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The 50p income tax rate

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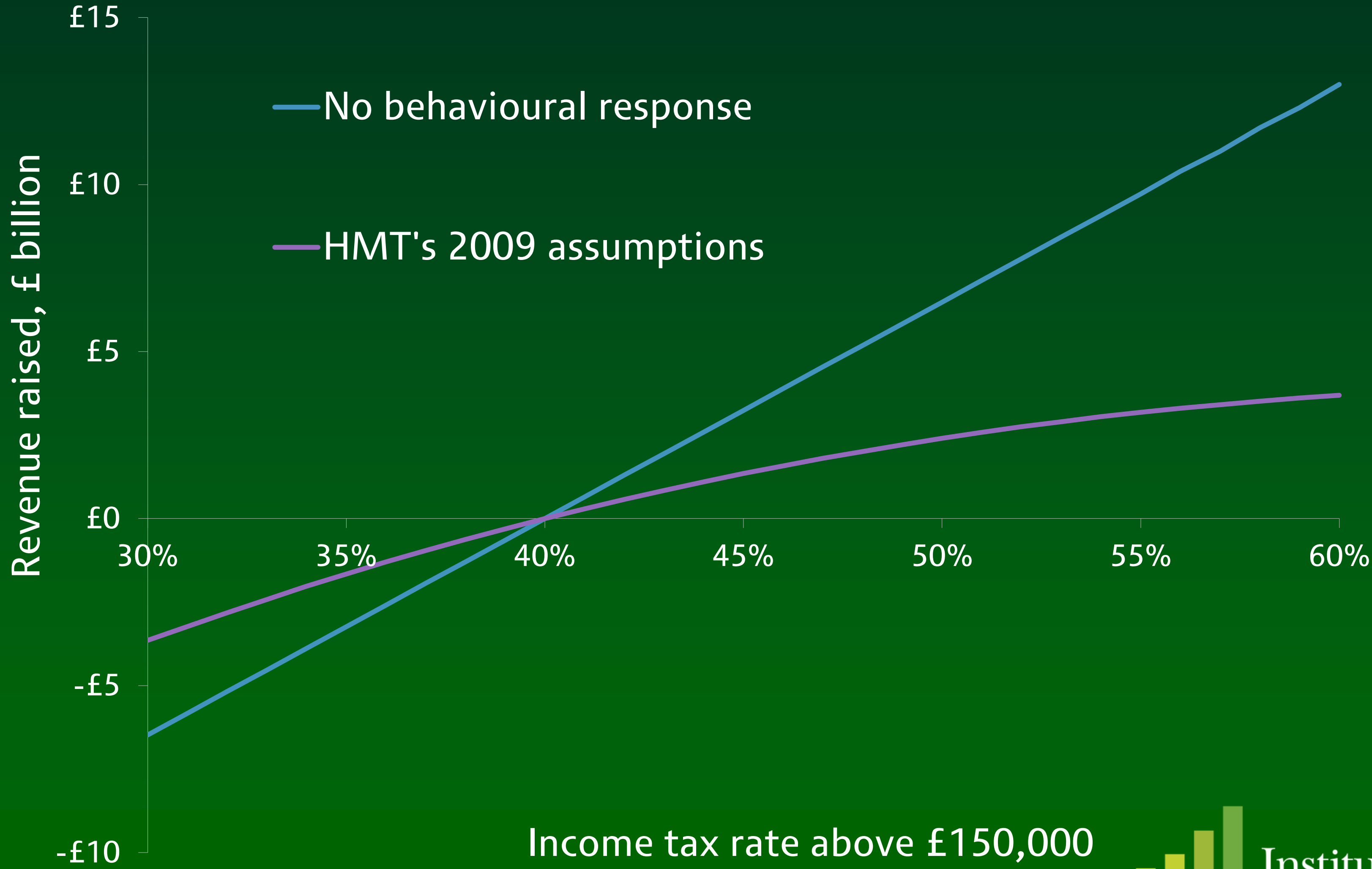
Background

- 50p income tax rate for those with incomes above £150,000 from 2010–11 announced in Budget 2009
- At the time, HMT estimated it would increase tax revenues by £2.7 billion a year
- No administrative data on how much actually paid until tax returns for 2010–11 submitted in January 2012
- In Budget 2011, Chancellor asked HMRC to produce a report on how much 50p rate was raising in time for this Budget

How might we expect people to have responded to the 50p rate?

- HMT’s estimate from 2009 implied significant reduction in income resulting from the change: static costing £6.8 billion

Laffer curve using HMT’s assumptions from 2009



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How might we expect people to have responded to the 50p rate?

- HMT's estimate from 2009 implied significant reduction in income resulting from the change: static costing £6.8 billion
- Two broad forms of behavioural response that lead to lower tax revenues:
- Genuine reductions in income: working less hard, retiring early, leaving the UK
  - Would expect these to reduce expenditure and hence indirect tax revenues as well as income tax revenues
- Avoidance responses: shifting income to different time periods, converting to capital gains, shifting income between spouses
  - Would probably not reduce indirect tax revenues
  - Moving income forward from 2010–11 to 2009–10 particularly important when examining 2010–11 data: clear incentive to do this when tax rise pre-announced

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HMRC's report

- HMRC asked to examine income tax returns from 2010–11
- Provides information on how much income tax those above £150k are paying…
- …but not on how much they would have paid if rate were 40p
  - Need to work out how much incomes have changed in response to 50p rate
- HMRC had to try to predict what would have happened to incomes in the absence of the tax change
  - Always very difficult, particularly when only have one year of data available after tax change introduced

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What did HMRC do?

- Estimate what income growth would have been in the absence of the 50p rate in 2009–10 and 2010–11 among those with incomes above £150k using information on
  - income growth among the group with incomes between £115k and £150k in 2009–10 and 2010–11 and
  - stock market growth 2009–10 and 2010–11

Is HMRC's method reasonable?

- Probably the best they could do with information available
- For HMRC's estimate to be unbiased, requires income growth among those with lower incomes to be unaffected by reforms
  - Unlikely: if people reduce income below £150k in response, would increase total income of those between £115k and £150k
  - Also, lower-income group may be affected by other policy changes introduced at the same time, in particular withdrawal of personal allowance above £100k
  - Trends in income among two groups could have been different in the absence of 50p rate because of other changes not controlled for
- HMRC recognise these problems and show results from other methods of estimating counterfactual incomes
  - These give similar results

HMRC's results

- Results indicate substantial 'forestalling' (bringing income forward to 2009–10): £16bn to £18bn shifted in this way
  - Overall, incomes among those with incomes above £150k increased 14% in 2009–10 but fell 25% in 2010–11
  - Particularly for dividend income: grew 78% among this group in 2009–10 and then fell 73% in 2010–11
  - Incomes would have been much lower in 2009–10 without 50p rate, and much higher in 2010–11

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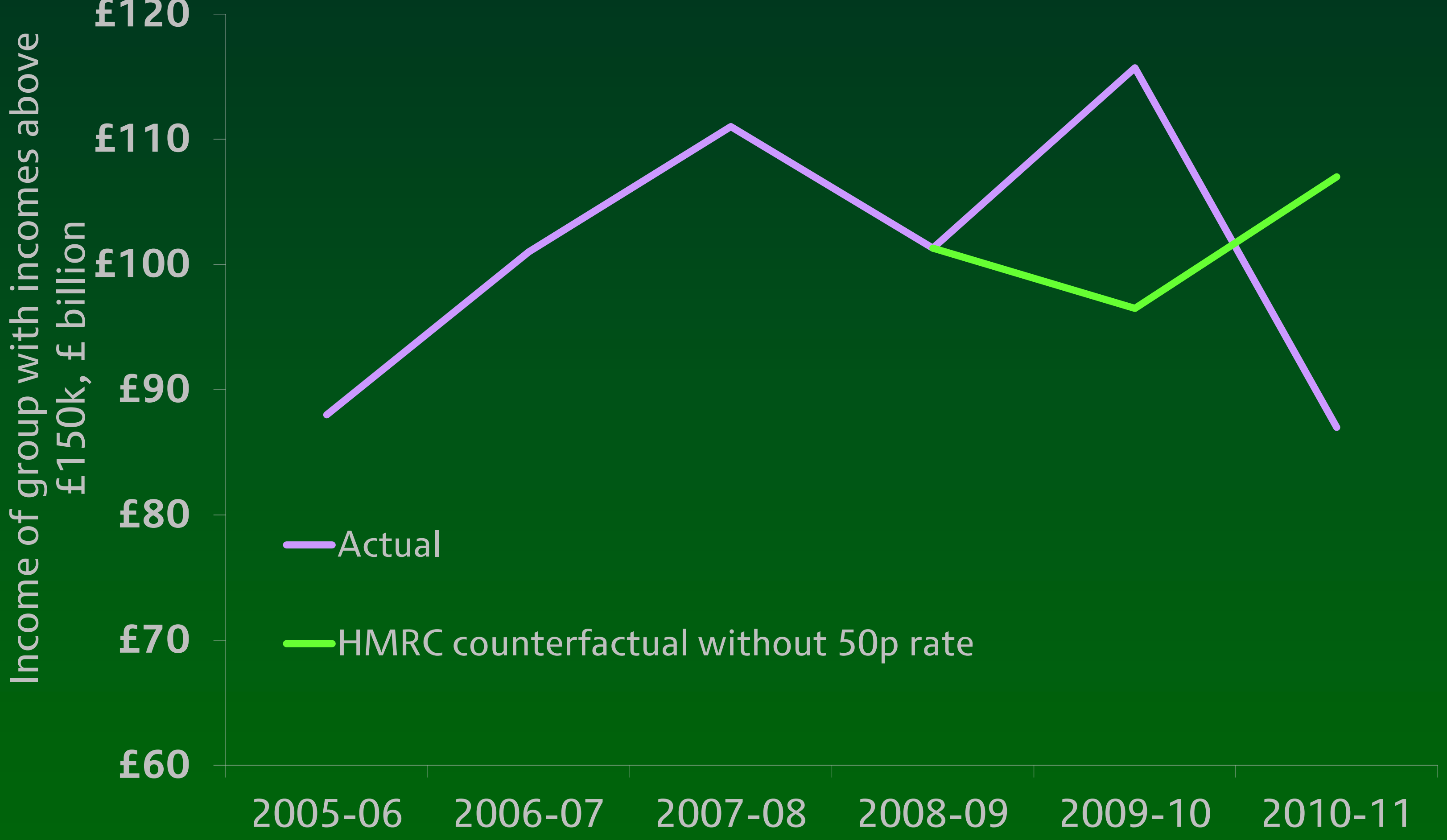
Total income among those with incomes above £150k, 2005–06 to 2010–11



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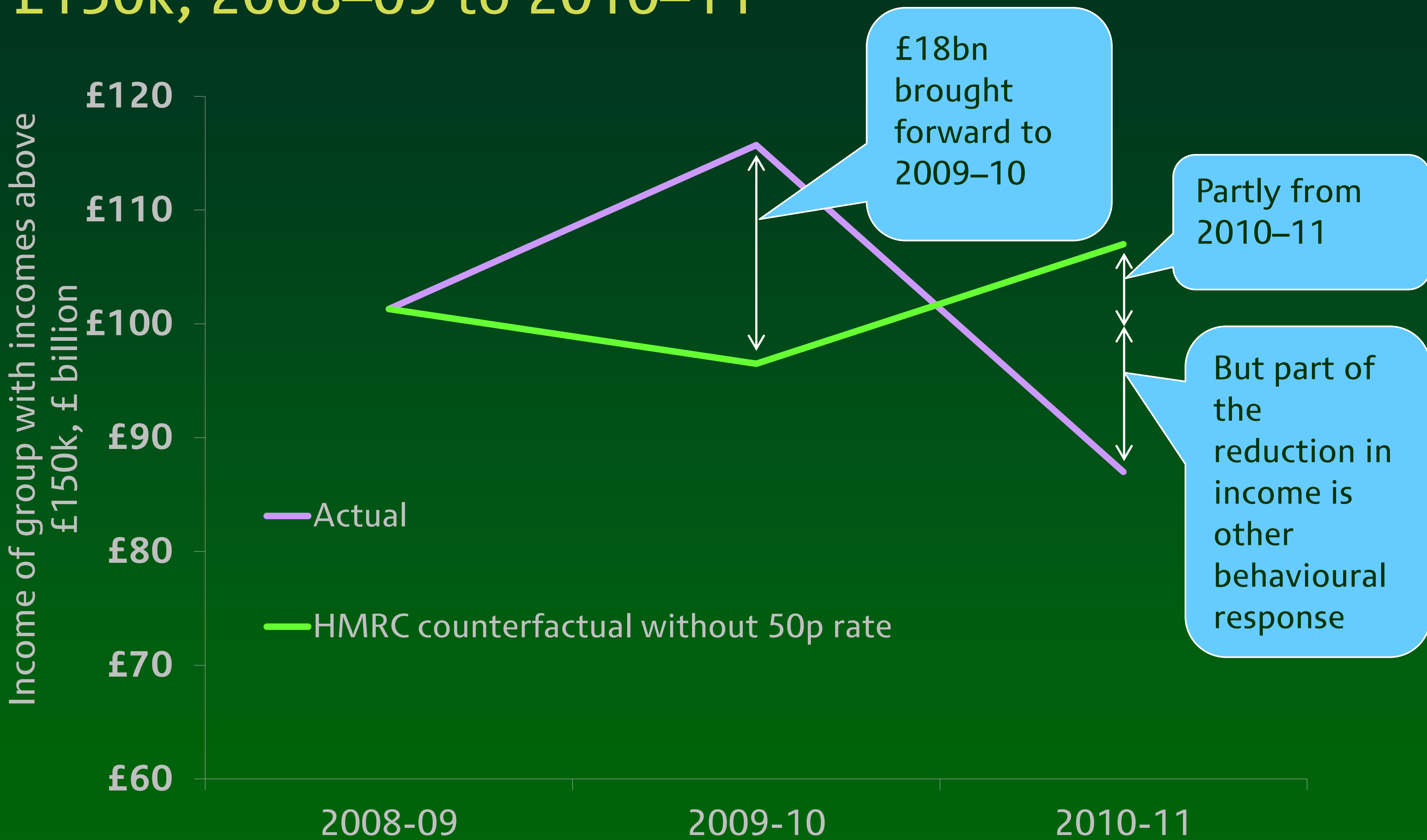
HMRC’s results

- Results indicate substantial ‘forestalling’ (bringing income forward to 2009–10): £16bn to £18bn shifted in this way
- Part of the fall in income in 2010 – 11 the result of forestalling, and part the result of other changes in behaviour
  - Forestalling will only affect the first few years of the 50p rate: can only bring a certain amount of income forward
  - To get the medium term costing, need to separate out unwinding of forestalling from other behavioural changes
  - HMRC attempt to distinguish between the two effects, but requires assumption about how quickly forestalling unwound

Total income among those with incomes above £150k, 2008–09 to 2010–11



HMRC's estimate of medium run impact of 50p rate on revenues

- HMRC then estimate a taxable income elasticity
  - Summary parameter indicating how responsive taxpayers are to changes in their marginal tax rate
- Central estimate is 0.48
  - Implies 50p rate raises £1 billion relative to 40p
  - Very similar to IFS central estimate of 0.46 based on experience of tax cuts in the 1980s
  - OBR used an estimate of 0.45 for costing of cut to 45p announced yesterday: means cost is £100 million a year
- But estimates produced by their model are very imprecise
  - Standard errors so large that there is a one-third chance that revenue-maximising rate in the model is less than 30% or more than 75%
- And revenue estimates are highly sensitive to taxable income elasticity…
  - (and to how much indirect tax revenues affected)

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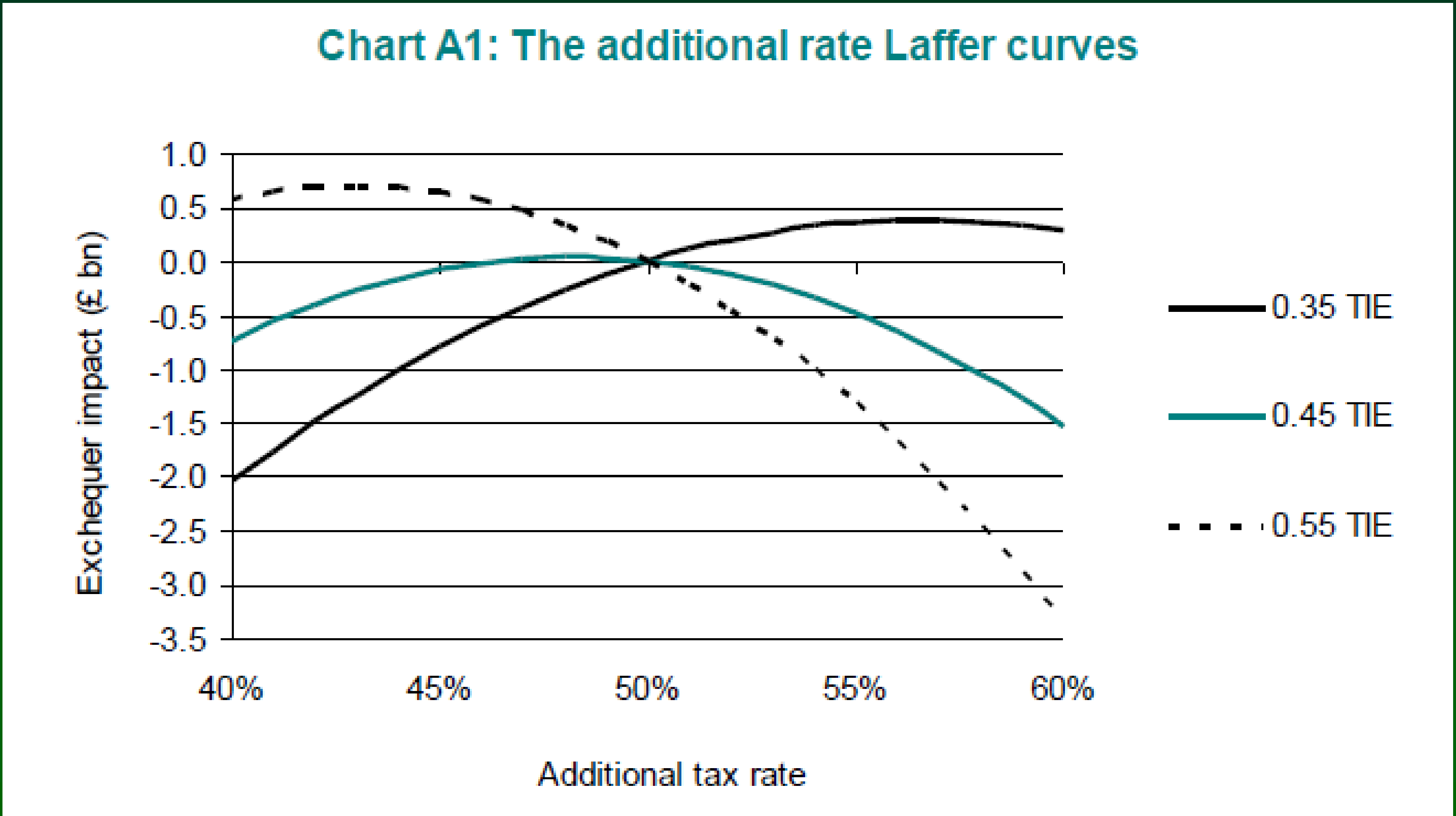
HMRC’s Laffer curves



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Going forward

- Chancellor announced that 50p rate will be cut to 45p from April 2013
- OBR costed the measure at £100m in a full year based on taxable income elasticities similar to those produced by HMRC and IFS
  - Does not allow indirect tax revenues to be affected
- Key questions
  - Will short-run response to tax cut be symmetric to response to tax rise? Will people continue to use avoidance techniques currently being used for 50p rate rather than increase taxable incomes?
  - How much forestalling from pre-announcement of tax cut? OBR estimates £2.4 billion drop in revenue in 2012–13
  - What impact will yesterday's anti-avoidance measures have? Should increase amount raised by 45p rate and increase revenue-maximising tax rate

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Conclusions

- HMRC report shows that 50p rate led to substantial shifting of income forward to 2009–10
- Unclear to what extent this was responsible for significant drop in income in 2010–11
  - Using reasonable assumptions, HMRC find other considerable behavioural responses that reduced incomes
  - But model is so imprecise that results are not very informative in themselves
- HMRC's estimate of taxable income elasticity in line with IFS estimate from 1980s and other estimates from academic literature
  - Suggests cutting to 45p cost £100 million a year, and cutting back to 40p would cost about £1 billion a year
  - But remains considerable uncertainty around both of these figures

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