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Taxes and Benefits: The Parties' Plans

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Executive summary

The last five years have seen considerable policy activity in the tax and benefit sphere: in total, some £56 billion per year of giveaways and £89 billion per year of takeaways by 2015–16. Most of the main tax reforms have simply changed rates or thresholds within current structures – the increase in the main rate of VAT, cuts to the main corporation tax rate, real cuts to the rates of fuel duties and the big increase in the income tax personal allowance being the most important. Only for pensions and savings has there been a significant reshaping in terms of what is taxed and what is not. Changes to benefits have mostly been straightforward cuts in generosity, with more significant structural reform coming in the next parliament – the introduction of the single-tier pension, the introduction of universal credit and the replacement of disability living allowance (DLA) with personal independence payment (PIP).

As for what is to come, there are important areas of agreement between the main UK parties. There is apparently a huge amount of money to be extracted through a clampdown on tax avoidance (mysteriously missed by all previous clampdowns). There is yet more money to be extracted from those on very high incomes saving in a private pension. The main rates of income tax, National Insurance contributions (NICs) and VAT will not be increased. The 'triple lock' on indexation of the basic state pension will remain and most pensioner benefits will be protected. There is also a shared lack of any attempt to paint a coherent strategy for tax reform, a shared desire to impose further, often absurd, complications to the tax system, and a shared lack of willingness to set out specific benefit measures that chime with the parties' rhetoric. On that last point: on the one hand, the Conservatives have spent two years promising substantial additional benefit cuts of £12 billion a year whilst failing to come up with more than 10% of that figure in actual cuts; on the other hand, Labour's promised 'toughness' involves reducing spending by almost nothing by taking winter fuel payments from the small number of pensioners subject to the higher rates of income tax, and most likely by literally nothing by limiting the uprating of child benefit rates.

There are significant differences between the parties too. The Conservatives are promising significant income tax cuts through further increases in the personal allowance and an increase in the point at which higher-rate tax becomes payable. The first of these ambitions is shared by the Liberal Democrats, while the Labour manifesto is silent on these points. Labour and the Liberal Democrats (and the SNP) share a desire to impose a 'mansion tax', not a policy adopted by the Conservatives. Labour (and the SNP) would return the top rate of income tax to 50%. The Conservatives are alone in saying they would seek big cuts in benefit spending and generosity.

In this summary, we look at the main proposed changes to income tax, the taxation of housing, other taxes, and benefits in turn, with a particular focus on Labour and the Conservatives. The main body of this document then examines most of the specific tax and benefit policies of Labour, the Conservatives and the Liberal Democrats in some detail.

Income tax

Rates and thresholds

Since 2010, 2.6 million working-age people have been taken out of income tax as a result of a big increase in the personal allowance to £10,600 (instead of £7,765). Further increases to £11,000 in nominal terms by 2017–18 have been announced. At the same time, the higher-rate threshold has been cut substantially in real terms, more than

offsetting higher-rate taxpayers' gain from the increase in the personal allowance and keeping the combined cost down to £8 billion. The number of higher- and additional-rate taxpayers has, partly as a result, increased from 3.3 million in 2010–11 to an estimated 4.9 million in 2015–16.

Conservative and Liberal Democrat plans to increase the personal allowance to £12,500 by 2020–21 would cost around £4 billion a year in current prices, relative to uprating it with CPI inflation after 2017–18.

Only 57% of adults now pay income tax, down from 61% in 2010–11, and of course further increases in the personal allowance will not help the 43% who pay no income tax. Further increases will, though, help those aged 65 and over, few of whom have benefited from the policy up to now; they have historically benefited from a higher personal allowance than under-65s, but the main allowance will catch up to that higher level in 2016–17.

In part because so many people do not pay income tax, and in part because the biggest gainers are two-earner couples where both can benefit from the higher allowance, increases in the personal allowance benefit those in the middle and upper-middle parts of the income distribution the most. Obviously, increases in the higher-rate threshold, as proposed by the Conservatives, will only benefit higher-rate taxpayers, who are typically located towards the top of the income distribution. That said, even under Conservative plans to raise that threshold to £50,000 by 2020–21, it will still be below where it would have been had it simply been uprated with inflation since 2010. Even with that increase, we calculate the number of higher-rate taxpayers would increase from 4.9 million now to 5.3 million in 2020–21. Neither Labour nor the Liberal Democrats are proposing to raise the higher-rate threshold. If it merely keeps pace with inflation, the number of higher-rate taxpayers could hit 6.4 million by 2020–21, 1.5 million more than now and double the 3.3 million there were in 2010–11. The 'no reform' option actually represents a radical, albeit gradual, change in the nature of the income tax system.

Labour's two main proposed changes to income tax rates would reintroduce a 10% starting rate, paid for by the abolition of the married couple's transferable personal allowance, and would raise the additional rate from 45% to 50%.

The first of these policies would remove one small complication from the system and replace it with another. Abolishing the transferable allowance would provide enough cash to implement a 10% band a mere £260 wide, worth a princely 50 pence a week to most income tax payers. There is no point in introducing such a band. Virtually the same result could be achieved, only very slightly more simply and progressively, through raising the tax-free allowance. Labour would ensure that those on the highest incomes would not benefit from a 10% band by further widening the effective 60% income tax band that currently stretches from £100,000 to £121,200 so that it stretched to £121,330. This band would stretch between £100,000 and £125,000 (in 2020 prices) under Conservative and Liberal Democrat plans to raise the personal allowance to £12,500. None of the parties is proposing to do anything about this ridiculous and rather hidden anomaly in the income tax system.

The proposed reintroduction of the 50% additional rate of income tax would clearly leave those with annual incomes over £150,000 worse off. The extent to which it would raise any additional revenue is unclear. HM Revenue and Customs' (HMRC's) central estimate, signed off as reasonable by the Office for Budget Responsibility (OBR), was that cutting the additional rate from 50% to 45% would cost just £110 million. Raising it again might raise this much, it might raise substantially more, or it might actually cost

the exchequer revenue. We genuinely cannot be sure. The policy should be seen more as a way to reduce the highest taxable incomes rather than a way to increase revenue significantly.

Finally on rates and bands, it is important to note that, by default, major parts of the income tax system are not being increased in line with inflation. The additional rate still bites at £150,000, the same nominal level at which it was introduced in 2010. The absurd 60% rate still starts at £100,000. CPI inflation since April 2010 means that the real value of these thresholds has already fallen by 15%. If they continue not to be indexed, their real value will have fallen by 23% by 2020 – equivalent to having introduced them at thresholds of £120,000 and £80,000 respectively (and those numbers do not take account of any greater growth in incomes than in prices).

Pension taxation

There has been a dramatic reduction in the limits on tax-relieved pension contributions since 2010. In particular, the maximum amount that can be contributed annually has been cut from £255,000 to £40,000, while the maximum value of the pension pot is being cut from £1.8 million to £1 million. The OBR estimates that changes since 2010 have increased revenues by £5 billion a year in the short run (though some of that will be offset by lower taxable pension income in future years). Labour and the Conservatives both want to continue along this path. Both propose to alter the treatment of an eminently sensible part of the income tax system – allowing people to save out of pre-tax income and pay income tax when the income is withdrawn from the pension instead. Neither proposes to do anything about the excessive generosity that does exist – allowing tax-free withdrawal of 25% of pension savings which have never been subject to income tax, and allowing employer contributions to escape NICs entirely.

The Conservatives would like to reduce the annual allowance for those with taxable incomes over £150,000 so that it falls from £40,000 to £10,000 by the time income reaches £210,000. Why someone earning £150,000 should be able to save £40,000 in a pension while someone earning £210,000 should be able to save just £10,000 with tax relief is unclear. Note also that this policy discourages would-be pension savers on high incomes from increasing their incomes over this range, in a similar way to straightforward increases in their marginal rates of income tax.

Labour policy aimed at high earners is more complex still. They want to reduce the rate of income tax relief from 45% (50% under their policy) to 20% for those whose gross income including employee (but not employer) pension contributions is over £130,000 and whose gross income including employee and employer contributions is in excess of £150,000. Their way of phasing out higher-rate relief would create a substantial 'cliff edge' – some people would become significantly worse off as the result of a pay rise – and would increase complexity. More fundamentally, it is hard to see why it should be 'unfair' for those above £150,000 to get tax relief at their marginal rate but not 'unfair' for higher-rate taxpayers to do so. Labour want, in addition, to reduce the maximum amount that can be saved tax free in a pension to £30,000 a year.

Stability and predictability are important in most parts of the tax system, but none more so than the taxation of pension savings. The frequency and direction of reforms to pension taxation under this government have been concerning. The continued desire to dismantle an important and relatively sensible part of the tax system is more worrying still.

Housing and tax

Both Labour and the Liberal Democrats (and the SNP) say they want to introduce a 'mansion tax', an additional annual charge on residential properties worth more than £2 million. The Conservatives, in contrast, would like to reduce the effective tax on some owner-occupied homes by effectively increasing the inheritance tax (IHT) threshold to £1 million for married couples whose main residence is worth at least £350,000 and is bequeathed to their children or grandchildren.

There are many problems with the way in which housing is taxed at present. One such problem is the structure of council tax. As well as, ludicrously, still being based on the relative values of properties in 1991 in England and Scotland, it is regressive in the sense that the amount of tax due rises less than proportionally to the (1991) value of the property. In addition, council tax is capped: no more is paid on a property worth £10 million than on one worth £2 million (assuming they were both worth more than £320,000 back in 1991).

By increasing the annual tax on probably around 100,000–150,000 high-value properties – though nobody knows for sure quite how many – the proposed mansion tax could be seen as a partial remedy to this deficiency in council tax. But setting up an entirely separate tax is unnecessarily complicated: a sensibly reformed council tax would already entail much higher bills for the most valuable properties, whilst ironing out anomalies in the taxation of less expensive properties in the process. Labour's intention to start bringing in revenue from a brand new tax during this financial year also looks less than cautious given the need to sort out the details of valuations, administration and so on.

Labour's intention is to raise £1.2 billion annually from the tax, of which £3,000 would come from each property worth £2–3 million and the remainder from more valuable properties. If there were, for example, a total of 150,000 properties worth more than £2 million and 55,000 of those were worth more than £3 million (HM Treasury's estimates, according to the Liberal Democrats), that would imply raising £285 million from £2–3 million-properties, and properties above £3 million would face an average tax charge of around £16,600 to make up the rest of the revenue. Setting a revenue target is not a sensible way to make policy: it is not clear that the appropriate tax rate on high-value properties should be higher if there turn out to be fewer of them than expected, or vice versa.

There are problems with the structure of council tax. Neither the Conservatives, Labour nor the Liberal Democrats look like addressing them. The mansion tax would not solve those problems.

It is also hard to see the economic or social question to which the Conservatives' proposed additional IHT allowance for housing is the right answer, and it is striking that they are proposing this despite Treasury advice that 'there are not strong economic arguments' for the policy. Offering additional IHT relief for owner-occupied housing can only increase the distortions in the tax system both in favour of owner-occupation and against trading down. Tax incentives that effectively lock older people into bigger and more expensive properties do not look helpful.

Again, there are significant problems with the current structure of IHT. The fact that it is so easily avoided by the very wealthy by the simple expedient of passing on wealth at least seven years before death is one obvious issue. The fact that significant classes of assets, including farm land and certain types of business, are free of IHT creates both

distortions and inequities. Again, none of the main UK parties seems to want to grapple with these issues.

Other tax proposals

By far the biggest apparent revenue-raising proposals from each of the Conservatives, Labour and the Liberal Democrats are 'clampdowns' on tax avoidance and evasion. They claim they will raise, in today's terms, £4.6 billion, £6.7 billion and £9.7 billion a year respectively from such policies. Yet none of the parties has proposed specific measures that would increase revenues by these sorts of amounts. One might think of these revenue targets as, at best, aspirational, yet the parties' fiscal plans rely on achieving them. It is not helpful to the public debate to pretend that raising such sums is easy, certain or necessarily painless. In the end, the best route to reducing avoidance is to tax similar activities similarly so that there is no tax saving to be had by dressing up one activity as another. With some small exceptions, there is no sign that any of the three main UK parties is thinking about this sort of structural reform, which would in the long term reduce opportunities for gaming the system.

There is strikingly little in the Conservative or Labour manifestos about business taxation, perhaps reflecting a significant degree of agreement and acquiescence with recent reforms. Labour would like to raise the main rate of corporation tax from 20% – which it reached just this month – to 21%. Labour have committed to keeping the UK's main rate of corporation tax the lowest in the G7, though given that the next-lowest is Canada at 26.3% this commitment is not terribly constraining. One oddity of the Labour proposal is that it would maintain a small profits tax rate of 20% such that corporation tax rates would be 20% on profits up to £300,000, 21.25% on profits between £300,000 and £1.5 million, and 21% on profits above £1.5 million. That is not a sensible tax schedule.

Part of the £1 billion or so in revenue raised from this corporation tax increase is earmarked for a small reduction in business rates. After a long period of stability, the business rates regime – which, lest we forget, raises £28 billion a year for the exchequer – has seen a lot of change and meddling in the last few years. A review of the regime was announced in the March 2015 Budget.

Labour are also proposing yet another increase in the bank levy, aimed at raising an additional £800 million. That would be the ninth increase announced since the levy was introduced in 2011. There are plausible economic reasons for having special taxes on banks: to reduce the risk they can pose to financial stability, as a charge for the effective insurance that 'lender of last resort' facilities provide, and to stand in place of VAT given that financial services are, under European law, exempt from VAT. That does not mean that changing rates every year and continuing to try to raise ever-more revenue from the bank levy is economically sensible.

Benefit proposals

There are fewer specific proposed changes to the social security system in the two main parties' manifestos. This may reflect in part the very big scale of reforms due to be implemented in any case. While Labour have said they would pause and review the universal credit programme, they have given no indication that they would abandon its planned roll-out. While the SNP have said they would want to stop the move from DLA to PIP, at an estimated cost of over £2 billion, none of the three major UK parties has indicated any such desire.

The transition to a single-tier state pension has cross-party support, as does continuing with the 'triple lock' on the state pension. Relative to a policy of CPI indexation, the triple lock has cost £1.1 billion over this parliament. Relative to a policy of earnings indexation, it has cost £4.6 billion. As the OBR has pointed out, continuing with the triple lock indefinitely is expected to be expensive, coming at a price of 0.8% of national income by the early 2060s (£15 billion in today's terms). And as we have pointed out elsewhere,[2] it has the curious feature that, in the long run, the level of the single-tier pension will depend not just on how prices or earnings grow over time but on whether years with high price growth were also years with high earnings growth. That is absurd.

There appears to be a conspiracy of silence over the future of pension indexation. Differences between the Conservatives and Labour with respect to other pensioner benefits are also more apparent than real. The former have promised to protect all the universal benefits payable to pensioners. The latter have said they would take the 'tough' decision to withdraw winter fuel payments from those paying higher and additional rates of income tax. That would save a paltry £100 million – less than 0.1% of the pensioner benefit bill – and come at the cost of greater complexity in the tax system. The Liberal Democrats would also remove the free TV licence from those aged 75 and over, saving a further £15 million. No party devoted serious attention to state provision for pensioners in their manifesto, despite the large cost of that provision, the scale of population ageing and the benefits of getting the design right.

As far as working-age benefits are concerned, Labour propose to cap the uprating of child benefit at 1% in the current year and next year. The saving in the current year, which has already started, is zero and the likely saving next year is also zero. The Conservatives propose to freeze a range of working-age benefits for two years, saving around £1 billion. On the other side of the ledger, Labour (and the SNP) propose to abolish the so-called 'bedroom tax' (the reduction in housing benefit for social tenants deemed to be 'under-occupying' their property) at a cost of £400 million or so, while the Liberal Democrats would water it down significantly.

All in all, then, there are no specific proposals for either substantive additional reform to, or savings from, the £220 billion annual social security budget – over and above the significant ones already in the pipeline – from the Conservatives, Labour or the Liberal Democrats.

The Conservatives have, though, expressed a very clear ambition to cut £12 billion from the annual social security budget within the two years up to 2017–18, or £11 billion in today's terms. They are around £10 billion short of that target in terms of any specific proposals they have made. Achieving such cuts whilst protecting most pensioner benefits would, as we have written elsewhere, be extremely challenging.[3] The amount required is around 10% of spending on social security benefits other than the state pension and universal pensioner benefits, with most of this spending going to working-age households in the bottom half of the income distribution. To provide just a few examples of policy options and what they might save:

- Abolishing child benefit and compensating low-income families through universal credit would reduce spending by around £5 billion.

[2] Pages 14–15 of A. Hood and D. Phillips, 'Benefit spending and reforms: the coalition government's record', IFS Briefing Note BN160, http://www.ifs.org.uk/publications/7535.

[3] See J. Browne and A. Hood, 'Options for reducing spending on social security', in C. Emmerson, P. Johnson and R. Joyce (eds), *The IFS Green Budget: February 2015*, http://www.ifs.org.uk/uploads/gb/gb2015/ch9_gb2015.pdf.

- Reducing the child element of universal credit by 30% to reach its 2003–04 level in real terms would also cut spending by around £5 billion.
- Taxing DLA, PIP and attendance allowance would raise around £1½ billion.
- Making all housing benefit recipients pay at least 10% of their rent would cut spending by around £2½ billion.

There are many other options and those above are listed merely as illustrations. The point is that cutting spending by this amount, especially while protecting pensioner benefits, would undeniably be painful. It is important to remember that the majority of the net cut to the social security budget (and 40% of the gross cut) achieved over the last parliament came from changes to indexation rules, including periods of uprating less quickly than inflation. The Conservatives have already pledged to freeze most working-age benefits for two years – saving only £1 billion in the current low-inflation environment – and so the remaining £10 billion must come from policies other than below-inflation uprating.

The Conservatives have been talking about saving £12 billion from social security spending for a long time. It is disappointing that no further details have been spelt out in their manifesto.

Conclusion

With significant deficit reduction still to come, households can expect the tax and benefit changes implemented over the next parliament to reduce their incomes, on average. There are large differences between the Conservatives, the Labour Party and the Liberal Democrats in how they propose to do this. But they share a lack of willingness to be clear about the details and an inability to resist the urge for piecemeal changes that make the overall system less efficient and coherent.

1. Introduction

This briefing note examines the tax and benefit proposals put forward in the manifestos of the three largest parties in the last parliament (i.e. the Conservatives, Labour and the Liberal Democrats). For each party, we describe the policies in their manifestos, the main winners and losers and the effects on incentives, and we assess whether the policies would make the tax and benefit system simpler and more efficient.

We do not perform an overall distributional analysis of each party's policies by income level or household type. This is neither possible given the lack of precision in the manifestos nor necessarily desirable given the different mix of changes in taxes on income and wealth proposed by the parties. We do show the distributional impacts of particular policies where we are able to do so, including proposed changes to income tax and benefits.

As well as the measures mentioned in the manifestos, there are a number of tax and benefit changes that have already been announced and are due to be implemented over the next few years under current coalition government plans. These are listed in Appendix A. As we are primarily interested in long-term effects of the parties' plans, all of

our analysis is conducted as though these pre-announced measures are already in place.[4] All figures are in 2015–16 prices unless otherwise stated.

The proposals of the Conservative, Labour and Liberal Democrat parties are discussed in Sections 2, 3 and 4 respectively. Section 5 concludes.

2. Conservative proposals

The Conservatives' manifesto contains a number of tax and benefit proposals that go beyond the plans that have been announced in the coalition's Budgets and Autumn Statements and scored in the public finances. They have also set out targets for 2017–18 to reduce social security spending by £12 billion (about £11.1 billion in today's terms) and raise £5 billion of revenue (around £4.6 billion in today's terms) through tackling tax avoidance and evasion, but have not set out policies that would achieve either of these targets. Table 2.1 sets out the firm commitments they have made, and the annual exchequer cost or yield of these policies.

Table 2.1. Estimated exchequer cost/yield of main permanent tax and benefit changes proposed by the Conservative Party (2015–16 prices)

Measure	Exchequer cost/yield (£ billion, 2015–16 prices)
Income tax	**–4.5**
Increase personal allowance to £12,500 by 2020–21	*–4.0*[a,e]
Increase higher-rate threshold to £50,000 by 2020–21	*–1.9*[a,e]
Reduce annual allowance for pension contributions for those with incomes above £150,000	*+1.4*[b]
Other taxes	**+3.6**
Introduce main residence allowance in inheritance tax	*–1.0*[b]
Anti-avoidance and anti-evasion target	*+4.6*
Total tax	**–0.9**
Benefits	
Freeze most working-age benefits in 2016–17 and 2017–18	*+1.0*[a]
Reduce household benefit cap to £23,000 a year	*+0.1*[c]
Remove entitlement to housing benefit for some 18- to 21-year-olds on jobseeker's allowance	*+0.1*[d]
Unspecified	*+9.9*
Total benefits	**+11.1**
Grand total	**+10.3**

Sources:
[a] Authors' calculations using TAXBEN run on uprated data from the 2012–13 Family Resources Survey.
[b] Conservative Party costing.
[c] Conservative Party costing supplied to the *Daily Mail*.
[d] Authors' calculations using administrative data.
[e] The costing of the personal allowance increase assumes that the higher-rate threshold is unchanged (rather than the basic-rate limit, the amount of income above the personal allowance at which higher-rate tax becomes payable) and the costing of the higher-rate threshold increase is relative to that baseline.

[4] The only exception to this rule is that we ignore universal credit in some instances where measures will be introduced before it has been fully rolled out, or where reforms are being made to the legacy benefits system.

The Conservative manifesto also outlined a number of further small changes to the benefits system, which are likely to have a small and somewhat uncertain impact on benefit spending:

- Replacing jobseeker's allowance for 18- to 21-year-olds with a youth allowance time-limited to six months, after which claimants would have to take an apprenticeship or traineeship or do daily community work.
- Tightening the rules governing the benefit entitlements of EU migrants, along with their access to social housing.
- Reviewing whether those who refuse help for a treatable condition that is preventing them from working should see their benefits reduced.

There are a number of other policies in the Conservative Party manifesto that are less precisely defined, meaning that it is impossible to say how much they would cost or raise. These include:

- A pledge to set a 'new, significantly higher, permanent level for the Annual Investment Allowance' (the amount of investment a firm can immediately deduct from profits for tax purposes).
- A pledge to retain tax incentives for films, theatre, video games, animation and orchestras and to 'expand them when possible'.
- A desire to maintain 'the most competitive business tax regime in the G20'. The UK currently has the joint-lowest rate of corporation tax in the G20 with Russia, Saudi Arabia and Turkey.[5] Although there is more to the competitiveness of the corporate tax regime than the headline rate of corporation tax, it may be the case that a Conservative government would feel that it had to cut the UK's corporation tax rate further to meet this target if other G20 countries did likewise. To give a sense of scale, HM Revenue and Customs (HMRC) estimates that a 1 percentage point reduction in the corporation tax rate would reduce government revenues by £1.9 billion in 2017–18.[6]
- The Conservatives would increase the remittance basis charge for foreign domiciliaries or 'non-doms'.

The Conservatives' manifesto also contains a number of pledges not to raise certain taxes or cut certain pensioner benefits. They have pledged not to increase the rates of income tax, National Insurance contributions (NICs) or value added tax (VAT) during the next parliament. Note, however, that this does not rule out raising revenue from these taxes in other ways. On the benefits side, the Conservatives have pledged to maintain all the current pensioner benefits including winter fuel payments, free bus passes, free prescriptions and free TV licences. They would also maintain the 'triple lock' on the basic state pension, severely limiting the scope for them to reduce social security spending received by pensioners (though not eliminating it entirely, since pensioners may also be affected by cuts to housing benefit, as they have been during the current parliament).

[5] See figure 3.1 of H. Miller and T. Pope, 'Corporation tax changes and challenges', IFS Briefing Note BN163, 2015, http://election2015.ifs.org.uk/uploads/publications/bns/BN163.pdf.

[6] See HM Revenue and Customs, 'Direct effects of illustrative tax changes', 2015, https://www.gov.uk/government/statistics/direct-effects-of-illustrative-tax-changes.

In the remainder of this section, we discuss each of the Conservatives' tax and benefit commitments in turn.

2.1 Tax policies

Increase the personal allowance to £12,500 by 2020–21

The Conservatives (and the Liberal Democrats) would increase the income tax personal allowance (the amount of income on which no income tax is paid) to £12,500 by 2020–21. Taking into account increases to the personal allowance announced in Budget 2015 – it will rise from £10,600 in 2015–16 to £10,800 in 2016–17 and £11,000 in 2017–18 under current policies – the personal allowance would increase to £11,640 by 2020–21 as a result of normal indexation in line with consumer price index (CPI) inflation. The Conservative (and Liberal Democrat) policy will therefore represent an £860 increase in the personal allowance relative to this baseline, reducing the income tax liabilities of basic-rate taxpayers by £172 a year in 2020–21 (equivalent to £160 a year in current prices).[7] Including the gains from the pre-announced increases in the personal allowance, in real terms basic-rate taxpayers would pay £208 a year less in income tax in 2020–21 than they will in 2015–16. These are smaller gains than they have seen from increases in the personal allowance during this parliament – basic-rate taxpayers today are paying £567 a year less in income tax than they would have done had the personal allowance been increased in line with default indexation since 2010–11.

Higher-rate taxpayers with incomes below £122,000 would benefit by the same amount as basic-rate taxpayers from the Liberal Democrat policy. The Conservatives would also increase the income tax higher-rate threshold, meaning that higher-rate taxpayers would gain more than this. (The withdrawal of the personal allowance from those with incomes greater than £100,000 means that those with higher incomes would not benefit from the policy.)

Further increases in the personal allowance will affect different groups from those who have been affected by increases so far:

- First, since the personal allowance has increased over the last five years, fewer low-income individuals pay income tax now and so no longer benefit from further increases in the personal allowance: of the 52.4 million adults in the UK in 2014, only 29.8 million or 57% paid income tax, meaning that the lowest-income 43% of adults would not benefit from further increases in the personal allowance.[8] By contrast, 61% of adults paid income tax in 2010–11.[9]
- Second, pensioners would benefit from further increases. They have not benefited from increases over the last five years. Over the course of this parliament, the personal allowance for those aged under 65 has caught up with the personal allowances for those aged 65 and over, and under current policy the personal

[7] Figures downrated using OBR forecasts of CPI inflation.

[8] Source: HMRC Statistics Table 2.1, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/404149/Table_2.1.pdf and ONS Population Projections, 2012-based, http://www.ons.gov.uk/ons/rel/npp/national-population-projections/2012-based-projections/stb-2012-based-npp-principal-and-key-variants.html.

[9] Source: HMRC Statistics Table 2.1, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/404149/Table_2.1.pdf and ONS Revised Annual Mid-year Population Estimates, 2001 to 2010, http://www.ons.gov.uk/ons/rel/pop-estimate/population-estimates-for-uk--england-and-wales--scotland-and-northern-ireland/mid-2001-to-mid-2010-revised/stb---mid-2001-to-mid-2010-uk-revised-population-estimates.html.

allowance will be the same for individuals of all ages from 2016–17, meaning that pensioners' personal allowances will also increase if the main personal allowance is increased further.[10]

Among adults who pay income tax, a reduction in income tax liability of £160 a year would represent a larger percentage of net income for those with lower incomes. But since 43% of adults do not have incomes high enough to pay income tax, and around a quarter of families do not contain a taxpayer,[11] increasing the personal allowance would not increase the incomes of the very poorest in society. In addition, if we examine the distributional impact at the family or household level (as in Figure 2.2 later), there are two more reasons why this policy is less than progressive as commonly assumed.

First, two-earner couples, who tend to have higher family incomes, can benefit twice over from the increase in the personal allowance because both members of the couple would see their income tax liability fall by £160, meaning that they would gain £320 in total. There are 6.3 million couples where both partners would gain from this increase in the personal allowance, 14.4 million families (single people or couples) where only one person would gain and 12.9 million families where nobody would benefit.

Second, universal credit (and housing benefit in the current benefits system, and most systems of council tax support across Great Britain) is means-tested on after-tax income, meaning that reductions in income tax lead to reductions in the amount of means-tested support people receive. This interaction between the tax and benefit systems means that taxpayers receiving universal credit will typically only receive 35% of the benefit of reductions in tax liabilities resulting from an increase in the personal allowance (i.e. £56 a year in this case). Around 1.8 million families fall into this category, most of whom are in the second, third and fourth household income deciles.

Together, these factors mean that the highest average cash gain from increasing the personal allowance occurs in the second-richest tenth of the income distribution (some of the richest tenth would not benefit because of the withdrawal of the personal allowance above £100,000, lowering the average gain for this group). As a percentage of income, the gain is highest in the upper-middle of the household income distribution, with the bottom and the very top gaining by less than this.

These further increases in the personal allowance proposed by the Conservatives and Liberal Democrats will reduce tax revenues by £4.0 billion a year in today's prices, assuming that individuals do not change their behaviour in response to the change. While there may be some effect in increasing work incentives, this is likely to be quantitatively small and hence this 'first-round' estimate of costs is probably adequate.

The proposed increase in the personal allowance would ensure that an individual working for 30 hours a week at the National Minimum Wage in 2020–21 would not pay income tax on their earnings.[12] That is in fact also true now. After 2020–21, the

[10] Equalising the personal allowances for individuals of different ages has also had the welcome effect of removing the odd tapering of the higher personal allowance for older people – in effect, a band of income in which the marginal tax rate rises from 20% to 30% before falling back to 20%, an opaque design for which it is hard to find a coherent rationale and which unnecessarily complicated the tax system.

[11] See T. Pope and B. Roantree, 'A survey of the UK tax system', IFS Briefing Note BN9, 2014, http://www.ifs.org.uk/uploads/publications/bns/BN09_Survey%20of%20the%20UK%20tax%20system_2014.pdf.

[12] This assumes a National Minimum Wage of £8 an hour in April 2020: the Conservative manifesto says that the National Minimum Wage is 'on course' to reach this level by this point.

Conservatives have said they would increase the personal allowance in line with the National Minimum Wage rather than CPI inflation as at present (they would pass a 'Tax Free Minimum Wage law' to change the default for increasing the personal allowance), increasing the cost of the policy over time. Linking increases in the personal allowance to increases in the minimum wage might be justified by a desire to ensure that fiscal drag does not increase the number of income tax payers over time or that those earning the minimum wage do not pay income tax (though only if they do not work for more than 30 hours per week and do not have any taxable income from other sources). It is to be hoped that such a rule would not lead to government rejecting proposed increases to the minimum wage on the grounds that to do so would be expensive in terms of lost tax revenue.

More importantly, those working for 30 hours per week at the National Minimum Wage would still be paying National Insurance contributions (which effectively act as a second income tax on earned income). It is curious that the coalition has introduced significant real increases in the personal allowance but has not announced any increases in the primary threshold (the point at which employee NICs start to be payable), despite this being significantly lower than the personal allowance at £155 per week or £8,060 a year for full-year workers. Increasing the primary threshold would help more low earners – both those who work for the full year and earn between £8,060 and £10,600, and those who work for part of the year but whose incomes are less than £10,600 for the whole year. It would also do more to strengthen work incentives: since NICs only apply to earned income, the tax cut on earned income would be larger for a given exchequer cost. The ongoing emphasis on income tax and neglect of NICs highlights the absurdity of continuing to have two similar but separate taxes given that National Insurance is not a true social insurance scheme.

Increase the higher-rate threshold to £50,000 by 2020–21

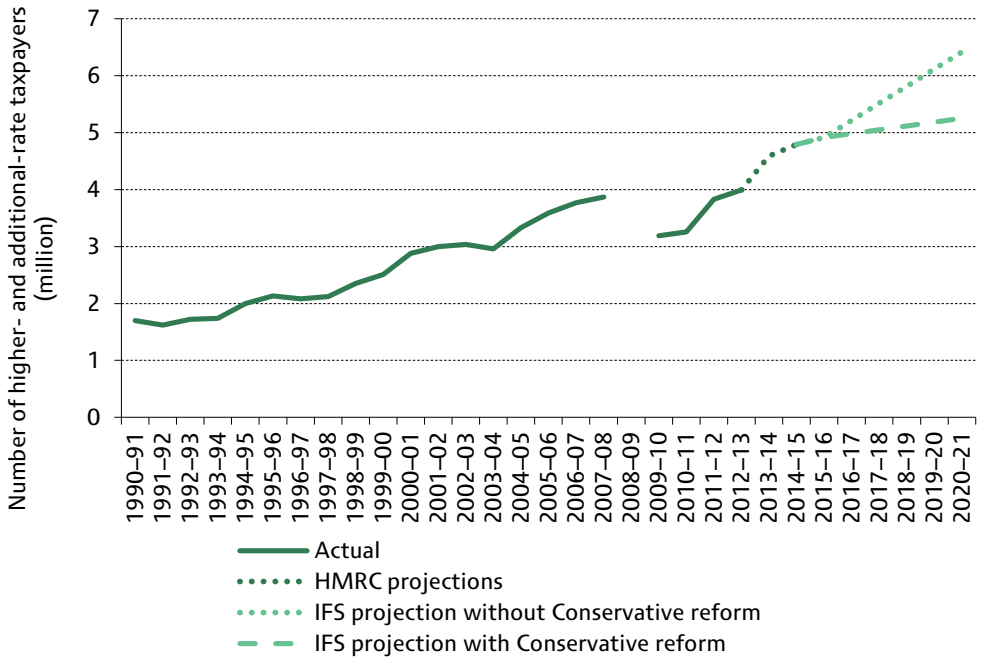
As well as increasing the personal allowance to £12,500 by 2020–21, the Conservatives would also increase the point at which the 40% 'higher' rate of income tax becomes payable (known as the 'higher-rate threshold') to £50,000 by 2020–21 rather than the £45,940 it would be under current policy. This would reduce tax revenues by the equivalent of £1.9 billion in today's prices in 2020–21. Increasing the higher-rate threshold by £4,060 would reduce the tax liabilities of those with earnings of £50,000 or more by £406 in 2020–21 prices,[13] which is equivalent to around £380 in current prices. These individuals would also gain from the increase in the personal allowance, taking their total gain from the Conservatives' income tax policies to £574 in 2020–21 or £539 a year in current prices. Individuals with incomes between £45,940 and £50,000 in 2020–21 would see their marginal tax rate fall as a result of this policy, strengthening their incentives to increase their earnings.

Such a policy would only partially undo the effects of coalition policy over this parliament. Had the higher-rate threshold increased in line with CPI inflation over the course of this parliament, it would already be above £50,000. This means that higher-rate taxpayers are currently paying more in income tax than they would have been had income tax thresholds increased in line with CPI inflation, despite the increases in the personal allowance.

[13] The precise gain would depend on the composition of individuals' incomes since the National Insurance upper earnings limit (the point at which the employee NICs rate falls from 12% to 2% and the self-employed NICs rate falls from 9% to 2%) is set equal to the higher rate threshold in income tax. Thus the gain for those whose income came from self employment or unearned income sources would be larger than this.

The Conservatives say in their manifesto that 'The 40p tax rate was only supposed to be paid by the best-off people in our country. But in the past couple of decades, far too many have been dragged into it' because the higher-rate threshold has not kept pace with income growth. It is true that the number of higher-rate taxpayers has increased over time (as shown by Figure 2.1) from 1.7 million in 1990–91 to 4.8 million in 2014–15, and indeed particularly over the course of this parliament as the coalition reduced the higher-rate threshold in real terms. This increase in the number of higher-rate taxpayers would likely continue under the current policy of increasing the higher-rate threshold in line with CPI inflation as earnings growth is forecast to exceed CPI inflation over the next five years. We estimate that there would be 1.5 million more higher-rate taxpayers by 2020–21 as a result of this 'fiscal drag'. Increasing the higher-rate threshold to £50,000 by 2020–21 would restrict this growth to around 300,000 but not eliminate it, since the higher-rate threshold would still be increasing by less than projected earnings growth over this period.

Figure 2.1. Number of higher- and additional-rate taxpayers, 1990–91 to 2020–21



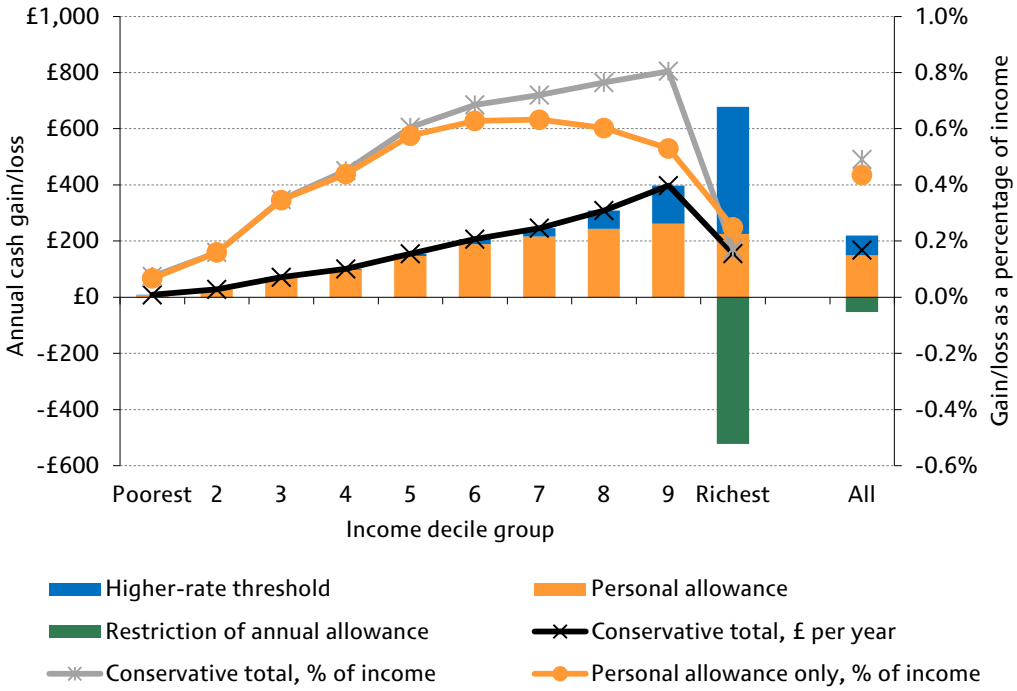
Note: No data available for 2008–09. IFS projections from 2015–16 to 2020–21 are a linear interpolation between these two points.
Source: HMRC Statistics Table 2.1, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/404149/Table_2.1.pdf; authors' calculations using TAXBEN run on uprated data from the 2012–13 Family Resources Survey.

Increasing the higher-rate threshold benefits those who are currently paying the higher or additional rates of income tax: those with incomes above £42,385 in 2015–16. These are roughly the richest 9% of adults, and most of these are in the richest 10% of households.

Figure 2.2 shows the distributional effects of the Conservatives' and Liberal Democrats' income tax proposals. Only one of the policies analysed is a Liberal Democrat proposal, namely increasing the personal allowance to £12,500. We can see that the greatest cash gains from this go to households in the top half of the income distribution. As a percentage of income, the gains are greatest in the upper-middle of the household income

distribution. The Conservatives would also increase the higher-rate threshold and reduce the annual limit on pension contributions for those with incomes greater than £150,000 (see below for a discussion of this policy). Both of these policies mainly affect the highest-income tenth of households; however, there is significant variation within the top income group: those with incomes between £50,000 and £150,000 will benefit from the increase in the higher-rate threshold and not lose out from the Conservatives' policy on tax relief on pension contributions, so they are the biggest winners from the Conservatives' proposals. Those with incomes above £150,000 who were contributing more than £10,000 a year to a private pension would lose out, however, as the loss from the reduction in the maximum amount they can contribute to a private pension each year exceeds their gain from the increase in the higher-rate threshold. Overall, the average gain from the Conservatives' income tax proposals is highest in the second-highest income decile, both in cash terms and as a percentage of income.

Figure 2.2. Distributional impact of Conservative and Liberal Democrat income tax policies to 2020–21, by income decile group



Note: Income decile groups are derived by dividing all households into 10 equal-sized groups according to net income adjusted for household size using the McClements equivalence scale.
Source: Authors' calculations using TAXBEN run on uprated data from the 2012–13 Family Resources Survey.

Reduce annual allowance for pension contributions for those with incomes above £150,000

The Conservatives have announced that they would reduce the generosity of pension tax relief for those with an income of above £150,000 a year. At present, those with taxable incomes over £150,000 a year – there are about 300,000 such individuals (around two-thirds of one per cent of all adults in the UK) – pay income tax at 45%. Any pension contribution they make up to an annual allowance of £40,000 a year attracts income tax relief at that rate. Income tax would be paid at the point at which the pension is withdrawn – as an annuity or in some other form. The exception is that a tax-free lump sum worth a quarter of the accumulated pension pot can be withdrawn.

The Conservatives propose to reduce the annual allowance to £10,000 once income reaches £210,000. In other words, 50p of allowance will be lost for every additional £1 of income in a range between £150,000 and £210,000. The Conservatives state that this reform would raise £1.4 billion a year, which is equivalent to around £4,700 a year for each person with an income over £150,000. Therefore it is a considerable tax rise on a group of individuals who we are already reliant on for a large share of tax revenue and who are known to be particularly responsive to changes in taxes. For those who would wish to place a portion of any additional income in a pension, but who become constrained by the lower annual allowance, the reform will reduce their incentive to increase their income.

While affecting a relatively small number of high-income individuals, this reform would further complicate the pension tax system. It would have the curious effect of allowing tax relief on up to £40,000 of pension contributions for those with an income of up to £150,000 but restrict that to £10,000 a year for those with an income of more than £210,000. As discussed in the February 2014 IFS Green Budget,[14] a desirable benchmark for the taxation of pensions is a system where full tax relief is given up front, returns in a pension are left free of personal taxation and income is taxed in full on receipt. Given that there is a great deal to be said for this system of taxation, the added complexity that the Conservatives' measure would bring would not improve the efficiency of the system. It is really not clear why someone earning £150,000 should be able to receive income tax relief on £40,000 of pension saving while someone earning £250,000 should only be able to receive relief on £10,000 of pension saving.

As stated above, the Conservatives estimate that this measure would boost revenues by £1.4 billion. In fact, it is a difficult measure to cost: the amount it would raise in the long run will depend in large part on how people respond. To the extent that those affected spend their income now rather than in the future, at least some of the apparent additional tax revenues will be brought forward rather than increased in total. Similarly, if people respond by putting more money into ISAs, the exchequer will get more revenue now and less later on.

Introduce a main residence allowance in inheritance tax

The Conservatives would introduce a new £175,000 per person transferable allowance in inheritance tax (IHT) for main residences when they are passed to children or grandchildren. For many couples, this will give a total allowance of £1 million (£325,000 plus £175,000 each). This new allowance will be tapered away from those leaving more than £2 million, with the allowance reduced by 50p for every £1 of estate worth more than £2 million. This means that those leaving more than £2.7 million will not be able to benefit from the new allowance.[15]

The vast majority of estates (over 90%) are not liable to IHT at the moment and therefore would not benefit. The Conservatives estimate that their policy would be a giveaway of about £1 billion. With around 50,000 estates forecast to pay IHT over the next few years, this gives an average (mean) gain per IHT-paying estate of around £20,000. The

[14] See C. Emmerson, 'Taxation of private pensions', in C. Emmerson, P. Johnson and H. Miller (eds), *The IFS Green Budget: February 2014*, http://www.ifs.org.uk/budgets/gb2014/gb2014_ch10.pdf.

[15] This figure is for those who have two main residence allowances – one from each partner in a marriage or civil partnership – which would be worth up to £350,000. Since this is tapered at a rate of 50%, it means the allowance is exhausted at £700,000 above the £2 million point at which the new allowance starts to be tapered away. For those with a single allowance, the benefits will extend to those with estates worth up to £2.35 million.

maximum reduction in IHT on a couple's estate is £140,000, which will go to married couples with estates worth between £1 million and £2 million. Since the children of those with very large estates are disproportionately towards the top of the income distribution, the gains from this (and in fact any) IHT cut will also go disproportionately to those towards the top of the income distribution.

Many (but not all) features of the policy are similar to one analysed in a Treasury document that was leaked to, and published by, the *Guardian* last month.[16] This estimates that, based on Budget 2014 forecasts, the policy would reduce the proportion of estates liable for IHT from 8% in 2015–16 to just over 6% by the end of the parliament, rather than seeing it rise to just over 10% under current policy. As this HMT document rightly argues (paragraph 16, page 9), 'there are not strong economic arguments for introducing an inheritance tax exemption specifically related to main residences'. The document highlights a number of problems with the policy, in particular that it would:

- encourage investment in owner-occupied housing rather than other more productive investments;
- push up house prices;
- discourage downsizing late in life when that might otherwise be appropriate;
- lead to inequitable outcomes as some smaller estates would pay more IHT than larger ones simply because they had a smaller proportion of the estate held in property.

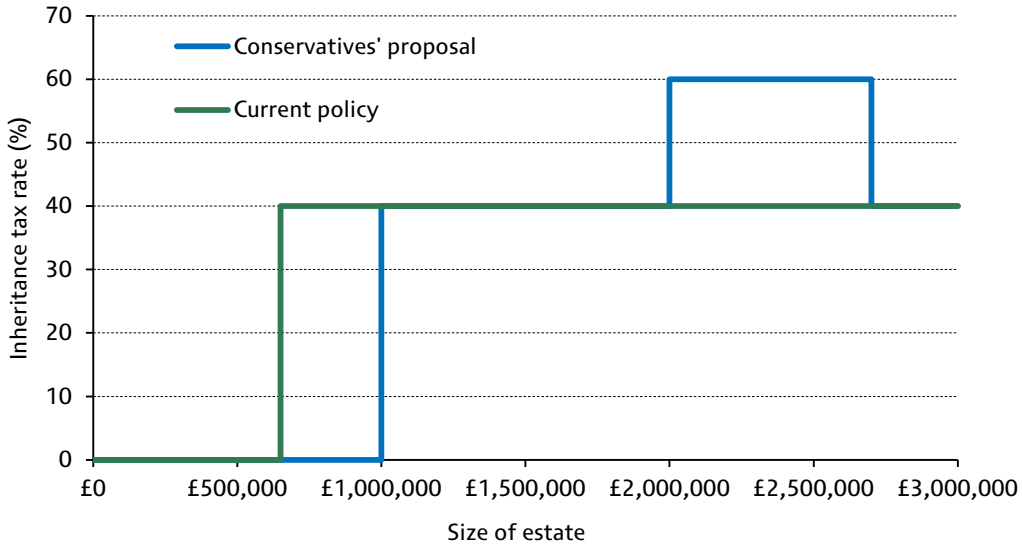
These are serious concerns with the policy, particularly in the context of a tax system which is already relatively favourable towards owner-occupation and which, through stamp duty, already discourages moving house. It is hard to think of the economic problem to which the answer is to further discourage older people from unlocking any housing equity they may have.

The Conservatives' proposal would further complicate the IHT system. Figure 2.3 shows the marginal rate of IHT faced by a widowed individual with a home worth at least £350,000 by the size of their total estate, before and after the change (assuming their estate is to be bequeathed to their children and/or grandchildren and that the individual received a full unused allowance on the death of their spouse). The new effective IHT rate of 60% that kicks in at £2 million is due to the tapering back of the new allowance. Why the IHT rate should go 0%, 40%, 60% and then return to 40% is difficult to justify. A preferable policy – in that it would have been much simpler and arguably fairer and would not have created the distortions listed above – would have been simply to increase the existing threshold from £325,000. Under current policy, it is set to be frozen at this level (which is the level it was at in 2009–10) through to 2017–18.[17]

[16] 'Budget 2015: Tories' £1m inheritance tax break aimed at wealthier households', *The Guardian*, 17 March 2015, http://www.theguardian.com/money/2015/mar/16/tories-1m-inheritance-tax-giveaway-sensitive-papers-wealthier-households.

[17] For a discussion of more radical reforms to inheritance tax, see S. Adam and C. Emmerson, 'Death to the death tax?', IFS Observation, April 2014, http://www.ifs.org.uk/publications/7164.

Figure 2.3. Inheritance tax schedule for widowed individual with a main residence worth at least £350,000



Note: Assumes that the individual inherited a full unused IHT allowance from their deceased partner and that they wish to leave their main residence to their children and/or grandchildren.

Increase the remittance basis charge for 'non-doms'

The Conservatives would increase the remittance basis charge for foreign domiciliaries or 'non-doms'. These individuals live in the UK but their permanent home for tax purposes ('domicile') is considered to be elsewhere. They are already taxed in full on their UK income and capital gains. But unlike other UK residents, they can opt to be taxed on the 'remittance basis', meaning that they are not taxed on their overseas income and capital gains unless they bring the proceeds into the UK.[18] Since 2008, non-doms who had lived in the UK for seven years have had to pay an annual charge, and to give up their income tax and capital gains tax annual allowances, if they wish to be taxed on the remittance basis. The coalition government increased the charge for longer-term residents so that it is now £30,000 after seven years in the UK, £60,000 after 12 years and £90,000 after 17 years. The Conservatives propose to increase these charges further. They do not say by how much, or how much this would raise, though a broad indication might be the Liberal Democrats' proposals (see Section 4.1), which they say would raise £135 million per year in 2017–18 (or £125 million in today's terms).

Raise £5 billion a year from anti-evasion and anti-avoidance measures

Tax evasion (illegally failing to pay one's full tax liability) and tax avoidance (legally arranging one's affairs to reduce tax liability without necessarily changing the underlying economic nature of one's activities, in keeping with the letter of the law but not with parliament's intention) have been prominent issues in recent years, prompted by some high-profile examples.

The Conservatives' fiscal plans rely on raising £5 billion a year by 2017–18 (£4.6 billion in today's terms) by reducing tax evasion and aggressive tax avoidance. But they give precious little indication of how this is to be achieved. One measure mentioned explicitly is the tax increase for 'non-doms' discussed above. Quite why the Conservatives describe

[18] Non-doms also get other tax privileges, notably favourable treatment of non-resident trusts, even if they do not claim the remittance basis.

this as an anti-avoidance measure is unclear: if claiming the remittance basis constitutes aggressive tax avoidance – in the sense of being contrary to the intentions of parliament – then one wonders why they do not propose to abolish it completely, as governments routinely close 'loopholes' they 'discover'. Be that as it may, the Conservatives (unlike the Liberal Democrats) do include it, leaving them less to find from other anti-avoidance and anti-evasion measures; but it is clearly going to make only a small contribution. A few other, often vague, policies are mentioned, but none seems likely to raise a significant amount of revenue. Like Labour and the Liberal Democrats, the Conservatives are relying on as-yet-unspecified measures to deliver billions of pounds of revenue and achieve their fiscal targets.

Oddly, the Conservatives tend not to describe this as a tax rise, often saying that their fiscal plans involve no tax increases, as if this £5 billion were not tax being collected from people.

Increase the annual investment allowance

The Conservatives' manifesto contains a pledge to set a 'new, significantly higher, permanent level for the Annual Investment Allowance' (the amount of investment a firm can immediately deduct from profits for tax purposes), though they have not said what this level is likely to be. The annual investment allowance has been an example of erratic policymaking under the coalition government. Having reduced the allowance from £100,000 to £25,000 in April 2012, the coalition subsequently 'temporarily' increased it again, first to £250,000 and then to £500,000, its current level. The level is currently due to fall back to £25,000 in 2016. Whatever the level, the next government would be well advised to avoid the tinkering that has beset this policy in this parliament – this creates unnecessary uncertainty for businesses planning investment projects. The policy has the biggest effect for small firms that invest relatively little; the majority of firms invest less than the current allowance of £500,000, but they only account for a small share of total investment. To give a sense of scale, if the permanent level of the annual investment allowance were set at £250,000 (as opposed to the £25,000 level to which it is currently due to fall in 2016), this would have an exchequer cost of around £1 billion a year.

2.2 Benefit policies

The Conservative Party's plans for deficit reduction involve a £12 billion reduction in annual benefit spending by 2017–18 (£11.1 billion in today's terms). They have outlined policies in their manifesto that account for around £1.5 billion of this, leaving around £10 billion of unspecified cuts. In this section, we first analyse the specific policies proposed, before discussing the £12 billion target.

Freeze most working-age benefits in 2016–17 and 2017–18

By far the largest benefit policy announced by the Conservative Party is the proposal to freeze most working-age benefit rates until April 2018 in nominal terms. Disability benefits, maternity allowance, statutory maternity pay, statutory paternity pay, statutory adoption pay and statutory sick pay would be excluded. Given current inflation expectations, the result would be relatively small falls in the real benefit entitlements of a large number of families. By default, benefit rates would increase in line with September 2015 CPI inflation in April 2016 and with September 2016 CPI inflation in April 2017. The Office for Budget Responsibility (OBR)'s most recent forecasts are for those inflation figures to be 0.2% and 1.2% respectively, implying that the policy would cut the level of

the benefits included by 1.4% in real terms.[19] Under these assumptions, we estimate the freeze would reduce spending in 2017–18 by £1.0 billion in today's terms, with over 11 million families affected.[20]

However, the amount by which spending will be reduced in practice is sensitive to differences between forecast and actual inflation – higher-than-expected inflation would mean a bigger real-terms cut, and vice versa. This uncertainty can be important: for example, the 1% cap on nominal increases in a very similar set of benefits for three years from April 2013 reduced annual spending by £1.8 billion, rather than the £2.8 billion expected as of Budget 2013, because of lower-than-expected CPI inflation. This illustrates a major drawback of freezing benefit rates in nominal terms – the government does not choose the size of the real-terms cut, making the reduction in spending indeterminate and exposing recipients to inflation risk. If a government does wish to reduce the generosity of benefit entitlements across the board, it would be better to make future benefit uprating sensitive to actual rates of inflation.

Reduce the benefit cap to £23,000

The coalition government has introduced a restriction on the total weekly amount of benefit a family can receive, set at £350 per week for childless single adults and £500 per week for other families (with some exemptions, notably for those receiving certain disability benefits). The Conservatives propose to reduce the cap for couples and lone parents from £26,000 to £23,000 a year (£500 per week to about £440 per week), which would reduce spending by £135 million a year.[21] The small reduction in spending is a consequence of the small number of families that would be affected – 24,000 who are subject to the cap at the moment (and would all lose a further £3,000 per year) and 70,000 other workless families[22] who have a benefit income of between £23,000 and £26,000 (who would lose less than £3,000 per year). Evidence from the impact of the benefit cap so far suggests that some of those affected may respond by moving into work, but there has been little evidence of claimants moving to cheaper accommodation in response to the benefit cap.[23]

Remove housing benefit entitlement from 18- to 21-year-olds on jobseeker's allowance

Under a Conservative government, recipients of jobseeker's allowance aged between 18 and 21 would no longer be automatically entitled to housing benefit. We estimate that if housing benefit were withdrawn from all 20,000 claimants in that group, the reduction in spending would be around £100 million. Removing housing benefit entitlement for this

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[19] Source: Office for Budget Responsibility, *Economic and Fiscal Outlook: March 2015*, http://budgetresponsibility.org.uk/economic-fiscal-outlook-march-2015/.

[20] Source: Authors' calculations using TAXBEN run on uprated data from the 2012–13 Family Resources Survey.

[21] Source: http://www.dailymail.co.uk/news/article-2927561/New-welfare-crackdown-workshy-100-day-election-countdown-begins-PM-vows-slash-cap-3-000-days-Tory-election-victory.html.

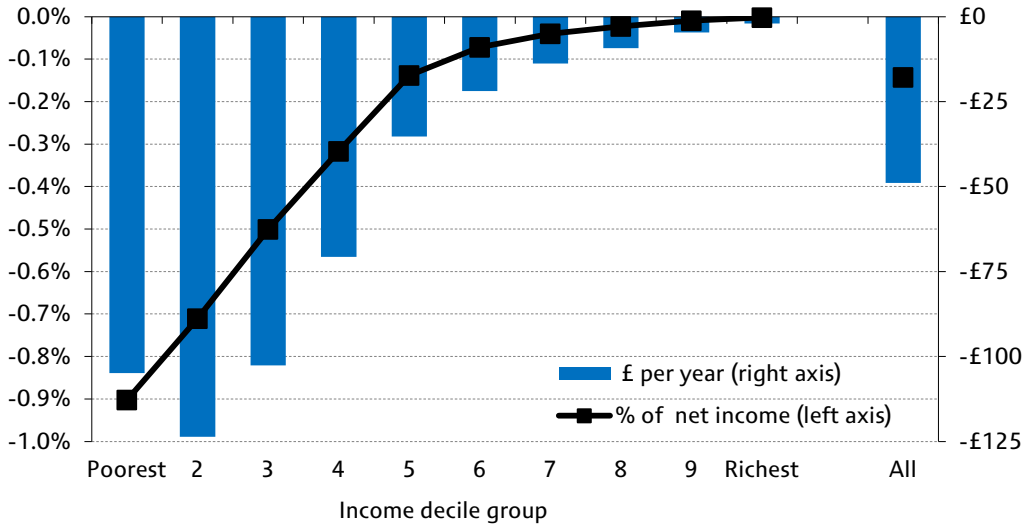
[22] Source: Department for Work and Pensions, *Benefit Cap: Analysis of Outcomes of Capped Claimants*, DWP ad-hoc research report 11, 2014, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/385970/benefit-cap-analysis-of-_outcomes-of-capped-claimants.pdf. For more discussion, see C. Emmerson and R. Joyce, 'Coping with the cap?', IFS Observation, December 2014, http://www.ifs.org.uk/publications/7482.

[23] Source: Department for Work and Pensions, *Benefit Cap: Analysis of Outcomes of Capped Claimants*, DWP ad-hoc research report 11, 2014, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/385970/benefit-cap-analysis-of-_outcomes-of-capped-claimants.pdf. For more discussion, see C. Emmerson and R. Joyce, 'Coping with the cap?', IFS Observation, December 2014, http://www.ifs.org.uk/publications/7482.

group would strengthen their incentives to find work. But it would also create a stronger incentive to claim employment and support allowance instead, or be a carer or a lone parent with a child under 5 in order to qualify for income support. These issues would have to be borne in mind when making changes to the benefit entitlements of this group.

Taken together, the three benefit policies outlined above would reduce benefit spending by around £1.5 billion a year. Figure 2.4 shows the impact of this £1.5 billion cut on the incomes of households across the distribution. As one would expect, the pattern is regressive – households in the bottom decile would lose the most as a percentage of their income (nearly 1%), while those towards the top of the distribution would be mostly unaffected.

Figure 2.4. Distributional effect of benefit reforms proposed by the Conservative Party by income decile in 2017–18



Note: Income decile groups are derived by dividing all households into 10 equal-sized groups according to net income adjusted for household size using the McClements equivalence scale. Assumes full take-up of means-tested benefits and tax credits.
Source: Authors' calculations using TAXBEN run on uprated data from the 2012–13 Family Resources Survey.

How might the Conservatives reach their £12 billion target for cuts in social security spending?

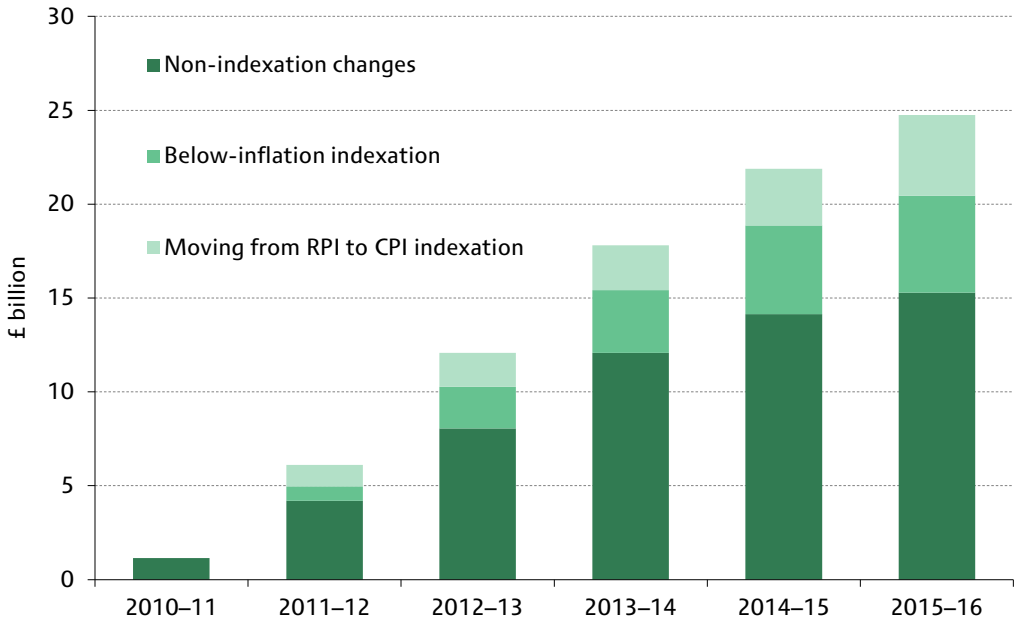
The £1.2 billion of benefit cuts outlined in the Conservative manifesto are rather dwarfed by their commitment to find £12 billion of cuts to annual spending by 2017–18 (just over £11 billion in today's terms). In this subsection, we investigate the feasibility of this target and discuss its likely distributional impact.

Total government spending on social security is around £220 billion in 2015–16. The planned £12 billion cut therefore represents a 5% cut in overall social security spending. However, the Prime Minister has already committed to maintain the 'triple lock' on the state pension (whereby it increases each year with the highest of average earnings growth, CPI inflation and 2.5%) and to universal benefits for pensioners, including winter fuel payments and free TV licences. Total spending on these protected benefits is around £95 billion. The Conservative plan is therefore to make roughly a 10% cut in the remaining £125 billion of spending on social security (hereafter referred to as 'unprotected' spending). If these cuts were implemented, social security spending would be around the same share of GDP in 2017–18 as it was a decade earlier, just before the

financial crisis. However, because spending on the state pension will be much higher, spending excluding the state pension would be at its lowest level since 1990–91 (as a share of GDP).

Figure 2.5 shows how the gross cuts to annual spending on social security (i.e. excluding giveaways) cumulated over the course of the current parliament. We can see that in the first two full years of the parliament, the coalition government implemented around £12 billion of gross cuts to annual social security spending (of a total of £25 billion by the end of the parliament).[24] The Conservative plan is therefore to cut at roughly the same pace in the first two years of the next parliament as in the first two years of the current parliament.

Figure 2.5. Gross cuts to annual social security spending: 2010–11 to 2015–16.



Source: Authors' calculations using HM Treasury Budgets, Autumn Statements and Spending Reviews (various years), OBR policy measures database (http://budgetresponsibility.org.uk/policy-measures-database/) and OBR, *Economic and Fiscal Outlook* (March 2014, December 2014 and March 2015).

However, the figure also shows that a large share of the cuts made over the current parliament – roughly £10 billion – came through changes in indexation policy (how benefits are increased in cash terms over time). This is important because the potential savings from such changes in the next two years are small. The switch from using RPI to CPI inflation cannot be repeated, and with CPI inflation near zero, freezes in benefit rates deliver only relatively small savings. The Conservative plans thus require them to deliver around £10 billion of cash cuts to benefits in the first two years of the next parliament, compared with £15 billion of cash cuts over the whole of the current parliament. The most that the coalition managed during the last parliament over a two-year period was less than £8 billion from 2011–12 to 2013–14.

[24] This was partially offset by an £8 billion giveaway, resulting in a £17 billion net giveaway.

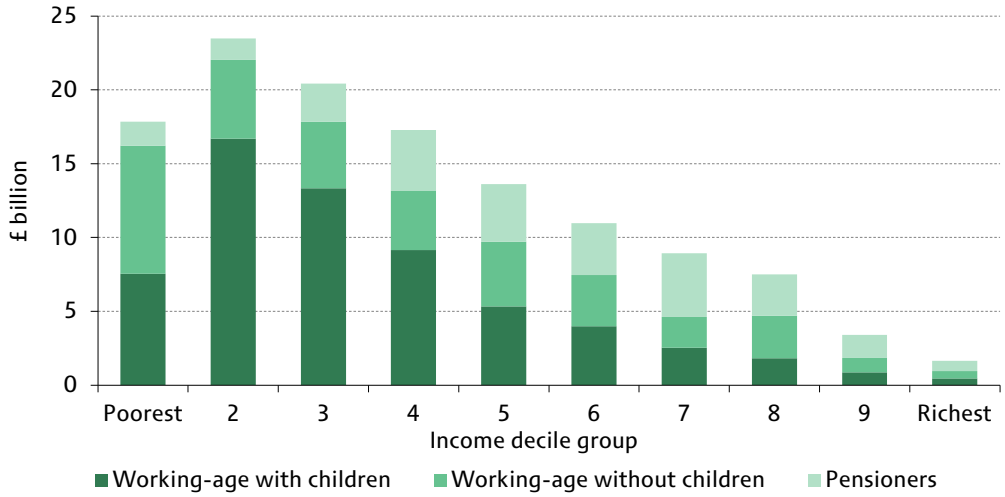
Possible routes to cuts on this scale are set out in both a chapter of the IFS Green Budget 2015[25] and leaked Department for Work and Pensions (DWP) documents.[26] To provide some examples:

- Abolishing child benefit and compensating low-income families through universal credit would reduce spending by around £5 billion.
- Reducing the child element of universal credit by 30% to reach its 2003–04 level in real terms would also cut spending by around £5 billion.
- Taxing disability living allowance (DLA), personal independence payment (PIP) and attendance allowance would raise around £1½ billion.
- Making all housing benefit recipients pay at least 10% of their rent would cut spending by around £2½ billion.

There are many other options and those above are listed merely as illustrations. The point is that finding the savings targeted by the Conservatives would almost certainly require significant cuts to some of the main benefits – child benefit, housing benefit, tax credits and disability benefits.

Figure 2.6 shows how benefit spending is spread across the income distribution (excluding state pensions and universal pensioner benefits, since the Conservatives have pledged to protect these benefits).[27] The Conservatives' plans imply roughly a 10% cut in this spending.

Figure 2.6. Estimated distribution of unprotected benefit spending



Note: Income decile groups are derived by dividing all households into 10 equal-sized groups according to net income adjusted for household size using the McClements equivalence scale. Total unprotected benefit spending is allocated across decile groups and family types according to their proportion of modelled entitlement.

Source: Authors' calculations using TAXBEN run on uprated data from the 2012–13 Family Resources Survey; Department for Work and Pensions, OBR and DSDNI data.

[25] See J. Browne and A. Hood, 'Options for reducing spending on social security', in C. Emmerson, P. Johnson and R. Joyce (eds), *The IFS Green Budget: February 2015*, http://www.ifs.org.uk/uploads/gb/gb2015/ch9_gb2015.pdf.

[26] See http://www.bbc.co.uk/news/uk-32084722.

[27] We allocate spending on unprotected benefits across income groups and family types according to the distribution of modelled entitlements using TAXBEN run on uprated data from the 2012–13 Family Resources Survey. This slightly overstates the share of unprotected spending directed at pensioners (22% as opposed to the 20% given by administrative data).

Unsurprisingly, spending on unprotected benefits is mostly directed at low-income households: of £125 billion in annual unprotected benefit spending, over £90 billion goes to households in the bottom half of the income distribution and over £60 billion to households in the bottom three deciles. Spending on working-age benefits is even more concentrated among low-income households: around £80 billion of the £100 billion spent goes to households in the bottom half of the income distribution.

We do not know the precise distributional consequences of the planned £12 billion of benefit cuts, nor their effect on the shape or coherence of the system, because the Conservatives have not outlined how the vast majority of that reduction would be achieved. Three things are clear, however. First, aiming to reduce annual spending by £12 billion by 2017–18 is ambitious, requiring an increase in the pace of cuts compared with that during the current parliament. Second, it is not possible for the Conservatives to meet this target by increasing benefits by less than inflation – large cuts to cash entitlements would be required. Third, those large cuts are likely to predominantly affect households towards the bottom of the income distribution.

2.3 Summary

Out of the three largest parties in the last parliament, the Conservatives are the only party proposing a (small) net tax cut, but they are also proposing the largest cut to benefits. Since the cut to benefits is much larger than the proposed overall tax cut, the Conservatives' policies represent a similar-sized net 'takeaway' from households to those of the other two parties featured in this briefing note. However, although the main giveaways to households – increasing the personal allowance and higher-rate threshold and introducing a new main residence allowance in inheritance tax – have been clearly set out, there is little detail on the benefit cuts and anti-avoidance measures that will reduce household incomes.

Two of the three main tax cuts proposed in the Conservative manifesto – the increase in the personal allowance and the cut in inheritance tax – will come as little surprise to those who have paid attention to Mr Osborne over the last 10 years. Increasing the higher-rate threshold, on the other hand, contrasts with the cuts in the higher-rate threshold seen between 2010 and 2015. Though still large, these proposals represent a smaller income tax cut than the increases in the personal allowance that have occurred over the last five years.

Overall, the biggest winners from the Conservatives' income tax proposals would be those with incomes between £50,000 and £150,000 (though note that this group has lost out as a result of changes implemented since the start of 2010, and the proposed changes over the next parliament would not come close to making up those losses, especially for those on incomes over £100,000). Higher-income individuals would also gain more on average from the proposed cut to inheritance tax. Although the Conservatives have not specified details of their benefit cuts, it is highly likely that the poorer half of households would lose overall from the Conservatives' proposals given the distribution of entitlements to the benefits that could potentially be cut. The overall distributional impact of the Conservatives' proposals would probably end up looking not too dissimilar to that of the coalition's policies during the previous parliament, with poorer households

losing, the largest gains going to households in the upper-middle of the income distribution but the very richest doing less well.[28]

By cutting benefits received by those who are not in paid work and increasing post-tax wages by raising the personal allowance, the Conservatives' proposals would likely do the most to strengthen work incentives of the three parties studied in this briefing note, though this would depend on the precise composition of the Conservatives' cuts to social security.

Though sizeable in revenue terms, the Conservatives' proposals would do little to alter the overall structure of the tax and benefit system, leaving its fundamental problems unaddressed. There is nothing to match the radical changes to the taxation of savings (with 95% of taxpayers no longer paying income tax on their savings income), to the flexibility of pension contributions, to the working-age benefits system (with the introduction of universal credit to integrate most means-tested benefits for those of working age) and to the state pension system (with the introduction of the single-tier pension) that we have seen over the last five years. Unfortunately, what we do see in the Conservative manifesto are more examples of Mr Osborne's tendency to complicate the tax system: the proposals would needlessly complicate the inheritance tax system, and add more complexity and instability to the taxation of pensions for better-off individuals. That said, none of the big structural changes to the tax and benefit system seen over the past five years were in the 2010 Conservative manifesto, and Mr Osborne may again surprise us.

3. Labour proposals

The Labour manifesto contains a number of specific proposals to change the tax and benefit system. Labour have also set a target to raise £7.5 billion of annual revenue through tackling tax avoidance 'by the middle of the next Parliament' (assuming this to mean 2018–19, their target is about £6.7 billion in today's terms). Associated with this is a '10-point plan', although they do not claim that the measures in that plan would raise the full £7.5 billion.[29] Table 3.1 lists the main permanent tax and benefit changes proposed by Labour and summarises their implications for the public finances.

Overall, these proposals would raise substantial additional amounts in tax (about £12.2 billion per year including the anti-avoidance target, £5.5 billion without it) – much of it from a small group of high-income or high-wealth individuals – and would make a number of changes to benefits which leave the total level of spending broadly unchanged.

[28] See J. Browne and W. Elming, 'The effect of the coalition's tax and benefit changes on household incomes and work incentives', IFS Briefing Note BN159, 2015, http://election2015.ifs.org.uk/uploads/publications/bns/BN159.pdf.

[29] http://press.labour.org.uk/post/116144568329/labour-announces-ten-point-plan-to-tackle-tax. Note that the 10-point plan includes the abolition of the 'shares for rights' scheme (discussed in Section 3.1), although the revenue from that measure would not all come from reduced avoidance activity.

Table 3.1. Estimated exchequer cost/yield of main permanent tax and benefit changes proposed by Labour (2015–16 prices)

Measure	Exchequer cost/yield (£ billion, 2015–16 prices)
Income tax	**+2.4**
Abolish married couple's transferable allowance	*+0.7*[a]
Introduce 10% starting rate of income tax	*–0.7*
Raise additional rate of income tax from 45% to 50%	*+0.1*[b]
Pensions tax relief: restrict to basic rate for those on higher incomes and reduce annual allowance	*+2.3*[c]
Corporate tax	**+1.8**
Increase main rate of corporation tax from 20% to 21%	*+1.0*[d]
Cut business rates multiplier by 3.8%	*–0.2*[e]
New tax on profits of tobacco companies	*+0.2*[f]
Increase in bank levy	*+0.8*[g]
Other tax measures	**+8.0**
'Mansion' tax on properties worth more than £2m	*+1.2*[g]
Stamp duty on collective investment schemes	*+0.2*[i]
Anti-avoidance and anti-evasion target	*+6.7*[g]
Total tax	**+12.2**
Benefits	
Abolish social sector size criteria in housing benefit	*–0.4*[h]
Increase paternity leave and paternity pay	*–0.2*[f]
Remove entitlement to winter fuel payments for higher- and additional-rate taxpayers	*+0.1*[j]
Cap increase in child benefit in April 2016 at 1%	*0*
Total benefits	**–0.4**
Grand total	**+11.8**

Source:

[a] http://www.markpack.org.uk/wp-content/plugins/google-document-embedder/load.php?d=http%3A%2F%2Fwww.markpack.org.uk%2Ffiles%2F2015%2F04%2FLiberal-Democrat-2015-general-election-manifesto-costings.pdf.

[b] HM Revenue and Customs, 'The exchequer effect of the 50 per cent additional rate of income tax', 2012, http://webarchive.nationalarchives.gov.uk/20130129110402/http:/www.hmrc.gov.uk/budget2012/excheq-income-tax-2042.pdf.

[c] Authors' calculations: the original Labour Party estimate was that these two measures, combined with a cut in the lifetime allowance from £1.25 million to £1.0 million, would raise £2.7 billion. In Budget 2015, the Chancellor announced that the government would be cutting the lifetime allowance and that this would raise £0.4 billion, suggesting that perhaps the remaining Labour measures might raise around £2.3 billion.

[d] Page 67 of HM Government, *Budget 2015*, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/416330/47881_Budget_2015_Web_Accessible.pdf.

[e] Authors' calculations using Valuation Office Agency, *2010 Local Rating Lists: Summary*, made available in September 2013 as the result of a freedom of information request, http://webarchive.nationalarchives.gov.uk/20141002130923/http://www.voa.gov.uk/corporate/_downloads/xls/RV-by-Band.xls.

[f] Labour Party costing (the unrounded figures in both cases are £150 million).

[g] Labour's stated revenue targets.

[h] Authors' calculations using administrative data from Department for Work and Pensions, Stat-Xplore.

[i] Page 64 of HM Treasury, *Budget 2013*, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/221885/budget2013_complete.pdf.

[j] Authors' calculations using TAXBEN run on uprated data from the 2012–13 Family Resources Survey.

In addition, Labour propose three temporary tax measures:

- a one-off tax on bankers' bonuses (revenue uncertain);
- a one-off tax rebate for firms that raise all wages to Living Wage levels (revenue uncertain);
- a stamp duty 'holiday' for three years for first-time buyers purchasing homes at less than £300,000 (Labour estimate that this would cost £225 million per year for the three years).

The Labour manifesto also contains proposals for a number of other small changes to the benefits system, none of which would have a substantial impact on government spending:

- Replacing jobseeker's allowance for 18- to 21-year-olds with a youth allowance dependent on recipients being in training and means-tested against parental income. Individuals with high-income parents would lose, but this saving would be likely to be outweighed by the costs of providing additional training.
- Introducing a 'higher' initial rate of contributory jobseeker's allowance, funded by increasing the number of years of contributions needed. This is an extremely small step towards strengthening the contributory principle, but provides a good example of what revenue-neutral change in that direction would look like: those with more contributions gain, while those with fewer lose.
- Pausing the roll-out of universal credit, in order to review the programme.
- Tightening the rules governing the benefit entitlements of migrants.
- Allowing local authorities that negotiate rent reductions on behalf of tenants claiming housing benefit to retain some of the savings, on the condition that the money is invested in building new homes.

Like the Conservative Party, Labour has pledged *not* to implement certain kinds of tax rises or certain kinds of cuts to pensioner benefits. In particular, their manifesto rules out increases to the basic and higher rates of income tax or rates of National Insurance; and it rules out increasing rates of VAT, as well as extending the VAT base to include food, children's clothes, books, newspapers or public transport fares. This does not rule out raising more revenue from these taxes in other ways: they could, for example, change income tax or National Insurance thresholds, or implement further restrictions to income tax relief on pension contributions. These could affect many of the same people, via the same tax, as the hypothetical tax rises that they have ruled out.

On the benefits side, Labour have pledged to make no further changes to winter fuel payments beyond their firm commitment to remove it from higher- and additional-rate taxpayers; and they have pledged to leave free TV licences and bus passes for pensioners in place as now. Much more significantly for the public finances, they also pledge to maintain the 'triple lock' on the basic state pension, which guarantees that it rises each year by the highest of earnings growth, inflation and 2.5%.

The remainder of this section discusses the specific measures proposed by Labour, taking taxes and benefits in turn.

3.1 Tax policies

Reintroduce a 10% starting rate of income tax and abolish the married couple's transferable personal allowance

Labour's manifesto confirms that they would reintroduce a 10% starting rate of income tax, the last incarnation of which was (in)famously abolished by Gordon Brown in the 2007 Budget. It says this policy would be funded by the abolition of the married couple's transferable personal allowance (discussed below). This suggests that Labour would have about £675 million per year to spend on introducing a 10% rate. This would imply a 10% marginal rate band that is just £260 wide (all in 2015–16 prices).[30]

The 10% rate would reduce liability for income tax by a mere £26 per year for almost everyone with annual taxable income of £11,108 or more, as it would reduce income tax from 20% to 10% on £260 of their annual taxable income. There would be (even) smaller cash gains for those within the 10% band (i.e. those with incomes between £10,848 and £11,108). Labour would extend by a further £130 the 60% effective marginal income tax band which starts at £100,000 – currently caused by the withdrawal of the personal allowance – to ensure that those on the highest incomes do not gain overall.

It is quite remarkable to introduce an entirely new rate of income tax in order to achieve such minuscule effects. Narrow marginal rate bands achieve nothing that cannot be more simply achieved through changing the thresholds above which they apply. In this case, a new narrow 10% starting rate has virtually identical impacts to simply raising the personal allowance. Consider the difference between Labour's proposed policy, of a new 10% band of £260, and a policy that simply increases the personal allowance by £130 (half the amount). Income tax liabilities would be identical under the two systems for anyone with annual taxable income less than £10,848 (who would be unaffected by either policy) or above £11,108 (who would pay £26 less income tax per year under both policies). The only difference is that those on between £10,848 and £11,108 would gain slightly more from an increase to the personal allowance than a 10% rate (i.e. the lowest-income beneficiaries gain more from extending a 0% band than from introducing a 10% band). In other words, the small difference between the distributional impacts of the two policies is that a personal allowance increase is slightly less regressive. The wider point is that the effects of the two policies are extremely similar, and hence it is a needless complication of the income tax system to introduce a new marginal rate band. In the longer term, it seems likely that Labour would like a wider 10% band; but unless and until it is substantially wider, its effects are so similar to raising the personal allowance that there is no plausible economic rationale for having it.

Labour would pay for the 10% rate by abolishing the transferable personal allowance (TPA) for married couples. This was introduced in April 2015 by the coalition government. It works as follows: if an individual is not using all of their income tax

[30] The £675 million figure in 2015–16 prices corresponds to the Liberal Democrats' estimate (which they attribute to HM Treasury) that abolishing the married couple's transferable allowance would raise £725 million in nominal terms in 2017–18 (source: http://www.markpack.org.uk/wp-content/plugins/google-document-embedder/load.php?d=http%3A%2F%2Fwww.markpack.org.uk%2Ffiles%2F2015%2F04%2FLiberal-Democrat-2015-general-election-manifesto-costings.pdf). We estimate that, if everyone took up their entitlement, the transferable allowance would cost £755 million in 2015–16 prices. Hence the Liberal Democrat estimate implies an assumption that about 89% of those entitled to the transferable allowance take up their entitlement. This is consistent with the assumption made in the official costing of the policy that take-up will reach 'in excess of 85%' in steady state (see the Autumn Statement 2013 policy costings document at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/263434/autumn_statement_2013_policy_costings.pdf).

personal allowance – because their income is less than the allowance – then they can transfer up to 10% of it to their spouse, if their spouse is a basic-rate taxpayer. Currently-planned policy implies that the personal allowance and higher-rate threshold will reach £10,848 and £42,633 respectively by 2017–18 (in 2015–16 prices). Hence, up to £1,085 of a personal allowance would be transferable between married couples, lowering the higher-income spouse's tax bill by up to £217 a year (the amount of basic rate (20%) income tax that would be paid on £1,085) as long as their own income does not exceed £42,633.

The impacts of the TPA – and hence the would-be impacts of its abolition – are small. The gainers gain by no more than about £4 per couple per week. The social message sent by the tax break looks more significant than its financial consequences for families, as the Prime Minister has stated himself. And only one-third of married couples (4.3 million out of 12.7 million) are eligible for it, because the following three groups of married couples do not qualify:

- couples whose members both have incomes above the personal allowance (there is no unused allowance to transfer in such cases);
- couples containing a higher-rate (40%) or additional-rate (45%) income tax payer;
- couples whose members both have incomes below the personal allowance: they would pay no income tax anyway, so cannot benefit from any income tax cut.

Among the working-age population, those who can benefit from the transferable allowance are therefore mostly one-earner married couples with a basic-rate taxpayer (some two-earner couples can also gain, where one worker earns less than the personal allowance and the other is a basic-rate taxpayer). In total, 2.8 million of the 4.3 million eligible married couples have someone in work. The vast majority of the other 1.5 million are married pensioners. Note also that not all eligible families take up their entitlement. Both our costing of the policy and our distributional analysis in Figure 3.1 assume that a random 11% of eligible families do not take up their entitlement: we estimate that this is consistent with the Liberal Democrats' costing of the allowance's abolition, and it is consistent with the description of the assumption made in the official costing of the policy.[31]

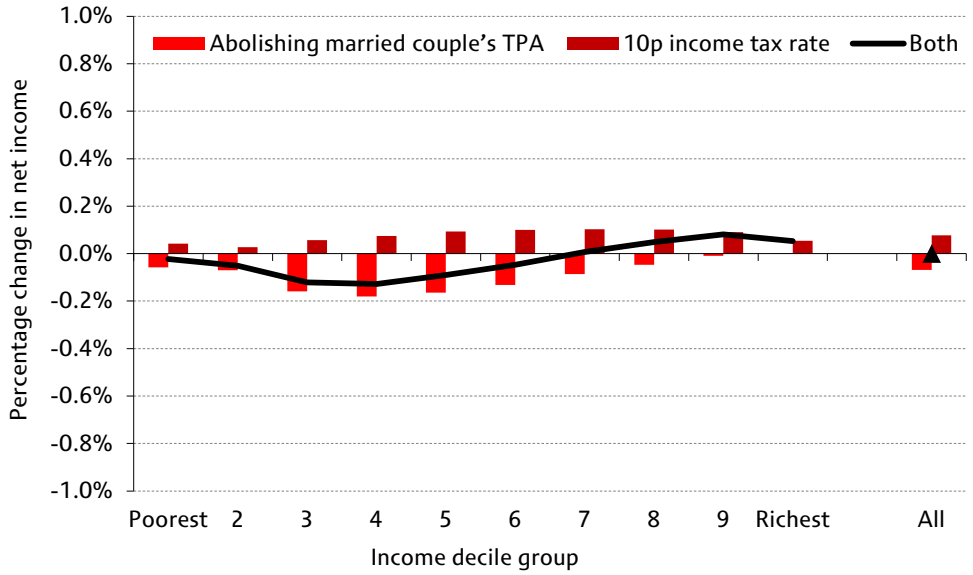
Since the TPA is not available to higher-rate taxpayers, workers benefiting from it have a weaker incentive to increase their taxable income above the higher-rate threshold (or a stronger incentive to make more pension contributions or charitable donations, which can be deductible from taxable income, to remain in the basic-rate band). Indeed, some can be worse off after a pay rise, or better off after a pay cut, because the transferred allowance is withdrawn in 'cliff-edge' fashion – that is, income tax liability jumps by more than £200 per year when taxable income crosses the higher-rate threshold. The removal of this cliff edge would be a welcome side effect of abolishing the TPA.

Taking the whole revenue-neutral package of a 10% rate funded by the abolition of the married couple's TPA, Labour are proposing to implement a modest tax rise on 3.8 million married individuals (assuming 89% take-up of the transferable allowance, as above) and to use the revenue to pay for a tiny tax cut for 27.5 million individuals. Single-earner married couples will tend to lose overall, funding small gains for a much larger group of basic- and higher-rate taxpayers.

[31] See previous footnote.

The distributional impact is very limited, but regressive, as shown by Figure 3.1 (using the same scale as on other distributional impact figures, to emphasise how small these policies are). Because a 10% rate is so similar to a rise in the personal allowance, its distributional impacts are essentially the same, with the middle and upper-middle of the income distribution gaining most on average (see Section 2.1 for more discussion). Abolishing the TPA, on the other hand, hits middle- and lower-middle-income families hardest on average. Gains from the TPA are less skewed towards higher-income families than the gains from a 10% starting rate of income tax, because couples in which both members have an income high enough to pay income tax cannot benefit from the TPA, whereas they would gain twice over from a 10% rate; and no higher-rate taxpayers gain from the TPA.

Figure 3.1. Distributional impact of revenue-neutral package abolishing married couple's transferable personal allowance and introducing a 10% income tax rate (percentage changes)



Note: Income decile groups derived by dividing all households into 10 equal-sized groups according to income adjusted for household size using the McClements equivalence scale. Estimates for abolition of the married couple's TPA assume that a random 11% of those eligible do not take it up.
Source: Authors' calculations using TAXBEN run on uprated data from the 2012–13 Family Resources Survey.

Just as the impacts on incomes would be of extremely small magnitude, so too would be the effects on work incentives.

The package of a 10% rate funded by the abolition of the married couple's TPA replaces one small complication of the income tax system with another. On the one hand, abolishing the TPA would remove the small but unwelcome cliff edge at the higher-rate threshold for someone who would – if a basic-rate taxpayer – gain from the TPA. On the other hand, Labour would needlessly introduce an additional income tax band into the system, even though it achieves nothing that could not be more simply achieved by other means. It would also effectively extend the extremely opaque 60% marginal rate band that is sandwiched by the higher (40%) rate, as a way of stopping the highest-income individuals gaining – making one of the most absurd features of the current income tax system slightly worse.

Increase the additional rate of income tax to 50%

Labour would increase the additional rate of income tax that applies above £150,000 from 45% to 50%. This would return it to its level between 2010–11 and 2012–13. HMRC expects that in 2014–15, the additional rate of income tax was paid by the highest-income 313,000 adults, or roughly two-thirds of one per cent.[32] (Since the £150,000 threshold has been frozen since 2010–11, this number has increased over the course of the last parliament from 236,000 or around half a per cent of adults).[33] This small group of taxpayers are expected to contribute around 28% of total income tax in 2014–15, which in itself is 8% of total tax revenue. They will of course contribute more revenue in other taxes, emphasising how reliant the exchequer is on this small number of individuals. These individuals are disproportionately likely to be male, aged 35–55, live in London or the South East of England, and work in financial services or be self-employed.[34]

If individuals did not change their taxable incomes in response to the higher tax rate, this tax increase would raise around £3.6 billion a year (an average of about £11,500 per affected individual).[35] However, we know that this is a highly implausible scenario: it is a well-established empirical finding in the economics literature that very-high-income individuals are particularly responsive to changes in their marginal tax rates.[36] The most recent evidence we have on the responsiveness of this group comes from a study by HMRC officials following the introduction of the additional rate of income tax in 2010–11.[37] HMRC's central estimate – signed off by the Office for Budget Responsibility as reasonable – is that the cut in the additional rate from 50% to 45% introduced in 2013–14 would cost just £110 million in 2015–16 once one allows for behavioural response by the affected individuals, suggesting that one could expect a similarly small increase in revenue by increasing the rate to 50% again. In other words, the estimate suggests that affected individuals would reduce their taxable income in response in a way that lowers tax revenues by £3.5 billion. However, there is considerable uncertainty around this estimate: it is well within the range of possibility that increasing the tax rate could yield more revenue for the exchequer than this, or lead to a reduction in total tax revenues.

It is possible that Labour's attempts to reduce tax avoidance and to restrict the extent to which those with the highest incomes can avoid paying the additional rate of income tax by paying more into a private pension could increase the yield from raising the additional tax rate. It is a common result from the studies in this area that much of the response of high-income individuals to higher tax rates takes the form of increased use of tax shelters and deductions rather than real reductions in income.[38] Reductions in the opportunities

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[32] Source: HMRC statistics Table 2.1, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/404149/Table_2.1.pdf.

[33] Source: Ibid.

[34] Manning (2015) shows that in 2010–11, 86% of additional-rate taxpayers were male, 67% were aged 35 to 55, 55% lived in London or the South East of England, 29% worked in financial services and 33% were self-employed. See A. Manning, 'Top rate of income tax', Centre for Economic Performance Paper EA029, 2015, http://cep.lse.ac.uk/pubs/download/EA029.pdf.

[35] Source: Authors' calculations using HMRC Statistics Table 2.6, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/404158/Table_2.6.pdf.

[36] See, for example, T. Piketty, E. Saez and S. Santcheva, 'Optimal taxation of top labor incomes: a tale of three elasticities', *American Economic Journal: Economic Policy*, 2014, 6, 230–71.

[37] HM Revenue and Customs, 'The exchequer effect of the 50 per cent additional rate of income tax', 2012, http://webarchive.nationalarchives.gov.uk/20130129110402/http:/www.hmrc.gov.uk/budget2012/excheq-income-tax-2042.pdf.

[38] See, for example, J. Gruber and E. Saez, 'The elasticity of taxable income: evidence and implications', *Journal of Public Economics*, 2002, 84, 1–32.

available to individuals to avoid tax may therefore not only increase the revenue raised at a given tax rate, but also increase the revenue-maximising tax rate. The extent to which this happened in practice would depend on the effectiveness of Labour's anti-avoidance measures. Evidence from Denmark has found much more modest responses to high marginal tax rates than those found by HMRC, perhaps because the tax base is very broad in Denmark and there is little scope for individuals to reduce their taxable income through the use of deductions.[39]

However, what is clear is that Labour cannot rely on significant additional revenues as a result of increasing the additional rate to 50%.

Pensions tax relief: restrict relief to the basic rate for those on the highest incomes, and reduce annual pension contribution limit from £40,000 to £30,000

Like the Conservatives, the Labour Party has said that it wishes to reduce the generosity of pension tax relief for those on high incomes, but in a different way. At present, those with taxable incomes (after deducting pension contributions) of over £150,000 a year – there are about 300,000 such individuals (about two-thirds of one per cent of all adults in the UK) – pay income tax at a marginal rate of 45%. Any pension contribution they make up to an annual allowance of £40,000 a year attracts income tax relief at that rate. Income tax would be paid at the point at which the pension is withdrawn – as an annuity or in some other form. The exception is that a tax-free lump sum worth a quarter of the accumulated pension pot can be withdrawn.

Labour plan two changes to the regime for pensions tax relief. The first of these they describe as restricting income tax relief on pension contributions for those with incomes above £150,000 a year to a rate of 20% (rather than the 50% marginal rate of income tax they would face under Labour). More precisely, they plan to apply this restriction to those with pre-tax incomes (before deducting employee pension contributions) above £130,000 and whose pre-tax income plus employer pension contributions exceeds £150,000.[40] In addition, the annual pension contribution limit would be reduced by a quarter from £40,000 to £30,000. The original Labour Party costing – adjusted for changes announced in Budget 2015 – suggests that these changes will in combination boost revenues by about £2.3 billion.[41] Much of this money would come from the same group of very-high-income individuals as those affected by Labour's proposed rise in the additional rate of income tax (see previous subsection).

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[39] See H. Kleven and E. Schultz, 'Estimating taxable income responses using Danish tax reforms', *American Economic Journal: Economic Policy*, 2014, 6(4), 271–301. The authors conclude that '[t]he fairly low taxable income elasticities that we find for Denmark, despite the presence of very high marginal tax rates, suggests that the Danish system offers small opportunities for avoidance and evasion. There are two main reasons for this. First, tax bases are very broad and offer limited opportunities for deductions and negative capital income to count against the income tax base. Second, as shown by Kleven et al. (2011), tax enforcement is very effective and overall tax compliance is high due to the widespread use of double-reporting by third parties such as employers and financial institutions. The overall conclusion that emerges from the two studies together is that a tax system with the broadest possible bases and extensive use of information reporting can impose high marginal tax rates with fairly modest behavioural responses.'

[40] For a discussion, see C. Emmerson, 'A response to the Treasury consultation on restricting pensions tax relief', IFS Press Release, 1 March 2010, http://www.ifs.org.uk/publications/4773.

[41] The original Labour Party estimate was that these two measures, combined with a cut in the lifetime allowance from £1.25 million to £1.0 million, would raise £2.7 billion. In Budget 2015, the Chancellor announced that the government would be cutting the lifetime allowance and that this would raise £0.4 billion, suggesting that perhaps the remaining Labour measures might raise around £2.3 billion. However, costing this measure is difficult.

The policy to restrict income tax relief to the basic rate for those on high incomes is in fact the same as the one proposed by the last Labour government in its 2009 Budget.[42] It means that some with large employer pension contributions would face a substantial increase in their income tax bill if their income rose from just under to just above the £130,000 threshold. For example, an individual earning £129,000 plus an employer pension contribution of £40,000 would face an increase in their annual income tax bill of over £10,000 if their current wage were to rise to £130,000 (assuming a top rate of income tax of 50%). The incoming coalition government decided to drop Labour's 2009 policy in favour of a reduction to annual and lifetime allowances designed to raise the same amount of money.

As discussed in the February 2014 IFS Green Budget,[43] a desirable benchmark for pensions taxation is a system where full tax relief is given up front, returns in a pension are left free of personal taxation and income is taxed in full on receipt. Unfortunately, Labour's proposed changes would move the system further away from this benchmark.

Fundamentally, the idea that income tax relief should be restricted to the basic rate is misguided. The error stems from looking at the tax treatment of pension contributions in isolation from the tax treatment of the pension income they finance. Pension contributions are excluded from taxable income precisely because pension income is taxed when it is received: in effect, the tax due on earnings paid into a pension is deferred until the money (plus any returns earned in the interim) is withdrawn from the fund. The tax system should treat pension contributions and pension income in a symmetric way: it is hard to see why it should be unfair for those above £150,000 to get tax relief at their marginal rate, but not for other higher-rate taxpayers to do so. Indeed, these very-highest-income individuals are less likely to be only basic-rate taxpayers in retirement, removing one of the principal (although still not well-founded) arguments for restricting relief.

Reducing the annual allowance also moves us further away from an appropriate pensions tax regime and does so in a way that penalises those making occasional large contributions rather than frequent smaller contributions. It is also problematic in practical terms, as valuing annual contributions to defined benefit pension schemes is difficult; the lower the annual limit, the more of these difficult valuations that must be done.

If the system of pensions taxation is to be made less generous, then it would be better to tackle the two elements of the system that look generous relative to the aforementioned benchmark of taxing pension income when it is received rather than when it is paid in or accrued. First, up to one-quarter of an accumulated pension can be taken tax-free. This means that given the £1 million lifetime limit, some could receive £250,000 that had escaped income tax altogether: it would be taxed neither when it was earned nor when it was withdrawn from the pension. Second, roughly three-quarters of pension contributions – those made by employers – escape National Insurance contributions

[42] At the time, the Labour policy was expected to raise £3.6 billion (from just 300,000 individuals, implying an average (mean) tax increase for these people of £12,000 per year). However, the reductions in annual and lifetime allowances that have occurred since then mean that such a policy would now be expected to raise far less than this.

[43] See C. Emmerson, 'Taxation of private pensions', in C. Emmerson, P. Johnson and H. Miller (eds), *The IFS Green Budget: February 2014*, http://www.ifs.org.uk/budgets/gb2014/gb2014_ch10.pdf.

entirely. The official estimate of the cost of this NICs relief is a whopping £14 billion in 2013–14.[44]

If Labour's reforms are implemented, then – like many of the reforms to pensions taxation implemented by the current government and those proposed by the Conservatives and the Liberal Democrats – they would add further undesirable complexity and be a missed opportunity to rationalise those parts of the pensions tax system that are overly generous.

Abolish long-term 'non-dom' status

While the Conservatives and the Liberal Democrats propose to increase the taxation of non-doms, the Labour Party proposes to abolish non-dom status entirely except for people who only come to the UK for a short period. It argues that this would be fairer than the current system and would raise 'hundreds of millions of pounds'.

Whether Labour's policy would in fact raise much, if any, revenue is uncertain. It depends on details that have not yet been announced (such as the length of the exemption for 'temporary' residents and the treatment of trusts), on the amounts of foreign money involved (which are not known) and on how non-doms respond to the reform (which is hard to predict). But revenue is not the only criterion by which the proposal should be judged. It matters more broadly how far it would improve the efficiency and equity of a clearly problematic aspect of the current tax system.

The current non-dom rules look anachronistic: it does seem inequitable to give preferential treatment to some individuals who have lived in this country all their lives. But that does not describe most non-doms, and there are benefits to having highly skilled, internationally mobile individuals living and working here for periods of time. Changes that ironed out the obvious inequities whilst preserving the UK's attractiveness to mobile workers would be welcome. The details of Labour's proposal, especially with respect to the period of time for which people arriving in the UK continue to be taxed preferentially, will be important. The proposal is discussed more fully in a recent IFS Observation.[45]

Abolish employee shareholder status ('shares for rights')

In September 2013, the government introduced 'employee shareholder status' (widely known as 'shares for rights'), whereby employees can give up certain employment rights in exchange for their employer giving them at least £2,000-worth of shares in the company they worked for: the first £2,000 of shares given would be excluded from earnings for the purposes of calculating income tax and NICs, and up to £50,000 of shares would be exempt from capital gains tax on any rise in value before the employee sold them. The Labour Party proposes to abolish this scheme.

Before the policy was introduced, the government forecast that it would cost £120 million in 2017–18 (£110 million in today's terms).[46] However, the longer-run cost of the scheme, and therefore the saving from abolishing it, is very difficult to forecast.

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[44] See https://www.gov.uk/government/statistics/registered-pension-schemes-cost-of-tax-relief.

[45] S. Adam, 'Unknown quantities: Labour's "non-dom" proposal', IFS Observation, April 2015, http://www.ifs.org.uk/publications/7703.

[46] Tables 2.1 and 2.2 of HM Treasury, *Budget 2013*, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/221885/budget2013_complete.pdf.

When the policy was announced, the Office for Budget Responsibility noted that the forecast annual cost was particularly uncertain but was 'expected to rise towards £1 billion beyond the end of the forecast horizon'.[47] If that is borne out, the long-run saving from abolition would be far higher than £120 million a year.

However, there is suggestive evidence that take-up of the policy has been very low: the Department for Business, Innovation and Skills (BIS) had received just 19 enquiries about the scheme by the end of 2013,[48] and HMRC had agreed barely 350 share valuations with British companies in connection with the scheme by February 2015.[49] These facts are merely suggestive: there is no requirement to enquire with BIS or agree a share valuation with HMRC in order to use the scheme, and the government has not published estimates of the number of businesses or employees participating. Yet with the government originally expecting around 6,000 companies and 50,000 to 80,000 employees to participate eventually,[50] there is little sign of such numbers materialising. If large-scale participation were never to emerge, the saving from abolishing the scheme may be very small.

Aside from the potential scope for tax avoidance – and corresponding revenue loss – that this scheme opens up,[51] its underlying rationale looks dubious. It has never been clear why, if employment rights are to be negotiable, it should be possible to give them up in exchange for shares but not, for example, a higher salary; why the government should encourage giving them up (via tax breaks) rather than merely allowing it; and why the reward for giving them up should depend on the size of subsequent capital gains (in other words, why the taxation of increases in the value of employee-owned shares should depend on what employment rights the employee has). This was always an incoherent policy and its abolition would be welcome.

One-off bankers' bonus tax

The last Labour government levied a one-off tax of 50% on discretionary bonuses in excess of £25,000 paid to bankers between December 2009 and April 2010, which HMRC estimates raised £2.3 billion.[52] The Labour Party now proposes to repeat this with another one-off tax. It estimates that this would raise £1.5–2 billion, though given that the

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[47] Page 52 of OBR's Annex B to the Autumn Statement 2012 policy costings document, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/221551/as2012_policy_costings.pdf.

[48] 'Nick Clegg urges end of "shares for rights"', *Financial Times*, 6 January 2014, http://www.ft.com/cms/s/0/97581034-7701-11e3-807e-00144feabdc0.html#axzz3XyBVETwe. See also http://www.hrmagazine.co.uk/hro/news/1078185/workers-employee-shareholder-contracts-employment-lawyers.

[49] Answer by Lord Deighton to House of Lords written question HL4811, http://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Lords/2015-02-09/HL4811/.

[50] 'Chancellor's "shares for rights" plan flops', *Financial Times*, 28 June 2013, http://www.ft.com/cms/s/0/6ec7934e-e005-11e2-bf9d-00144feab7de.html#axzz3XyBVETwe; HM Revenue and Customs, 'Employee shareholder status: capital gains tax exemption and income tax/NICs treatment', Tax Information and Impact Note, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/262692/emp-shareholder-status.pdf.

[51] The OBR (2012, op. cit.) warns that 'it is hard to predict how quickly the increased scope for tax planning will be exploited; again this could be quantitatively significant as a quarter of the costing already arises from tax planning'.

[52] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/348227/PAYE_and_corporate_tax_receipts_from_the_banking_sector_2014.pdf.

size of banks' bonus pools has fallen substantially – halved since 2009, according to the British Bankers' Association[53] – this revenue estimate does not look cautious.

There may be arguments for heavier taxation of the financial sector and those working within it. It is harder to see why bonuses should be taxed more heavily than fixed pay: why someone receiving a bonus should be taxed more heavily than someone receiving the same total remuneration via a higher fixed salary instead. If banks responded by reducing bonuses and increasing fixed pay instead, it would make the banks' financial position more rather than less risky by reducing their scope to reduce remuneration costs in adverse circumstances.

A temporary tax opens up the possibility of avoiding the tax by changing the timing of bonuses (paying bigger bonuses the next year instead, for example), though new EU limits on the size of bankers' bonuses would limit the scope for this. But if the policy is believed to be one-off, it should have less effect on the real behaviour either of banks or of bankers. As a permanent policy, the downsides of the tax might be more serious. The fact that this would be the second time such a tax had been levied, however, might lead people to doubt whether it would really be 'one-off'.

Stamp duty holiday for first-time buyers purchasing home for under £300,000

Stamp duty land tax (SDLT) is levied on purchases of property. For residential property, it is now charged at a rate of 0% on the first £125,000 of the property value, 2% on the value between £125,000 and £250,000, 5% on the value between £250,000 and £925,000, 10% on the value between £925,000 and £1.5 million and 12% on the value above £1.5 million. On 27 April – two weeks after the publication of their election manifesto – Labour announced that, for the first three years of a Labour government, SDLT would not be paid by first-time buyers purchasing homes worth up to £300,000. The tax bill being eliminated ranges from zero for a property worth up to £125,000 to £5,000 for a £300,000 property.

This policy would help first-time buyers and would also help existing owners of the kinds of properties favoured by first-time buyers (as the policy would increase the value of their properties). SDLT is a highly distortionary tax, so cutting it is a good thing. But doing so in a temporary way, restricting it to first-time buyers and making SDLT liability rise from nothing to £5,000 when property values cross £300,000 would create new distortions. In particular, it may encourage people to change the timing of purchase and the type of property purchased, and it penalises joint ownership (as it is only available to joint purchasers if both are first-time buyers). The policy would also reintroduce an unwelcome 'cliff edge' into the system of SDLT for residential properties, just months after the absurd cliff edges in the old system were removed: a first-time buyer purchasing a home for £300,000 would face no SDLT but someone purchasing a home for just a pound more would face a bill of £5,000.

The Labour Party has claimed that the policy would cost £225 million a year for the three years, while the Conservatives have claimed that the cost would be almost twice this at £520 million. In the context of the overall budget deficit, which is estimated to have been £87.3 billion in 2014–15, this is a small difference. Data limitations make this a difficult

[53] 'UK's top 5 banks slash bonus pools by more than £1bn', *Financial Times*, 6 April 2015, http://www.ft.com/cms/s/0/ac9b5e78-d949-11e4-a8f1-00144feab7de.html#axzz3XyBVETwe.

policy to cost with any precision. Our own approximate calculation suggests that the cost would be between these two estimates, but closer to the Labour one.[54]

Raise main rate of corporation tax and cut business rates for small businesses

Labour have announced that they would cut business rates for small businesses, paid for by reversing the cut in the main rate of corporation tax from 21% to 20% that took effect in April 2015. Specifically, the Labour policy is to cut the business rates multiplier by 2.9% compared with its current level in 2015–16 (effectively reversing the 2% nominal increase that occurred earlier this month and adding a 1% cut on top of that) for properties with a rateable value no greater than £50,000 and to freeze it in nominal terms in 2016–17 (rather than indexing the multiplier to RPI inflation – forecast at 0.9% by the OBR – as is the default). We estimate that the cost of this move would be around £200 million per year. An increase in the main rate of corporation tax back to 21% would raise around £1.0 billion per year, and would therefore raise substantially more than the business rates policy would cost.[55]

The policy would reduce business rate bills for the near-90% of business properties that have a rateable value of less than £50,000. Overall, the two years' cuts mean that, from 2016–17 onwards, business rates for those properties would be 3.8% lower under Labour's plans than under current policy.

Companies making sufficiently large profits would see the increase in their corporation tax bill outweigh any reduction in their business rate bill. But firms occupying premises with rateable values below £50,000 would unambiguously see their overall tax payments fall if their profits were below £300,000 (because they wouldn't be affected by the corporation tax rate rise) – or if they were set up as unincorporated businesses (self-employed individuals or partnerships), which are not subject to corporation tax at all.

The merits of cutting business rates and raising corporation tax rates are debatable. Business rates are clearly ill designed. They distort firms' incentives regarding how they produce their output, with negative consequences for the efficiency of the production process. But corporation tax can also have negative consequences. Indeed, corporate profits can move overseas in a way that property cannot. This is not to say that business rates should not be reduced. But if the Labour Party (or any other party) wishes to reduce business rates, there may be better places to find the revenue than increasing corporation tax.

Increasing just the main rate of corporation tax would also complicate the tax system. The reduction of the main rate of corporation tax to 20% in April 2015 brought it into line with the small profits rate (see Figure 3.2) and, in effect, eliminated a system in which there were not two separate rates but three: the small profits rate applied to profits below £300,000, the main rate applied to profits above £1,500,000 and a system of relief (in effect, a third marginal rate) operated between these two thresholds. The rationale for

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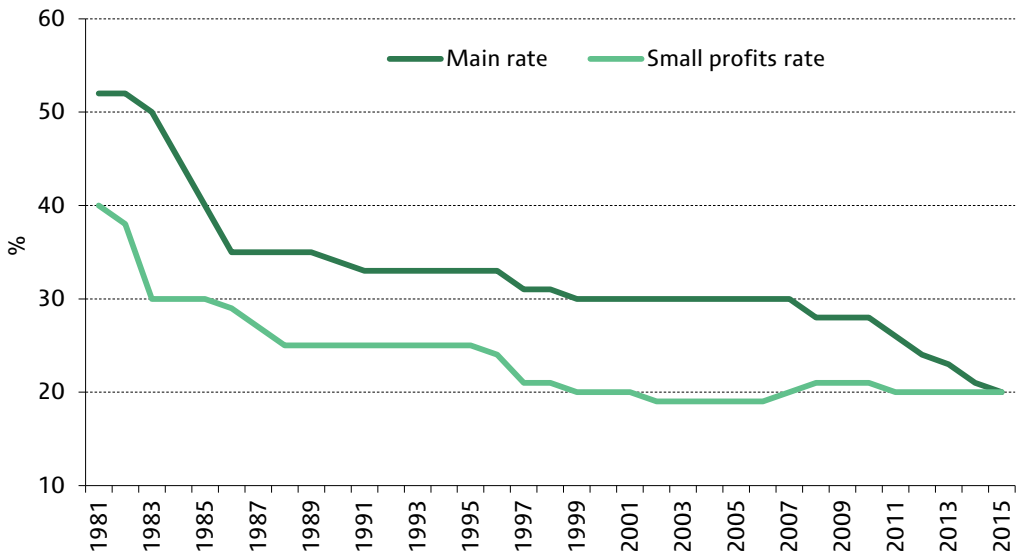
[54] Our estimate is around £260 million and perhaps a little less given that the Labour Party proposal would not apply to Scotland (Scotland now has its own, devolved, land and buildings transaction tax instead of SDLT). This is calculated using ONS statistics on the distribution of purchase prices paid by first-time buyers of properties between £125,000 and £300,000 (from table 34 at http://www.ons.gov.uk/ons/rel/hpi/house-price-index/february-2015/rft-annual-february-2015.xls) and an estimate of the total number of first-time buyers from the Halifax. Thanks to Daniel Chandler for providing this calculation.

[55] This estimate is based on the post-behavioural-change costing of reducing the main rate of corporation tax from 21% to 20%. See page 67 of HM Government, *Budget 2015*, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/416330/47881_Budget_2015_Web_Accessible.pdf.

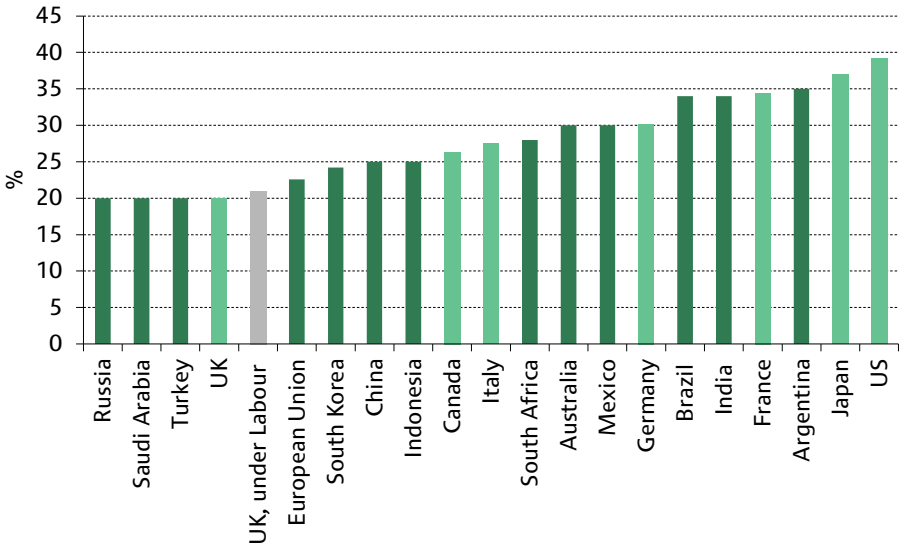
having a small profits rate of corporation tax was never clear in the first place – the redistributive motivation for a personal income tax system does not apply to firms – and moving to a single rate was a welcome simplification. Labour's policy now is to have – apparently permanently – a rate of 20% on profits below £300,000, a rate of 21.25% on profits between £300,000 and £1,500,000, and a rate of 21% on profits in excess of £1,500,000. Having three separate rates that are so similar to each other looks very peculiar. There is no economic rationale for it. The simplification of moving to a single rate of corporation tax (whether that is at 20% or some other rate) is a real achievement of the coalition government's tax policy, and it is one that should not be reversed.

Figure 3.2. UK corporation tax rates



Note: Small profits rate applies to companies with taxable profits of £300,000 or less.
Source: OECD Tax Database, tables II.1 and II.2 and historic tables II.1 and II.2 (http://www.oecd.org/tax/tax-policy/tax-database.htm).

Figure 3.3. G20 main corporate income tax rates, 2015



Note: The value for the European Union is an unweighted average across EU countries. Light green bars denote G7 countries.
Source: OECD Tax Database, table II.1 (http://www.oecd.org/tax/tax-policy/tax-database.htm); PKF worldwide tax guide 2014 and KPMG tax profiles.

Labour have said that they would maintain the lowest corporate tax rate in the G7. After the UK, the next-lowest rate in the G7 is Canada with a rate of 26.3% (see Figure 3.3, which highlights G7 countries in light green). That commitment leaves plenty of flexibility.

Introduce new levy on tobacco company profits

Labour are proposing a new permanent levy on tobacco companies, with the expected annual revenues of £150 million hypothecated for NHS spending. The policy will mirror the US model, introduced in 2009, in which manufacturers and importers of tobacco products must pay a quarterly user fee that is proportional to their share of the US tobacco market. That is, all companies resident in the UK that manufacture or import tobacco-based products would be subject to the new levy in proportion to their share of the UK market. Given the concentrated nature of the industry in the UK, the levy would fall almost exclusively on the four firms with the largest market share (Imperial Tobacco, Japan Tobacco International, British American Tobacco and Philip Morris International).

The idea of a new levy on tobacco companies has already been considered and supported in principle by the coalition government – it is currently under review by HM Treasury following a consultation that started in December 2014[56] – and features in the Liberal Democrats' manifesto. In both the consultation document and the Labour proposal, the aim of the new levy is to increase the contribution of tobacco companies to the costs related to smoking, including those incurred by the NHS and by employers in the form of lost productivity.

One of the uncertainties with such a levy is the extent to which the cost would be reflected in higher consumer prices rather than in lower profits. Tobacco demand has been found to be relatively inelastic,[57] which suggests that much of the cost of tobacco duties may be passed on to smokers.

Increase the bank levy

The bank levy – a tax on certain equity and liabilities of banks and building societies – was introduced in 2011 and is expected to raise £3.6 billion in 2015–16. The Labour Party proposes to increase the rate of the levy to raise an additional £800 million a year.

When introduced, the bank levy had two stated aims: to ensure banks made 'a full and fair contribution in respect of the potential risks they pose on the wider economy' and to 'encourage the banks to make greater use of more stable sources of funding, such as long-term debt and equity'.[58]

Any future government should be clear about its reasons for having a bank levy, and set (and maintain) the rate that best meets those aims. On the goal of reducing risk in the financial system, the base of the bank levy is reasonably well designed to encourage banks to use more equity capital and borrow less, thereby reducing the risks associated with high leverage. But the levy must be considered alongside regulations over capital requirements, which allow banks that have more equity capital to hold riskier assets. A study of the UK's bank levy and similar levies in other EU countries found that banks did

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[56] HM Treasury, *Tobacco Levy: Consultation*, 2014, http://www.gov.uk/government/uploads/system/uploads/attachment_data/file/384769/tobacco_levy_consultation.pdf.

[57] C. A. Gallet and J. A. List, 'Cigarette demand: a meta-analysis of elasticities', *Health Economics*, 2003, 12, 821–35.

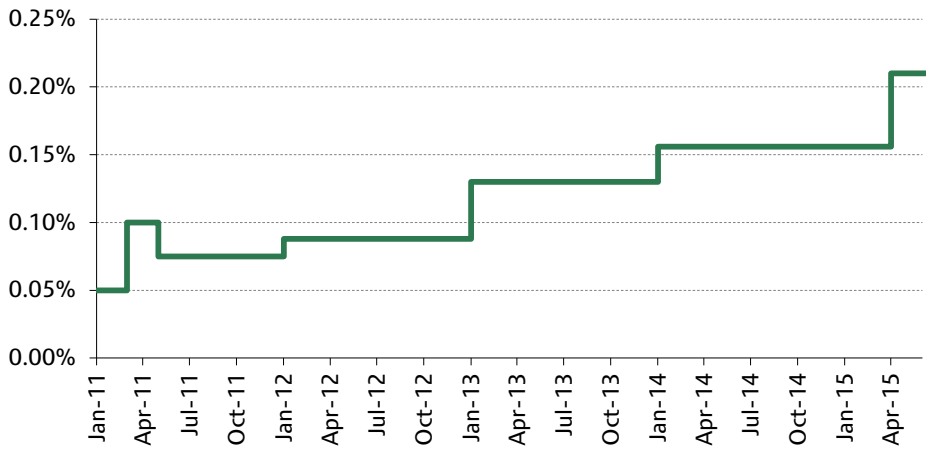
[58] https://www.gov.uk/government/news/government-introduces-bank-levy.

use more equity in response to the levies, but that for riskier banks – those that had little initial equity (and were therefore more likely to find the regulations a constraint) – this was accompanied by a move to hold riskier assets: reduced funding risk but increased portfolio risk. The study concluded that 'while the levies have reduced the total risk of relatively safe banks, they have done nothing to curb the risk of relatively risky banks, which presumably pose the greatest threat to financial stability.'[59]

If the objective is to discourage excessive risk-taking, the tax rate should be set in conjunction with regulatory capital requirements to provide the appropriate spur to reduce risk, and there is no obvious reason that it should rise or fall over time. Other objectives might imply different designs for a tax. If the goal is simply to raise more revenue from the banking sector rather than to correct a specific problem in the market, then policymakers should aim for a tax with as little effect on the market as possible, and behaviour changes induced by a higher bank levy should be regarded as an undesirable distortion.

Labour seem to be continuing the coalition's approach of setting a revenue target for the tax and adjusting the rate to try to meet it. That is not a good way to make tax policy. It can imply levying higher taxes on activities that are more responsive to tax – the opposite of what policymakers should aim for, all else equal. For example, if a tax rise reduces the taxed activity more than expected, that implies that the tax distorts behaviour more than expected and therefore that the optimal tax rate is lower – yet a fixed revenue target would instead require a further increase in the tax rate.

Figure 3.4. The bank levy rate over time



Note: This figure shows the actual bank levy rate over time – some announced changes were never implemented because a further increase was announced before the change took effect. The temporarily higher (0.1%) rate in March and April 2011 was intended to bring the effective rate for 2011 as a whole to 0.75%.

Whatever tax rate is chosen, stability is important. Since 2011, increases in the bank levy rate have been announced eight times. While there may be a good rationale for having a tax like the bank levy, changing it so frequently introduces potentially damaging uncertainty into the tax system. Figure 3.4 illustrates the many changes to the bank levy rate that we have already seen – and note that this ignores instances where a future bank

[59] M. P. Devereux, N. Johannesen and J. Vella, 'Can taxes tame the banks? Evidence from European bank levies', Oxford University Centre for Business Taxation, Working Paper WP13/25, 2013, http://www.sbs.ox.ac.uk/ideas-impact/tax/publications/working-papers/can-taxes-tame-banks-evidence-european-bank-levies.

levy rate has been specified and then changed before implementation. Yet another proposed increase, this time from the Labour Party, adds to the uncertainty and reinforces the damaging impression that further increases are to be expected on an arbitrary basis.

One-off tax rebate for firms that increase all wages to Living Wage levels

Labour say that they would increase the National Minimum Wage to £8.00 per hour by October 2019. This is around 20p higher than would be the case if it only kept pace with forecast growth in average earnings.[60] However, it would likely leave it well below the level of the so-called 'Living Wage' – designed to capture the wage a typical worker needs to fund an acceptable standing of living – that politicians of all the main parties have said they would like to see all employers pay as a minimum, if possible.

Rather than compelling employers to increase the wages of low-paid workers further, another approach is to encourage them to do so voluntarily. This is the approach taken in the Labour Party's proposed 'Make Work Pay' contracts. Under these contracts, employers that increase the wages of all their workers to the Living Wage or higher and become accredited Living Wage employers in the first year of a Labour government would receive a tax rebate for one year, equal to 32p for every £1 increase in wages up to the level of the Living Wage.[61] This 32p is equal to the basic rate of income tax plus employee National Insurance contributions.

It is not clear how effective this policy would be at incentivising employers to increase pay.[62] While it will reduce the cost of raising wages, and may have some positive demonstration effect, it is probably not well targeted at addressing the underlying factors that drive low pay. In cases where low pay is purely a result of low productivity, a temporary subsidy that covers only part of a wage increase would not be sufficient to persuade a profit-maximising employer to raise wages. In cases where employers are able to pay low wages by exploiting their labour market power, the policy would again not address the root cause of low pay, although it may have some (at least temporary) effect by increasing the bargaining power of low-paid workers relative to other workers.

The voluntary nature of the policy would not necessarily prevent it from creating undesirable distortions. For example, an employer must pay all of its workers at least the Living Wage (and ensure plans are in place for subcontractors do the same) to become accredited and benefit from the tax rebate. The most cost-effective way for them to satisfy this condition may be to increase the wages of some of their low-paid workers but not to employ others (perhaps, instead, using a smaller number of higher-paid workers or investing in additional capital).

The Labour Party argues that this policy would raise revenue in its first year in operation, as more would be raised from employer NICs and less would be spent on means-tested benefits and tax credits. After the first year, the government would also benefit from the higher income tax and employee NICs revenues if these higher wages persisted. But these are not the only effects – reduction in employment and company profits (both among

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[60] Authors' calculations using Office for Budget Responsibility, *Economic and Fiscal Outlook: March 2015*, http://budgetresponsibility.org.uk/economic-fiscal-outlook-march-2015/.

[61] Employers that already pay all their workers the Living Wage or more prior to the policy commencing would not benefit from the rebate.

[62] A further, more detailed assessment of the policy can be found in section 7.4 of A. Hood, R. Joyce and D. Phillips, 'Policies to help the low paid', in C. Emmerson, P. Johnson and H. Miller (eds), *The IFS Green Budget: February 2014*, http://www.ifs.org.uk/budgets/gb2014/gb2014_ch7.pdf.

firms paying the Living Wage and among other firms subject to knock-on effects) could act to reduce revenues. There is therefore real uncertainty about whether the policy would raise or cost money.

'Mansion tax'

Labour have proposed the introduction of a new 'mansion tax' on properties worth more than £2 million. Like council tax, properties would be put into bands, with all properties in a given band liable for the same tax but properties in higher bands charged more. The Labour Party has said that all properties worth between £2 million and £3 million would be charged £3,000 per year, with a series of higher bands for properties above £3 million attracting successively more tax.[63]

Nobody knows exactly how many properties in the UK are worth more than £2 million, and therefore how much revenue would be raised by different rates of a mansion tax: the last time all properties in the UK were systematically valued was prior to the introduction of council tax in 1993. However, various estate agents have produced their own estimates: Savills suggests the figure is 97,000, Zoopla 108,000 and Knight Frank 110,000; Hometrack, a housing market analyst, puts the figure rather lower, at 58,500.[64] According to the Liberal Democrats, HM Treasury's estimate is 150,000 (see Section 4.1).

Regardless of the size of the tax base, the Labour Party has set a revenue target of £1.2 billion, implying that the tax rates on properties in the highest bands would be set at whatever levels were required to raise the remainder of this revenue.[65] Thus if there were, for example, a total of 150,000 properties worth more than £2 million and 55,000 of those were worth more than £3 million (HM Treasury's estimates, according to the Liberal Democrats), that would imply that a £3,000 charge on all properties worth £2–3 million would raise £285 million and properties above £3 million would face an average tax charge of around £16,600 to make up the rest of the revenue. Setting a revenue target does not seem like a sensible way to make policy: it is not clear that the appropriate tax rate on high-value properties should be higher if there turn out to be fewer of them than expected, or vice versa.

In practice, the Labour Party's policy – and so the rate calculations – is more complicated than this. Labour have said that they 'will look at asking overseas owners of second homes in the UK to make a larger contribution than people living in their only home'.[66] They also said that only higher- and additional-rate income tax payers would be required to pay the tax immediately: others would be allowed to defer the tax (with interest accruing on the deferred liability) until the property was next sold or until the owner's death (at which point the tax would be taken from the deceased's estate alongside any inheritance tax). Again, it is not known exactly how many properties worth more than £2 million are owned by individuals with an income below £42,385 and would therefore have this option to defer paying the tax. And how attractive deferral would be depends on, among other things, the interest rate charged on deferred liabilities (which is yet to be

[63] See http://www.standard.co.uk/comment/comment/ed-balls-a-mansion-tax-will-be-fair-simple-and-pay-to-save-the-nhs-9805924.html.

[64] Savills figure from http://www.savills.co.uk/_news/article/55328/183956-0/11/2014/prime-housing-market---the-ultimate-political-football-; Zoopla from http://blog.zoopla.co.uk/2014/09/23/labours-mansion-tax-proposal-to-place-heavy-burden-on-south-east/; Knight Frank and Hometrack cited in http://www.bbc.co.uk/news/business-29326057.

[65] See http://www.labour.org.uk/blog/entry/six-things-you-need-to-know-about-labours-mansion-tax.

[66] http://www.labour.org.uk/blog/entry/six-things-you-need-to-know-about-labours-mansion-tax.

decided) and how likely homeowners thought it was that a future government opposed to the mansion tax might cancel accrued liabilities before they became payable (which is difficult to guess).

Council tax is currently charged at a much lower percentage of property value for high-value properties than for low-value properties and there is a case for taxing high-value properties more heavily than at present. But it is doubtful that adding a new tax on top of the existing system is the best way to achieve that. Council tax could be reformed to make tax bills more proportional to band values. This should be accompanied by a long-overdue revaluation of all properties (absurdly, council tax in England and Scotland is still based on the relative values of different properties in 1991, something that none of the main parties proposes to change). Alternatively, a mansion tax could be integrated with the annual tax on enveloped dwellings (ATED), which is already charged (in a similar banded structure) on residential properties worth more than £1 million held through certain 'non-natural persons' such as companies and unit trusts.[67] Subjecting high-value properties to three separate annual taxes – council tax, ATED and a mansion tax – seems unnecessarily complicated.

Labour have said that they want to introduce the mansion tax in a Budget in their first 100 days of office, and for it to be bringing in revenue before the end of 2015–16. That might be possible (Ed Balls has talked of introduction in 2016–17 'as a backstop' in case introduction in 2015–16 proves impossible[68]) but it does not seem prudent. When introducing a brand new tax, with numerous details to resolve (regarding valuations, administration, deferral and appeals, for example) it would seem important to allow time for detailed consultation and carefully-drafted legislation rather than rushing the introduction of the policy.

Stamp duty on collective investment schemes

The Labour Party proposes to reintroduce a stamp duty charge, which was abolished in April 2014, applying to units in collective investment funds that are surrendered and then reissued to new investors within two weeks. The government estimated that removing this charge would cost £160 million a year,[69] so reinstating it would presumably raise a similar amount.

Tackling tax evasion and avoidance

While the Conservative Party wants to raise £5 billion from tackling tax evasion and avoidance, Labour have set themselves a £7.5 billion revenue target with the 'ambitious goal of doing so by the middle of the next Parliament'.[70] Assuming this to mean 2018–19, it corresponds to about £6.7 billion in today's terms.

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[67] While ATED currently applies only to properties worth more than £1 million, smaller amounts are due to become payable on properties worth more than £500,000 from April 2016. Further increasing ATED itself could itself be a way to increase revenues from high-value property. The 2014 Autumn Statement increased ATED rates for properties above £2 million by 50% above normal inflation uprating from April 2015, taking the charge on affected properties in the £2–5 million bracket, for example, to £23,350 instead of £15,600 and raising around £100 million per year. A further increase of the same magnitude could raise a similar sum, but it is clear that only modest additional revenue is available from this source. (For details, see https://www.gov.uk/annual-tax-on-enveloped-dwellings-the-basics.)

[68] http://www.independent.co.uk/news/uk/politics/ed-balls-labour-government-would-fasttrack-the-mansion-tax-9941165.html.

[69] Page 64 of HM Treasury, *Budget 2013*, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/221885/budget2013_complete.pdf.

[70] http://press.labour.org.uk/post/116144568329/labour-announces-ten-point-plan-to-tackle-tax.

To help them on the way to this, Labour have set out a 10-point plan of actions they would take.[71] Both the 'non-dom' proposal and the abolition of 'shares for rights', discussed above, feature in the plan. As explained above, the long-run revenue consequences of both of these are highly uncertain: it is possible they could raise £1 billion apiece but it is also possible they could raise virtually nothing (or even cost money in the case of the non-dom proposal). Of the other eight measures in the plan, some seem more likely than others to yield significant additional revenue, but Labour do not claim that the plan as a whole would generate anything close to their £7.5 billion target.[72]

3.2 Benefit policies

The Labour Party manifesto contains a number of proposed changes to the benefits system, all of which would have a small impact on the public finances. Overall, we estimate that fulfilling Labour's manifesto commitments would increase benefit spending by around £400 million a year.[73]

Abolish the social sector size criteria ('bedroom tax')

Perhaps one of the most controversial benefit changes implemented by the coalition government has been the introduction of the social sector size criteria (SSSC) – the so-called 'bedroom tax' or 'removal of the spare room subsidy'. From April 2013, working-age housing benefit (HB) claimants in social housing who are deemed to be 'under-occupying' their homes have had their maximum housing benefit awards reduced. As of November 2014, around 460,000 families were affected by the SSSC (about 15% of working-age social sector claimants) and had lost an average of £15 a week (£780 per year).[74]

Survey evidence suggests that the policy has not, in the short run at least, had much effect on the use of the social housing stock – one of the coalition's stated aims. In the first six months of the policy, only 4.5% of affected tenants moved to a smaller social house, partly because of a shortage of smaller properties. The survey evidence also suggests that those affected have struggled to pay the share of their rent no longer covered by HB; around half of those affected and surveyed were in rent arrears six months after the introduction of the policy.[75]

Labour plan to abolish the SSSC, increasing the HB entitlements of those currently affected by the SSSC and costing around £380 million a year.[76]

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[71] Ibid.

[72] Bizarrely, in places, Labour also describe restricting income tax relief on pension contributions – which could raise significant sums – as a tax avoidance measure. But it does not count that towards its £7.5 billion revenue target.

[73] The abolition of the social sector size criteria, increase in statutory paternity pay and removal of winter fuel payments from higher- and additional-rate taxpayers would in aggregate cost about £430 million per year. There would be small but uncertain savings from the removal of jobseeker's allowance from some 18- to 21-year-olds with relatively high-income parents and from the tightening of eligibility rules for migrants. The compulsory jobs guarantee could also reduce benefits spending slightly – through increased sanctions and/or movements into work – but this would be more than offset by other costs of the policy.

[74] Source: Department for Work and Pensions, Stat-Xplore.

[75] Figures in this paragraph are from Department for Work and Pensions, *Evaluation of Removal of the Spare Room Subsidy*, Research Report 882, 2014.

[76] Source: Department for Work and Pensions, Stat-Xplore.

The compulsory jobs guarantee

A future Labour government would 'ensure' that all 18- to 24-year-olds who have been claiming jobseeker's allowance (JSA) for a year or more, and all those aged 25 or over who have been claiming JSA for two years or more, would be offered a paid job. Those who refused the job would risk losing entitlement to their JSA, in line with the current sanctions regime. Government-accredited businesses (or voluntary organisations) who employed these individuals on a six-month contract to work 25 hours a week at the National Minimum Wage would have the wages and employer National Insurance contributions covered by the government, and would receive an additional £500 per employee taken on. Labour cite House of Commons Library estimates that the total cost of the policy would be £1.2 billion in the first year and £300 million thereafter, with each job having a gross cost to government of around £5,000.[77]

From the perspective of the unemployed individual, this policy represents a significant increase in current income – 25 hours at the NMW is more than twice the rate of JSA (although those claiming support for housing costs and/or council tax wouldn't benefit in full, as entitlement to these income-related benefits would fall). The policy is also presumably motivated by the potential for longer-run benefits from reducing the length of time that individuals spend out of work, avoiding some of the skill depreciation and labour market detachment that might otherwise have occurred – and its targeting on young adults makes sense from this point of view.

From the perspective of employers, the gain is clear: the policy offers them free labour and hence, presumably, higher profits. It also provides them with an incentive to substitute these fully-subsidised employees for other, unsubsidised employees. It would often be extremely difficult to establish whether this substitution had occurred (for example, to prove what a firm's hiring strategy would have been in the absence of the policy) and so difficult to prevent it occurring to some extent. It is therefore possible that both current workers and other (ineligible) unemployed individuals could lose from the policy. And there would be a wider efficiency cost of distorting employers' choices of labour inputs towards workers who they would not have hired unsubsidised, potentially lowering output. The intention, of course, would be that the long-term benefits of cutting short unemployment spells would outweigh any such drawbacks. This is certainly possible. For all these reasons, this policy is a prime example of one that, once implemented, should be fully and rigorously evaluated so that its effects are understood.

Increase paternity leave and paternity pay

At the moment, fathers are entitled to two weeks of paternity leave after their child is born, during which they receive the lesser of £139.58 a week or 90% of their average weekly earnings in statutory paternity pay (SPP). The Labour Party proposes to double the length of paternity leave to four weeks and increase SPP to around £240 a week (about the equivalent of working full time at the National Minimum Wage). On the basis of analysis by the Institute for Public Policy Research, which assumes an increase in take-up from 55% to 70%, Labour expect this policy to increase spending by around £150 million a year.[78]

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[77] There are two reasons the cost of the policy would decline after the first year. First, for adults aged 25 and over, the fully-subsidised job would only be for three months at 20 hours a week at the NMW after the first year (at a cost of £1,690 per job). Second, the number of claimants entering the eligible group of recipients each year would be smaller than the number who are currently in the eligible group.

[78] Source: http://www.ippr.org/assets/media/publications/pdf/No-more-baby-steps_Jun2014.pdf.

This would be the first significant change in the rate of SPP since its introduction in April 2003, and would represent a giveaway of around £680 to fathers who took up their increased entitlement in full. Despite nearly doubling the rate of paternity pay received by most recipients, it would still leave SPP significantly less generous than statutory maternity pay (per week, as well as in total).

Remove winter fuel payments from higher- and additional-rate taxpayers

The largest benefit cut proposed by Labour is the removal of winter fuel payments – which are currently universal for pensioners – from higher- and additional-rate taxpayers. Affected families would lose £200 or (if they contain an individual aged over 80) £300 per year. This is expected to reduce spending by about £100 million a year, with about half a million families affected.[79] This is a trifling figure in the context of overall benefit spending (less than 0.05%) and benefit spending on pensioners specifically (less than 0.1%). The Labour manifesto explicitly promises the party would not look for further savings in this area, guaranteeing that there would be no additional changes in the eligibility rules for universal pensioner benefits (winter fuel payments, free TV licences and bus passes).

'Cap child benefit rises for two years'

The Labour manifesto contains the commitment to 'cap child benefit rises for two years' in a list of policies aimed at reducing the deficit. There are two points to note about this. First, one of the two years to which the statement refers is 2015–16. The commitment therefore includes the 1% nominal increase in child benefit rates already in the books and implemented in April 2015: it is bizarre and indeed misleading to include as a future manifesto commitment a policy that has already been implemented by the government. Second, the commitment to cap the nominal increase in child benefit at 1% in April 2016 is likely to be irrelevant. Since Labour first announced this policy, inflation has fallen rapidly and the Office for Budget Responsibility's current forecast is for September 2015 CPI inflation (which determines the default April 2016 increase in child benefit rates) to be 0.2%. As a result, the cap is unlikely to bite, i.e. it is unlikely to have any effect on child benefit rates and to save any money.[80]

3.3 Summary

Out of the three largest parties in the last parliament, Labour are proposing the largest tax rise and a small increase in benefit spending (rather than benefit cuts, as the Conservatives and Liberal Democrats propose). Overall, Labour's tax and benefit policies would represent a long-run takeaway from households of about £12 billion per year. In aggregate, this is quite similar to the Conservatives' and Liberal Democrats' proposed takeaways. But its composition is very different. Labour's takeaway is entirely accounted for by a net tax rise, which would be heavily concentrated on a group of high-income or high-wealth individuals.

Labour prove no exception to the fad for claiming that large amounts of additional tax revenue (nearly £7 billion per year (in today's terms) 'by the middle of the next Parliament') will be raised from anti-avoidance and anti-evasion measures. To their

[79] Source: Authors' calculations using TAXBEN run on uprated 2012–13 Family Resources Survey data.

[80] The Bank of England's February 2015 *Inflation Report* estimated that the probability of CPI inflation exceeding 1% in 2015Q3 is less than 20%. Source: http://www.bankofengland.co.uk/publications/Pages/inflationreport/irprobab.aspx.

credit, they have published a 10-point plan containing some specific measures of this kind. However, the measures in question are of varying credibility, the revenue they would actually raise is highly uncertain, and Labour do not claim that they would be enough to raise anywhere near the targeted revenue.

In terms of what Labour's proposals would do to the design of the tax and benefit system, they represent a mixed bag. Abolishing the 'shares for rights' tax break is a small, but eminently sensible, simplification. The 'mansion tax' also has some logic underpinning it – the current system of property tax is based on absurdly out-of-date property values, and the highest-value properties are taxed at a much lower rate than lower-value ones – but it would be better to fix council tax rather than layer a separate tax on top of it. With the abolition of the married couple's transferable allowance and introduction of a 10% starting rate, Labour would replace one small complication of the income tax system with another, which achieves nothing that could not be achieved more straightforwardly by increasing the personal allowance. Labour would also reintroduce a needlessly convoluted system of corporation tax, with separate marginal rates of 20%, 21.25% and 21%; and would move us even further away from a well-designed system of pensions taxation. On the benefits side, Labour's proposals are mostly too small to have a meaningful effect on the coherence or generosity of the system.

4. Liberal Democrat proposals

In their manifesto, the Liberal Democrats say that 'our plans do not require any increase in the headline rates of Income Tax, National Insurance, VAT or Corporation Tax', though they do not go quite as far as Labour and the Conservatives in categorically ruling out increasing headline tax rates.

The plans they do have involve permanently raising taxes by a net £11.7 billion and reducing benefit spending by a net £2.1 billion in today's terms. The main items making up those totals are shown in Table 4.1.[81]

The table shows that £9.7 billion of the £11.7 billion tax rise comes from (largely unspecified) anti-avoidance and anti-evasion measures, while £1.9 billion of the £2.1 billion benefit cuts comes from somewhat vague aspirations (which would presumably be shared by all parties) to reduce fraud and error and to help more benefit claimants move into work. Excluding those, the Liberal Democrats' specific policy commitments amount to only £2.0 billion of tax rises and £0.2 billion of benefit cuts.

Table 4.1 excludes two council tax measures which have small but hard-to-estimate fiscal impacts and which the Liberal Democrats also exclude from their calculations:

- A council tax reduction of 'at least £100 for 10 years, when the resident's home has an energy saving improvement of at least two bands'. The cost of this measure would depend on how many households took sufficient energy-saving steps and claimed the corresponding council tax discount.

[81] In addition to the permanent policies listed in Table 4.1, the manifesto includes a few policies that will have only temporary effects: an 8 percentage point increase in the corporation tax rate for banks that applies for only two years; investing to clear a backlog in assessing DLA and PIP claims; and two policies associated with the introduction of universal credit, which will become irrelevant once UC is gradually embedded. These reforms are discussed below where appropriate but excluded when calculating the long-run fiscal impact of the package.

Table 4.1. Estimated exchequer cost/yield of main permanent tax and benefit changes proposed by the Liberal Democrats (2015–16 prices)

Measure	Exchequer cost/yield (£ billion, 2015–16 prices)
Income tax and capital gains tax	**–1.3**
Increase personal allowance to £12,500 by 2020–21	*–4.0*[a]
Abolish married couple's transferable allowance	*+0.7*[a]
Reduce CGT allowance to £2,500, allow transferral of unused income tax allowances and reform entrepreneur's relief	*+0.6*[b]
Abolish employee shareholder status ('shares for rights')	*+0.1*[c]
Increase remittance basis charge for 'non-doms'	*+0.1*[b]
Increase higher and additional rates of tax on dividends	*+1.1*[b]
Corporation tax	**+1.5**
Restrict deductibility of interest payments	*+0.7*[b]
Limit loss offsets	*+0.6*[b]
New tax on profits of tobacco companies	*+0.2*[d]
Other taxes	**+11.6**
'Mansion' tax on properties worth more than £2m	*+0.9*[d]
Increase vehicle excise duty	*+0.8*[d]
Reintroduce landfill tax escalator	*+0.1*[e]
Anti-avoidance and anti-evasion target	*+9.7*[d]
Total tax	**+11.7**
Benefits	
Restrict application of social sector size criteria in housing benefit	*–0.3*[b]
Increase benefits for carers	*–0.2*[f]
Offer to pay reduced housing benefit directly to landlords	*+0.3*[f]
Reduce capital limits in universal credit	*+0.3*[a]
1% cap on uprating of most working-age benefits in 2016–17 and 2017–18	*+0.1*[b]
Remove winter fuel payments and free TV licences from higher- and additional-rate taxpayers	*+0.1*[b]
Keep household benefit cap linked to average income	*–0.1*[g]
Back-to-work support	*+0.9*[d]
Reduced fraud and error	*+0.9*[d]
Total benefits	**+2.1**
Grand total	**+13.8**

Source:
[a] Authors' calculations using TAXBEN run on uprated data from the 2012–13 Family Resources Survey.
[b] Liberal Democrats' costing, attributed by them to HM Treasury.
[c] HM Treasury, *Budget 2013*, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/221885/budget2013_complete.pdf.
[d] Liberal Democrat revenue target.
[e] Authors' calculations using OBR inflation forecasts and HM Revenue and Customs, 'Direct effects of illustrative tax changes', https://www.gov.uk/government/statistics/direct-effects-of-illustrative-tax-changes.
[f] Liberal Democrat estimate.
[g] Authors' calculations using administrative data.

- Allow local authorities to charge up to 200% council tax on second homes. The amount raised by this would depend on whether and how councils chose to use this power, but any additional revenue would affect local rather than central government finances.

The manifesto also mentions three potentially major reforms that the Liberal Democrats are seriously considering but that are not firm commitments for the coming parliament:

- They propose to 'Establish a review to consider the case for, and practical implications of, introducing a single rate of tax relief for pensions, which would be designed to be simpler and fairer and which would be set more generously than the current 20% basic rate relief'. The revenue implications of this would obviously depend on the rate of relief chosen. But whatever the rate, it is hard to see how this could be administratively simpler than the current system, and hard to see how it would be fair to give everybody (say) 25% or 30% relief on their pension contributions yet charge some people 20%, some 40% and some 45% income tax on the pension income that is generated.
- After they have fulfilled their pledge to increase the income tax personal allowance to £12,500 (discussed below), the Liberal Democrats would 'Consider … raising the employee National Insurance threshold to the Income Tax threshold'. This contrasts with the Conservatives' emphasis on ensuring ongoing rises in the income tax personal allowance by linking it permanently to the National Minimum Wage. As we discuss in Section 2.1, increasing the employee NICs threshold is a better way of helping low earners than increasing the personal allowance, so it is welcome that the Liberal Democrats are at least considering this alternative, though still curious that they place a greater emphasis on further increasing the personal allowance rather than increasing the NICs threshold.
- 'Liberal Democrats remain committed to introducing Land Value Tax (LVT), which would replace Business Rates in the longer term and could enable the reduction or abolition of other taxes.' The manifesto does not commit to reform in the next parliament, but proposes to extend the remit of the review of business rates policy currently under way so that it examines the implementation of LVT. That is an admirable position, and consistent with the recommendations of the Mirrlees Review of the tax system, which argued that LVT should replace business rates subject to confirming practical feasibility.[82] There is a strong case against levying a tax on buildings used for business purposes, as business rates does, because it artificially skews economic activity away from property development and property-intensive production activities. In contrast, a tax on the value of land (excluding the value of any buildings on it) would simply make it less valuable to its owners without discouraging any desirable activity. Owners of highly-developed properties would gain, while owners of undeveloped land would lose, but the productive potential of the economy would be increased.

In the remainder of this section, we discuss each of the Liberal Democrats' firm commitments in turn.

[82] Chapter 16 of J. Mirrlees, S. Adam, T. Besley, R. Blundell, S. Bond, R. Chote, M. Gammie, P. Johnson, G. Myles and J. Poterba, *Tax by Design: The Mirrlees Review*, Oxford University Press for the Institute for Fiscal Studies, Oxford, 2011, http://www.ifs.org.uk/publications/5353.

4.1 Tax policies

Increase the personal allowance to £11,000 by 2016–17 and £12,500 by 2020–21

Like the Conservatives, the Liberal Democrats would increase the personal allowance to £12,500 by 2020–21 (see Section 2.1 for a more complete discussion of this policy) – though while the Conservatives would also increase the higher-rate threshold to £50,000, the Liberal Democrats would leave it unchanged in real terms. This would reduce income tax revenues in 2020–21 by the equivalent of £4.0 billion in today's prices.

En route to that end, the Liberal Democrats have pledged to increase the personal allowance to £11,000 in 2016–17 rather than the £10,800 that is currently planned under coalition government policy. This would reduce income tax revenues by around £1 billion in 2016–17; in 2017–18, the Liberal Democrats would not increase the personal allowance in real terms, unlike under the coalition's plans, meaning that the exchequer cost would fall to below £800 million in that year.

Abolish the married couple's transferable personal allowance

Like the Labour Party, the Liberal Democrats propose to raise about £675 million per year by abolishing the married couple's transferable income tax allowance that was introduced at the start of April by the coalition government. This policy is discussed in detail in Section 3.1.

Capital gains tax reforms

Capital gains tax (CGT) is charged on the increase in the value of an asset between its acquisition and disposal.[83] The first £11,100 of capital gains realised each year is currently free of tax. This is parallel to, but separate from, the £10,600 income tax personal allowance, so an individual with both income and capital gains in a given year benefits from both allowances. The Liberal Democrats propose to reduce the CGT annual exempt amount drastically, to £2,500, but at the same time allow people to transfer any unused part of their income tax personal allowance to set against capital gains.

Capital gains are a return to saving just like capital income is, and it would make sense to tax them together. This reform would be a big step in that direction, in effect introducing a single main allowance to set against both income and capital gains, with just a relatively small allowance specifically for capital gains to avoid disproportionate administrative burdens for those realising trivial gains. That is sensible: it is hard to see why a person with some income and some capital gains, who currently benefits from the two separate allowances, should be taxed less heavily than a person with high income but no capital gains, or with high capital gains but no income, who currently benefits from only one allowance.

While a single allowance for both income and capital gains makes more sense than separate allowances, CGT captures some capital gains that should not be taxed at all. Since Gordon Brown's ill-conceived reform in 1998, there has been no allowance for inflation in CGT, so tax can be due even if assets' values do not grow in real terms, and even at modest rates of inflation the effective tax rates on real investment returns can be far higher than the statutory rates. That does not justify favouring people with some income and some gains over people with exclusively one or the other. But reducing the

[83] Assets held in pension funds or Individual Savings Accounts (ISAs), and individuals' main homes, are exempt from CGT. References to capital gains throughout this section mean gains on non-exempt assets.

effective CGT allowance for income tax payers will increase the extent to which purely nominal gains are taxed. This policy would be much more welcome if accompanied by the reintroduction of indexation for inflation – which was in fact Liberal Democrat policy up until 2014[84] but is not part of their current platform.[85]

One could argue that a single combined allowance should be set higher than each of the separate allowances it is replacing. The Liberal Democrats' plan to increase the income tax personal allowance would achieve precisely that, though of course with room for debate as to whether their planned level is appropriate.

If the proposed reform were implemented in 2015–16 (without any further increase in the personal allowance), individuals would:

- lose if their (nominal) capital gains exceeded £2,500 and their income and capital gains together exceeded £13,100, with the maximum loss (£1,548 for standard-rate CGT payers and £2,408 for higher-rate CGT payers) incurred by those with capital gains in excess of £11,100;
- gain if their capital gains exceeded £11,100 and their income were below £2,000, with the maximum gain (£360 for standard-rate CGT payers and £560 for higher-rate CGT payers) going to those with zero income;
- be unaffected if their capital gains were below £2,500, or if their capital gains exceeded £2,500 and their income exceeded £2,000 but their capital gains and income together were below £13,100.

The precise numbers would differ in future years as the income tax and CGT allowances were adjusted.

The effect of the reform on incentives would reflect that pattern of gains and losses. For those expecting to have an income above the personal allowance (and so no unused allowance to transfer), it would provide a disincentive to realise capital gains above £2,500 in a year, and therefore to save in forms likely to generate such taxable capital gains. For those expecting to have no income, on the other hand, the incentive to generate capital gains would be increased.

The Liberal Democrats also propose another change to CGT. Entrepreneurs' relief applies a reduced CGT rate of 10%, instead of the 18% standard rate or 28% higher rate, to capital gains (up to a lifetime limit of £10 million) on certain eligible assets. At present, these include shares in a trading company (or holding company of a trading group) of which the shareholder has been a full-time employee or director, owned at least 5% of the shares and had at least 5% of the voting rights, all for at least a year.[86] The Liberal Democrats propose to add a further requirement that the shareholding must have been at least 10% within the last three years. They argue that 'this will ensure that entrepreneurs' relief continues to benefit genuine entrepreneurs but isn't open to

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[84] See, for example, the tax policy paper adopted by the party's 2013 Autumn Conference: http://d3n8a8pro7vhmx.cloudfront.net/libdems/pages/2017/attachments/original/1390843573/111_-_Fairer_Taxes.pdf?1390843573. Reintroducing indexation for inflation was also a feature of their 2010 election platform.

[85] Even more welcome would be a move to indexing not only for inflation but for a 'normal' (risk-free) rate of return on the purchase price, as suggested in the Mirrlees Review as part of a wider reform of savings taxation (see chapters 13 and 14 of Mirrlees et al. (2011, op. cit.)).

[86] Eligible assets also include an unincorporated business (or distinct part of a business), or business assets sold after the individual stops carrying on the business.

abuse'.[87] One year and three years, 5% and 10%, are all arbitrary thresholds, and wherever the boundaries are drawn some inequities and gaming of the system will remain. Entrepreneurs' relief as a whole is complex, distorts commercial decisions and is arguably unfair.[88] It would be best to abolish it entirely.

According to the Liberal Democrats, HM Treasury estimates that all these CGT reforms taken together would raise £680 million in 2017–18 (£630 million in today's terms).

Abolish employee shareholder status ('shares for rights')

Like the Labour Party, the Liberal Democrats sensibly propose to abolish the ill-conceived 'shares for rights' scheme. See Section 3.1 for a discussion.

Reform 'non-dom' taxation

The Liberal Democrats propose to increase the charges that non-doms must pay to claim the remittance basis of taxation from £30,000 to £50,000 after seven years living in the UK, from £60,000 to £90,000 after 12 years and from £90,000 to £150,000 after 17 years. According to the Liberal Democrats, HM Treasury estimates that this would raise £135 million per year in 2017–18 (£125 million in today's terms). They also propose to reform the domicile rules so that the past domicile of a person's parents is no longer a critical factor in determining the person's own domicile. That seems like an anachronism worth correcting, though the devil could be in the detail of what would replace it, so it would be good to approach the reform by thinking about what the basis for taxation should be rather than just what it should not be.

Increase the higher and additional rates of income tax on dividends

While ordinary income is subject to income tax at a basic rate of 20%, higher rate of 40% and additional rate of 45%, for dividend income the statutory rates are currently 10%, 32.5% and 37.5% respectively and the presence of a dividend tax credit (provided to reflect corporation tax already levied on the profits from which dividends are paid) further reduces the effective personal income tax rates on dividends to 0%, 25% and 30.6% respectively.[89] The Liberal Democrats propose to increase the higher and additional rates of income tax on dividends by 5 percentage points, and say that HM Treasury estimates the yield of that at £1.2 billion in 2017–18 (£1.1 billion in today's terms).

The stated rationale for increasing dividend tax rates is 'to more closely align them with marginal income tax rates'.[90] Alignment should not be judged by looking solely at income tax rates: what matters is the overall tax levied on income from different sources, taking account of (employee and employer or self-employed) NICs levied on earned income, corporation tax levied on company profits, and CGT levied if returns take the form of capital gains instead. Taking all of those into account, the Liberal Democrats' proposal does look for the most part like a move towards greater alignment; the main exception is

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[87] http://www.markpack.org.uk/wp-content/plugins/google-document-embedder/load.php?d=http%3A%2F%2Fwww.markpack.org.uk%2Ffiles%2F2015%2F04%2FLiberal-Democrat-2015-general-election-manifesto-costings.pdf.

[88] See page 254 of S. Adam and B. Roantree, 'Options for increasing tax', in C. Emmerson, P. Johnson and R. Joyce (eds), *The IFS Green Budget: February 2015*, http://www.ifs.org.uk/uploads/gb/gb2015/ch10_gb2015.pdf.

[89] Dividends paid into pension funds or ISAs are not subject to income tax or eligible for dividend tax credits.

[90] http://www.markpack.org.uk/wp-content/plugins/google-document-embedder/load.php?d=http%3A%2F%2Fwww.markpack.org.uk%2Ffiles%2F2015%2F04%2FLiberal-Democrat-2015-general-election-manifesto-costings.pdf.

that capital gains for owner-managed business that are eligible for entrepreneurs' relief, which are already tax-privileged relative to both dividends and salary for higher- and additional-rate taxpayers (and where the scope for converting income into capital gains is greatest), would look even more favoured by comparison if dividend taxation were increased. But while for the most part being a step towards alignment of effective tax rates, the proposal would still leave a long way to go. And it is striking that the case in which dividends are currently most tax-favoured relative to ordinary income (and capital gains) is for basic-rate taxpayers yet the Liberal Democrats do not propose to increase dividend taxation for them, perhaps because that would impose losses on many middle-income people or perhaps because of the administrative convenience of continuing to have a zero effective rate of dividend tax for basic-rate taxpayers. Among UK taxpayers receiving dividends (outside pensions and ISAs), basic-rate taxpayers make up the majority, though they receive only a fifth of the aggregate amount.[91]

While achieving greater alignment of effective tax rates has clear advantages in terms of reducing inequities in treatment and reducing the scope for profitable tax planning, those are not the only considerations. On its own, increasing the taxation of dividends would discourage people from saving in shares (outside a pension or ISA wrapper). To address this, the Mirrlees Review recommended introducing a tax allowance for a 'normal' (risk-free) rate of return to amounts saved, but taxing returns in excess of that (whether dividends, ordinary income or capital gains) at full labour income tax (including employee and employer NICs) rates.[92] That would enable full alignment of effective tax rates with minimal discouragement to saving. In the absence of such an allowance, the trade-off between minimising disincentives to save and minimising avoidance opportunities will remain a delicate one.

Temporarily higher rate of corporation tax for banks

The Liberal Democrats propose to increase the rate of corporation tax for banks from 20% to 28% in 2016–17 and 2017–18. They say that HM Treasury estimates that this would raise £1 billion in each of those years.

This would be the latest in a series of additional taxes on banks' activities since 2010, including a one-off bonus tax in 2010 (which Labour now propose to repeat, as discussed in Section 3.1), a bank levy since 2011 (which Labour propose to increase, as discussed in Section 3.1) and, from 2015, a cap on the proportion of taxable profits that banks can offset each year against losses accumulated before 2015. It is not clear why we would want to have all of these. There are obviously many different taxes that could be imposed if the desire is simply to raise revenue from the financial sector. The question is what the more specific goal is: for example, to recoup the cost of past bail-outs, to charge banks for the implicit guarantees that the government is providing to them now, to discourage excessive risk-taking in future, or to offset the distortions caused by the exemption of financial services from VAT. Taxing a percentage of banks' profits in 2016–17 and 2017–18 is poorly targeted at any of those.

The additional tax would provide an incentive for firms to minimise their UK taxable profits for the period of the charge. They could achieve this by, amongst other things, trying to alter the timing at which taxable profits accrue (for example, avoiding realising

[91] Authors' calculations using HMRC Statistics Tables 2.6 and 3.7, https://www.gov.uk/government/organisations/hm-revenue-customs/about/statistics.

[92] See chapters 13 and 14 of J. Mirrlees et al. (2011, op. cit.).

capital gains on assets during that two-year period, or paying off loans during the period) or by undertaking activities (such as capital investment or advertising) that incur tax-deductible costs during the high-tax period and generate income in later, lower-tax periods. For banks that are part of multinational groups, shifting activities, and possibly profits, outside the UK may provide additional scope to mitigate the tax. An upside of having a temporary tax is that, while it may generate timing responses, banks are less likely to make major changes to their real activities for the sake of saving tax for a short period.

Limit loss offsets

At present, a business making a loss in a particular year does not receive a tax refund, but can instead carry forward the loss and set it against profits to reduce tax liabilities in future years.[93] The Liberal Democrats propose permanently limiting loss offsets for all large companies to 50% of profits, a major extension of a 2014 Autumn Statement policy that applied only to banks and only to losses accumulated before 2015. The Liberal Democrats cite HM Treasury estimates that their policy would raise £650 million in 2017–18 (£600 million in today's terms). This overstates the long-run yield: revenue is mostly brought forward from later years, since companies will still be able to set losses against later profits instead (except where a firm goes out of business before exhausting the loss relief). But there is a value to the government – and a cost to firms – in the same cash tax payments being made earlier.

It is important to consider in this case why we have loss offsets in the corporate tax system. Ideally, the tax system would treat profits and losses symmetrically. Failing to do so means that the government shares in the firm's pay-off if the investment is a success but does not fully share in the downside risk, so the tax system discourages risky investment more than it discourages low-risk investments that would be equally commercially attractive in the absence of taxation. There is empirical evidence from the US that asymmetric treatment of losses has important effects on the behaviour of entrepreneurs in practice.[94] There may be reasons why governments are reluctant to give outright tax refunds in the event of losses. But the next best thing would be to allow the losses to be carried forward with interest, so as to maintain their present value. As it is, losses are only carried forward in cash terms, so the loss offsets become ever less valuable the longer they must be carried forward (as well as delays increasing the risk that bankruptcy prevents them ever being used). Restricting loss offsets would take us further away from the symmetric ideal, further increasing the time horizon over which the same cash losses could be offset. This policy differentiates between firms with the same profitability but different profit profiles over time, favouring those with stable low positive profits over firms that make both large losses and large profits in different years. If anything, policy should be moving to increase the generosity of loss offsets, allowing losses to be carried forward with interest or to be offset against profits from a wider range of sources. The Liberal Democrats' policy would discourage risky investment projects and would be a step in the wrong direction.

[93] There are restrictions on this, and within limits loss offsets can also be carried back to set against previous years' profits. The detailed rules on loss offsets are complicated.

[94] J. Cullen and R. Gordon, 'Taxes and entrepreneurial risk-taking: theory and evidence for the U.S.', *Journal of Public Economics*, 2007, 91, 1479–505.

Restrict deductibility of interest payments for corporation tax

The OECD's project on countering Base Erosion and Profit Shifting (BEPS) is currently under way and is due to finish in September 2015. At that point, there will be a number of corporate tax policy recommendations made with a view to reducing the extent to which multinational companies can shift taxable profits across countries to reduce their tax liabilities. One of the areas of work will set out best practice for restrictions on the tax deductibility of interest costs within multinational groups. At this stage, there are various policy options on the table.[95]

The Liberal Democrats have announced that they would implement whatever restrictions on interest deductibility the OECD proposes, and assume that this would raise £800 million in 2017–18 (£740 million in today's terms). But it is not yet clear what recommendations will be made and whether other countries will sign up to them. There is no guarantee that implementing the proposals would be the best option, especially unilaterally, and certainly no guarantee that doing so would raise £740 million per year. The UK already has rules in place, notably a worldwide debt cap, to limit profit shifting using excessive debt.[96] It is not clear whether the new policy would supplement or replace current rules.

New tax on tobacco companies

The Liberal Democrats propose to introduce a new levy on tobacco companies, which they want to raise around £150 million per year. It would probably follow the proposal set out in a 2014 government consultation and be very similar to the Labour proposal. See Section 3.1 for further discussion.

Introduce a high-value property levy ('mansion tax')

The Liberal Democrats have proposed a 'high value property levy', with a similar design to the Labour Party's proposed 'mansion tax' discussed in Section 3.1 – though they plan to implement it in 2017–18, not 2015–16 as Labour do. Properties valued at more than £2 million would incur a charge depending on the band a property falls into, with properties in higher bands taxed more heavily. While Labour have said what the tax rate would be for properties worth up to £3 million, the Liberal Democrats have specified maximum tax rates for properties up to £5 million. Their proposals refer to at least five bands (£2.0–£2.5 million, £2.5–£3.0 million, £3.0–£4.0 million, £4.0–£5.0 million and above £5 million), along with a maximum annual charge for each of the four lower bands and a revenue target of £1.0 billion in 2017–18 (£0.9 billion in today's terms). This implies that the tax rate(s) on properties worth more than £5 million would be set at whatever level(s) were required to raise the remainder of this revenue. Whereas Labour would allow non-higher-rate taxpayers to defer payment of the tax, the Liberal Democrats would allow pensioners to do so. We do not know what proportion of properties above £2 million are owned by pensioners, but a rough guide to scale is that a little over a quarter of properties in each of the top two council tax bands in England are all-pensioner households.

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[95] For a discussion, see OECD Public Discussion Draft 'BEPS ACTION 4: interest deductions and other financial payments', 18 December 2014 – 6 February 2015, http://www.oecd.org/ctp/aggressive/discussion-draft-action-4-interest-deductions.pdf.

[96] Broadly speaking, where the UK member(s) of a large multinational group of companies have net debt exceeding 75% of the group's worldwide gross debt, the worldwide debt cap prevents the UK company/ies from deducting interest costs (net of interest income) that exceed the total gross interest payments that the group as a whole pays to external creditors. The precise rules are complicated; see http://www.hmrc.gov.uk/manuals/cfmmanual/CFM90000.htm for details.

Table 4.2 shows the maximum tax rate the Liberal Democrats would apply to each band and the revenue that would accrue in 2017–18, given the (uncertain) estimates of the number of properties in each band that the Liberal Democrats attribute to HM Treasury and assuming that the maximum tax rate is applied in each band.[97] It also shows the corresponding figures for Labour's proposed mansion tax in 2015–16. In both cases, it ignores any effects of deferral. On these figures, the highest-value properties would be in line for an annual tax bill of almost £36,000 from the Liberal Democrats' high-value property levy – on top of the existing council tax and (where appropriate) ATED.

Table 4.2. Liberal Democrat and Labour proposed mansion taxes

Band (£m)	Number of properties	Liberal Democrats		Labour	
		Tax (£ per year)	*Revenue (2017–18, £m)*	*Tax (£ per year)*	*Revenue (2015–16, £m)*
2.0 – 2.5	57,000	2,000	114	3,000	285
2.5 – 3.0	38,000	3,500	133		
3.0 – 4.0	29,000	5,000	145	16,636[a]	915
4.0 – 5.0	12,000	9,000	108		
> 5.0	14,000	35,700[a]	500		
Total	150,000	6,667	1,000	8,000	1,200

[a] Average; may vary across higher bands.
Note: Ignores deferrals.
Source: Authors' calculations, assuming estimated numbers of properties as attributed to HM Treasury by the Liberal Democrats and that those numbers remain the same in 2017–18.

Charging £5,000 for a £3.6 million property but nothing for a pair of £1.8 million properties, and charging nearly £36,000 for a £5.2 million property but 'only' £7,000 for a pair of £2.6 million properties, creates some strange incentives. Owners are encouraged to convert large properties into several smaller one (e.g. flats), and people shopping in this market are encouraged to buy two less expensive properties instead of one that attracts a big(ger) tax liability. It is not clear why we should want to do that. If the tax is to be progressive rather than proportional to value, it would be fairer and more efficient (though more administratively cumbersome) to tax the total value of all properties owned rather than taxing each property separately.

Environmental and motoring taxes

Alone among the three main parties from the last parliament, the Liberal Democrats mention environmental taxes in their manifesto. They pledge to 'Help incentivise sustainable behaviour by increasing the proportion of tax revenue accounted for by green taxes' – repeating a promise made in both the Conservative manifesto and the coalition agreement in 2010 but not echoed by the Conservatives (or Labour) this time round. Whether it is a sensible environmental goal is another matter. The targeting of environmental taxes matters as much as their size, and effective environmental taxes will reduce the prevalence of the activities being taxed, thus potentially reducing tax revenues.

The Liberal Democrat manifesto also proposes specific environmental tax measures.

[97] The estimated number of properties worth more than £2 million has been rising rapidly in recent years and may rise further before the Liberal Democrats introduced their policy in 2017–18, in which case the number of properties in each band would be higher and the average rate required for the top band lower than Table 4.2 suggests. On the other hand, the expectation of a large annual tax would itself act to reduce the value of these properties considerably.

It links tax reductions to energy efficiency, offering 'A Council Tax reduction of at least £100 for 10 years, when the resident's home has an energy saving improvement of at least two bands'.

It also includes proposals on waste management: 'reinstating the Landfill Tax escalator and extending it to the lower rate and consulting on the introduction of an Incineration Tax'. Up to and including April 2014, the standard rate of landfill tax was increased by £8 each April; if that rate of increase were resumed (and the same percentage real-terms increases applied to the lower rate), then HMRC estimates imply the tax would raise around £150 million per year more by the end of the parliament. It is not at all clear that such an increase could be justified. The guiding principle for such a tax should be to set the rate equal to the value of the environmental damage done by additional landfill. When the tax was first introduced in 1996, the standard rate was set, on that basis, at £7 per tonne.[98] Even if that was an underestimate, the current rate of £82.60 per tonne is clearly far higher than any reasonable estimate of the costs of landfill, and further sharp increases therefore look hard to justify.

In practice, environmental tax revenues are dominated by motoring taxes, and here too the Liberal Democrats offer proposals. They wish to increase vehicle excise duty (VED) 'to drive continuous reductions in greenhouse gas and other pollutants from the UK car fleet and return revenues to levels projected in 2010', raising £790 million per year in today's terms. But even a VED that depends on a vehicle's fuel efficiency is a poorly-targeted tool for reducing emissions. The higher VED payable on high-emission vehicles at the point of purchase may be effective if up-front costs are more prominent in purchasers' minds than ongoing costs, but annual VED bills thereafter do not depend on the amount the vehicle is driven and therefore do not discourage motoring as much as taxing fuel consumption directly.

On fuel duties themselves, the Liberal Democrats wish to extend the reduced rate the coalition introduced for remote areas to apply to more such areas. It is sensible to tax motoring less in rural areas – not because fuel is more expensive there (many goods may cost more in remote areas because of transportation costs, while others such as housing can be cheaper, but such normal market prices do not generally call for 'corrective' taxes and subsidies) but because the principal harm caused by motoring – congestion – is lower in rural areas. But taxing motoring less in remote areas can only scratch the surface of reflecting congestion in policy, and it is not without downsides: as the geographical scope of such discounts grows, so does the problem of drivers from neighbouring areas refuelling in these favoured areas – possibly even driving further to do so. It would be better to tackle congestion more directly, by replacing most of fuel duties with a national system of congestion charging, as recommended by the Mirrlees Review of the tax system.[99] A national system of road pricing was in fact proposed in the 2010 Liberal Democrat manifesto but is not in their 2015 manifesto.

Tackle tax evasion and avoidance

The Liberal Democrats' fiscal plans for 2017–18 assume that they will raise £7 billion in that year (£6.5 billion in today's terms) from tackling tax evasion and avoidance. Within this total, they do not count the revenue from abolishing employer shareholder status

[98] The evidence cited at the time came from Centre for Social and Economic Research on the Global Environment (CSERGE), University of East Anglia, *Externalities from Landfill and Incineration*, Department of the Environment, London, 1993.

[99] Chapter 12 of Mirrlees et al. (2011, op. cit.).

(unlike Labour), from higher taxation of non-doms (unlike both Labour and the Conservatives) or from restricting interest deductibility, so their £6.5 billion is on top of that. Furthermore, beyond 2017–18, the Liberal Democrats say that increasing the income tax personal allowance from £11,000 in 2016–17 to £12,500 in 2020–21 would be paid for by additional anti-avoidance and anti-evasion measures. We estimate that that would require an additional £3.2 billion of revenue in today's terms, making a daunting total of £9.7 billion annually to be found by the end of the parliament from tackling evasion and avoidance on top of the interest deductibility, non-dom and employee shareholder status proposals. As with the other parties, the Liberal Democrats have indicated some areas in which they would take action but nothing that would suggest anything like the revenue they require.

4.2 Benefit policies

The plans for deficit reduction laid out by the Liberal Democrats include a £2.7 billion cut to benefit spending in 2017–18 (£2.5 billion in today's terms). However, almost all of this comes from general ambitions to reduce fraud and error and to help claimants into work, which would presumably be shared by all parties if they were deliverable. Specific proposals on benefit rates and rules would reduce spending by less than £600 million in 2017–18, and only by around £200 million in the long run. In this section, we first analyse those specific policies, before discussing how they hope to close that gap.

Restrict the application of the social sector size criteria ('bedroom tax')

The Liberal Democrats propose to increase the generosity of housing benefit by restricting the application of the social sector size criteria (SSSC).[100] Under their proposal, the SSSC would still be applied to new tenants in social housing, but existing claimants would not have their maximum housing benefit entitlement reduced unless they had refused a 'reasonable' offer of alternative accommodation with the correct number of bedrooms. In addition, disabled tenants who need a spare room or whose home has been substantially adapted would be exempt from the SSSC. These exemptions are expected to increase housing benefit spending by around £300 million a year (according to Liberal Democrat figures attributed to HM Treasury), compared with the nearly £400 million cost of abolishing the SSSC (as proposed by Labour).

In the long run, there may be some benefit from retaining the SSSC for new claimants, as the Liberal Democrats propose, because it would incentivise social housing providers to tailor their housing stock to the needs of social sector claimants. In the short run, it could also encourage more efficient use of the social housing stock, although it may simply result in providers prioritising those potential social tenants whose bedroom entitlements match the properties available rather than those potential tenants in the greatest need.

Changes to benefits for carers

The other increases in the generosity of the benefits system included in the Liberal Democrat manifesto are two changes to benefits for carers. The first proposal is to introduce an annual 'carer's bonus' of £125 for those caring for someone for 35 hours or more each week in 2017–18, rising to £250 by 2020–21. The Liberal Democrats estimate that there are just over 1 million such individuals,[101] and therefore that the long-run cost

[100] See the discussion of Labour's benefit policies in Section 3.2 for details on the impact of the SSSC.

[101] Source: http://www.bbc.co.uk/news/election-2015-32425983.

of the policy would be roughly £240 million in today's terms. Most of those who would benefit already receive carer's allowance (CA), although the bonus would also go to a significant number of carers in receipt of the state pension (who do not receive CA). For those currently receiving CA, the policy is equivalent to increasing its generosity by about 8%. The second proposal is to 'work to raise the amount you can earn before losing Carer's Allowance from £110 to £150 a week', which would allow some people to combine caring responsibilities with part-time work more easily.

Offer to pay housing benefit directly to landlords at a 5% discount

Policy changes in recent years have increased the share of housing benefit claimants who receive the benefit themselves (rather than the government paying it directly to their landlord). There is evidence this leads to higher rent arrears.[102] The Liberal Democrats propose to cut HB spending by offering to pay HB directly to landlords instead of their tenants, on the condition that the landlord receives only 95% of their tenant's entitlement. For this policy to be taken up, both the landlord and the tenant must agree to the landlord receiving 95% of the tenant's HB entitlement, instead of the tenant receiving 100% of that entitlement. For landlords, 95% might represent an increase in the amount they receive and/or a reduction in the risk they face, if they expect that tenants might get into arrears. On the other hand, the policy cannot increase the incomes of tenants – if some prefer HB to be paid direct to their landlords, it is presumably on the basis that it removes costs (such as hassle and stress) associated with managing their money and paying the rent themselves.

The Liberal Democrats assume this offer would be taken up in 25% of cases, and on that basis estimate that the policy would cut housing benefit spending by £320 million a year.

Reforms associated with the introduction of universal credit

The Liberal Democrats' plans include three reforms associated with the introduction of universal credit (UC) – two of which are temporary and one of which is permanent (assuming UC is eventually fully introduced). Under current policy, individuals being moved from existing benefits to UC whose benefit entitlements would be lower under UC than under the current system will have their existing entitlement protected in cash terms until their circumstances change. The first temporary change proposed by the Liberal Democrats is to remove this 'transitional protection' for claimants with no entitlement to UC. The second temporary change is the abolition of the 30-hour premium for new claimants of working tax credit, which would reduce the incentive for those individuals to be in full-time rather than part-time work, but only until working tax credit was rolled into UC.

The permanent cut proposed by the Liberal Democrats is to reduce the level of (non-housing, non-pension) assets above which families stop being eligible for UC from £16,000 to £10,000. We estimate that this would reduce spending by around £300 million a year when UC is fully in place, with around 50,000 families losing their entitlement.[103] Those losing would not be the poorest claimants – they lose their entitlement by virtue of having significant assets. But the policy would discourage saving among people who thought they might claim UC in future.

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[102] Source: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/333065/dpdp-12-month-stage-reports.pdf.

[103] Source: Author's calculations using TAXBEN run on uprated 2012–13 Family Resources Survey data.

1% cap on uprating of most working-age benefits in April 2016 and April 2017

The annual uprating of working-age benefits (excluding disability benefits) was capped at 1% in cash terms for three years from April 2013, reducing annual spending by an estimated £1.8 billion a year. The Liberal Democrats propose to repeat this policy for two more years (April 2016 and April 2017), with the same benefits excluded as in the proposed Conservative freeze (discussed in Section 2.2). However, the reduction in spending from nominal restrictions is likely be much smaller in future years than over the current parliament, because CPI inflation (and hence the default nominal increase in benefit rates) is expected to be much lower. On current Office for Budget Responsibility inflation forecasts, the 1% cap is expected to have no impact on benefit rates in 2016–17 and to reduce them by just 0.2% in 2017–18. According to the Liberal Democrats, HM Treasury estimates that this 0.2% cut would reduce spending by £150 million (in today's terms). Like the Conservative proposal for a two-year freeze, this policy has the undesirable feature that the size of the real-terms cut (and the saving) would depend on inflation out-turns.

Remove winter fuel payments and free TV licences from higher- and additional-rate taxpayers

The Liberal Democrats would remove winter fuel payments and free TV licences from pensioner households where an individual pays higher- or additional-rate tax. They cite HM Treasury as estimating that this would reduce spending on these benefits by £115 million a year. As with the Labour policy to remove winter fuel payments from these households (discussed in Section 3.2), this is more a symbolic reform than a significant attempt to reduce government spending on higher-income pensioners.

Keep household benefit cap linked to average income

Whereas the Conservatives want to reduce the household benefit cap, the Liberal Democrats want to increase it – at least after 2017–18 – by linking it to some measure of average family income (it is currently frozen in cash terms each year by default). In total the cap is expected to reduce benefit spending in 2015–16 by just £185 million, so in the short run the cost of indexing the cap would probably be around £100 million. But indexing the cap each year rather than freezing it cumulates to an ever larger difference in its level, so the annual cost of this policy would rise over time.

Reduce fraud and error and increase employment

The benefit proposals discussed so far would save very little money: less than £600 million in 2017–18 and falling after that. That leaves the Liberal Democrats around £2 billion short of the £2.5 billion of cuts required for their deficit reduction plan. They plan to fill that gap by reducing fraud and error in the system (which they have estimated could save up to £1 billion a year) and improving back-to-work support for benefit claimants (which they estimate could save another £1 billion a year). While these are both laudable aims, it seems unlikely that they would not be shared by any incoming government.[104] Moreover, both of these figures are subject to significant uncertainty and may well require significant up-front investment to realise the revenues targeted.

[104] One could, of course, believe that the Liberal Democrats would be better managers of the system than other parties.

4.3 Summary

The Liberal Democrats have some tax and benefit proposals in common with the two biggest parties. As with the Conservatives, their single biggest tax policy is to increase the income tax personal allowance to £12,500 by 2020–21. And several of their other proposals are shared with Labour: to introduce a 'mansion tax' and a tax on tobacco companies' profits, abolish 'shares for rights' and the transferable income tax allowance for married couples, and withdraw winter fuel payments from higher- and additional-rate income tax payers. They also want to water down the 'bedroom tax', though not to abolish it entirely as Labour does.

But there are also some distinctive elements to the Liberal Democrats' platform. Their corporation tax proposals are quite different from anything offered by the Conservatives or Labour and they are the only party of the three even to mention environmental taxation – though not all of their proposals in these areas look sensible, notably their intention to restrict loss offsets and to reintroduce a landfill tax 'escalator'. Their proposals on taxation of dividends and capital gains at least show some welcome first signs of considering how different parts of the tax system fit together.

The gains from the Liberal Democrats' package are dominated by the personal allowance increase, which would benefit predominantly the higher-income half of households (though not the very-highest-income households).

Interestingly, the losses imposed by many of the measures are based on the assets people own. At one end of the scale, universal credit would be denied to anyone with more than £10,000 of (non-housing, non-pension) wealth. At the other end of the scale, the high-value property levy would hit people with houses worth more than £2 million. There is also a rise in dividend taxation for those owning shares and in CGT for income tax payers realising significant capital gains. Non-doms with substantial foreign wealth would lose out, as would shareholders in currently profitable banks. And shares awarded by one's employer would no longer be eligible for such favourable treatment.

As with the other parties, however, there is a divorce between these specific measures and their overall fiscal targets. Indeed, the Liberal Democrats are relying on hypothetical anti-avoidance measures to an even greater extent than Labour and the Conservatives, requiring an eye-watering £9.7 billion of annual revenue from that source by the end of the parliament compared with £6.7 billion for Labour and £4.6 billion for the Conservatives. And while the Liberal Democrats are far from approaching the Conservatives' £11 billion of unspecified benefit cuts, the £2 billion of net reductions they do wish to make is almost entirely accounted for by rather hopeful promises to increase employment and reduce fraud and error.

5. Conclusion

Starting with the measures that they have said they will *not* implement in the coming parliament, there is some overlap between what the Conservatives and the Labour Party have pledged. The Conservatives have stated that they would not increase the rates of income tax, National Insurance contributions or VAT. The Labour manifesto rules out increases to the basic and higher rates of income tax or rates of NICs; and it rules out increasing rates of VAT, as well as extending the VAT base to include food, children's clothes, books, newspapers or public transport fares. The Liberal Democrats don't go as far as ruling out such changes, but have pointed out that 'our plans do not require any

increase in the headline rates of Income Tax, National Insurance, VAT or Corporation Tax'. While these pledges might turn out to be somewhat constraining, it should be noted that they do not prevent the parties from raising revenue from these taxes in other ways.

In terms of the tax and benefit measures that the three parties we consider have proposed, it is striking that in each case the magnitude of the net takeaway from households is of a broadly similar size (despite the Conservatives having a far more ambitious deficit reduction target), but that the composition of this net takeaway varies considerably:[105]

- The Conservative policies imply a £10 billion net takeaway from households, comprising a £1 billion net tax cut and an £11 billion benefit cut.
- The Labour Party policies imply a £12 billion net takeaway from households, comprising a £12 billion net tax increase offset slightly by a small net increase in benefit spending.
- The Liberal Democrats' policies imply a £14 billion net takeaway from households, comprising a £12 billion tax increase and a £2 billion net cut to benefit spending.

As well as the overall size of the net takeaway from households being of a broadly similar magnitude, all three parties' plans rely on raising billions of pounds of additional revenue from reducing tax evasion and what they regard as tax avoidance. The amounts they require are not the same: in today's terms, the Conservatives require £4.6 billion, Labour £6.7 billion and the Liberal Democrats £9.7 billion. Moreover, this understates the difference between them, since the Liberal Democrats' £9.7 billion is in addition to measures on 'non-dom' taxation and employee shareholder status whereas the other parties count their proposals in those areas towards their totals.

Each of the parties has listed some actions they would take – not all of them new, convincing or sensible. There are some common themes, such as strengthening the General Anti-Abuse Rule (in varying ways) and reducing cross-border tax avoidance through participation in the OECD-led BEPS process. But none of the parties claims that the policies they have specified would be anywhere near enough to achieve their revenue targets. All three parties are relying on raising a lot of revenue from measures they have not yet announced (which, it should be noted, is something that the Scottish National Party has laudably chosen not to do).

The Conservatives claim that the coalition's measures on tax avoidance and evasion in the last parliament raise £7 billion a year, suggesting that further savings on a similar (or in their case smaller) scale in the next parliament should be achievable.[106] But it is hard to be sure what anti-avoidance and anti-evasion measures actually raised in the past. There is no clear dividing line between reducing avoidance opportunities and broadening the tax base, so it is hard to separate out 'anti-avoidance' measures in Budgets and quantify their intended revenue yield: the parties' different classifications of similar proposals in their manifestos is a case in point. And it is even harder to know whether the measures did in fact bring in the sums forecast.

The figures being cited by each party appear to have been plucked out of thin air. They may be achievable but the parties have given us little indication of how they would be

[105] The amounts that follow are in today's terms.

[106] Page 8 of their manifesto.

achieved or who would pay the extra tax (the Conservatives in particular seem prone to saying that their fiscal plans involve no tax increases, apparently forgetting that anti-avoidance measures increase real people's tax bills). Do they already have specific measures in mind and, if so, what are they – and in the case of the two governing parties, why haven't they done them already? Or do they just expect to uncover more schemes they can close down – in which case, how can they be confident of achieving so much and why should one party manage more than another?

Some similar issues arise with the social security cuts proposed by the Conservatives and, albeit to a lesser extent, the Liberal Democrats. The Conservatives state that they would deliver an £11 billion cut to benefit spending by 2017–18 (in today's prices) but have outlined policies that will only deliver about one-tenth of that amount. To achieve their target, they would need a faster rate of benefit cuts than was seen in this parliament. Doing this will not be easy – the timescale is tight and the protections for state pensions and universal pensioner benefits mean that unprotected social security needs to be cut by 10% in two years.

The Liberal Democrats expect to cut social security spending by £1 billion a year from reduced fraud and error and by a further £1 billion by improving back-to-work support for benefit claimants. While these are both laudable aims, it seems unlikely that they would not be shared by any incoming government. Labour frequently point to their policies to remove the winter fuel payment from families containing a higher- or additional-rate income tax payer and to cap increases in child benefit at 1% as evidence of 'tough choices' they would make on benefit spending. But the former would reduce social security spending on pensioners by just one-tenth of one per cent, while the latter would, on current forecasts, reduce spending by literally nothing.

With significant deficit reduction still to come, households can expect the tax and benefit changes implemented over the next parliament to reduce their incomes, on average. There are large differences between the Conservatives, Labour and the Liberal Democrats in how they propose to do this. But they share a lack of willingness to be clear about the details and an inability to resist the urge for piecemeal changes that make the overall system less efficient and coherent.

Appendix A: List of preannounced policies to be implemented during the next parliament

All of the parties whose plans are featured in this briefing note would introduce the following changes that are set to come in after the general election:

- The income tax personal allowance will increase by more than consumer price index (CPI) inflation in both 2016–17 and 2017–18 to £10,800 and then £11,000. This will align the personal allowances for those aged above and below 75 in 2016–17. Cost: £1.5 billion in 2017–18.
- A new 'personal savings allowance' in income tax of £1,000 for basic-rate taxpayers and £500 for higher-rate taxpayers that can be used against taxable income from savings will be introduced in 2016–17. Cost: £565 million in 2017–18.
- The lifetime allowance for tax-favoured saving in a private pension will be reduced from £1.25 million to £1 million in 2016–17, and the limit will then be increased in line with CPI inflation from 2018–19. Yield: £590 million in 2019–20.

- Company car tax will be increased by 2 percentage points (ppts) in 2016–17, 2017–18 and 2018–19 and by 3ppts in 2019–20. The 3ppt diesel supplement will be removed in 2016–17. Yield: £1.1 billion a year from 2019–20.
- The single-tier pension will be introduced in April 2016 and individuals will no longer be able to contract out of the second state pension. The single-tier pension will leave social security spending on pensioners broadly unchanged; removing contracting out will increase revenues from National Insurance contributions (NICs) by £4.9 billion a year from 2017–18.
- Men born before April 1961 and women born before April 1963 will be able to make voluntary NICs to top up their state pension entitlement between October 2015 and April 2017. This is expected to raise revenue in the short term (by £450 million in 2015–16 and £415 million in 2016–17), but will increase state pension spending in the longer term.
- Employer NICs will be abolished for apprentices aged under 25 from 2016–17. Cost: £105 million in 2016–17.
- Individuals will be able to withdraw and replace money from their cash ISA in-year without it counting towards their annual ISA subscription limit from the autumn of 2015.
- A new 'help to buy ISA' will be introduced from the autumn of 2015. The government will provide a 25% top-up of any funds in one of these accounts when they are withdrawn to place a deposit on a property by a first-time buyer. Cost: £835 million a year in 2019–20.
- Individuals will be able to sell back pension annuities from April 2016, though income tax will be payable on the proceeds. This will increase income tax revenues in the short run, but reduce them in the longer run as it effectively brings forward tax revenues.
- The inheritance tax threshold will be frozen at £325,000 until 2018–19. Yield: £115 million from 2017–18.
- The taxes that apply to high-value UK residential property held by companies, partnerships with companies as members and collective investment schemes – namely the stamp duty land tax (SDLT) at 15% on acquisition of a residential property, the annual tax on enveloped dwellings (ATED) and capital gains tax (CGT) at 28% – will apply to properties worth more than £500,000 (as opposed to £1 million at present).
- Tobacco duties will increase by 2ppts more than retail price index (RPI) inflation each year until 2019–20. Yield: £135 million by 2018–19.
- Children aged 12–15 will no longer be charged air passenger duty when travelling in economy class from April 2016. Cost: £40 million in 2016–17.
- The annual investment allowance (the amount of investment a firm can immediately deduct from profits for tax purposes) will fall to £25,000 in January 2016.
- Banks' compensation payments will cease to be deductible for corporation tax purposes from July 2015 under current plans. Yield: £260 million in 2016–17.

- The previous 'below-the-line' research and development tax credit scheme will close in April 2016.
- The rate of petroleum revenue tax will fall from 50% to 35% from January 2016. Cost: £125 million in 2016–17.
- Various 'temporary' business rate reductions – the £1,500 discount for retailers, the doubling of small business rate relief, the discount for those who reoccupy long-term empty premises and the longer exemption for newly-built empty properties – are set to expire in April 2016.
- Universal credit will continue to be rolled out, and the work allowances frozen in 2016–17 and 2017–18.
- The childcare element of universal credit will cover 85% rather than 70% of childcare costs from 2016–17. Cost: £305 million in 2019–20.
- The 'tax-free childcare' scheme (which gives a 20% subsidy on childcare spending of up to £10,000 per child to families who are not entitled to universal credit) will be introduced from the autumn of 2015. Cost: £750 million a year in the long run.
- The maximum size of mortgage against which support for mortgage interest can be claimed will fall from £200,000 to £100,000 and the waiting period for receiving support will increase from 13 to 39 weeks. Yield: £90 million.