

9. The distributional effects of fiscal reforms since 1997

The government has carried out many reforms to the tax and benefit system since coming to power in May 1997. We estimate that the overall effect of the changes enacted or announced to date will be an annual cost to the exchequer of around £1.6 billion in 2003–04. This is the difference between a large set of revenue-raising reforms and a slightly larger set of costly changes. These reforms will not have affected all groups in the population equally. Rather, the gains or losses of different people will depend on individual characteristics such as income level, age and family circumstances.

The aim of this chapter is to gain a deeper understanding of how tax and benefit reforms have affected different groups in the population. The discussion will also cover the issue of how the burden of ‘taxes on businesses’ has changed. But, in considering this, it is important to remember that individuals ultimately pay all taxes. So our main focus is how the reforms have affected people at different points in the income distribution.

After a first section that lists the main reforms made since 1997, Section 9.2 begins the detailed distributional analyses. There, we mainly consider ‘direct’ taxes on labour income and unearned income and ‘indirect’ taxes on expenditure – the payment of which can be allocated relatively straightforwardly to households according to their earnings and their expenditures – as well as receipt of benefits, credits and tax credits.¹ We then discuss, in Section 9.3, some of the limitations of this analysis. These include both conceptual limitations (in terms of how we allocate tax payments to particular groups in the population) and data limitations (which constrain the range of taxes we can consider). Section 9.4 looks at ‘taxes on business’, while Section 9.5 considers the distributional consequences of changes to stamp duty on domestic property. Section 9.6 concludes.

9.1 What fiscal reforms?

A helpful benchmark when considering the distributional effects of the fiscal reforms made since Labour came to power is their overall impact on the government’s finances. Table 9.1 reports an estimate of the effect on revenues in 2003–04 of the reforms, compared with the revenues that would have been expected if the tax system implied by the November 1996 Budget had been retained (with benefit rates and expenditure taxes uprated in line with inflation

¹ This section updates previous IFS work: M. Myck, *Fiscal Reforms Since 1997*, Briefing Note no. 14, IFS, London, 2000 (www.ifs.org.uk/taxben/fiscalreform.pdf), and T. Clark, M. Myck and Z. Smith, ‘Fiscal reforms affecting households, 1997–2001’, chapter 5 of T. Clark and A. Dilnot (eds), *Election Briefing 2001* IFS, London, 2001 (www.ifs.org.uk/election/ebn5.pdf).

Table 9.1. Revenue effects in 2003–04 of changes to taxes and benefits made since 1997

	Net revenue raised for exchequer	Net revenue cost to exchequer
Total income tax		£0.3bn
<i>Of which:</i>		
Married couple's allowance	£3.3bn	
Income tax rates and personal allowances		£10.4bn
Dividend tax credits	£6.5bn	
Total National Insurance	£5.2bn	
<i>Of which:</i>		
Employee contributions	£2.0bn	
Employer contributions	£1.5bn	
Self-employed contributions	£0.6bn	
Total indirect taxes	£8.3bn	
<i>Of which:</i>		
VAT	£0.0bn	
Tobacco taxation	£2.6bn	
Road fuel duties	£4.9bn	
Alcohol taxation		£0.2bn
Insurance premium tax	£1.2bn	
Vehicle excise duty		£1.1bn
Total stamp duties	£2.1bn	
<i>Of which:</i>		
Changes to rates for properties	£2.0bn	
Total corporation tax		£2.8bn
<i>Of which:</i>		
Changes to rate structure		£4.4bn
Other corporation tax changes	£1.6bn	
Total change in cost of benefits / credits / tax credits		£14.3bn
<i>Of which:</i>		
Mortgage interest relief at source	£3.4bn	
Working families' tax credit (TC) + Disabled persons' TC + Working TC + Child TC		£8.6bn
Child benefit (and non-attributable child-based reforms)		£1.7bn
Pensioners' package (winter allowance, basic pension and minimum income guarantee increases)		£6.1bn
Overall total		£ 1.6bn

Notes: All costings have been deflated to 2003–04 using nominal GDP growth published by the Office for National Statistics and (for projections) HM Treasury. The totals include all measures, not just the taxes and benefits costed in detail in the table. Some taxes and benefits have been reformed more than once since 1996–97, which means that they may score as both exchequer gains and exchequer losses. The figures in the detailed breakdowns in this table are approximate. In some instances, it is not possible to break down the cost of measures introduced into the categories given in the table. For example, increases to child premiums in both income support and WFTC are often grouped together in costings published by the Treasury. In such cases, the effect of the changes is either attributed to the category deemed likely to be responsible for the greater part of the cost, or added to child benefit (and non-attributable child-based reforms). The difficulty with separating the effects of some measures also explains why the WFTC, DPTC, WTC and child TC are considered as one category.

Sources: HM Treasury, Financial Statement and Budget Report and Pre-Budget Report, various years.

and the parameters of the income tax system uprated in line with statutory rules). The table also lists the costs or revenues raised by certain specific measures that had large effects on the government budget. The measures considered include some that were announced by the Conservative government before May 1997 and which Labour chose to implement, such as the tobacco and fuel duty escalators, which were originally announced in the Budgets of 1993.

The table shows that the net effect of all policy changes in the tax and benefit systems will have been a small fiscal loosening of around £1.6 billion compared with what the government's budgetary position would have been had the system implied by the November 1996 Budget been retained. This figure is actually the difference between a large set of revenue-raising measures (around £51.7 billion) and a slightly larger set of costly reforms (around £53.3 billion). For example, Table 9.1 shows that costly changes to income tax, such as the introduction of the 10p starting rate and reduction of the basic rate, have been almost entirely offset by revenue-raising changes to the same tax. In contrast, by next year, the exchequer will have gained significant net revenues from changes to National Insurance² and indirect taxes (such as road fuel duties), plus a smaller amount from stamp duties. The tax changes overall raise around £12.7 billion, in effect paying most of the £14.3 billion projected net cost of benefit increases and the creation of new credits and tax credits.

The reforms listed in Table 9.1 only include fiscal changes that involve direct financial transfers to or from the state. In the second half of its first term in office, the Labour government also began to devote significant funds to extra spending on the National Health Service, and on education and other public services. Much of this spending was financed from extra tax revenues that have not been due to the discretionary policy changes considered in Table 9.1. Taxes as a share of national income in 2003–04 are forecast by the Treasury to be 39.3%, compared with 37.4% in 1996–97.³ This increase of 1.9 percentage points is equivalent to £20.8 billion in 2003–04 terms. Analysis of the increase to 2001–02 shows that much of it is increased income tax receipts as a share of national income. Likely causes of the overall increase include changes in the composition of national income, and the level of the oil price.⁴

In this chapter, we will not attempt to consider the distributional effects of spending on public services, nor the impact of changes in tax take or benefit expenditure that are not due to policy changes: we focus our attention on the effects of discretionary changes in financial transfers. In the next section, we consider the distributional effects of those reforms where the financial transfer can most straightforwardly be allocated to particular households. The latter

² For details of the changes to National Insurance, see Chapter 5.

³ HM Treasury, *Pre-Budget Report 2002*, Cm. 5664, London, 2002 (www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr02/prebud_pbr02_index.cfm).

⁴ For a fuller discussion, see chapter 2 of A. Dilnot, C. Emmerson and H. Simpson (eds), *The IFS Green Budget: January 2001*, Commentary no. 83, IFS, London, 2001, and chapter 3 of T. Clark and A. Dilnot (eds), *IFS Election Commentary*, Commentary no. 84, IFS, London, 2001.

part of the chapter discusses some of the reasons why it is more difficult to model the distributional effects of changes in ‘business taxes’ and stamp duties.

9.2 The distributional impact of reforms directly affecting households

In the previous section, we listed the main reforms to taxes and benefits that have occurred since 1997. In this section, we use TAXBEN, the IFS simulation model of the tax and benefit system, to assess the distributional impact that followed from some of them.

The taxes and benefits that we include in the analysis are those levied directly on incomes or on personal expenditures. We can allocate the payment of these taxes and benefits to households using data on the incomes and expenditures of household members. The direct taxes we model include payments of income tax due on labour income and benefit income, but not all of those that are levied on other incomes (so we do not model the effect of the abolition of dividend tax credits). We also model both employer and employee National Insurance contributions. Employers’ National Insurance is sometimes thought of as a tax on businesses, but, like income tax and employee contributions, it is levied on wages and salaries, and so it is consistent with our methodology to include it as a tax on labour income (see also Section 9.4). Reforms to the benefit system are also analysed,⁵ and the expenditure taxes that we model include VAT and most excise duties, but not stamp duty on house purchases.

Table 9.1 indicated that amongst the changes we analyse, reforms to income tax, National Insurance and excise duties (notably including road fuel duty) all had significant revenue effects. Many households also benefited from increased transfers via benefits or credits and tax credits. The net modelled effect of the changes considered here is to increase household incomes⁶ and therefore loosen the government’s fiscal position next year by £9.8 billion,⁷ which is approximately £8 per household per week.⁸ Given that we calculated the overall net effect of Labour’s reforms to be a fiscal loosening next year of just £1.6 billion – nearer £1.50 per household per week – it is clear that by focusing only on the subset of measures that directly affect households, we show a much more generous average ‘giveaway’ than we would do if we included all the tax and benefit changes. For example, we do not capture the

⁵ With the exception of some reforms to bereavement and incapacity benefits, which we cannot model due to data limitations.

⁶ Net of direct taxes and benefits, credits and tax credits.

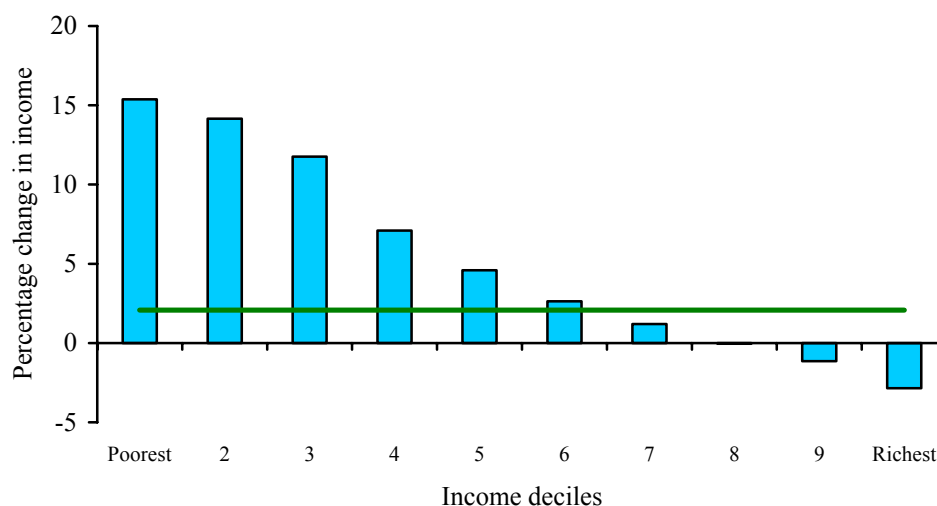
⁷ Cash changes are expressed in October 2002 prices.

⁸ The modelling that underlies these numbers and Figure 9.1 compares a world with the tax system that will exist once all the reforms announced by January 2003 have been enacted, and a hypothetical world in which the 1996–97 tax system had been retained and benefit rates and expenditure taxes had been uprated in line with inflation whilst the parameters of the income tax system were uprated in line with statutory rules. This means that we do include changes to National Insurance and the new credits and tax credits that will come into force during 2003.

relatively large tax revenues from dividend tax changes or increases in stamp duties, although neither do we capture the more modest cuts in corporation tax. Another reason for the discrepancy in the estimated budgetary effects is that payments of (for example) expenditure taxes that are levied on institutions other than households will not show up in the analysis presented here.⁹

Figure 9.1 shows how the gains from our relatively generous subset of tax and benefit changes are spread across the income distribution. In the figure, the population of households is ranked according to income and then split into 10 equally sized groups or ‘deciles’. For each decile, the figure plots the estimated average percentage change in net incomes resulting from the reforms modelled.

Figure 9.1. Impact of direct personal tax, benefit and expenditure tax changes since 1997



Notes: Deciles are constructed by ranking households according to their income – measured before housing costs and adjusted for family size – and then splitting the population into 10 equally sized groups. The bars show the modelled impact on real incomes (measured in October 2002 prices) of the majority of changes to direct and indirect taxes and to benefits and credits that have occurred since 1997.

Source: Authors’ calculations based on results from the IFS tax and benefit model, TAXBEN, run using Family Resources Survey 2000–01 and Family Expenditure Survey 1999–2000.

We can see that the reforms are progressive. Whilst net incomes across the population increase by around 2% on average (shown by the black line), incomes in the poorest group increase by slightly more than 15%. Increases get steadily smaller as income rises and are almost exactly zero in decile 8. There are small losses in decile 9, and the richest group experiences a loss of almost 3% of its net income. In cash, rather than proportional, terms, average gains are found to be £20 or more per week in each of the bottom three

⁹ In part, the discrepancy may also be due to undercounting of revenues from some expenditure taxes in our model because the data available to us tend to under-report some types of household expenditures.

deciles, whilst average losses are around £6 per week in decile 9 and around £28 per week in the richest group.

As well as looking at how changes vary across the income distribution, we can also look at which types of family have gained from the reforms that we model. This is of interest because, as well as targeting benefit increases and tax cuts towards those with low incomes, Labour has also given special priority to reducing poverty among children and among pensioners.¹⁰ It is not surprising to find that pensioners and low-income families with children were the biggest gainers from the package of reforms that we model. No-earner couples with children are found to gain around £40 a week, on average, and the figure is around £28 for single parents. Pensioner households also gain more than £20 per week, on average. For groups containing working-age adults with no children, average changes were of a smaller magnitude than the gains amongst the elderly and those with children.

9.3 Limitations of the distributional analysis

The above analysis measures the distributional impact of changes to taxes and benefits where the payment can relatively easily be allocated to households according to the personal incomes or expenditures of household members. It therefore encompasses the majority of those taxes that are levied on the earnings or spending of private individuals, plus the majority of transfer payments made through the benefit system.

The ‘tax payment’¹¹ that we allocate to each household is the sum of the tax levied on all spending by household members and that levied on the incomes received for the labour supplied by household members, minus any benefit payments that they receive. To make comparisons between the distributional effects of the tax system as it existed at different points in time, we assume that (gross) incomes and expenditures (inclusive of tax payments) are not affected by the tax system. In other words, for each household in the data, we compare the tax payment implied by each tax system, given their observed expenditure and labour income.

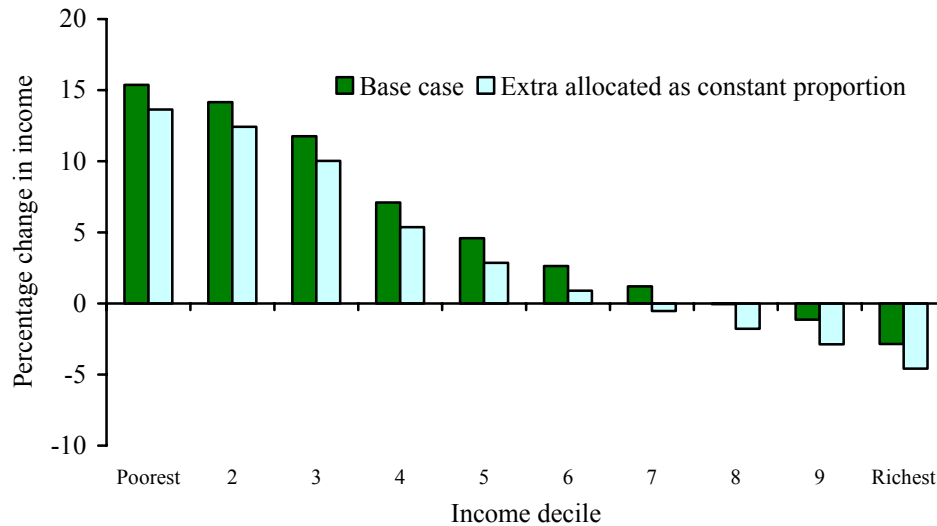
Using this notion of ‘tax payment’ is not the same thing as considering who makes the cash transfer to the state: much of income tax and VAT is administered via cash transfers between companies and the relevant authority. Nor does it capture the economic notion of effective incidence – in other words, who is ultimately made financially worse off as a result of a particular tax being imposed rather than collecting the same revenue (and financing the

¹⁰ The different ways that Labour has used social security and direct tax reforms to target support towards particular groups are discussed in M. Brewer, T. Clark and M. Wakefield, ‘Social security in the UK under new Labour: what did the third way mean for welfare reform?’, *Fiscal Studies*, 2002, vol. 23, pp. 505–37 (see especially section VI).

¹¹ This terminology and many of the ideas here are due to A. Dilnot, J. Kay and M. Keen, ‘Allocating taxes to households: a methodology’, *Oxford Economic Papers*, 1990, vol. 42, pp. 210–30.

same pattern of government expenditure) from some other source. The effective incidence of a tax depends on how prices charged and quantities traded are affected by this tax, and we do not model these. Since the welfare of households will also ultimately depend on the amount that they consume and the number of hours that they work, we also do not capture the welfare effects of tax changes.

Figure 9.2. Impact of direct personal tax, benefit and expenditure tax changes since 1997



Notes: See notes to Figure 9.1.

Source: Authors' calculations based on the numbers in Table 9.1 (see sources there) and results from the IFS tax and benefit model, TAXBEN, run using Family Resources Survey 2000–01 and Family Expenditure Survey 1999–2000.

Nonetheless, our methodology does yield a first approximation to how the tax system affects households. Accepting the usefulness of such an approximation, the biggest weakness in the analysis is that, while we have acknowledged that all taxes and benefits are ultimately paid to or by people, we also omit a large set of reforms. We estimated that the reforms that we are able to model would increase household incomes in 2003–04 by around £8.2 billion more than will the full set of tax and benefit reforms since 1997. A crude way to generate a comprehensive picture of the distributional implications of all of these tax and benefit reforms would be to assume that those changes that were omitted had an equal proportionate impact on all households, reducing disposable incomes by approximately 1.7%.¹² This is equivalent to taking £2.25 per week, on average, from households in the poorest decile and almost £17 per week, on average, from those in the richest tenth. Allocating extra changes in this proportional way will not affect the progressive shape of the distribution of proportional changes in incomes due

¹² In allocating the full £8.2 billion to the UK household sector, we ignore the fact that some taxes may be levied on the incomes or expenditures of individuals who are not UK residents.

to the reforms modelled.¹³ This is shown in Figure 9.2, which compares the results of Figure 9.1 with the results as they would look if the package modelled did take an extra 1.7% from the incomes of all households.

The assumption of equal proportional changes is unlikely to reflect accurately who would actually pay extra tax due to the measures omitted in Section 9.2. An important set of taxes that were omitted are those levied on incomes that derive from company profits or from the ownership of property. For example, tax-raising changes to stamp duties and dividend tax credits, and cuts in corporation tax, were not modelled. It is unlikely that these taxes have a constant proportional impact on incomes across the income distribution. Their omission was largely due to inadequate data rather than due to these taxes not being amenable to analysis within the framework of ‘tax payments’. To help clarify the conceptual framework, and to see how misleading the benchmark case of a constant proportional impact is, in the next two sections we consider ‘taxes on business’ and stamp duty on residential property transactions.

9.4 Taxes on business

How much have taxes on business increased? The answer depends, to a large extent, on what we think should be included under the heading of ‘taxes on business’. At one extreme, we might start with the idea of all taxes paid to the government by firms. This would include not only corporation tax and business rates, but also most of VAT, all of income tax collected under the PAYE system and all National Insurance contributions levied on the earnings of employed workers, regardless of whether these are labelled as employer or employee contributions. Most observers would agree that this definition would be much too broad. At the other extreme, we might classify taxes according to who feels their ‘effective incidence’, or who is ultimately made worse off by their imposition. Unfortunately, this would lead us to the conclusion that there are no taxes on business, as companies have a legal identity only and cannot be made worse off in any meaningful sense.

A reasonable intermediate position might be to consider those taxes whose effective incidence falls on the owners of companies. This does not produce a neat, operational classification of taxes into those on business and those not on business, and may suggest rather surprising results in some cases. For example, in a small, perfectly competitive, open economy with a high degree of international capital mobility but limited international mobility of labour, it can reasonably be argued that much of the effective incidence of a source-based corporate income tax will ultimately fall on domestic workers rather than on shareholders. With mobile capital, investors – regardless of where they live – will only finance investment projects that generate a given post-tax rate of return – regardless of where the activity is located. If a country imposes a corporation tax that reduces the post-tax return on investment located in its territory, the result will be that investors finance fewer investment projects in

¹³ Indeed, allocating changes in this fashion is equivalent to shifting the axis marking a zero proportional change up by 1.7 percentage points on the bars showing the changes for each decile.

that country – only those projects with a pre-tax return high enough to pay the required post-tax return after corporation tax will continue to be viable. Workers in that country will then operate with less capital per worker, be less productive and earn lower wages as a result. Assuming that migration is insufficient to equalise wages across countries, it is workers rather than shareholders in the country imposing the corporation tax who will ultimately be worse off.¹⁴

Interesting as this may be, it does not accord well with popular perceptions of what are considered as taxes on business. A more pragmatic and more common approach focuses on rights to the sources of income on which different taxes are levied. This is very similar to the way in which we allocated tax payments in Section 9.2. There we allocated the payment of labour taxes to the individual on whose labour income the tax is levied. A natural extension would be to allocate taxes on incomes derived from company profits to the owners of the company who have the right to the income stream on which the tax is levied. Applying this idea suggests that taxes that are levied on company profits, or on some component of company profits (e.g. dividends), can be classed as a category of ‘taxes on (the owners of) business’. This may be considered too narrow, but it is unclear what general principles would lead to a satisfactory, broader definition.

Following this approach, corporation tax, which is levied on company profits that are ultimately paid to the owners of companies, is classified as a business tax. Income tax on wages and salaries is not classified as a tax on business, since wages and salaries are paid to workers, not to shareholders. Income tax on company dividends is however classed as a business tax, since dividends are distributed profits, and are clearly paid to the owners of companies.

By the same principle, National Insurance contributions are classed as a tax on individuals, regardless of whether these are nominally employer or employee contributions. Like income tax, all National Insurance contributions are levied on a base of wages and salaries (albeit with different rates structures), and it is hard to think of any reasonable principle that would result in employer and employee National Insurance contributions being treated *differently*. There may be disagreement as to whether their effective incidence is mainly on workers or mainly on the owners of firms, but a basic principle of public economics is that the effective incidence of a tax should not depend, at least in the long run, on whether it is levied on the buyer or the seller of a good or service. Thus the effective incidence of employer National Insurance contributions *may* be on employers, to the extent that it is not shifted onto workers in the form of lower wages. But *if* this is so, the effective incidence of employee National Insurance contributions would also fall on employers, as higher wages would then need to be paid to attract the same workforce. In this case, the effective incidence argument would quickly lead to personal income

¹⁴ Shareholders continue to earn the same post-tax rate of return on their investments, though the companies they own may be locating less activity at home and more activity overseas. Under these conditions, owners of companies can only be made worse off in the long run by residence-based taxes levied on their worldwide investment income from all sources. Since relatively little revenue is collected from such taxes, this approach would not classify most taxes as ‘business taxes’.

tax on wages and salaries also being classed as a business tax, which does not seem a satisfactory result.

By how much have ‘business taxes’ changed since 1997?

Notwithstanding the limitations of this approach, we focus here on the extent to which taxes levied on company profits have increased under Labour governments since 1997. A broader approach might also include taxes levied on some components of business expenditure – for example, business rates levied on the occupation of non-domestic property and environmental taxes such as the climate change levy and the aggregates tax. As it happens, extending our analysis to include these taxes would have little impact on the discussion in this section. Business rates have generally been increased in line with inflation under Labour, as they were under the previous Conservative administration. The introduction of the climate change levy and the aggregates tax was intended to be revenue-neutral for the business sector overall, with a corresponding reduction in employer National Insurance contributions.¹⁵

Even restricting our attention to taxes on company profits, there has been no shortage of tax changes since 1997, with somewhat offsetting effects on overall tax revenues. The principal changes are summarised in Table 9.2. The biggest single increase was brought about by the abolition of repayable tax credits on dividend income for pension funds and some other tax-exempt shareholders, introduced in July 1997. This was, in effect, an increase in tax levied on distributed profits for those shareholders. At the time, this was estimated to raise upwards of £5 billion per annum for the exchequer by 1999–2000, although, so far as we are aware, estimates for later tax years have not been published.¹⁶

The second major increase was temporary, resulting from the introduction of quarterly instalment payments of corporation tax for large companies. The effect of the new system was to accelerate tax payments compared with the old system of advance corporation tax (ACT). This brought in substantial revenues over the four financial years up to 2002–03: it was estimated to increase corporation tax receipts by, on average, around £2 billion in each of those years. It should be noted that this reform has a major effect on tax revenues if figures are presented on a cumulative basis for the period from 1997 onwards, but has little impact if figures are presented for individual years from 2003–04 onwards.¹⁷ Immediately prior to this temporary rise in

¹⁵ Note that the offsetting reduction in employer NICs would not be classed as a reduction in business taxes, following the general approach of this section. However, the extent to which the effective incidence of these environmental taxes falls on the owners of companies, or is shifted onto consumers in the form of higher product prices, is also unclear. Without further analysis of such issues, it would seem unduly harsh to treat this revenue-neutral policy as imposing an increase in taxes on business.

¹⁶ Our estimates for later years simply uprate the initial £5.4 billion in line with nominal GDP growth.

¹⁷ Actually, there is a small negative effect of this reform from 2003–04 onwards. This comes mainly from the loss of revenue from ‘surplus ACT’. ACT only affected the timing of tax payments for most firms, but had the effect of increasing total tax payments for firms in a

corporation tax payments, there was a temporary contribution to government revenues of a similar amount in 1997–98 and 1998–99 from the windfall levy imposed on privatised utilities. More recently, there is a small increase in tax revenue resulting from changes to the taxation of North Sea oil and gas production.

Table 9.2. Revenue effects of major changes in ‘business taxes’ (£ billion)

	1997–98	1998–99	1999–2000	2000–01	2001–02	2002–03	2003–04
<i>Corporation tax rate cuts:</i>							
July 1997		-1.6	-2.2	-2.3	-2.4	-2.5	-2.6
March 1998				-0.8	-1.1	-1.2	-1.2
March 1999					-0.1	-0.1	-0.1
April 2002						-0.0	-0.3
Total		-1.6	-2.2	-3.1	-3.6	-3.8	-4.3^a
R&D tax credits					-0.1	-0.5	-0.6
ACT replaced by quarterly instalments		0.1	1.6	2.0	3.1	2.2	-0.5
Dividend tax credits	2.3	4.0	5.4	5.7	5.9	6.2	6.5
<i>North Sea taxation:</i>							
Introduction of 10% supplementary charge and 100% capital allowances						0.1	0.5
Abolition of licence royalties							-0.2
Windfall levy	2.6	2.6					
Total revenue effect	4.9	5.1	4.8	4.6	5.3	4.1	1.4^a

^a Differences between these figures and those in Table 9.1 arise from the fact that here we only consider reforms that were announced by Labour after the party was elected in 1997, whereas Table 9.1 includes costings for all measures enacted since 1997. Table 9.1 is also more comprehensive and includes the estimated effects of a number of technical changes and anti-avoidance measures that are excluded from this table of major reforms.

Notes: Tax rate cuts include the revenue effects of cuts in the small companies’ rate and the introduction and subsequent reduction in the starting rate. Initial costings come from Budget and Pre-Budget Reports, and where necessary these have been updated to later years using the index of nominal GDP growth published by the Office for National Statistics and (for projections) HM Treasury.

Sources: HM Treasury, *Financial Statement and Budget Report*, various years; HM Treasury, *Pre-Budget Report, 2002*; Inland Revenue Press Release 2, 2 July 1997; Inland Revenue Press Release 8, 17 March 1998; Inland Revenue Press Release 9, 17 March 1998.

These increases in taxes on company profits have been offset by cuts in the main rate of corporation tax, which was reduced from 33% to 31% in the July 1997 Budget at a cost of around £2 billion per annum, and to 30% in the March 1998 Budget at a cost of around £1 billion per annum. Corresponding reductions in the small companies’ corporation tax rate are costing the exchequer around £0.5 billion per annum. Further tax cuts include the introduction of a 10% starting rate of corporation tax in the March 1999 Budget, which was reduced to 0% in the April 2002 Budget, and the introduction of new tax credits for research and development.

‘surplus’ ACT position, which could not fully offset their ACT payments against mainstream corporation tax liabilities.

An accurate estimate of the overall effect of these changes is difficult to produce, as official costings of different reforms have covered different time periods and some are now rather outdated. A ballpark figure for 2002–03 would suggest an increase in the region of £4 billion, reflecting around £8 billion extra revenue from dividend taxation and quarterly instalments, offset by around £4 billion from rate cuts and other changes. For 2003–04, we estimate a smaller increase, in the region of £1–£2 billion, as the effect of the transition to quarterly payments is no longer present. Much then depends on the particular year for which any estimates are reported, and, as noted earlier, the effect of the switch from ACT to quarterly instalments appears much more significant if measured cumulatively over this period rather than for the final year that we consider. Our discussion here also excludes the effect of a host of technical changes and anti-avoidance measures,¹⁸ the costs of which are inherently difficult to estimate accurately, and a number of measures limited to smaller firms.¹⁹

We conclude by reiterating that there is no compelling way of classifying particular taxes as ‘taxes on business’. In our distributional analysis, we have followed an approach that allocates ‘tax payments’ to the individual who has the right to the income stream on which a tax is levied, or whose resources are used to fund an expenditure on which a tax is levied. Largely due to limitations of data, taxes levied on incomes derived from company profits were not allocated to households.

These taxes on company profits have been higher over the period 1997–98 to 2002–03 as a result of changes introduced by Gordon Brown. The government’s emphasis on changes to corporation tax rates does not tell the full story here. On the other hand, estimates of the scale of the increase in ‘business taxes’ can easily be exaggerated. Moreover, some of these effects are explicitly temporary, and it is expected that revenues from these taxes in 2003–04 will be only around £1–£2 billion greater than would have been the case had Labour not introduced any of these reforms. This is small compared with the net giveaway of £9.8 billion modelled in Section 9.2, and so allocating the payment of ‘business taxes’ to individuals according to their ownership shares in companies would not significantly affect the distributional results found there. Further, since share ownership tends to be concentrated in the upper reaches of the income distribution,²⁰ allocating these taxes might add to the progressive overall effect of reforms since 1997.

¹⁸ Examples include stricter limits on the carry-back of losses, changes to the taxation of insurance companies and changes to the rules affecting controlled foreign companies.

¹⁹ Examples include higher capital allowances for investment in plant and machinery, and tax relief for venture capital trusts.

²⁰ The pattern of share ownership in the UK, and how little data we have on the amount of wealth individuals have in pension funds, are discussed in J. Banks and M. Wakefield, ‘Stockholding in the United Kingdom’, chapter 8 of L. Guiso, M. Haliassos and T. Jappelli (eds), *Stockholding in Europe*, Palgrave Macmillan, Hampshire, 2003.

9.5 Stamp duty on residential properties

Although stamp duty is paid on transactions of both residential and non-residential properties, here we only consider sales of residential properties. We restrict our focus in this way because it is easier to allocate payments within the income distribution when the buyer is an individual or a family, rather than a company.

In the analysis of Section 9.2, revenues are deemed to have been raised from expenditure taxes if there have been increases in the rate of the tax or expansion of the tax base (i.e. the total value of the transactions on which the tax is levied). Considered in this way, stamp duty on residential properties would have raised money since 1997 for two reasons: first, the threshold house price at which tax payments begin has been fixed in nominal terms, which means that some revenues have been due to the fact that house price inflation has moved more property transactions into the stamp duty tax base; secondly, a graduated structure has been added to what was previously a tax with only one positive tax rate. In this section, we discuss only the revenues raised from the introduction of the graduated structure.²¹

When Labour came to power in 1997, stamp duty was paid at a rate of 1% on the value of property transactions that exceeded £60,000. Transactions of £60,000 or less were not liable for the tax. Since 1997, a graduated structure has been introduced via a series of reforms, as shown in Table 9.3.

Table 9.3. Rate of stamp duty on property, 1997 to present day

Transaction value (£000)	Before	8 July 1997	24 March	16 March	28 March
	8 July 1997	– 23 March 1998	1998 – 15 March 1999	1999 – 27 March 2000	2000 to date
0–60	0%	0%	0%	0%	0%
60–250	1%	1%	1%	1%	1%
250–500	1%	1.5%	2%	2.5%	3%
500+	1%	2%	3%	3.5%	4%

To summarise, the rate of stamp duty on any residential property that sells for more than £250,000 has increased since 1997. It has increased from 1% to 3% for properties that sell for between £250,001 and £500,000, and from 1% to 4% for properties that sell for more than £500,000.

Labour has not changed the fact that stamp duty operates as an average rate tax. This means that if a property transaction falls into the top stamp-duty band, then the tax is paid at 4% on the full value of the sale, not just the value exceeding £500,000. Similarly, if a transaction falls into one of the lower bands, then 1% or 3% tax will be levied on the entire transaction value. To take an example, a £300,000 property transaction will be liable for £9,000 of stamp duty, which is 3% of £300,000.

²¹ Although some of these revenues are themselves due to the fact that since the graduated structure was first created in 1997, the thresholds for higher-rate bands have not been increased to allow for inflation.

The data in Table 9.1 indicate that £2.1 billion extra revenue has been raised from stamp duties since 1997, but they do not isolate how much of this has come from the introduction of a graduated system for residential properties. We approximate for this figure by using data published by the Inland Revenue that give the yield of stamp duty on residential properties by the price band of property transactions. For example, in 2001–02, when the increases to 3% and 4% had been fully implemented, we know that yields were as given in the first column of Table 9.4.

Table 9.4. Yield of stamp duty on residential property, 2001–02

Stamp duty band	Yield £ million	Proportion due to change in rates	Estimated £millions due to change in rates
£250,001–£500,000	965	$\frac{2}{3}$	643
£500,001+	715	$\frac{3}{4}$	536
Total	1,680	n/a	1,180

Sources: *Inland Revenue Statistics*, www.inlandrevenue.gov.uk/stats; authors' calculations.

If the structure of stamp duty had not been changed after 1996–97, then for property transactions exceeding £60,000 in value, the tax yield would have been 1% of transaction values. Due to changes in the tax structure, the tax yield for transactions in the £250,001–£500,000 price range in 2001–02 was actually 3% of transaction values. If we assume that property prices in 2001–02 were not affected by the changes in the structure of stamp duty after 1997,²² then we can state that the extra stamp duty paid on property transactions in this price range due to increases in the tax rate was 2% of transaction values (the excess of 3% over 1%). In other words, two-thirds of the tax yield for these transactions was due to the reforms. By similar reasoning, we can argue that three-quarters of the yield on transactions of £500,001 or more was due to increases in the tax rate. Applying this reasoning, Table 9.4 shows that we estimate the amount of extra tax paid to be around £1.18 billion. In other words, if we had included this change in stamp duty in our distributional analysis in Section 9.2, then the total cost to the exchequer of the reforms considered would have been around £8.6 billion (or £7 per family per week, on average) rather than £9.8 billion (or around £8 per family per week).

We now consider how payments of this stamp duty might be spread across the income distribution. Our analysis of this issue will be conducted in a slightly different way from that in which we allocated payments of expenditure taxes in Section 9.2, but it might give a reasonable approximation for how we would have allocated these duties. As we now explain, the results might also be of interest if the financial cost of stamp duty actually falls on house-sellers rather than house-buyers.

Throughout this chapter, in allocating tax payments we have assumed that total expenditures remain unaltered after a reform and that the extra tax is paid out of these expenditures. We then allocate the tax payment to the household

²² This is unlikely to be the case, as we would expect to observe spikes in the distribution of sale values just below the thresholds.

containing the person who made the particular expenditure (that is, to the buyers of goods and services). In order to allocate payments of stamp duty on properties in this way, we would need to know the incomes of house-buyers and the amount that they paid for their new homes. But data of this kind are not easily available. We can, though, observe the incomes and estimated property values for homeowners in the British Household Panel Survey (BHPS) for 2000. We will allocate the cost of stamp duty across the income distribution according to these data.

To the extent that house-buyers have different characteristics from homeowners, allocating payments of stamp duty according to the values of the stock of properties owned and the characteristics of owners will give us different results from allocating according to the values of properties that are traded and the characteristics of buyers. First-time buyers are perhaps especially likely to fall into different age and income groups from typical homeowners. Also, the approximation will only be accurate to the extent to which homeowners tend to stay within the same stamp-duty band when they move home. The results of our method are also of interest in themselves because they tell us who loses out from an increase in stamp duty if the tax change results in a fall in the price that owners can expect to receive for their properties.

Table 9.5. Distribution of the value of homes worth more than £250,000, across the income distribution

Decile of total population income distribution	Percentage of value of total stock of homes worth £250,000+
Poorest	6.4
2	1.3
3	3.1
4	4.8
5	6.3
6	7.7
7	5.0
8	14.6
9	14.8
Richest	36.0
<i>Total</i>	<i>100.0</i>

Notes: Deciles are constructed by ranking households according to their income adjusted for family size and then splitting the population into 10 equally sized groups. Also, see footnote 23.

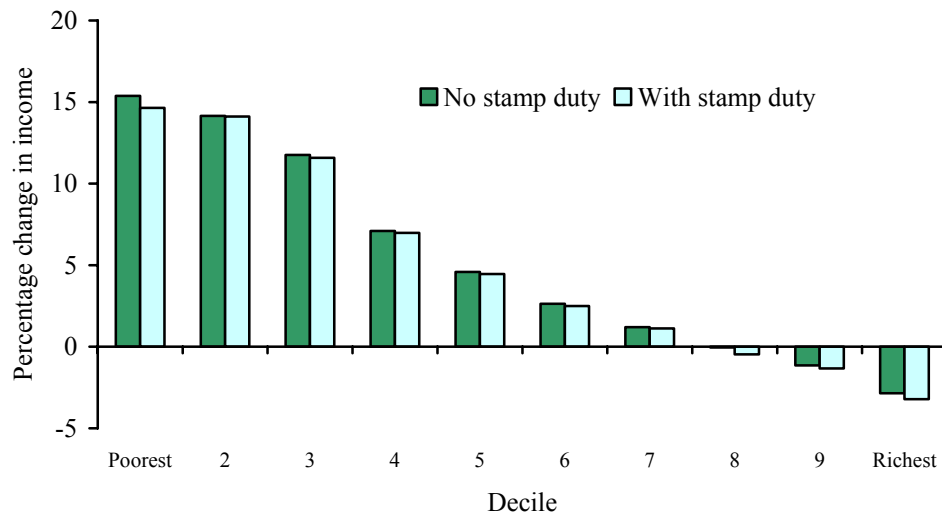
Sources: British Household Panel Survey 2000; authors' calculations.

For each income decile, we will allocate a proportion of the cost of the extra stamp duty paid that is equal to the proportion of the total value of the stock of all properties in each stamp-duty band that is owned by people in that income group. For a sample of 4,824 households from the 2000 BHPS, Table 9.5 reports percentages of the value of the stock of all properties worth more than £250,000 that were owned by households in each income decile. In the table, we do not split properties according to whether or not they are worth more or

less than the upper £500,000 stamp-duty threshold because there were too few very valuable homes in the data to make such a split interesting.²³

We have estimated that, in total, the changes to stamp duty that we are considering raised around £1.18 billion for the exchequer, or slightly less than £1 per household per week on average. Allocating the stamp duty payment in line with the values of homes owned at different points in the income distribution in our sample, we find that approximately £825 million of the increase would be paid by the richest 30% of the population. Of this, almost £450 million would be allocated to the richest tenth. This implies households in the richest tenth paying extra tax worth approximately £3.50 per week (or 0.4% of their income), on average, due to these stamp duty reforms. This is small compared with net losses of around £28 per week (or 3% of income) that we estimated to be taken, on average, from those in the richest income group by the package of reforms considered in Section 9.2.

Figure 9.3. Impact of direct personal tax, benefit and expenditure tax changes since 1997, with and without effect of stamp duty



Notes: See Figure 9.1.

Source: Authors' calculations using the British Household Panel Survey for 2000 and results from the IFS tax and benefit model, TAXBEN, run using Family Resources Survey 2000–01 and Family Expenditure Survey 1999–2000.

The effect of stamp duty is small relative to the package considered in Section 9.2. Figure 9.3 shows that it also does not affect the progressive shape of the results we found there. The figure reproduces the results of Figure 9.1 and compares them with a set of results that include the distributional effects of stamp duty as modelled here. If anything, the stamp duty reform tends to add

²³ There were actually 187 households with homes worth more than £250,000, but only 15 of these homes were valued at more than £500,000. We *do* use information on whether or not a home falls into the top stamp-duty band when calculating how much extra tax households in each decile would pay.

to the progressive shape of the package since, as modelled (and with the exception of a relatively large proportionate income loss in the poorest tenth), it tends to take proportionally slightly more from those in higher income deciles. Raising money from stamp duties is certainly progressive in the sense that it takes the largest cash amounts from people towards the top of the income distribution.

9.6 Conclusion

In this chapter, we have looked at the distributional impact of reforms to taxes and benefits that have been implemented since 1997. Amongst the reforms we model in Section 9.2, the pattern has generally been progressive. Many of the reforms that we do not model are tax increases. This means that if we could include the distributional impact of all these reforms, we would be assessing a package that is less generous to households than the package considered in Section 9.2. We have seen that attempting to model the reforms that were omitted raises a series of difficult conceptual questions and problems of data availability. Some of the taxes that are omitted are levied on incomes derived from company profits or from owning property. It is likely that the payment of these taxes falls relatively heavily on those high up the income distribution, and so it seems safe to assume that, in a more comprehensive distributional analysis, the progressive nature of the package of reforms made since 1997 would not be compromised.

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