



Tax policy and inequality

Robert Joyce, Institute for Fiscal Studies

Presentation at HMT/HMRC tax policy school

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Introduction

- Not for economists to specify strength of preference for equality or philosophies of ‘fairness’
 - But given these judgements, how should tax policy be made?
- This talk is in broadly two parts:
 1. General points about how to make policy, with links to examples
 2. Comments on specific parts of tax system
- Political feasibility of suggestions will vary greatly, but:
 - What is feasible depends on time horizon
 - Need clear benchmark for what a good system looks like before you try to approximate it or move towards it
- See Mirrlees Review: www.ifs.org.uk/publications/mirrleesreview

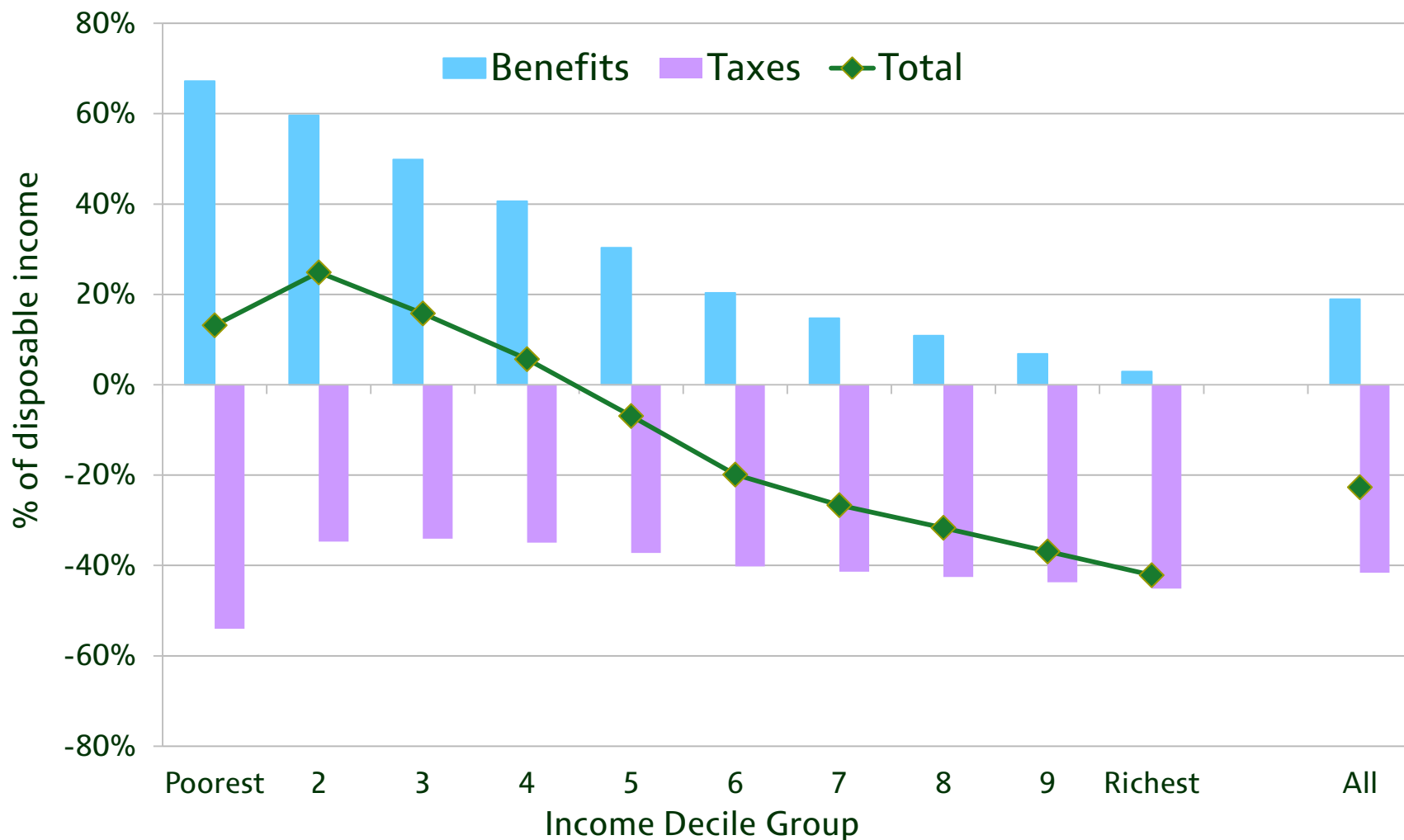
Tax policy and fairness / distribution

General points

1. Consider effects of tax and welfare system **as a whole**
 - Much of the redistribution is done by benefits/tax credits

Distributional effect of the tax and benefit system

2014-15, excluding most 'business taxes'



Source: Author's calculations from ONS (2016), *The effects of taxes and benefits on household income, 2014/15*

Tax policy and fairness / distribution

General points

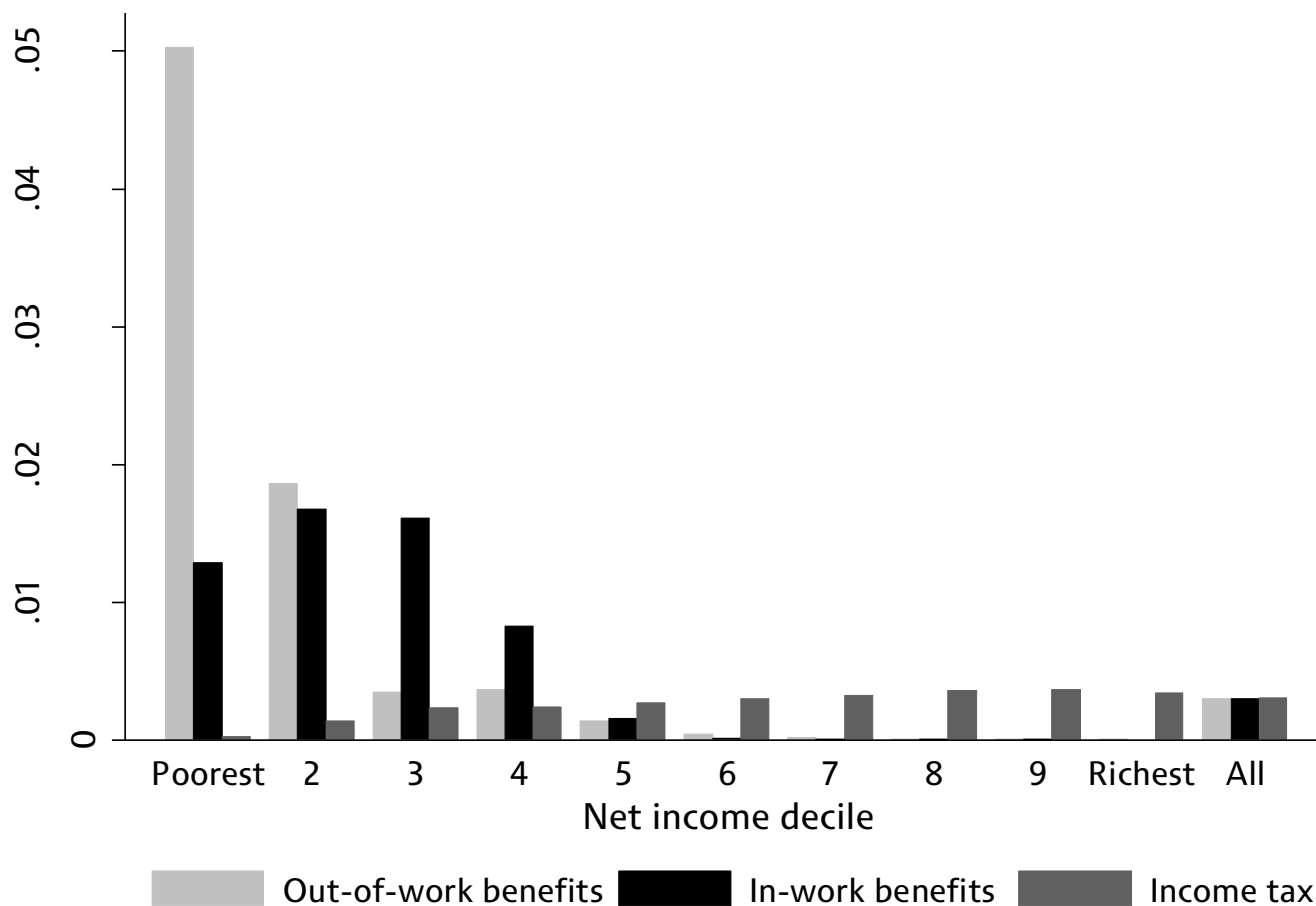
1. Consider effects of tax and welfare system **as a whole**
 - Much of the redistribution is done by benefits/tax credits
 - Trying to get every part of system to achieve every objective can lead to bad policy, e.g. indirect taxes are ill-suited for use as a means of redistribution (see Mirrlees Review on differential VAT rates)
 - Coherence, fairness and avoidance opportunities: is the system treating similar activities similarly?

Tax policy and fairness / distribution

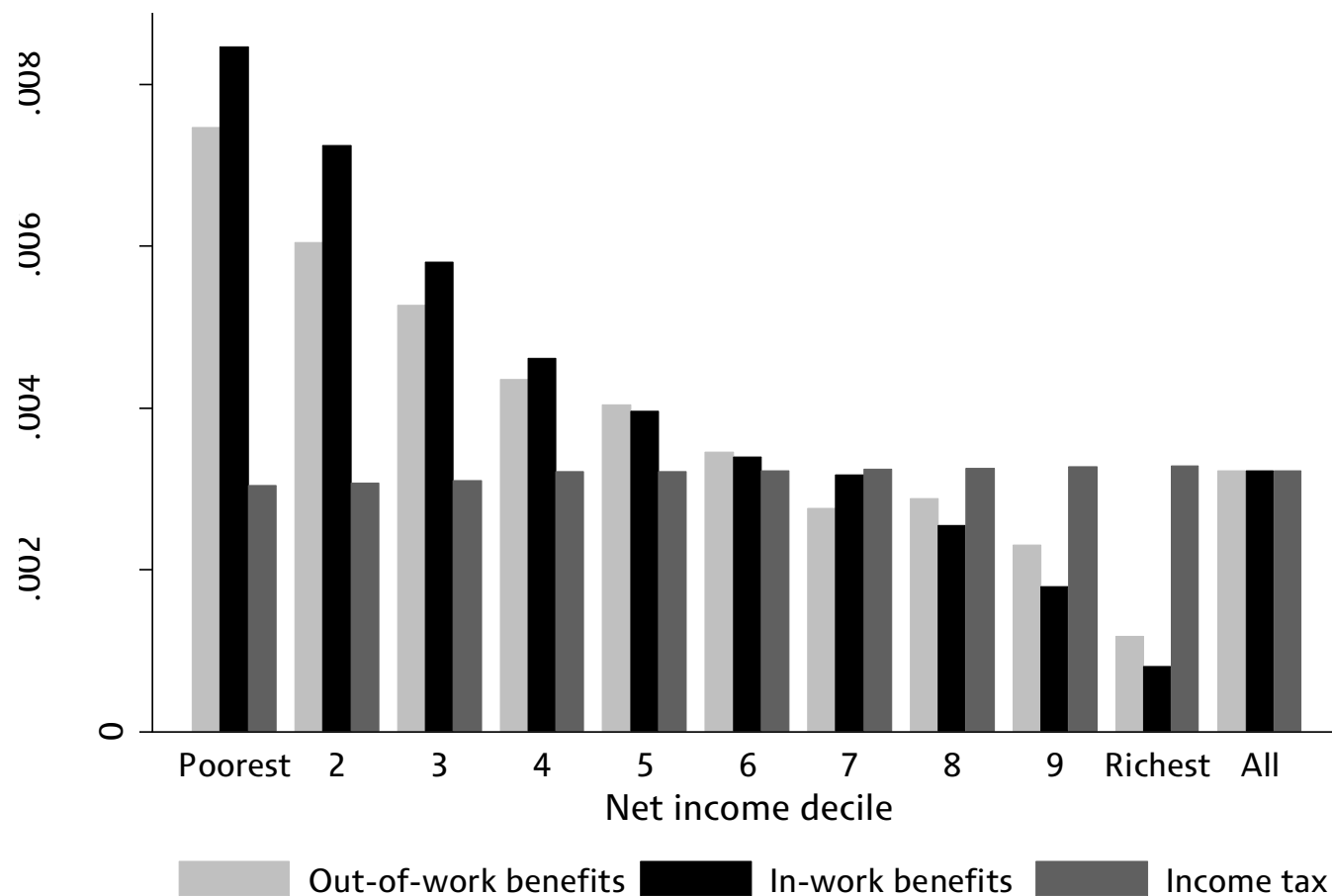
General points

1. Consider effects of tax and welfare system **as a whole**
2. Take a long term (ideally lifetime) view of who gets what

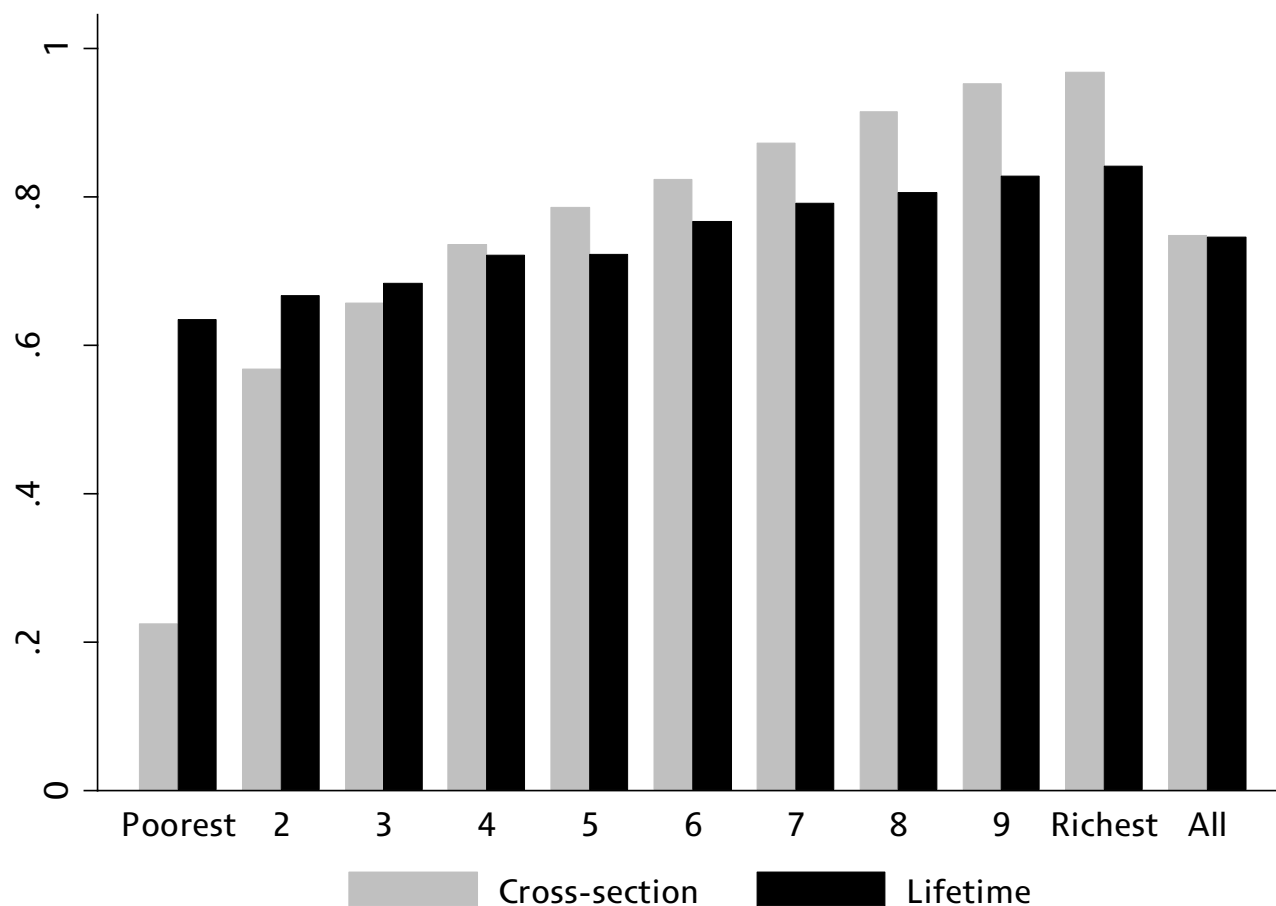
Increase in out-of-work benefits is most progressive in cross-section



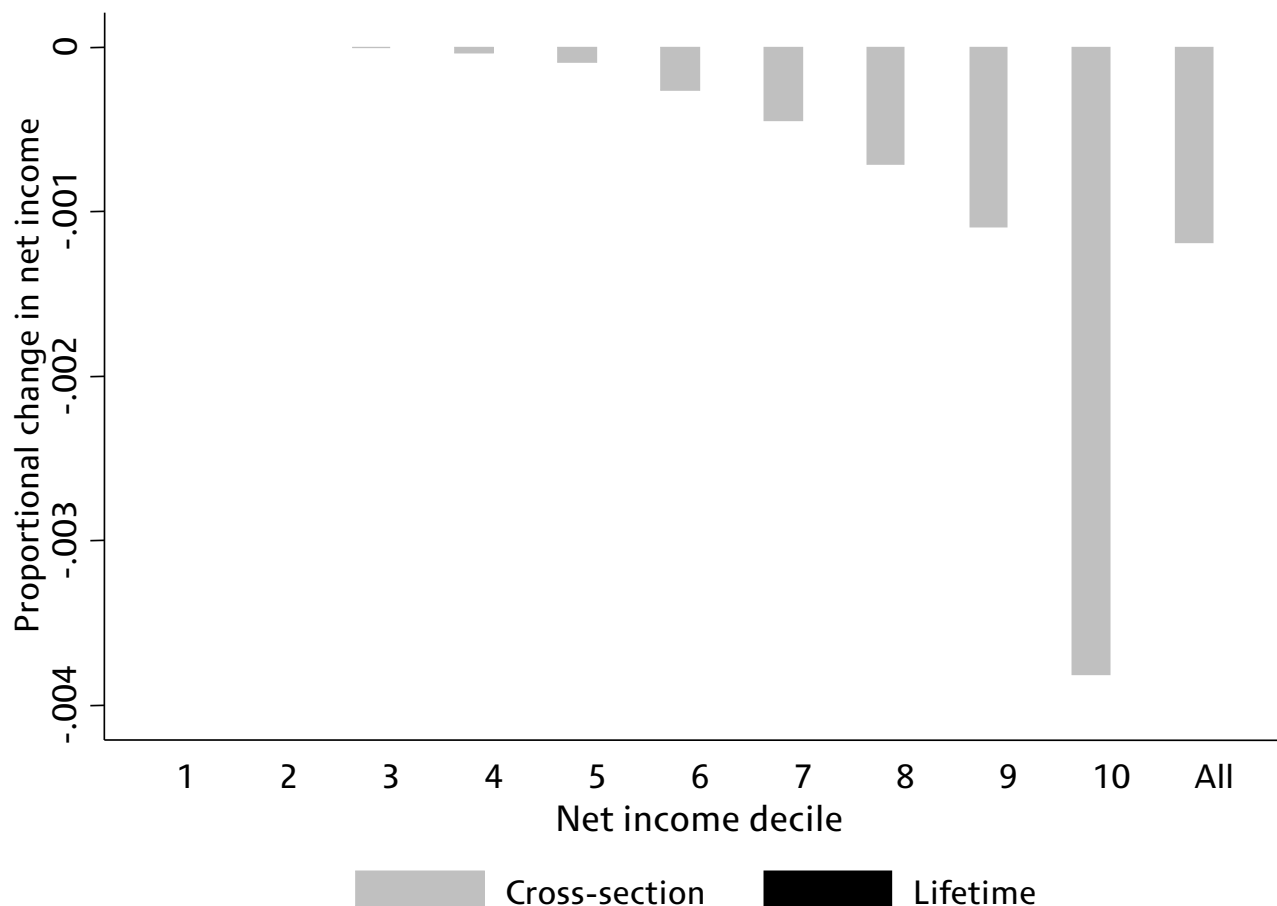
Over the lifetime, increases in in-work and out-of-work benefits are equally progressive



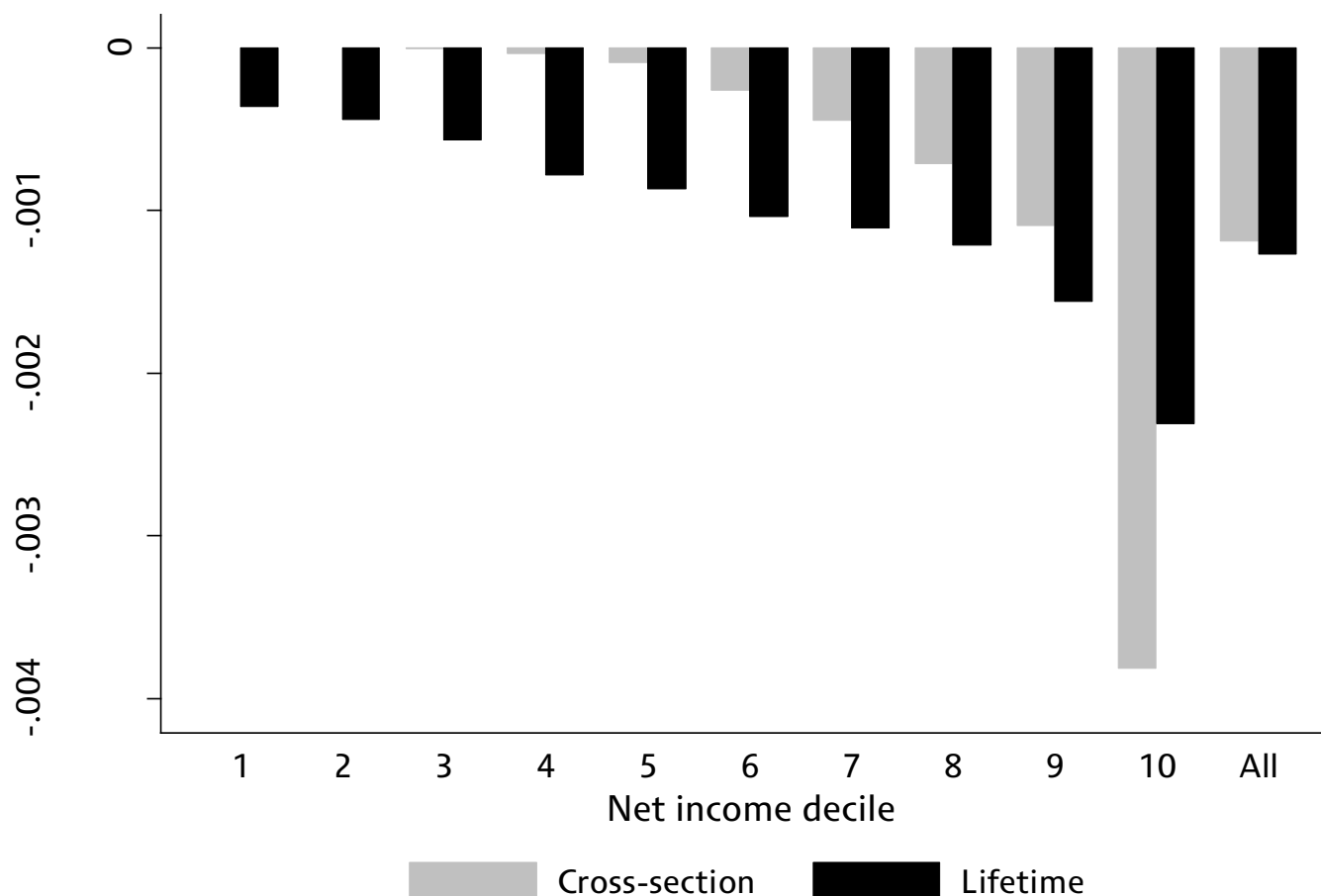
Explanation: the poorest individuals spend most of working-age life in work



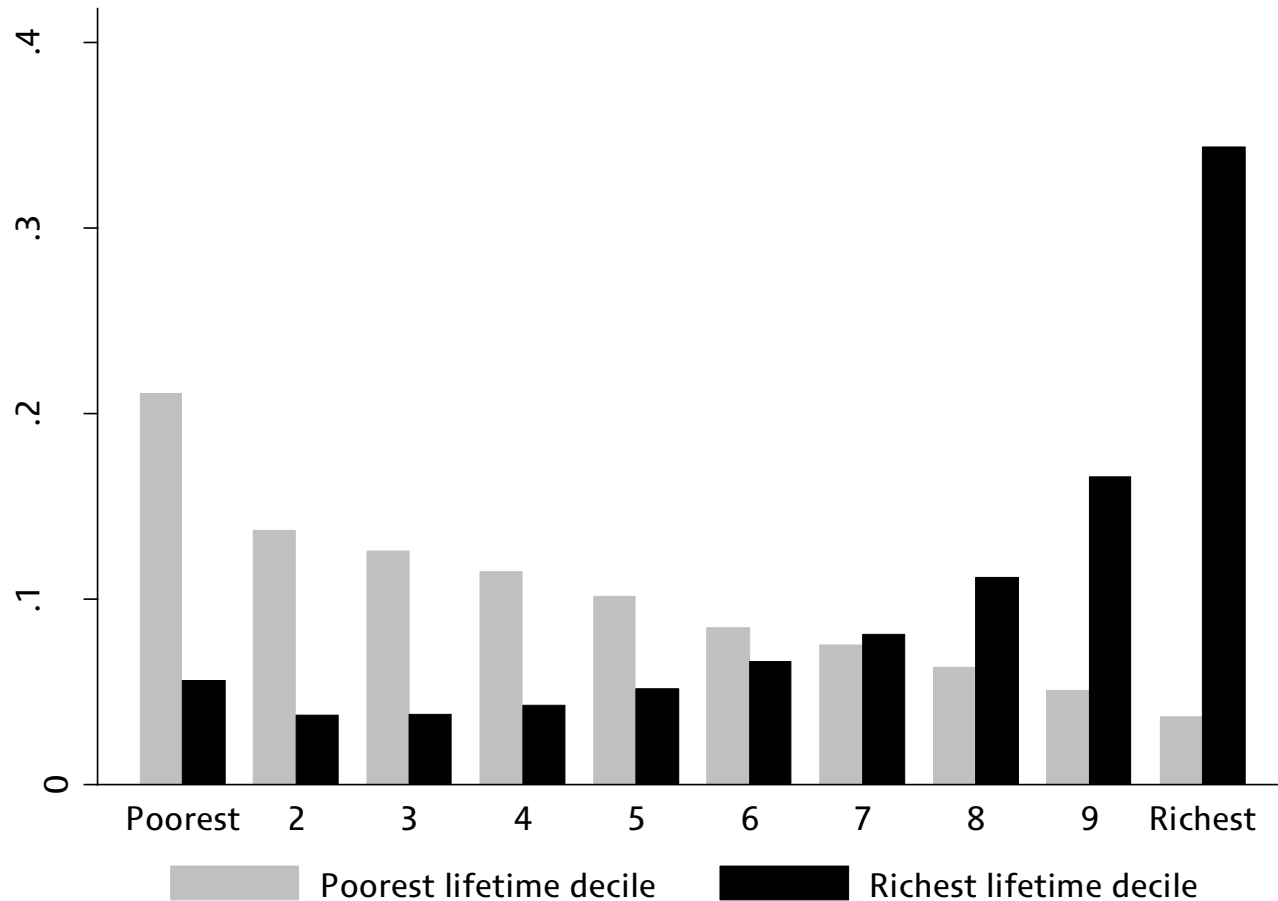
Changes to the higher rate of income tax are reasonably effective at targeting the lifetime rich



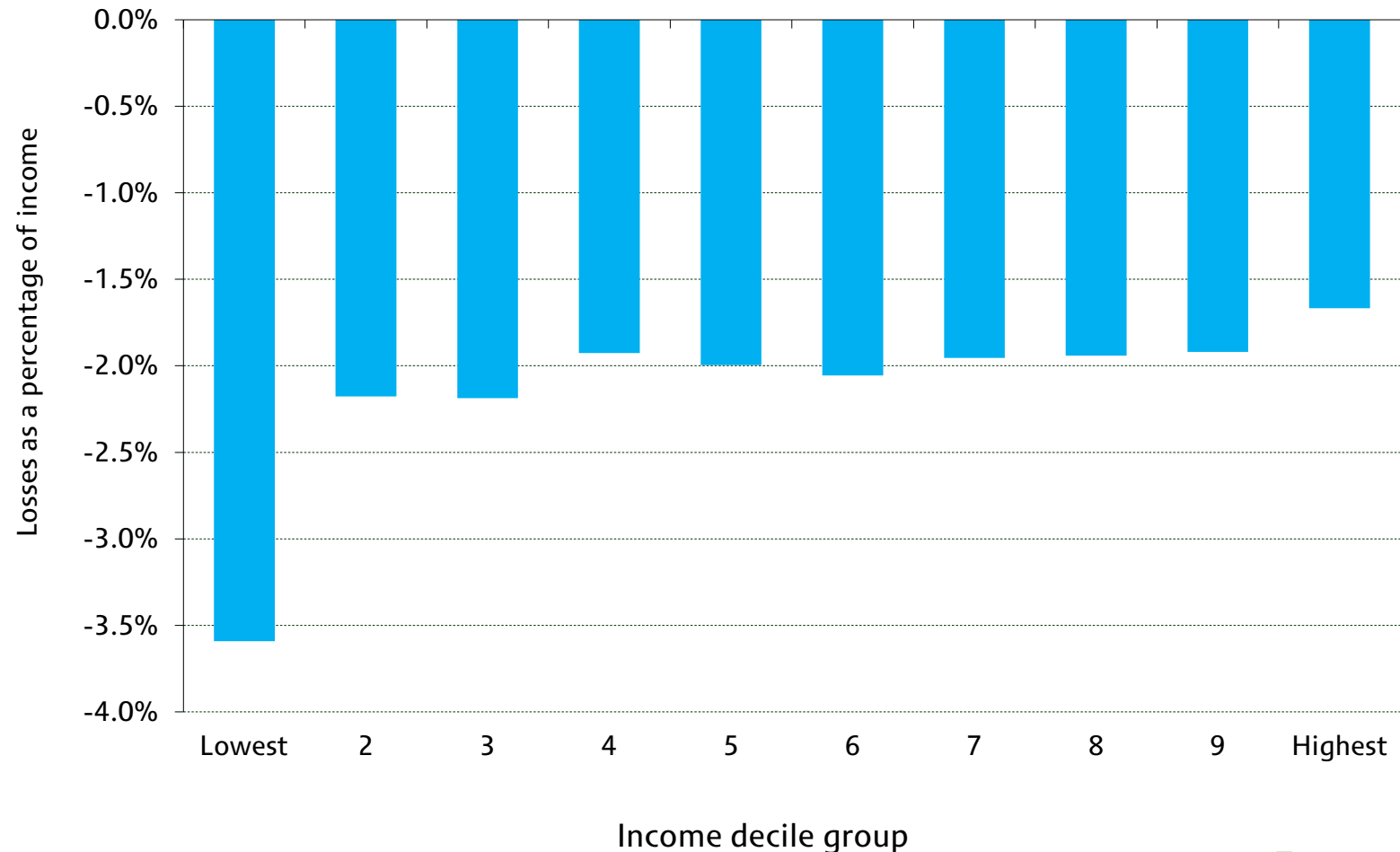
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Explanation: persistence in incomes is greater at the top of the distribution than the bottom

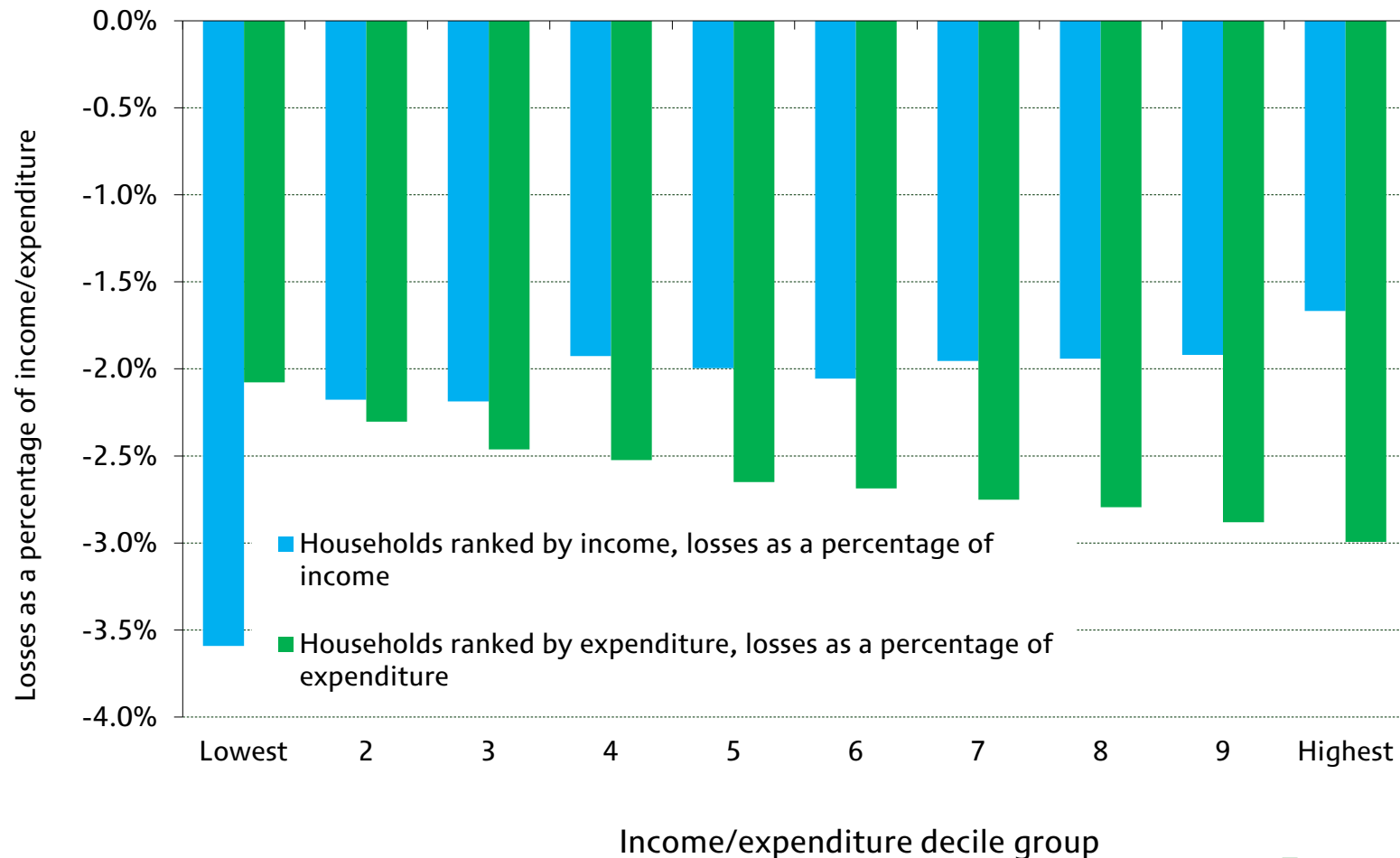


Increases in the standard rate of VAT look misleadingly regressive if using (snapshot) income



But progressive when we look at losses relative to spending, and rank households by spending

Spending is a better reflection of long-term income



Tax policy and fairness / distribution

General points

1. Consider effects of tax and welfare system **as a whole**
2. Take a long term (ideally lifetime) view of who gets what
 - Can really change impression of policy impacts e.g. VAT, WTC
 - Many more people (e.g.) have kids, are lone parents, or have health problems at some point in lifecycle than in a snapshot
 - Of course short term needs do matter too - though more relevant for 'safety net' benefits than for taxes

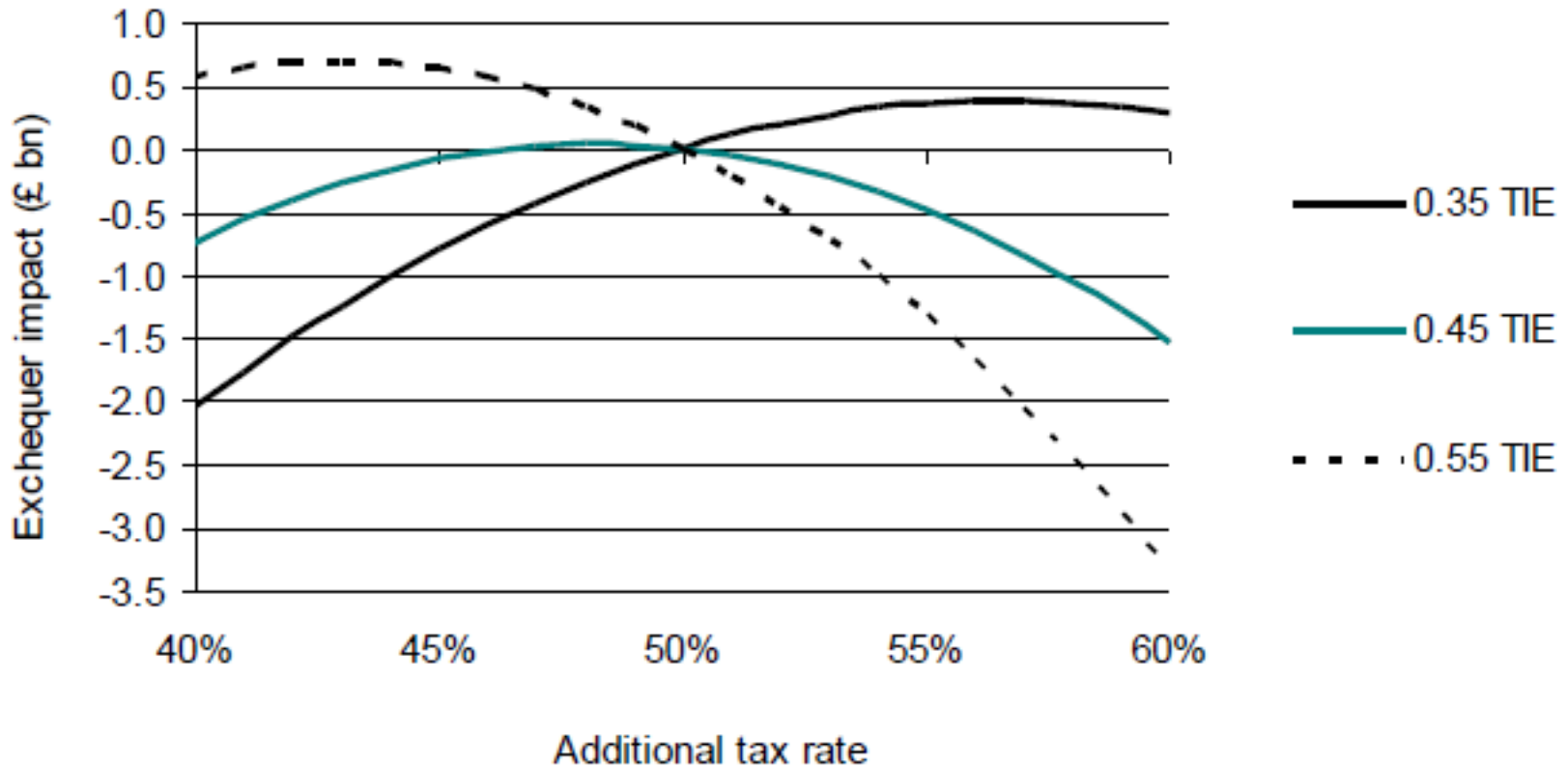
Tax policy and fairness / distribution

General points

1. Consider effects of tax and welfare system **as a whole**
2. Take a long term (ideally lifetime) view of who gets what
3. Use empirical evidence on how people respond to incentives
 - e.g. labour supply of parents of school-age children more responsive than for those with younger kids: could increase employment overall by cutting Child Tax Credit for former and raising for latter
 - Note again importance of lifecycle view –redistribution would largely be between periods of parenthood, not across people
 - Sometimes evidence is less clear-cut: but that in itself can be good reason to proceed with caution...

Top income tax rate and revenue

Chart A1: The additional rate Laffer curves

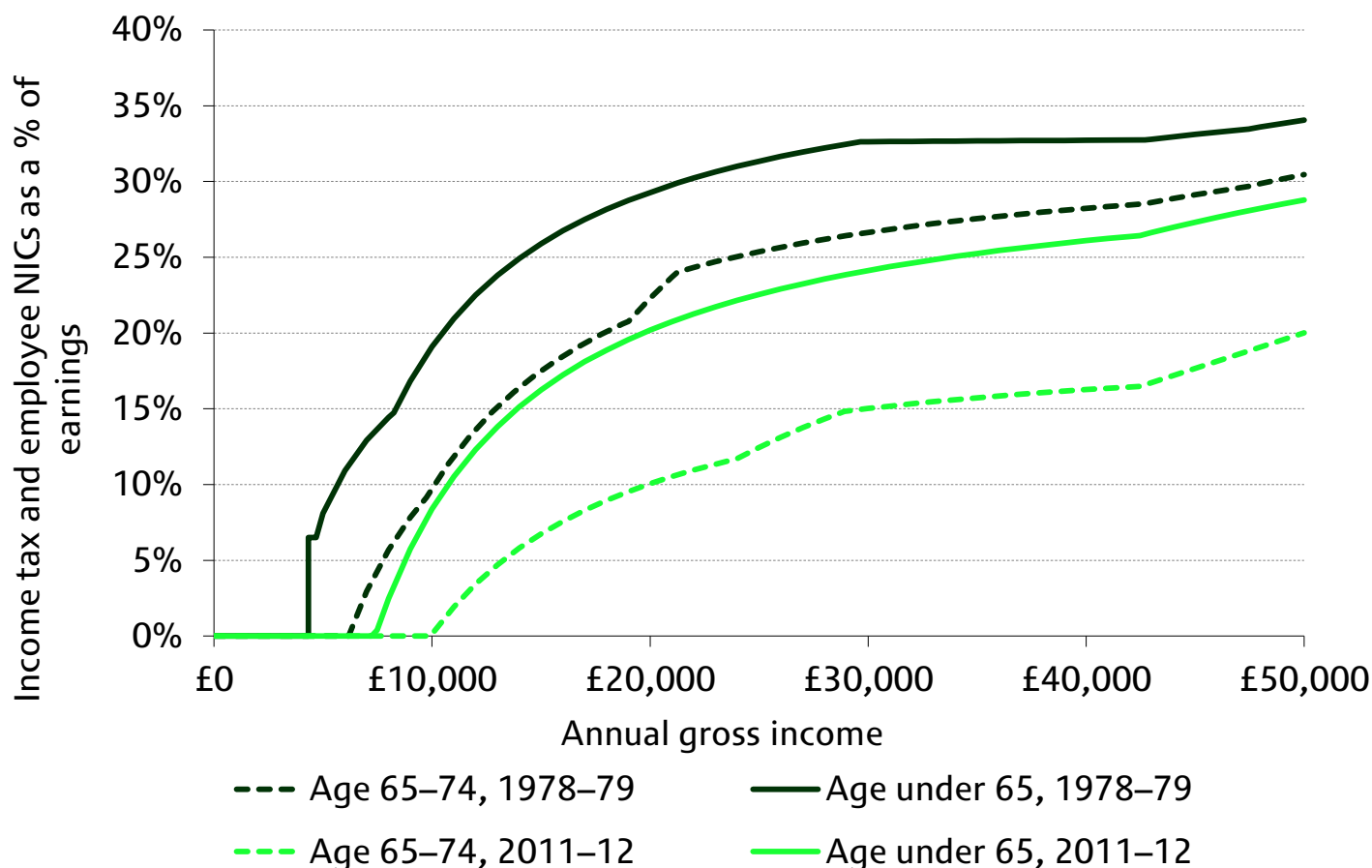


Source: HMRC (2012), *The Exchequer effect of the 50 per cent additional rate of income tax*

Direct tax: income tax and NI

- Increasing the IT personal allowance is not progressive and is a very expensive way of helping the lowest earning beneficiaries
 - and increasingly so: 43% of adults now have incomes too low to pay income tax, and pensioners now benefit too
- Totemic significance of income tax and relative ability of NI to go ‘under the radar’ seems to lead to policy outcomes that are unintended and/or go against grain of govt policy
 - e.g. earnings threshold for NI remained almost untouched while the income tax PA has been massively increased

Average direct tax paid by workers and pensioners by income level



Source: Adam, Browne and Johnson (2012).

Direct tax: income tax and NI

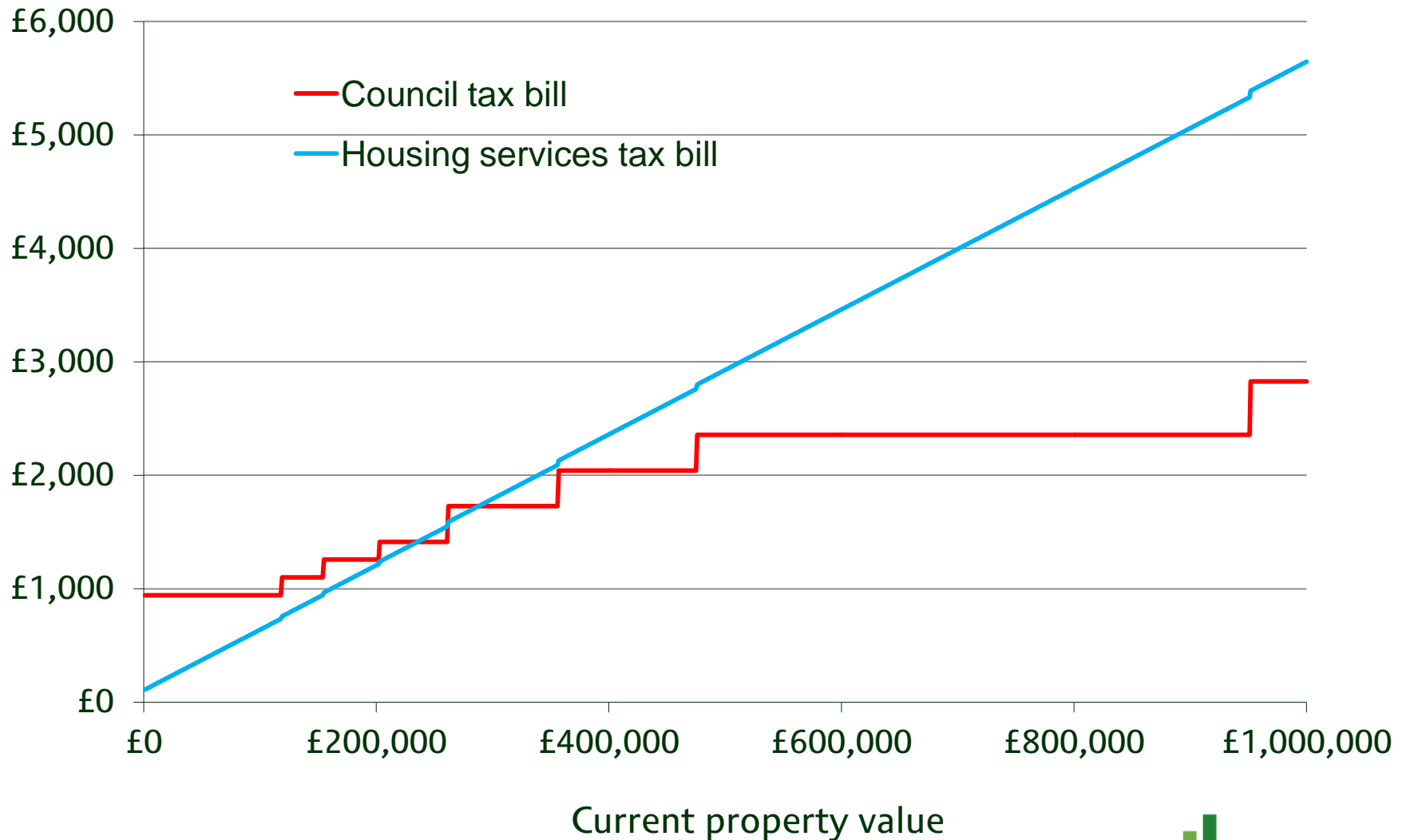
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 - e.g. earnings threshold for NI remained untouched while the income tax PA has been massively increased
- (Big issues around top tax rates and tax relief on pension contributions, covered elsewhere)

Property tax

- Perhaps the worst-designed part of the tax system?
- From point of view of equity and fairness, obvious deficiencies in council tax:
 - Still based on 1991 property values in England and Scotland
 - Wide bands
 - Regressive

A 'housing services tax' (proportional to value)

Note: rough guide only – see Chapter 16 of Mirrlees Review for details

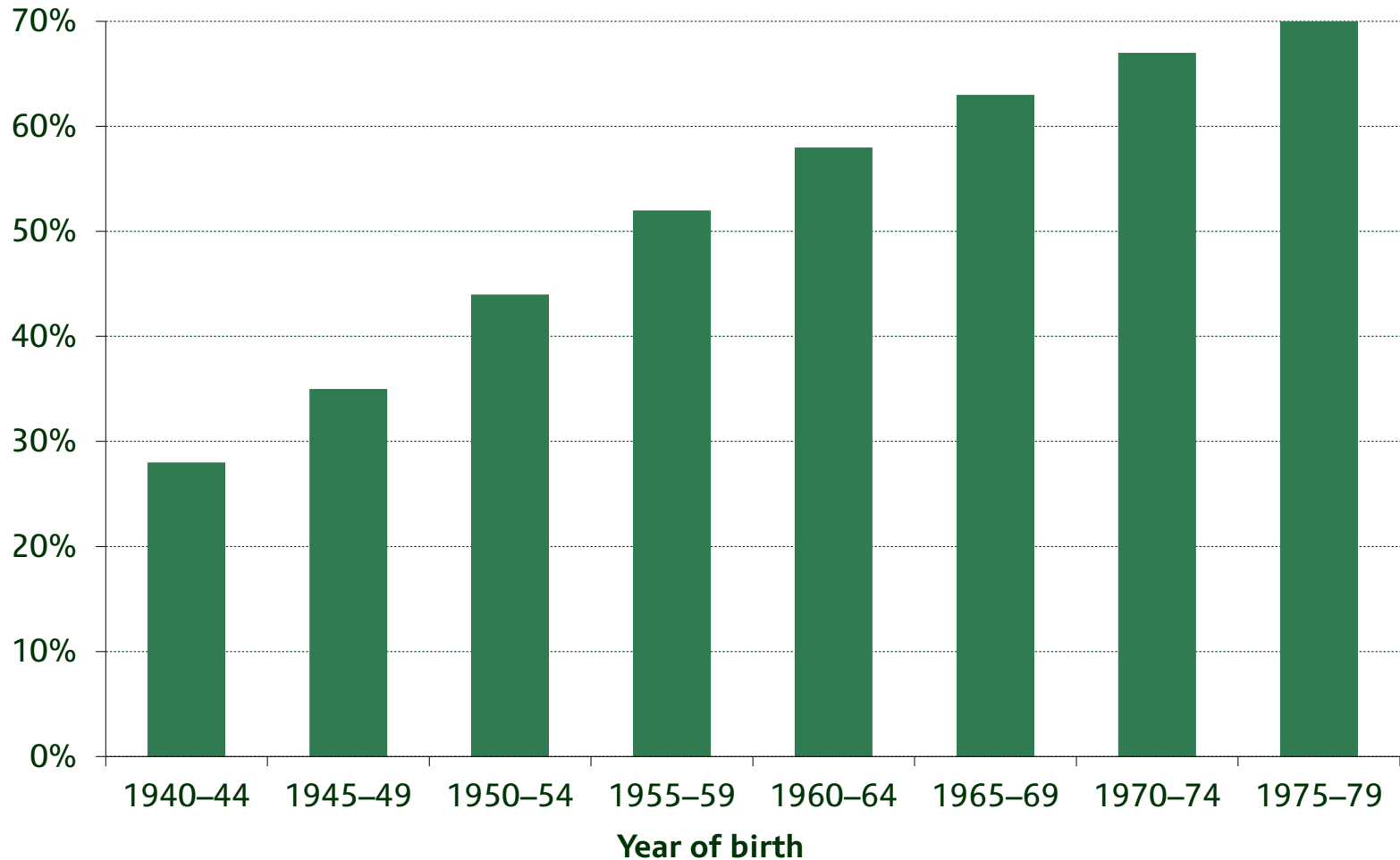


Property tax

- Perhaps the worst-designed part of the tax system?
- From point of view of equity and fairness, obvious deficiencies in council tax:
 - Still based on 1991 property values in England and Scotland
 - Wide bands
 - Regressive
- A sensibly reformed council tax would involve higher tax on expensive properties, which could replace revenue from stamp duty land tax...
- As a transaction tax, SDLT should not be part of tax system
 - Why impose heavier tax on properties that change hands more often?
 - Assets should be held by the people who value them most
 - Reduced labour mobility and rates of downsizing are likely examples of damaging effects of SDLT

Transfers across generations growing in importance

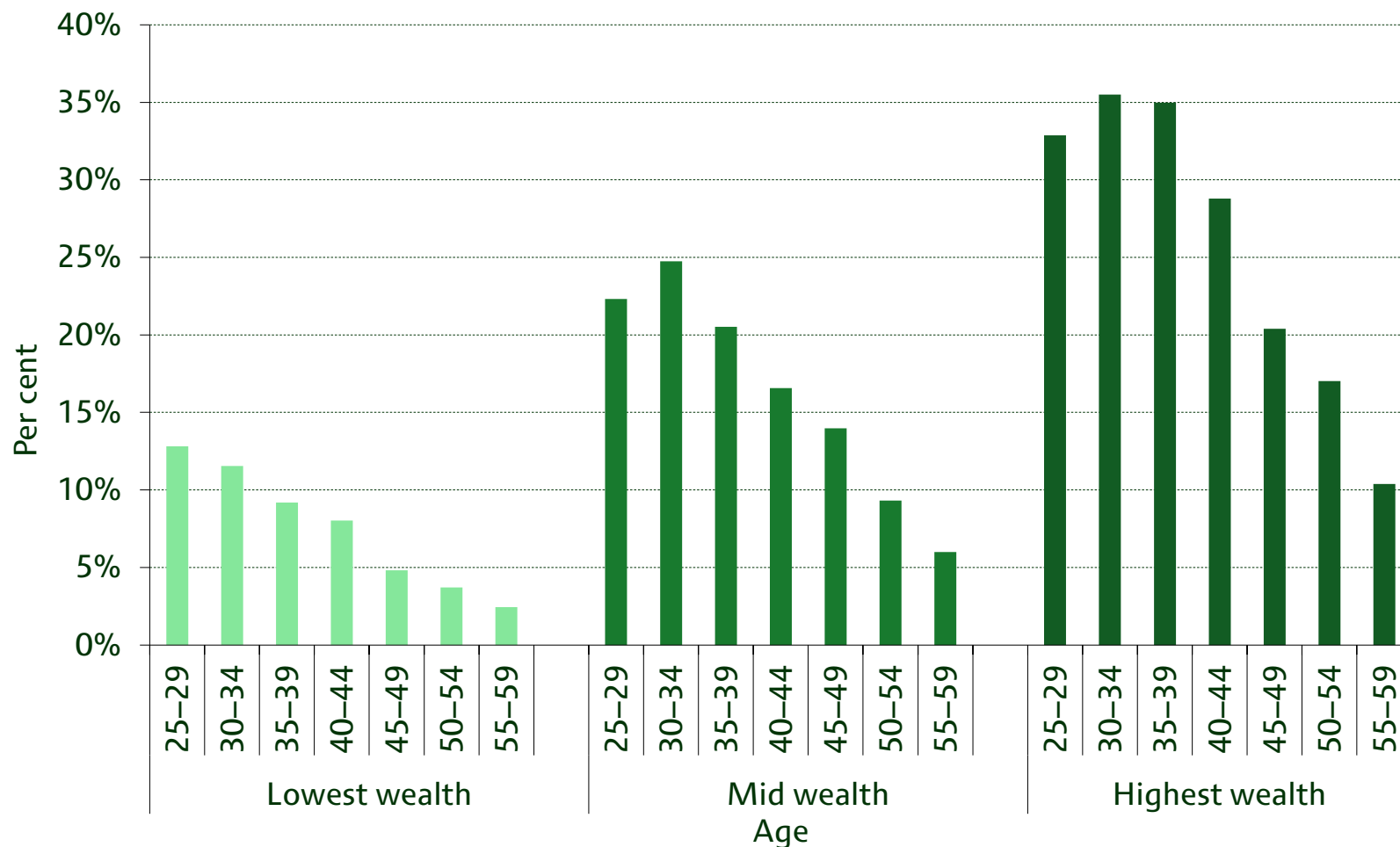
% who have received, or expect to receive, an inheritance



Source: Figure 4.2, Hood and Joyce (2013)

Potential relevance for ‘equality of opportunity’

% expecting to inherit more than £100,000, by age and current wealth



Source: Hood and Joyce (2013)

Taxing intergenerational transfers

- There are (principled) arguments over whether to tax intergenerational transfers
- But the *way* in which we do this can certainly be improved
- Lots of exemptions, e.g. for business assets, agricultural land, and any gifts made in at least seven years before death
 - Inheritance tax favours “the healthy, wealthy and well-advised” (Kay and King, 1990)
 - For some of the rich, it largely resembles a voluntary contribution
- Should certainly remove some avoidance opportunities
- More fundamentally, could either:
 - Transform into a proper tax on lifetime receipts
 - Abolish

Taxing the very richest

- Revenue heavily reliant on a small number of taxpayers
- 29% of income tax is paid by the 332,000 additional-rate taxpayers (0.6% of adults)
- 54% of CGT is paid by 5,000 individuals (<0.01%) realising gains >£1m
- 70% of inheritance tax is paid by 2,000 estates (0.4%) worth >£1m
- (...and these groups overlap to substantial degree)
- Must be conscious of how their behaviour responds to tax: stakes are high
- It matters not only how much you tax the rich, but how you tax them

Some relatively sensible ways to tax the well-off...

...More than we do

- Remove IHT reliefs for agricultural and business assets and main homes
- Remove CGT entrepreneur's relief and forgiveness at death
- Charge NICs on employer pension contributions and cut tax-free lump sum
- Increase (updated!) council tax at top end
- Merge income tax and CGT allowances
- Tax lifetime gifts as well as bequests

...Less than we do

- Abolish withdrawal of personal allowance above £100,000
- Allow all to get tax relief on pension contributions at their marginal tax rate, with same annual allowance
- Reduce higher rates of SDLT (or abolish completely)
- Reduce or abolish IHT
- Give full IT & CGT allowance for amounts saved/invested
- Cancel abolition of higher-rate relief for landlords' mortgage interest

But avoid

- Increasing SDLT
- Further restricting pension tax relief
- Annual wealth tax
- Creating/increasing incentives to seek tax advantages

Note: important caveats not included!

Summary

- When assessing impacts on inequalities we should
 - Consider system in the round
 - Appreciate that people live lifecycles, not snapshots
- Never going to have agreement on what is fair and equitable
- But can achieve a given degree of equity in vastly different ways
 - We should choose the least costly ways
 - In many cases we have lots of evidence to guide us