

## 4. Options for raising revenue

The Treasury is relying on an increase in tax revenues as a share of national income to finance its current spending plans while continuing to comply with its fiscal rules. As set out in Chapter 3, further tax increases may need to be announced to deliver this increase in tax revenues.

The area that has been the subject of most recent speculation in this regard is the taxation of housing; this is discussed in Chapter 5. In this chapter, we discuss other parts of the personal tax system where revenues could be raised; taxes on companies are discussed in Chapter 6. We begin with income tax and National Insurance, looking at the rates in Section 4.1 and thresholds in Section 4.2. Section 4.3 moves on to consider the third big tax, VAT, while Section 4.4 looks at excise duties. In Section 4.5, we briefly discuss the possibility of other tax rises. Section 4.6 concludes.

### 4.1 Income tax and National Insurance rates

Perhaps the simplest option for the Chancellor if he wishes to raise revenue in the Budget would be to increase the rates of income tax or National Insurance contributions (NICs). Box 4.1 describes the structure of the income tax and National Insurance (NI) systems and the terminology involved. The two systems are very similar, and to a degree income tax, employee NICs and employer NICs can be added together into a combined ‘payroll tax’ schedule, as shown in Figure 4.1.<sup>1</sup> Despite their similarities, NI has traditionally been seen as less politically sensitive than income tax, and in any case the government has pledged not to increase the basic or higher rate of income tax for the duration of this Parliament.<sup>2</sup> NI rises therefore seem the more likely option, and indeed the last significant increase in personal taxation was a one percentage point increase in NI contribution rates for employees, employers and the self-employed (announced in the April 2002 Budget and taking effect in April 2003). It is possible that such a rise could be repeated.

A notable feature of that reform was that the rise was uncapped: the extra 1% contributions applied to earnings above the upper earnings limit (UEL) (upper profits limit for the self-employed), so that employees and the self-employed paid contributions (at a rate of 1%) on those earnings for the first time. This effectively created a new 1% tax rate above the UEL, and there is scope for increasing this further. A five percentage point increase in this additional rate

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<sup>1</sup> For more details on the similarities between income tax and National Insurance, see Chapter 5 of R. Chote, C. Emmerson and H. Simpson (eds), *The IFS Green Budget: January 2003*, London, 2003. ([www.ifs.org.uk/gb2003/ch5.pdf](http://www.ifs.org.uk/gb2003/ch5.pdf)).

<sup>2</sup> Page 10 of Labour Party, *Ambitions for Britain* (Labour’s general election manifesto 2001), London, 2001 ([www.labour.org.uk/ENG1.pdf](http://www.labour.org.uk/ENG1.pdf)).

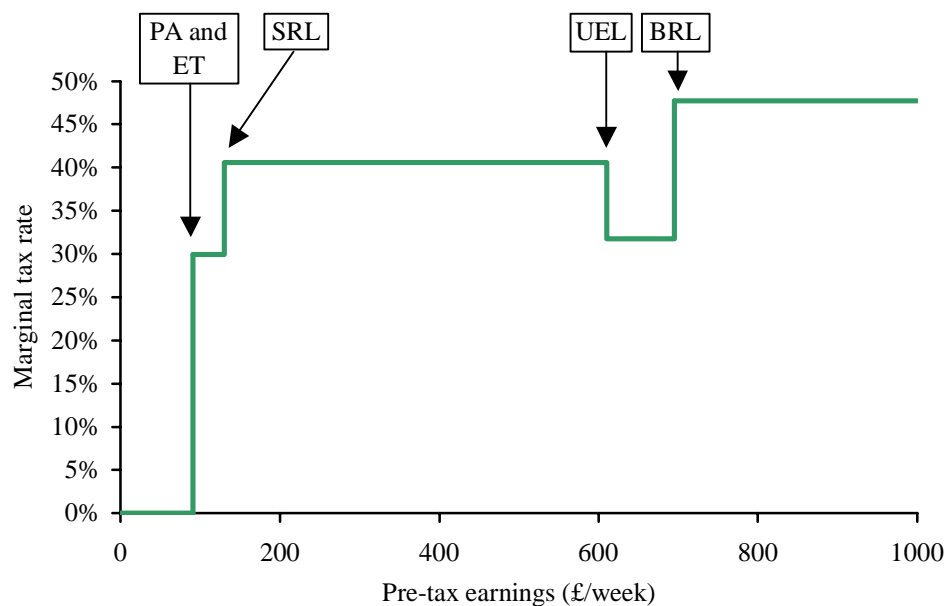
**Box 4.1. A brief guide to income tax and National Insurance**

The *personal allowance* is the income on which no income tax is paid. In 2004–05, it will be £4,745 per year, or £91 per week (higher for those aged 65 or over).

The first part of taxable income (i.e. income above the personal allowance) is taxed at the *starting rate*, currently 10%, up to the *starting-rate limit*. Taxable income above the starting-rate limit is taxed at the *basic rate*, currently 22%, up to the *basic-rate limit*. Taxable income above this is taxed at the *higher rate*, currently 40%. (Reduced rates apply to interest and dividend income.) The starting-rate limit and basic-rate limit for 2004–05 will be announced in the next Budget, but the ‘default’ increase (in line with inflation) would set them at £2,020 per year and £31,400 per year respectively, so that those with incomes above £6,765 per year, or £130 per week, would pay basic-rate tax, and those with incomes above £36,145 per year, or £695 per week, would pay higher-rate tax.

The *lower earnings limit* (LEL) is the level of earnings – £79 per week in 2004–05 – at which employees build up entitlement to NI (contributory) benefits. Contributions are not payable, however, until the *earnings threshold* is reached; at the moment, the earnings threshold is equal to the income tax personal allowance, i.e. £91 per week in 2004–05. Between the earnings threshold and the *upper earnings limit* (UEL) – £610 per week in 2004–05 – employees pay contributions at a rate of 11% and employers pay contributions at a rate of 12.8%, although one or both rates can be reduced if the employee is contracted out of the State Second Pension. Above the UEL, employee contributions fall to 1% while employer contributions remain at 12.8%.

**Figure 4.1. Combined payroll tax schedule, 2004–05**

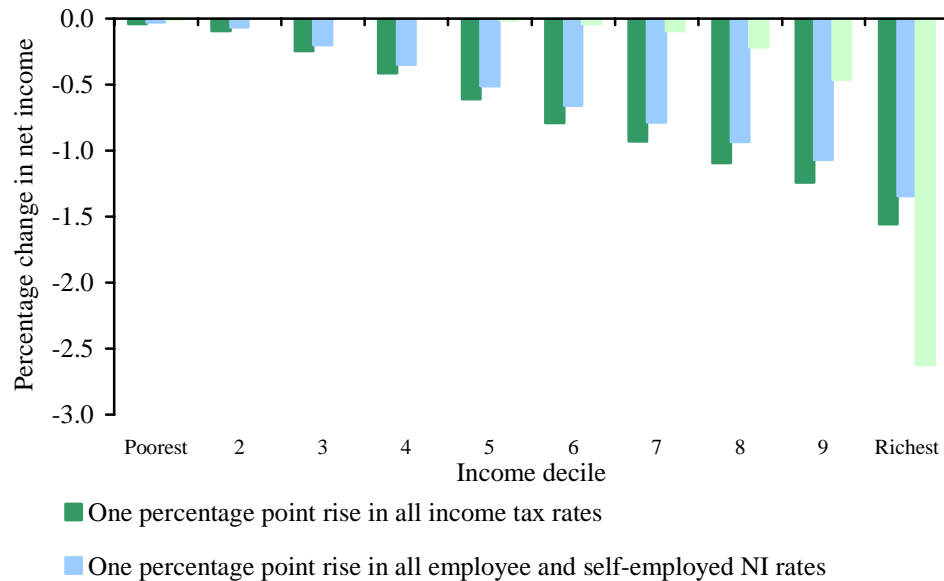


Notes: Combines income tax, employee NICs and employer NICs. Assumes 2.8% indexation of starting- and basic-rate income tax limits and statutory rounding. Rates shown are for a childless employee under 60 years old, not contracted out of the State Second Pension, working for the full year with no unearned income.

PA = personal allowance; ET = earnings threshold; SRL = starting-rate limit; UEL = upper earnings limit; BRL = basic-rate limit.

for employees and the self-employed would raise about the same as a one percentage point increase in all rates for employees and the self-employed (£4.2 billion and £4.4 billion respectively).<sup>3</sup> Figure 4.2 divides families into 10 equal-sized groups ('deciles') according to their income adjusted for family size, and shows the percentage change in family disposable income that these two reforms would represent for each decile. For comparison, it also shows the effect of a one percentage point rise in all income tax rates, which would raise slightly more (£5.1 billion) because it is based on a wider definition of income.

**Figure 4.2. Losses across the income distribution from increases in various rates of income tax and National Insurance contributions**



Notes: Income deciles are derived by dividing all families into 10 equal-sized groups according to income adjusted for family size. Decile 1 contains the poorest tenth of families, decile 2 the next poorest and so on, up to the richest tenth in decile 10.

Source: IFS tax and benefit model, TAXBEN, run using data from the Family Resources Survey 2001–02; vertical scale adjusted for consistency with government revenue estimates.

The patterns are clear. Increases in all income tax rates and increases in all NI rates have very similar distributional effects, and are fairly progressive overall, costing richer families a higher proportion of income than poorer families.<sup>4</sup> Raising the same amount using only the new NI rate above the UEL would be far more progressive: only the top end of the income distribution would be affected at all, and the burden would fall overwhelmingly on the richest tenth.

Increasing NI rates would raise a sizeable amount of revenue in a progressive way, so it looks like a promising option – and indeed the Chancellor did this last time he felt the need to increase taxes. But an increase may be more difficult politically this time, for two reasons. First, people might have become

<sup>3</sup> A one percentage point increase in employer rates would raise £4.1 billion, slightly less than the employee and self-employed rates combined. Source: HM Treasury, *Tax Ready Reckoner and Tax Reliefs*, London, 2003 ([www.hm-treasury.gov.uk/media/AAB24/pbr03\\_trr.pdf](http://www.hm-treasury.gov.uk/media/AAB24/pbr03_trr.pdf)).

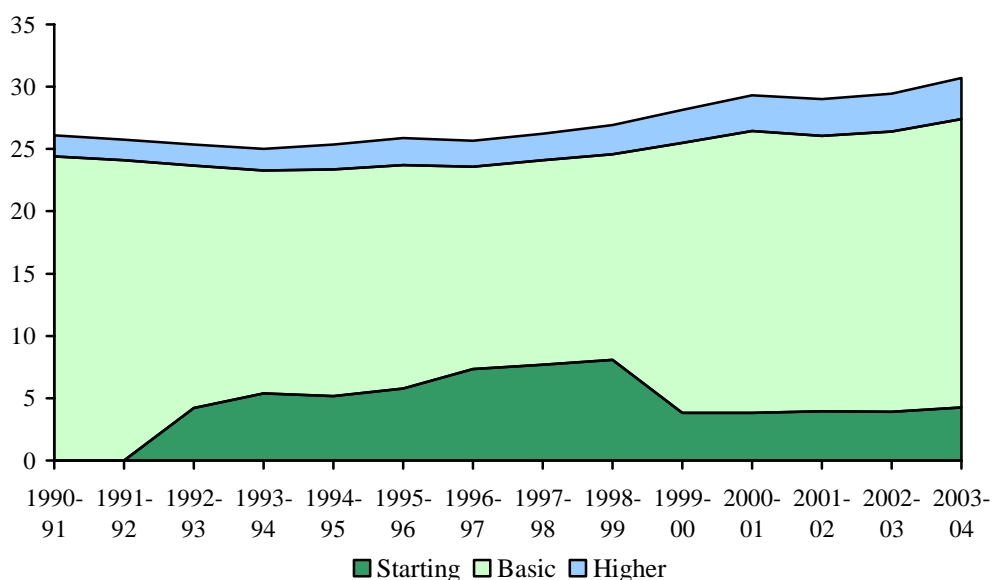
<sup>4</sup> The pattern for employer NI is also similar.

more conscious of NI as a result of the recent rise; and second, the last rise was closely linked to a rise in NHS spending. In the absence of such a corresponding commitment, which would be the case if extra revenue were required simply to reduce government borrowing, a rise in NICs might be more unpopular a second time round. The Chancellor could therefore opt for a different approach, altering income tax and National Insurance thresholds to change the number of people in different tax brackets.

## 4.2 Income tax and National Insurance thresholds

Thresholds are as important as rates in the income tax and NI systems, and in recent months increasing attention has been devoted to how many people are now paying higher-rate tax, as well as to the overall number of income tax payers. Figure 4.3 shows what has happened to the number of people in each income tax band since the introduction of independent taxation in April 1990. The most eye-catching changes are to the number of people paying starting-rate tax, which are largely the result of policy changes: the starting-rate band was introduced (at a rate of 20%) in 1992–93, and it was narrowed when the rate was reduced to 10% in 1999–2000. But we can also see a steady rise in the number of higher-rate taxpayers, from 1.7 million in 1990–91 to 2.1 million in 1996–97 and an estimated 3.3 million in 2003–04. The total number of taxpayers has risen less consistently, falling from 26.1 million in 1990–91 to 25.7 million in 1996–7, before rising to an estimated 30.7 million in 2003–04.

**Figure 4.3. Number of taxpayers by marginal rate (millions)**



Notes: 1999–2000 data are considered unreliable and the Inland Revenue has therefore withdrawn the figures; those shown are authors’ interpolations. ‘Starting’ includes those whose only income above the starting-rate limit is from either savings or dividends.

Source: Inland Revenue Statistics

([www.inlandrevenue.gov.uk/stats/income\\_tax/it\\_t01\\_1.htm](http://www.inlandrevenue.gov.uk/stats/income_tax/it_t01_1.htm)).

## Fiscal drag

Much of the rise in the number of taxpayers and in the number of higher-rate taxpayers can be explained by the process of *fiscal drag*. Income tax and NI thresholds are increased every year in line with inflation unless the Chancellor explicitly decides to the contrary. But incomes tend to rise more quickly than prices, so over time an increasing number of people's incomes cross the thresholds and move into higher tax brackets. Fiscal drag is not restricted to income tax and NI: it applies to any tax or benefit with thresholds that increase less quickly than the 'tax base' over time. Thus, unless the government explicitly overrides the statutory uprating arrangements, means-tested benefits will cover ever fewer people, while inheritance tax, for example, will capture ever more.

The rises in the number of taxpayers and in the number of higher-rate taxpayers are not solely due to above-inflation income growth. Fiscal drag can be accelerated if thresholds are increased by less than inflation. This has happened several times in recent years – the personal allowance was frozen in cash terms in 1993–94, 1994–95 and 2003–04, while the basic-rate limit was frozen from 1991–92 until 1994–95. Conversely, drag can be slowed if thresholds are increased by more than inflation – this occurred with the personal allowance in 1996–97 and 1997–98, for example. A further influence on the number of people in each tax band has been increasing inequality in pre-tax incomes: over the last 25 years, high-income people have experienced faster income growth than the average, while low-income people have experienced lower-than-average income growth.<sup>5</sup> This means that the number of higher-rate taxpayers has been increasing even more quickly, but the total number of taxpayers more slowly, than average real income growth alone would suggest.

Clearly, increases in the number of taxpayers and in the number of higher-rate taxpayers increase government revenue, both in real terms and as a proportion of national income. To an extent, therefore, fiscal drag can do the same job as raising tax rates, although it is important to note that normal fiscal drag is already built into the Treasury's medium-term revenue forecasts.

## Fiscal drag in the future

If we are willing to make assumptions about how people's incomes will grow in the future, we can forecast the number of people in different tax bands and the implications for government revenue. We can also see how these change if the government decides not to increase thresholds in line with inflation but to increase them in some other way.

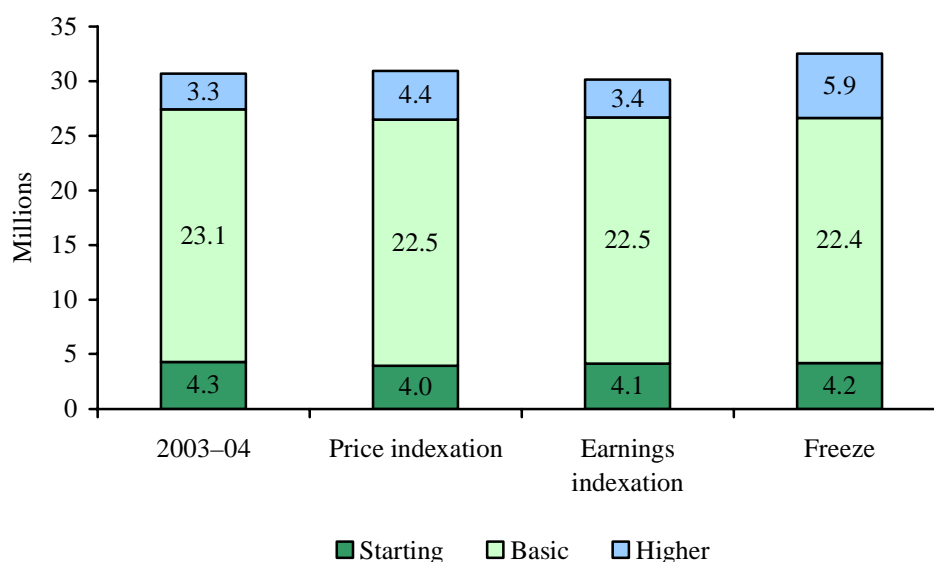
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<sup>5</sup> For more details on changes in income inequality since the 1970s, see T. Clark and J. Taylor, 'Income inequality: a tale of two cycles?', *Fiscal Studies*, 1999, vol. 20, pp. 387–408; and for analysis of changes since 1997, see A. Shephard, *Inequality under the Labour Government*, Briefing Note no. 33, Institute for Fiscal Studies, London, 2003 ([www.ifs.org.uk/inequality/bn33.pdf](http://www.ifs.org.uk/inequality/bn33.pdf)).

In this chapter, we make the assumption that private incomes grow at a rate of 2% in real terms (i.e. above inflation).<sup>6</sup> Note that this applies across the population; we do not attempt to predict or model any increase in pre-tax income inequality of the kind discussed above, so if such an increase occurs then we will overestimate the number of taxpayers, and underestimate the number of higher-rate taxpayers, in the future.<sup>7</sup>

It has already been announced that the income tax personal allowance and the NI earnings threshold will increase in line with inflation in 2004–05.<sup>8</sup> We assume that all other thresholds will also increase in line with inflation in 2004–05. For the following five years to 2009–10, we consider three different scenarios: price indexation (all thresholds increasing in line with inflation), earnings indexation (increasing in line with average earnings growth) and freezing (remaining the same in cash terms).

**Figure 4.4. Number of taxpayers by marginal rate in 2009–10 under different indexation assumptions**



Notes: Assumes 2.8% indexation of starting- and basic-rate income tax limits in 2004–05, and 2% real growth in private incomes each year. ‘Starting’ includes those whose only income above the starting-rate limit is from either savings or dividends.

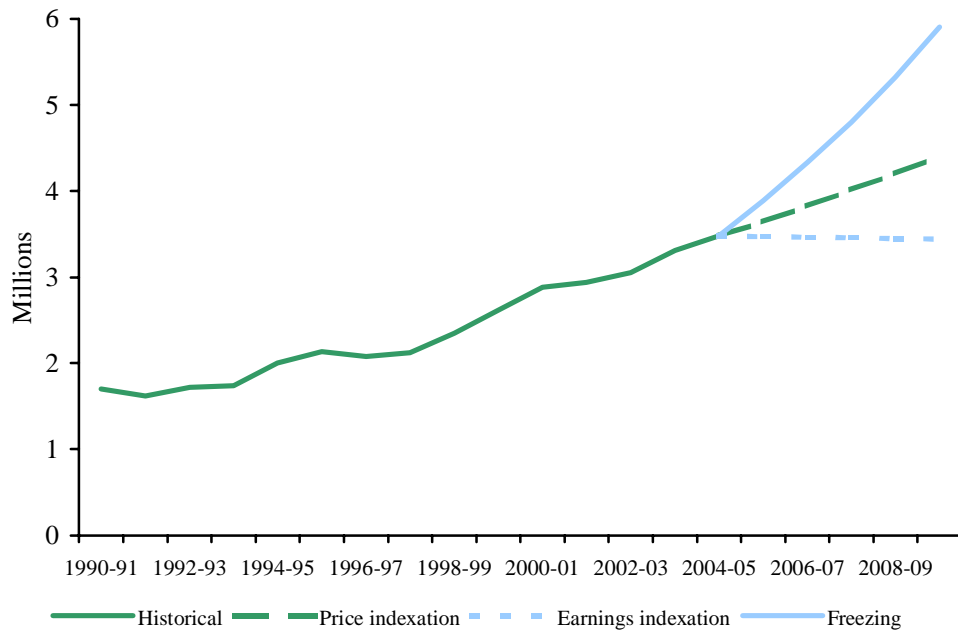
Source: Authors’ calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on data from the Family Resources Survey 2001–02.

<sup>6</sup> This is the Treasury’s ‘cautious case’ assumption for medium-term productivity growth (see table A2 of HM Treasury, *The Strength to Take the Long-Term Decisions for Britain: Seizing the Opportunities of the Global Recovery* (the 2003 Pre-Budget Report), December 2003 ([www.hm-treasury.gov.uk/media/AD2D6/pbr03annexa338.pdf](http://www.hm-treasury.gov.uk/media/AD2D6/pbr03annexa338.pdf))). The Treasury argues that ‘a reasonable long-term assumption is that real earnings will increase in line with productivity growth’ (paragraph 6.18 of HM Treasury, *Long-Term Public Finance Report: Fiscal Sustainability with an Ageing Population*, December 2003 ([www.hm-treasury.gov.uk/media/555E2/longterm\\_fiscal\\_1to6\\_436.pdf](http://www.hm-treasury.gov.uk/media/555E2/longterm_fiscal_1to6_436.pdf))).

<sup>7</sup> Obviously, the reverse will be true if pre-tax inequality falls.

<sup>8</sup> Except for the higher personal allowances for those aged 65 or over, which will increase in line with average earnings growth.

**Figure 4.5. Number of higher-rate taxpayers under different indexation assumptions**



Note: Assumes 2% real annual growth in private incomes, and 2.8% indexation of starting- and basic-rate income tax limits in 2004–05.

Source: Authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on data from the Family Resources Survey 2001–02.

Figure 4.4 shows projections of the number of people in each income tax band in 2009–10 under these three alternative assumptions for tax thresholds. Figure 4.5 shows the number of higher-rate taxpayers in each scenario alongside the historical trend since 1990–91.

If income tax thresholds were increased in line with earnings over the five years from 2005–06 to 2009–10, then the number of higher-rate taxpayers would remain virtually unchanged over that period.<sup>9</sup> Revenue from income tax would increase broadly in line with national income, leaving it around £10.6 billion higher (in today's prices) in 2009–10 than in 2004–05: people would be paying tax at the same rates, but on more income.

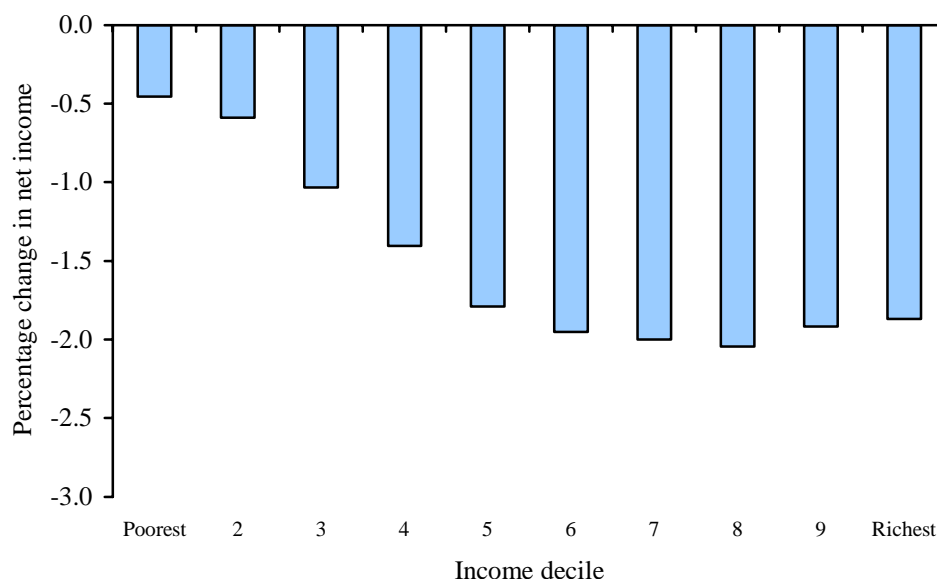
If, on the other hand, thresholds increased in line with prices (as they would by default), some 300,000 extra people would start paying income tax and more than 900,000 would move into the higher-rate band; income tax revenue would increase by £16.7 billion, £6.1 billion more than under earnings indexation. Alternatively, if thresholds were frozen, there would be 2.0 million more taxpayers, 2.4 million more higher-rate taxpayers and income tax revenue would rise by £24.5 billion, £7.8 billion more than under price indexation.

The effect of fiscal drag on NI revenues is less clear, because the structure of employee NI is not fully progressive: whereas the income tax rate rises at the

<sup>9</sup> The total number of taxpayers would actually fall unless benefits were also increased in line with earnings, as some benefit recipients would fall out of the tax system.

basic-rate limit, the employee NI rate falls at the UEL. This means that fiscal drag has an ambiguous effect on receipts of employee NI: some people move above the earnings threshold, increasing their marginal contribution rate from zero to 11%, but others move above the UEL, reducing their marginal contribution rate from 11% to 1%.<sup>10</sup> We find that these two effects offset each other almost completely; if anything, fiscal drag slightly reduces revenue from employee NI. There is no such ambiguity with employer NI: the contribution rate does not fall at the UEL.<sup>11</sup> This means that overall NI revenues are currently increased by fiscal drag in practice.

**Figure 4.6. Losses across the income distribution in 2009–10 from a freeze in all income tax and National Insurance thresholds from 2005–06 to 2009–10, relative to price indexation**



Notes: See Figure 4.2.

Source: IFS tax and benefit model, TAXBEN, run using data from the Family Resources Survey 2001–02.

A further complication is that the different tax liabilities arising from the different uprating options will leave people with different net incomes and therefore have knock-on effects on their benefit entitlements.<sup>12</sup> Overall, therefore, we estimate that earnings indexation of all income tax and NI thresholds over the five years from 2005–06 to 2009–10 would cost the government £7.2 billion a year relative to price indexation by 2009–10, while freezing all thresholds would raise £8.8 billion more than price indexation.<sup>13</sup> The distributional impact of such a freeze is shown in Figure 4.6. The reform

<sup>10</sup> The reduction is smaller for those contracted out of the State Second Pension.

<sup>11</sup> Indeed, for some people, the rate of employer NI rises at the UEL because the contracted-out rebate ends.

<sup>12</sup> Different net incomes available to spend may also affect government receipts from VAT and excise duties. We do not model such behavioural changes, however.

<sup>13</sup> This assumes that the rest of the tax and benefit system is price-indexed.



hits deciles 7 and 8 of the income distribution hardest as a percentage of income, although the richest lose most in cash terms. This is also indicative of the distributional impact of fiscal drag generally.

While the default option is for thresholds to increase in line with prices and that is the assumption built into the Treasury's medium-term public finance projections, it is not necessarily realistic to expect price indexation to continue indefinitely. Perpetual price indexation would mean that thresholds fell ever lower relative to incomes, ultimately meaning that almost everyone paid almost all their tax at the higher rate. It seems unlikely that this would be allowed to happen, and indeed the Treasury's long-term forecasts assume income tax and NI revenues are a stable proportion of national income, suggesting something more akin to earnings indexation over the long term.<sup>14</sup>

### **Changes to particular thresholds**

The Chancellor need not, of course, increase all thresholds in the same way, nor need he rely only on fiscal drag to increase revenues.

One obvious option for the Budget would be to freeze the income tax personal allowance and the NI earnings threshold (these have been set at the same level since 2001–02, and are likely to remain aligned). Their level in 2004–05 has already been set, but a freeze could be announced for the following year. This has been done several times in the past and might well be repeated, raising around £1.3 billion. Most of the revenue would come from higher earners (since income tax allowances reduce the amount of income taxed at the highest rate paid by each taxpayer), but middle-income families would lose most as a proportion of income.

Reducing the basic-rate threshold seems unlikely because of a manifesto pledge that 'we will extend the 10p tax band'.<sup>15</sup> So the only other thresholds that might be changed are the basic-rate limit and the upper earnings limit. The gap between these two is a long-standing anomaly in the structure of the tax system: the fact that the UEL is reached at a lower income level than the basic-rate limit causes a peculiar dip in the effective marginal tax rate for earnings between £610 and £695 per week (as shown in Figure 4.1) for which it is hard to find an economic rationale.

The Chancellor may choose to correct this anomaly either by raising the UEL to match the basic-rate limit (so that income currently between the two would be subject to 'standard' NICs and basic-rate income tax, like the income below it) or by lowering the basic-rate limit to match the UEL (so that income currently between the two would be subject to 'additional' NICs and higher-rate income tax, like the income above it). Either reform would be extremely progressive – the richest 10% would provide two-thirds of the revenue, while the bottom half of the income distribution would be virtually unaffected – but

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<sup>14</sup> See paragraphs 6.17 and 6.18 of HM Treasury, *Long-Term Public Finance Report: Fiscal Sustainability with an Ageing Population*, December 2003 ([www.hm-treasury.gov.uk/media/555E2/longterm\\_fiscal\\_1to6\\_436.pdf](http://www.hm-treasury.gov.uk/media/555E2/longterm_fiscal_1to6_436.pdf)).

<sup>15</sup> Page 10 of Labour Party, *Ambitions for Britain* (Labour's general election manifesto 2001), London, 2001 ([www.labour.org.uk/ENG1.pdf](http://www.labour.org.uk/ENG1.pdf)).

they would raise very different amounts of revenue: increasing the UEL to the basic-rate limit would raise a little over £1 billion, while reducing the basic-rate limit to the UEL would raise around £3 billion.

In view of the attention focused on the growing number of higher-rate taxpayers, increasing the UEL to match the basic-rate limit seems the likelier of these two options. But the Chancellor could choose to align them in a different way. One possibility would be to increase the UEL *and* reduce the basic-rate limit, equalising them at some intermediate level. Another would be to align them gradually: if the income level at which higher-rate tax started was frozen while the UEL continued to rise in line with inflation, then the two would meet in about 2008–09 (the exact year depending on the rate of inflation), although this would mean that revenues increased only gradually (£0.6 billion in 2004–05, for example). There have already been some moves towards gradual alignment: the UEL was increased by more than inflation in April 2000 and April 2001 (announced in the April 1999 Budget).

A more radical option would be to abolish the UEL altogether. This would raise around £7.5 billion. Since this would mean contribution rates of 11% both below and above the UEL, it is roughly equivalent to a 10 percentage point increase in the rate of employee contributions above the UEL. The distributional effect can therefore be gauged from the third set of bars in Figure 4.2, but doubling the height of each bar. Such a measure would be extremely progressive, but the sheer magnitude of the tax increase that would be borne by high earners (and the possible political backlash resulting from this) means that the government would be unlikely to do this without using some of the revenue to compensate losers. It would be possible, for example, to cut the higher rate of income tax, increase the basic-rate limit to reduce the number of people paying higher-rate tax, and still have revenue left over from abolishing the UEL.

Rises in tax rates of this magnitude also bring into focus the issue of the possible disincentive to work created by high tax rates. High marginal rates reduce people's incentive to increase their hours of work at the margin, although it should be noted that even the effective marginal rate of 56.6% that abolishing the UEL would introduce is still lower than the top marginal rate that existed before March 1988. It is also lower than those faced by many people towards the bottom of the income distribution as a result of benefit and tax credit withdrawal. This highlights one limitation of looking at the number of higher-rate taxpayers, notwithstanding its political symbolism: income tax is only one of the factors affecting work incentives, so incentives should be assessed looking at the whole tax and benefit system together. Furthermore, if we are more concerned about people's incentive to start (or stop) working at all, we should be more interested in the overall tax burden they face, which is better measured by the *average* tax rate (the proportion of total income, rather than extra income, taken in tax) and is affected much less by increases in the top marginal rate. For example, a person earning £40,000 per year would find that a ten percentage point increase in the higher rate in 2004–05 would increase his marginal income tax rate from 40% to 50% but would only

increase his average income tax rate from 20.5% to 21.5%.<sup>16</sup> The number of higher-rate taxpayers in itself says nothing about average tax rates – indeed, most people moving into higher-rate tax will find their average tax rate barely affected since only a small amount of their income will be taxable at the higher rate. The government will also have to trade off different policy objectives: for example, it may think that raising tax rates at the top of the income distribution is a sensible redistributive response to rising pre-tax inequality even if it creates some disincentives.

## **Conclusions**

Adjustments to income tax and NI thresholds provide a wide range of possibilities for raising revenue. Fiscal drag alone will increase revenues a great deal, but operates only slowly and is already built into the Treasury's medium-term revenue forecasts; freezing tax-free allowances or aligning the basic-rate limit and the UEL are options for the forthcoming Budget that would raise moderate amounts; while the most radical and redistributive option would be to abolish the UEL altogether.

## **4.3 VAT**

After income tax and National Insurance contributions, value added tax (VAT) is the government's biggest source of revenue, raising an estimated £69 billion in 2003–04.<sup>17</sup> The main rate of VAT is 17.5%, but some goods and services are exempt, zero-rated or subject to a 5% reduced rate. This is estimated to cost the Treasury £33 billion in 2003–04 compared with what would have been raised had all goods and services been subject to the main rate.<sup>18</sup> There is ample scope, therefore, to raise revenue by widening the tax base: for example, changing food from a zero-rated to a reduced-rated good would raise around £3.0 billion.<sup>19</sup> A widening would bring the UK more into line with other European countries, since the UK currently has a very narrow VAT base by international standards: for example, the UK and Ireland are the only EU countries to apply a zero rate to food, water, books or children's clothes. A widening would also be consistent with the International Monetary Fund's recent recommendation that 'If adjustments are to be made on the revenue

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<sup>16</sup> His combined marginal rate rises from 47.7% to 56.6%, while his combined average rate only rises from 35.4% to 36.3%. Note that these percentages apply not to the £40,000 'gross earnings', but to the employer cost including employer NICs. Both these and the rates in the main text are for a childless employee under 60 years old, not contracted out of the State Second Pension, working for the full year with no unearned income.

<sup>17</sup> Source: Table B9 of the December 2003 Pre-Budget Report ([www.hm-treasury.gov.uk/media/DBB0D/pbr03annexb227.pdf](http://www.hm-treasury.gov.uk/media/DBB0D/pbr03annexb227.pdf)).

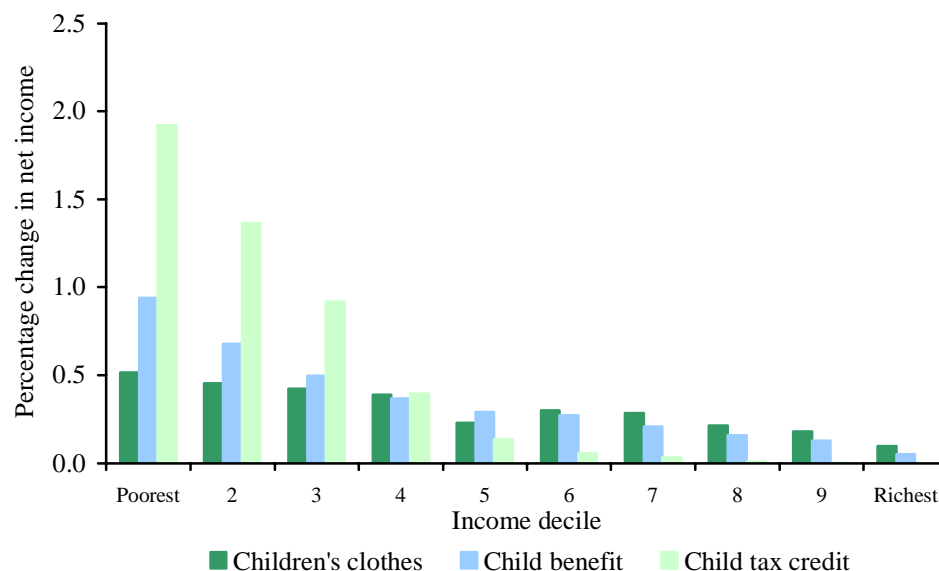
<sup>18</sup> Source: Table 7 of HM Treasury, *Tax Ready Reckoner and Tax Reliefs*, London, 2003 ([www.hm-treasury.gov.uk/media/AAB24/pbr03\\_trr.pdf](http://www.hm-treasury.gov.uk/media/AAB24/pbr03_trr.pdf)).

<sup>19</sup> Authors' calculations from HM Treasury, *Tax Ready Reckoner and Tax Reliefs*, London, 2003 ([www.hm-treasury.gov.uk/media/AAB24/pbr03\\_trr.pdf](http://www.hm-treasury.gov.uk/media/AAB24/pbr03_trr.pdf)).

side, we would argue for broadening tax bases rather than for raising tax rates'.<sup>20</sup>

Zero-rating, reduced-rating and exemptions are usually defended on distributional grounds: the items involved are mainly necessities, in the sense that lower-income families spend a higher proportion of their incomes on them; charging VAT on these items would thus cost the poor a larger proportion of their income. But this argument must be balanced by the recognition that, as long as richer people buy more of any good than poorer people, the rich will benefit more than the poor *in cash terms* from zero-rating. It would actually be better for poor people on average if these tax breaks were ended and the proceeds distributed evenly across the population – and, of course, a more progressive distribution of the proceeds would benefit the poor even more.

**Figure 4.7. Gains across the income distribution from existing zero-rating of children's clothing, from a £1.67 increase in child benefit, and from a £3.11 increase in the child element of the child tax credit**



Notes: Income deciles are derived by dividing all households into 10 equal-sized groups according to income adjusted for household size. Decile 1 contains the poorest tenth of households, decile 2 the next poorest and so on, up to the richest tenth in decile 10. Source: IFS tax and benefit model, TAXBEN, run using data from the Family Expenditure Survey 2000–01; vertical scale adjusted for consistency with government revenue estimates.

As an illustration, Figure 4.7 shows the distribution of gains from zero-rating children's clothes, along with the distribution of gains from using the same amount of money – £1.2 billion in 2003–04 – to increase (universal) child benefit by £1.67 per week or the child element of the (means-tested) child tax credit by £162 per year (£3.11 per week). The graph shows that low-income

<sup>20</sup> Paragraph 11 of International Monetary Fund, *United Kingdom – 2003 Article IV Consultation: Concluding Statement of the IMF Mission*, December 2003 ([www.imf.org/external/np/ms/2003/121803.htm](http://www.imf.org/external/np/ms/2003/121803.htm)).

households do indeed gain more as a percentage of income than higher-income households from the zero-rating of children's clothes. But despite there being more children in poorer deciles, the average cash gain is bigger for richer households: 84 pence per week for the richest decile, compared with 70 pence per week for the poorest. Increasing child benefit is rather more progressive – the flat-rate payment represents a larger proportion of income for low-income households than for high-income households, as well as being payable for more children in the lower deciles – while means-tested payments would be even better targeted at low-income households.

Of course, if the proceeds from widening the tax base were redistributed in this way, the reform would not raise any net revenue. But the argument demonstrates that the proceeds from widening the tax base could be *partly* redistributed, raising some net revenue, while still on average compensating the poorest third, say, of the population. Zero-rating is not a particularly effective tool for achieving purely distributional goals; any justification for it must have some other basis – presumably that society has an interest in promoting consumption of these goods beyond the level people would choose if left to themselves.

Whatever its economic merits, a widening of the VAT base seems unlikely: the government pledged in its 2001 manifesto 'not to extend VAT to food, children's clothes, books, newspapers and public transport fares',<sup>21</sup> which collectively account for almost half of the cost of exemptions, zero-rating and reduced-rating. If anything, the government has been moving in the opposite direction, cutting the reduced rate on domestic fuel from 8% to 5% in 1997, and extending it in 2001 to cover women's sanitary products, children's car seats and certain residential conversions.

The other obvious way to raise more money from VAT would be to increase the main rate. A one percentage point rise in the main rate of VAT, from 17.5% to 18.5%, would raise around £4 billion;<sup>22</sup> the distributional impact is shown in Figure 4.8.

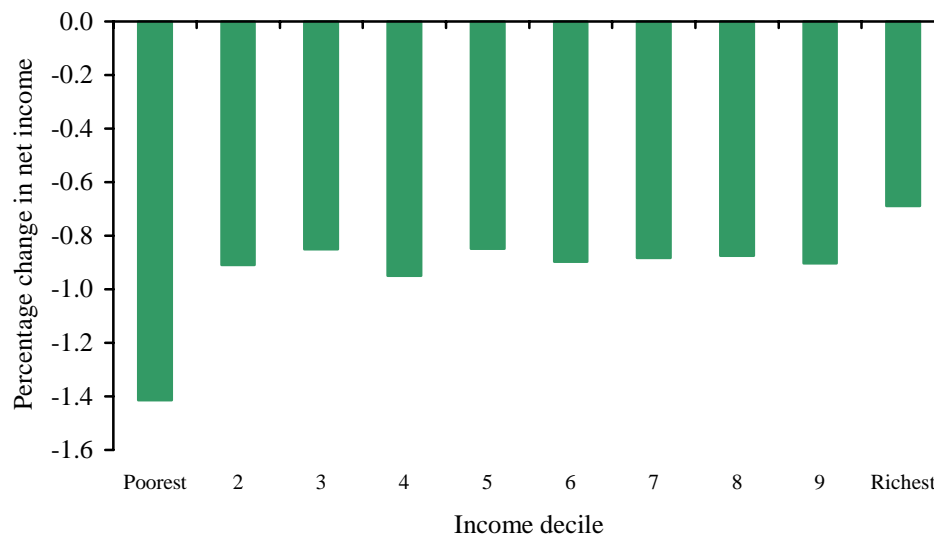
At least in the middle of the income distribution, the effect is seen to be approximately proportional, costing households at most income levels an amount equivalent to about 0.8–0.9% of their disposable income. Given that poorer households might be expected to spend a higher proportion of their income, this might seem surprising, for we might have expected more of their income to be liable to this point-of-sale tax. But this effect is offset by the fact that, as mentioned above, the poor spend a greater proportion of their income than do the rich on goods that are zero- or reduced-rated.

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<sup>21</sup> Page 10 of Labour Party, *Ambitions for Britain* (Labour's general election manifesto 2001), London, 2001 ([www.labour.org.uk/ENG1.pdf](http://www.labour.org.uk/ENG1.pdf)).

<sup>22</sup> Authors' calculations from tables 6 and 7 of HM Treasury, *Tax Ready Reckoner and Tax Reliefs*, London, 2003 ([www.hm-treasury.gov.uk/media/AAB24/pbr03\\_trr.pdf](http://www.hm-treasury.gov.uk/media/AAB24/pbr03_trr.pdf)).

**Figure 4.8. Losses across the income distribution from increasing the main rate of VAT by one percentage point**



Notes: See Figure 4.7.

Source: IFS tax and benefit model, TAXBEN, run using data from the Family Expenditure Survey 2000–01; vertical scale adjusted for consistency with government revenue estimates.

The main exceptions to the pattern of proportionality are the extremes of the income distributions: the poorest tenth of households lose more than most, with a 1.4% reduction in the purchasing power of their disposable income, while the richest tenth lose less – only 0.7% of their disposable income. For benefit claimants, the effect of the reform would be tempered somewhat in the long run as the VAT increase would feed through into the retail price index, which is used to uprate benefits. This means that prices and benefit income would both increase, making the overall outcome at the bottom end of the distribution less clear.

In addition, we should remember that we have only considered a ‘snapshot’ of income at a particular point in time. Some households at the bottom of the income distribution may be spending a lot relative to their income because their income is only low temporarily. Higher-income households that save more will eventually pay VAT when they spend the wealth that they are building up. If we were to compare tax payments with average *lifetime* incomes, VAT would appear much more progressive than this relative to income tax.

Nevertheless, VAT rises are widely perceived as more regressive than income tax or NI rises. Implementing this reform in isolation would therefore represent something of a break with the redistributive direction of Labour’s reforms to date. And, although not unprecedented, VAT rises are rare: the main rate has changed only once since 1979 (in 1991), and that was linked to a simultaneous reduction in the community charge. Reform to VAT does not, therefore, seem a likely source of extra revenue in the forthcoming Budget.

The government is currently trying to increase VAT revenues without changing rates or coverage by tackling evasion and fraud – a significant problem, since VAT losses accounted for 15.7% of theoretical liability in 2002–03 (up from 11.3% in 1997–98).<sup>23</sup> The government's target is to reduce this gap to 12% by 2005–06, and there have been some early signs of success: the government raised its forecast for VAT receipts for 2003–04 in December's Pre-Budget Report. But some increases in VAT revenue are already assumed in the Chancellor's public finance forecasts, and since the government will presumably have taken the most effective steps first, it is unclear how far further initiatives can be expected to generate extra revenue in excess of the costs of doing more to tackle evasion and fraud.

## **4.4 Excise duties**

Excise duty increases were a major source of extra revenue during Labour's first term: duty on unleaded petrol increased in real terms by 14% and duty on cigarettes by 30%. But this has not been repeated during Labour's second term: there have been no real rises in duty rates since the 2001 election.

Fuel duties are the government's fifth-biggest revenue-raiser – accounting for over 5% of total receipts – and increases could raise significant amounts of money, with additional environmental benefits. However, this would be a difficult move politically: tax already accounts for more than three-quarters of the price of petrol and diesel, and with oil prices now high by historical standards, memories of the 2000 fuel protests will still be fresh in the Chancellor's mind. In addition, the government has pledged to use any additional revenues from fuel taxes for increased transport spending. This pledge, if kept to, would constrain the government, since it would need to add to the transport spending plans that are set out until March 2006 rather than use the revenue for any other purpose.

Alcohol and tobacco duties are much less significant for the exchequer, and it is doubtful whether higher rates could raise much revenue. Once taxes are high enough, the revenue lost by discouraging people from buying the goods – or at least, from buying them legally in the UK – outweighs the extra tax paid on each item bought. Recent research by HM Customs and Excise concludes that 'although the current spirits duty rate is considerably below the revenue-maximising level, the additional revenue yield from increasing spirits duty would be modest'. Increasing duty on spirits to the revenue-maximising level would mean a large rise in the tax rate but would raise only £177 million.<sup>24</sup> Smuggling and fraud are another reason we would not expect to see increases in the duty on spirits: the government estimates that 16% of the market share

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<sup>23</sup> Source: Table 3.1 of HM Customs and Excise, *Measuring and Tackling Indirect Tax Losses: An Update on the Government's Strategic Approach*, 2003 ([www.hmce.gov.uk/forms/budgetnotices/pbr-2003/meas-ind-tax-loss-03.pdf](http://www.hmce.gov.uk/forms/budgetnotices/pbr-2003/meas-ind-tax-loss-03.pdf)).

<sup>24</sup> See C. Walker and C-D. Huang, *Alcohol Taxation and Revenue Maximisation: The Case of Spirits Duty*, HM Customs and Excise Forecasting Team Technical Note Series A no. 10, 2003 ([www.hmce.gov.uk/business/othertaxes/alcohol-supp-paper.pdf](http://www.hmce.gov.uk/business/othertaxes/alcohol-supp-paper.pdf)).



for spirits was illicit in 2001–02, more than double the level in 1997–98.<sup>25</sup> In his Pre-Budget Report statement, the Chancellor raised the possibility of introducing a requirement for a ‘duty paid’ stamp on all legal bottles, and the government has said that if this is confirmed, it will consider freezing duty on spirits until the next election.<sup>26</sup>

Duties on beer and wine are much further from their revenue-maximising levels; nevertheless, existing taxes are sufficiently high that quite large rises would be needed to yield significant revenue. Less is known about how close tobacco duties are to their revenue-maximising levels, but tax already accounts for more than four-fifths of the price of a packet of cigarettes, and smuggling is again a particular concern: 18% of the market share was illicit in 2002–03, although this in fact represents a slight fall, reversing the previous upward trend.<sup>27</sup> In addition, the government has committed itself to spending any revenues from tobacco taxes on the NHS. Like the pledge on fuel taxes mentioned above, this pledge would constrain the government, since it would need to add to the NHS spending plans that are set out until March 2008 rather than use the revenue for any other purpose.

Excise duties are as high as they are in part because governments have wanted to discourage smoking, drinking and driving as well as raise revenue. But the political sensitivity of all these goods and the relatively small sums involved make further large rises in excise duties unlikely.

## **4.5 Other taxes**

We have focused in this chapter on the government’s main existing sources of revenue in the personal tax system: income tax, National Insurance, VAT and excise duties. Changes to other existing taxes, or indeed completely new taxes, are of course possible, although in the case of the latter, one would hope that the government would publish detailed proposals for consultation before implementing any large-scale measures. Here we confine ourselves to possible announcements in the area of environmental taxation.

In the run-up to the publication of the government’s White Paper on aviation in December, there was considerable speculation that it would make provision for an increase in air passenger duty to ensure that the industry took account of its contribution to climate change (especially in the light of the exemption of aviation kerosene from fuel tax, which the government recognises is anomalous but is difficult to change without international co-ordination). Air

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<sup>25</sup> See HM Customs and Excise, *Measuring and Tackling Indirect Tax Losses: An Update on the Government’s Strategic Approach*, 2003 ([www.hmce.gov.uk/forms/budgetnotices/pbr-2003/meas-ind-tax-loss-03.pdf](http://www.hmce.gov.uk/forms/budgetnotices/pbr-2003/meas-ind-tax-loss-03.pdf)).

<sup>26</sup> See HM Customs and Excise, *Business Brief 26/03: Tackling Alcohol Fraud: Introduction of Tax Stamps for Spirits*, 2003 ([www.hmce.gov.uk/news/bb2603.pdf](http://www.hmce.gov.uk/news/bb2603.pdf)).

<sup>27</sup> See HM Customs and Excise, *Measuring and Tackling Indirect Tax Losses: An Update on the Government’s Strategic Approach*, 2003 ([www.hmce.gov.uk/forms/budgetnotices/pbr-2003/meas-ind-tax-loss-03.pdf](http://www.hmce.gov.uk/forms/budgetnotices/pbr-2003/meas-ind-tax-loss-03.pdf)).



passenger duty currently raises £0.8 billion per year,<sup>28</sup> and it was suggested that this might be doubled, for example. However, the White Paper concluded that ‘because of its blunt nature, Air Passenger Duty is not the ideal measure for tackling the environmental impacts of aviation’,<sup>29</sup> implying that such a rise is unlikely in the Budget. The government instead proposed to try to bring aviation within the EU emissions trading system and to press for action by aerospace manufacturers, airlines, airports and air traffic controllers, while retaining the option of using further economic instruments if these measures generated insufficient progress.

Other environmental taxes are possible. The UK might follow Ireland’s example by introducing a tax on plastic bags; another possibility is the extension of congestion charging. But any such reforms would probably raise only small amounts of revenue, which makes reliance on these taxes to fill any shortfall in revenue unlikely.

## **4.6 Conclusions**

The analysis in Chapter 3 suggests that further increases in tax may be needed to maintain the health of the public finances unless there are substantial cutbacks in government spending. The Chancellor does not seem to accept the argument that he may need to raise revenue. But if he were to do so, the likeliest sources considered in this chapter (see Chapter 5 for a discussion of taxes on housing) might be to accelerate fiscal drag by, for instance, freezing the income tax personal allowance and NI earnings threshold, or – more dramatically – to increase National Insurance contributions by raising the employee rate above the upper earnings limit or moving the UEL closer to the basic-rate income tax limit.

*Stuart Adam and Howard Reed*

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<sup>28</sup> Source: Source: Table B9 of the December 2003 Pre-Budget Report ([www.hm-treasury.gov.uk/media/DBB0D/pbr03annexb227.pdf](http://www.hm-treasury.gov.uk/media/DBB0D/pbr03annexb227.pdf)).

<sup>29</sup> Paragraph 3.43 of Department for Transport, *The Future of Air Transport*, 2003 ([www.dft.gov.uk/aviation/whitepaper/main/chap3.htm](http://www.dft.gov.uk/aviation/whitepaper/main/chap3.htm)).