



Taxes and Benefits: The Parties' Plans

2010 Election Briefing Note No. 13 (IFS BN100)

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Summary

- Tax and benefit measures already announced by the current Government and due to take effect over the coming Parliament will cost households around £15.8 billion a year in total or £610 per household, compared with the tax and benefit system in place now.
- Labour's manifesto contains no significant additional tax or benefit proposals. The Conservatives propose to offset about a third of Labour's pre-announced net 'takeaway' with tax cuts, paid for predominantly by deeper cuts to spending on public services than planned by Labour. The Liberal Democrats would increase Labour's net 'takeaway' by about a quarter through a net tax increase, thus providing scope to cut spending on public services by less than Labour until 2014–15 while borrowing the same.
- There is greater uncertainty around the net fiscal impact of the Liberal Democrat proposals than those of the other parties. We can be pretty confident that the Liberal Democrats' headline giveaway (increasing the income tax personal tax allowance to £10,000) will probably cost roughly what they expect. There is much more uncertainty around the estimates for their revenue raising measures, but no clear overall bias: some look likely to raise more than they expect and some less.
- Labour pre-announced measures are progressive taken as a whole, with small losses for poorer households that increase in size on average as households get richer – especially for the richest 1%. The Conservative proposals would make the net 'takeaway' somewhat less progressive, reducing the losses of households at the top of the income distribution proportionately more than those at the bottom. The Liberal Democrats would make the 'takeaway' more progressive, redistributing resources from the wealthy to middle-income households (though not the poorest households).
- The increase in the tax burden implied by Labour's pre-announced measures will weaken work incentives for most people. Relative to these measures, the Conservative plans (notably their proposed National Insurance cut) would strengthen the incentive for many people to be in paid work, but would do almost nothing to encourage most existing workers to earn a bit more. The Liberal Democrats' proposed income tax cut would probably strengthen the incentive to be in paid work for more people than the Tory NI cut (thus increasing employment more), as well as increasing the incentive for those earning less than £10,000 to earn more. But they would do more than the other two parties to weaken incentives to work and save among richer households.

¹ This series of Election Briefing Notes has been funded by the Nuffield Foundation, grant OPD/36607. The Nuffield Foundation is an endowed charitable trust that aims to improve social well-being in the widest sense. It funds research and innovation in education and social policy and also works to build capacity in education, science and social science research. More information is available at <http://www.nuffieldfoundation.org/>. Any views expressed are those of the authors and not necessarily those of the Foundation. The authors would also like to acknowledge ongoing financial support from the ESRC Centre for the Microeconomic Analysis of Public Policy at IFS (grant number RES-544-28-5001) for the analysis on which this briefing note is based. The Family Resources Survey was made available by the Department for Work and Pensions, which bears no responsibility for the interpretation of the data in this Briefing Note. Expenditure and Food Survey data are collected by the Office for National Statistics and distributed by the Economic and Social Data Service. Crown copyright material is reproduced with the permission of the Controller of HMSO and the Queen's Printer for Scotland. The authors are grateful to Robert Chote, Carl Emmerson, Malcolm Gammie and Luke Sibieta for helpful discussions and comments on previous drafts. Any errors and omissions are the responsibility of the authors.

- Looking at the structure of the tax system, Labour's pre-announced measures are not an appealing set of reforms (even given the need to raise revenue). For example: their plans to restrict tax relief on pension contributions for those with high incomes create significant complexity, unfairness and inefficiencies; increasing stamp duties for houses worth over £1 million increases a particularly damaging and inefficient tax; the stamp duty holiday for first-time buyers adds complexity and creates new distortions (even though it cuts a damaging tax); and the cut in corporation tax on patent income will largely benefit a few big companies while doing little to achieve its stated goal of promoting innovation. Labour's planned NI increase is a relatively straightforward way to raise significant revenue; it is a "tax on jobs", but the same would be true of increases in income tax or VAT.
- The Conservatives propose to offset partially perhaps the least badly-designed of Labour's major tax increases (National Insurance), but to maintain perhaps its worst designed one (the restriction of pension contributions relief for high earners). They also intend to cut income tax (to recognise marriage) and stamp duty (for first-time buyers) in ways that would complicate the tax system further.
- The Liberal Democrats are proposing the most radical and far-reaching set of tax reforms of the three parties. Several of them would reduce or remove features that distort people's behaviour in damaging ways, for example equalising tax rates between income and (some) capital gains, between property repairs and new build, and between benefits-in-kind and other remuneration. Replacing air passenger duty with a per-plane tax also looks sensible on environmental grounds. The glaring exception is their proposal to restrict tax relief on pension contributions for many more people than planned by the Government.
- The role that the Westminster government would have over future UK tax policy would be different under each of the parties. The Conservative Party seems the least keen on the Calman Commission's proposals for devolving more tax-raising powers to the Scottish Parliament, and would give local authorities less control over their revenue and spending in the short-run. But the Liberal Democrats would give greater powers to Edinburgh by implementing of all of the Calman Commission's proposals, and give local authorities control over a far greater share of their revenues.

1. Introduction

In the period since the impact of the financial crisis became apparent in its public finance forecasts, the current Labour government has announced and legislated for a number of net tax increases and benefit cuts to take effect over the course of the coming parliament to help reduce government borrowing. Labour has made no significant additional proposals in its manifesto. The Conservatives have accepted the bulk of Labour's proposals, but have also announced a very small additional benefit cut and a more substantial net tax cut to be paid for by cuts in spending on public services. The Liberal Democrats propose an additional cut in benefits than the Conservatives and a modest net tax increase rather than a net tax cut. The modest net tightening relative to Labour's plans masks much larger gross giveaways and takeaways in the most far-reaching of the three packages. This note discusses these various proposals, looking at their economic and administrative merits, their distributional impact and their effect of incentives to work and save. Readers seeking a single comparative analysis of the gains and losses for different income groups or household types will be disappointed, however. Because we (and in many cases the Treasury too) do not have data allowing us to identify accurately which households would be affected by many of the proposed tax and benefit reforms (especially the revenue-raising measures planned by the Liberal Democrats), we

cannot quantify the overall impact of the parties' plans on household incomes. More fundamentally, the three packages of tax reforms – each of which is a different mix of changes in taxes on income, spending and wealth – are not necessarily best analysed with reference to the change in taxes paid as a proportion of a snapshot measure of net income. However, we can and do model separately the impact of certain policies, such as changes to income tax, National Insurance (NI), excise duties, and benefits and tax credits. We are also able to give a qualitative assessment of the overall impact of each party's plans on household incomes and incentives, and the efficiency, simplicity and consistency of the tax system.

The rest of this note proceeds as follows. Section 2 analyses the changes planned by the current Labour government and announced up to Budget 2010. Section 3 briefly discusses policies announced in the Labour Party manifesto, section 4 analyses Conservative Party plans, and section 5 analyses the plans of the Liberal Democrats. Section 6 concludes, comparing the impact of each party's policies on the total tax 'takeaway', the distribution of winners and (more often) losers, work incentives and the efficiency and structure of the tax and benefit system.

2. Pre-announced tax and benefit changes for the next Parliament

This section analyses changes to taxes and benefit that have already been announced by the current government and that are due to take effect between now and April 2014, inclusive.²

Table 2.1 lists these reforms and the costs or gains to the Treasury, with the costings coming from Budget and Pre-Budget Report (PBR) documents wherever possible. Overall we estimate that these changes represent an £15.8 billion 'takeaway' from households, or an average of about £610 per household per year.³

The following sub-sections analyse the main policy measures in turn. We also state whether the main UK opposition political parties have plans not to go ahead with these proposals.

² Another IFS election briefing note analyses the reforms the Government made to the tax and benefit system between 1997 and 2010: see Browne, J. and D. Phillips (2010), *Tax and benefit reforms under Labour*, 2010 Election Briefing Note No. 1, London: Institute for Fiscal Studies, available at: <http://www.ifs.org.uk/bns/bn88.pdf>

³ Note this figure is different from the £17.0 billion tax increase cited in the IFS election briefing note looking at the impact of the three main parties' manifesto on the public finances. This is because the £17.0 billion takes 2009–10 as the baseline, and so includes the revenue raised from measures which were introduced in April 2010, such as the new 50p income tax rate. This note, however, takes the 2010–11 tax system as the baseline, and considers what further changes are expected.

Table 2.1. Revenue effects of tax and benefit changes to be implemented between 2010 and 2014 under current Government plans if implemented in 2010–11, £ billion (2010–11 prices)

	Change in Revenue (£bn)
Income tax	
Reducing the Personal Allowance by £130	+0.8
Freezing the basic rate limit / higher rate threshold	+0.8
Restricting income tax-relief on pension contributions for those with income over £130,000.	+3.2
Other	+0.8
Total income tax	+5.5
National Insurance	
Increasing Primary Threshold	–2.8
Increasing employee, employer and self-employed rates by 1%	+8.5
Other	0.0
Total National Insurance	+5.7
Indirect taxes	
Alcohol duties	+0.3
Tobacco duties	+0.2
Fuel duties	+2.0
Other environmental taxes	+0.3
Total indirect taxes	+2.8
Inheritance tax	+0.2
Stamp duties	+0.4
Corporation tax	
Increasing small companies' rate	+0.5
Other	–1.1
Total corporation tax	–0.6
Total other taxes and royalties	+0.2
Total taxes	+14.3
Benefits and tax credits	
Reduce benefits by 1.5% in real terms	+0.7
Child tax credit	–0.2
Benefits for pensioners ^a	+0.6
Other	+0.3
Total benefits and tax credits	+1.5
Grand total	+15.8

Notes and Source: See previous page.

a. The rise in the state pension age for women, and re-linking the state pension with increases in average earnings are not included in this table

Income tax

The government has announced a cut in the personal allowance of £130 in real terms (i.e. after adjusting for inflation) in April 2011 (undoing a real increase of the same amount that came into effect in April 2009), a freeze in the basic-rate limit (the band of income above the personal allowance before 40% income tax is paid) in April 2011, and a freeze in the higher-rate threshold (the point at which people begin to pay 40% income tax) in April 2012.

These real-terms cuts to tax thresholds will result in a small increase in the number of income tax-payers, and a more notable increase in the number of people facing the 40% income tax rate. We estimate that as a result of these changes, there will be 100,000 more income tax-payers and 500,000 more higher-rate tax-payers than if the government increased allowances as normal. Together, these changes will raise about £1.6 billion per year, according to the Treasury (in 2010–11 terms). The government has also announced a freeze in the annual and lifetime contribution limits to pensions for four years from 2011–12, raising about £0.4 billion per year (in 2010–11 terms) from higher income people saving for a pension.

It is also worth noting that the point at which the new 50% income tax rate kicks in is to be frozen at £150,000, and the point at which the personal allowance starts to be withdrawn will be frozen at £100,000. Budget documents do not state how much is raised by freezing these (as opposed to increasing them in line with inflation), and we have not included this as a tax rise in Table 2.1 either. IFS researcher estimates that the number of people facing the 50% tax rate will increase from 360,000 to 500,000 between 2011–12 and 2014–15 as taxable incomes grow but the threshold is frozen).⁴

The most significant (in revenue terms), and by far the least sensible, announced change to income tax is the plan to restrict the rate of tax relief on pensions contributions for those whose income (including pension contributions) is greater than £150,000, with 20% relief applying for those for those whose income (including pension contributions) exceeds £180,000. The government has argued that, as well as raising much-needed revenue, this will remove a subsidy that the wealthy enjoy on their pensions contributions.⁵ But this policy has serious drawbacks; as explained in full in a recent IFS press release, it would create complexity, unfairness and inefficiencies (we come back to some of the reasons for this in our analysis of the Liberal Democrat proposal in Section 5).⁶ Indeed, it is not clear that giving relief at the higher or top rate of income tax represents a 'subsidy' in the first place (although the large tax-free lump-sums that can be taken from pension pots do represent a subsidy from which higher earners benefit most). A more efficient way to raise revenue and reduce the generosity of the subsidy to pension saving enjoyed by the wealthy would be to reduce the maximum tax-free lump sum people can receive from their pension pot (from the current £437,500).

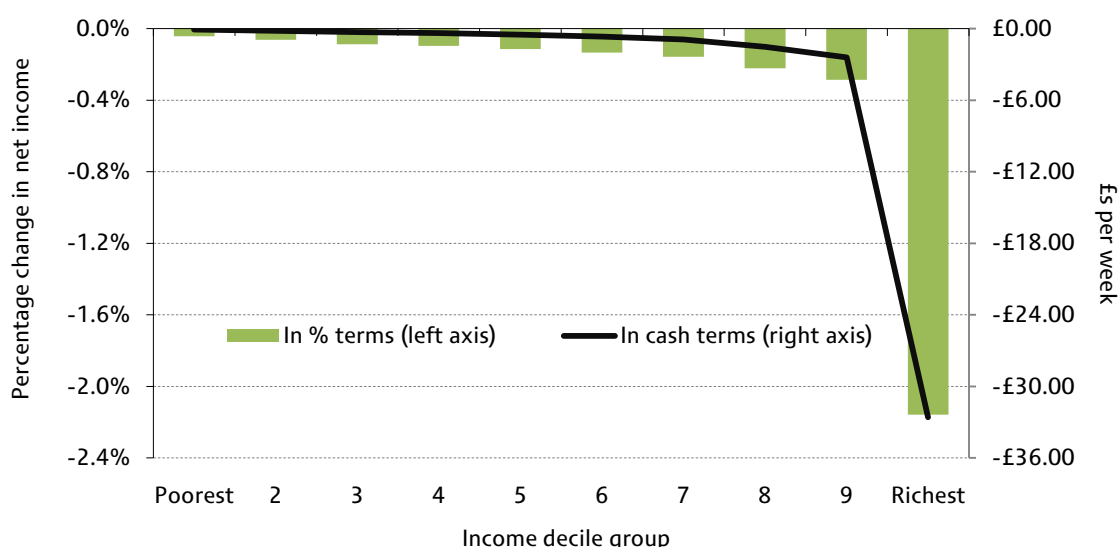
Figure 2.1 shows the distributional impact of the Government's planned changes to the income tax system (excluding a few small anti-avoidance measures). The bars indicate losses as a proportion of net income, whilst the line represents losses in cash terms. Losses are negligible for those towards the bottom of the income distribution, are small, on average (less than 0.3% of net income) for those up to the ninth decile group, and are significant only for those in the top 10% of the income distribution (and more specifically, the 300,000 or so individuals who will be affected by restricting tax relief on pensions contributions).

⁴ Box 2.1 of chapter 2 of R. Chote, C. Emmerson and J. Shaw (eds), *The IFS Green Budget: February 2010*, (<http://www.ifs.org.uk/budgets/gb2010/10chap2.pdf>) shows that the number of people subject to the 60% marginal rate associated with the tapering of the personal allowance is also expected to increase from 150,000 to 230,000 between 2011–12 and 2014–15. The extent to which freezing these thresholds affects the revenue raised depends on how those affected might respond.

⁵ See paragraphs 1.2, 1.3 and 1.5 of http://www.hm-treasury.gov.uk/d/budget2010_pensionstaxrelief_summary.pdf

⁶ Emmerson, C., 'A response to the Treasury's consultation on restriction pensions tax relief', Institute for Fiscal Studies, available at: http://www.ifs.org.uk/pr/tax_relief.pdf. Other informed parties have also been highly critical: the Chartered Institute of Taxation, for example, recently said that the proposals 'involve such administrative complexity as to make them virtually unworkable' (<http://www.tax.org.uk/showarticle.pl?id=9147>). The government estimates that the compliance costs associated with this policy would be £1.1 billion in the first year and £115 million per year thereafter (see http://www.hm-treasury.gov.uk/d/budget2010_impactassessments.pdf, page 47).

Figure 2.1 The effect on household income of planned changes to the income tax system between now and April 2014



Notes: Income decile groups are derived by dividing all households into 10 equal-sized groups according to income adjusted for household 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. Sources: Family Resources Survey, 2006–07, HMRC tax-payer statistics and authors' calculations using TAXBEN.

National Insurance contributions

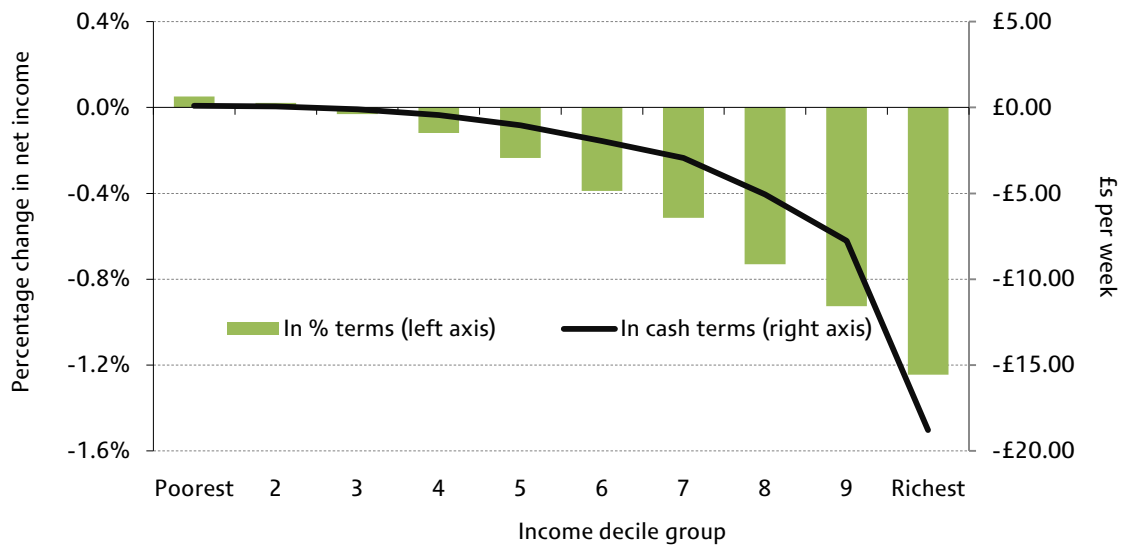
The current government has announced plans to increase the rate of NI contributions payable by employees, employers and the self-employed by 1 percentage point, and to increase the primary threshold and the lower profits limit (the points at which the employees and self-employed, respectively, start paying NI) by £1,170 a year (or £23 per week). The government estimates that this will raise a total of £6.0 billion in 2011–12, which consists of a 'give-away' of £3.0 billion from an increased primary threshold and a 'take away' through higher rates of £9.0 billion.⁷ In 2010–11 prices, this comes to £5.7 billion.⁸

Figure 2.2 shows the distributional impact of the Government's planned changes to the NI system, assuming that the increase in employers' NI is passed on to workers in the form of lower wages (which is likely to happen over time). Households at the very bottom of the income distribution gain a little, on average, because for most of those poorer households with someone working, the higher primary threshold more than offsets the impact of higher NI rates. Losses then increase steadily in both cash and as a share of income further up the income distribution.

⁷ Budget documents cost the measures in this order. In IFS Press Release 29 March 2010, http://www.ifs.org.uk/pr/conservatives_ni.pdf, we incorrectly gave £6.3 billion as the revenue due to be raised in 2011–12; this is, in fact, the number for 2012–13.

⁸ Some of the higher NI revenue would be offset through lower yields of other taxes, as higher employer NICs means lower profits and therefore lower corporation tax revenue. In the longer term, wages would probably adjust to take account of changes to employer NICs, meaning lower revenue from income tax and employee NICs, and higher spending on means-tested benefits and tax credits. In the case where all changes to employer NI are passed on to employees, the yield would fall to £5.1 billion.

Figure 2.2 The effect on household income of planned changes to the NI system between now and April 2014



Notes: As Figure 2.1.

Source: As Figure 2.1.

An increase in NI rates acts to weaken the incentive to work at all for most people (by reducing in-work net income), and weakens the incentive for people to increase their income slightly (because they get to keep less of this additional income). However, the increase in the primary threshold more than offsets the higher NI rates for low earners, increasing the incentive to work at all for those with low skills or who, perhaps, can only work part time.

As section 4 describes, this net tax rise has been branded a “jobs tax” by the Conservative Party.⁹ We need to distinguish here between the impact on the demand side (the total amount of spending in the economy and thus the demand for labour) and the supply side (the productive potential of the economy and the level of employment that it could sustain without fuelling inflationary pressures). Other things being equal, a tax increase would withdraw spending power from the economy and reduce employment. But the government has ceded management of the total amount of spending in the economy to the Bank of England, in pursuit of its inflation target. We might thus expect the demand-reducing impact of the tax increase to be offset by a loosening of monetary policy, leaving spending in the economy unchanged. In current circumstances, however, there remains concern about the effectiveness of monetary policy given the problems of the banking and financial systems. On the supply side, an increase in the tax burden increases the gap between the what it costs an employer to buy an extra person-hour of labour and the value of goods and services that the employee could buy with the additional post-tax income they receive (i.e. there is a bigger ‘tax wedge’). This will reduce the level of employment that the economy can sustain in the long run while keeping inflation stable. But NI is not unique in that.

The argument that the increase in NI rates represents a unique “jobs tax” seems to reflect two misconceptions about the economics of taxation. The first misconception is that employers’ NI makes people more expensive to employ in a way that employee NI does not, at least in the long-

⁹ The Conservative Party manifesto contains several mentions of “Labour’s jobs tax”. See, in particular, pages 8 and 9. Manifesto available at: <http://www.conservatives.com/Policy/Manifesto.aspx>

run.¹⁰ The second misconception is that taxes on earnings (such as NI and income tax) have a negative impact on work incentives whilst taxes on spending (such as VAT) do not. This is not correct, because what ultimately matters for work incentives is the amount people can buy for a given amount of work; it does not matter if taxes increase the price of goods or reduce take-home wages: both would reduce work incentives.

The government's plans for NI do worsen an existing distortions in favour of self-employment over employment, because the self-employed face a 1 percentage point increase in their contributions rate, and employees have to bear an increase of 1 percentage point in both the employee and employer rates.

Indirect taxes

Alcohol, tobacco and fuel duties

The government has said that it will increase alcohol duties by 2% above inflation every year until 2014–15, raising a total of £0.3 billion per year by that year. In Budget 2010, the government also announced an immediate 10% increase in cider duty, which will be rescinded on June 30th unless the new government renews the increase (which Labour has said it would do). Cider is currently taxed less heavily per unit of alcohol than other beverages, which is difficult to justify.

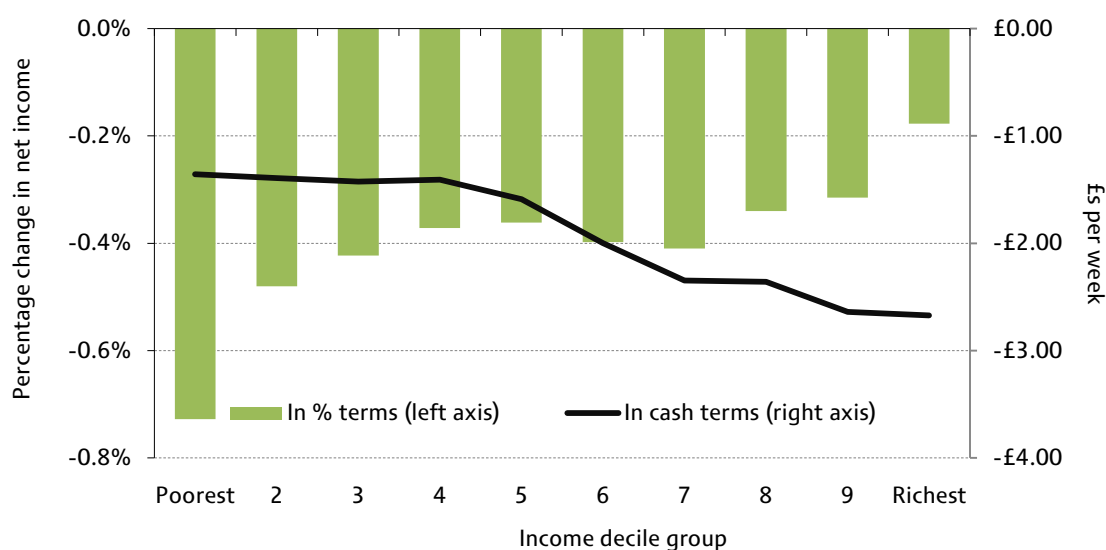
The government has also announced that it will increase tobacco duty by 2% above inflation every year until 2014–15 raising £0.2 billion

The Government plans to increase fuel duties by 1 pence per litre above inflation until 2014–15, raising £2.0 billion (although the increase in 2010–11 is to be staged, at a one-off cost of £0.6 billion). A paper prepared for the IFS's Mirrlees Review suggests that fuel duties are already close to the maximum that can be justified by their external costs.¹¹

¹⁰ This may be true in the very short-run, but is unlikely to be true in the long run. Apart from a name, employers' and employees' NI are essentially the same tax, and in the long-run will have the same economic incidence.

¹¹ See Fullerton, D., A. Leicester and S. Smith, 'Environmental Taxes', in J Mirrlees, S Adam, T Besley, R Blundell, S Bond, R Chote, M Gammie, P Johnson, G Myles and J Poterba (eds), *Dimensions of Tax Design: The Mirrlees Review*, Oxford University Press for Institute for Fiscal Studies. Draft available at; <http://www.ifs.org.uk/mirrleesreview/reports/environment.pdf>. Another note in this series, "Environmental Policy Proposals" by Paul Johnson and Peter Levell, discusses the parties' proposals on road pricing and other environmental issues.

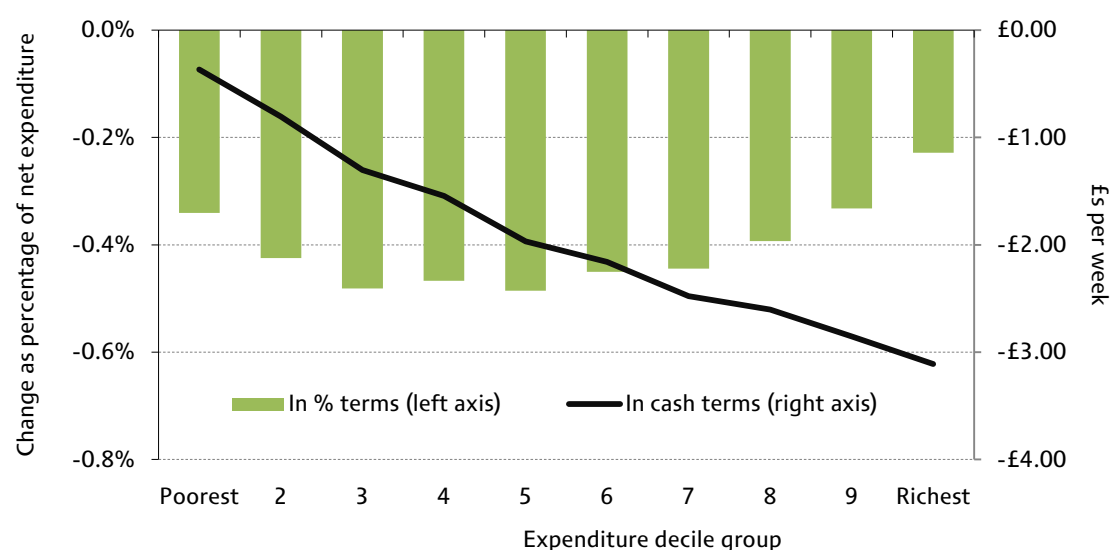
Figure 2.3 The effect on households of planned changes to duties between now and April 2014 (by position in the income distribution)



Notes: As Figure 2.1.

Source: As Figure 2.1.

Figure 2.4 The effect on households of planned changes to duties between now and April 2014 (by position in the expenditure distribution)



Notes: Expenditure decile groups are derived by dividing all households into 10 equal-sized groups according to expenditure adjusted for household 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. Sources: Expenditure and Food Survey, 2007, Family Resources Survey, 2006–07, HMRC tax-payer statistics and authors' calculations.

Figure 2.3 shows the impact of all these increases in duties (which will be dominated by the rise in fuel duties) on household incomes based on their position in the income distribution. This shows that average losses are largest in cash terms for those towards the top of the income distribution but are highest as a share of income for those towards the bottom of the income distribution. This reflects the fact that many households with low incomes are only temporarily poor and can maintain higher levels of spending (on fuel, cigarettes and alcohol, amongst other things) than their

current income by borrowing and saving. Figure 2.4, therefore repeats the analysis using expenditure. This shows that cash losses increase steadily moving up the expenditure distribution, but proportional losses that are highest in the middle of the expenditure distribution.

Other environmental taxes

The government has announced a number of small changes to company car taxation that increase the rate of tax on cars with carbon emissions above 99g/km and offer reduced rates for five years on cars with emissions of 75g/km or less. Overall, this is forecast to raise £120 million per year in 2012–13.¹²

The government has also announced increases in landfill tax of £8 per year until 2014–15, an increase in the aggregates levy in 2011–12, and a reduction in the discount on the climate change levy available to energy-intensive sectors, also from 2011–12. Together these changes raise £0.3 billion. Increases in air passenger duty are also planned for November 2010.

Inheritance tax

The government has announced a freeze in the threshold for inheritance tax at £325,000 (or up to £650,000 for couples who are married or in a civil partnership if the allowance of the first partner to die is fully transferred the surviving partner) until 2014–15. This will raise £0.2 billion a year by 2014–15.

Stamp duty land tax

Stamp duty vies for the title of the most economically inefficient tax in the United Kingdom. Taxing, and thereby discouraging, property transactions means that property is less likely to be owned by those who value it the most; since many own the home that they live in, it also reduces worker and family mobility. Furthermore, stamp duty land tax operates a “slab” structure: once you cross a stamp duty threshold, a new rate applies to the entire purchase price of a property, not just that above that threshold, and this creates a very significant incentive to keep transactions below the various stamp duty thresholds, further distorting the housing market.

The government has announced that a stamp-duty holiday for first-time buyers purchasing a house priced between £125,000 and £250,000 which began in April 2010 will end in March 2012 (the total cost over this period is £0.6 billion). Cutting an undesirable tax is a good thing in itself, but restricting this holiday to first-time buyers adds to the complexity of the current system and creates new distortions. In particular, it may encourage people to change the time of purchase and the type of property purchased, and it penalises joint ownership (as it is only available to joint-purchasers if both are first-time buyers). The end of this temporary tax cut is counted as a tax rise in table 2.1.

The government has also announced that, from April 2011, the rate of stamp duty land tax for domestic property purchases over £1 million will increase from 4% to 5%, raising around £0.2 billion a year. An increase in a damaging tax is obviously a bad way to raise money. Given that the supply of houses worth over £1 million is unlikely to change much, we expect that the burden of the tax will be largely borne by existing owners of houses worth £1 million or more, as the price potential buyers are willing to pay falls because of the higher stamp duty bills.

¹² Company car taxation is included in income tax for the purposes of table 2.1 (it is a part of the income tax system), but is discussed here because the changes relate to the treatment of the environmental rating of vehicles.

Corporation tax and business rates

The government has announced a number of changes to the corporation tax regime, the net impact of which is a give away of £0.5 billion per year by 2014–15. The small companies' rate of corporation tax is due to rise from 21% to 22% in April 2011, raising £0.5 billion a year, but one might reasonably doubt whether this increase will ever come about, as it has been postponed twice since its first announcement. The increase in the small companies' rate of corporation tax would be sensible because there is no good rationale for the existence of the small companies' rate: the small companies' rate gives a significant incentive to incorporate for many small businesses, as incorporated firms are treated more favourably by the tax system than the self-employed who are, themselves, treated more favourably than the employed. There is no clear rationale for this situation: if it is investment or employment by small businesses that the government wishes to encourage, more focussed tax incentives – such as the annual investment allowance for plant and machinery, which was doubled to £100,000 in April 2010 – would be better than a generally lower rate of tax for those companies that have low levels of profits. Another poorly-targeted incentive to innovate is the introduction of a “Patent Box” in 2013–14. This involves applying a lower corporation tax rate of 10% to income derived from patents held in the UK and granted after this date at an eventual cost of £1.3 billion per year (£1.0 billion in 2010–11 terms). IFS researchers have analysed this in detail elsewhere¹³, and conclude that the policy is a poor way of encouraging innovation in the UK. A better way to encourage research and innovation would be to try to limit cuts to the science budget.

The government has announced an increase in the generosity of business rates relief for small firms for one year from October 2010, costing a one-off £0.4 billion.

Other tax changes

The government confirmed in Budget 2010 that it would introduce a 50p per month tax from October 2010 on landline phone connections to fund the roll out of next-generation broadband internet services. This did not make the final version of the 2010 Finance Bill (negotiated during the ‘wash-up’ period following the announcement of an election), but the government pledged to re-introduce this policy if re-elected.¹⁴ It is estimated to raise £175 million per year.

In Budget 2010, the Government laid out the principles for a ‘systemic risk tax’ that would be levied on financial institutions that ‘might contribute significantly to systemic risk’.¹⁵ The Government maintains that this can only be levied if there is formal international agreement and must be co-ordinated to ‘minimise competitive distortions’, which contrasts with the positions of the two main opposition parties who argue that the UK can levy a tax without such an agreement. The government has not yet defined the relevant tax base (e.g. profits, value-added, turnover or liabilities). What it has said is that the tax should take account of ‘the characteristics of a firm’s business that give rise to systemic risk. In particular it should take into consideration size, interconnectedness, and substitutability’. This wording is almost identical to part of the IMF’s description of one of the two taxes it recently proposed for financial institutions, the ‘financial stability contribution’ – though the IMF argues that while payments should vary by these

¹³ See Griffith, R. and H. Miller ‘Support for research and innovation’, Chapter 10, Green Budget 2010, Institute for Fiscal Studies (<http://www.ifs.org.uk/budgets/gb2010/10chap10.pdf>) and Griffith, R. and H. Miller ‘Productivity, innovation and the corporate tax environment’, 2010 Election Briefing Note (<http://www.ifs.org.uk/publications/4839>).

¹⁴ The Liberal Democrats say they would implement this tax but differ with the Government on how to support the roll-out of next generation broadband. The Conservative Party oppose this tax plan.

¹⁵ Box 3.1, Chapter 3, ‘Reforming Financial Services’, Budget 2010, HM Treasury, London.

characteristics, the underlying tax base should be institutions' liabilities, something the government does not specify.¹⁶ And the government currently proposes nothing akin to the IMF's second proposed tax, a 'financial activities tax' based on the sum of profits and remuneration of financial institutions. The Government argues that proceeds of the tax should be counted as general taxation revenue in order to minimise 'moral hazard'. In its 2010 election manifesto, the Labour Party says that the revenues raised would be used to support lending by third-sector organisations (such as credit unions) and the Post Office.

In November 2009, the Government published a white paper 'Scotland's future in the United Kingdom', a response to the recommendations of the Calman Commission.¹⁷ In this, the Government sets out proposals that would mean, in effect, that the Scottish Parliament had discretion on the rates of income tax (except on savings and dividends)¹⁸, stamp duty land tax, aggregates levy and landfill tax, as well as the power to introduce certain new taxes (with the agreement of the UK Parliament). This would be a major devolution of tax-raising power, though it is worth noting that the Scottish Parliament has not yet chosen to exercise its right to vary the basic rate of tax (on income other than savings and dividend income), so it is unclear whether this would mean any changes in tax rates in Scotland in practice.

Benefits and tax credits

Cutting benefits

In the 2009 PBR, the Chancellor announced a temporary, one year, 1.5% real increase in certain benefit rates (including those parts of the child and working tax credits which are uprated in line with RPI inflation and most disability benefits) from April 2010 at a cost of £0.7 billion. Therefore, in April 2011, the same benefits rate will be cut by 1.5% in real terms, saving the government £0.7 billion per year as they un-do the initial real increase. A temporary increase in the generosity of income support mortgage interest relief (ISMI) is also due to expire at the end of 2010 which will save the government £0.3 billion per year.

Similarly, the current government has announced a continuation of a temporary rise in the winter fuel payments for households containing an individual aged 60 or over for winter 2010–11. This is due to expire the following year, saving the government £0.6 billion per year.¹⁹

Changes to tax credits and in-work benefits

The government has announced a higher level of the child element of child tax credit for families with children aged 1 or 2 which will be worth an additional £4 a week (it is currently about £44 per week). This costs £0.2 billion per year from 2012–13 onwards. This is a small change, but may help to make tax credits more focused on the poorest children. It also announced a number of small changes to the rules of working tax credit (that make it more generous for a small number of households).

¹⁶ The IMF says the financial stability contribution should start out as a flat percentage of but then be 'refined over time to reflect institutions' riskiness and contributions to systemic risk – such as those related to size, interconnectedness and substitutability'. See *A fair and substantial contribution by the financial sector*, Interim Report for the G20, International Monetary Fund, 2010, available at: http://news.bbc.co.uk/1/shared/bsp/hi/pdfs/2010_04_20_imf_g20_interim_report.pdf

¹⁷ 'Scotland's future in the United Kingdom', The Scotland Office, London, 2009. Available at <http://www.scotlandoffice.gov.uk/scotlandoffice/files/Scotland's%20Future%20in%20the%20United%20Kingdom.pdf>

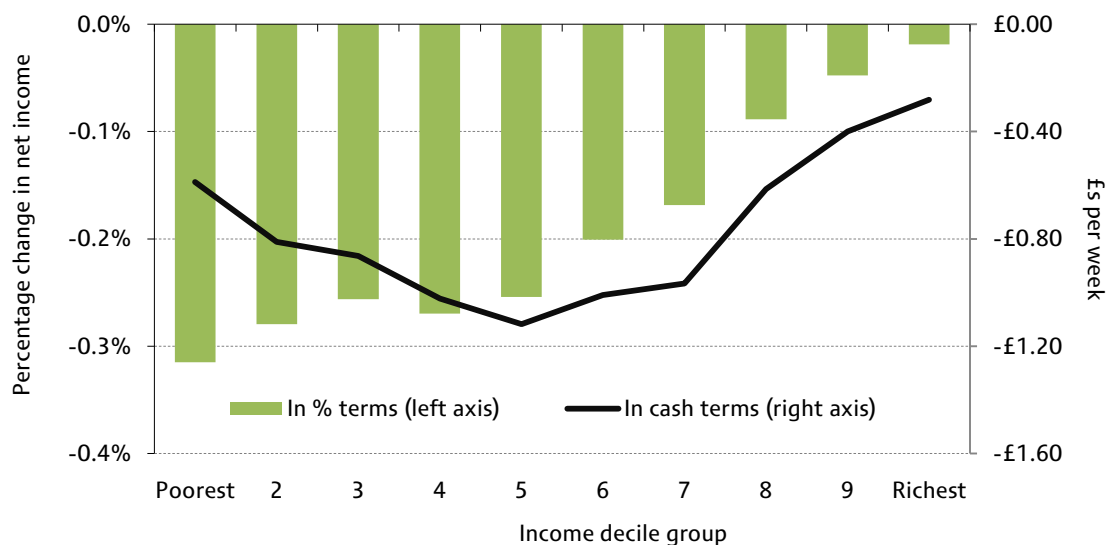
¹⁸ The specific proposal is that the basic, higher and top rates of income tax would be reduced by 10% in Scotland, with a flat Scottish income tax imposed on top of the reduced rates of 10%, 30% and 40%. This would give the Scottish Government discretion over the overall levels of income tax, but not the relativities of the different bands (e.g. the difference between the basic and higher rates of income tax would always be 20%).

¹⁹ It is questionable whether a reduction in the winter fuel payment is credible: a "one-off" increases in the winter of 2008–09 has now been repeated for two further years and it may be difficult to avoid extending this further.

The government has also announced plans to introduce a £40 per-week “Better off in Work Credit” (BWC), which will be paid at a rate sufficient to ensure that those in-work have weekly incomes £40 a week higher than when receiving out-of-work benefits. It will be payable for the first 6 months of employment for those who have been out of work for 6 months or more and who received out-of-work benefits (e.g. Income Support or Job Seekers Allowance) during this time. A pilot of this policy was not a success, with an evaluation concluding that “In the course of its year-long pilot period, very few customers were entitled to a BWC”, and “overall the evidence suggests that the BWC as piloted has not been a significant addition to the range of back-to-work support”.²⁰ Making the scheme time-limited (and thereby also excluding those already in work) makes this policy much cheaper than an equivalent increase in the Working Tax Credit, but also means it is likely to be less of an incentive to enter paid work than a permanent guarantee.

Figure 2.5 shows the impact of the planned changes to benefit rates, winter fuel payments, and child tax credit between now and April 2014 (total expenditure on BWCs represents a small sum and we do not have data on who benefits from income support mortgage interest relief so these changes are not included in the modelling). Losses are largest in cash terms towards the middle of the income distribution. This reflects the fact that families in receipt of child benefit and pensioner households in receipt of the winter fuel payment are most concentrated in the middle part of the income distribution. Cash losses are not quite so large at the bottom of the income distribution because there are more gainers from the ‘toddler tax credit’, and because the benefits being cut are not the income-related benefits (like income support or housing benefit), which were not increased in real terms in April 2010 either. Nevertheless, losses are biggest as a share of income for those towards the bottom of the income distribution.

Figure 2.5 The effect on household income of planned changes to benefits and tax credits between now and April 2014



Notes: As Figure 2.1. Excludes the impact of BWC and changes to ISMI.

Source: As Figure 2.1.

²²It should be noted that the proposed BWC is more generous than the £25 per week trialled in the project pilots. See Dorsett, R., H. Metcalf, and H. Rolfe, with H. Bewley, A. Dhudwar, A. George, and R. Hopkin, ‘The Better-off in Work Credit: Incentives and Experiences’, DWP Research Project 627, CDS, Leeds, 2010, <http://research.dwp.gov.uk/asd/asd5/rports2009-2010/rrep637.pdf>

Changes affecting the state pension and pension credit

A number of changes affecting pensioners are due to take effect between now and 2015:

- The state pension age for women (and the age at which people become entitled to pension credit guarantee, the winter fuel payment, free bus passes and certain other benefits-in-kind) is due to be increased by one month every two months from April 2010.²¹ This change has been planned since the 1995 Pensions Act. Further increases in the State Pension Age to 66 by 2026, 67 by 2036 and 68 by 2046 are planned following the 2007 Pensions Act.
- The 2007 Pensions Act laid out plans to restore the link between the state pension and earnings growth from 2012 “if funding permits”, or 2015 “at the very latest”. Despite the dire fiscal position, the Labour Manifesto now states definitively that they would implement this reform in 2012. Assuming real wage growth of 1% per year, this would cost the Government about £0.9 billion per year by 2015 (in 2010–11 prices), compared with the case where the State Pension increased in line with prices instead, and after accounting for offsetting reductions in expenditure on means-tested benefits, and higher income tax revenues.²² Restoration of the link with earnings will reduce the number of pensioners entitled to the means-tested Pension Credit, thereby lessening the disincentive to work and save for retirement that means-tested benefits entail. However, there seems no clear economic rationale for the specific up-rating procedure that will apply to the State Pension: whichever is the greatest of inflation, earnings, or 2.5%. It seems that money illusion applies to the state pension, but no other part of the UK tax and benefit system.

Summary: pre-announced tax and benefit changes

Labour’s pre-announced tax and benefit measures are progressive: on average they will inflict small losses as a percentage of income on the poorest households, with those losses increasing as you moves up the income distribution – and particularly into the richest 1% of the population:

- The biggest losers will be those with incomes above £130,000 a year and making significant contributions to private pensions. They will be hit by the restriction of income tax relief on pension contributions.
- Losses from the increase in NI increase in both cash and percentage terms as you move up the income distribution, but losses are not as concentrated at the top. Most lower-income households will be unaffected as they are made up of non-workers, but there are small gains at the bottom, on average, as people earning less than about £15,000 gain more from the higher primary threshold than they lose from the higher rates of employee and employer NI.
- The expiry of one-off increases in benefits will hurt those in the middle of the income distribution most in cash terms, and those towards the bottom in percentage terms. Households with children and/or with disabled members will be the main losers from a 1.5% real cut in certain benefits rates, whilst pensioner households will lose out from a cut in the winter fuel payment. However, households with children aged 1 or 2 will gain from the new ‘toddler tax credit’.

²¹ This means that by April 2014, the age will be sixty two, and by April 2015, sixty two and a half.

²² The government has previously estimated that each year of earnings indexation costs £0.7 billion (in 2010–11 prices), but the exact amount depends on the difference between growth in earnings and prices. The government does not state the real earnings growth assumption underlying this estimate but it appears to be closer to 2% per year – a rate significantly greater than observed in recent years. See <http://www.publications.parliament.uk/pa/cm200506/cmselect/cmworpen/1068/106807.htm#a35>. We chose 1% as this is more in line with recent trends.

- Increases in alcohol, cigarette and fuel duties will hit those households that spend the most on these goods; assessed as a share of expenditure, the hardest are those towards the middle of the *expenditure* distribution.

The increasing tax burden will reduce work incentives for most people, particularly for those towards the top of the income distribution (who will be hit by increases in NI and the freezing of the higher rate threshold), and for those at the very top (who will be hit by taxes on their pension contributions). Research suggests that very high income individuals are more responsive to changes in tax rates than those lower down the income distribution. The pension reform will also discourage pensions saving by very high income individuals. However, the increases in the NI primary threshold will increase the incentive to enter work for those who would earn less than about £15,000 per year if they did work, a group which will include many part-time workers and those with lower skill levels).

Looking at what they do to the structure and efficiency of the tax system, the Government's announced tax changes for the next Parliament are not an appealing set of reforms, even considering the need to raise revenue. In particular, restricting tax relief on pension contributions for those with high incomes creates significant distortions, unfairness and complexity, increasing stamp duties for houses worth over £1 million involves increasing a particularly damaging and inefficient tax, and the stamp duty holiday for first-time buyers introduces new distortions (although it involves cutting a damaging tax, which in itself is a good thing). Furthermore, the introduction of a patent box that taxes income derived from patents less heavily than other income does not seem to be a good way of encouraging innovation. Most of these measures could, therefore, be replaced with alternatives which would raise similar amounts of money from similar groups of individuals, but in a way that would be less distorting and more efficient. However, it is not clear this is the case for the planned increases in NI, which is a straightforward and effective way of raising a fairly significant amount of extra revenue from a significant fraction of the population. It is true that an increase in NI is a "tax on jobs", but so too would be an increase in income tax or VAT.

3. The Labour Party's tax and benefit pledges

The Labour Party's manifesto contains very little in the way of tax and benefit reforms not already set out in Budget 2010 or beforehand.

There is a pledge to reform housing benefit so as to "not subsidise people to live in the private sector on rents that other ordinary working families could not afford". But there are no specific details about what this means in practice.²³

"Things we won't do"

The manifesto does repeat two pledges *not* to increase the existing basic, higher or additional rates of income tax, and to rule out the imposition of VAT on food, children's clothing, books, newspapers and public transport (although they do not rule out imposing or increasing VAT on other exempt, zero- or reduced-rate goods). How meaningful and sensible are these pledges?

A pledge not to increase rates of income tax does not mean the government cannot raise revenue from changes to income tax. In particular, it can freeze or reduce thresholds and allowances rather than increasing them in line with prices (as is normal practice), bringing more people into the

²³ Page 18, Labour Party Manifesto 2010, available at <http://www2.labour.org.uk/uploads/TheLabourPartyManifesto-2010.pdf>. Budget 2010 announced an immediate reform that excludes the most expensive properties when calculating local reference rents for housing benefit, and said that further reforms would follow.

income tax system and into the higher rates. Indeed, as discussed in the previous section, the Government plans to freeze the basic rate limit and reduce the personal allowance by £130 in real terms in April 2011, and freeze the higher rate threshold in April 2012, raising a total of £1.6 billion. Furthermore, NI is, in effect, a second income tax charged on earnings (with a reduced rate for those aged over the state pension age).²⁴ The Labour Party has made no pledges regarding NI, and indeed in April 2011, NI rates will increase by 1 percentage point for employees, employers and the self-employed; NI rates also rose in April 2003 despite the Labour Party's 2001 manifesto pledging not to increase income tax rates. It is also worthwhile noting that the government broke a similar pledge in the 2005 manifesto by introducing a new top rate of income tax of 50% for income over £150,000.

IFS researchers have looked at the distributional rationale for having zero or reduced rates of VAT on distributional grounds, and, in general, found it unpersuasive.²⁵ The revenue forgone is significant, and the resultant changes in relative prices act to distort household's purchasing decisions in a way that reduces people's welfare (because the basket of goods and services they choose to buy for a given amount of money is worth less to them than the basket they would choose to buy for the same money if the VAT rate was uniform). Furthermore, whilst poorer households do spend a higher fraction of their income on zero and reduced rate goods (particularly food and domestic fuel) than richer ones, the rich spend more on these goods in cash terms and therefore get most of the cash gains. Hence, zero and reduced-rating of certain goods is not an effective way of redistributing to poorer households; most of the cash gains go to richer households.

The National Minimum Wage

Whilst the National Minimum Wage (NMW) is not part of the tax and benefit system, the Labour Party counts it as part of their broader package of policies to make work pay and help low income families.²⁶ Their manifesto includes a pledge to give the Low Pay Commission a remit to set the NMW so that it increases by at least the rate of average earnings, between now and 2015. Whilst there has been no formal "floor" to increases in the NMW since its introduction, this would be a lower rate of increase than the average since 1999 (if the minimum wage had been increased in line with average earnings it would be around £5.10 per hour now, instead of the actual £5.80). It should be noted, however, that much of this increase took place in 2001, 2003, and 2006; since 2006, the rate of increase has been slightly slower than the rate of growth in average earnings. In any case, increases in the NMW are not very effective at raising the incomes of low income households.²⁷

²⁴ Contrary to popular perception, NI revenues are not ring-fenced in any meaningful way to pay for the NHS, state pension or contributory benefits. See Adam, S and G. Loutzenhiser, 'Integrating income tax and National Insurance: an interim report', Institute for Fiscal Studies Working Paper 21/07, available at: <http://www.ifs.org.uk/wps/wp2107.pdf>.

²⁵ See Crossley, T, D. Phillips and M. Wakefield 'Value added tax', Chapter 10, Green Budget 2009, Institute for Fiscal Studies (<http://www.ifs.org.uk/budgets/gb2009/09chap10.pdf>) and Brewer, M., J. Browne, A. Leicester, and H. Miller, 'Options for fiscal tightening: tax increases and benefit cuts', Chapter 7, Green Budget 2010, Institute for Fiscal Studies (<http://www.ifs.org.uk/budgets/gb2010/10chap7.pdf>)

²⁶ See Page 4, Labour Party Manifesto, available at: <http://www2.labour.org.uk/uploads/TheLabourPartyManifesto-2010.pdf>.

²⁷ IFS research for the 2010 Low Pay Commission report found that the withdrawal of means-tested benefits and tax credits as income increases means that a large fraction of low income recipients of the NMW gain little in the way of additional income when the NMW increases. It also means that increases in the NMW often do little to make work pay for those facing the worst work incentives. At the same time, second earners in couples (usually women) often gain the most from an increase in the NMW because their partner's earnings are high enough to take them off means-tested benefits and tax credits, and their own earnings are sufficiently low that they do not pay Income Tax or NI. See Brewer, M., R. May, and D. Phillips (2010) "Taxes, Benefits and the National Minimum Wage", Low Pay Commission Research Report, available at http://www.lowpay.gov.uk/lowpay/research/pdf/FromLPC_Document_Feb.pdf.

4. Conservative proposals

The Conservative Party's plans involve implementing all the changes mentioned in Section 2, with the following exceptions:

- A Conservative government would not implement the 50p/month 'broadband tax' on phonelines. The Conservatives would instead open up the network infrastructure to private companies to build a superfast broadband network, foregoing revenue of £175 million in a full year.
- The 10% real increase in cider duty announced in Budget 2010 would not go ahead, forgoing revenue of £15 million per year.
- Unlike Labour and the Liberal Democrats, the Conservatives are not committed to introducing the reforms recommended by the Calman Commission. While the Conservative Party accepts that 'the Scottish Parliament should have more responsibility for raising the money it spends' a Conservative government would produce their 'own White Paper by May 2011 to set out how we will deal with the issues raised by Calman, and we will legislate to implement those proposals within the next Parliament'.

The Conservative Party would also further limit the losses from the pre-announced increase in NI rates by increasing the threshold at which employees' National Insurance Contributions (NICs) are payable by more than the current government intends, and by increasing the threshold at which employers start to pay NICs. This would reduce NI revenues by £5.4 billion if introduced in 2010–11.

In addition, a Conservative government would implement the following reforms (the estimated costs are those given by the Conservative Party in 2010–11 terms; we discuss in more detail below where we disagree with them):

- Give additional grants to councils who agree to freeze council tax rates for two years. Cost to central government: £1.0 billion.²⁸
- Introduce a transferable tax allowance for some married couples. Cost: £500m.²⁹
- Increase the inheritance tax threshold to £1 million. Cost: £1.2 billion.³⁰
- Extend the existing £30,000 flat-rate charge to all non-domiciled UK residents. The Conservatives estimate that this would raise at least £1.8 billion a year, enough to pay for their changes to inheritance tax and stamp duty land tax.
- Make the temporary increase in the stamp duty threshold for first time buyers permanent. Cost: around £300m per year from 2012–13.³¹
- Cut the main rate of corporation tax to 25%, and the small companies' rate to 20%, while reducing the generosity of capital allowances to make the reform revenue neutral.

²⁸ This is the annual amount of net council tax revenue foregone. See M. Brewer, C. Emmerson and D. Phillips, The 'Conservative Party's council tax freeze', <http://www.ifs.org.uk/publications/4780> for more discussion.

²⁹ The IFS provided this costing for the Conservative party, see IFS Press Release 9 April 2010, http://www.ifs.org.uk/pr/marriage_pr.pdf, for more discussion.

³⁰ Source: FOI request from HM Treasury, see http://www.hm-treasury.gov.uk/d/foi_inheritance_costing.pdf.

³¹ The government's planned stamp duty holiday is expected to cost £290m in a full year (http://www.hm-treasury.gov.uk/d/budget2010_annexa.pdf), but the cost of a permanent cut for first-time buyers would be less than this. But the cost of any stamp duty holiday depends greatly on the state of the housing market, and an old costing of this policy by HM Treasury was £300m to £350m a year (http://www.hm-treasury.gov.uk/d/foi_oppcostings13.pdf).

- A levy on the wholesale liabilities of banks, the precise design of which would depend on what similar policies are introduced by other countries. Nevertheless, the Conservatives are confident that it would raise at least £1 billion a year.³²
- Reduce the threshold at which the family element of the Child Tax Credit starts to be tapered away from £50,000 to £40,000. Raises £400 million.
- Stop government Child Trust Fund payments for children whose parents have incomes above £16,040. Raises £225 million.
- Waive employer NICs for new business start-ups for the first ten employees for two years of a Conservative government. This would cost £250 million in each of these two years, but does not affect revenues in 2014–15 and so does not appear in table 4.1.
- Reform the Climate Change Levy to give an effective floor price on carbon permits in the European Emissions Trading Scheme. This policy is discussed in a further Briefing Note in this series.³³
- Increase the state pension age to 66 earlier than is intended under the current government's proposals, although this would not start until 2016 at the earliest for men and 2020 at the earliest for women. As this is beyond the lifetime of the next parliament, we do not consider this policy any further in this Briefing Note, although it is discussed in another Briefing Note on pensions policy in this series.

The Conservative manifesto also contains a number of reforms which are less precisely defined, meaning that it is impossible to say how much they would cost or raise:

- The Conservatives have promised to 'increase the proportion of tax revenues accounted for by environmental taxes, ensuring that any additional revenues from new green taxes that are principally designed as an environmental measure to change behaviour are used to reduce the burden of taxation elsewhere'. However, the manifesto contains no details of any environmental tax rises other than those already announced by the current government, and does not state which other taxes the Conservatives would seek to reduce with any revenue raised. This policy is discussed further in another Briefing Note in this series.³⁴
- The Conservatives have pledged to 'end the couple penalty for all couples in the tax credit system as we make savings from our welfare reform plans'. Given that any means-tested and jointly-assessed system will have some form of 'couple penalty', it is difficult to see how this could be accomplished without a radical restructuring of the tax credit system that would be either very expensive or involve large losses for single people. IFS research to be published shortly will discuss the issue of 'couple penalties' in more detail.³⁵
- The Conservatives would refocus the research and development tax credit on high-tech companies, small businesses and new start-ups. It is not clear what this would involve in practice.
- The Conservatives 'do not view the 50p income tax rate [applying above £150,000] as a permanent feature of the tax system', but have not pledged to abolish it in the next parliament, nor to increase the £150,000 threshold in line with inflation or earnings. The Conservatives

³² See http://www.conservatives.com/Policy/Where_we_stand/Economy.aspx.

³³ P. Johnson and P. Levell (2010), 'Environment Policy Proposals', IFS Election Briefing Note 2010.

³⁴ P. Johnson and P. Levell (2010), 'Environment Policy Proposals', IFS Election Briefing Note 2010.

³⁵ See <http://www.ifs.org.uk/projects/17/320> for more details of this research.

have made no such statement with regard to the withdrawal of the income tax personal allowance above £100,000, which creates a small band of income where the marginal income tax rate is 60%, or the planned restriction of tax relief on pension contributions discussed in section 2.

- The Conservatives would like to 'start to remove the effects of the abolition of the dividend tax credit for pension funds', although only 'when resources allow'. If resources ever did allow, it is not clear whether this would simply involve the reversing the government's 1997 reform, or something else. A Conservative government could, of course, provide the resources to fund this tax cut by increasing other taxes or cutting government spending, but the Conservatives have not outlined such a plan in their manifesto.

The Conservative Party also said that it would hold consultations on the following policies, although it has not committed to introducing them if it were to form the next government:

- A 'fair fuel stabiliser' that would reduce the rate of fuel duty when the price of oil is high, and increase it when the price of oil is low. It is not clear how this policy would operate in practice. This policy will be analysed in another briefing note in this series.³⁶
- A lorry road user charge, which would vary according to distance driven. This would be accompanied by a compensating reduction in fuel duty for lorries, making the reform revenue neutral overall. This is intended to reduce tax avoidance by lorry drivers who can purchase fuel in countries with lower duty rates before or after coming to the UK. Again, this is discussed more in a different briefing note.³⁷
- Shifting corporation tax from being a system that taxes UK companies on all foreign income to 'a territorial system that only taxes UK income'. Given that in 2009 the Labour Government introduced an exemption system under which much of the foreign income of UK firms is exempt from UK corporation tax, it is not clear in what specific ways this would differ from the current system.³⁸
- Having a different corporate tax rate in Northern Ireland, to ensure that it remains an attractive location for investment relative to the Republic of Ireland, which has a much lower statutory corporation tax rate. This might be an effective way of encouraging firms to invest in Northern Ireland, but it would add additional complexity to the UK corporate tax system. There would be major difficulties in identifying exactly how much of a company's profit was generated in Northern Ireland if they had operations in different locations across the UK. As a result, this policy would also provide tax avoidance opportunities as companies attempted to shift profits artificially to Northern Ireland from other locations.

³⁶ P. Johnson and P. Levell (2010), 'Environment Policy Proposals', IFS Election Briefing Note 2010.

³⁷ P. Johnson and P. Levell (2010), 'Environment Policy Proposals', IFS Election Briefing Note 2010.

³⁸ Some foreign income (broadly that which is deemed to be located offshore for tax purposes) is still taxed in the UK under the current system. This is determined by the Controlled Foreign Companies rules for which the Labour Government has started a consultation on reforms. See R. Griffiths and H. Miller (2010) 'Corporate tax', IFS Election Briefing Note 2010.

Table 4.1: Revenue effects of Conservatives' plans to be implemented by 2014–15 (all in 2010 prices) relative to Labour's, 2010–11 prices

	Change in revenue
Income tax	
Transferable personal allowance	–£0.5
Extend £30,000 charge to all non-doms	+£1.8
Total income tax	+£1.3
Total National Insurance	–£5.4
Total council tax (net of council tax benefit)	–£1.0
Total inheritance tax	–£1.2
Total stamp duties	–£0.3
Corporation tax	
Cut main rate from 28p to 25p	–£2.3
Cut small companies' rate from 22p to 20p	–£1.2
Reductions in reliefs and allowances	+£3.5
Total corporation tax	£0
Total other taxes and royalties^a	+£1.0
Total taxes	–£6.3
Benefits and tax credits	
Cut threshold at which family element of CTC starts to be withdrawn	+£0.4
Withdraw government contributions to child trust funds from families with incomes below £16,040	+£0.2
Total benefits and tax credits	+£0.6
Grand total	–£5.7
Memo: Current government's plans	+£15.8
Net tightening relative to today	+£10.1

Notes and Source: See previous page.

a. This is the proposed bank levy.

We now go on to discuss each of the firm commitments mentioned above in turn.

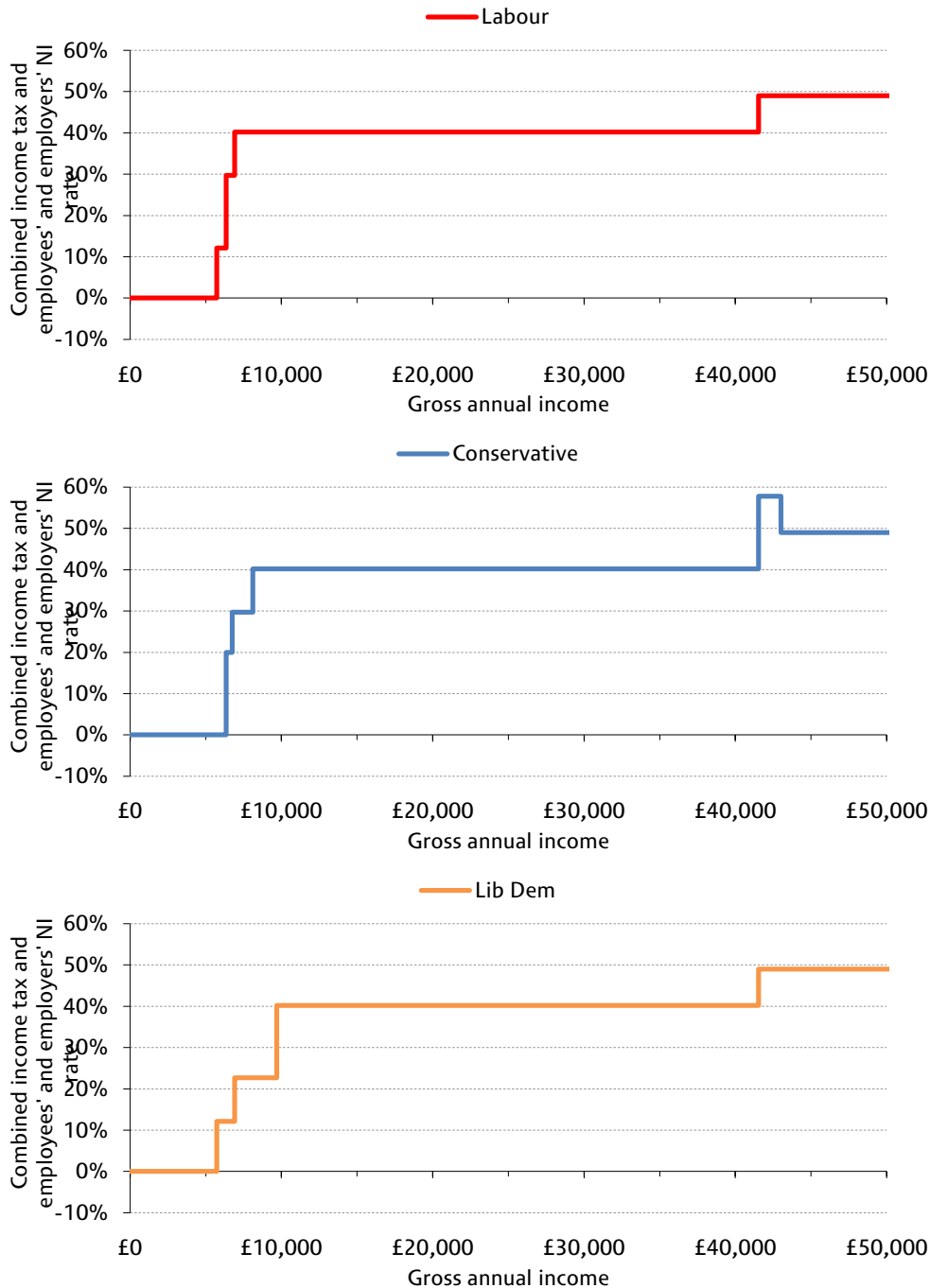
Reforms to National Insurance Contributions

As we discussed in section 2, the Labour government has pre-announced 1% increases in all employee, employer and self-employed NI rates from April 2011, together with an increase in the threshold at which employees start having to pay NICs of £1,170 per year. This would mean that those earning less than £20,000 per year would pay less in employee NICs, and those earning more than £20,000 per year would pay more, although some of those with incomes below £20,000 would also lose out if, as we expect, employers pass on at least part of the increase in employer NICs to workers in the form of lower wages. The Conservatives wish to compensate more individuals for the increase in NI rates by further increasing the threshold at which employees start to pay NICs by £1,248 a year (i.e. increasing the threshold by £2,418 a year overall). This would mean that those earning less than £35,000 a year would pay less in employee NICs than under the current system, while those earning more than £35,000 would pay more. Overall, those earning between £8,400 a year and £44,000 a year would pay £150 less in employee NICs under the Conservatives' NI plan than under Labour's. However, those earning more than £45,500 per year would have to pay no less under the Conservatives' plans than under Labour's, as the Conservatives would increase the Upper Earnings Limit (UEL, the point at which the employee's NI rate falls from 12% to 2% for an employee who is contracted in to the Second State Pension) by £1,548 a year. This is currently aligned with the higher rate threshold in income tax (the point at which the higher 40% rate starts to be paid), but the two would be decoupled under the Conservative proposals, creating a short

band of income where the combined marginal income tax and employee NI rate is 52% (which would be difficult to justify).

The overall income tax and NI schedule for employees is shown in Figure 4.1. For completeness, we also show the schedule that would exist under the Liberal Democrats' proposals for income tax, which we discuss in section 5.

Figure 4.1. Combined income tax and employees' and employers' NI schedule in 2014–15 under the three main parties, 2010–11 prices



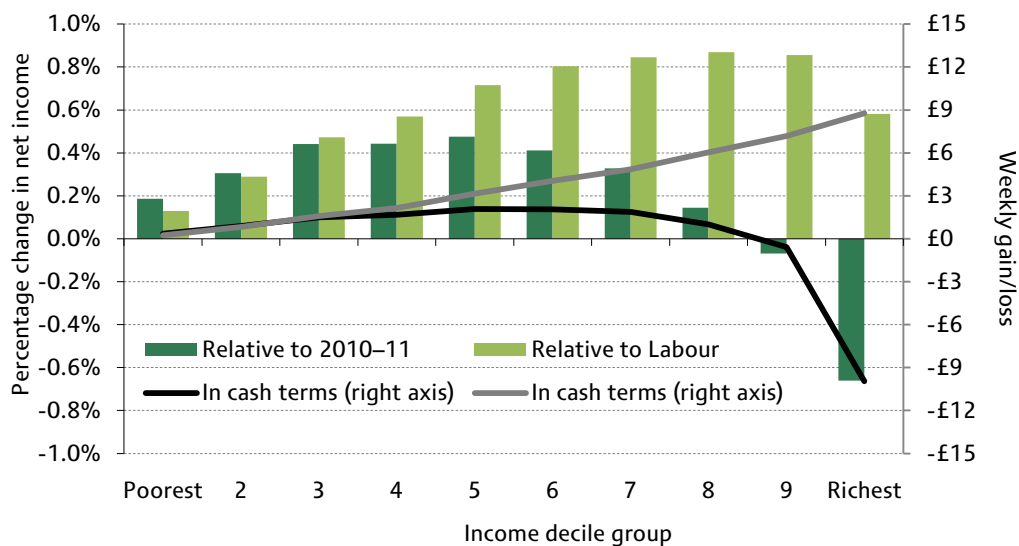
Note: Individual aged under 65, no unearned income, contracted in to State Second Pension.
Source: Authors' calculations.

The Conservatives would also increase the threshold at which employers start to pay NICs in respect of an employee by £1,092 per year. In the short run, this would mean that it would cost £150 a year less for an employer to employ someone earning more than £8,400 under the Conservatives than under Labour. However, in the longer term we would expect employers to adjust wages to pass on at least some of the changes in employer NICs to employees, so total employer cost would not change by so much. In the case where employers fully pass on changes in employer NICs to employees, the break-even point for an employee who was contracted in to the State Second Pension and had no tax credit entitlement would be £29,000 a year under the Conservatives' plans compared with £15,000 under Labour's.

We estimate that NI revenues would be £5.4 billion lower in the short term under this plan than they would be under Labour's plan, although some of this would be recouped through other taxes as lower employer NICs means higher profits and therefore higher corporation tax revenue than under Labour's policy. In the longer term, wages would probably adjust to take account of changes to employer NICs, meaning higher revenue from income tax and employee NICs, and lower spending on means-tested benefits and tax credits, than under Labour's policy. In the case where all changes to employer NI are passed on to employees, the cost would fall to £4.1 billion. Note that, using Treasury figures, the Conservative NI proposal still involves increasing tax revenues by £400 million compared with the current system.³⁹

The distributional impact of the Conservatives' policy relative to both the current NI system and Labour's planned changes is shown in figure 4.2. The darker bars and line represent the change in net income relative to now, whilst the light bars and line represent the change in net income relative to the Labour Government's plans for the NI system.

Figure 4.2. Distributional impact of the Conservatives' NI proposal



Note: See figure 2.1.

Source: See figure 2.1.

We can see that the pattern of losses compared with today from the Conservatives' NI proposals is similar to that of Labour's – it is the rich who would be most affected. However, unlike under Labour's plan, the poorest four-fifths of families gain slightly on average as a result of the increase in NI thresholds. The gains relative to Labour's plans are increasing as a share of income over the

³⁹ We estimate that this would be £900 million if wages adjusted in response to changes in employer NI.

income distribution until we reach the richest decile, who do not benefit so much as a proportion of their income on average. The richest tenth of households are the largest beneficiaries in cash terms, however.

As we mentioned in section 2, increases in NI do weaken the incentive to work at all, and the incentive for workers to increase their earnings slightly. It is little different from other tax rises such as income tax or VAT in this regard, however. Removing most of the losses from the NI increase means that the Conservatives would, on average, reverse the effect of the government's NI policies on weakening the incentive to work at all. However, by going ahead with the proposed increases in NI rates, the Conservatives would still weaken the incentives for workers earning more than the revised threshold to increase their earnings, as a larger proportion of each additional pound earned would be lost in higher NICs (although the increase in the threshold does lower METRs for people earning above the current threshold and below the Conservative's proposed threshold).

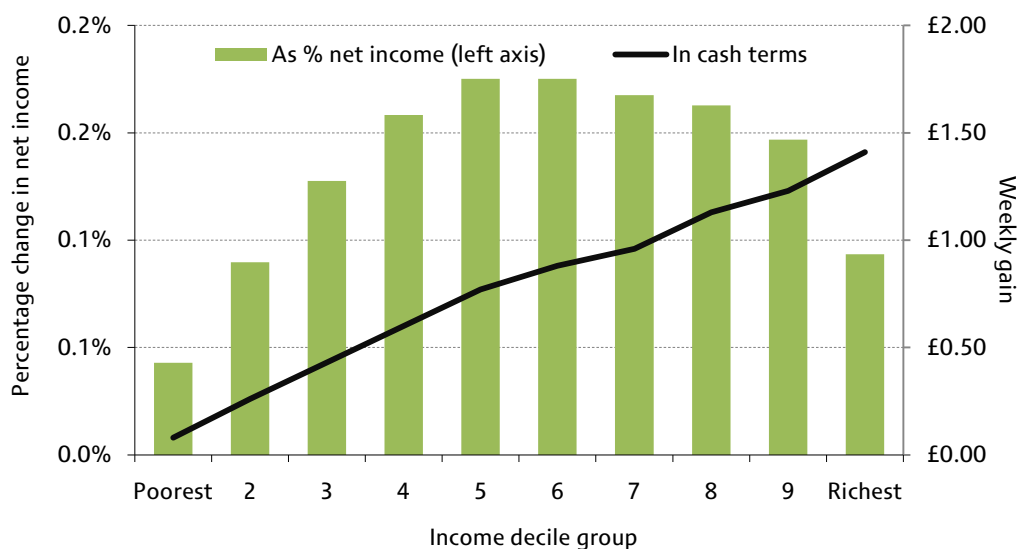
The Conservatives would waive employer NICs for the first ten employees of new businesses for the first two years of a Conservative government, at a cost of £250 million a year (although there would be no cost by the end of the Parliament. It is not clear what the justification is for targeting this policy only at new businesses, or why it should only last two years. Any argument for targeting new businesses over existing ones would need to rely on there being some market failure that this policy would correct, or that new businesses were more responsive to tax changes than existing ones. It is not clear that either of these is the case, and even if it were, there would seem little justification to have this policy in place for two years only.

Council tax freeze

The Conservatives have announced that they would increase grants to local authorities in England who keep council tax rises below 2.5% by an amount which would enable them to finance another 2.5% reduction in council tax, a policy which the Conservative Party describe as a freeze in council tax. If all councils took up the offer, this policy would require higher spending of £1.4 billion once the additional payments to the devolved administrations in Scotland, Wales and Northern Ireland that the Barnett formula would imply in response to this change are taken into account. (The Conservatives claim to be funding this by reducing central government spending on advertising and consultancy in England by £1.1 billion, which would reduce grants to Scotland, Wales and Northern Ireland by enough to render the package revenue-neutral overall.) This would further centralise the tax system, and increase the complexity of local authority funding. Also, note that this policy would not necessarily reduce spending by local authorities, as they could freeze council tax to qualify for the additional grants but choose to lower reserves rather than reduce spending to pay for this.⁴⁰ The distributional impact of freezing council tax for two years is shown in Figure 4.3. It suggests that the gains from a freeze in council tax are greatest as a percentage of net income for the middle of the income distribution. Those low-income households which receive council tax benefit are unaffected by changes in the level of council tax, but we have exaggerated the impact of that by assuming that there is full take-up of council tax benefit: in reality, the impact on the bottom income decile groups will be a little larger than suggested here. The largest cash gains go to the richest households, however, as they tend to live in larger properties with the largest council tax liabilities.

⁴⁰ See M. Brewer, C. Emmerson and D. Phillips, The "Conservative Party's council tax freeze", <http://www.ifs.org.uk/publications/4780> for more discussion.

Figure 4.3. Distributional impact of freezing council tax for two years



Note: See figure 2.1.

Source: See figure 2.1.

Transferable tax allowance for married couples

If the Conservatives form the next government, they would make up to £750 of the income tax personal allowance transferable between adults who are married or in a civil partnership, so long as the higher-income member of the couple is a basic-rate taxpayer.⁴¹ This means that if one adult in a couple is not using all of their personal income tax allowance (because their income is less than the personal allowance, currently £6,475 per year), then they can transfer up to £750 of this unused allowance to their spouse. This transferred allowance would then lower the spouse's tax bill by up to £150 (the tax that would be paid on £750 of income at the basic rate of 20%). However, this transferred allowance would be tapered away from individuals whose income exceeds £42,375, at a rate of 50p for every £1 by which their income exceeds £42,375.⁴² This means that no-one with an income above the threshold of £43,875 at which the higher 40% income tax rate applies would benefit. The cost of this policy would be £500 million if introduced in 2010–11.

A married individual with an income of less than £5,725 per year would therefore be able to transfer £750 of their personal allowance to their spouse, so long as their spouse's income is less than £42,375, increasing the couple's net income by up to £150 a year. Married individuals with incomes of between £5,725 and £6,475 would be able to transfer the unused portion of their personal allowance to their spouse, increasing the couple's net income by less than £150, but again subject to this being tapered away when their spouse's income exceeds £42,375.

The only families which can gain from this policy are married couples where only one partner has an income high enough to be paying income tax and the taxpaying spouse is a basic-rate taxpayer. Out of 12.3 million married couples in the UK, 5.8 million would not benefit because they are both already taxpayers (so there is no unused tax allowance to transfer), 1.6 million would not benefit because neither are taxpayers (meaning that there is no benefit to either partner from a higher personal allowance) and 0.8 million would not benefit because, although only one partner is a

⁴¹ See IFS Press Release 9 April 2010, http://www.ifs.org.uk/pr/marriage_pr.pdf for more discussion.

⁴² Values calculated as if the policy were introduced into the current tax system – the Conservative Party has pledged to introduce this policy in the next parliament, but has not given a specific date for its introduction.

taxpayer, they are a higher-rate taxpayer. Four million couples would benefit, a third of all married couples.

A policy that benefits only married couples would increase the financial benefits of being married compared with being an unmarried couple. However, the extent to which marriage decisions respond to financial incentives is not known with any confidence; many couples would not benefit from the policy even if they were married; and the incentives to marry (or not to divorce) provided by a policy whose maximum benefit is £150 a year must surely be weak relative to the other costs and benefits involved. The policy would also increase the financial benefits of being married compared with not having a partner at all. For some beneficiaries, the proposed policy would reduce the so-called 'couple penalty' that is said to exist in the tax and benefit system by up to £150 a year. For a small number of beneficiaries, the proposed policy would lead to a 'couple premium' in the tax and benefit system, where the state collects less tax from the couple when they are married than if they were to divorce. IFS research to be published shortly will document the size of existing couple penalties and premiums in the tax and benefit system, and how these have changed in recent years.⁴³

A bigger question is why any government would want to encourage more couples to get married, or provide greater support to married couples than unmarried ones. Children born to parents who are married do better on a wide range of outcomes than children born to cohabiting couples (and indeed to lone parents). However, analysis by IFS researchers suggests that this relationship is unlikely to be causal: children born to married parents seem to do better because married parents are different from unmarried parents in pre-existing ways, not because getting married leads to better outcomes for one's children. In that case, providing incentives for marriage in the tax system is unlikely to lead to child outcomes improving.⁴⁴ Even if marriage did improve child outcomes, though, it is not clear that a policy where pensioner families make up more than a third of the beneficiaries and receive 31% of the gains is well targeted. In fact, only 35% of the families who gain from the policy have children, and only 17% have children aged under 5.

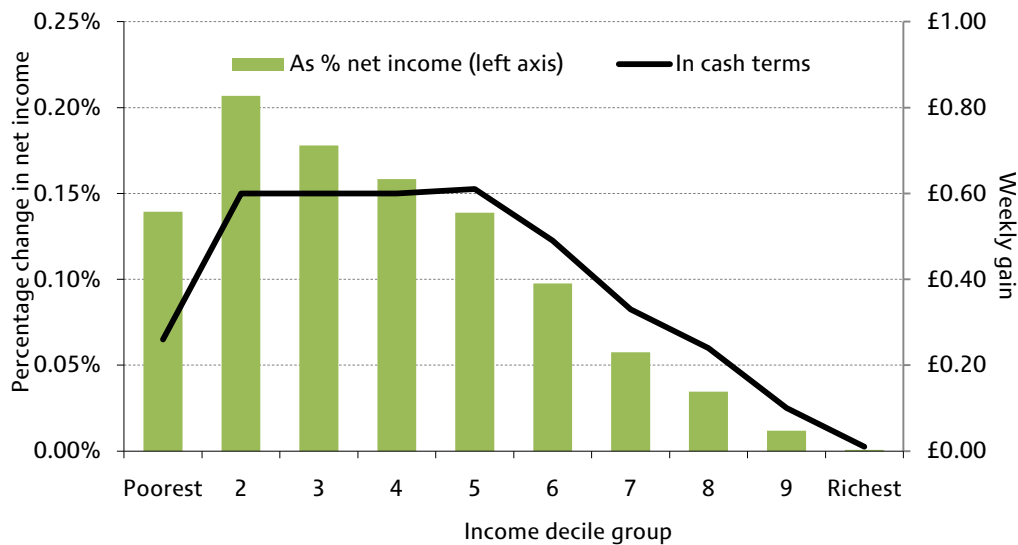
The most striking feature of the policy is that it would significantly complicate the income tax system, introducing new marginal rate bands into already increasingly Byzantine tax schedules. A simpler way to provide support to low- to middle income married couples would be to introduce a married couples' 'premium' into working tax credit and pension credit. A transferable personal allowance, restricted to married couples, capped at £750 and tapered away above £42,375 would surely be complicated to understand and costly to administer, and this cost must be considered in addition to the direct cost of the policy. The policy would represent yet another use of a tapered personal allowance, which is a complicated and opaque way of increasing some individuals' marginal income tax rates from 20% to 30% over a small band of income below the higher rate threshold.

The distributional impact of this policy is shown in figure 4.4.

⁴³ For more on this research, see <http://www.ifs.org.uk/projects/17/320>.

⁴⁴ A. Goodman and E. Greaves (2010), 'Cohabitation, marriage and child outcomes', IFS Commentary 113, <http://www.ifs.org.uk/comms/comm114.pdf>.

Figure 4.4. Distributional impact of the Conservatives' plans for a transferable personal allowance



Note: As for figure 2.1.

Source: As for figure 2.1.

The Conservatives' policy for a transferable personal allowance would benefit the poorer half of households more than the richer half in both cash and percentage terms. This is because gains are withdrawn from higher-rate taxpayers, and couples where both have incomes above the personal allowance cannot benefit.

The effects of this policy on work incentives are less clear-cut. The incentive to work at all would be slightly strengthened for the first potential earner in married couples (provided that, upon entering the labour market, they would pay income tax and their personal income would be less than £43,875), since they would pay less tax on their earned income when moving into work. But it would slightly weaken the incentive to work at all for some actual or potential second earners in married couples (in particular, for those whose spouse's income is less than £43,875, and whose own income in work would exceed £5,685). This is because increases in that individual's income above £5,685 would result in a reduced personal income tax allowance for their working partner. Withdrawing the transferred personal allowance between £42,375 and £43,875 means that workers with an income in this range who are benefitting from a transferred personal allowance would have a weaker incentive to increase their earnings slightly, since their marginal income tax rate would increase from 20% to 30%.

Increase in inheritance tax nil-rate band

The Conservatives have proposed increasing the inheritance tax (IHT) nil-rate band from £325,000 to £1 million, which would mean that single people could bequeath £1 million of their assets without paying any IHT; given the fact that married couples can transfer the unused portion of the nil-rate band to the surviving spouse, the second person to die in a married couple could bequeath £2 million free of IHT. The cost of this measure, according to a Treasury estimate published in December 2009, would be £1.2 billion if introduced in 2010–11. In 2009–10, only 3% of estates or 15,000 estates were estimated to be liable for inheritance tax on death, and this number would fall further to just 2,000 under the Conservative plans, around a third of a per cent.⁴⁵ The

⁴⁵ 15,000 figure from Table 1.4 of HMRC statistics, http://www.hmrc.gov.uk/stats/tax_receipts/table1-4.pdf estimates that 15,000 estates will be liable for IHT on death out of a total of around 580,000 deaths (source ONS *Monthly Digest of Statistics*, table 2.4). Costing of £1.2 billion and the reduction in number of estates paying IHT to 2,000 are estimates from

Conservatives' reform would therefore abolish IHT for all except a very small number of very rich families who do not plan their affairs in a tax-efficient manner (by giving away all except £1 million or £2 million of their assets at least seven years before their death, for example). And those individuals who would still be paying IHT after the Conservatives' reform was introduced would be paying considerably less: a couple whose joint estate was worth more than £2 million at death would attract £540,000 less tax as a result of this reform. Therefore, this policy would leave IHT as a tax that very few estates were liable to pay, and which raised little revenue (only £1.2 billion in 2010–11). HM Treasury estimates that around half of the £1.2 billion giveaway from this reform would go to estates that would no longer be paying IHT as a result of this reform (i.e. those of single people worth between £235,000 and £1 million, and those of couples worth between £650,000 and £2 million), while half would go to those that were still liable to IHT.

Permanently increase stamp duty land tax threshold to £250,000 for first-time buyers

As discussed in Section 2, the current Government has already increased the stamp duty land tax threshold from £125,000 to £250,000 for first-time buyers until March 2012 on a temporary basis. The Conservatives would like to make this permanent, at a cost of around £300 million a year from 2012–13.⁴⁶ This policy would help first-time buyers, though some of the benefit would go to existing owners of the kinds of properties favoured by first-time buyers, as they might be able to increase their selling price. Generally reductions in stamp duty are welcome, since, as mentioned in section 2, it is a highly distortionary tax, although this policy would cause some additional distortions as it is only offered to first-time buyers. First, since individuals can only take advantage once, they have an incentive to purchase a larger property to take maximum advantage, which may involve delaying their first purchase. Second, it discourages joint home ownership by couples – they can potentially benefit twice if one partner purchases the couple's first property individually, and then the other purchases the property individually the second time.

Extend £30,000 charge to all non-domiciled UK residents

Non-domiciled UK residents ("non-doms") pay UK income tax on their UK income and on foreign income remitted to the UK, but do not pay UK income tax on foreign income that they do not bring into the UK. However, since 2008–09 those who have lived in the UK for seven years have had to pay £30,000 per year (and forgo their income tax personal allowance) for the privilege of having their unremitted foreign income untaxed in the UK; otherwise they can choose to give up their non-domiciled status (for tax purposes) and pay tax on their worldwide income like other UK residents. The Conservative Party would extend this new regime to all non-doms, and believes that extending the charge to those who have been in the UK for less than seven years would raise at least an additional £1.8 billion a year. The Treasury does not believe that the policy would raise anywhere near this much – in an answer to a parliamentary question, it stated that a flat rate charge of £25,000 to replace the current policy would raise very little relative to the government's existing policy.⁴⁷

It is very difficult to know exactly how much revenue could be raised from additional taxes on non-doms: the government has no information on these individuals' foreign incomes, so it does not know how many of the individuals affected have foreign incomes that are sufficiently high to make

HM Treasury that has been released as a result of a FOI request: see http://www.hm-treasury.gov.uk/d/foi_inheritance_costing.pdf.

⁴⁶ Table 1 of Budget 2010 says that the government's policy will cost £230 million in 2010–11 and £290 million in 2011–12. The higher cost in 2011–12 is likely to be a result of individuals moving transactions forward to take advantage of the temporary cut in stamp duty.

⁴⁷ The Treasury believes that this policy would raise £350 million in the first year of its operation, falling gradually to £50 million by the fourth year. See http://www.publications.parliament.uk/pa/ld200910/ldhansrd/text/91207w0004.htm#column_WA101.

it worthwhile to pay this charge rather than become domiciled for tax purposes and pay income tax on all their worldwide income, nor how much additional tax those who became tax-domiciled would pay.⁴⁸ It is also unclear how these highly mobile individuals would respond to such a tax change: some may decide to leave the country rather than pay the extra charge, and others who might otherwise have come to the UK may no longer do so. The Treasury forecast that 4,000 non-doms would choose to pay the Government's new £30,000 charge rather than drop their non-dom status, and this forecast seems to have been accurate for the first year of the new regime: initial tax return data indicate that 4,200 individuals paid the charge in 2008–09). This might suggest that the Treasury's estimate of the revenue raised from the Conservative party's proposal is more likely to be accurate. However, we might decide not to read too much into the apparent accuracy of the Treasury's forecast given that the initial 4,000 number seems to have been intended as a long-term (rather than first-year) forecast, and was made before the start of a recession which might have reduced the income of non-doms, and hence the number we would expect to pay the charge; it may, therefore, be the case that the initial 4,000 estimate was too low. Furthermore, the revenue raised by the current policy depends not just on the number who choose to pay the charge, but also on how much is raised by taxing the foreign incomes of those who do not have sufficient foreign income to justify paying the charge, and how many non-doms choose to leave the UK (which would deprive the UK government of all the tax revenue they currently contribute on their UK incomes). More fundamentally, those non-doms who have been in the UK for less than seven years may be different from those who have been here longer, with possibly different amounts of foreign income and a different propensity to alter their behaviour. This means that it is still very unclear which of the two costings of the Conservative policy is likely to be nearer to the truth.

Cut corporate tax rates, broaden tax base

The Conservative Party is committed to reducing the headline rates of corporation tax from 28% to 25% for large firms and from its current rate of 21% to 20% for small firms. Reducing the main rate to 25% would cost £2.3 billion in 2010–11 terms, and reducing the small companies' rate from the 22% (the intended rate under the current government's plans from 2011–12) to 20% would cost £1.2 billion. They intend to keep this reform revenue-neutral within the corporate sector by reducing what the party terms 'complicated reliefs and allowances'. A Conservative document from 2008 suggests that this would involve reducing plant and machinery allowances from 20% to 12.5%, reducing both long-life plant and machinery allowances and integral fixtures allowances from 10% to 6%, and removing the Annual Investment Allowance, which allows firms to deduct the first £100,000 of investment in plant and machinery when calculating taxable profits. But the Conservatives say they would reduce allowances by more or less than this as necessary to ensure the reform was revenue-neutral overall.

This proposal is very much in line with the trend in the UK and internationally since 1979 in terms of reducing both statutory tax rates and the generosity of capital allowances (and indeed is very similar to what the Labour government did for large companies in its 2007 Budget, despite Alistair Darling's assertion in his 2010 Budget speech that "scrapping investment allowances, as some have proposed, in order to pay for a reduction in the overall rate of corporation tax makes no sense"). But the Conservatives' proposed changes to capital allowances would make corporation tax more complicated, not simpler: in particular, abolishing the Annual Investment Allowance would mean that most small firms would have to 'write down' their investment on plant and machinery over

⁴⁸ Tax evasion would be a potential problem here, as it is very difficult for the government to identify and verify unremitted foreign income.

several years rather than simply deducting it from taxable profits in the year the investment was made.⁴⁹

If the package is revenue-neutral then on average there would be no change in firms' overall tax burden. However, some firms would benefit and others would lose. The losers would be firms that invested heavily but made little profit – notably in the manufacturing and transport sectors but also some capital-intensive service-sector firms. The winners would be less capital-intensive but more profitable firms, historically typified by the financial sector.

Cutting headline rates of corporation tax would make the UK a more attractive place for multinational companies to locate their profits, and on its own would encourage companies to do business in the UK. But by reducing the generosity of capital allowances, the Conservatives would weaken the incentive for firms to invest in new equipment in the UK. It is difficult to imagine that this is the most efficient way of financing a cut in corporation tax rates.

Bank levy

The Conservative Party has said that it would introduce a levy on banks' wholesale liabilities that would raise at least £1 billion a year if it formed the next government. Few details have been specified, but the Shadow Chancellor, George Osborne, has suggested that it would be 'similar to the levy on wholesale funding proposed by President Obama or the levy already implemented in Sweden', which is also a levy set as a very small proportion of banks' wholesale liabilities.⁵⁰ As mentioned in Section 2, a tax based on liabilities (albeit not necessarily just wholesale liabilities) is one idea recently put forward by the IMF – though (unlike the Government) the Conservatives do not follow the IMF in suggesting that the tax might vary by specific risk-based characteristics, and (like the Government) they propose nothing akin to the IMF's second proposed tax, on the sum of profits and remuneration.

Reduce Child Tax Credit for high-income families

The Conservative Party's manifesto states that they wish to 'stop paying tax credits to families with incomes over £50,000'. Information provided to use makes clear that it wants to reduce the threshold at which the family element of the Child Tax Credit (CTC) starts to be withdrawn from £50,000 to £40,000. The family element of the CTC is currently worth £545 per year to all families with dependent children with incomes below £50,000 a year. It is withdrawn at a rate of £1 for every £15 of income above this level, meaning that families with incomes above £58,175 do not benefit at all.

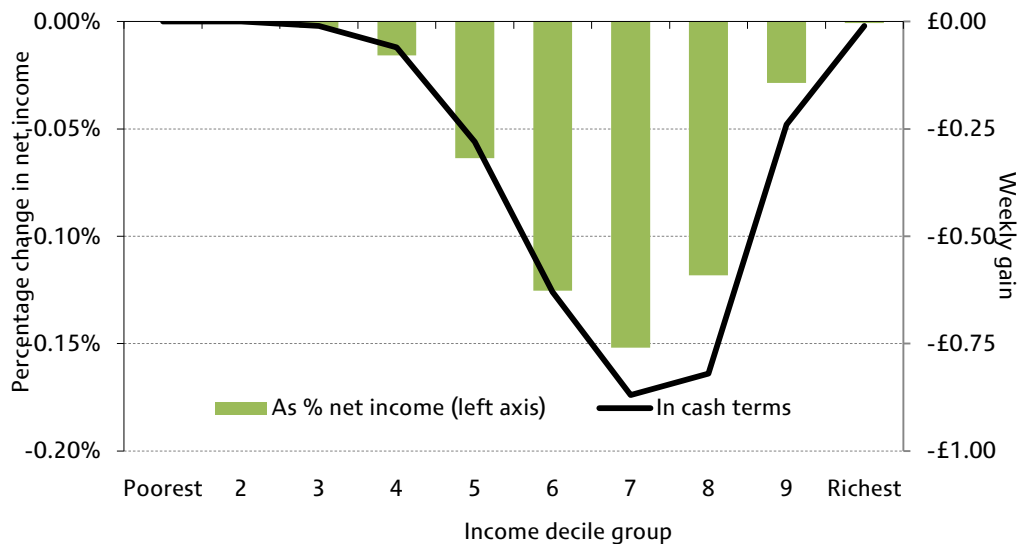
Families whose joint incomes are below £40,000 would be unaffected by the Conservatives' policy, those with incomes between £40,000 and £48,175 would lose some of their tax credits, and those with incomes above this level would lose all their tax credits (unless they have a baby under 1 year old, in which case they get £1,090 in the family element of CTC and so it is not exhausted until the family's income is £66,350, or £56,350 under the Conservatives' proposal). The maximum loss in cash terms would be £545 a year for those families with incomes between £48,175 and £50,000. The description of the policy in the Conservative manifesto does not suggest that those with incomes below £50,000 would lose out, and therefore seems incomplete at best and misleading at worst.

⁴⁹ The doubling of the Annual Investment Allowance in Budget 2010 was welcomed as a simplifying measure by the Chartered Institute of Taxation, for example: see <http://www.tax.org.uk/showarticle.pl?id=9126;n=427>.

⁵⁰ Quote from George Osborne's Mais Lecture, 24th February 2010, available at http://www.conservatives.com/News/Speeches/2010/02/George_Osborne_Mais_Lecture_-_A_New_Economic_Model.aspx.

An initial costing of this policy for the Conservative Party by IFS researchers estimated that it would save £400 million a year, assuming that all families entitled to tax credits received them. However, since many of the families who would lose entitlements to tax credits under the Conservative policy do not claim their entitlements at the moment, withdrawing these entitlements would reduce expenditure on tax credits by less than the full £400 million. The government, which has access to administrative data on tax credit payments that are unavailable to IFS researchers, has said that, in order to reduce tax credit spending by £400 million, the threshold would have to be reduced to £31,000.⁵¹ The government did not say how much they believed a policy of reducing the threshold to £40,000 would raise, but it can be stated confidently that it would raise less than £400 million, but more than £45 million (the latter being what would be raised if there were a cliff-edge at £50,000, so that families with incomes less than £50,000 received what they did at the moment, but those with incomes over £50,000 received nothing, which might be described as a very literal interpretation of the Conservative manifesto).⁵²

Figure 4.4. Distributional impact of reducing the second income threshold to £40,000



Note: As for figure 2.1.

Source: As for figure 2.1.

The Conservatives' proposal would remove tax credits from families whose joint incomes are above £40,000 per year, who tend to be towards the top of the income distribution, as suggested by the distributional analysis shown in Figure 4.4. However, the richest families do not receive any tax credits in the first place and so do not lose out from this change. We do not account for non take-up of tax credits in this distributional analysis, which means we overstate the losses that would occur were this policy to be implemented in practice.

Remove Child Trust Fund payments for better-off families

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 below £16,190 getting an extra £250. Families and friends can put additional money

⁵¹ See *Hansard*, 9th December 2009, Col. 407W, <http://www.publications.parliament.uk/pa/cm200910/cmhansrd/cm091209/text/91209w0014.htm#09120968000035>.

⁵² For more see Box 7.4 of M. Brewer, J. Browne, A. Leicester and H. Miller (2010), 'Options for fiscal tightening: tax increases and benefit cuts' in R. Chote, C. Emmerson and J. Shaw (eds.) *The IFS Green Budget :February 2010*, <http://www.ifs.org.uk/budgets/gb2010/10chap7.pdf>.

into these accounts if they wish (up to an annual limit of £1,200). This money can be invested in savings accounts or shares and (in most circumstances) is only available to the child once they are aged 18. The Conservatives would like to scrap government contributions to these accounts for those who do not qualify for the additional £250 for lower-income families: children would therefore either get £500 if their parents' income was less than £16,190 or nothing. We estimate that this policy would save around 45% of the total cost of the policy, or around £225 million in 2010–11.⁵³

Two arguments have been made in favour of Child Trust Funds.⁵⁴ The first is that they relieve credit constraints for young adults with few assets of their own, potentially facilitating investment in their education and career. The second is that they may act as an aid to financial literacy and encourage a culture of saving. The first justification would seem to be less relevant as an argument for providing child trust funds to better-off families, while there may be more cost-effective education-based approaches to improving financial literacy.

Summary: the Conservative Party's proposals

The Conservative manifesto does not set out a radically different vision for the tax system from Labour's, and it certainly does not take us towards the 'simpler, flatter tax system' that George Osborne has argued for in the past.⁵⁵ This can be seen from figure 4.1, which shows a Byzantine structure of marginal rates and no alignment between the income tax and NI systems. A number of the Conservative proposals involve offering small tax breaks to deal with what the party perceives to be specific social or economic problems (such as problems facing first-time buyers or new businesses, and a desire to recognise marriage in the income tax system). These may or may not be justified, but would certainly increase the complexity of the tax system as a whole.

The Conservative Party's NI plans represent a tax cut relative to those preannounced by the Labour government, but it is interesting to note that they have used Alistair Darling's favoured route of increasing tax thresholds to 'protect' those on lower earnings from rate rises rather than reversing the proposed rate rises outright. While the Conservatives would reverse most of Labour's proposed NI increase, they have chosen not to reverse its more distortionary or complex tax rises, such as the restriction of tax relief on pension contributions and the higher rate of stamp duty land tax for properties worth more than £1 million.

The Conservatives' corporation tax plans are very much in line with trends since 1979 in both the UK and elsewhere, in terms of reducing both headline rates and the value of capital allowances. While reducing statutory tax rates would make the UK a more attractive location for companies to locate profits, their proposed reductions in the generosity of capital allowances seem to be a complication rather than a simplification of the tax system, and would weaken the incentive for firms to invest in plant and machinery in the UK. It is difficult to see why tax reform should have to be revenue-neutral within the corporate sector. If cuts in statutory corporation rates are desirable, it is unlikely that lower capital allowances are the most efficient way of financing them.

Even with their proposed rises in NI thresholds, the Conservatives' plans involve keeping most of Labour's planned tax rises and offering a few smaller tax cuts of their own. Compared with Labour's

⁵³ See M. Brewer, J. Browne, A. Leicester and H. Miller (2010), 'Options for fiscal tightening: tax increases and benefit cuts' in R. Chote, C. Emmerson and J. Shaw (eds.) *The IFS Green Budget :February 2010*, <http://www.ifs.org.uk/budgets/gb2010/10chap7.pdf>.

⁵⁴ For a longer discussion, see C. Emmerson and M. Wakefield (2001), "The Saving Gateway and the Child Trust Fund: Is asset-based welfare 'well fair'?", IFS Commentary 85, London: IFS.

⁵⁵ See, for example, http://www.conservatives.com/News/Speeches/2008/02/George_Osborne_The_Principles_of_Tax_Reform.aspx.

proposals, the Conservatives' are probably regressive: reducing the losses across the income distribution but by proportionately more towards the top of the income distribution. But taken alongside the measures already in the pipeline, the overall picture would remain broadly progressive.

The losers from the Conservatives' proposed changes to the non-dom levy are likely to be among the richest households, but so too are the likely winners from the Conservatives' proposed IHT cut. Lower down the income distribution, households would gain from NI changes under the Conservatives rather than losing under Labour, although they would still lose out from the changes to duties, benefits and the income tax personal allowance that have been announced by the current government and which would be retained by the Conservatives.

The Conservatives' reforms to NI would strengthen the incentive to be in paid work relative to Labour's plans. However, as the Conservatives would still go ahead with Labour's proposed increases in NI rates, the incentive for workers whose earnings are above the NI threshold to increase their earnings slightly would still be weaker than they are today. Introducing a transferable personal allowance for married couples would very slightly strengthen the incentive for the first earner in a married couple to work, but very slightly weaken the incentive for the second earner to work.

5. The Liberal Democrats' proposals

Like the Conservatives, the Liberal Democrats accept most of the forthcoming changes to the tax and benefit system already announced by the Government and discussed in Section 2. Notably, unlike the Conservatives, they propose to implement in full the recommendations of the Calman Commission for devolving more tax-raising powers to the Scottish Parliament (without the exceptions that the Government makes).

The Liberal Democrats have made a number of additional proposals for tax and benefit reform. Their firm commitments, and the costings they estimate, are as follows (we discuss the plausibility of their costings below).⁵⁶ The costings are expressed here in 2010–11 terms for consistency with the analysis above, though the Liberal Democrats express their costings in 2011–12 prices and the discussion in the rest of this section is in those terms.

- Increasing income tax personal allowances to £10,000, while holding constant the level of income at which people start to pay higher-rate income tax. Cost: £16.0 billion
- Restricting income tax relief on pension contributions to the basic rate. Yield: £5.2 billion
- Introducing anti-avoidance and anti-evasion measures. Yield: £4.4 billion
- Reforming air passenger duty to operate per flight instead of per passenger and introducing additional tax for some domestic flights. Yield: £3.2 billion
- Introducing an additional 10% tax on the profits of UK banks until bank regulation is fundamentally reformed. Yield: £2.1 billion
- Reducing the capital gains tax allowance from £10,100 to £1,000 and taxing some capital gains above this at marginal income tax rates (after indexing for inflation). Yield: £1.8 billion
- Introducing an annual 1% tax on domestic property values above £2m. Yield: £1.6 billion

⁵⁶ The Liberal Democrat manifesto also makes two more commitments on tax: to change the tax on the National Lottery from a ticket tax to a gross profits tax, and to introduce a VAT rebate for mountain rescue. These proposals are both tiny and we do not discuss them further here.

- Reforming business rates – relocalising them, basing them on land value rather than the rental value of the property, and automating small business relief. Revenue-neutral.
- Allowing local authorities to charge a higher rate of council tax on second homes. Revenue-neutral (for central government).
- Reducing the rate of VAT on property repairs, and introducing VAT on new build, to equalise them at some intermediate rate. Revenue-neutral
- Making the rate of tax relief for Gift Aid donations a flat 23% (or whatever rate would be revenue-neutral) instead of the donor's marginal income tax rate. Revenue-neutral.
- Abolishing non-domiciled status for tax purposes after 7 years of residence. Revenue-neutral.
- Reducing fuel duties in remote rural areas and increasing them in the rest of the UK. Revenue-neutral
- Linking the basic state pension to average earnings from April 2011 rather than April 2012. Cost: £0.3 billion.
- Withdrawing the 'family element' of child tax credit immediately after the 'child element'. Yield: £1.2 billion.
- Moving tax credits to 6-month fixed awards. Revenue-neutral.
- Ending government contributions to child trust funds. Yield: £0.5 billion.
- Removing winter fuel payments from under-65s not currently receiving pension credit while extending them to certain recipients of disability benefits. Yield: £0.1 billion⁵⁷

They also aspire, but do not commit, to introducing four other major reforms – two sizeable additional giveaways when resources allow, and two radical (but not necessarily costly) reforms to the structure of taxation that they wish to prepare for (but not necessarily introduce) in the next Parliament:⁵⁸

- They would “seek to reverse” the scheduled increase in NICs rates (see Section 2) “when resources allow”.
- In the long term, they “aim to bring in a Citizen's Pension that will be paid to all UK citizens who are long-term residents, set at the level of the Pension Credit, though this can only be done when resources allow.”
- They say that council tax should be replaced with a local income tax. But unlike in their 2005 manifesto, they do not commit to introducing one nationwide in the next Parliament; rather, initially they propose only to pilot it in local authorities that volunteer, in order to “resolve any practical issues of implementation before it can be rolled out nationally”.⁵⁹
- They propose to “undertake preparations for the introduction of a system of road pricing in a second parliament”, with the revenue to be used to cut fuel duty, abolish vehicle excise duty and extend high-speed rail links.

⁵⁷ As explained below, this measure gradually changes from raising money (£300 million in 2010–11) to costing money (£70 million in 2014–15). For consistency with the tax measures (which are given in the manifesto only for 2011–12), we report here the 2011–12 costing (expressed in 2010–11 prices).

⁵⁸ Quotations taken from the Liberal Democrat manifesto, http://network.libdems.org.uk/manifesto2010/libdem_manifesto_2010.pdf.

⁵⁹ Analysis by IFS researchers of the Liberal Democrats' 2005 proposal to replace council tax with a local income tax can be found at http://www.ifs.org.uk/pr/libdem_tax.pdf.

The rest of this section examines in turn each of the firm commitments listed above. Table 5.1 summarises their revenue impacts.

Table 5.1. Revenue effects of the Liberal Democrats' tax and benefit proposals to be implemented by 2014–15 relative to Labour's, 2010–11 prices

	Change in revenue (billions)
Income tax	
£10,000 personal allowance	–£16.0
Restrict income tax relief on pension contributions to the basic rate	+£5.2
23% flat-rate relief for Gift Aid	£0
Abolish non-dom tax status after 7 years of residence	£0
Total income tax	–£10.8
Total capital gains tax	+£1.8
Total VAT	£0
Total aviation taxes	+£3.2
Total fuel duty	£0
Total business rates	£0
Total anti-avoidance and anti-evasion measures^a	+£4.4
Total other taxes and royalties^b	+£3.7
Total taxes	+£2.3
Benefits and tax credits	
Link state pension to earnings from April 2011	–£0.3
Withdraw family element of CTC straight after child element	+£1.2
Move tax credits to 6-month fixed awards	£0
End government contributions to child trust funds	+£0.5
Reform winter fuel payments	+£0.1
Total benefits and tax credits	+£1.6
Grand total	+£3.9
Memo: tightening pre-announced by Government	+£15.8
Total relative to 2010–11 system	+£19.7

Notes and Source: See text for details.

a. This comprises £0.8 billion from corporation tax avoidance, £0.4 billion from stamp duty land tax avoidance, £0.8 billion from combined income tax, NICs and capital gains tax avoidance, and £1.4 billion from combined income tax, NICs and capital gains tax evasion.

b. This comprises £2.1 billion from the bank levy and £1.6 billion from the 'mansion tax'.

Tax proposals

Increasing the income tax personal allowance to £10,000

The Liberal Democrats propose to increase the income tax personal allowance to £10,000 while keeping the level of income at which people start to pay the higher rate of tax unchanged. They say this giveaway would cost £16.8 billion in 2011–12.

Those individuals with incomes already too low to pay tax would not gain at all from this. In 2009–10, only 62% of the adult population had a high enough income to pay income tax.⁶⁰ Some of these

⁶⁰ There were 30.0 million taxpayers, according to HMRC (http://www.hmrc.gov.uk/stats/income_tax/table2-1.pdf), out of a total 2009 population of 61.8 million (http://www.statistics.gov.uk/downloads/theme_population/NPP2008/NatPopProj2008.pdf) of whom 13.6 million were children as defined for child benefit purposes (http://www.hmrc.gov.uk/stats/child_benefit/chb-geog-aug09.pdf).

people will have a tax-paying spouse or partner, but in any given year around one in four families contains no income tax-payer and so would not benefit from this (or any other) cut in income tax.⁶¹ Many periods of low income are temporary, and so many of those who do not gain in a given year would gain in other years. But these figures are a reminder that income tax cuts are not well targeted to help the poorest in society.

In 2009–10 there were 3.6 million taxpayers with incomes below £10,000, paying a total of £1.1 billion in tax.⁶² Thus around 7% of the money spent increasing the personal allowance would go to those 3.6 million people taken out of tax, who would gain just over £300 per year on average.

Those aged under 65 with incomes between £10,000 and £112,950 would gain £705 each (20% tax would stop applying to £3,525 of income – the difference between the current £6,475 allowance and the new £10,000 allowance).⁶³

From 2010–11, the personal allowance is reduced by £1 for each £2 of income above £100,000, so the current £6,475 allowance is withdrawn completely when income reaches £112,950. A £10,000 allowance would not be fully withdrawn until income reached £120,000, so people with incomes between £112,950 and £120,000 would see some gain from the policy. Those with incomes above £120,000 would be unaffected. The impact of this reform on the income tax and national insurance schedule is shown in Figure 4.3.

Those aged 65 or over currently have a higher personal allowance – £9,490 for those aged 65–74 and £9,640 for those aged 75 or over – and so an increase to £10,000 would mean a much smaller giveaway to them (£102 and £72 respectively). But the additional allowance they currently receive is gradually withdrawn once income exceeds £22,900, so above that income level older taxpayers would gain more, and those with incomes above £28,930 (if aged 65–74) or £29,230 (if aged 75 or older) would gain the full £705. One welcome effect of the reform is the removal of this odd tapering of the higher personal allowance – in effect a band of income in which the marginal tax rate rises from 20 per cent to 30 per cent before falling back to 20 per cent, an opaque design for which it is hard to find a coherent rationale and which unnecessarily complicates the tax system. The distributional effect of increasing the personal allowance is shown in Figure 5.1. As mentioned above, those with the lowest incomes – non-taxpayers – would not gain from this reform. And families with two taxpayers would gain more than families with one taxpayer, who tend to be worse off. Thus, overall, better-off families (although not the very richest) would tend to gain most in cash terms from this reform. But clearly £705 would be less valuable to those on higher incomes than to those on lower incomes: as a percentage of income, the largest gains are around the upper-middle of the income distribution rather than at the top. In isolation, this giveaway could not be described as progressive; but to judge the distributional impact of the Liberal Democrats' package

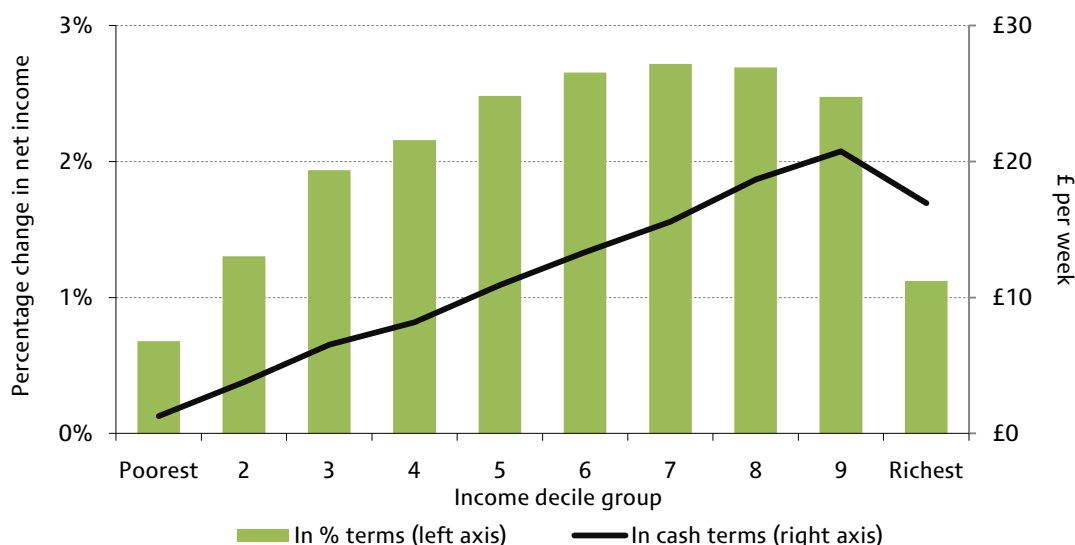
⁶¹ Adam, S. and J. Browne (2009), *A Survey of the UK Tax System*, IFS Briefing Note No. 9 (<http://www.ifs.org.uk/bns/bn09.pdf>).

⁶² Source: HMRC Statistics Table 2.5 (http://www.hmrc.gov.uk/stats/income_tax/table2-5.pdf).

⁶³ A few individuals with some savings income and less than £12,244 of other income will gain more or less than £705 (between £460 and £949). This is because of the continued existence of a 10 per cent tax rate for savings income which, treated as the top slice of income (except dividends), fall into the first £2,440 of taxable income. Some will gain more than £705 because they will become able to take advantage of the 10 per cent rate as well as gaining from the increase in the personal allowance; others will gain less than £705 because part of the income removed from tax by the increase in the personal allowance would be income taxed at 10 per cent rather than 20 per cent. The exact pattern of gains and losses is complicated, depending on the exact combination of savings income and other income received. One minor exception is that individuals whose total income is between £10,000 and £12,440, but whose income excluding savings income is below £10,000, would not gain by the full £705. That is because a 10 per cent tax rate applies to savings income which, treated as the top slice of income (except dividends), fall into the first £2,440 of taxable income. For individuals in this position, part of the income removed from tax by the increase in the personal allowance would be income taxed at 10 per cent rather than 20 per cent, so they would gain less.

as a whole we must also consider who would lose from the tax rises they would introduce to pay for this tax cut.

Figure 5.1. The distributional impact of increasing the income tax personal allowance to £10,000



Notes: As Figure 2.1.

Source: As Figure 2.1.

Increasing the personal allowance to £10,000 does indeed look like it would cost around £16.8 billion (or at most a billion or so more) if people did not change their behaviour in response to the tax cut. In practice, the cost would be reduced as the tax cut would encourage more people to be in paid work and paying taxes.⁶⁴

As well as encouraging people to move into (or stay in) employment, increasing the personal allowance would also strengthen the incentive for those currently earning between £6,475 and £10,000 to increase their earnings – perhaps for low-wage workers to move from part-time to full-time employment, for example. The fact that the effective 60% marginal income tax rate created by the withdrawal of the income tax personal allowance would apply to a wider band of income would reduce the incentive for some high earners to increase their incomes, though the fact that the higher personal allowances for those aged 65 or over would no longer be withdrawn as income rises would increase the incentive for those affected by that to increase their earnings (or not move from full-time to part-time work, for example).

Restricting tax relief on pension contributions to the basic rate

The Liberal Democrats propose that income tax relief on pension contributions be restricted to the basic rate of tax. Rather than simply excluding (employer and employee) pension contributions from taxable income, as happens at the moment, they propose to tax these contributions at 20 per cent for ordinary higher-rate taxpayers and 30 per cent for those subject to the new 50 per cent tax rate. As mentioned in section 2, the Government has already announced that this change will be

⁶⁴ We restrict attention here to the ‘substitution effect’ of the reform on people’s work decisions: the strengthened incentive to work that arises because people get to keep more of what they earn. In fact there would be a second effect going in the opposite direction: an ‘income effect’, whereby the giveaway means that people do not need to work as much to reach their desired standard of living. But all reforms have such income effects, so if the package as a whole is broadly revenue-neutral, what is given to some is taken away from others and income effects are likely to balance out (roughly speaking) across the population as a whole, allowing us to focus only on changes in the reward for working an extra hour (or at all).

introduced for those with the very highest incomes; the Liberal Democrats propose to extend this to all higher-rate taxpayers. They estimate that this extension would raise £5.5 billion in 2011–12, which is highly uncertain but does not seem unduly optimistic overall.

Unlike the reforms proposed by the Government (and accepted by the Conservatives), the Liberal Democrats' proposal does not require defining a new threshold above which to restrict relief and they are not planning to restrict relief gradually as incomes rise. As a result, the Liberal Democrats' proposal avoids some of the complexity of the Government's reform, and also avoids some of the distortions: there would not be a cliff-edge in tax liability when income hit £130,000, for example.

The Liberal Democrats' approach seems more coherent as well. It is hard to see how it could be unfair for those with incomes above £180,000 to receive relief at their marginal income tax rate (as the Government argues) but not unfair for those with incomes of £150,000 to receive relief at 50 per cent and for other higher-rate taxpayers to receive relief at 40 per cent. The Liberal Democrats have the virtue of consistency in arguing that relief should be restricted to the basic rate for everyone, not just some.

Nevertheless, the Liberal Democrats' proposal, like the Government's, is fundamentally misguided. Both the Government and the Liberal Democrats are guilty of proposing reforms to the tax treatment of pension contributions in isolation from the tax treatment of the pension income they finance. Pension contributions are excluded from taxable income precisely because pension income is taxed when it is received: in effect the tax due on earnings paid into a pension is deferred until the money (plus any returns earned in the interim) is withdrawn from the fund. It is hard to see how it can be unfair for higher-rate taxpayers to receive 40 per cent relief when basic-rate taxpayers receive 20 per cent relief, yet at the same time *not* be unfair for higher-rate taxpayers to pay 40 per cent tax on their pension income when basic-rate taxpayers pay only 20 per cent. If somebody is a higher-rate taxpayer throughout their adult life, it seems unfair for the tax relief on their pension contributions to be restricted to 20 per cent and for them then to pay 40 per cent tax on their pension income.

The Liberal Democrats point out that many of those receiving relief at the higher-rate will only pay basic-rate tax in retirement.⁶⁵ Again, this marks out their argument as more coherent than the Government's: the very richest pension savers are much less likely to pay only basic rate tax in retirement. But it is arguable whether it is really unfair for people to receive higher-rate relief and then pay only basic-rate tax: in effect such individuals are simply smoothing their taxable income between high-income and low-income periods, undoing the 'unfairness' that an annually-assessed progressive tax schedule creates by taking more tax from people whose incomes are volatile than from people whose incomes are stable. And even if receiving higher-rate relief and then paying basic-rate tax is seen as unfair, that does not diminish the case for accompanying the restriction of tax relief on contributions with a restriction of the tax relief on pensions (perhaps with transitional arrangements so that those who have received higher-rate relief in the past do not pay only basic-rate tax in retirement). If relatively few individuals pay higher-rate tax on their pension income, that merely suggests that such a policy would be cheap. A policy that treats pension contributions and pension income asymmetrically is indefensible.

Restricting tax relief on pension contributions would clearly reduce incentives to save in a pension. Those who do expect to be higher-rate taxpayers in retirement would find that employee contributions to private pensions received less generous tax treatment than, for example, saving in ISAs or owner-occupied housing; and even those who expect to be basic-rate taxpayers in

⁶⁵ Though the snapshot statistics of the income tax rates facing current pension savers and current retirees they use to illustrate the point are somewhat misleading – those currently contributing may not necessarily face the same tax rates in retirement as current retirees, not least because of ongoing fiscal drag.

retirement, or whose employers make contributions on their behalf (thus escaping NICs on the contributions), will find pension saving much less appealing than it is now. The Liberal Democrats' statement that their reform "is not forecast to result in a reduction in overall levels of contributions since it is anticipated that individuals will still value the basic rate relief on contributions" is patently nonsense. Basic-rate relief is valuable, but it is *less* valuable than higher-rate relief. People do not just make discrete decisions whether to save in a pension on the basis of whether it is worthwhile; they decide whether and how much save in a pension on the basis of *how* worthwhile it is. Removing higher-rate tax relief makes saving in a pension a less attractive option for higher-rate taxpayers, and so many of them will decide to contribute less (or not at all) to a pension as a result. They may save in other ways instead, or they may save less for retirement and spend more during their working lives. Since people are working in part to pay for their retirement, the fact that working an extra hour (or an extra year) would now buy less pension income would also make working less worthwhile.⁶⁶

While the Liberal Democrats' proposal is more coherent than the Government's, it is still unfair and inefficient to restrict tax relief on pension contributions without restricting tax on pension income. And while the Liberal Democrats' proposal is less complex than the Government's, it would still be enormously complicated – particularly in requiring valuation of the pension promises made by employers through defined benefit schemes. Even relatively simple rules of thumb for such valuations are likely still to be complicated, and by being inaccurate would also arbitrarily favour some groups than others and therefore create both inefficiencies (from unjustified distortions) and unfairness (from unintended redistribution). And the Liberal Democrats' proposal would apply to all higher-rate taxpayers contributing to a pension, not just the 300,000 affected by the Government's reform:⁶⁷ while a less bad design than the Government's reform, it would affect many more people. The compliance costs alone of this measure would be so high as to make it an incredibly inefficient way to raise revenue from higher-rate taxpayers. In summary, then, this proposal would be expensive to administer, unfair and inappropriately distort behaviour; there are far better ways to raise money from higher-rate taxpayers, or to reduce the generosity of pensions taxation, or even to do both at once.

Anti-avoidance and anti-evasion measures

The Liberal Democrats propose three measures to counter tax avoidance:

- Charging full (employer and employee) NICs on benefits in kind that are currently subject only to employer NICs, to raise £0.3 billion in 2011–12
- Introducing a 'look-through' rule in stamp duty land tax, to raise £0.7 billion in 2011–12
- Introducing a General Anti-Avoidance Principle, to raise £2.2 billion in 2011–12

They also argue that they could devote more resources to tackling tax evasion in the hidden economy and thereby raise £1.4 billion in 2011–12. We now consider each of these in turn.

At present, some benefits in kind (broadly, those that cannot be sold or traded) are subject to employer NICs but exempt from employee NICs. There is no good reason for these forms of remuneration to receive preferential treatment. It artificially encourages firms to pay their employees in this form, and leads to particularly perverse distortions around the borderlines: for example, if an employer pays for private health insurance taken out by an employee then full

⁶⁶ The fact that working yields less pension income might also have the opposite effect, encouraging people to work more so as to receive the same retirement income. This 'income effect' is the obverse of that mentioned in footnote 64, by which an income tax cut discourages work as people can maintain a given living standard more easily. As noted there, income effects apply to all these reforms so if the package as a whole is revenue-neutral, the income effects will tend to cancel each other out across the population as a whole so we ignore them for our main analysis.

⁶⁷ There are around 3.1million higher-rate taxpayers, the majority of whom will be contributing to a pension.

employer and employee NICs are due, but if the employer takes out the insurance policy on the employee's behalf then only employer NICs are due. Whether this really constitutes 'tax avoidance' is not clear: these benefits in kind openly receive preferential treatment, and remunerating people in this form hardly seems like a cunning wheeze to bamboozle the taxman. But in any case removing this anomaly, as the Liberal Democrats propose, would be very welcome.

At present, stamp duty land tax can be avoided by having a special purpose vehicle (SPV) own the property and then selling the SPV rather than selling the property itself. The Liberal Democrats want to prevent this by 'looking through' the formal structure of the transaction and levying full stamp duty land tax whenever the underlying ownership is in the UK. If this could be implemented in practice – which we are not qualified to judge – it could raise a significant sum, though we have no way of knowing whether the Liberal Democrats' guess at the likely yield is right.

A general anti-avoidance principle (GAAP) is intended to help prevent behaviour that reduces tax liabilities through transactions that satisfy the letter of the law but are said to violate the spirit of the law in some way. In the past, concerns have been raised that a GAAP would be inherently vague and would potentially create uncertainty for taxpayers, and therefore that a resource-intensive 'pre-clearance' mechanism would be required whereby taxpayers could check in advance with HMRC whether particular arrangements would fall foul of the GAAP. The Liberal Democrats' response to these concerns is to propose that 'pre-clearance' be provided by a new branch of HMRC which would charge commercial rates for such advice. This is a reasonable solution, but note that in effect it simply shifts the cost of pre-clearance from HMRC to the taxpayer.

The effects and effectiveness of a GAAP would depend a great deal on exactly how it was worded and on how the courts interpreted it. International experience has been varied in these respects. It is not a panacea and is unlikely to remove the need for more specific anti-avoidance legislation, but it could potentially raise some revenue.⁶⁸ To estimate how much a GAAP would yield, the Liberal Democrats have taken the Government's estimates of how much it loses from both 'avoidance' and differences in 'legal interpretation', and simply guessed what fraction of this total a GAAP would deliver: 20% for income tax, NICs and capital gains tax, and 25% for corporation tax. Yet a GAAP of the kind they describe would do little to address differences in 'legal interpretation'.⁶⁹ To raise £2.2 billion, therefore, the fractions of 'avoidance' alone that a GAAP would need to eliminate are much larger than the 20% and 25% that Liberal Democrats assume. Since these percentages are arbitrary guesses in any case (and we have no better way of estimating the yield), it is possible that larger percentages would turn out to be accurate. But relying on bringing in £2.2 billion is clearly less cautious than the 20% and 25% numbers might suggest. In recent years the Government has already been putting strenuous efforts into tackling tax avoidance, including not only rafts of specific anti-avoidance rules but also a general requirement that innovative avoidance schemes be reported to HMRC so that the Government can (if it wants) legislate against them.

⁶⁸ See Bowler, T. (2009), *Countering tax avoidance in the UK: which way forward?*, IFS Tax Law Review Committee Discussion Paper No. 7 (<http://www.ifs.org.uk/comms/dp7.pdf>) for an analysis of the impact a GAAP might have had on tax avoidance had the current Government introduced one following consultation in 1998.

⁶⁹ The HMRC document from which the Liberal Democrats take their estimate of the tax gap (<http://www.hmrc.gov.uk/pbr2009/protect-tax-revenue-5450.pdf>) describes the difference between 'avoidance' and 'differences in legal interpretation'. Avoidance, according to HMRC, is "the use of schemes or arrangements that seem to HMRC to have been implemented primarily in order to deliver a tax advantage"; by contrast, "Legal interpretation relates to the potential tax loss from cases where HMRC and customers have different views of how, or whether, the law applies to specific and often complex transactions. Examples include the correct categorisation of an asset for allowances, the allocation of profits within a group of companies, or VAT liability of a particular item. In these situations the customer will have an alternative view of the law and of how it applies to the facts in their case to that held by HMRC." A GAAP as normally envisaged would address avoidance but not differences in legal interpretation, on these definitions; and indeed it is notable that the stated aim of the Lib Dems' GAAP is to target transactions "constructed in such a way that the sole or main purpose, or one of the main purposes, is to reduce or eliminate tax liability" – a phrase that is almost indistinguishable from the above definition of 'avoidance' rather than 'legal interpretation'.

Raising £1.4 billion from tackling tax evasion in the hidden economy looks doubtful, because it is not clear where the extra resources for this crusade would come from. The Liberal Democrats argue that their other reforms would simplify the tax system and therefore free up HMRC resources; and that further resources would be generated by the new commercial arm of HMRC described above. But it is not clear that their other reforms would reduce the cost of administering the tax system: there would be fewer income tax payers, but more capital gains tax payers; and it is far from clear that the pensions tax reform would reduce the demands on HMRC as the Liberal Democrats suggest. And the proposed new commercial arm of HMRC has to meet the costs of a pre-clearance mechanism before having anything left over to spend tackling evasion. To assume that a combination of profitable pre-clearance activities and 'simplification' would generate enough spare resources to stop £1.4 billion of evasion seems optimistic. Given the manifold uncertainties, and the doubts over some specific aspects, an overall revenue figure of £4.6 billion from these measures looks highly speculative. The Liberal Democrats acknowledge this uncertainty and describe their £4.6 billion figure as a 'target', but they are relying on the revenue to fund their income tax cut.

Reforming aviation taxation

Air passenger duty is charged per passenger at one of eight flat rates depending on (banded) distance travelled and whether the passenger is flying economy or club/first class. The Liberal Democrats propose to replace this with a per-plane tax (rather than a per-passenger tax, so freight flights would be brought into tax and relatively empty passenger flights would be taxed more) which would be based on factors more closely related to emissions than are distance band and class. The rates of this per-plane tax would be chosen to yield £3.1 billion more than the current air passenger duty. They also propose to introduce a supplement to the tax for some domestic flights, which would be set so as to yield £255 million. Moving to a per-plane tax seems broadly sensible on environmental grounds; the proposal is discussed more fully in another note in this series.⁷⁰ Clearly bringing in £3.3 billion more revenue in total could be achieved since the Liberal Democrats propose to set the rates as high as is necessary to do so.

A bank tax

The Liberal Democrats propose to introduce an additional 10% tax on the profits of UK banks (with no offset for losses). This tax would remain in place until a fundamental reform of banking regulation could be implemented to separate 'utility' from 'casino' banking. The Liberal Democrats estimate that this tax would raise £2.2 billion in 2011–12.

Taxing bank profits to recognise state support that has been (and continues to be) provided is a broadly defensible argument. Unlike the Labour and Conservative proposals, it would bear little relationship to the IMF's proposed 'financial stability contribution', which is more explicitly designed to capture risk considerations. It bears more relationship to the IMF's proposed 'financial activities tax', which has broader objectives, though basing it on profits rather than the sum of profits and remuneration is a fundamental difference, as is the fact that the Liberal Democrats propose this as a purely temporary measure pending regulatory reform. For this tax, unlike for corporation tax, the Liberal Democrats would not allow losses to be offset against profits in other years, so banks could not get a rebate for the losses they suffered during the financial crisis which may have reflected excessive risk-taking on their part.

This tax would of course make the UK a less attractive location to conduct profitable banking business, especially since the Liberal Democrats (like the Conservatives, but unlike Labour) do not

⁷⁰ "Environmental Policy Proposals" by Paul Johnson and Peter Levell.

insist on international agreement as a precondition for imposing the tax. Revenue can be extracted from taxing banks' profits: the fact that banks paid substantial corporation tax in the past (non-life financial companies – not exclusively banks – contributed about a quarter of corporation tax receipts in the years before the crisis, though the longer-term average was more like a fifth) suggests that it would not be simple for them to relocate their activities or otherwise avoid paying this extra tax. There would nevertheless be some behavioural response, but it is not easy to judge whether the 20% loss of revenue the Liberal Democrats have allowed for as a result would prove accurate. It is also difficult to predict what will happen to banks' profits in the coming years, and together these two unknowns make it very difficult to forecast the likely revenue from the tax. The Liberal Democrats' estimate of £2.2 billion does not seem unduly optimistic, but once again the margin of uncertainty is large.

Reforms to capital gains tax

The Liberal Democrats propose to make three fundamental changes to capital gains tax:

- Reducing the capital gains tax allowance from £10,100 to £1,000
- Taxing capital gains above this at marginal income tax rates instead of the current flat 18 per cent rate (though entrepreneur's relief would continue to apply a reduced rate to certain gains)
- Re-introducing indexation for inflation

These reforms to capital gains tax would probably raise more than the £1.9 billion the Liberal Democrats suggest (in 2011–12).

The latter two changes would, as the Liberal Democrats say, "in effect re-introduce the tax system for capital gains that was designed by Nigel Lawson under Margaret Thatcher." Labour replaced this system with a poorly designed system of 'taper relief' in 1998, only to replace that in turn with a flat 18% rate (and an 'entrepreneur's relief' bolted on in response to howls of protest) in 2008. The Liberal Democrats want to return to the pre-1998 system, though they would keep entrepreneur's relief (the pre-1998 system had retirement relief, which was somewhat different) and the low allowance is a new feature.

The Liberal Democrats claim that "those on very low incomes who make capital gains will still not have to pay tax due to our proposed £10,000 personal allowance". This was not in fact true under the pre-1998 regime: it has never been possible to use unused income tax allowances to reduce CGT liability. And since the Liberal Democrats say they are returning to the pre-1998 regime, and do not specify that they would introduce this new feature, we must assume that it would not in fact be true under their proposals either. It would be possible – probably desirable – to introduce this provision, but it has never been in place before, and it would reduce the yield of the tax – though the reduction would be small since relatively few CGT payers tax have too little income to pay tax and the amount at stake for each is relatively small.

Aligning CGT rates with income tax rates is, in itself, an excellent idea. Capital gains are essentially just another form of income: there is no strong reason for taxing them less heavily, and doing so provides a big incentive to convert income into capital gains (especially for the richest, now that a 50% rate of income tax has been introduced). However, our broad support for this alignment comes with three qualifications.

- First, fully aligning CGT with income tax would require giving relief for gains on shares to reflect corporation tax already paid, mirroring the dividend tax credit in income tax. The fact that the Liberal Democrats do not propose this means that the reform would actually 'overshoot' equal treatment: in some cases, capital gains would be taxed more heavily than income, instead of less heavily as at present. In respect of higher-rate taxpayers in

- particular, it would replace the current artificial incentive for companies to retaining profits to increase the value of the company (rather than paying them out in dividends) with an artificial incentive not to retain profits in the company – except where gains would qualify for entrepreneur's relief.
- Second, keeping entrepreneur's relief forgoes a large part of the benefit of alignment. Entrepreneur's relief applies a reduced tax rate of 10 per cent (strictly, 10/18 of the standard rate) to the first £2 million of lifetime gains on businesses (or substantial shareholdings in businesses) for which the seller worked. This reduced rate creates the biggest differential between tax rates on capital gains and ordinary income, and those benefiting from entrepreneur's relief – owner-managers of businesses – are more able than almost any other group to take advantage of differential tax rates, simply by retaining profits in the business rather than taking more in salary or dividends. It is not clear whether the Liberal Democrats would keep entrepreneur's relief as a flat 10 per cent rate or as 10/18 of the rate people would otherwise face. 10/18 would be less bad: keeping a flat 10 per cent rate would mean an even wider differential than exists now, since entrepreneur's relief would now be operating in conjunction with an indexation allowance. But even charging 10/18 of people's marginal rate would mean a big differential between tax rates on qualifying gains and on ordinary income. Furthermore, keeping entrepreneur's relief for some gains while the tax rate on other gains increased to marginal income tax rates would also put immense pressure on the distinction between business assets (on which gains would be taxed at the reduced rate) and non-business assets (on which gains would, like ordinary income, be taxed at rates of up to 50%).
 - World, increasing capital gains tax rates would reduce incentives for saving and investment. The Liberal Democrats rightly point out that such activities could be encouraged more effectively in other ways, but they do not in fact propose to use any of the revenue generated for such purposes.

Re-introducing indexation for inflation is probably sensible: it would add some complexity to the system, and make the treatment of capital gains different from ordinary savings income (bank interest, for example, is taxed in full rather than taxed only in so far as it exceeds inflation), but fundamentally there is no good rationale for imposing a hefty tax bill even where no real gain has been made, or for discouraging saving and investment more when inflation is higher, as the current system does.

The reintroduction of indexation would mean that some people would actually gain from this reform: as mentioned above, those qualifying for entrepreneur's relief would receive even more generous treatment, while many basic-rate taxpayers selling other assets that have risen in value over a long period will see the rise in their tax rate from 18% to 20% outweighed by the introduction of an allowance for inflation. The main losers would be those making only small capital gains, for whom the reduction in the allowance would dominate other considerations, and higher-rate taxpayers not qualifying for entrepreneur's relief, for whom the rise in their tax rate rise from 18% to 40% or 50% would usually outweigh the benefits of an indexation allowance.

A 'mansion tax'

The Liberal Democrats propose to introduce an annual 1% tax on domestic property values above £2 million, so that a £5 million property would attract a tax bill of £30,000 a year (1% of £3 million). They estimate that about 70,000 properties (barely 1 in 400 domestic properties), worth an average of £4.4 million each, would attract tax bills averaging £24,000 a year, yielding £1.7 billion in total.

These are huge tax increases on affected properties, and would significantly reduce the value of the properties, which might lose up to 20% of the portion of their value above £2m if it were believed

that the tax would remain in place permanently. For example, a property worth £3 million before the reform might lose up to £200,000 in value while a property worth £10 million before the reform might lose up to £1.6 million in value.⁷¹

Although the £1.7 billion estimated yield does not look unduly optimistic, there is considerable uncertainty as to exactly how much the reform would yield. There are simply no current data on the distribution of UK property values – the last time all domestic properties were valued was in 1993, based on estimated 1991 values, for council tax – which is still based on those 19-year-old values. Indeed, introducing a mansion tax would entail some additional administrative cost in estimating the value of those properties that it is thought might be worth more than £2 million. The Liberal Democrats propose to limit the cost by valuing only properties in the highest council tax band – about 144,000 out of some 26.4 million properties in Britain – meaning that any properties in lower bands that are nevertheless worth more than £2 million would escape the tax. Since such properties would have to have risen in value by at least twice the national average since 1991 to be worth more than £2 million now, this seems unlikely to exclude many properties that ought to fall within the tax.

The Liberal Democrats propose to allow anyone affected by the new tax to defer payment for up to two years, and until sale of the property if the owner is aged over 65 (and does not have a mortgage worth more than half of the property value). They say that any deferral would be “index-linked”. If deferral were with interest, then it would have no cost to the Government in present value terms (assuming eventual payment could be relied upon) and would, as the Liberal Democrats suggest, “help people who fall into temporary financial difficulties” – although how many owners of £2 million properties can really be described as in “financial difficulties” must be open to question. But if “index-linked” means (as it normally does) that payments would be deferred with only an inflation adjustment, then everyone affected would (at least in periods when real interest rates are positive) have an incentive to defer payment for as long as possible to earn interest on the money in the interim, and this deferral would entail a cost to the Exchequer in present-value terms since the Government would correspondingly be paying interest on its higher borrowing while awaiting payment. Allowing deferral also complicates the tax somewhat, and must raise some concerns as to whether the deferred tax bill would ever actually be paid.

Notwithstanding these concerns on detail, the mansion tax is fundamentally well designed: if property is to be taxed, it makes sense to levy such a tax in proportion to property value and to base it on up-to-date valuations – neither of which council tax does, with the result that high-value properties are under-taxed relative to lower-value properties, making council tax regressive, and that properties that have risen most in value since 1991 are even more under-taxed.

To some extent a mansion tax would reduce the incentive to build mansions, though the main constraint on development overall is planning restrictions rather than financial incentives. It would induce developers to build smaller properties (two smaller houses rather than one mansion, for example) and potentially even to divide up existing mansions; but since mansions are taxed at a lower percentage of value than other properties under council tax, this is really redressing an existing tax bias towards larger properties rather than introducing a new tax bias towards smaller properties.

But although the mansion tax itself is well designed, it is hard to discern a consistent view in the Liberal Democrats' approach to the taxation of housing. They argue for a tax proportionate to up-to-date values – but they propose it only for mansions, not for all properties. They then propose to

⁷¹ Calculations assume a 5 per cent discount rate. The falls in value cited assume the number of mansions is unchanged; if the number of mansions were reduced in response to the reform (a possibility discussed below), those that remained would fall less in value; but we doubt that the number of mansions would fall by very much in practice.

pilot (with a view to, but not a commitment to, fully introducing) a local income tax to replace council tax, suggesting that they do not think housing should be taxed at all: it is not clear whether they think a mansion tax should survive once council tax was abolished. And they have in the past said a long-term goal should be to tax land values (as they propose to do in their first term for business property – see next sub-section).⁷² Thus they propose a sensible reform to housing taxation, but only for the highest-value properties; and then potentially in the longer-term a move from one form of property taxation (council tax) to another (land value tax) via a system that abolished housing taxation altogether (local income tax). This does not smack of a coherent underlying philosophy.

Reforming business rates

The Liberal Democrats propose to reform business rates in three ways.

- basing them on land value, rather than the rental value of the property as at present
- returning control over their level to local authorities (which had set rates until 1990)
- automating small business relief

They are not intending to raise or spend money in this way, although obviously once rates were under local control, councils could choose to set rates higher or lower than their current level.

Reforming business rates to be based on land value rather than the rental value of the whole property (land plus buildings) is highly desirable. Business rates violate a basic economic principle by taxing a produced (or intermediate) input to production, with the effect that economic activity in the UK is artificially skewed away from property-intensive production. A land value tax – long favoured by economists – would not do this. The disincentive to develop and use property would be removed since the tax would not depend on the value of the buildings.⁷³ Moving business rates to a land-value basis would involve redistribution: owners of highly developed properties would gain while owners of less developed land would lose. But insofar as the value of property is largely determined by the value of the land on which it stands, this redistribution would not be large; and if the reform is revenue-neutral, the gains would be as large as the losses.

Although attractive in principle, one practical difficulty with a land value tax is the need to value land separately from the buildings on it. In many areas land is rarely sold separately from the buildings, so establishing an accurate market price would be difficult. But it may not be impossible; and note that while using inaccurate valuations may be unfair, it would not compromise the economic efficiency of the tax. At the very least, given the potential economic gains from the reform, a serious attempt at replacing business rates with a land value tax would be most welcome.

The case for returning (reformed) business rates to local control – as before 1990 – is less strong. If one wished to give local authorities more tax-setting powers, relocalising business rates has considerable attractions: property is immobile, and land even more so: unlike (say) income, it cannot be moved to a different area in response to differential tax rates. But business rates also have disadvantages as a local tax. Those made worse off by it may not live and vote in the local authority setting their tax rate, which raises issues of accountability: taxation without representation. Returning business rates to local control would presumably also mean repealing

⁷² See Liberal Democrats (2006), “Fairer, Simpler, Greener”, Policy Paper 75,

⁷³ A tax on the value of business land would not eliminate all incentive problems. Since it applied to business land only, the tax – like business rates at present – might affect the incentive to apply for land to be designated for business use (rather than residential or agricultural, say). But note that since land used for residential purposes falls within council tax, distortions would only arise in so far as the implicit taxation of land was different between council tax and the reformed business rate. And in any case such incentives are only a problem to the extent that land designations respond to tax incentives. Insofar as the amount of land available for business use is fixed by planning restrictions and would not change in response to changes in demand – which may be close to the truth, if not completely true – then a tax on the value of business land would be entirely non-distortionary.

the law that limits annual increases to the rate of inflation; it would therefore add unwelcome uncertainty for businesses, which is not conducive to investment.

We have little to say about the proposal to automate small business relief. If it could be implemented straightforwardly, it would seem to have obvious merits, but we have no expertise in those practicalities.

Allowing local authorities to charge a higher rate of council tax on second homes

At present second homes qualify for a council tax discount of at least 10%, with local authorities having the discretion to offer further discounts if they wish. The Liberal Democrats would give local authorities additional powers to charge more than the standard rate of council tax.

It is not clear why second homes should qualify for discounts, nor why local authorities should have the power to reduce the rate but not to increase the rate. But allowing local authorities to increase the rate might again raise concerns over accountability: as with relocating business rates, those paying the tax may not be able to vote for those setting the tax rate.

Equalising the VAT treatment of property repairs and new build

At present, there is zero VAT on the construction and sale of new housing; but repairs are subject to the full 17.5% rate. The Liberal Democrats propose to equalise the treatment of new build and repairs, introducing VAT on new build and reducing it on repairs so that they meet at whatever reduced rate would make the reform revenue-neutral overall (which neither they nor we have estimated).

The current differential treatment is a distortion that it would be sensible to remove. It seems perverse to provide an incentive, as the current system does, to build new properties rather than redevelop or refurbish existing (perhaps derelict) sites. Imposing some VAT on new build would provide a disincentive to construct new homes – encouraging over-use of existing properties instead – but this would be offset by an increased incentive to renovate existing properties, and in any case a government concerned that the reform would lead to too little construction could always choose to counterbalance the effect of introducing VAT by relaxing planning restrictions, which are the main constraint on new development.

Although removing the distortion between construction and repair would be sensible, reducing the tax rate on repairs would create a new, awkward boundary in defining and policing what constitutes a 'repair'. Trying to distinguish between repairs to be taxed at the reduced rate and improvements to be taxed at the standard rate is the kind of nightmare that bedevils VAT administration in too many areas already. Would a paint job count as a repair if the old paint was peeling but not if the purchaser just wanted a change of colour, and how would HMRC know? Nevertheless, the creation of yet another horrible borderline in VAT would probably be a price worth paying for removing a fundamental distortion in the property market.

Reforms to Gift Aid

£4.3 billion of gross donations were made through Gift Aid in 2008–09 (out of total donations estimated to be of £10 billion), costing £1.13 billion in tax relief. Under the current system of tax relief, donations (made out of after-tax income) attract income tax relief at the taxpayer's marginal rate, with basic-rate relief being paid to the charity and higher-rate taxpayers able to reclaim their extra relief through income tax Self-Assessment or their PAYE code. In fact, for a transitional period until the end of 2010–11, charities can reclaim 22 per cent relief rather than the 20 per cent basic rate, to prevent them losing in this period from the reduction of the basic rate from 22 per cent to 20 per cent announced in Budget 2007. The Liberal Democrats propose to replace this system of relief at the taxpayer's marginal rate with a flat rate of 23 per cent relief for all taxpayers, paid to

the charity. The proposal would mean that the relief that charities can reclaim would increase from the 22 per cent transitional rate to a permanent 23 per cent rate instead of falling to 20 per cent as currently scheduled, and that higher-rate taxpayers would lose the right to reclaim additional relief. The intention is that this change would be revenue-neutral, with the rise in relief from 20 per cent to 23 per cent for basic rate taxpayers offset by the reduction of relief to this level for higher-rate taxpayers; if it proved not to be revenue-neutral, the Liberal Democrats say they would adjust the 23 per cent rate until it was.

The possible effects of this reform are discussed further in Box 5.1.

Box 5.1. The likely impact of the Liberal Democrats' proposed reforms to Gift Aid

Sarah Smith, Institute for Fiscal Studies and CMPO, University of Bristol

The withdrawal of higher-rate tax relief for Gift Aid donations would be likely to trigger a reduction in donations out of after-tax income among higher-rate donors who currently reclaim the rebate. Although the charities would receive more for each pound of nominal donation, our recent research,⁷⁴ which compared the effect of possible changes to Gift Aid with the current system (without transitional relief), suggests that the overall effect is likely to be a reduction in total money received by charities from this group. However, the potential adverse effect would be lessened by the fact that many donors would be likely to keep their donations out of after-tax income unchanged. In our research, nearly three out of four donors indicated that these would not change in response to the introduction of a 23 per cent flat rate. In this case, the cost of the policy reform would be borne by the higher-rate taxpayer (who would lose the rebate) rather than the charity (which would keep the donation and also reclaim more tax relief).

In any case, not all higher-rate taxpayers currently reclaim the extra tax relief to which they are entitled. Our research estimated that only 35 per cent of higher-rate donors giving through Gift Aid actually reclaim the higher-rate relief, although reclaimers are estimated to account for nearly 80 per cent of the value of donations from higher-rate donors. The reform would tend to increase the amount of money going to charities from higher-rate taxpayers who do not reclaim and from basic-rate taxpayers, who are the majority of donors. Donations from both these two groups would attract more tax relief for the charity.

Taking these effects into account, the overall impact of a 23 per cent flat rate is likely to be a small increase (around 2 per cent) in total donations received by charities, including the value of tax relief. Within the charitable sector, there are likely to be winners and losers. Charities that rely heavily on a small number of donations from major donors who are more sensitive to the withdrawal of the rebate are likely to see their incomes fall. Those with donations from basic-rate taxpayers would be the winners.

Abolishing non-domiciled status for tax purposes after seven years of residence

As explained in Section 2, non-doms who have lived in the UK for more than seven years can choose either to be taxed on their worldwide income, like other UK residents, or to pay £30,000 for the privilege of tax exemption on any foreign income they do not bring into the UK. The Liberal Democrats propose to withdraw the option of paying £30,000 to have unremitted foreign income untaxed – in effect abolishing non-domiciled status after seven years of residence. Unlike the Conservatives, they do not propose any additional taxation of non-doms who have lived here for less than seven years.

⁷⁴ Kimberley Scharf and Sarah Smith (2009) "Gift Aid donor reform: Exploring options for reforming higher-rate relief", www.hm-treasury.gov.uk/d/gift_aid_reseach_report_091208.pdf

If nobody changed their behaviour, the Liberal Democrats' proposal would raise revenue: those who currently choose to pay the £30,000 (4,200 individuals is HMRC's initial estimate for the first year of the new system) presumably do so because they pay less tax than they would if they were taxed in full on their worldwide income instead.

However, the Liberal Democrats would have to address the reasons why non-domiciled tax status has survived so far and neither Labour nor the Conservatives have proposed removing it. First, unremitted foreign income would be difficult for the government to identify and verify, making tax evasion a potential problem (this is also be a problem for UK-domiciled individuals, but perhaps to a lesser degree). Second, non-doms are likely to be more internationally mobile than others, leading to a potential revenue loss if they leave the UK (or do not come in the first place) in response to this tax rise. If these individuals were sufficiently mobile, it is possible that more would be lost from those who left (or did not come) than would be raised from those who stayed (or came anyway). We have no way of knowing whether this would be the case in practice, though presumably those who have been living in the UK for seven years are less footloose than those who have been here less long.

Overall, therefore, we have little idea how much this reform would raise or cost. The Liberal Democrats do not count on it to deliver any extra revenue, but nor do they allow for the possibility that it would cost money overall.

Reducing fuel duties in remote rural areas and increasing them in the rest of the UK

The Liberal Democrats propose to introduce a reduced rate of fuel duties in (as yet unspecified) remote rural areas of the UK, paid for by increasing the rate of fuel duties in the rest of the country. Clearly the two rates could be set so as to make the policy revenue-neutral overall; the likely effects and merits of the proposal are briefly discussed in another note in this series.⁷⁵

Benefit and tax credit proposals

Linking the state pension to earnings in 2011

The Liberal Democrats propose to re-link the state pension with earnings from April 2011, one year earlier than the Government (and the Conservatives). The government estimates that this would cost £0.3 billion a year.⁷⁶

Withdrawing the 'family element' of child tax credit immediately after the 'child element'

The Liberal Democrats propose two reforms to the tax credit system. First, they propose that the family element of the child tax credit (worth £545 per family, or £1,090 if the family contains a child aged under 1) be tapered immediately after the child element has been completely withdrawn (it is currently available in full until a family's income reaches £50,000). This means that a family with one non-disabled child (aged 3 or over) would no longer be entitled to tax credits if their income exceeded about £25,000, with each additional child increasing the point at which entitlement ends by about £6,000. Families with incomes between this point and the existing family element threshold would be worse off; poorer families who are entitled to the child element would be unaffected, as would families with incomes over about £58,000, who are not entitled to any tax credits under the present system. Contrary to some claims, this policy would not increase child

⁷⁵ "Environmental Policy Proposals" by Paul Johnson and Peter Levell.

⁷⁶ See Hansard, 13 Jan 2010, Column WA161. The cost of £0.3 billion is consistent with real earnings growth of about 1%. An earlier (2006) estimate that this reform would cost £0.7 billion appears to have been based on a rather higher estimate of real earnings growth.

poverty, as the income at which the family element would be tapered away is well above the poverty line.⁷⁷ A few families would see their marginal effective tax rate (METR) increase from 32% (the combined rate for income tax and employee NICs) to 71% (the combined rate of income tax, employee NI tax credit withdrawal), but families with an income between £50,000 and about £58,000 would see their METR fall from 49% to 42%.⁷⁸

IFS researchers have recently estimated that this policy would save around £0.9 billion a year. The Liberal Democrats have said that this would save £1.3 billion a year. It is not clear what their source is for this, but an earlier estimate by IFS researchers estimated that the measure would save £1.3 billion, under the assumption that all families with children claimed the child tax credit to which they were entitled; as some do not, this estimate therefore overstates the likely savings.⁷⁹

Moving tax credits to 6-month fixed awards

The second proposal is to move tax credits to a system of fixed 6-monthly awards, rather than adjusting payments on a regular basis as income and circumstances change. The advantages of such a system are that families will never have to face an under- or over-payment and that it should be considerably easier for families to work out what their awards might be if they moved into work. The disadvantage of such a system is that awards would necessarily be based on past, rather than current, circumstances. The key question is whether this slight loss of precision in the targeting of tax credit awards is a price worth paying for greater certainty and transparency. In past work, IFS researchers argued that it almost certainly would be.⁸⁰

The Liberal Democrats do not say what impact this change might have on spending on tax credits. In principle, a system of tax credits in which awards depend on past circumstances should give very similar level of entitlements, on average, as one in which awards depend on current circumstances, but there are good reasons to think the proposed change will reduce tax credit spending. First, the current system is asymmetric (and works in the favour of the tax credit recipient), because the first £25,000 of income rise in any year is ignored for the purpose of calculating entitlements, but any falls in income are counted in full; this asymmetry (and its resulting cost) would not be present under a system of backward-looking, fixed awards. Second, some over-payments of tax credits are currently written-off, a cost to government which could not occur under a system of fixed, backward-looking, awards which would not have over-payments. But it is not possible to us to estimate by how much spending on tax credits would fall, nor which tax credit recipients would be affected.

Ending government contributions to child trust funds

The Liberal Democrats propose to end all Government contributions to child trust funds (tax-free accounts accessible when a child turns 18), saving about £0.5 billion per year. This would affect all children aged under seven, with those from poorer families affected most because they currently receive larger contributions from the Government. The arguments over whether this is a sensible cut to make are similar to those for the Conservative policy (discussed in Section 4), but the Liberal

⁷⁷ Alistair Darling claimed that the similar Conservative Party policy to withdraw the family element from £40,000 as opposed to £50,000 could have a negative impact on progress towards reducing child poverty.

⁷⁸ These METR figures exclude employer NICs and indirect taxes, but these would not be changed by the reform in any case.

⁷⁹ See footnote 83 in chapter 7 of R. Chote, C. Emmerson and J. Shaw (eds) *The IFS Green Budget: February 2010*

⁸⁰ M. Brewer, E. Saez and A. Shephard, 'Means-testing and tax rates on earnings', in J. Mirrlees, S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles and J. Poterba (eds), *Dimensions of Tax Design: The Mirrlees Review*, Oxford University Press for Institute for Fiscal Studies, Oxford, forthcoming; draft available at http://www.ifs.org.uk/mirrleesreview/press_docs/rates.pdf.

Democrats also propose to withdraw the payments from children in lower-income families, for whom credit constraints at age 18 may be more of an issue. But it is far from clear whether payments into a child trust fund at young ages are really the best way for the government to alleviate credit constraints at age 18 (as opposed to extending student loans, for example).

Reforming the winter fuel payment

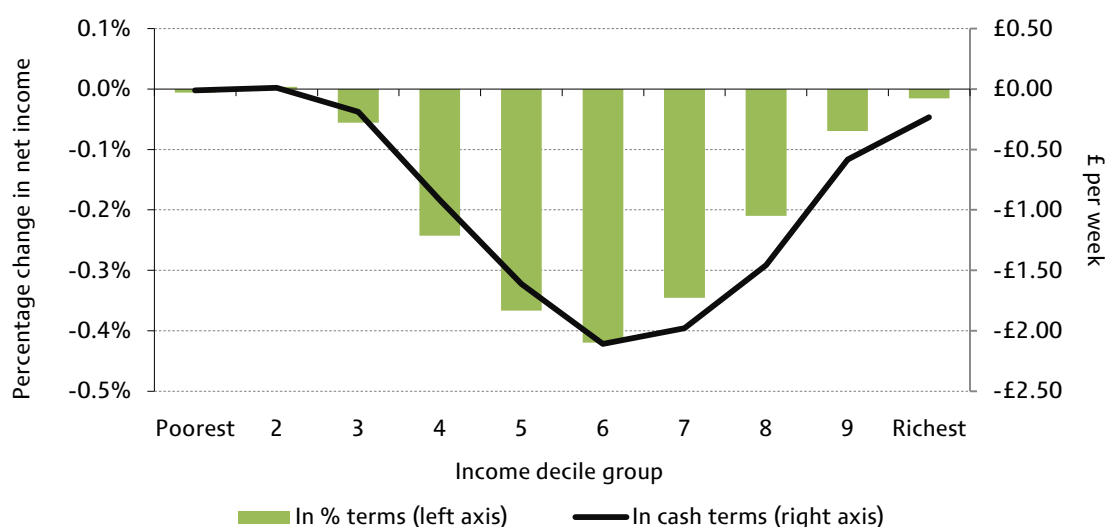
The Liberal Democrats propose to remove entitlement to winter fuel payments from households where the oldest person is aged 60 to 64 unless they are also currently claiming the pension credit guarantee (i.e. existing pension credit claimants would be 'protected'). This would save about £0.3 billion per year in the short run, but by 2020 it will involve no savings as the Government already plans to increase the age of eligibility for winter fuel payments from 60 to 65 in line with the increase in the state pension age for women. There is no obvious reason to make winter fuel payments means-tested for existing pension credit claimants aged 60 to 64, but unavailable to new claimants aged 60 to 64, and not means-tested for those aged 65 or over. Restricting eligibility to pension credit guarantee recipients at all ages would save a more substantial £0.9 billion a year. However, this would be an additional disincentive to save for retirement, particularly for those who expect to have an income in retirement close to the point at which entitlement to the pension credit guarantee runs out.

The Liberal Democrats also propose to extend winter fuel payments to families claiming the highest rate of the mobility element of disability living allowance (DLA), and to families with a child aged under 5 claiming the highest rate of either the mobility or care element of DLA. But the connection between receipt of different elements of DLA and fuel needs in winter is far from clear or why annual lump-sum payments is the best way to help these groups. If the Liberal Democrats want to provide more support for these benefit recipients, it would be simpler just to increase the relevant rates of DLA itself.

Figure 2.5 shows the combined distributional impact of the proposals to increase the state pension, withdraw the family element of child tax credit straight after the child element, and reform winter fuel payments.⁸¹ The change to fixed awards in tax credits and the ending of government contributions to child trust funds are excluded as their distributional impact is unclear. The reforms modelled have little impact on average at the extremes of the income distribution, but involve modest losses, on average, for families in the upper-middle of the income distribution. Increasing the basic state pension helps most pensioners (although not those receiving pension credit, who are the poorest), and cutting winter fuel payments hurts most families in the relevant age bracket. But the picture is dominated by the cut in child tax credit, which hurts the richer half of families with children (those with incomes too high to receive the child element) but not the richest tenth (those with incomes already too high to receive the family element).

⁸¹ The change to winter fuel payments shown is the first-year impact, including the maximum effect of bringing forward the increase in the age requirement.

Figure 5.2 The distributional impact of benefit and tax credit changes proposed by the Liberal Democrats



Notes: As Figure 2.1.

Source: As Figure 2.1.

The National Minimum Wage

The Liberal Democrats plan to set the minimum wage at the same level for all workers aged 16 and over. Currently, there is a lower rate for 16- and 17-year-olds, a 'middle' rate for 18- to 21-year-olds and a higher rate for those aged 22 and over. See Brewer, M., and Joyce, R. "Welfare reform and the minimum wage", IFS Briefing Notes 95 for more details.

Summary: the Liberal Democrats' proposals

The Liberal Democrats are proposing radical reforms to the tax system, with large gross giveaways and large gross takeaways adding up on their own figures to a modest net tax increase and a modest net benefit cut on top of those already in the pipeline from Labour.

We can be pretty confident that the Liberal Democrats' headline giveaway – increasing the income tax allowance to £10,000 – would cost roughly what they claim. Whether their revenue raising measures would yield what they expect is much more uncertain – but we cannot even say with confidence whether they are more likely to raise too much revenue or too little. On the one hand, their estimates of the revenue to be raised from tackling avoidance and evasion seem optimistic; while, on the other hand, their estimates of the revenue to be raised from the rest of the package if anything look slightly pessimistic. In any event, it is notable that the Liberal Democrats are attempting to add to the fiscal tightening implied by Labour's preannounced tax and benefit measures rather than subtracting from it as the Conservatives are.

Many parts of the Liberal Democrats' tax package display a welcome tendency to reduce distortions and ensuring neutrality in the tax system. Equalising tax rates on income and (some) capital gains, property repairs and new build, benefits in kind and other remuneration, are all moves in the right direction. Replacing air passenger duty with a per-plane tax also looks sensible on environmental grounds. We would quibble with the details of some of their proposals, but the only major one that strikes us as thoroughly misconceived is the proposed reform to pension taxation, which would extend a reform almost as undesirable as that being introduced by Labour to many more people

The Liberal Democrats also propose a genuinely radical decentralisation of tax-raising powers. Taking their pledge to implement the Calman Commission proposals in full, along with their proposals to relocalise business rates and to give local authorities the power to tax second homes more, they would reduce the extent to which tax rates are set in Westminster.

Broadly speaking, the Liberal Democrat package would redistribute from the well-off to middle-income families – augmenting the progressive pattern of Labour's pre-announced measures but doing little for the poorest households. This latter feature might appear odd given the Liberal Democrats' often-expressed anger at the relatively high rate of tax paid on the gross income of the poorest households.

The biggest losses under the Liberal Democrats would be felt by higher-rate taxpayers who save in a pension or realise quick capital gains on their investments, and by those living in very valuable homes; the biggest gains would be felt by two-earner couples on modest-to-middling incomes. There would also be losses amongst higher-rate taxpayers who make Gift Aid donations, high-income long-term resident non-doms, middle-to-high-income parents, some 60-65-year-olds, owners of less developed business land in high-value areas, and frequent long-distance flyers on empty planes, and gains for those with severe disabilities and owners of highly developed business land. Who would ultimately feel the burden of revenue extracted from freight flights, banks and tax avoidance is hard to say.

One interesting pattern is that the Liberal Democrats propose to increase taxes on saving and wealth while reducing taxes on income. This is in stark contrast to the party's 2005 manifesto, which proposed to reduce property taxes (abolishing council tax and raising the stamp duty threshold) while increasing income tax (introducing a local income tax and a 49% top tax rate).

Increased taxes on capital gains and pension saving would reduce incentives to save. What is often overlooked is that they would also reduce incentives to work, since money earned is less valuable if savings taxes reduce what it can eventually be used to purchase. On average, this weakening of work incentives would be smaller than the strengthening implied by the headline income tax cut. But focussing the pain on the well-off means that work incentives are weakened for a group which accounts for a large share of total tax revenue and which may be relatively responsive to incentives.

6. Conclusion

The tax and benefit measures already in the pipeline, together with those proposed in the manifestos, mean that taxes will be increased (particularly on the very rich), and benefits and tax credits will be cut (albeit slightly) whoever forms the next government. But there are differences in the implications for the total size of the 'take-away' from households, the distributional impact of reforms, incentives to work and save, the efficiency and complexity of the tax system, and who has control over tax policy.

The Government's pre-announced plans amount to a substantial net 'take-away' from households. They are clearly progressive, with small losses inflicted on poorer households that increase in size for richer households and especially for the richest 1% (who are hit by the restriction of income tax relief on their pension contributions). The Conservatives would reverse about a third of this net 'take-away' and do so in a way that would make the pattern of losses somewhat less progressive. They would also, in effect, be redistributing resources away from the consumers of public services, who would be affected by the cuts in departmental spending that would pay for the giveaway. The Liberal Democrats would increase the size of the net 'takeaway' by about a quarter, and would do so in a way that would make the pattern of losses more progressive, by redistributing from the wealthy to those on middle-incomes (but not so much to those on lower incomes). The small tax

rise would give them scope to cut back spending on public services slightly less. However, there is more uncertainty around the revenue estimates and the distributional consequences of the Liberal Democrats' plans than the other parties'.

The increase in the tax burden that is already in the pipeline will weaken work incentives for most people, particularly those towards the top of the income distribution who would be hit by freezing the higher-rate income tax threshold, restrictions in relief on contributions to pensions, higher NI bills, and more expensive fuel, alcohol and tobacco. Relative to the Government's plans, the Conservatives' NI cut would strengthen the incentive to be in paid work at all, but would do nothing to improve the incentive for existing workers to earn a little more except for a few very low earners. The Liberal Democrats' plans would increase the incentive to be in paid work for more people than the Conservatives' NI cut, as well as increasing the incentive to earn more for those earning £10,000 or less, but at the cost of discouraging work and saving for some high earners. Thinking about the structure and efficiency of the tax system as a whole, the plans announced by the Government do not represent a particularly appealing set of reforms, even considering the need to raise revenue. Although the rise in NI is a straightforward and effective way of raising extra revenue from a significant fraction of the population, the Government's plans to restrict relief on pensions contributions for the top 1% of earners, have a stamp duty holiday for first-time buyers, increase stamp duty on properties bought for over £1 million, and introduce a lower rate of corporation tax on income from patents would all significantly increase complexity or distortions in the tax system.

The Conservatives would not improve matters. The Conservatives would partially reverse perhaps the least bad of Labour's major tax increases while implementing cuts in income tax (to recognise marriage), national insurance (for new business start-ups) and stamp duty (for first-time buyers) in ways that would complicate the system further. They would leave Labour's most complex, unfair and inefficient proposal (on pensions tax relief for high earners) in place. Cutting headline rates of corporation tax would make the UK a more attractive place for multinational companies to locate their profits, and on its own would encourage companies to do business in the UK; but reducing the generosity of capital allowances would weaken the incentive for firms to invest in new equipment in the UK. The Liberal Democrats are proposing a much more radical set of reforms to the tax system, which would reduce damaging distortions and inconsistencies of treatment in a number of areas. However, their proposal to restrict pension contributions relief, while more coherent and less complex than the Government's, is still misguided and would affect many more people than planned by the Government.

Finally, there is a difference between the parties over the role that the Westminster government would have over future UK tax policy. The Conservative Party seems the least keen on the Calman Commission's proposals for devolving more tax-raising powers to the Scottish Parliament; indeed, its proposed freeze in council tax means, if anything, a weakening of English local authorities' control over their revenue and spending. At the other extreme, the Liberal Democrats would give greater powers to Edinburgh by implementing of all the Calman Commission's proposals, and give local authorities control over a far greater share of their revenues through their proposed reforms to business rates.