Institute for Fiscal Studies

Jeremy Hunt's tax and spending policies: what would they cost and who would benefit?

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Paul Johnson
Tom Waters
Ben Zaranko

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Paul Johnson, Tom Waters, and Ben Zaranko

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Key findings

Jeremy Hunt has announced several policy proposals, including reducing corporation tax, increasing the point at which workers become liable for National Insurance (NICs) contributions, increasing defence spending, and reducing the interest rate applied to student debt. We find that:

- **Cutting the main rate of corporation to 12.5% would cost around £13 billion per year in the short run, though probably somewhat less in the long run.** This is not a tax cut that would pay for itself as some have claimed – our existing tax base is too big for it to be plausible that this loss of revenue could be made up a result of higher profits being reported in the UK. A cut of this scale would take the UK's headline corporation tax rate to the second lowest in the OECD, alongside Ireland.

- **Increasing the NICs threshold is a good way of helping low earners through the tax system,** though using the tax credit system would be more effective and better targeted. Raising the threshold is expensive however, costing at least £3 billion per year for each £1,000 that it is raised. Raising it to the current income tax personal allowance of £12,500 would cost at least £11 billion per year and take 2.4 million workers out of NICs altogether.

- **Increasing defence spending to 2.5% of national income over the next five years implies spending £15 billion more in 2023–24 than today, and around £12 billion more than if spending remained at its current level of 2% of national income.** Doubling defence spending as a proportion of national income, as Mr. Hunt has previously mooted, would cost more than £40 billion per year. Any significant increase would represent a major reversal in a 70 year trend – a trend which has allowed for more spending on the welfare state, and especially on health, without significant tax rises.

- **Cutting the rate of interest on student loans to just equal the RPI rate of inflation would cost very little in the short run and just over £1 billion in the long run.** Because most students aren't expected to pay back their loans in full, only around the highest earning 30% of graduates would benefit from such a policy. That said, the current system does mean high earners pay back more than the cost of their loan, providing an incentive for some families to pay up front.

- **Mr. Hunt's policies for higher spending and lower taxes would amplify the long-run challenges facing the UK public finances.** The UK already faces considerable spending pressures from an ageing population and rising health care costs. Mr. Hunt's combination of policy proposals would exacerbate these pressures and widen a gap in the public finances that will ultimately need to be filled through some combination of higher borrowing, tax increases or cuts to other areas of spending.

Introduction

In his bid to be leader of the Conservative Party and Prime Minister, Jeremy Hunt has announced a number of policy proposals. In this briefing note we examine two tax and two spending promises: cutting corporation tax, raising the point at which workers begin to pay National Insurance contributions (NICs), increasing defence spending, and reducing the interest rate paid on student loan debt.

Cutting corporation tax

Mr. Hunt has stated that he wants to reduce the corporation tax rate – currently 19% – to 12.5%. The government already plans to cut the rate to 17% in April 2020, so this would amount to a 4.5 percentage point (ppt) cut on top of that.

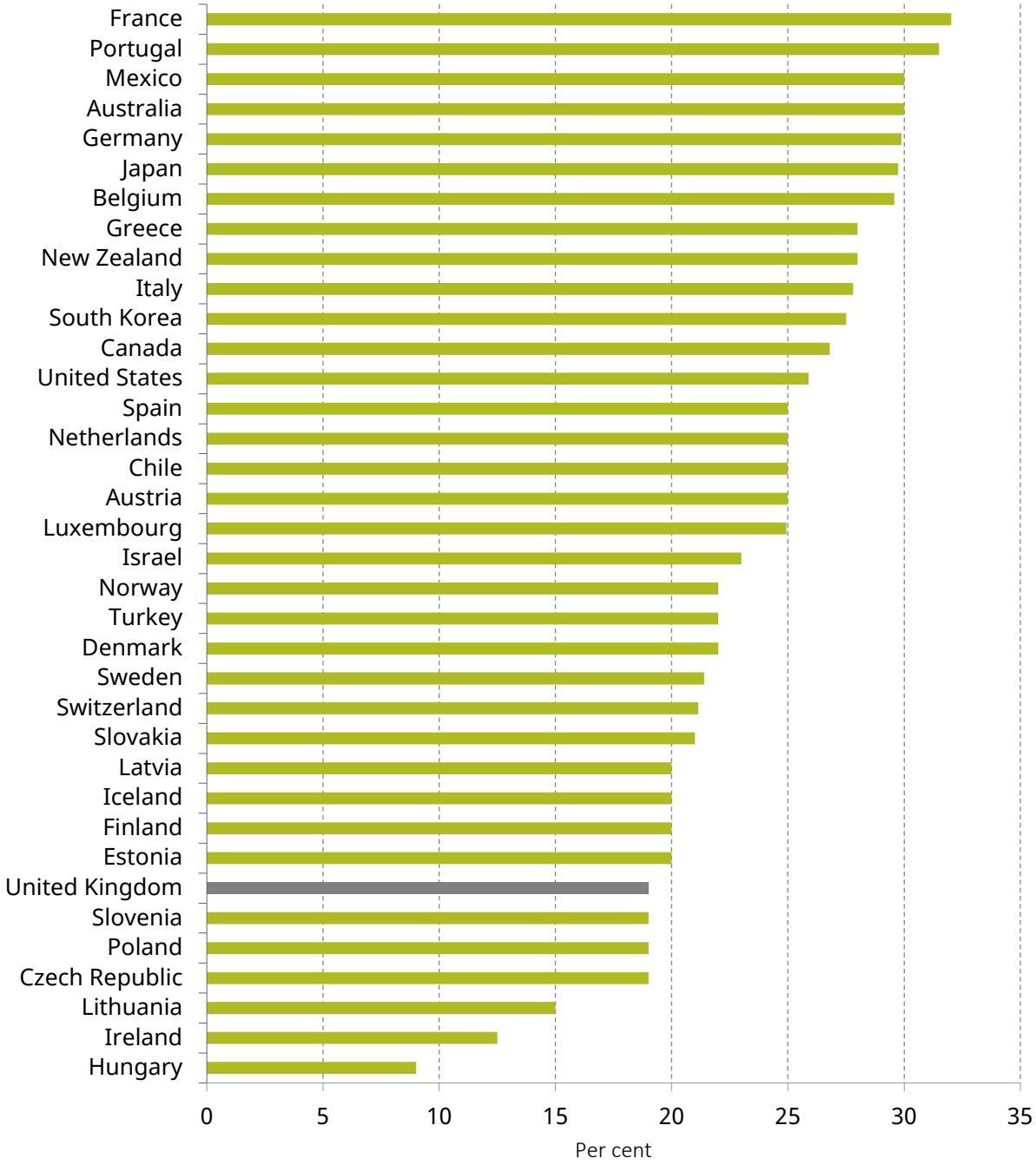
Such a cut would take the UK's headline rate – already low by international standards (see Figure 1) – to the joint second lowest in the OECD (tied with Ireland, and higher than Hungary). This follows substantial cuts seen in recent years – in April 2010 the rate stood at 28%, while in April 1997 it was at 31%. But it is in sharp contrast to Labour Party policy as of their 2017 general election manifesto, where they pledged to increase the rate to 26%.

Reducing the headline rate to 12.5% would cost around £13 billion in the short-run. In the long-run it would probably cost less as the cut would incentivise greater investment in the UK which would in turn boost tax receipts. The extent to which it would increase investment is unknown, however, and given that the rate is already low by international standards the effect on investment is likely to be less than it would have been when the rate was higher.

One thing we can be fairly sure of is that a cut of this magnitude would not pay for itself. It is implausible to believe that profits earned or recorded in the UK could increase by enough to make up for the immediate £13 billion fall in revenue. Some have pointed to the Irish experience where the corporate tax rate was cut to 12.5%. The difference is that prior to that decision very little was raised in corporate tax revenue as few big and profitable corporations were headquartered there, so there was little to lose and much to gain. The UK has far more tax revenue to lose in the first place.

The headline rate is also not the only part of the corporation tax regime that affects investment decisions – other aspects, such as R&D tax credits, Patent Boxes, and capital allowances, also matter. Relative to other countries the UK has a particularly ungenerous set of capital allowances.

Figure 1. Main rates of corporation tax in OECD countries, 2019



Note: The rate shown refers to the combined corporate income tax rate, which is the combination of the central government rate and subnational rates (if any).

Source: OECD tax database, combined corporate income tax rate, https://stats.oecd.org/index.aspx?DataSetCode=TABLE_II1.

It is worth remembering that corporation tax – like every other tax – is ultimately paid by real people. The most immediate effect of a corporation tax cut is to increase dividends and capital gains for shareholders (which includes almost anyone with a defined contribution pension pot). But over the longer-run, it is likely that at least some of the effect will be passed through to consumers in the form of lower prices, or to workers in

higher wages. The empirical evidence suggests that a significant fraction of corporation tax – and therefore a significant fraction of the gains from a corporation tax cut – is felt by workers.[1] But because we do not know exactly who bears the burden of corporation tax, the distributional effects of a cut are not clear.

Raising the NICs threshold

Currently, only earnings above £8,632 per year[2] are subject to NICs (employee, employer, and self-employed). It has been reported that Mr. Hunt wants to increase this threshold to at least £12,000 per year.[3] In another briefing note we examine the implications of raising the NICs threshold to £12,500 – the point at which individuals become liable for income tax. This would cost £11 billion p.a., (or £17 billion if the increase was made to employer as well as employee and self-employed NICs). While the proportional impact on after-tax earnings would be larger for low earning than high earning employees, it is actually mid to high income households that gain the most (partly because low income households often do not have anyone in paid work). Raising the NICs threshold to £12,000 rather than £12,500 would obviously cost slightly less, though it would also be unnecessarily complex to have two thresholds (the point at which individuals start paying NICs and start paying income tax) so close together.

Defence spending

The UK currently spends 2% of national income on defence, in line with its commitments as a member of NATO. Jeremy Hunt has declared that he believes the UK should consider a "decisive increase" in the proportion of national income devoted to defence, hinting that he could go as far as to double defence spending to 4% of national income over the next decade.[4] Doing so would require more than £40 billion of additional spending, in today's terms. More recently, Mr. Hunt has indicated that he would increase defence spending to 2.5% of national income over the next five years.[5] This would imply defence spending in 2023–24 around £15 billion higher than today (in today's terms) and around £12 billion more than if spending remained at 2% of national income. This would be a considerable increase relative to today, but would fall short of the recommendation of the House of

[1] For a review of work on the incidence of corporate income taxes, see A. Auerbach, 'Who bears the corporate tax? A review of what we know', in J. Poterba (ed.), Tax Policy and the Economy, 20, National Bureau of Economic Research, Washington DC, 2006

[2] Strictly speaking NICs is levied on a weekly or monthly basis, not an annual basis. However for simplicity we refer to the annual equivalent in this briefing note.

[3] For example, see Miller, L., 'Which Tory leader hopeful's tax plan will leave you better off?', *The Telegraph*, 24 June 2019, https://www.telegraph.co.uk/tax/income-tax/tory-leader-hopefuls-tax-plan-will-leave-better/.

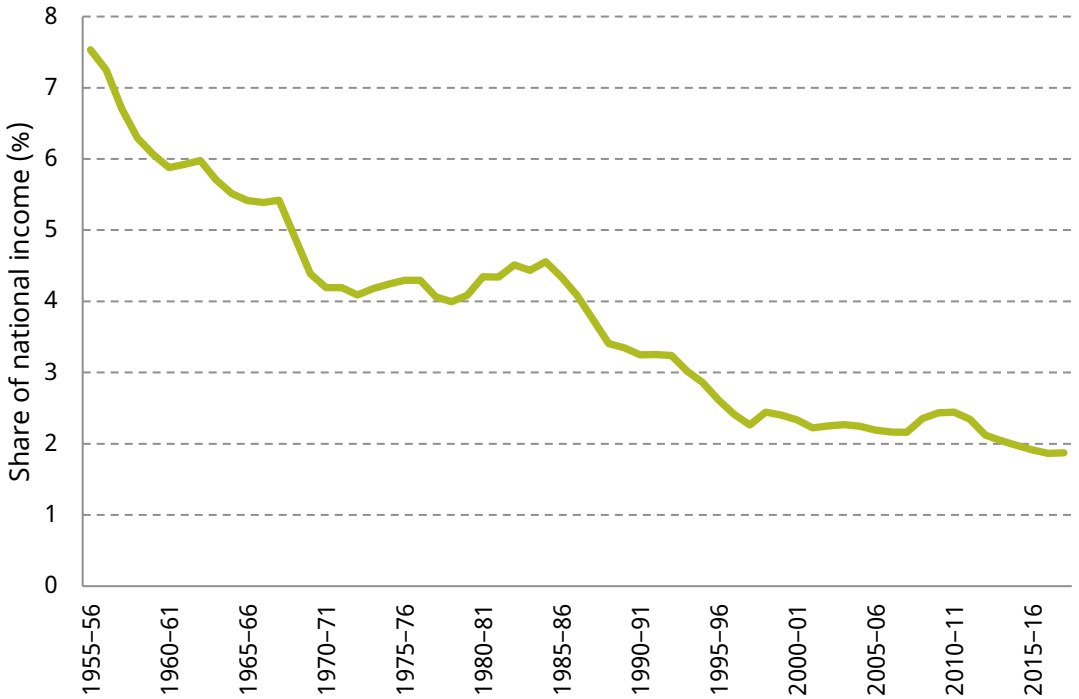
[4] Jeremy Hunt MP, speech at Lord Mayor's Banquet 2019, https://www.gov.uk/government/speeches/lord-mayors-banquet-2019-foreign-secretarys-speech. See also coverage in *The Telegraph,* 13 May 2019, https://www.telegraph.co.uk/politics/2019/05/13/jeremy-hunt-wants-double-defence-spending-calls-uk-project-hard/ and *The Guardian,* 13 May 2019 , https://www.theguardian.com/politics/2019/may/13/jeremy-hunt-uk-double-defence-spending-brexit-tory-leadership.

[5] BBC News, 25 June 2019, https://www.bbc.co.uk/news/uk-politics-48752226

Commons Defence Committee, which called last year for an increase to 3% of national income.[6]

A sustained increase in defence expenditure of this scale would represent a marked break from the recent past. Figure 2 shows that spending on defence has fallen steadily over the last 70 years, from more than 7% of national income in 1955–56 to around 2% of national income today. Doubling defence spending to 4% of national income would return it to its highest level since 1986–87, before the end of the Cold War. Increasing spending to 2.5% of national income would return it to its highest level since 1995–96.

Figure 2. Defence spending as a share of national income



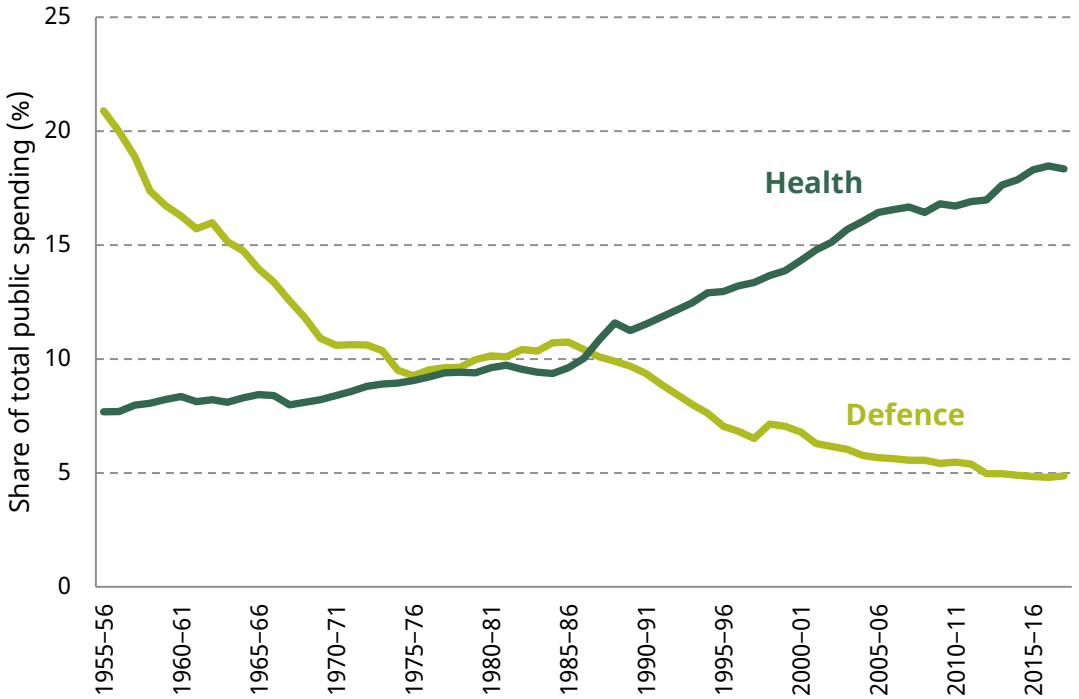
Note: this definition of defence spending excludes some elements which count towards the NATO 2% target, such as expenditure on war pensions and Ministry of Defence civilian pensions.

Source: Authors' calculations based on various HM Treasury Public Expenditure Statistical Analyses, UK National Accounts and OBR Public Finances Databank.

Spending on defence has also fallen as a share of total public spending (Figure 3). In 1955–56, defence accounted for more than one pound in every five the government spent. Today, the equivalent figure is just one in twenty. In contrast, spending on health has steadily increased, growing from 7.7% of total spending in 1955–56 to 18.3% in 2017–18.

[6] House of Commons Defence Committee, 'Beyond 2 per cent: A preliminary report on the Modernising Defence Programme', June 2018, https://publications.parliament.uk/pa/cm201719/cmselect/cmdfence/818/818.pdf

Figure 3. Defence and health spending as a share of total public spending



Source: Authors' calculations based on various HM Treasury Public Expenditure Statistical Analyses, UK National Accounts and OBR Public Finances Databank.

In the past, rising spending on health and social security has been compensated in large part by falling spending on defence. Savings from defence have, in effect, been used to finance a growing welfare state without a corresponding increase in taxes or the overall size of the state.

Given the pressures associated with an ageing population, public spending on health, pensions and long-term care is likely to continue to grow. For instance, the Office for Budget Responsibility project that if we are to keep pace with demographic and other cost pressures, spending on those areas would need to increase by 3.1% of national income over the next 15 years alone, equivalent to around £66 billion of extra spending in today's terms.[7] Even without a "decisive increase" in spending on defence, meeting those pressures poses considerable challenges to the public finances. If at the same time we choose to increase decisively – perhaps double – defence spending, that would create an even bigger gap to be filled by some combination of higher taxes, higher borrowing, or cuts to other areas of spending.

Reducing the interest on student loans to just the RPI rate of inflation

An interest rate is applied to student loans. It is set at RPI+3% while the student is at university. After graduation it is fixed at RPI+0% whilst earnings are below £25,000 but gradually rises to a maximum of RPI+3% when earnings reach £45,000. The application of this relatively high interest rate, especially while at university, is an unpopular feature of

[7] Authors' calculations using Office for Budget Responsibility, Fiscal Sustainability Report, July 2018, Supplementary table 1.1 (baseline projection), https://obr.uk/fsr/fiscal-sustainability-report-july-2018/

the current system. It means, for example, that a student studying for a three year degree can accrue up to £6,000 of additional debt as a result of this interest rate just while studying. Mr. Hunt has proposed to reduce the interest rate to just RPI for all students and graduates.

This would have a long run cost to government of somewhat more £1 billion a year, though would make very little difference in the short run.

The recent change announced by the ONS to how it will account for student loans will make such a change easier from the point of view of its impact on measures of the public finances that we tend to focus on. Until now, rather bizarrely, accruing interest appeared in the public accounts in the same way as tax payments appear. In other words, accruing interest reduced the headline deficit directly. This despite the fact that most of it would never in fact be paid to the government by the students and graduates accruing the interest.

This last point is crucial in understanding the impact of this policy. Because student loans are only paid back on an income contingent basis, and are written off after 30 years, the large majority of graduates will not pay off the loan in full. This is something that will only be achieved by the highest earning graduates. For something like 70% of graduates the accrual of interest will make no difference to their actual repayments. The amount they can expect to have written off at the end of 30 years is likely to be equal to more than the total amount of accrued interest.

The result is that the actual impact of reducing the interest rate would be to benefit only around 30% of graduates, and in particular the highest earning 30%. While most middle and lower earners would be unaffected by a cut in interest rates the higher earning fifth of graduates would benefit to the tune of more than £20,000 in reduced loan repayments.

That’s not to say this is an unreasonable policy. To charge interest at a rate well above not only the government’s cost of borrowing but also currently well above the cost faced by most mortgagors means two things. First, higher earners are effectively being charged considerably more than the actual cost of their degree. This is a form of redistribution away from high earning graduates, but not a terribly transparent one. Second, there is an incentive for those who expect to earn a lot to pay fees up front (or rather more likely for their parents to do so on their behalf). Given these facts there is a case to be made for reducing the interest rate. The key question, as ever, is one of priorities. Is this the best way to spend upwards of £1 billion a year?

One final, tangential, point on this policy. Whatever the appropriate rate of interest is, it should not be tied to the RPI. The RPI is a measure of inflation which is wrong, discredited and which does not qualify as a “national statistic” because of problems in the way in which it is constructed. Much better to move to a system based on the CPI.