal Studies*, 1997, 18, 319–334.

¹² When calculating which tax band income sources fall into, dividend income is considered to be the top tranche of income, followed by savings income, followed by other income. This means that, in practice, very few people are affected by the 10p rate for savings income – TAXBEN estimates that fewer than 400,000 people could benefit from this rate in 2011–12. Even then, since it is necessary to claim back the excess tax that has been deducted at the 20% rate, even fewer take advantage of it.

Box 7.3. Should savings income be taxed differently?

Although the 10p rate on savings income seems an unwelcome complication of the income tax system, most economists think that the net rate of tax on the normal rate of return to saving should be zero (that is to say, one should not have to pay any more tax if one chooses to spend one's income in the future rather than now).^a However, currently, income tax is levied on income from savings, dividends and rental income, which violates this principle. While matters have improved over the last 25 years with the introduction of PEPs, TESSAs, ISAs and personal pensions and the removal of MIRAS and life assurance premium relief, this is still a matter of concern.^b However, since reforms to correct this problem would by themselves cost money, we do not consider them here, but this issue should be borne in mind when considering increasing the amount raised from income tax, as doing so would exacerbate the problem. The Mirrlees Review of the tax system, due to be published later this year, will discuss this issue in more detail and suggest solutions. In January 2009, the Conservative Party proposed not taxing savings income for all basic-rate taxpayers (but not those paying income tax at the higher rate), at an estimated cost of £2.6 billion per year, but has not committed to introducing this change if it formed the next government.^c

a. This was one of the main conclusions of the Meade Review in 1978: Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation*, George Allen and Unwin, London, 1978, <http://www.ifs.org.uk/docs/meade.pdf>. However, Meade proposed that more assets should be given the tax treatment currently given to pensions (i.e. where contributions and returns were exempt but withdrawals taxed), rather than ISA-style treatment (i.e. where saving is made out of taxed income, but the interest earned and withdrawals are not taxed).

b. Effective tax rates on different forms of investment are presented in M. Wakefield, *How Much Do We Tax the Return to Saving?*, Briefing Note 82, Institute for Fiscal Studies, London, 2009, <http://www.ifs.org.uk/bns/bn82.pdf>.

c. Source: Conservative Party press release, 5 January 2009, http://www.conservatives.com/News/News_stories/2009/01/Britains_economic_future.aspx.

current historic lows. The Ready Reckoner published at the time of the 2008 PBR estimated that this measure would raise £0.2 billion in a full year.

National Insurance

Politicians have been much more willing to contemplate rises in NI rates than income tax rates over the last two decades, despite the similarity of the two taxes. Since National Insurance contributions (NICs) are only levied on earned income, it has the advantage that it does not impose a positive net rate of tax on interest from savings. However, the tax base for NI is arguably too narrow (and we suggest ways to expand it below). More generally, though, there is little economic rationale for the existence of NI as a separate tax: merging it with income tax would solve many of these problems, although there are various administrative and transition issues and policy decisions that would need to be tackled first.¹³ Here, we confine ourselves to considering how revenue could be raised by increasing NI rates, and by extending NICs to cover other forms of income. We also discuss increasing the upper earnings limit (the point at which the employee NI rate currently falls from 11% to 1%); lowering the thresholds at which employee and

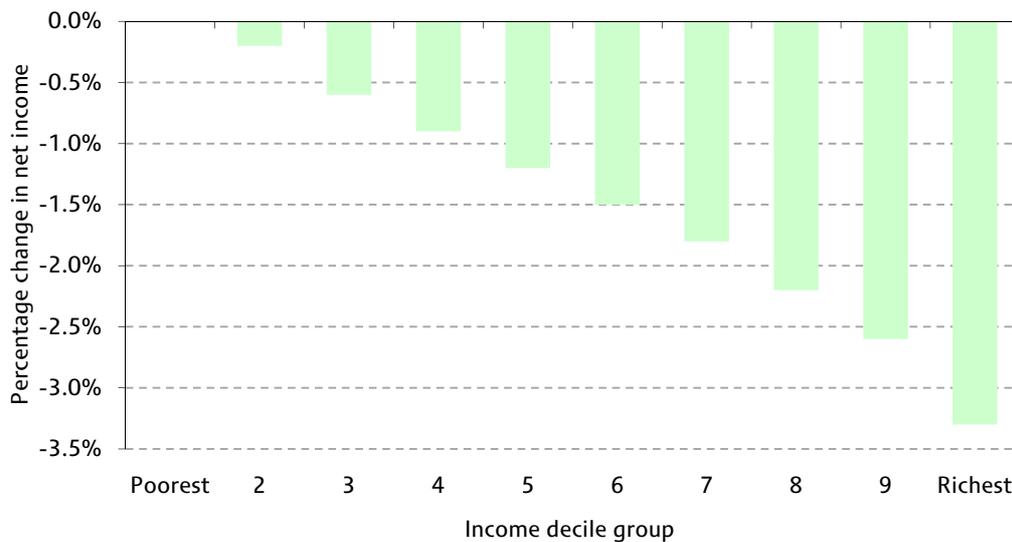
¹³ For more on these, see S. Adam and G. Loutzenhiser, 'Integrating income tax and National Insurance: an interim report', Institute for Fiscal Studies, Working Paper WP21/07, 2007, <http://www.ifs.org.uk/wps/wp2107.pdf>.

employer contributions start to be paid was discussed alongside cutting income tax thresholds in the previous subsection.

Increasing National Insurance rates

In both the 2008 and 2009 PBRs, the Chancellor announced rises of 0.5p in all NI rates (for employees, employers and the self-employed, above and below the upper earnings limit) to take effect from April 2011. To raise another 1% of national income, the rates for employees and the self-employed would need to increase by a further 3p.^{14,15} The distributional impact of this change is shown in Figure 7.4. It is very similar to the distributional impact of increasing the basic and higher income tax rates by 3p (see Figure 7.2 above), with the main exception that the retired would be unaffected.

Figure 7.4. Distributional impact of 3p rise in employee and self-employed NI rates



Note: As for Figure 7.2.
Source: As for Figure 7.2.

Increasing the UEL to £100,000

Earlier, we discussed increasing the higher rate of income tax from 40% to 50%. A very similar reform would be to increase the UEL to £100,000: in both cases, the marginal tax rate between £43,875 and £100,000 is being increased by 10p. In this case, however, the higher marginal tax rate would only apply to earned income, and would increase the marginal rate of tax on earnings up to £100,000 rather than up to £150,000. Again,

¹⁴ Note that this rise would increase the marginal tax rate on earnings above £150,000. As we mentioned when discussing income tax rates, it is unlikely that increases in NI or income tax above this level would yield much revenue.

¹⁵ Although the last two announced increases in NI rates have involved equal-sized increases in the employee, employer and self-employed rates, here we propose a rise only in the employee and self-employed rates, and no change in the employer rate. In the long run, the economic and distributional impact of changes to employee and employer NI should be identical, as they are essentially the same tax: they both impose a wedge between the employer's cost of employing someone and the amount the employee actually receives. Therefore, if it is the case that rises in employee NICs are fully incident on employees (meaning that it is employees who ultimately bear the burden of the tax through lower net wages), then rises in employer NICs must also be fully incident on employees, but this time through lower gross wages in the long run. If this is the case, then a given percentage point rise in employer NI will lead to a smaller increase in tax revenues than a given percentage point rise in employee NI, as the former leads to lower wages, which would reduce revenues on income tax and NICs. The Ready Reckoner does not appear to make this distinction.

assuming relatively little behavioural response among those affected (a taxable income elasticity of 0.2), we estimate this would raise £4.2 billion in 2011–12 or around 0.3% of national income.

Increasing rates for the self-employed

The self-employed currently have a far more generous NI regime than employees – they do not have to pay employer NI contributions and their NI rates are lower than those for employees who contract out of the state second pension despite the fact that neither accrue entitlement to the state second pension.¹⁶ To equalise the treatment of employees who contracted out and the self-employed, rates for the self-employed would need to rise to 18.6% below the UEL and 13.9% above it.¹⁷ This would remove a distortion in favour of being self-employed rather than employed or incorporating. Assuming no behavioural response, this would raise £6.8 billion a year, around 0.4% of national income. However, it is likely that such a move would lead to a considerable change in behaviour (or at least in the amount of self-employment earnings individuals report to HMRC), which would reduce the revenue yield substantially.

Value added tax

One of the most striking features of tax reform over the last 30 years has been the increase in the share of government revenue coming from VAT. This is mainly due to two big increases in the standard rate of VAT: from 8% to 15% in 1979, and to 17.5% in 1991. The current government apparently considered increasing the standard VAT rate to 18.5% from April 2011 when preparing the 2008 PBR,¹⁸ but a much larger increase – to around 21% – would be necessary to raise 1% of national income. One potential advantage with pre-announcing future increases in VAT is that it may encourage consumers to bring forward consumption and therefore have less of an adverse effect on a weak economy than other tax rises. Another possible advantage is that VAT also taxes income that has been earned but not yet spent, meaning it creates a capital levy that does not affect efficiency. However, this may be seen as unfair. Both of these issues are discussed in more detail in Chapter 3.

Another way to raise more revenue from VAT would be to extend VAT to goods that are currently zero rated or exempt, or increase the rate that applies to some or all of the goods that are currently subject to the reduced 5% rate. This would help resolve one of the main criticisms of VAT: that it distorts expenditure patterns towards goods that are more favourably treated.¹⁹ In isolation, this would be a regressive tax increase, since poorer households tend to spend proportionally more than average on zero-rated items such as food and children's clothes. But it would be possible to provide some compensation for low-income households through other mechanisms – even without

¹⁶ Treating the self-employed exactly the same as employees would involve giving the self-employed a choice about whether to contract in or out of the state second pension. The government would raise more revenue in the short term from those who chose to contract in, but there would be additional costs in the longer term. To avoid having to estimate these additional costs, we assume that the self-employed would be forced to contract out or, equivalently, that they would all choose to do so.

¹⁷ This is because the combined employee and employer NI rate as a percentage of employer cost is $(0.104+0.101)/1.101 = 18.6\%$ below the UEL and $(0.02+0.138)/1.138 = 13.9\%$ above it for an employee who is contracted out of the state second pension.

¹⁸ See <http://www.parliament.uk/commons/lib/research/briefings/snbt-00701.pdf>.

¹⁹ See I. Crawford, M. Keen and S. Smith, 'Value-added tax and excises', submission to Mirrlees Review of the Tax System, Institute for Fiscal Studies, London, 2008, <http://www.ifs.org.uk/mirrleesreview/reports/indirect.pdf>.

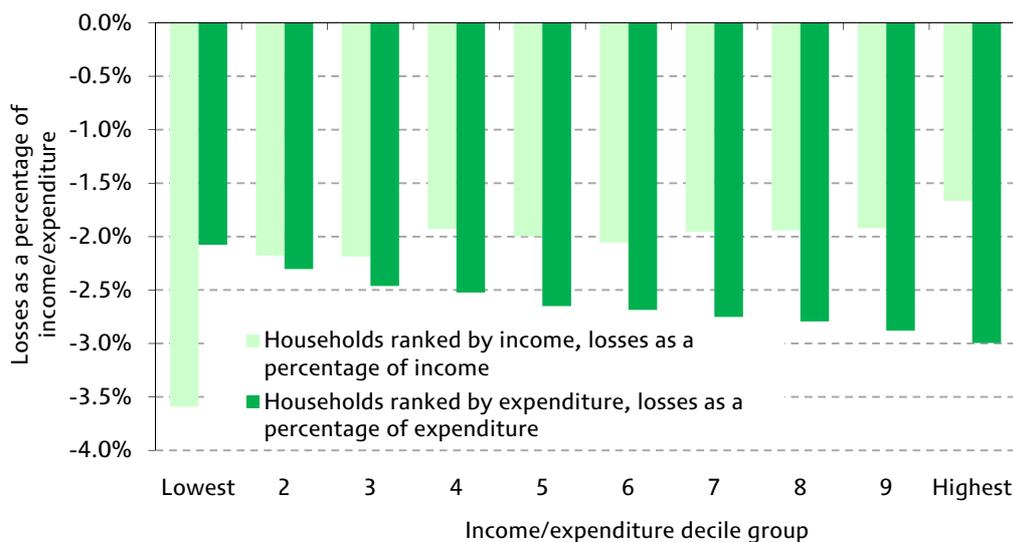
resorting to means-testing – and still have revenue left over; this is because the biggest beneficiaries in cash terms from zero-rating are those on high incomes, since they spend more on these goods in cash terms than lower-income households. Therefore, in this subsection, we consider increasing the standard VAT rate to 21% and extending the standard rate to all items, with and without compensation for those on low incomes.

Note that both increasing the rate and broadening the base of VAT would weaken work incentives just as increases in income tax would. This is because the attractiveness of working, as opposed to not working, or working an extra hour presumably depends on the amount of goods and services that can be bought with the wage earned. In this way, a uniform income tax and a uniform consumption tax will have very similar effects.

Increasing the standard rate of VAT

It has been widely speculated that if either Labour or the Conservatives win the forthcoming general election, the standard rate of VAT will be raised to 20% from its current 17.5%.²⁰ The Ready Reckoner estimates that raising the standard rate by 1% would raise £4.5 billion in 2011–12,²¹ so raising it to 20% would raise £11.25 billion, around ¾% of national income, and an increase to 21% would raise slightly more than 1% of national income for the government. The distributional impact of this last measure is shown in Figure 7.5.

Figure 7.5. Distributional impact of increasing the standard rate of VAT to 21%



Notes: As for Figure 7.2. Expenditure decile groups are derived by dividing all households into 10 equal-sized groups according to total expenditure adjusted for family size using the McClements equivalence scale. Decile group 1 contains the lowest-spending tenth of the population, decile group 2 the second lowest-spending, and so on up to decile group 10, which contains the highest-spending tenth. Total expenditure and total VAT revenues scaled up to match National Accounts consumption.

Source: Authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on the 2007 Expenditure and Food Survey.

²⁰ See, for example, <http://www.spectator.co.uk/coffeehouse/5252658/20-percent-vat-is-likely-whoever-wins-the-next-election.shtml>.

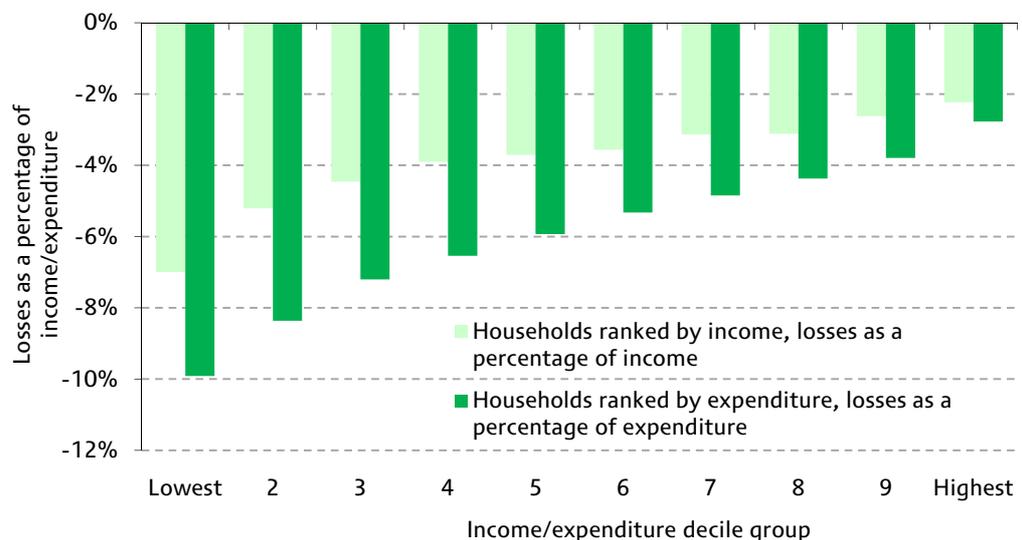
²¹ This estimate accounts for the effect of VAT in terms of shifting expenditure from VATable to non-VATable goods and services, but does not allow for total consumption to decrease in response to an increase in VAT. Since in reality households would consume less if VAT increased, this is an upper bound of the revenue raised by an increase in VAT.

Figure 7.5 suggests that increasing the standard rate of VAT is a regressive tax change when households are ranked by income and losses are expressed as a percentage of net income. However, this conclusion needs some qualification. VAT falls on those who spend a lot, and will therefore target those with high incomes less precisely than, say, income tax. But those with a low income at a particular point in time may not necessarily be those whose lifetime income is the lowest: while some people are persistently poor, others may have temporarily low incomes while they are studying, temporarily unemployed, living off savings in old age, taking time out of the labour market to raise children, etc. People's ability to borrow and save means that those with low incomes will, on average, have higher expenditure relative to their income, and those who have high expenditures but low incomes are not those who would generally be considered as 'poor'. Over a lifetime, income and expenditure must be equal (ignoring bequests and inheritances), and indeed annual expenditure is arguably a better guide to lifetime living standards than annual income. Dividing households into deciles according to annual expenditure, and expressing losses as a percentage of expenditure, gives us a different picture of the distributional impact of increasing the standard VAT rate (see Figure 7.5).

Broadening the VAT base

Another way for the government to increase VAT revenues would be to extend its scope to cover those items that are currently zero rated, including food, children's clothes, domestic passenger transport, books, newspapers, magazines, water and sewerage services, and prescription drugs. It could also tax those items that are currently taxed at the lower 5% rate (principally domestic fuel and power) at the standard rate. The Ready Reckoner estimates that extending the 17.5% rate to all these items would have raised £24.3 billion in 2008–09, or around 1.7% of national income.²² The distributional impact of this change is shown in Figure 7.6.

Figure 7.6. Distributional impact of extending the standard rate of VAT to cover all items^a



a. See footnote 22.

Notes: As for Figure 7.5.

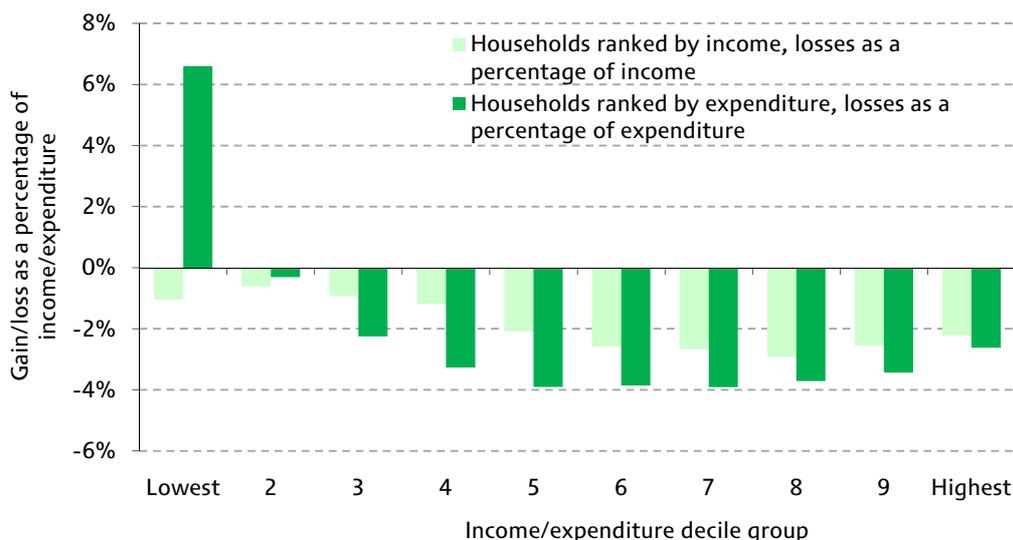
Source: As for Figure 7.5.

²² Note that we do not consider extending the standard rate of VAT to new houses, the portion of international passenger transport that takes place in the UK, and ships and aircraft above a certain size. We consider imposing VAT on goods that are currently classified as exempt (such as insurance and financial services) later.

This is a regressive tax increase, whether households are ranked by expenditure or income. This is because both low-income and low-spending households are more likely to spend a higher proportion of their income or total budget on items that are zero rated, such as food.

Nevertheless, it is richer households which lose the most in cash terms: a lower proportion of their budget is spent on zero-rated items, but their budgets are sufficiently large that they still spend a greater absolute amount than the poorest on these items. This implies that it would be possible to use some of the revenue raised to compensate poorer households and still have revenue left over. Since this change would raise 1.7% of national income for the government, in order to raise 1% of national income a government could spend 0.7% of national income on increasing benefits and tax credits to ensure that the poorest did not lose disproportionately. Figure 7.7 shows the effects of the reform before and after a compensation package that involves a 10% increase in all income support, pension credit (PC) and child and working tax credit rates.²³ It shows that it is possible to raise 1% of national income by broadening the VAT base and ensuring that, on average, the poorest households lose out by a smaller fraction of their income than those higher up the income distribution (indeed, the lowest-spending tenth of households would gain significantly on average).

Figure 7.7. Distributional impact of extending the standard rate of VAT to cover all items,^a with compensation for low-income households



a. See footnote 22.
 Notes: As for Figure 7.5.
 Source: As for Figure 7.5.

²³ The associated housing benefit premiums are increased by the same amounts. The compensation package is intended to be illustrative – the government may wish to compensate particular groups more than others, and may wish to raise more or less than 1% of national income. A very heavily means-tested package such as this would also damage work incentives.

Imposing VAT on financial services

Financial services are currently exempt from VAT in the UK and most other countries.²⁴ This exemption is widely seen as undesirable for a number of reasons, including distortions that arise in the relative price of financial services.²⁵ There is currently discussion in the EU and IMF regarding the rationale and practicalities of introducing a VAT on financial services.²⁶ The removal of this VAT exemption would raise significant revenue: the Ready Reckoner estimates that the exemption of finance and insurance services has a cost of £2.8 billion in 2009–10.

The main reason for the exemption is the administrative difficulty of measuring value added in the financial sector. Put simply, value added is calculated as the value of sales minus the value of inputs. In terms of the value of sales, when a fee is charged for financial services it is conceptually straightforward to determine this value. This is not true, for example, in the case of bank loans where the interest received from the borrower reflects not only a return on the loan but also a risk premium. In addition, it is difficult to price financial capital, a major input in these services.²⁷

While it may be infeasible to implement a comprehensive solution that would fully remove the exemption, there are proposed solutions that would move towards a VAT on financial services and, in doing so, remove distortions and likely raise significant revenue.²⁸ There are a number of implementation issues that would need to be ironed out but it would seem like a good time to address this issue.

Taxation of pensions, contributions to pensions and pensioners

This subsection discusses a number of related reforms that could be made to the taxation of pensions and pensioners. The government will introduce a reform that will restrict tax relief on pension contributions for those with very high incomes from 2011–12; an option that would raise more revenue would be to restrict tax relief to the basic rate for all higher-rate taxpayers. Other ways to reduce the generosity of the tax treatment of pensions would be to charge NICs on employer pension contributions and reduce or abolish the 25% tax-free lump sum. A way of taxing existing pensioners more would be to reduce or abolish the additional income tax allowances given to those aged 65 or over.

Restricting pensions tax relief to the basic rate

From April 2011, the government has announced that pension contributions will no longer be exempt from income tax for those whose gross incomes (i.e. taxable income plus individual pension contributions plus charitable donations) are above £130,000 and whose incomes plus the estimated value of employer pension contributions exceed

²⁴ There are only a few countries that attempt to impose a regular VAT on a few specific financial services. Mexico levies VAT on bank accounts and on credit card interest, while New Zealand charges VAT on general and fire insurance through its goods and services tax. See H. Huizinga, 'A European VAT on financial services?', *Economic Policy*, 2002, 17, 497–534.

²⁵ See I. Crawford, M. Keen and S. Smith, 'Value-added tax and excises', submission to Mirrlees Review of the Tax System, Institute for Fiscal Studies, London, 2008, <http://www.ifs.org.uk/mirrleesreview/reports/indirect.pdf>.

²⁶ See, among others, R. de la Feria and M. Walpole, 'Options for taxing financial supplies in value added tax: EU VAT and Australian GST models compared', *International and Comparative Law Quarterly*, 2009, 58, 897–932, and H. Huizinga, 'A European VAT on financial services?', *Economic Policy*, 2002, 17, 497–534.

²⁷ See H. Huizinga, 'A European VAT on financial services?', *Economic Policy*, 2002, 17, 497–534.

²⁸ An example of this is the cash-flow treatment of financial services. See I. Crawford, M. Keen and S. Smith, 'Value-added tax and excises', submission to Mirrlees Review of the Tax System, Institute for Fiscal Studies, London, 2008, <http://www.ifs.org.uk/mirrleesreview/reports/indirect.pdf>.

£150,000; it expects this to raise £3.6 billion in a full year (just under 0.25% of national income).²⁹ Relief will gradually be reduced from 50% for those with incomes (including employer pension contributions) of £150,000 to the 20% basic rate for those with incomes (again including employer pension contributions) above £180,000. This in effect means that those with incomes above £180,000 will have to pay 30% income tax on all pension contributions above £150,000 and 20% income tax on any that take their income minus pension contributions to between £130,000 and £150,000. It also creates a potential large cliff-edge in the tax system at £130,000 of gross income, since an individual whose gross income is less than £130,000 is unaffected by the policy but someone whose gross income excluding employer pension contributions is over £130,000 and whose income including employer pension contributions is over £150,000 is affected by it. This means that someone whose employer makes a pension contribution of more than £20,000 on their behalf will have to pay tax on the whole of their pension contributions once their income (excluding employer pension contributions) increases above £130,000. This is likely to result in those in such a position entering into salary sacrifice arrangements to increase their employer pension contributions in order to keep their income excluding employer pension contributions below £130,000.³⁰

A similar policy suggested by the Liberal Democrats is to restrict tax relief on pension contributions to 20% (the current basic rate) for all higher-rate taxpayers (meaning that they would have to pay 20% tax on pension contributions). The Liberal Democrats estimate that this would raise £4.6 billion a year or around 0.3% of national income.³¹ However, this costing was made before the 2009 Pre-Budget Report in which the government announced that its policy of restricting pensions tax relief would cover more individuals (who would also be affected by the Liberal Democrat policy) and raise a further £0.5 billion per year from 2012–13. Therefore, we would now expect this policy to only raise a further £4.1 billion a year, since £0.5 billion of the revenue it would have raised before the PBR is now included in the baseline. But as with the government's decision to restrict tax relief for very rich individuals, it is hard to know how much this proposal would raise after allowing for behavioural responses. The Liberal Democrat proposal would have the advantage of avoiding the cliff-edges created by the government's policy, although clearly more individuals would be affected by the compliance costs mentioned later.

Restricting tax relief on pension contributions has been justified on the grounds of fairness, and as an anti-avoidance measure, since individuals can currently avoid paying higher rates of tax on their income by putting it into pensions and then only paying basic-rate tax on it in retirement. However, this argument supposes that all pensioners will have incomes below the higher-rate threshold. The government's current proposals target those who are most likely still to be higher-rate taxpayers in retirement. These

²⁹ Sources: Table A1 of HM Treasury, *Budget 2009: Building Britain's Future*, April 2009, http://www.hm-treasury.gov.uk/bud_bud09_repindex.htm and table B4 of HM Treasury, *Pre-Budget Report 2009*, December 2009, http://www.hm-treasury.gov.uk/prebud_pbr09_repindex.htm.

³⁰ An extreme example would be someone whose gross income excluding employer pension contributions was £129,999 and whose employer made a pension contribution of £50,000 on their behalf. If their income excluding employer pension contributions increased by £1 to £130,000, they would only be eligible for tax relief at the 20p basic rate on the whole £50,000 contribution. This would mean that they would have to pay additional tax of £4,000 (20% of £20,000) on the part of their employer contribution between £130,000 and £150,000 plus £9,000 (30% of £30,000) on the part of their employer contribution above £150,000, a total of £13,000.

³¹ Source: Liberal Democrats, 'Liberal Democrat tax plans', Briefing Document, <http://www.libdems.org.uk/siteFiles/resources/PDF/Tax%20Plans%20-%20Briefing%20Document.pdf>. It is unclear how they arrived at this estimate, so we are unable to say whether or not we agree with it.

very wealthy individuals will now pay tax at 30% when they make contributions to their pension and will then also pay tax at 40% on the same income in retirement. In this situation, a pension would be a very unattractive investment.

If tax relief on pensions is to be restricted to the basic rate, it would seem fairer, and less distortionary, for pension income only to be subject to tax at the basic rate also. While this could work theoretically, in practice individuals making a decision about whether to save in a pension today might not believe that they would only be taxed on their pension income at the basic rate of income tax when they retired: the government would always have an incentive to renege on a commitment to tax pension income only at the basic rate, as renegeing would raise revenue at little cost in the short run in terms of efficiency.

Another disadvantage to restricting tax relief on pension contributions is the level of complexity it would introduce to the tax system. It is fairly simple to tax each individual's contribution to a defined contribution (DC) pension scheme at the appropriate rate, but it is far more difficult to tax contributions to defined benefit (DB) schemes. In order to tax these, it is necessary to calculate the value of pension benefits that have been accrued for each individual each year. To do this properly, one would typically need to know, among other things, what their final salary will be, when they will retire, how long they will live, the appropriate discount rate for valuing future pension entitlements, future inflation rates, the likelihood that the employer goes bankrupt in a period when there was also a deficit on the pension fund, and whether the individual will be married when they die. The government has published a consultation document running to over 100 pages which outlines how it is intending to value contributions to DB schemes.³² However it chooses to do so, it is likely to involve significant compliance costs for scheme organisers and/or members as well as being a somewhat rough-and-ready measure, creating a distortion in terms of the choice between DB and DC schemes.

Removing exemption of employer pension contributions from NI

Contributions to a personal pension made by an employee are currently subject to NI, but those made by an employer are not. This makes pension contributions made by employers a particularly tax-favoured form of saving, since these pension contributions escape NICs altogether. It is surprising that more pension contributions are not made through employers – for example, through salary sacrifice arrangements – to take advantage of this.³³ The Treasury estimates that this exemption costs £8.3 billion or 0.6% of national income in 2009–10, but it is likely that a behavioural response to removing it would lower the yield.³⁴ Again, though, this would require a method of valuing contributions made by employers to DB schemes, with the associated complexity, compliance costs and distortions mentioned above. An alternative would be for the NI system to treat pension contributions in the same way as the income tax system, and exempt employee pension contributions from NICs also but charge NICs on pension payments in retirement. Moving to this system would clearly involve serious transition issues in order to deal with concerns about the fair treatment of those who had not

³² See HM Treasury and HM Revenue & Customs, *Implementing the Restriction of Pensions Tax Relief*, December 2009, http://www.hm-treasury.gov.uk/d/pbr09_consult_pensions.pdf.

³³ See M. Wakefield, *How Much Do We Tax the Return to Saving?*, Briefing Note 82, Institute for Fiscal Studies, London, 2009, <http://www.ifs.org.uk/bns/bn82.pdf>.

³⁴ Since NICs do not have to be made on pension income, imposing employer NI on contributions by employers would not create a positive net rate of tax on saving in a pension.

benefited from NICs relief on their contributions and those who had planned on the basis of the current system; these issues are discussed in Adam and Loutzenhiser (2007).³⁵

Abolishing the 25% tax-free lump sum

It is currently possible for those who have invested in a private pension to take 25% of their pension fund as a tax-free lump sum, which can be as large as £437,500 given the total amount of tax-privileged pension saving over a lifetime that individuals are entitled to in 2009–10. This makes pensions a very attractive investment choice for most people: the effective tax rate on this lump sum is effectively negative.³⁶ A back-of-the-envelope calculation suggests that abolishing the 25% tax-free lump sum would have raised £3.2 billion in 2008–09, around 0.2% of national income.³⁷ However, if it were abolished, there would be less incentive for individuals to save in a private pension (particularly if tax relief on pension contributions were also restricted to the basic rate): an ISA would offer the same tax advantages while offering instant access to the accumulated funds. There is also no obligation for individuals to use the accumulated funds in an ISA to purchase an annuity when they reach a particular age. The government may see this as a disadvantage, though, if it wishes people to save for retirement in a vehicle where funds are not accessible until retirement and that involves compulsory annuitisation. Therefore, while abolishing the tax-free lump sum would probably not be desirable, reducing the proportion of the total pension pot that can be taken tax-free or capping the cash amount that can be taken would both be revenue-raising reforms that would not impose a positive rate of tax on saving or severely reduce the attractiveness of saving in a pension.

Abolishing additional tax allowances for pensioners

Currently, those aged 65 and over have higher tax allowances than younger people (and there is an additional allowance for married couples where one member is aged 75 or over). The additional tax allowance is then withdrawn once income is above a threshold (currently £22,900). The withdrawal creates a situation where the marginal income tax rate increases from 20% to 30% before falling to 20% again.

A higher allowance for older people might be justified on administrative grounds – taxing pensioners' income is harder than taxing the earnings of an employee – but there seems no obvious rationale for the odd marginal rate structure applying to pensioners that is created by the withdrawal of the extra allowance. We estimate that abolishing the additional personal allowances for pensioners and the married couple's allowance would save the government £2.8 billion a year or 0.2% of national income in 2011–12.

Corporation tax

Increasing the statutory corporation tax rate

The current UK statutory rate of corporation tax is 28%, making it the lowest in the G7 and mid-ranking among EU15 countries. In 2010–11, the government estimates that

³⁵ S. Adam and G. Loutzenhiser, 'Integrating income tax and National Insurance: an interim report', Institute for Fiscal Studies, Working Paper WP21/07, 2007, <http://www.ifs.org.uk/wps/wp2107.pdf>.

³⁶ See tables 10 and 12 of S. Adam, J. Browne and C. Heady, 'Taxation in the UK', submission to Mirrlees Review of the Tax System, Institute for Fiscal Studies, London, 2008, <http://www.ifs.org.uk/mirrleesreview/reports/uktax.pdf>.

³⁷ We calculate this using the fact that the amount of income tax raised from pension income was £9.5 billion in 2008–09 (see <http://www.hmrc.gov.uk/stats/pensions/table7-9.xls>) and assuming that everyone takes advantage of the 25% lump sum and that the marginal income tax rate for those affected equals the average tax rate on their pension income.

around 7.7% of total government receipts will come from corporation tax.³⁸ This percentage has been fairly constant across the previous decade.

The amount of revenue raised from taxes on corporate income both in terms of the proportion of national income and in terms of the proportion of total tax revenue is higher in the UK than in France, Germany or the US and is around the EU15 average.³⁹ The fact that the UK raises a greater proportion of taxes from the corporate sector despite the lower statutory rate is indicative that the UK has a larger tax base. This is likely to result from a combination of a larger and more profitable corporate sector in the UK and tax rules that define the base more broadly.

The Ready Reckoner estimates that an increase of 1 percentage point in the statutory rate of corporation tax would raise something like £0.8 billion a year, which is less than 0.1% of national income.

An increase in the statutory rate obviously leads to an increase in the amount of tax raised per pound of taxable profit. However, there is an accompanying incentive for firms to move the profits they earn offshore. Concerns about the impact of tax competition have been widely acknowledged in Europe and the OECD.⁴⁰ As a result, statutory rates have tended to fall in recent years across Europe. Therefore, it may be difficult to increase the UK's corporate tax rate without also losing revenue from firms moving taxable profits to lower-tax countries.

Increasing the small companies' rate

The UK currently levies a reduced rate of corporation tax – the small companies' rate – on businesses with profits below £300,000. The small companies' rate stands at 21% in 2010 and is due to increase to 22% in April 2011.⁴¹ In 2007–08, 91% of companies paid tax at the small companies' rate. However, they represented only 20% of total chargeable profits.⁴²

The Ready Reckoner estimates that an increase of 1 percentage point in the small companies' rate would raise around £0.4 billion a year. However, increasing the small companies' rate to the main statutory rate of 28% – a 7 percentage point increase – would be likely to raise a more substantial amount. The Ready Reckoner estimates that the cost of the reduced small companies' rate – i.e. of not taxing all corporate income at the statutory rate – was £3.2 billion in 2009–10, around 0.2% of national income.

Raising the small companies' rate to the level of the main statutory rate would also remove a distortion: the reduced rate incentivises individuals to incorporate for tax purposes.⁴³ However, one rationale for the reduced rate for small companies is that it

³⁸ Source: TableB10 of HM Treasury, *Pre-Budget Report 2009*, December 2009, http://www.hm-treasury.gov.uk/d/pbr09_annexb.pdf.

³⁹ The EU15 average is pulled up by some of the smaller EU countries, such as Finland, that collect a large proportion of tax from corporations.

⁴⁰ See R. Griffith, J. Hines and P. B. Sørensen, 'International capital taxation', submission to Mirrlees Review of the Tax System, Institute for Fiscal Studies, London, 2008, http://www.ifs.org.uk/mirrleesreview/press_docs/international.pdf.

⁴¹ The increase in the small companies' rate to 22% was originally planned for April 2009 but was deferred for one year in the 2008 PBR and for another year in PBR 2009 as part of packages aimed at supporting small companies during the recession.

⁴² Authors' calculations from http://www.hmrc.gov.uk/stats/corporate_tax/11-3-corporation-tax.pdf.

⁴³ See C. Crawford and J. Freedman, 'Small business taxation', submission to Mirrlees Review of the Tax System, Institute for Fiscal Studies, London, 2008 http://www.ifs.org.uk/mirrleesreview/press_docs/small_businesses.pdf.

may play a role in encouraging entrepreneurial activity; individuals with a new idea are unable to capture the full returns to their efforts and as a result the optimal amount of risk-taking in society is higher than individuals will be prepared to undertake.⁴⁴ The incentives offered to entrepreneurs through the lower tax rate of the small companies' rate would be lost under a policy of alignment with the main rate.⁴⁵

But it is not clear that a lower corporation tax rate for companies with relatively low profits is a particularly effective way to encourage innovation. The government has also put in place two tax credits for expenditure on research and development (see Chapter 10). These are designed to provide an explicit incentive for firms to undertake R&D activity in the presence of externalities that reduce the amount of activity produced by the market to below the socially optimal level. These currently cost around £0.7 billion a year.

Environmental taxes

In 2008 receipts from environmental taxes amounted to £38.5 billion, representing 7.1% of all tax receipts or 2.7% of national income.⁴⁶ Relative to total receipts and the size of the economy, green tax revenues in 2008 were at their lowest levels since comparable figures have been readily obtainable, in 1987.⁴⁷

Both opposition parties have suggested that they would like to raise a greater share of revenues through environmental taxes, and the Liberal Democrats have proposed some specific policies such as reforms to air passenger duty (APD), vehicle excise duty (VED) and increases in fuel duties.⁴⁸

In general, there should be a strong economic rationale for departing from uniform taxes on all commodities. External costs, such as those generated by pollution and greenhouse gas emissions, are one such example that justifies higher taxes on the activities that generate them. Unless there is evidence that current taxes on these activities are insufficient to cover the external costs they generate, it is better to raise revenue by increasing a uniform commodity tax such as VAT rather than increasing taxes on specific goods. Therefore, before looking at how much increases in existing environmental taxes or the introduction of new environmental taxes could raise, we consider whether there is an environmental justification for them.

⁴⁴ In addition, recent work by the OECD has emphasised other reasons for favouring small and medium-sized enterprises (SMEs) in the tax system – for example, the possibility that a relatively high tax burden or disproportionately high compliance costs will impede SME creation and growth. See OECD, *Taxation of SME: Key Issues and Policy Considerations*, Tax Policy Study 8, 2009, http://www.oecd.org/document/15/0,3343,en_2649_34533_43890319_1_1_1_1,00.html.

⁴⁵ For further discussion on this trade-off, see D. Holtz-Eakin, 'Should small businesses be tax-favored?', *National Tax Journal*, 1995, 48, 387–395.

⁴⁶ Figures for 2008 revenues from environmental taxes in this section come from table 13.7 of Office for National Statistics, *United Kingdom National Accounts: The Blue Book – 2009 Edition*, 2009, http://www.statistics.gov.uk/downloads/theme_economy/BB09.pdf.

⁴⁷ In real terms, receipts peaked in 2000 at £40.9 billion, and as a share of national income the peak was 3.6% in 1999. Source: Authors' calculations using table 13.7 of Office for National Statistics, *United Kingdom National Accounts: The Blue Book – 2009 Edition*, 2009.

⁴⁸ See, for example, http://www.conservatives.com/News/Speeches/2007/09/David_Cameron_Meeting_economic_challenges_of_the_future.aspx and <http://www.libdems.org.uk/siteFiles/resources/PDF/Tax%20Plans%20-%20Briefing%20Document.pdf>.

Fuel duties

By far the largest single environmental tax is fuel duty, which in 2008 raised £24.8 billion (with an additional £4.3 billion from VAT charged on top of the duty).

On current plans, real fuel duty rates will have returned to just below their peak levels of 2000 by 2014. The Ready Reckoner estimates that a 1p/litre rise in the main rates of petrol and diesel duty raises approximately £500 million, including assumed behavioural responses.

To what extent is there a strong economic or environmental justification for further rises? Fullerton et al. (2008)⁴⁹ conclude that fuel duty rates are already at roughly the levels implied by the various external costs of motoring, such as climate change, noise, accidents, air pollution and, above all, congestion. Further increases could be justified by the very high costs of congestion in urban areas, but would be hard to justify in rural areas with low congestion costs. This highlights the fact that fuel duty is a particularly poor instrument to target congestion costs: from an economic efficiency perspective, it would be preferable to introduce a system of road or congestion pricing with an accompanying *reduction* in fuel duty that left overall revenues broadly unchanged. So the case for substantially higher fuel duties alone is fairly weak.

Aviation taxes

Air passenger duty – a tax on passengers on flights departing from most UK airports – raised around £1.9 billion in 2008. There are already plans to increase rates further in November 2010 (taking the most commonly paid rate from £11 to £12), but is there a rationale for further increases? To some extent, APD can be thought of as a proxy for a tax on aviation fuel, and to compensate for the fact that VAT is not levied on domestic aviation tickets.⁵⁰ From 2012, aviation will be included in the EU Emissions Trading Scheme (ETS), which limits (but does not eliminate) the rationale for a domestic carbon tax on aviation.⁵¹ Other externalities (noise and non-carbon emissions, as well as congestion in the air and around airports), though, would provide ongoing justification for national aviation taxes beyond 2012, but it is not clear whether an environmental case can be made for further increases.

Other current green taxes

It is hard to see how large increases in revenues can come from the remaining green taxes:

- Vehicle excise duty, which raised around £5.5 billion in 2008, may well see changes in rates to sharpen the environmental incentives, but it is unlikely to raise significantly more revenue.
- The landfill tax is a tax on waste sent to landfill sites, with a standard rate (currently £40/tonne) applied to most waste and a reduced rate (£2.50/tonne) to inert waste such as building rubble. In 2008, it raised just under £1 billion. The standard rate of

⁴⁹ D. Fullerton, A. Leicester and S. Smith, 'Environmental taxes', submission to Mirrlees Review of the Tax System, Institute for Fiscal Studies, London, 2008, <http://www.ifs.org.uk/mirrleesreview/reports/environment.pdf>.

⁵⁰ The UK is one of only a small number of EU countries that zero rate domestic aviation tickets under VAT, though most other countries do not impose VAT at the full rate. It is not clear what the economic rationale for zero-rating aviation is.

⁵¹ See http://www.decc.gov.uk/en/content/cms/what_we_do/change_energy/tackling_clima/emissions/eu_ets/aviation/aviation.aspx.

landfill tax is currently scheduled to increase by £8/year every year up to and including 2013–14, when the rate will reach £72/tonne. But the environmental case for even these increases already announced by the government is very weak: before the introduction of the tax, the marginal externality was estimated at around £7/tonne for most waste and £2/tonne for inert wastes.⁵²

- The climate change levy (CCL), which raised £0.7 billion in 2008, is a tax on the commercial and business use of energy that varies according to the type of energy supplied. There may be scope to increase the rates, which are now lower in real terms than when the tax was introduced, but, as we discuss below, a more sensible reform would be a wider carbon tax that replaced the CCL.
- The aggregates levy is a tax on the extraction of aggregates (such as sand and gravel). It raised only £0.3 billion in 2008, and so the scope for it to contribute substantially more revenue is very limited.

A new tax on carbon

The most likely new green tax to raise significant sums would be a carbon tax. A carbon tax would be a way to price the external costs of greenhouse gas (GHG) emissions into those activities that generate them. The key benefits of using a tax rather than direct regulation to control emissions are that it provides incentives for those who can reduce emissions most cheaply to abate more than those whose costs are higher and that it generates revenue for the government.⁵³

A uniformly-applied carbon tax (and equivalent auctioning of permits for firms already participating in the EU Emissions Trading Scheme) of £21/tonne of CO₂ – the Department of Energy and Climate Change (DECC)'s most recent assessment of the price of a tonne of emissions for firms in the ETS – would raise around £13.4 billion, ignoring any behavioural response.⁵⁴ This is just under 1% of national income.

But the net increase in revenue would be lower than this, for several reasons:

- A carbon tax would remove the environmental case for some existing taxes, such as hydrocarbon duties (especially on road fuels), APD and the CCL. For example, in 2007, GHG emissions from road transport were 123 mtCO₂e, so total tax revenues would be reduced by approximately £2.6 billion (almost 20%) if fuel duty were cut to offset a carbon tax, and by a further £0.7 billion a year after abolishing the CCL. In this case, the reform would raise £10.1 billion a year, or around 2/3% of national income.

⁵² CSERGE, *Externalities from Landfill and Incineration*, Department of the Environment, London, 1993.

⁵³ Some issues in the design and implementation of a carbon tax can be found in D. Fullerton, A. Leicester and S. Smith, 'Environmental taxes', submission to Mirrlees Review of the Tax System, Institute for Fiscal Studies, London, 2008, <http://www.ifs.org.uk/mirrleesreview/reports/environment.pdf>. A discussion of recent policy issues around carbon taxes in the UK and internationally can be found in L. Smith, *The Future for Green Taxes*, House of Commons Library Research Paper 09/86, 2009, <http://www.parliament.uk/commons/lib/research/rp2009/rp09-086.pdf>.

⁵⁴ In 2007, total emissions of GHGs in the UK were 636.2 million tonnes of CO₂ equivalent (mtCO₂e). Of these, around 40% (256.4 million) were emitted by firms operating under the ETS. Currently, almost all of the permits allocated to firms in the ETS are allocated for free ('grandfathered'). Data are taken from <http://www.defra.gov.uk/evidence/statistics/environment/globalatmos/download/xls/gatb05.xls>. These figures exclude around 42.3 mtCO₂e from international aviation and shipping based on refuelling in the UK. In practice, it would be very hard to apply a national carbon tax to these emissions and so we exclude them from our analysis. See also Department of Energy and Climate Change, *Carbon Valuation in UK Policy Appraisal: A Revised Approach*, 2009, http://www.decc.gov.uk/en/content/cms/what_we_do/lc_uk/valuation/valuation.aspx for details of the pricing of carbon. We assume that auctioned permits for firms in the ETS would be sold for an average price of £21/tonne of CO₂ emissions and that an equivalent tax is applied to the non-traded sector to produce a common national carbon price.

- The tax should lead to a reduction in activities that lead to GHG emissions, and this would reduce revenues.
- There may be pressure to exempt the domestic sector from the carbon tax because of concerns over the regressive nature of a tax on energy, which makes up a much larger proportion of the budget of poorer households. If carbon taxes formally incident on power suppliers were passed on fully to the domestic sector, the total liability facing households would be approximately £3.1 billion, or around £120 per household on average (assuming a total of 26.1 million households). If these payments were exempt – which would clearly substantially limit the ability of the tax to reduce GHG emissions – the yield from the tax would fall by just under a quarter.

The distributional impacts of a widely-applied carbon tax are hard to estimate, since its indirect effect on goods' prices is uncertain. The largest impact would be on domestic energy prices. Fullerton et al. (2008)⁵⁵ show that poorer households spend around three times as much of their budget on energy as richer households (about 12% versus 4% in 2005). One possibility would be to use some of the revenues from the tax to compensate poor households, though Dresner and Ekins (2006)⁵⁶ suggest that it would be hard to target this support since there is so much variation in energy usage even for households with similar incomes.

The taxation of housing

Council tax is the main tax on residential property in England, Scotland and Wales. Rates are set by local authorities, rather than the central government, but central government has some influence over council tax rates through the level of grants it gives to local authorities and the responsibilities it places on them. The central government can also cap local authorities whose council tax levels or increases it deems excessive, which places another limitation on local authorities' financial autonomy. Reducing grants to local authorities could be one way in which the central government could choose to lower its budget deficit, and it is likely that local authorities would increase council tax in response to this. But council tax is only expected to raise 1.75% of national income in 2010–11, and so it is unlikely that increasing council tax could raise an additional 1% of national income on its own.⁵⁷

The Liberal Democrats have recently proposed a so-called 'mansion tax' on properties worth more than £2 million. Owners of such properties would have to pay a levy of 1% of the amount by which the value exceeds £2 million. The Liberal Democrats estimate that this would raise £1.7 billion a year, or 0.1% of national income.⁵⁸ This is effectively an unbanded council tax set as a proportion of property values. This is similar to the new system of property taxation in Northern Ireland, although the Northern Irish system has a cap on property values that can be taxed, in direct contrast to this proposal.

⁵⁵ D. Fullerton, A. Leicester and S. Smith, 'Environmental taxes', submission to Mirrlees Review of the Tax System, Institute for Fiscal Studies, London, 2008, <http://www.ifs.org.uk/mirrleesreview/reports/environment.pdf>.

⁵⁶ S. Dresner and P. Ekins, 'Economic instruments to improve UK home energy efficiency without negative social impacts', *Fiscal Studies*, 2006, 27, 47–74.

⁵⁷ Source: Tables B1 and B10 of HM Treasury, *Pre-Budget Report 2009*, December 2009, http://www.hm-treasury.gov.uk/d/pbr09_annexb.pdf.

⁵⁸ Source: Liberal Democrats, 'Liberal Democrat tax plans', Briefing Document, <http://www.libdems.org.uk/siteFiles/resources/PDF/Tax%20Plans%20-%20Briefing%20Document.pdf>. It is unclear how they arrived at this estimate, so we are unable to say whether or not we agree with it.

If council tax is to continue, then levying it at a constant percentage of the property price would be more desirable than the current regressive structure. Ideally, it would also not have bands (although this might increase the administrative costs associated with the tax, as all householders would have an incentive to appeal their property valuations) and would be based on recent and regularly-updated property values (property bandings in England and Scotland are still assessed based on 1991 valuations). Such a reform could be designed to increase total revenue raised if this were thought desirable (but even if it were not, it would still be a sensible reform).

Inheritance tax

Despite the political controversy it causes, inheritance tax (IHT) raises relatively little revenue for the government (£2.3 billion is the estimate for 2010–11⁵⁹). Therefore, it seems unlikely that there is much scope for raising significant further sums from IHT, at least in its current guise. Indeed, the Ready Reckoner estimates that increasing the current 40% rate by 1 percentage point would only raise £50 million in a full year. Similarly, the government's decision to freeze the IHT threshold at £325,000 in 2010–11, rather than increase it to £350,000 as previously announced, will only raise £170 million in 2011–12.⁶⁰

However, there are some IHT reliefs which could be abolished that could raise some revenue. Agricultural and business property relief are poorly targeted and arbitrary in their effect.⁶¹ But the Ready Reckoner estimates that abolishing both of these reliefs would only have raised £345 million in 2009–10. Similarly, abolishing the relief given to donations to charities would have raised £295 million in 2009–10.

If the government wished to raise more substantial sums from taxing wealth transfers, a more radical redesign of IHT would seem necessary. One reason IHT raises so little revenue, and a feature that makes it seem unfair to many people, is that the very wealthy can avoid it by passing on most of their wealth more than seven years before death, whereas those with more modest wealth are less able to do this because more of their wealth is tied up in their main home. A simple reform that would alleviate this problem to some extent is to extend the seven-year period before death during which transfers are taxed according to a sliding scale to, say, 15 years, as proposed by the Liberal Democrats in 2007.⁶² More radically, (a renamed) inheritance tax could be applied to all lifetime gifts made by an individual above a threshold. An accompanying reform might be to make this tax donee-based rather than donor-based as IHT is at the moment, so that each individual could receive a certain value of gifts or bequests in their lifetime before they had to start paying it. If the motivation for having a wealth transfer tax at all were that the unequal distribution of large bequests is a source of inequality of opportunity, reforming the tax in this way would more clearly align the tax with its objective. Taxing lifetime gifts and hence removing the main avoidance mechanism in IHT would increase the total amount of revenue that could be raised from the taxation of wealth transfers. However, such a tax

⁵⁹ Source: Table B10 of HM Treasury, *Pre-Budget Report 2009*, December 2009, http://www.hm-treasury.gov.uk/d/pbr09_annexb.pdf.

⁶⁰ Source: Table B4 of HM Treasury, *Pre-Budget Report 2009*, December 2009, http://www.hm-treasury.gov.uk/d/pbr09_annexb.pdf.

⁶¹ Currently, agricultural property relief is available to all those who own agricultural land; restricting it to those who are working farmers would seem a better way of targeting the relief on those who want to hand on a family business to the next generation, if this were considered a desirable policy aim.

⁶² Source: Liberal Democrats, *Reducing the Burden*, Policy Paper 81, 2007.

would be administratively complex, as it would require records to be kept of all lifetime gifts. Furthermore, without a political consensus in favour of such a change, the tax might lead to individuals delaying gifts in the hope that the change might be reversed in the future, which would reduce the amount of revenue raised.⁶³

Capital gains tax

Capital gains tax (CGT) has been substantially reformed on two occasions since 1997: in 1998, when indexation allowances (which existed to ensure that only real capital gains were taxed, not those that arose as a result of inflation) were abolished (for gains made after that point) and replaced with taper relief; and in 2008, when taper relief was itself abolished and replaced by a flat 18% rate (and an entrepreneur's relief was introduced that allows the first £1 million of capital gains on certain business assets to be taxed at 10% rather than 18%).

The current structure of CGT offers a considerable incentive for those whose income is greater than £43,875 (and would thus be subject either to the 40p higher rate of income tax or, from April 2010, the effective 60p rate or the 50p additional rate) to reclassify income as capital gains, as the rate of tax is significantly lower. We discuss below changes that would minimise this distortion, as well as some extensions of CGT.

Aligning CGT and income tax rates

A desirable feature of a tax system is that it should not discriminate between different forms of economic activity. However, by taxing capital gains more lightly than dividends (for higher-rate taxpayers) or employment income, the current system in the UK does favour certain types of activity over others. A particular controversy was caused over the treatment of 'carried interest' received by private equity fund managers, but the same principle applies to owners of small businesses, who are able to forgo some or all of their salary to increase the value of their business and then sell it on. They are then liable to pay CGT rather than income tax, which, as mentioned above, has a much lower flat rate. This also creates a distortion whereby individuals have an incentive to move into occupations in which remuneration can be taken in the form of capital gains. Therefore, there is a strong case that aligning income tax and CGT rates would be less distortionary than the current system and would raise revenue at the same time.⁶⁴ An obvious revenue-raising and anti-avoidance measure, therefore, is to align income tax and CGT rates; this has been proposed by the Liberal Democrats, and they estimate it would raise £3.2 billion a year or around 0.2% of national income.⁶⁵

However, increasing CGT rates would discourage saving and investment, at least for higher-rate taxpayers. But there are better ways of ensuring that the tax system does not discourage saving and investment than having a blanket low rate of capital gains, as Adam (2008) discusses.⁶⁶

⁶³ For more on this issue, see R. Boadway, E. Chamberlain and C. Emmerson, 'Taxation of wealth and wealth transfers', submission to Mirrlees Review of the Tax System, Institute for Fiscal Studies, London, 2008, http://www.ifs.org.uk/mirrleesreview/reports/wealth_transfers.pdf.

⁶⁴ Note that this would not completely resolve the situation, however, as income tax is not the only tax on earnings – NICs need to be taken into account also.

⁶⁵ Source: Liberal Democrats, 'Liberal Democrat tax plans', Briefing Document, <http://www.libdems.org.uk/siteFiles/resources/PDF/Tax%20Plans%20-%20Briefing%20Document.pdf>. It is unclear how they arrived at this estimate, so we are unable to say whether or not we agree with it.

⁶⁶ S. Adam, 'Capital gains tax', in R. Chote, C. Emmerson, D. Miles and J. Shaw (eds), *The IFS Green Budget: January 2008*, Commentary 104, Institute for Fiscal Studies, London, 2008, <http://www.ifs.org.uk/budgets/gb2008/08chap10.pdf>.

Of particular concern is the continued absence of indexation allowances for inflation. Even with low rates of inflation, a tax on nominal capital gains corresponds to a much higher tax rate on real gains: for example, if inflation is 3%, a 40% tax rate on a 5% nominal return corresponds to a 100% tax on the real return. And it can generate tax liabilities even if no real capital gain has been made. There is no obvious reason to tax purely inflationary gains, and no reason to tax saving and investment more when inflation is higher. The reintroduction of indexation allowances, which existed from 1982 to 1998, would be an obvious way to deal with this issue, although this would limit the amount of revenue any rise in the CGT rate would raise. However, there are arguments against the reintroduction of indexation allowances: they would add a little complexity to the tax system and, since indexation allowances do not exist anywhere else in the tax system (for example, when taxing interest on savings accounts), they would distort saving decisions in favour of assets that accrued capital gains rather than earned interest income. Obviously, the ideal solution would be to introduce inflation indexation of capital income as well as capital gains. But if it were not possible to do this, it is not obvious that some indexation is better than none.

Reducing the capital gains exempt amount

There is no obvious rationale for a separate tax allowance for capital gains that cannot be offset against income: it provides an incentive for individuals to arrange their affairs in such a way that they have some income and realise some capital gains each year, rather than exclusively having one or the other. Reducing the exempt amount to a much lower level (it would be desirable to have some threshold to ensure that those realising trivial capital gains avoided the compliance cost of paying CGT) and aligning income and CGT rates (meaning that it would be possible to use the income tax personal allowance for capital gains if one did not have sufficient income to use it fully) would seem a sensible reform. The Liberal Democrats have suggested reducing the exempt amount of capital gains on which no CGT is chargeable to £2,000 from its current level of £10,100, which they estimate would raise a further £0.9 billion a year.⁶⁷

Abolishing exemption of primary residence

CGT is not payable on gains in the value of an individual's primary residence. The Ready Reckoner estimates that the abolition of this exemption would have raised £3.7 billion (around 0.25% of national income) in 2009–10, but this is a year when there are relatively few property transactions; in 2008–09, abolishing the exemption would have raised £5 billion (around 0.35% of national income).

It is clearly desirable for the tax system to treat different types of asset equally, so it is undesirable for CGT to favour investment in the primary residence. Abolishing the exemption would reduce the distortion between investing in a primary residence and a rental property, for example, but would lead to investment in a primary residence being less favourably treated than, say, an ISA.⁶⁸

From a political perspective, however, it is difficult to imagine that removing the exemption of primary residences from CGT would be easy. It might be feasible if it were

⁶⁷ Source: Liberal Democrats, 'Liberal Democrat tax plans', Briefing Document, <http://www.libdems.org.uk/siteFiles/resources/PDF/Tax%20Plans%20-%20Briefing%20Document.pdf>. It is unclear how they arrived at this estimate, so we are unable to say whether or not we agree with it.

⁶⁸ Table 7 of M. Wakefield, *How Much Do We Tax the Return to Saving?*, Briefing Note 82, Institute for Fiscal Studies, London, 2009, <http://www.ifs.org.uk/bns/bn82.pdf> demonstrates this point. Capital gains made by ISA funds are exempt from CGT.

combined with a rollover relief that enabled individuals to defer payment of tax if they were reinvesting the money raised in a new primary residence. This would also prevent a distortion whereby homeowners would be reluctant to move because doing so would result in the realisation of a capital gain and hence a CGT liability.⁶⁹ Since most homeowners own a property until they die and capital gains are forgiven on death (meaning that there would be a strong incentive to own a primary residence until death), this would mean that the reform would not raise any significant revenues. This would change if CGT were levied at death, though, and it is to this question that we now turn.

Charging CGT at death

Forgiving CGT liability at death is often justified on the basis that estates are subject to inheritance tax, but this is not a particularly convincing argument. It is not clear why capital gains should not be taxed simply because of the existence of a wealth transfer tax: CGT exists to ensure that capital gains are taxed just like other forms of income, which will have been taxed as they accrue. All forms of wealth should then be subject to IHT as well. Imposing CGT at death would make the 'double taxation' imposed by IHT more obvious, which might make it politically difficult to maintain IHT. But double taxation is a feature of wealth transfer taxation itself, rather than being due to the taxation of capital gains.⁷⁰

The Ready Reckoner estimates that removing this exemption would have cost the government £280 million in 2009–10. However, it is likely that it would raise significantly more revenue if CGT were also applied to primary homes with a rollover relief, as discussed above.

Summary

This section has discussed the scope for raising tax revenue. Table 7.2 summarises the measures mentioned and their likely yields, and gives a brief assessment of who would lose out. Please note that the yields should not be added together: many of the estimated yields interact with each other, and some of the options are mutually inconsistent.

⁶⁹ Of course, the same argument applies for other capital gains on assets other than the primary residence. Taxing capital gains when they are realised, rather than when they accrue, effectively gives the taxpayer an interest-free loan on the tax liability from the point of accrual to the point of realisation, and creates an incentive for individuals to hold on to assets for longer than they otherwise would.

⁷⁰ Various arguments for and against wealth taxation are presented in R. Boadway, E. Chamberlain and C. Emmerson, 'Taxation of wealth and wealth transfers', submission to Mirrlees Review of the Tax System, Institute for Fiscal Studies, London, 2008, http://www.ifs.org.uk/mirrleesreview/reports/wealth_transfers.pdf.

Table 7.2. Summary of possible tax increases

Proposal	Revenue raised (in 2011–12)	Losers
Increase basic rate of income tax by 4p	£16.2 billion ^a	All basic-, higher- and additional-rate taxpayers
Increase basic and higher rates of income tax by 3p	£15.0 billion ^a £14.5 billion ^{a,c}	All basic-, higher- and additional-rate taxpayers
Increase higher rate of income tax to 50p	£9.5 billion ^{a,d,e} £7.4 billion ^{c,e}	All individuals with incomes greater than £43,875
Reduce personal allowance and employee NI threshold to level of employer NI threshold and freeze for 5 years	£15.3 billion (by 2015–16) ^b	All individuals liable to pay income tax or NI
Increase personal allowance by 1.5% less than inflation in April 2011	£0.6 billion ^b	All individuals liable to pay income tax or NI
Reduce personal allowance to level of employer NI threshold	£4.5 billion ^b	All individuals liable to pay income tax or NI
Restrict personal allowance to basic rate	£4.1 billion ^b	All individuals with incomes greater than £37,400
Abolish 10p starting rate for savings income	£0.1 billion ^a	Individuals with non-savings income below starting-rate limit and some savings income
Increase employee and self-employment NI rates by 3p	£16.8 billion ^a	All individuals liable to pay NI
Increase UEL to £100,000	£4.2 billion ^c	Those with earned income greater than £43,875
Increase self-employed NI rates to match those for employees	£6.8 billion ^b	Those with self-employment income greater than £5,715
Increase standard VAT rate to 21%	£15.75 billion ^a	All households, particularly high spending
Apply standard VAT rate to zero-rated and reduced-rated goods	£24.3 billion ^a (in 2009–10)	All households, particularly low income or spending
Impose VAT on financial services	£2.8 billion ^a (in 2009–10)	Users of financial services
Restrict pension tax relief to the basic rate	£4.1 billion ^{f,g}	Higher-rate taxpayers contributing to a pension
Abolish exemption of employer pension contributions from NI	£8.3 billion ^a (in 2009–10)	Employees whose employers make pension contributions on their behalf
Abolish 25% tax-free lump sum in private pensions	£3.2 billion ^h (in 2008–09)	Those with private pension funds
Abolish additional tax allowances for pensioners and married couple's allowance	£2.8 billion ^b	Those aged 65 or over with incomes greater than £6,475
Increase main corporation tax rate by 1p	£0.8 billion ^a	Shareholders
Increase small companies' corporation tax rate to 28%	£3.2 billion ^a (in 2009–10)	Shareholders in small companies
Increase fuel duty by 1%	£0.3 billion ^a	Motorists
Introduce a carbon tax of £21/tonne of CO ₂	£13.4 billion ^{i,j}	Energy users
'Mansion tax' – levy of 1% of property value above £2 million	£1.7 billion ^f	Owners of properties worth more than £2 million
Increase inheritance tax rate by 1p	£0.05 billion ^a	Those inheriting from estates worth more than £325,000
Abolish agricultural and business property reliefs in inheritance tax	£0.345 billion ^a (in 2009–10)	Those inheriting agricultural or business property
Align capital gains and income tax rates	£3.2 billion ^f	Capital gains tax payers
Reduce capital gains tax exempt amount to £2,000	£0.9 billion ^f	Capital gains tax payers
Abolish capital gains tax exemption on primary residence	£3.7 billion ^a (in 2009–10)	Those realising capital gains on their primary residence
Charging capital gains tax at death	£0.28 billion ^a (in 2009–10)	Those inheriting estates on which unrealised capital gains had been made

Notes to Table 7.2

These yields are not additive. Many of the estimated yields interact with each other, and some of the options are mutually inconsistent.

- a. Source: HM Treasury and HM Revenue & Customs, *Tax Ready Reckoner and Tax Reliefs*, December 2009, http://www.hm-treasury.gov.uk/d/pbr09_taxreadyreckoner.pdf.
- b. Source: Authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN.
- c. Source: Authors' calculations using the 2006 Survey of Personal Incomes and assuming a taxable income elasticity of 0.2 for higher-rate taxpayers.
- d. Ready Reckoner costing does not allow for behavioural response.
- e. As explained in the text, retaining the withdrawal of the personal allowance above £100,000 would not be sensible in these circumstances. Abolishing it would reduce the revenue raised by £1.6 billion.
- f. Source: Liberal Democrats, 'Liberal Democrat tax plans', Briefing Document, <http://www.libdems.org.uk/siteFiles/resources/PDF/Tax%20Plans%20-%20Briefing%20Document.pdf>. It is unclear how they arrived at these estimates, so we are unable to say whether or not we agree with them.
- g. As explained in the text, the revenue that would be raised by this measure has been reduced by £0.5 billion as a result of the announcement in the 2009 PBR that more individuals would be affected by the government's plans to restrict pensions tax relief.
- h. Authors' calculations using <http://www.hmrc.gov.uk/stats/pensions/table7-9.xls> and assumptions specified in the text.
- i. Source: Department of Energy and Climate Change.
- j. As explained in the text, it would be desirable to reduce fuel duty and abolish the climate change levy to offset the new carbon tax. This would reduce the revenue raised to £10.1 billion.

7.3 Cuts to social security benefits and tax credits

The average annual real growth rate in spending on social security benefits and tax credits between 1996–97 and 2010–11 is 3.2%, and, in 2011–12, spending on social security benefits and tax credits could reach £202 billion.⁷¹ In this section, we consider options for saving money from the social security and tax credits budget.

The suggested savings come from reducing the real value of entitlements to benefits and tax credits, and removing some people's eligibility for benefits and tax credits, but not from measures to encourage benefit recipients to stop claiming benefits more quickly than they would otherwise have done so.⁷² We discuss the amount of money that could be saved, characterise the sort of families who would lose out, and discuss any impacts on incentives to work or save; given the number of options, these discussions will be extremely brief, however.

The section considers the following sorts of reforms:

- freezing the rates of benefits and tax credits throughout the next Parliament;
- means-testing existing means-tested benefits and tax credits more aggressively;
- means-testing currently non-means-tested benefits;
- scaling-back contributory benefits;

⁷¹ See footnote 78 for derivation of 2011–12 total. Real growth rates based on table 4 of DWP Benefit Expenditure Tables, http://research.dwp.gov.uk/asd/asd4/medium_term.asp, plus the figures for child benefit and tax credit spending in 2010–11 described in the sources to Table 7.3. Includes all spending on tax credits, although some is counted by the government as negative tax revenues.

⁷² We do not consider the extent to which money could be saved by tougher conditionality, or other measures to encourage people to leave benefits and move into paid work faster. There are considerable difficulties in costing such reforms, and in knowing to what extent any savings would be achieved under proposals that have already been announced and which have been, or are in the process of being, implemented. But decisions made by a future government about how strictly conditionality is enforced by Jobcentre Plus personal advisers could lead to lower spending on social security benefits.

Table 7.3. Forecast of social security and tax credit spending in 2010–11

Benefit or tax credit	Forecast spend in 2010–11 (£ million)
Retirement pension	69,721
Winter fuel payments	2,153
Free TV licences	565
Pension credit, of which	7,853
<i>Guarantee credit</i>	6,447
<i>Savings credit</i>	1,406
Jobseeker's allowance, ^a of which	7,520
<i>Contributory</i>	1,390
<i>Means-tested</i>	6,130
Employment and Support Allowance, of which	3,771
<i>Contributory</i>	1,583
<i>Means-tested</i>	2,188
Incapacity benefit	5,325
Income support (for under-60s)	6,773
Attendance allowance	5,201
Disability living allowance	11,740
Carer's allowance	1,594
Severe disablement allowance	847
Child benefit	11,850
Maternity allowance	359
Statutory maternity pay	1,882
Tax credits, of which	29,300
<i>Classified as social security spending</i>	22,800
<i>Classified as negative tax revenue</i>	6,500
Housing benefit	20,878
Council tax benefit	4,928
Return-to-work and in-work credits	155
Industrial injuries benefits	822
Bereavement benefits	585
Social Fund	511
Other	753
Total (excluding tax credits)	165,789
Total (including tax credits that count as social security spending)	188,589
Total (including all tax credits)	195,089

a. Spending was considerably lower before the current recession.

Notes: Tax credit spending is consistent with the 2009 PBR. Child benefit forecast is consistent with the 2008 Budget. Other lines are consistent with the 2009 Budget. Spending on asset-based welfare is not included in this table, but is discussed later in this section. Footnote 78 describes how these numbers have been used to estimate the baseline of spending in 2011–12.

Sources: Table 3 of DWP Benefit Expenditure Tables, http://research.dwp.gov.uk/asd/asd4/medium_term.asp (consistent with Budget 2009);

<http://www.publications.parliament.uk/pa/cm200708/cmhansrd/cm080430/text/80430w0011.htm#080430129000036> (Answer to PQ, 30 April 2008, Col 472W) for child benefit; tables B10 and B15 of HM Treasury, *Pre-Budget Report 2009*, December 2009, http://www.hm-treasury.gov.uk/prebud_pbr09_repindex.htm for tax credits.

- unpicking parts of the post-Pensions Commission settlement on benefits for pensioners;
- restricting entitlements to benefits and tax credits;
- abolishing or scaling-back asset-based benefits.

As background, Table 7.3 reports the latest available detailed forecast of levels of benefit and tax credit spending in 2010–11.⁷³

Reduce the value of benefits and tax credits

A simple way to reduce spending on social security benefits, and one which spreads the losses over as many families as possible, is to freeze their value in cash terms.⁷⁴ The present government usually uprates some benefits in line with growth in the RPI, some in line with growth in the ROSSI index (an alternative measure of inflation which ignores changes in housing costs and council tax, usually used to uprate means-tested benefits) and some in line with average earnings; others are usually frozen in cash terms. One large exception, which we discuss explicitly below, is that the basic state pension rises by the larger of RPI inflation and 2.5%.

The December 2009 PBR announced that some benefits that are usually increased in line with growth in the RPI would be increased by 1.5% in April 2010, even though RPI inflation to the previous September was –1.5%, and that the rise in April 2011 would be 1.5 percentage points below the value of inflation recorded in September 2010. The upshot of all this is that the real value of these benefits in 2010–11 will be 3% higher than if the nominal values had been changed by the rate of inflation in each April, and the real values will permanently be 1.5% higher from April 2011.⁷⁵

Rather than increasing the value of these benefits in April 2011 by 1.5 percentage points less than RPI inflation, as the government plans, there is a case for increasing the value of these benefits in April 2011 by 3 percentage points less than RPI inflation, thereby entirely undoing the 3% real rise that will occur in April 2010. The government is currently predicting a value of RPI inflation of 3% for September 2010, and so such a policy could be brought about by freezing the cash value of all of these benefits. Such a policy should save the government around £0.7 billion a year from 2011–12.⁷⁶

The current government had a policy of increasing the basic state pension by the greater of 2.5% or growth in the RPI. It is hard to see why this policy is justified over one that simply uprates the state pension in line with the RPI; its only justification seems to be

⁷³ Except for tax credits, these are consistent with the 2009 Budget, but not necessarily with the 2009 PBR: at the time of writing, the DWP had not published its detailed forecast of benefit spending that is consistent with the 2009 PBR. PBR 2009 forecast social security spending in 2010–11 to be £1 billion lower than in Budget 2009, presumably because the fall in the Treasury's assumption about the level of unemployment (which saves the government money) more than offset the discretionary policy changes (which will increase spending on the RPI-indexed benefits): see paragraph B.80 of HM Treasury, *Pre-Budget Report 2009*, December 2009, http://www.hm-treasury.gov.uk/prebud_pbr09_repindex.htm.

⁷⁴ The rises take place in April, and are based on the inflation rate for the year to the previous September (or the earnings growth rate for the year to the previous May–July). There is no single definitive source on uprating practice. Some partial information is given in annex A of DWP, *The Abstract of Statistics for Benefits, National Insurance Contributions, and Indices of Prices and Earnings*, 2009, <http://research.dwp.gov.uk/asd/asd1/abstract/Abstract2008.pdf>.

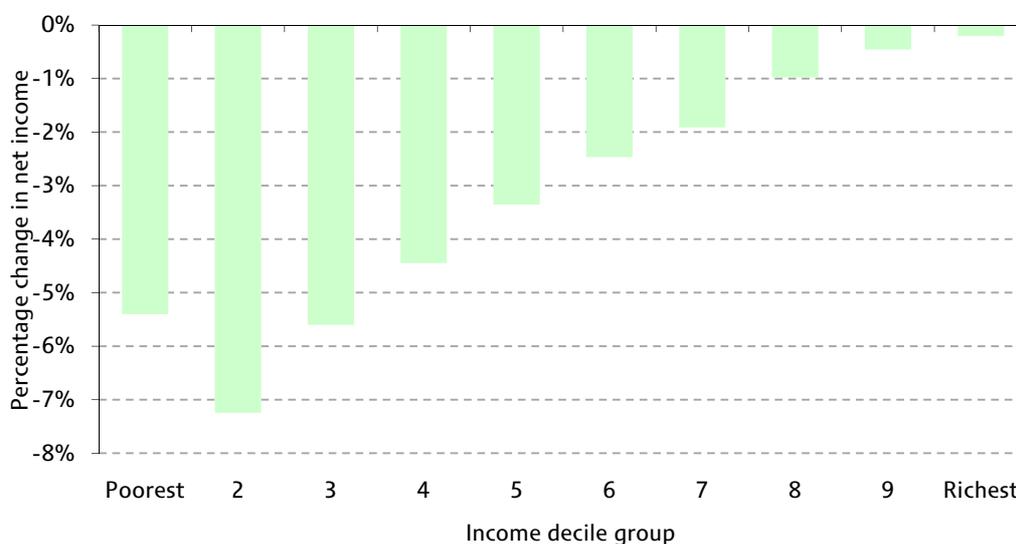
⁷⁵ The underlying problem is that there is an asymmetry in the uprating rules, with benefits only ever rising in line with rises in prices, not falling in line with falls in prices: this was confirmed in box 5.1 of HM Treasury, *Pre-Budget Report 2008*, November 2008, http://www.hm-treasury.gov.uk/prebud_pbr08_repindex.htm.

⁷⁶ The estimate is based on the December 2009 PBR estimate of the cost of a 1.5% real rise in these benefits.

based on a form of money illusion, whereby the government is criticised for small rises in benefits for pensioners when inflation is low, but not criticised when it makes large increases in benefits when inflation is high, even when both have the same impact on pensioners' standard of living.⁷⁷ However, if growth in the RPI follows the government forecast and exceeds 2.5% throughout the next Parliament, then adopting a more sensible uprating rule would not save any money in the short run, but might in the long run.

Obviously, more money could be saved if more benefits were frozen for longer periods of time, but this would reduce their value below that of April 2009. For example, given the inflation forecasts in the December 2009 PBR, we estimate that freezing all benefits in April 2011 would save £4.1 billion a year (0.25% of national income).⁷⁸ Freezing all benefits for the lifetime of the Parliament could save £24.6 billion a year by the fifth year (1.3% of national income in 2014–15) relative to current policy.⁷⁹ Clearly, greater savings

Figure 7.8. Distributional impact of freezing benefits and tax credits throughout the next Parliament



Notes: As for Figure 7.2. Assumes full take-up of all benefits and tax credits, which means that the losses are probably overstated amongst the poorest families.

Sources: As for Figure 7.2.

⁷⁷ There was a political row following a rise in the state pension of 75p in April 2000, which was in line with the low rate of RPI inflation in the previous September, and this led to an above-inflation increase in April 2001 of £5 a week. But there was no similar increase for working-age recipients of benefits. There is a case for indexing the basic state pension to the average inflation rate experienced by pensioners, rather than to that of the whole economy, but the current uprating rules are a poor proxy for this.

⁷⁸ This calculation uses the IFS tax and benefit microsimulation model, TAXBEN, to estimate what fraction of social security and tax credit spending would be saved, and then applies these proportions to a projected level of spending in 2011–12. The fall comprises a 1.8% fall in benefit spending and a 3.1% fall in tax credit spending, and about 5% of the savings are offset by reduced tax revenues on the taxable benefits. The government has not published its estimate of social security and tax credit spending in 2011–12: we assume it to be £202 billion, including those parts of tax credits that count as negative tax: this is based on the 2010–11 values in Table 7.3 and an assumed 3.5% nominal growth between 2010–11 and 2011–12. The 3.5% growth rate is based on the growth rates in the leaked Treasury document from after Budget 2009, but updated to reflect the change in the outlook for inflation between Budget 2009 and PBR 2009. See Chapter 8 for more details.

⁷⁹ Freezing all benefits and tax credits for the lifetime of the Parliament would mean that benefits would be 13%, 9% and 17% lower than they would have been had they been uprated with RPI/ROSSI/AEI respectively. This policy would reduce total spending on social security and tax credits by 10.8% compared with a world where the current uprating rules were followed. This estimate uses the forecasts for RPI and ROSSI in the 2009 PBR, and assumes that earnings growth will be equal to RPI inflation in 2010–11 and 1 percentage point higher than RPI inflation in subsequent years.

could be made (or the savings made at a faster rate) were a government prepared to cut benefits and tax credits in cash terms.

The losers from such policies would be the recipients of the relevant benefits and tax credits. The distributional impact is shown in Figure 7.8, which confirms that such a policy would reduce incomes in proportionate terms more at the bottom of the income distribution than at the top, thereby acting to increase income inequality and relative poverty.⁸⁰

Means-test more aggressively

It is obviously possible to save money by means-testing the existing means-tested benefits and tax credits more aggressively. In this subsection, we discuss the scope for saving money by means-testing tax credits, pension credit and housing benefit / council tax benefit more quickly than now. However, as we discuss below, such reforms will affect people's incentives to work and save, although the overall impact is complicated and would depend on the particular reform.

Tax credits

If there were no behavioural response, we estimate that increasing the main taper in tax credits from 39% to 44% would save £1.3 billion a year, and increasing it to 49% would save £2.3 billion a year. A rise to 49% would mean that the marginal effective tax rate (METR) faced by someone who was paying basic-rate income tax, employee NI (but ignoring employer NI) and facing a withdrawal of tax credits would be 80%, the same level as was faced by someone in 1997 who was paying basic-rate income tax, employee NI (but ignoring employer NI) and facing a withdrawal of family credit (the ancestor of the current tax credits), rather than the 70% that it is at present. Losers from this policy would be all families receiving tax credits and on the existing taper, which broadly corresponds to those with joint family pre-tax incomes above £6,500 and below £24,400 (plus some higher-income families with more than one child), some of whom would be in relative poverty on the current government's definition.

Cutting the threshold in tax credits – the point above which additional earnings reduce tax credit awards – would also save money. A reform which would help reduce some complexity would be to align the tax credit threshold with the income tax personal allowance. Based on the government's plans for the personal allowance, this would actually involve a slight *increase* in the threshold in 2011–12, which would cost around £0.1 billion a year, but if a future government adopted the policy discussed in Section 7.2 of aligning the income tax personal allowance with the (currently lower) employer NI threshold, and also aligned the tax credits threshold to it, then we estimate this would save £0.6 billion a year in 2011–12. A larger cut in the threshold, to a value corresponding to 16 hours of work a week at the national minimum wage, would save around £1.2 billion a year in 2011–12.⁸¹ The losers would be very similar to those under the policy of increasing the taper rate.

⁸⁰ Losses are smaller in the bottom decile group than in the second because the bottom decile group contains a disproportionate number of families reporting losses from self-employment, and such families are often not entitled to means-tested benefits. Losses in the top decile groups mostly reflect recipients of child benefit and the basic state pension.

⁸¹ This was recommended in M. Brewer, E. Saez and A. Shephard, 'Means-testing and tax rates on earnings', submission to Mirrlees Review of the Tax System, Institute for Fiscal Studies, London, 2008, http://www.ifs.org.uk/mirrleesreview/press_docs/rates.pdf. To cost this reform, it was assumed the minimum wage would be £6 an hour in 2011–12.

Several organisations have suggested that better-off families with children should not be eligible for tax credits.⁸² One way to do this would be to taper the family element of the child tax credit away at 39% immediately upon the exhaustion of the child element of the child tax credit, rather than at the existing threshold of £50,000. We estimate that this would raise around £0.9 billion a year⁸³ (rising to £6.5 billion a year were child benefit combined with what remained of the child tax credit). The potential losers from this would be families with children whose joint pre-tax annual income exceeded £24,400; these will mostly be in the richer half of families with children.⁸⁴ The Conservative Party has proposed reducing the threshold at which the family element is tapered away from £50,000 to £40,000: see Box 7.4. It is, though, worth noting that the decisions by successive Chancellors Gordon Brown and Alistair Darling to freeze the value of the family element at £545 since 2003 have meant that its real value was lower in 2009–10 than when it was introduced in 2003–04: had it kept pace with inflation, it would have been worth £670 a year in 2009–10, and the £50,000 threshold would have been £61,500.

Box 7.4. Conservative Party policy on the child tax credit

At its 2009 party conference, the Conservative Party proposed to start the withdrawal of the family element of the child tax credit at an annual family income of £40,000, rather than the current threshold of £50,000. An early estimate of the savings from this reform was produced by researchers at IFS and cited by the Conservative Party, and this was that the change could save £0.4 billion a year. However, the government has estimated that the threshold would have to be cut by more – to £31,000 a year – in order to save £0.4 billion.^a

It is likely that the estimate from the government is more accurate, because the IFS estimate assumed full take-up of the child tax credit. Without access to HMRC's data, it is not possible for us to say precisely how much money would be raised by the Conservative Party's proposal having allowed for incomplete take-up, but it can be stated confidently that it would be less than £0.4 billion (because that would require lowering the threshold to £31,000), but more than £45 million (which is what would be raised if the threshold at £50,000 were replaced by a cliff-edge, as this is the total amount to which families with incomes exceeding £50,000 are entitled).

a. See *Hansard*, 9 December 2009, Col. 407W, http://www.publications.parliament.uk/pa/cm200910/cmhansrd/cm091209/text/91209w0014.htm#column_406W.

⁸² Tapering away the family element of the child tax credit as soon as the child elements have been withdrawn has been suggested by organisations and individuals with a range of political backgrounds, including the think tank Reform, the Centre for Social Justice, Vince Cable and the Institute for Public Policy Research (IPPR), as well as in M. Brewer, E. Saez and A. Shephard, 'Means-testing and tax rates on earnings', submission to Mirrlees Review of the Tax System, Institute for Fiscal Studies, London, 2008, http://www.ifs.org.uk/mirrleesreview/press_docs/rates.pdf.

⁸³ Previous IFS work (R. Chote, R. Crawford, C. Emmerson and G. Tetlow, *Britain's Fiscal Squeeze: The Choices Ahead*, Briefing Note 87, 2009, <http://www.ifs.org.uk/bns/bn87.pdf>) estimated that this would save £1.3 billion a year, but this assumed full take-up. In 2007–08, families entitled for no more than the family element were entitled for £1.1 billion a year (<http://www.hmrc.gov.uk/stats/personal-tax-credits/ctcw-tax-credit-final-may09.pdf>), but the number of families receiving no more than the family element fell considerably in 2008–09 (<http://www.hmrc.gov.uk/stats/personal-tax-credits/cwtc-apr09.pdf>), and our revised estimate reflects this.

⁸⁴ The threshold for losing would rise by around £6,080 for each additional child, and also if anyone in the family is disabled, and with spending on formal childcare. The child tax credit is usually paid to mothers in couples.

Pension credit

The pension credit (PC) has a taper of 40% applied to income above a threshold. If there were no behavioural response, we estimate that raising this to 60% could save £1.2 billion a year, raising it to 80% could save £2.1 billion a year and raising it to 100% – which would return the PC to something like its predecessor, the Minimum Income Guarantee – could save £3.0 billion.⁸⁵ The losers would be low-income pensioners receiving the saving credit part of the PC.

Housing benefit and council tax benefit

There is not much scope for increasing the taper in housing benefit (HB) or council tax benefit (CTB), because their combined taper already reaches 85% of net income. However, if there were no behavioural response, increasing either the HB taper from 65% to 75% or the CTB taper from 20% to 30% could save around £0.6 billion (these reforms should not be done together, as that would take the combined HB/CTB taper over 100%. The most penal reform would be to merge HB and CTB with income support (IS) and income-based jobseeker's allowance (JSA), which would mean that they had a 100% taper, but this could not be done immediately).⁸⁶ Losers would be low-income households (but not those receiving out-of-work benefits) receiving HB and CTB.

The impact of more aggressive means-testing

Any change to the withdrawal rates or thresholds will also affect incentives to be in work, or to earn more or save more. However, the effects are complicated, and not all individuals will be affected in the same way. An increase in the withdrawal rate of tax credits, HB or CTB would have the following impact on the financial reward to work (compared with not working):

- i. reduce the financial reward for some single people, and for the primary earner in some couple families;
- ii. increase the financial reward for secondary earners in some couple families.

And it would have the following impacts on marginal effective tax rates:

- iii. increase the number of people facing very high METRs;
- iv. reduce the number of people facing high (but not very high) METRs.

Impact (i) will tend to reduce the number of people in work, as some people would prefer to remain on benefits for longer, or look less hard for a job, or even stop working. But impact (ii) will tend to mean that more second earners decide to work. Impacts (iii) and (iv) also operate in opposite directions: anyone in work who sees their METR rise will have less incentive to increase their earnings, whether through working more hours or seeking a pay rise or better-paid job, but the opposite will apply for those who see their METR fall. For these two pairs of effects, the overall impact will depend on the details of the reform, the distribution of earnings and family income, and how responsive are the individuals affected by the reform.⁸⁷

⁸⁵ These could be overestimates of the savings, because the calculations do not reflect the low take-up rate of the PC by those on the taper, although this is offset to some extent because these estimated savings do not reflect savings from pensioners who do not live in private households, and therefore not covered by the Family Resources Survey.

⁸⁶ These estimates should be seen as tentative, because they ignore the low take-up rate of these benefits amongst those in work and pensioners, and they ignore the fact that estimated entitlement to HB in TAXBEN assuming full take-up is less than the amount spent by the government.

⁸⁷ A rise in the tax credit taper would undo part (but not all) of the change in incentives that came about when working families' tax credit (WFTC) was introduced, and research has shown that the introduction of WFTC led

Families who remain entitled to the means-tested benefit or tax credit even after it is means-tested more aggressively will, in general, experience the first and third of these, although some will also experience the second. Families who lose entitlement to the means-tested benefit or tax credit after it is means-tested more aggressively will, in general, experience the first and fourth of these, but may also experience the second. For example, a rise in the tax credit taper by 5 percentage points would mean that some people who currently face a 70% METR, because they are on the tax credit taper and pay basic-rate income tax and employee NI, would face a 75% METR (if they remained on the tax credit taper), and others would face a 31% METR (if they lost all entitlement to tax credits). If the people concerned were lone parents or primary earners, then they would also see their gain to work fall, but if they were second earners, they would see their gain to work rise.

Similarly, any increase in the withdrawal rate of the PC would weaken the incentive to save for those individuals who remain (or expect to remain) on the PC taper, but strengthen it for those who are (or expect to be) no longer eligible.⁸⁸

Means-test the existing non-means-tested benefits

There is often pressure to target social security benefits more tightly on those with the lowest resources: such a move could reduce total spending on benefits but maintain the living standards of those in greatest need of state support. Other than child benefit and the basic state pension, the important non-means-tested benefits are disability living allowance (£11.7 billion a year in 2010–11), attendance allowance (£5.2 billion a year in 2010–11) and carer's allowance (£1.6 billion a year in 2010–11).⁸⁹ This subsection considers the scope for means-testing, or abolishing, benefits that are paid to all eligible families at a rate that does not depend upon the family's income.⁹⁰

Child benefit

Currently, financial support for children is mostly delivered through the income-related child tax credit and the universal, non-means-tested child benefit.

One argument to justify child benefit not being means-tested is that it helps achieve horizontal redistribution (between those with and without children) and redistribution across the life cycle. If it is thought that better-off families with children should not be eligible for state support for their children, then this could justify removing not only the

to a net increase in the number of workers (see M. Brewer and J. Browne, *The Effect of the Working Families' Tax Credit on Labour Market Participation*, IFS Briefing Note 69, 2006, <http://www.ifs.org.uk/bns/bn69.pdf>). Research that examined the impact of cutting the withdrawal rate in HB found that it would increase average METRs, so increasing the withdrawal rate (as suggested in this chapter) would probably lower average METRs (which must mean that impact (iv) is more significant than impact (iii)). It also suggests that increasing the withdrawal rate in HB would improve the incentive to have a job for nearly as many people (all of whom would be potential second earners in couples) as it would weaken the incentive to have a job. See S. Adam, M. Brewer and A. Shephard, *The Poverty Trade-Off*, Policy Press, Bristol, 2006.

⁸⁸ This ignores income effects, which will tend to reduce any adverse impacts on employment or saving.

⁸⁹ See Table 7.3 for details of estimated spending in 2010–11. We do not discuss cuts to the basic state pension, but we discuss the impact of delaying increasing it in line with earnings.

⁹⁰ The think tank Reform recently analysed the extent to which social security benefits are paid to families in the top half of the income distribution, and proposed that these be scaled back: see T. Cawston, A. Haldenby and P. Nolan, *The End of Entitlement*, Reform, London, 2009, <http://www.reform.co.uk/LinkClick.aspx?fileticket=ECSzk1Mtle8%3d&tabid=118>. However, George Osborne said that 'we will preserve child benefit, winter fuel payments and free TV licenses. They are valued by millions' in his speech to the 2009 Conservative Party Conference, http://www.conservatives.com/News/Speeches/2009/10/George_Osborne_We_will_lead_the_economy_out_of_crisis.aspx.

family element but also child benefit.⁹¹ For example, if child benefit were combined with the child tax credit and subject to the same withdrawals, we estimate that £5.1 billion a year could be saved.⁹² The potential losers from this would be families with children whose joint pre-tax annual income exceeded £24,400, most of whom will be among the richer half of families with children; losses amongst the losers would increase with the number of children.⁹³ Note that if this policy were implemented at the same time as tapering away the family element of child tax credit as soon as the child element of tax credits have been tapered away, then the total savings would be around £6.5 billion a year compared with the current regime. Roughly the same families would lose as above, but the average losses would be higher.

Winter fuel payments and free TV licenses for those aged 75 and over

Two universal benefits introduced by the current government are winter fuel payments (WFPs) for those aged 60 or over, and free TV licences for those aged 75 or over. It is unclear why these programmes need to exist when pensioners can also receive the (taxable) basic state pension and the (means-tested) PC. Scrapping these outright would save £2.7 billion a year;⁹⁴ scrapping them but with an offsetting rise in the PC to ensure there were no low-income losers could save around £1.4 billion a year.⁹⁵ The losers from the latter change would be better-off pensioners, plus some low-income pensioners who are not taking up the PC to which they are entitled.

Other non-means-tested benefits: AA, DLA and CA

Should a government desire, it would clearly be possible for other non-means-tested benefits to be means-tested in some way, or even abolished. For example, substantial reforms would include:

- scrapping carer's allowance (CA): if this did happen, many recipients would instead be entitled to claim income support, which is potentially more generous but is means-tested against any income of the carer and their partner;
- scrapping attendance allowance (AA) as a benefit in its own right but replacing it by higher premiums in PC, and HB/CTB;
- scrapping disability living allowance (DLA) as a benefit in its own right and replacing it with higher credits in tax credits and means-tested benefits (alternatively, a new means-test for DLA could be devised).

Although £1.6 billion is estimated to be spent on CA in 2010–11, we estimate that scrapping it would save only around £0.5 billion, as some of its recipients would be entitled to additional means-tested benefits or tax credits. The impact of abolishing AA

⁹¹ This policy has been suggested by, for example, Vince Cable MP (although he said that some compensation would be needed in the form of tax cuts) and the think tank Reform.

⁹² Our estimate of the cost of this policy is based on abolishing child benefit, and increasing the child element of the child tax credit by an amount equal to the rate of child benefit for children beyond the first, and increasing the family element by an amount equal to the current first child premium in child benefit. We do not discuss any administrative complications that might arise.

⁹³ The threshold for losing would rise by around £6,080 for each additional child, and also if anyone in the family is disabled, and with spending on formal childcare. Child benefit is usually paid to mothers in couples.

⁹⁴ DWP, *The Abstract of Statistics for Benefits, National Insurance Contributions, and Indices of Prices and Earnings*, 2009, <http://research.dwp.gov.uk/asd/asd1/abstract/Abstract2008.pdf>.

⁹⁵ It has not been possible to estimate this precisely. Scrapping the WFP but with a compensating increase in the PC guarantee would save around half of the gross cost of the WFP, or around £1.0 billion a year. If the same ratio also applies to free TV licences, then scrapping both the WFP and the free TV licences for those aged 75 or over but with compensating increases in the PC guarantee would save around £1.4 billion a year.

and DLA would depend on how precisely it was implemented, but if recipients of means-tested benefits are to be protected, then the potential savings would be considerably lower than the gross cost of these benefits (£5.2 billion for AA and £11.7 billion for DLA in 2010–11).

The current design of these benefits leads them to be described as ‘extra needs’ or ‘extra costs’ benefits, designed to ensure fairness by offsetting the costs (i.e. a disability or a requirement to care for a disabled person) that some individuals face through no fault of their own, regardless of income. Scrapping CA, AA and DLA could be justified through a desire to focus state support on those who need it most, or a desire to have individuals rely more on private insurance products. A means-tested DLA, for example, would help offset the extra costs of having a disability only if the disabled person had a low income, and any partner had a low income, but would not help offset the extra costs of disabled individuals with high private incomes, or with partners with high incomes.⁹⁶ Abolishing or means-testing CA, AA and DLA would also increase the number of people facing a high marginal effective tax rate due to the withdrawal of a means-tested benefit, thus weakening work incentives.⁹⁷

Making benefits taxable

A more generous alternative to means-testing the non-means-tested universal benefits is to make them taxable. The government estimates that, in 2009–10, taxing child benefit would raise, at best, £1.2 billion a year, taxing DLA would raise around £0.5 billion a year and taxing AA would raise £0.2 billion a year; we estimate that taxing WFPs would raise £0.2 billion a year.⁹⁸ The losers from such policies would be the recipients of the relevant benefits and tax credits who have incomes high enough to be liable for income tax.

The arguments for and against taxing AA and DLA are very similar to those for scrapping or means-testing them. The arguments for taxing child benefit in the hands of its recipient are similar, but a policy of taxing child benefit in the hands of its recipient would mean that one-earner couples would usually not pay tax on child benefit, but two-earner couples with the same joint income would, which might be seen as unfair.⁹⁹ The case for taxing WFPs is perhaps the strongest, though, as there is no clear justification for having them free of income tax when the basic state pension is taxable.

Scale-back contributory benefits

Successive governments have eroded the contributory principle in the UK’s social security system, thereby making it look less like a system of social insurance and more like a set of needs-based benefits.¹⁰⁰ But some elements of the contributory system

⁹⁶ A separate argument can be made for abolishing CA and having its recipients claim IS, as this would ensure fairness between those who do not work because they care full-time for a disabled adult (who currently claim CA) and lone parents who do not work because they care full-time for children aged under 7 (who currently claim IS).

⁹⁷ Such people would include the partners of the benefit recipients where the abolition of one of these benefits led a family to be on a withdrawal of a means-tested benefit or a tax credit.

⁹⁸ Government estimates are from the Ready Reckoner. CA is already taxable. Equivalent estimates from TAXBEN are that taxing AA, DLA and child benefit would raise £0.3 billion, £0.7 billion and £1.2 billion a year respectively. We do not discuss the practical issues (i.e. administrative costs for DWP and HMRC, and compliance costs for individuals) that would be involved were these benefits to be taxable.

⁹⁹ For further discussion, see T. Clark and J. McCrae, *Taxing Child Benefit*, IFS Commentary 74, 1998, <http://www.ifs.org.uk/publications/1948>.

¹⁰⁰ J. Hills, ‘Inclusion or insurance? National Insurance and the future of the contributory principle’, CASEpaper 68, LSE, 2003.

remain. Those opposed to social insurance argue that, like the non-means-tested benefits discussed in the previous subsection, they direct government resources to those who may have little need of it. On the other hand, the Fabian Society has recently called for an expansion of the contributory principle.¹⁰¹ An alternative approach, discussed in Box 7.5, would be to make greater use of compulsory accounts, similar to the forthcoming Personal Accounts, into which individuals (and perhaps the government and employers) would have to contribute, and which would be used to fund some existing benefits.

Box 7.5. Compulsory savings accounts, and making more use of private insurance

A more radical approach to spending less on social security benefits would be to make use of compulsory savings accounts, into which individuals (and perhaps the government and employers) would have to contribute, and which could be used to fund some benefits currently funded through general taxation. This is similar to the principle behind using Personal Accounts to fund income in retirement (although they are not compulsory), and it clearly could be extended to other benefits.

One approach to compulsory savings accounts is to use them to replace those benefits that are mostly about redistributing income across an individual's life cycle (as opposed to those that are about redistributing income from the lifetime rich to the lifetime poor, which would include most of the means-tested benefits). Benefits that might fall into this category include the state pension, child benefit and maternity pay, jobseeker's allowance (for short spells of unemployment) and statutory sick pay or employment and support allowance (for short spells of sickness/disability). Under a system of compulsory savings accounts, each working-age adult would have an account, into which mandatory contributions would be made (perhaps replacing some existing NI contributions). The benefits listed above would then be paid out of an individual's account, rather than from general taxation; note that account balances would be permitted to become negative. Upon reaching the state pension age, negative balances could be forgiven – to provide some form of redistribution – and positive balances annuitised (see Bovenberg et al. (2007) for an example of this proposal^a). The advantages of such schemes derive from the fact that richer individuals would effectively fund their own benefits directly; this strengthens incentives for such individuals both to work and not to make use of those benefits, and it should therefore allow savings to be made at current levels of benefit entitlement.

Another approach to the benefit system is to make more use of private insurance for things such as disability and unemployment, thereby lowering the need for JSA and ESA (as suggested by Reform^b). However, a fully private market for unemployment or disability insurance might lead to some people being unable to insure themselves, because of the usual problems of moral hazard and adverse selection (moral hazard would exist because whether someone is unemployed depends to some extent upon that person's actions; adverse selection would exist because the value to an individual of disability insurance depends on that person's health, and an individual may have a much better idea of his or her health than an insurer).

a. Bovenberg, A.L., M.I. Hansen and P.B. Sørensen, 'Individual accounts and the life cycle approach to social insurance', Working Paper, 2007, <http://www.econ.ku.dk/pbs/diversefiler/Paper%20version%20July%2007.pdf>.

b. T. Cawston, A. Haldenby and P. Nolan, *The End of Entitlement*, Reform, London, 2009, <http://www.reform.co.uk/LinkClick.aspx?fileticket=ECszk1Mtle8%3d&tabid=118>.

¹⁰¹ T. Horton and J. Gregory, *The Solidarity Society*, Fabian Society, London, 2009.

The main remaining contributory benefits for working-age adults are jobseeker's allowance (JSA) and the employment and support allowance (ESA) (and its predecessor, incapacity benefit, IB). It would clearly be possible for these to be scaled back in some way. For example:

- contributory JSA could be limited to three months (rather than the current six), or abolished outright;
- IB and contributory ESA could be time-limited (say, to one or two years), or abolished outright.

Scrapping contributory JSA and IB/ESA saves less than the current spending on those benefits, as some recipients would be eligible for means-tested benefits instead. Our very tentative estimate is that scrapping contributory JSA could save around £0.3 billion a year (once the labour market has returned to its pre-recession state) and scrapping contributory IB/ESA could save around £2 billion a year.¹⁰² Scrapping these benefits would clearly be a dramatic policy change, but less money could be saved by the less dramatic policy of time-limiting contributory IB/ESA to, say, one or two years. The losers from these reforms would be recipients of contributory JSA or IB/ESA who also have other private sources of income, or a partner with an income.

Finally, it would be possible to make savings from statutory maternity pay (estimated to cost £1.9 billion in 2010–11) either by freezing the basic amount for one or more years (although savings here were included in the estimated savings given in the previous paragraph) or by only cutting the amount paid in the first six weeks (currently 90% of earnings). However, the data available to us do not permit accurate costings of any of these measures.¹⁰³

Unpick the Pensions Commission consensus

In 2006, the government published a major White Paper proposing changes to all aspects of the pensions system, following an independent review by the Pensions Commission.¹⁰⁴ The key proposals of the White Paper and the Pensions Act that followed were that:

- the basic state pension be indexed to earnings, beginning at some point in the next Parliament;
- the guarantee credit of the PC continue to be indexed to earnings, but the savings credit would be reformed so that it grew more slowly;
- entitlements to the basic state pension be increased, by relaxing the contribution conditions, but accruals of the state second pension to be reduced for higher earners;

¹⁰² These estimates are very tentative because such calculations require accurate data on which households are receiving JSA and/or IB/ESA, and whether they are receiving the contributory or income-related versions, and it is clear that the Family Resources Survey data, on which our estimates are based, are not perfectly accurate.

¹⁰³ There is also an inconsistency within the tax credit system, in that the first £100 a week of SMP does not count as earnings for the purpose of the tax credit means-test, even though the purpose of SMP is to replace forgone earnings. It would be sensible to correct this: if the government wished to increase the support for mothers of newborn children, then there are other instruments available to it. A mother receiving SMP who is on the tax credit taper would lose up to £1,521 if all of SMP were counted as earnings.

¹⁰⁴ Department for Work and Pensions, *Security in Retirement: Towards a New Pensions System*, Cm. 6841, The Stationery Office, London, 2006, <http://www.dwp.gov.uk/policy/pensions-reform/security-in-retirement/white-paper/>; Pensions Commission, *Implementing an Integrated Package of Pension Reforms: The Final Report of the Pensions Commission*, London, 2006.

- most employees be automatically enrolled by their employer into a private pension scheme, with a compulsory minimum employer contribution for those employees who do not choose to leave the scheme;
- the state pension age rise from 65 to 68 by 2046.

This subsection asks how much could be saved with a less generous settlement for pensioners. However, given that current policy on state pensions and on saving for retirement was the output of a careful, in-depth review by an independent commission, it would be preferable if a future government could continue to consider these policies as a whole, rather than seeking to unpick the post-Pensions Commission reforms in a piecemeal fashion.

The basic state pension

The current government has said that it hopes to restore the link between the basic state pension and earnings in April 2012.¹⁰⁵ The government could decide to push this back, not least as in 2006 it would have been difficult to imagine that the fiscal position could ever be as bad it is now. The government has previously estimated that each year in which the basic state pension is indexed to prices rather than earnings saves the government around £0.7 billion a year and so a postponement from 2012–13 to 2015–16 could save £2.1 billion a year in 2015–16.¹⁰⁶ Delaying the point at which the pension is indexed to earnings would be consistent with the current government's decision in the December 2009 PBR to delay the rolling-out of automatic employer enrolment, although the Pensions Commission's recommendation was that the link with earnings should begin in April 2010.¹⁰⁷ The losers would be pensioners who are not receiving the PC, most of whom will be better-off pensioners (with too much private income to be entitled to the PC) but some of whom will be low-income pensioners not claiming the PC to which they are entitled.

The pension credit

The current government is committed to increasing the PC guarantee in line with earnings, as it has done since 2003. But money could be saved if it were indexed in line with prices instead. The precise savings from adopting such a policy from 2012 would depend upon the future value of earnings growth and RPI inflation, but we estimate that each increase in the PC guarantee of 1.5 percentage points more than inflation (which would occur if average earnings were growing at 4% and the RPI growing at 2.5%) costs around £0.4 billion a year. Recipients of the PC would lose; most of them are towards the bottom of the income distribution of pensioners.

¹⁰⁵ In the White Paper, the government stated: 'During the next Parliament, we will re-link the uprating of the basic State Pension to average earnings. Our objective, subject to affordability and the fiscal position, is to do this in 2012, but in any event by the end of the Parliament at the latest. We will make a statement on the precise date at the beginning of the next Parliament' (page 17 of Department for Work and Pensions, *Security in Retirement: Towards a New Pensions System*, Cm. 6841, The Stationery Office, London, 2006, <http://www.dwp.gov.uk/policy/pensions-reform/security-in-retirement/white-paper/>).

¹⁰⁶ The original source is table 1 of the Work and Pensions Committee's Fourth Report, HC 1068(i), 2005–06 Session, <http://www.publications.parliament.uk/pa/cm200506/cmselect/cmworpen/1068/106807.htm#a35>, but the amounts have been updated to today's prices. However, the saving will depend in practice upon the difference between growth in average earnings and RPI inflation between 2012 and 2015.

¹⁰⁷ It would be possible to reduce spending on the basic state pension by tightening the contributory conditions – perhaps, for example, by reversing the changes in the 2006 Pensions Act (which, for those retiring from 2010, cut the years of contributions needed for a full BSP to 30 and scrapped the requirement to have contributed for a quarter of the working life to receive any BSP). It is also possible to reduce the generosity of the state second pension – perhaps, for example, by bringing forward the date after which all accrual will be flat-rate. The savings from both these measures would initially be small, but would build up over the long run.

The state pension age

The Conservative Party has proposed that the state pension age be increased at a faster rate than that proposed by the current government, rising from 65 to 66 for men from 2016 and rising from 65 to 66 for women after 2020 (the current government has stated that the age for both should rise to 66 by April 2026). The people made worse off by this reform would be men born between 1951 and 1959, and women born between 1955 and 1959.

We have produced estimates of the savings in benefit spending that would arise if the basic state pension age were increased today by one year (i.e. to 66 for men and 61 for women¹⁰⁸), assuming no one altered their employment or savings patterns. Such a move is estimated to reduce spending on the basic state pension by around £2.7 billion a year, but a net increase in spending on other benefits, and reduced tax revenues (as income from the basic state pension is taxable and despite the one-year rise in which employee NI is payable), mean the total gain for the Exchequer would be around £2.2 billion a year. However, this will be an underestimate of the savings that would arise from the same reform if it took place in 2016 or 2020 even if no one altered their employment or savings patterns.¹⁰⁹

The more substantial question, though, is to what extent a rise in the basic state pension age would affect people's decisions to work and save. If individuals work more in response to a rise in the state pension age, then the savings to the government would rise, as such individuals would contribute more in taxes and be entitled to less means-tested benefits. But if individuals saved more (by spending less), then the savings to the government would fall, at least in the short term.

The Conservative Party claimed that its reform would save £13 billion a year. It is unclear in what year the Conservatives were claiming the saving and in what year's prices, but the underlying research estimated the savings to be $\frac{2}{3}$ % of GDP by 2023, which would amount to £10 billion in 2011–12. The savings will stop in 2024, at which point the state pension age is due to rise to 66 under current government plans. This estimated saving is almost certainly too large, because it was based on research that examined the impact on the public finances of everyone working for one more year.¹¹⁰ It is very hard to imagine that all working-age adults will work another year in response to losing entitlement to the state pension for a year: there will almost certainly be some individuals who will not alter their behaviour at all if the state pension age is increased, such as those who are too ill to work or those who are so rich that they do not need to work. But we will soon have a better idea of how plausible this is from analysing the employment patterns of women affected by the rise in the basic state pension age from 60 to 65 from next April to 2020. It is likely, then, that the true savings from this reform lie somewhere between £2 billion and £13 billion a year.

¹⁰⁸ With associated increases in the age at which people become entitled to the WFP, PC guarantee, PC savings credit, pensioner's tax allowance and attendance allowance, and at which they lose entitlement to IB/ESA. Our reformed system would remove the PC savings credit from women aged 65, but it would allow men aged 61–65 to claim the PC guarantee and WFPs.

¹⁰⁹ The underestimate of the savings arises because entitlements to SERPS and S2P amongst people reaching state pension age in 2016 or 2020 are likely to be greater than now, and more elderly people are likely to be in work then than now; these mean that the savings from not paying state pension for a year would be greater in real terms in 2016 than now, fewer 65-year-olds will be entitled for extra PC were the state pension to be removed, and the extra tax revenue from removing the older person's tax allowance from 65-year-olds will be greater in 2016/2020 than it is now.

¹¹⁰ The costing is reported in http://news.bbc.co.uk/1/hi/uk_politics/8291835.stm. See NIESR press release of 6 October 2009, <http://www.niesr.ac.uk/pubs/searchdetail.php?PublicationID=2406>.

Reduce entitlements to benefits and tax credits

In principle, there are many ways to reduce entitlement to benefits and tax credits other than by a more aggressive means-test. For example, the number of recipients of ESA and DLA depends, in loose terms, on how unhealthy an individual has to be to receive them. Similarly, whether a lone parent can claim IS depends on whether her or his youngest child is under a certain age; and whether a person is entitled to claim CA depends on whether he or she spends more than a fixed number of hours caring. There are also numerous rent restrictions in HB (which limit the amount of rent that can be covered). All of these involve parameters or thresholds that could be altered, and which could cut the number of people entitled to claim benefits. But for many of them, it is very hard for us to know how much would be saved were the criteria to be altered, mostly because household surveys do not collect enough information to allow entitlements to be estimated under alternative conditions.

This subsection considers a mixed set of reforms which all reduce entitlement to benefits and tax credits by methods other than a more aggressive means-test.

Removing entitlement to benefits and tax credits in respect of dependent children aged 16 to 19

When the current government introduced the education maintenance allowance (EMA) – a payment to 16- to 19-year-olds in full-time further education means-tested against the income of their parent(s) – there was a suggestion that it could replace the benefits and tax credits that are paid to the parents of the EMA recipients.¹¹¹ However, this has not happened. A dramatic change would be not to pay extra benefits and tax credits in respect of dependent children aged 16 or over, and we estimate that this would save £3.0 billion a year. A significant drawback of this reform, though, is that it might discourage young people from staying on in education beyond the age of 16 and, to counter this, some of the savings might need to be put back into higher EMA payments. But even if, for example, only child benefit for 16- to 19-year-olds were scrapped and replaced by an equivalent rise in entitlements to EMA, then savings would be made, as the EMA is means-tested and child benefit is (currently) not; the losers would be families with dependent children aged 16 or over with incomes too high to be entitled to EMA.

Cutting the fraction of childcare costs that can be refunded through the childcare tax credit

Cutting the fraction of childcare costs that can be refunded through the childcare tax credit from 80% to 50% could save around £0.7 billion a year. But such a policy might mean that some parents use informal care rather than formal care, and some might decide that it is no longer worth working. Losers would be concentrated in the middle of the income distribution.¹¹²

¹¹¹ For example, the 1997 Labour Party manifesto, *New Labour because Britain Deserves Better*, said that ‘We are committed to retain universal Child Benefit where it is universal today – from birth to age 16 – and to uprate it at least in line with prices. We are reviewing educational finance and maintenance for those older than 16 to ensure higher staying-on rates at school and college, and that resources are used to support those in most need. This review will continue in government on the guidelines we have already laid down’. This clearly left open the prospect that child benefit for those aged 16 and over could be abolished.

¹¹² A distributional analysis of the childcare tax credit can be found in M. Brewer, C. Crawford and L. Dearden, ‘Reforms to childcare policy’, in R. Chote, C. Emmerson, D. Miles and Z. Oldfield (eds), *The IFS Green Budget 2005*, 2005, <http://www.ifs.org.uk/budgets/gb2005/05chap9.pdf>, and M. Brewer, ‘Quality costs: funding options for high quality early childhood education and care’, Daycare Trust, Working Paper 5, 2009, http://www.ifs.org.uk/docs/fundingoptions_wp.pdf.

Restricting the amount of council tax that can be rebated by council tax benefit

From 1998–99 to 2003–04, the amount of council tax benefit/rebate that a household could receive was limited to the tax due on a band E property. We estimate that restoring this restriction would save £0.6 billion a year, and a more substantial tightening, so that only the council tax due on a band C property could be rebated, would save £1.2 billion. The losers would be recipients of CTB in England and Scotland who live in houses in bands F to H (or D to H with the extra restriction) and in Wales who live in houses in bands F to I (or in bands D to I).

Asset-based benefits

Recently-introduced asset-based welfare policies – the Child Trust Fund and the planned nationwide roll-out of the Saving Gateway in 2010 – might also be seen as potential sources of savings.¹¹³

At present, all children have £250 paid by the government into their Child Trust Fund at birth, and when they are 7 years old, with children whose family is receiving certain means-tested benefits or has an income of below £16,040 (in 2009–10) getting an extra £250. The Liberal Democrats have said that they would abolish the Child Trust Fund, which would save around £0.5 billion a year. The Conservatives have proposed to scrap the payments for the better-off children (i.e. those children whose family does not receive certain means-tested benefits and has an income of above £16,040), which would probably save around 45% of the cost of the scheme (based on 37% of children continuing to be entitled to Child Trust Fund payments).

The Saving Gateway allows recipients of certain benefits to have contributions they make into a designated account (up to £25 a month) matched by the government after two years, at a rate of 50p for each £1 saved. The aim of such a policy is, presumably, to encourage saving. However, the evaluation of the second Saving Gateway pilots found mixed evidence on whether the accounts did increase saving.¹¹⁴ It is also not clear why the government wants low-income individuals to save; such individuals might be better served through policies aimed at increasing their incomes. Abolition of the Saving Gateway would save an estimated £130 million in 2012–13, but the savings would fall gradually to just £60 million a year.¹¹⁵

Abolition of the Child Trust Fund would affect as-yet-unborn children in 18 years' time, with those from low-income families losing by more than those from higher-income families. The Conservative policy would mean that children from families that do not receive certain means-tested benefits and have an income of above £16,040 would lose

¹¹³ This draws on R. Chote, R. Crawford, C. Emmerson and G. Tetlow, *Britain's Fiscal Squeeze: The Choices Ahead*, Briefing Note 87, 2009, <http://www.ifs.org.uk/bns/bn87.pdf>. See also C. Emmerson, 'Should the Child Trust Fund be abolished?', IFS Observation, September 2009, <http://www.ifs.org.uk/publications/4602>, and C. Emmerson and M. Wakefield, *The Saving Gateway and the Child Trust Fund: Is Asset-Based Welfare 'Well Fair'?*, Commentary 85, Institute for Fiscal Studies, London, 2001, <http://www.ifs.org.uk/comms/comm85.pdf>.

¹¹⁴ Higher-income account holders appeared to have financed their contributions into their accounts from reshuffling other assets, but there was some evidence that lower-income account holders did finance contributions through genuinely higher saving and lower spending. See P. Harvey, N. Pettigrew, R. Madden, C. Emmerson, G. Tetlow and M. Wakefield, *Final Evaluation of the Saving Gateway 2 Pilot: Main Report*, HM Treasury, London, May 2007, http://www.hm-treasury.gov.uk/d/savings_gateway_evaluation_report.pdf.

¹¹⁵ Costing from paragraph 10.2 of HM Revenue and Customs, 'Explanatory memorandum to the Saving Gateway Accounts Regulations 2009', http://www.uk-legislation.hmsso.gov.uk/si/si2009/draft/em/ukdsiem_9780111483404_en.pdf.

out (currently, around two-thirds of children would fall into this category¹¹⁶). Abolition of the Saving Gateway would affect those who would have qualified for and opened an account (who would be benefit recipients who are able to place funds in an account and therefore qualify for the government match).

Summary

This section has discussed the scope for saving money on social security and tax credits spending. Table 7.4 summarises the measures mentioned and their likely savings, and gives a brief assessment of who would lose out. Please note that the savings should not be added together: many of the estimated savings interact with each other, and some of the options are mutually inconsistent.

Notes to Table 7.4

a. This is the amount that would be saved in 2014–15 in 2014–15 prices.

BSP = basic state pension. CTC = child tax credit. SMP = statutory maternity pay. PCG = pension credit guarantee.

Notes: These savings are not additive. Some proposals are mutually incompatible, and some costings interact with each other.

¹¹⁶ Table 4 of HM Revenue and Customs, *Child Trust Funds Statistics: Detailed Distributional Analysis*, October 2009, http://www.hmrc.gov.uk/stats/child_trust_funds/dda-2009.htm.

Table 7.4. Summary of possible savings to spending on social security and tax credits

Proposal	Savings (in 2011–12)	Losers
Freeze RPI-linked benefits and tax credits (except BSP) in April 2011	£0.7 billion	Recipients of RPI-linked benefits (except BSP)
Freeze all benefits and tax credits in April 2011	£4.1 billion	All benefit recipients
Freeze all benefits and tax credits for all of Parliament	£24.6 billion ^a	All benefit recipients
Increase withdrawal rate in tax credits	Up to £2.3 billion	Recipients of tax credits with incomes in excess of threshold, except those receiving only family element
Align tax credit and income tax thresholds with employer NI thresholds	£0.6 billion	Recipients of tax credits with incomes in excess of new threshold, except those receiving only family element
Taper family element of CTC immediately after child element of CTC	£0.9 billion	Those receiving only the family element of CTC
Increase withdrawal rate in PC	Up to £3.0 billion	Recipients of PC savings credit
Increase withdrawal rate of HB or CTB	£0.6 billion	Recipients of HB or CTB currently on the taper
Taper child benefit and family element of CTC after child element of CTC	£6.5 billion	Richer half of families with children
Abolish WFPs and free TV licenses	£2.7 billion	All aged 60 or over
As above with protection for those on PC	£1.4 billion	All aged 60 or over and not on PC
Scrap CA	£0.5 billion	Recipients of CA who would not be entitled for a means-tested benefit
Means-test AA	Up to £5.2 billion	Better-off recipients of AA
Means-test DLA	Up to £11.7 billion	Better-off recipients of DLA
Make more benefits taxable	£2.1 billion	Recipients of DLA, AA, child benefit and WFP with incomes high enough to pay income tax
Time-limit contributory ESA	Up to £2.0 billion	Recipients of ESA with own income or partner with own income
Scrap contributory JSA	Around £0.3 billion	Recipients of JSA with own income or partner with own income
Reduce generosity of SMP	Unknown	Recipients of SMP
Delay indexation of BSP to earnings	£2.1 billion (in 2015–16)	Recipients of BSP not also receiving PC
Index PCG to prices, not earnings	£0.4 billion for each year	Recipients of PC
Increase state pension age by a year	Between £2.2 billion and £10.0 billion	For the proposal made by the Conservatives: men born between 1951 and 1959, and women born between 1955 and 1959
Do not pay benefits in respect of dependent children aged 16–19	Up to £3.0 billion	Families with children aged 16–19 still in full-time education
Cut childcare tax credit	£0.7 billion	Recipients of childcare tax credit
Limit CTB to band E properties	£0.6 billion	CTB recipients with houses in bands F to I
Scrap or limit Child Trust Fund	Up to £0.5 billion	Current and future recipients of Child Trust Fund
Scrap Saving Gateway	£0.1 billion (in 2012–13)	Saving Gateway account holders (benefit recipients)

7.4 Conclusion

This chapter has highlighted several ways in which a future government could increase tax revenues and reduce spending on social security benefits.

On the tax side, there has been much speculation that the next government will increase VAT. A 3.5 percentage point rise in VAT (to 21%) would increase tax revenues by around 1% of national income, but the same amount of revenue can also be raised through a 3 percentage point rise in the basic and higher rates of tax (to 23% and 43% respectively) or a 3 percentage point rise in employee and self-employment rates of National Insurance. Despite appearances, these reforms would have fairly similar impacts to each other: the main downside of all three is that they weaken incentives to earn more (and, for income tax and VAT, save more), and the distributional impacts of the three measures are similar. Two important differences are that the VAT rise would be less progressive than the others, because it would affect poor, non-tax-paying households, and that pensioners and savers would not be directly affected by a rise in NI. VAT also taxes income that has been earned but not yet spent, meaning it creates a capital levy that does not affect efficiency but might be seen as unfair.

These measures would share the pain over a large number of households (especially the rise in VAT). At the other extreme, a government that wished to lower the incomes of only the richest 10% might contemplate a rise in the higher rate of tax from 40% to 50% (raising £5.8 billion¹¹⁷) or a rise in the UEL to £100,000 (raising £4.2 billion): both leave those with incomes below £43,875 unaffected.

But significant amounts of revenue could also be raised by reforms that would remove certain distortions in the tax system. For example:

- Extending the standard rate of VAT to goods and services that currently attract a zero or reduced rate would remove an unwarranted distortion of spending on these goods, and could raise 1% of national income even after a substantial increase in benefits and tax credits to offset the impact on the poorest households.
- If administratively possible, VAT should also be extended to financial services, raising £3 billion.
- A comprehensive carbon tax could raise up to £10 billion a year, after offsetting falls in existing environmental taxes.
- Rates of NI for the self-employed are much lower than their equivalents for employees, and equalisation could raise £6.8 billion assuming no behavioural change. This would remove a distortion in favour of being self-employed rather than employed or incorporating in the current tax system.
- Charging NI on employer contributions to pension funds would prevent a tax-induced distortion in favour of salary sacrifice arrangements and could raise up to £8 billion a year.
- An equalisation of the small and large companies' rates of corporation tax would reduce tax-driven incentives to incorporate and could raise around £3 billion a year.

¹¹⁷ As explained in Section 7.2, retaining the withdrawal of the personal allowance above £100,000 would not be sensible in these circumstances. Abolishing it would reduce the £7.4 billion revenue raised by £1.6 billion, leaving £5.8 billion.

- An increase in the rate of capital gains tax towards the higher rate of income tax (40%), and a cut in the CGT allowance, would both help reduce the favourable tax treatment of capital gains over income. The Liberal Democrats estimate that £4.1 billion a year could be raised in this way,¹¹⁸ but any change ought to be accompanied by some form of allowance for inflation, which would lower the yield.

The chapter has also discussed many options for cutting spending on social security and tax credits. Unlike the tax rises, we have found it harder to highlight many of these as being more desirable (or less undesirable) than the others. The main consequences of the highlighted cuts are distributional – in that some recipients will be worse off – rather than economic. What can be said is that:

- Freezing the cash value of all benefits and tax credits in April 2011, and perhaps subsequent years, has the virtue of sharing the pain over a large number of households. A freeze over the entire next Parliament would save £24.6 billion a year by the fifth year (1.3% of national income in 2014–15). But such a change would be concentrated on fewer households than, say, a rise in VAT, and would act to increase income inequality and measures of relative poverty.
- A government that wanted to remove benefits from better-off households should consider saving £6.5 billion by means-testing the family element of the child tax credit and rolling child benefit into the tax credit system, £1.4 billion from scrapping winter fuel payments and free TV licences and compensating pensioners on the pension credit, £0.5 billion by abolishing carer's allowance, and perhaps up to £2 billion a year by time-limiting contributory IB and ESA. The main economic downside to all these is that they would increase the amount of means-testing in the benefits and tax credit system, which would tend to weaken incentives to work and save, and increase administrative and compliance costs.
- Measures that reduced the number of families affected by a means-test, by means-testing more aggressively – thereby reversing the direction of benefit reform since 1999 – could save up to £2 billion a year from benefits and tax credits for working-age households, and a similar amount from those households with adults aged 60 or over. The impact on incentives would be mixed, but the losers would almost certainly be in the bottom half of the income distribution.

Ultimately, for both the tax-raising and the benefit-cutting options, the next government will need to be clear on its wider objectives and distributional goals before deciding which, if any, to pursue. As the National Equality Panel concluded last week, 'the progressivity of taxes and the levels of benefits and tax credits relative to other incomes are central to overall inequalities. How the public finances are rebalanced will probably be the most important influence on how economic inequalities evolve'.¹¹⁹

¹¹⁸ Source: Liberal Democrats, 'Liberal Democrat tax plans', Briefing Document, <http://www.libdems.org.uk/siteFiles/resources/PDF/Tax%20Plans%20-%20Briefing%20Document.pdf>.

¹¹⁹ The National Equality Panel, *An Anatomy of Economic Inequality in the UK*, Government Equalities Office and CASE.