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

Revenue raised, £ billion

Income tax rate above £150,000

No behavioural response

HMT’s 2009 assumptions
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
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
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
Total income among those with incomes above £150k, 2005–06 to 2010–11

Income of group with incomes above £150k, £ billion

- Actual
- HMRC counterfactual without 50p rate

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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

- £18bn brought forward to 2009–10
- Partly from 2010–11
- But part of the reduction in income is other behavioural response

Income of group with incomes above £150k, £ billion

- Actual
- HMRC counterfactual without 50p rate

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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)
HMRC’s Laffer curves

Chart A1: The additional rate Laffer curves

Exchequer impact (£bn)

Additional tax rate

0.35 TIE

0.45 TIE

0.55 TIE
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
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