

## Analysis of Liberal Democrat tax proposals

The Liberal Democrats today announced further details of their alternative Budget proposals. On the tax side they would:

- Introduce a new 49% rate of income tax on incomes above £100,000 a year
- Abolish council tax (and council tax benefit)
- Introduce a new local income tax
- Increase the stamp duty threshold on property transactions from £60,000 to £150,000
- Reduce stamp duty disadvantaged area relief for non-residential properties

The net revenue raised from these measures would, among other things, pay for a citizen's pension for those aged 75 and over, the abolition of higher education fees and the provision of free personal care for the elderly.

This press release sets out some initial analysis of the Liberal Democrats' tax proposals. Further analysis, incorporating the impact of their spending plans, will be published before the general election.

### New 49% rate of income tax on incomes above £100,000 a year

This proposal would be a relatively large tax increase on a relatively small number of extremely high-income individuals. In 2004–05 only 419,000 individuals are estimated to have incomes in excess of £100,000. This represents 0.9% of the UK adult population, and 1.4% of those with incomes sufficiently high to pay income tax. The Liberal Democrats' costings are based on Inland Revenue figures suggesting that this reform would raise £4.7 billion in 2004–05 and £5.2 billion in 2005–06, assuming that individuals do not change their taxable incomes in response to the reform. This would mean an average (mean) loss of £216 per week in 2004–05 for each individual whose income is over £100,000 per year, or £29.50 per week on average for each family in the highest-income tenth of the population (there are virtually no losers outside the top tenth of the income distribution).

But there are reasons to believe that the actual revenue raised by the reform might be lower than this, eating into the reserve that the Liberal Democrats have incorporated into their plans. First, the Liberal Democrats' figures are based on Inland Revenue estimates of September 2004. But more recent (December 2004) Inland Revenue statistics imply that there is only enough income above £100,000 to yield £4.2 billion in 2004–05. How much a 49% rate would raise in future years will depend both on the growth in taxable income of those near to and above the new threshold and on how this threshold is indexed, but a 24% rise in the revenue raised to £5.2 billion in 2005–06 seems unlikely.

Second, the estimates also assume that reform itself has no effect on taxable incomes. But the increase in the marginal tax rate facing these individuals (their combined income tax and employee National Insurance (NI) contribution rate would increase from 41% to 50% while their employer NI rate would be left unchanged) could encourage them to reduce their taxable incomes, since the financial penalty from doing so is diminished. There are many ways in which individuals might reduce their taxable incomes. They could decide to reduce their work effort, or to retire earlier than they otherwise would. They could even choose to leave the country, or high-income foreigners might be discouraged from immigrating. People

could try to reduce their taxable income by engaging in greater tax avoidance measures. They might increase their contributions to private pensions, since they would receive tax relief at 49p in the pound and might only expect to be paying higher rate tax at 40p once in retirement. The likely extent of such behavioural responses is debatable, but to the extent that people do any of these things, the yield of the 49% rate would be reduced.

Conversely, it is possible that people might choose to increase their pre-tax incomes (work harder etc) to make up for the extra tax they are paying. This would increase the revenue raised from this reform. However, to the extent that the revenue is redistributed to the population (used to reduce local tax rates, reduce the cost of long-term care, etc), we might expect the reduced work effort of the beneficiaries broadly to offset the increased work effort of the losers.

#### Abolishing council tax (and council tax benefit) and introducing a new local income tax

Council tax (net of council tax benefit) is expected by the Treasury to raise £21.3 billion in 2005–06. The Liberal Democrats propose to abolish council tax on first homes (and council tax benefit), increase grants to local authorities by £2.3 billion and allow them to raise the rest through a local income tax levied on income between the personal allowance and £100,000.

Our calculations using Treasury estimates suggest that the required average local income tax rate would be between 3½% and 3¾% on all income between these two levels if there were no behavioural response to the reform. If the increase in income tax persuaded people to reduce their taxable incomes (as described above for the 49% tax rate) then the required average local income tax rate may be higher than this. This is likely to be less of an issue than with the 49% rate of income tax, and it is also the case that those individuals currently in receipt of council tax benefit would see a large fall in their marginal rate.

Winners would be those with relatively low incomes who pay relatively high council tax (which will include many pensioners), while losers would be those with relatively high incomes who pay relatively low council tax (which will include many two earner couples). Hence the reform would redistribute from those who are relatively rich in terms of their current income but poor in terms of their housing wealth towards those who are relatively rich in terms of their housing wealth but poor in terms of their current income. Not all low-income individuals would gain: those who currently receive full council tax benefit but pay income tax would lose from the proposed reform.

Using the IFS tax and benefit model, TAXBEN, we have estimated the effect of this reform on family incomes assuming that all local authorities impose the same local income tax rates. This shows that nearly half (49%) of families would gain more than £1 a week from this change and a further quarter (24%) of families would be largely unaffected. Just over one in four (27%) families would lose more than £1 a week. On average families in all of the bottom eight decile groups of the income distribution would gain, while those in the top two income decile groups would lose. Families with no-one currently in paid work would experience the largest average increase in net incomes. While there would be many fewer losers than gainers from this reform, the average losses among those who do lose are substantially greater than the average gains among those who gain. Further details of the distributional impact of this reform are shown in Tables 1 and 2 below.

In practice, the pattern of gains and losses might be slightly different from this if different local authorities set different local income tax rates. Many factors will affect each local authority's choice of local income tax rate, but a crucial factor will be how the change in the tax base and the allocation of grants from central government affect local spending decisions. People living in areas that see a reduction in support from central government (which would be areas that have relatively high incomes but a relatively low value stock of property) are more likely to see their local tax bills rise, while those in areas that see an increase in support from central government (which would be areas that have relatively low incomes but a relatively high-value stock of property) are more likely to see their local tax bills fall.

### Reforming stamp duty land tax

The Liberal Democrats propose to increase the stamp duty threshold on property from £60,000 to £150,000. This has already been done for properties in designated disadvantaged areas (in 2001) and for non-residential properties (in 2003); the Liberal Democrats would extend it to all properties nationwide. This is estimated to cost just under £½ billion in 2005–06 and would lift over 400,000 property transactions a year out of stamp duty. They would pay for this by re-imposing stamp duty on non-residential properties in disadvantaged areas (which have been exempt altogether since 2003), though initially at a reduced rate.

Those who wish to buy a property worth between £60,000 and £150,000 in a non-disadvantaged area will no longer pay stamp duty. But to the extent to which the reform increases house prices the gains will accrue to those already owning such properties instead. Hence many of those gaining from this reform will not necessarily be first time buyers. The extent to which the reform helps low income households is further limited by the fact that around a quarter of house purchases are for properties worth less than £60,000 and on average those who do not own a property have lower incomes than those who do.

The distributional impact of this reform is shown in Tables 3 and 4 below.

**Table 1. Gains and losses across the income distribution of the Liberal Democrat proposal to replace council tax with a uniform local income tax in 2004–05**

| Income decile group | Average change in net weekly income | % change in net income | No. families gaining at least £1 per week (000s) | No. families losing at least £1 per week (000s) | Proportion of families gaining at least £1 per week | Proportion of families losing at least £1 per week | No. families gaining at least £10 per week (000s) | No. families losing at least £10 per week (000s) | Proportion of families gaining at least £10 per week | Proportion of families losing at least £10 per week |
|---------------------|-------------------------------------|------------------------|--|---|---|--|---|--|--|---|
| Poorest             | £1.85                               | 2.40                   | 633  | 24  | 21%   | 1%   | 229   | 1  | 7%   | 0%  |
| 2 <sup>nd</sup>     | £3.82                               | 2.27                   | 1,457  | 139   | 48%   | 5%   | 512   | 0  | 17%  | 0%  |
| 3 <sup>rd</sup>     | £6.29                               | 2.91                   | 2,024  | 341   | 66%   | 11%  | 963   | 0  | 31%  | 0%  |
| 4 <sup>th</sup>     | £6.33                               | 2.69                   | 2,004  | 449   | 65%   | 15%  | 992   | 2  | 32%  | 0%  |
| 5 <sup>th</sup>     | £6.04                               | 2.19                   | 2,061  | 567   | 67%   | 18%  | 977   | 7  | 32%  | 0%  |
| 6 <sup>th</sup>     | £5.04                               | 1.60                   | 2,076  | 598   | 68%   | 19%  | 772   | 8  | 25%  | 0%  |
| 7 <sup>th</sup>     | £3.25                               | 0.90                   | 1,938  | 736   | 63%   | 24%  | 510   | 24   | 17%  | 1%  |
| 8 <sup>th</sup>     | £1.43                               | 0.33                   | 1,573  | 995   | 51%   | 32%  | 393   | 340  | 13%  | 11%   |
| 9 <sup>th</sup>     | -£2.64                              | -0.49                  | 928  | 1,805   | 30%   | 59%  | 232   | 602  | 8%   | 20%   |
| Richest             | -£17.67                             | -1.87                  | 236  | 2,746   | 8%  | 90%  | 62  | 1,934  | 2%   | 63%   |
| Overall             | £1.37                               | 0.38                   | 14,931   | 8,398   | 49%   | 27%  | 5,642   | 2,918  | 18%  | 10%   |

Note: See text for details of the policy. Income decile groups are derived by dividing all families into 10 equal-sized groups according to disposable income adjusted for family size using the McClements equivalence scale.

Source: Authors' calculations using the IFS tax and benefit model, TAXBEN, run on uprated data from the 2002–03 Family Resources Survey.

**Table 2. Gains and losses for different family types of the Liberal Democrat proposal to replace council tax with a uniform local income tax in 2004–05**

| Family type             | Average change in net weekly income | % change in net income | No. families gaining at least £1 per week (000s) | No. families losing at least £1 per week (000s) | Proportion of families gaining at least £1 per week | Proportion of families losing at least £1 per week | No. families gaining at least £10 per week (000s) | No. families losing at least £10 per week (000s) | Proportion of families gaining at least £10 per week | Proportion of families losing at least £10 per week |
|-------------------------|-------------------------------------|------------------------|--|---|---|--|---|--|--|---|
| Single, not working     | £1.54                               | 1.41                   | 799  | 78  | 23%   | 2%   | 228   | 15   | 6%   | 0%  |
| Single, working         | -£2.01                              | -0.74                  | 2,401  | 4,109   | 32%   | 55%  | 654   | 1,011  | 9%   | 13%   |
| Lone parent             | £4.65                               | 1.62                   | 1,137  | 121   | 62%   | 7%   | 425   | 26   | 23%  | 1%  |
| 0-earner couple, 0 kids | £7.04                               | 2.27                   | 512  | 92  | 66%   | 12%  | 289   | 14   | 37%  | 2%  |
| 0-earner couple, kids   | £8.77                               | 2.68                   | 279  | 1   | 78%   | 0%   | 161   | 0  | 45%  | 0%  |
| 1-earner couple, 0 kids | £4.56                               | 1.02                   | 1,067  | 310   | 73%   | 21%  | 481   | 139  | 33%  | 10%   |
| 1-earner couple, kids   | £2.69                               | 0.49                   | 1,044  | 426   | 66%   | 27%  | 479   | 215  | 30%  | 14%   |
| 2-earner couple, 0 kids | -£2.95                              | -0.48                  | 1,632  | 1,643   | 46%   | 46%  | 500   | 779  | 14%  | 22%   |
| 2-earner couple, kids   | -£1.92                              | -0.29                  | 1,569  | 1,332   | 50%   | 42%  | 490   | 621  | 15%  | 20%   |
| Single pensioner        | £4.03                               | 1.93                   | 2,271  | 164   | 55%   | 4%   | 669   | 31   | 16%  | 1%  |
| Pensioner couple        | £8.46                               | 2.31                   | 2,222  | 122   | 79%   | 4%   | 1,264   | 67   | 45%  | 2%  |
| Overall                 | £1.37                               | 0.38                   | 14,931   | 8,398   | 49%   | 27%  | 5,642   | 2,918  | 18%  | 10%   |

Note: See text for details of the policy. Income decile groups are derived by dividing all families into 10 equal-sized groups according to disposable income adjusted for family size using the McClements equivalence scale.

Source: Authors' calculations using the IFS tax and benefit model, TAXBEN, run on updated data from the 2002–03 Family Resources Survey.

**Table 3. Gains and losses across the income distribution from Liberal Democrats' proposed reforms to stamp duty**

| Income decile group | Average change in net weekly income | % change in net income |
|---------------------|-------------------------------------|------------------------|
| Poorest             | £0.15                               | 0.09                   |
| 2 <sup>nd</sup>     | £0.08                               | 0.03                   |
| 3 <sup>rd</sup>     | £0.09                               | 0.03                   |
| 4 <sup>th</sup>     | £0.18                               | 0.06                   |
| 5 <sup>th</sup>     | £0.11                               | 0.03                   |
| 6 <sup>th</sup>     | £0.07                               | 0.02                   |
| 7 <sup>th</sup>     | £0.09                               | 0.02                   |
| 8 <sup>th</sup>     | £0.03                               | 0.01                   |
| 9 <sup>th</sup>     | -£0.19                              | -0.03                  |
| Richest             | -£0.61                              | -0.06                  |
| Overall             | £0.00                               | 0.00                   |

Note: See text for details of the policy. Calculations based on characteristics of current home-owners rather than house-buyers or house-sellers. Impact of stamp duty on residential properties in disadvantaged areas assumed to be the same as in other areas; impact of stamp duty on non-residential properties in disadvantaged areas assumed to be proportional to household income. Income decile groups are derived by dividing all households into 10 equal-sized groups according to disposable income adjusted for household size using the McClements equivalence scale.

Source: Authors' calculations using wave 12 of the British Household Panel Survey and the 2002–03 Family Resources Survey.

**Table 4. Gains and losses across for different household types from Liberal Democrats' proposed reforms to stamp duty**

| Household type                      | Average change in net weekly income | % change in net income |
|-------------------------------------|-------------------------------------|------------------------|
| Single, not working                 | -£0.02                              | -0.01                  |
| Single, working                     | -£0.01                              | 0.00                   |
| Lone parent, not working            | -£0.17                              | -0.07                  |
| Lone parent, working                | £0.04                               | 0.01                   |
| 0-earner couple, no children        | -£0.06                              | -0.02                  |
| 0-earner couple, children           | -£0.24                              | -0.07                  |
| 1-earner couple, no children        | -£0.03                              | -0.01                  |
| 1-earner couple, children           | -£0.13                              | -0.03                  |
| 2-earner couple, no children        | £0.08                               | 0.01                   |
| 2-earner couple, children           | £0.10                               | 0.02                   |
| Single pensioner                    | £0.08                               | 0.04                   |
| Couple pensioner                    | £0.08                               | 0.02                   |
| Multi-family household, no children | -£0.10                              | -0.02                  |
| Multi-family household, children    | -£0.12                              | -0.02                  |
| Overall                             | £0.00                               | 0.00                   |

Note: See text for details of the policy. Income decile groups are derived by dividing all households into 10 equal-sized groups according to disposable income adjusted for household size using the McClements equivalence scale. Impact of stamp duty on residential properties in disadvantaged areas assumed to be the same as in other areas; impact of stamp duty on non-residential properties in disadvantaged areas assumed to be proportional to household income.

Source: Authors' calculations using wave 12 of the British Household Panel Survey and the 2002–03 Family Resources Survey.

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