The Green Budget

Summer 1997

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Contents

List of tables

List of figures

1. Summary

Economic prospects

The UK economy has been gathering momentum since mid-1995. GDP was up 3.0% in the year to the first quarter of 1997, and final demand has been growing more rapidly than this. Consumer spending has been and will continue to be the main driving force behind GDP growth this year and next, as personal disposable incomes rise. A recovering housing market, falling unemployment, and building society and other windfalls are all boosting confidence. And as capacity utilisation increases, investment should also strengthen.

Growth at this pace would be no cause for concern if we could be confident that there was still plenty of slack in the economy, but this is doubtful. Extrapolating the long-term trend growth rate suggests an output gap as much as 2% of GDP, but the labour market and business surveys suggest that we could already be close to or at trend. It may be that GDP figures will be revised upwards, as they were in the late 1980s, explaining the apparent paradox.

If the output gap has now been eliminated, continued above-trend growth would cause the economy to begin to overheat this year. This might show through first in a worsening balance of payments current account, and only later in higher inflation. To head this off, interest rates will need to rise further but the strength of the exchange rate creates dilemmas for policymakers. The main dilemma is whether interest rates should be raised in order to slow domestic demand growth, or left as they are given the favourable near-term outlook for inflation. We expect the Bank of England to raise interest rates gradually until there are clear signs that economic growth is slowing, but it is unlikely to tighten monetary policy aggressively until the sterling exchange rate softens.

If the current strength of sterling proves short-lived, interest rates could rise by enough to curb domestic demand without damaging the export sector too badly, and this is our central expectation. But if the pound remains stronger for longer, interest rate rises may be deferred, increasing the chance of unsustainably rapid growth in 1997 and 1998, leading to a much harder landing for the economy in 1999.

Sustainability of the public finances

On a range of different definitions, the appropriate objective for the structural budget deficit — that is, the budget deficit when the economy is at normal capacity — should be in the range just less than 1% to 2.5% of GDP. The so-called 'golden rule' requires a PSBR at the bottom end of the range, while maintaining the ratio of national debt to national income would imply a PSBR at the top of the range.

As was the case for the previous administration, the government appears to be committed to meeting both these criteria, which would also meet the requirements of the EU stability pact.

On unchanged policies, we expect a PSBR in 1997-98 of £14.3 billion, or 1.8% of GDP. If the economy is back at trend in 1997-98, this would achieve debt sustainability, but it would be 1 percentage point short of meeting the golden rule. Plugging this gap in one Budget would seem impossible to contemplate for a new government in its first Budget. But the reality is that, over the next few years, a very large fiscal tightening is already planned, through unprecedentedly low growth in public spending, pre-announced tax increases and real fiscal drag. Public spending is forecast to fall as a share of national income from 40.2% in 1997-98 to 37.8% in 2001-02, while government revenues rise from 38.4% to 40.3%. By 2001-02, the pre-announced real increases in fuel and tobacco taxation in this Parliament will be contributing tax increases of £7.5 billion per year, with £17 billion per year more from fiscal drag.

If the real plans for public spending were achieved and the economy grew at trend from 1998-99 on, we would expect the PSBR to be eliminated by 1999-00 and fall to -£24 billion, or -2.5% of GDP, by 2001-02. On this basis, no further fiscal tightening would be needed to address the structural deficit. Indeed, there would be ample scope to cut taxes or increase public spending during the second half of the Parliament.

But as we have said before, the public spending plans are very tight and slippage seems inevitable. Meeting them would imply radical restructuring of the nature and extent of public sector provision. If public spending instead grew at broadly the same rate as over the last 18 years, the PSBR would fall to £1 billion by 2001-02. The golden rule would have been missed for most of the Parliament, but the pre-announced tax increases and fiscal drag would still have tightened fiscal policy to a position that broadly met the government's targets by the end of the Parliament.

The case for further fiscal tightening now would seem to require that either the large planned fiscal tightening will not occur — indeed, that the government will choose to increase spending as a share of GDP — or that the economy is already well beyond trend, so that a further period of growth at or near trend rates is not possible if the Bank of England is to adhere to the inflation target. There seems no reason to doubt the seriousness of the government's intentions on public spending, and although there is room for doubt as to precisely where we are in the cycle, it seems unlikely that we are so far beyond trend that the fiscal tightening already in prospect will be inadequate to bring the public finances into an acceptable state during the course of this Parliament.

Income tax

Throughout the period of Conservative government, too much emphasis was put on income tax and, in particular, on rates of income tax. Income tax raises only a quarter of total tax revenue, and at the current rates it is hard to argue that it does

damage to incentives to work. If further changes are to be made to income tax, we must hope that they will form part of a wider strategy for tax reform, rather than being driven by presentational questions.

The new government has said '*our long term objective is a lower starting rate of income tax of ten pence in the pound*'. There are many ways of moving in this direction; to replace the current 20p rate with a 10p rate would cost around £9.5 billion per year. A new starting rate would add to the complexity of the income tax system — which has become substantially more complex already over the last six years — and particularly so if the existing 20p rate remained over some band of income.

In particular, the interaction of a new lower rate with the restricted married couple's allowance might mean that many married people would never face a marginal rate of income tax of 10p despite its existence in the tax system. In addition, the taxation at source of savings income would be difficult to implement with a 10p rate.

Reductions in mortgage interest tax relief, the married couple's allowance or the tax rate at which the main personal allowance is given could fund a 10p starting rate. Changes to the tax treatment of pension contributions are more difficult to implement, and could have significant implications for the pensions industry.

We also demonstrate that an alternative form of income tax cut — increasing allowances — produces a simpler, more progressive tax system than a reduced starting rate of income tax and moves more people out of tax altogether.

Company taxation

There has been some discussion of raising revenue by taxing companies more heavily. The most straightforward way of doing this would be to raise the corporation tax rate but this might be too transparent. Changes to advance corporation tax (ACT) might be more probable, not least since this is an area where changes are little understood. A reduction in the rate of ACT from 20% to 15% could raise between £1.5 billion and £2 billion per year. The principal losers would be tax-exempt pension funds and higher-rate shareholders. Such a change would marginally discourage dividend pay-outs, and for that reason is argued to encourage investment. But unless the extra tax was returned to the corporate sector — for example, by cutting the main corporation tax rate — investment might well fall rather than rise as company cash flows were affected by higher pension contributions.

There has also been speculation about possible changes to capital allowances with the objective of raising investment. General increases here would be extremely expensive, and targeted or temporary changes risk distorting choices and clearly do not provide a stable tax environment. This is an area where change would be best left until a thorough review has been conducted.

The windfall levy will be imposed, although the precise level and form are still unclear. It seems likely that the higher the level of revenue sought, the higher will be the possibility of some attempted legal challenge. We would not expect any substantial impact on either prices charged by the companies affected or their investment. To a large extent, the tax has already been paid by shareholders unlucky enough to be holding utility shares on days when new information about the scale of the windfall levy, or the likelihood of its being imposed, has been discounted into share prices. These losers are by no means necessarily those shareholders who gained from earlier high returns.

The two most likely tax bases for the levy would be either some measure of excess shareholder returns or excess company profits. Economic theory does not help in choosing between these bases, and legal considerations are likely to be of paramount importance.

Indirect taxes

The government is committed to a reduction in VAT on fuel, from 8% to 5%, at a cost of around £400 million in a full year. This proposed change to VAT illustrates one of the problems raised by many environmental taxes, that they tend to hit the less well off hardest. Increases in fuel and tobacco taxes will continue in line with the last government's pre-announced changes. The taxation of alcohol is still both complex and difficult to defend.

Welfare-to-work

The social security budget is now close to £100 billion per year and has grown rapidly, but only £7 billion per year goes directly to the unemployed. Given this, it is unlikely that a welfare-to-work strategy will be able to reduce the social security bill significantly.

In many countries, welfare-to-work policies have included reducing benefits levels to the unwaged, workfare schemes, help in finding work, financial incentives to take low-paid jobs, training for work and childcare subsidies. Labour's policies are likely to include action on many of these fronts. Evidence to date suggests that the schemes will have a positive impact on many individuals' lives but there is no guarantee that any money will be saved, even in the long run.

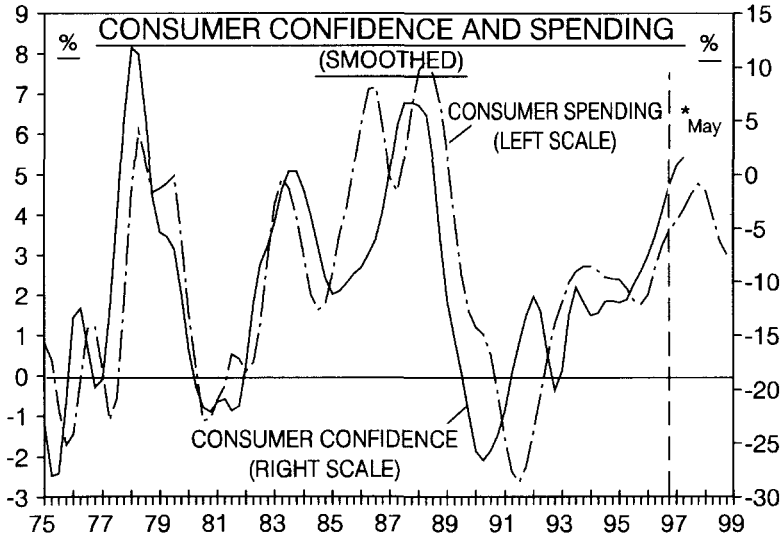
2. The economic forecast

'Britain is booming' was the campaign theme of the Conservatives in the general election, but the problem with booms is that they all too often end in 'bust'. The immediate task facing the new Labour government, and the Bank of England now that it has gained operational independence over the setting of interest rates, is therefore to engineer a soft landing for the UK economy after such an unusually long period of sustained economic growth. The conduct of policy is complicated by the strength of the exchange rate. Although the appreciation in sterling will slow growth in the manufacturing and external sectors, and allow the inflation target to be hit for the rest of this year, interest rates still seem too low to curb the excessive buoyancy in consumer demand. GDP growth is likely to be maintained at an above-trend rate during 1997 at a time when labour market developments suggest that the output gap in the economy may already have been eliminated, resulting in a mild bout of overheating for the economy. Given the strength of the exchange rate, signs of overheating are likely to be seen first in the balance of payments rather than in inflation. The best hope for a soft landing is that part of the rise in sterling is reversed, allowing interest rates to be raised to curb domestic demand without crushing the export sector. This is Goldman Sachs's central expectation. Base rates are likely to rise a further 100 basis points or so over the next year to 7.25-7.5%. But these rises could take longer to come through if the pound remains strong, increasing the odds of a more pronounced cycle in economic activity over the next two to three years.

2.1 Economic activity

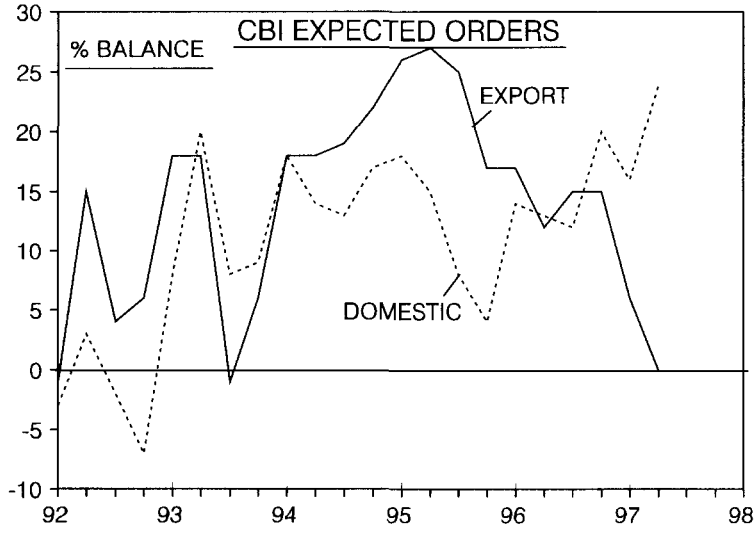
The economy has been gathering momentum since mid-1995. GDP was up 3.0% in the year to 1997Q1 and final demand has been growing more rapidly than this. The stock adjustment, which until now has been the main drag on economic growth, is well advanced and is unlikely to curb GDP growth in 1997 and 1998. Consumer spending has been and will continue to be the main driving force behind GDP growth this year and next. Real take-home pay (deflating average earnings by the tax and price index) has risen by more than 3% over the past year and growth in real personal disposable income is likely to be maintained in excess of 3% over the next 12 months. In addition, consumer confidence is being boosted by a recovering housing market, falling unemployment and a substantial amount of windfalls from take-overs and stock-market flotations of building societies and insurance companies. The latter are expected to total more than £25 billion this year, equivalent to 4.5% of annual personal disposable income. Although only a fraction of these are assumed to be spent, consumer spending is nevertheless forecast by Goldman Sachs to grow by 4.3% in 1997 and by a further 3.7% in 1998. Investment should also strengthen in response to rising capacity utilisation, contributing to domestic demand growth of 3.8% this year and 3.3% next.

Figure 2.1. Consumer confidence and spending



The strength of sterling will have a negative impact on export growth while import growth will be boosted by the ongoing strength of domestic demand. While these adverse trends in net trade will help to slow the economy, the recovery risks becoming unbalanced in the process. Warning of such a development was clearly given by the latest CBI Industrial Trends Survey — expected export orders weakened sharply between January and April while domestic orders strengthened to the highest level since July 1988. Net trade volumes may curb GDP growth by around 0.5 of a percentage point this year and 1 percentage point in 1998. Even so, above-trend GDP growth should be maintained in the next few quarters, taking the annual growth rate up from 2.4% in 1996 to 3.2% in 1997 but back to around 2.4% again in 1998 as the lagged effects of stronger sterling and the assumed tightening in monetary policy take their toll. On these forecasts, growth will be 1 percentage point

Figure 2.2. Expected orders from the CBI Industrial Trends Survey



faster than Britain's long-term trend rate in 1997.

2.2 Uncertainties about the output gap

Growth at this pace would not be a problem if plenty of slack still exists in the economy, but we are doubtful that this is the case. While the extrapolation of Britain's long-term trend growth rate suggests that the output gap could still be as high as 2%, other methods indicate that it may already have been eliminated even on the most optimistic view of its size. For example, business surveys indicate that there is little or no excess plant capacity in manufacturing or services. There is also little question that the labour market has become very tight. Even allowing for distortions in the monthly claimant count of unemployment caused by the introduction of the jobseeker's allowance last October, the more reliable Labour Force Survey (LFS) reports that short-term unemployment is now just 5,000 above its previous low; vacancies are 19,000 above their previous high; the ratio of vacancies to short-term unemployment — a useful indicator of the tightness of labour market conditions — is therefore at a new peak.

These labour market developments suggest that output may have been under-recorded by the Office for National Statistics (ONS). Historically, there has been a clear tendency for initial estimates of GDP growth to be understated, particularly during the upswing phase of the economic cycle when the bias has averaged 0.8 of a percentage point a quarter. This means that the preliminary estimate of annual GDP growth of 3.0% in 1997Q1 could easily have been revised up to around 3.8% when we look back in three years' time. If we go back over the past three years and add 0.8 of a percentage point to the preliminary estimates of annual GDP growth in each quarter, then the level of real GDP in 1997Q1 could eventually be shown to be around 3 percentage points higher than currently estimated. Adjusted for this historical bias, the output gap may therefore have already been eliminated. On this reasoning,

Figure 2.3. Labour market conditions

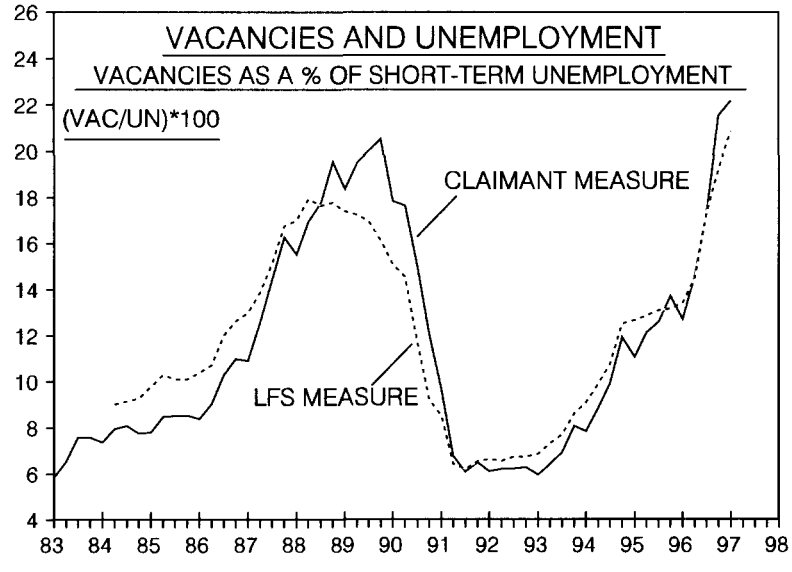
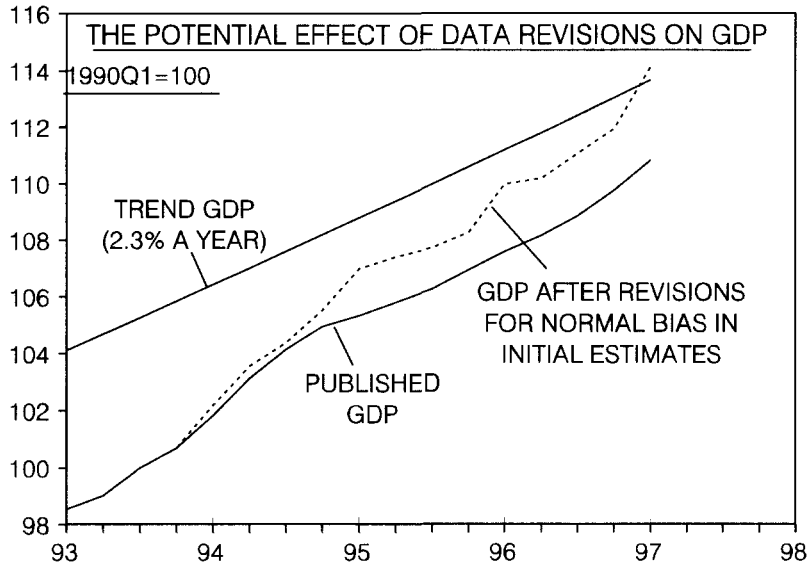


Figure 2.4. The potential effect of data revisions on GDP



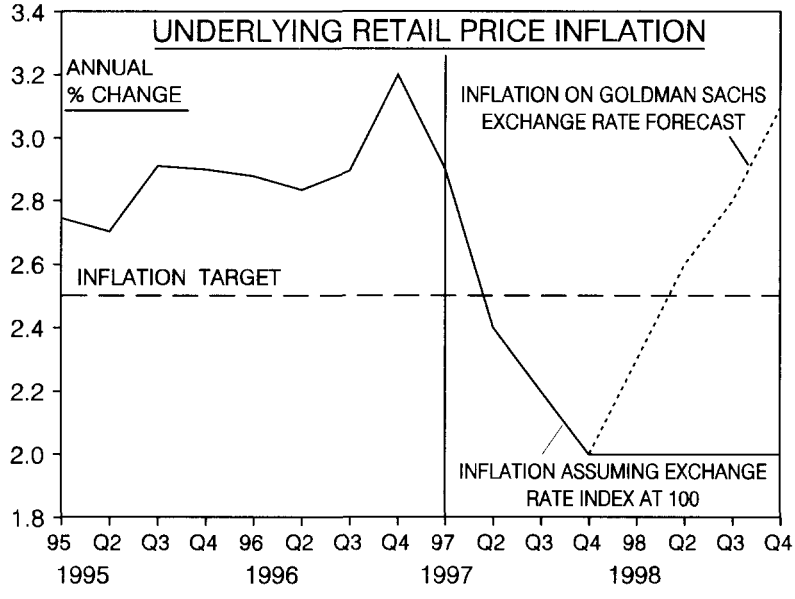
there is little scope for the economy to grow at an above-trend rate without overheating. This also has important implications for any assessment of the sustainability of the public finances, as we discuss in Chapter 3.

2.3 A mild bout of overheating likely

If the output gap has now been eliminated, then a continued period of above-trend GDP growth would cause the economy to begin to overheat this year. There are various ways in which overheating can show up. Eventually, inflation will rise but this need not emerge for some considerable time. In the late 1980s, for example, the economy was clearly overheating throughout 1987 but inflation only began to rise in earnest from Spring 1988 onwards. Given the 20% appreciation in sterling since the beginning of 1996, an even longer lag may be possible on this occasion. Underlying retail price inflation has fallen sharply so far this year — from 3.1% in January to 2.5% in April. This is due largely to lower food price inflation (currently -1.3%) which, in turn, is largely a function of the exchange rate. Food price inflation should continue to drop for a few more months (although the recent drought may boost seasonal food prices in the summer) and there is also scope for goods price inflation to improve reflecting the recent collapse in core producer output price inflation. Underlying retail price inflation could be running as low as 2% by the end of the year.

Despite the very favourable outlook for inflation in 1997, there are longer-term concerns, notably the upward creep in service price inflation to a two-year high of 3.3%, the tightening labour market and associated rise in average earnings growth to 4.5%, the high level of consumer confidence, rising house price inflation and rapid monetary growth. These could be masked for many months by exchange rate effects. According to simulations run by Goldman Sachs, underlying inflation could average 2% throughout 1998 if the Bank of England trade-weighted exchange rate index remains close to recent levels. However, if

Figure 2.5. Inflation simulations



the exchange rate were to depreciate at any time in the next 12 months, a renewed upward trend in inflation would quickly emerge.

The strength of the exchange rate has created dilemmas for policymakers and these might not be resolved any time soon. Should interest rates be raised in order to slow domestic demand growth or left on hold given the favourable near-term outlook for inflation? Up until the election, when the previous Chancellor, Kenneth Clarke, had the final say over interest rates, the latter view prevailed against the advice of the Bank of England. Now that control has passed to the Bank of England, the Bank is likely to raise interest rates gradually until there are clear signs that economic growth is slowing and longer leading indicators of inflation abate. On occasion, the Bank of England has played down the importance of sterling but there is little doubt that the exchange rate is taken into account when the Bank considers interest rates, not least because it has a significant impact on the short-term inflation outlook. Thus, despite its newly gained independence, the Bank of England is unlikely to start tightening monetary policy aggressively until the sterling exchange rate softens.

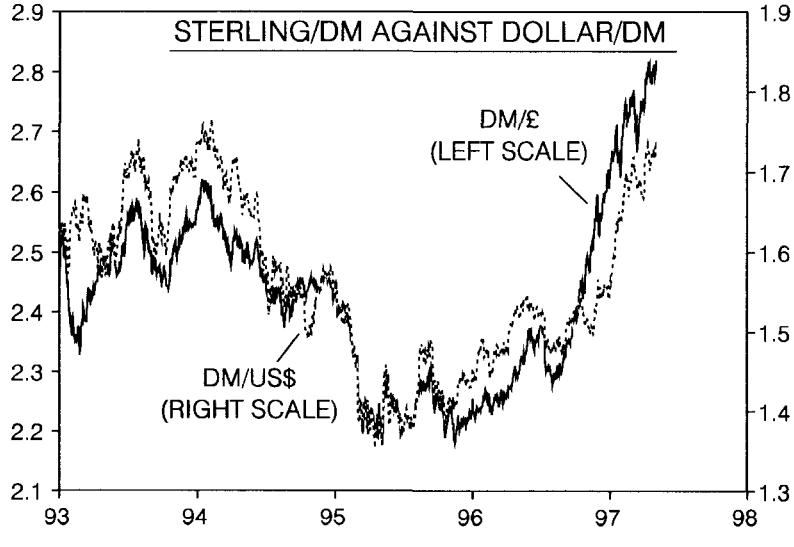
There is an inherent risk in a scenario where the exchange rate remains persistently strong. The current policy mix implies slowing the economy by hitting the external and manufacturing sectors. This is a legitimate course of action but the cost will be a serious deterioration in the balance of payments. At existing exchange rates, the current account could move from balance last year to a deficit of over 2% of GDP in 1998. In the mean time, interest rates will not be high enough to prevent the service sector and consumer spending from expanding rapidly, putting further upward pressure on average earnings and service sector inflation. At some point, the worsening current account deficit will undermine the exchange rate; interest rates might then need to be raised sharply to prevent a marked pick-up in inflation — in effect, a mini rerun of

1988. This chain of events raises the risk of a much harder landing for the economy, probably in 1999, than most forecasts currently suggest.

This potential conflict could be avoided if sterling were to depreciate, but this may be beyond the control of the authorities in the near term. Apart from a brief period at the end of last year when the pound moved above 1.70 against the US dollar, the pound has actually remained reasonably stable against the dollar. Since the beginning of 1993, it has averaged 1.55 and it is currently within 8 cents of this level. Sterling has appreciated substantially against the D-Mark over the past year but this seems more a function of movements in $/DM rather than independent movements in sterling. This is probably a reflection of three phenomena. First, the UK and US economic cycles have been much more closely synchronised with each other over this period than either has been with continental Europe. Second, the underlying inflation and productivity performance has been reasonably similar in both countries so that there should have been no major trend change in the equilibrium exchange rate for £/$. Third, official interest rate changes have been reasonably closely synchronised — the brief period of independent sterling strength against the dollar occurred when there were expectations of a more aggressive bout of UK policy tightening than has occurred. For as long as these three phenomena are in place, there is little reason to expect a major move in the £/$ exchange rate.

If this reasoning is correct, it follows that the main trend in sterling in coming months will be determined as much by events outside the UK as by domestic considerations, unless one or more of the above factors cease to exist or some other fundamental difference emerges. Two possibilities spring to mind. One is that the UK trade balance could deteriorate quite markedly later this year in response to a combination of excessive domestic demand growth boosting imports and lost competitiveness curbing exports. This could eventually trigger independent weakness in sterling, although similar trends are likely to be evident in the US too. Second, US monetary policy might eventually be tightened more aggressively than in the UK, although this is only likely if the

Figure 2.6. Exchange rate trends



UK government pursues a much tighter fiscal policy than the US.

Longer-term, the policy dilemmas caused by the strength of the exchange rate may dissipate of their own accord. According to estimates by Goldman Sachs, sterling and the dollar have both become overvalued. Both currencies are forecast to weaken over the next year against other currencies as their relative growth advantage diminishes and their respective balance of payments worsen. The sterling trade-weighted exchange rate is forecast to depreciate by around 10% over the next year. As this occurs, base rates will need to rise further to head off higher inflation. On this exchange rate forecast, base rates are likely to rise to 7.25-7.5% within a year. An alternative to relying on interest rates and the exchange rate to slow the economy would be if Gordon Brown were to tighten fiscal policy significantly further in the Budget. However, as we argue in Chapter 3, there seems only limited scope for this. So the burden of policy tightening will almost inevitably continue to rest with monetary policy. In this case, the best hope for a soft landing is that the current period of sterling strength (and, by association, the strength in the dollar) proves to be short-lived. This would allow interest rates to be raised sufficiently to curb domestic demand without crushing the export sector. This is our central expectation. However, if the pound stays stronger for longer, then it may take more time for base rate increases to come through. In this case, the odds of a rather more pronounced cycle in economic activity over the next two to three years would increase, with growth remaining unsustainably fast in 1997 and 1998, leading to a hard landing for the economy in 1999 as the authorities battle to control inflation.

3. The sustainability of the public finances

There has been much debate about the need for Gordon Brown to raise taxes in the Budget to ensure the medium-term sustainability of the public finances. This stemmed from the fact that the PSBR excluding privatisation was still 3.7% of GDP last year, which seems much too high for this stage of the economic cycle, and from doubts about Labour's ability to stick to the previous government's spending plans. While both of these concerns are valid, it does not follow automatically that taxes must rise now. If the real level of public spending breaches current plans but only increases at the rate seen under the Conservatives (i.e. just under 2% a year on average), it would be £24 billion higher by the end of the Parliament than shown in last November's Budget. At the same time, though, the Budget plans showed a surplus on the PSBR of £18 billion in 2001-02. If public spending is £24 billion higher, the PSBR would still fall to £6 billion or 0.6% of GDP. Whether an out-turn such as this is sustainable depends ultimately on the path of economic activity relative to trend and whether this increase in public spending is enough to satisfy the public's expectations.

3.1 The definition of sustainable fiscal policy

In successive Green Budgets, we have repeatedly argued that there are two rules of thumb in the public finances that can help to assess the sustainability of fiscal policy. The first is that fiscal policy should ensure the sustainability of the public finances in the sense that the ratio of public sector debt to GDP is stable. In a European context, the debt ratio should be stabilised no higher than 60%,

Figure 3.1. Gross general government debt (% of GDP)

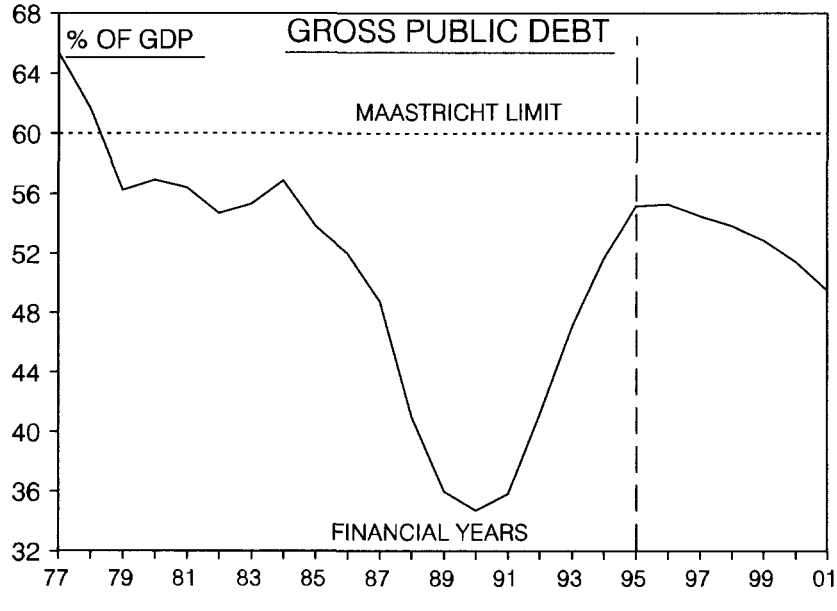
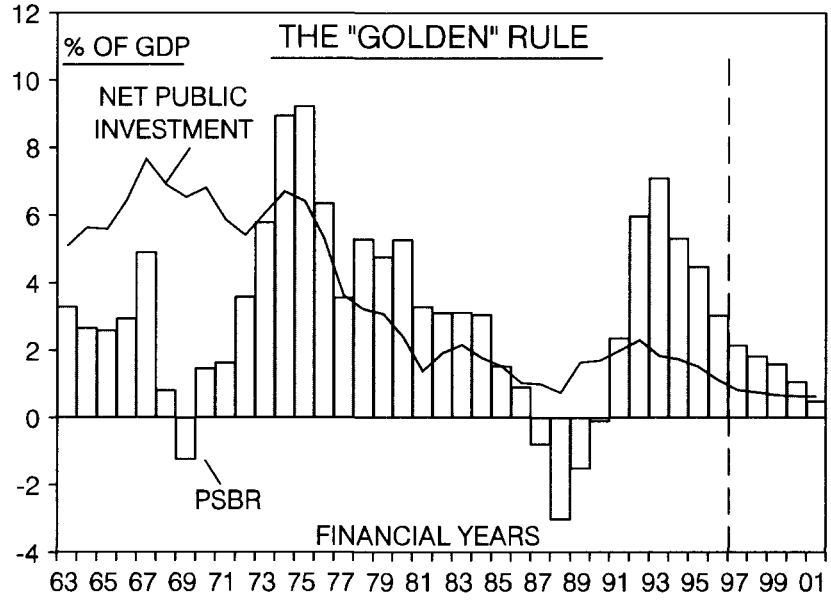


Figure 3.2. The golden rule



which would satisfy the Maastricht criteria for Economic and Monetary Union. Assuming that the new government aims to hit its 2.5% inflation target over the medium term, and that the real rate of interest in the UK is 4%, then the sustainable level for the PSBR would be around 2.5% of GDP a year. Clearly, the actual PSBR could vary around this sustainable level in the course of the economic cycle, but when GDP is at trend or mid-cycle levels, the government accounts should be set so that this level of public borrowing is achieved.

The second rule of thumb suggests that, over the course of the economic cycle, the government should avoid increasing its liabilities more rapidly than it increases the value of its assets. This in turn implies that its net borrowing requirement should be no greater than the level of net public investment — the so-called 'golden rule'. On the present plans for public investment, which were cut again in last November's Budget, the PSBR would need to be reduced to around 0.75% of GDP, which is the level of net public sector capital formation planned for the medium term, if the golden rule were to be met.

In opposition, Gordon Brown committed the Labour Party to both of these principles. This means that the government should be aiming for a PSBR of less than 1% of GDP when the economy is at trend. This fits with a third consideration — namely, the likely desire of any British government to publish fiscal objectives that are consistent with the EU stability and growth pact even if Britain remains outside EMU for most, if not all, of this Parliament. Under this pact, countries within the monetary union will commit themselves to aim for a medium-term government budget of close to balance.

Even armed with these rules of thumb for assessing the sustainability of fiscal policy, the difficulty is knowing precisely when the economy will be back to the trend (see Chapter 2). In last November's Budget, the Treasury assumed that the economy would achieve this in 1998-99. But recent developments in the labour market suggest the economy could already have returned to trend. With the economy likely to be growing by around 3.5% in 1997-98, it would

certainly be prudent for the new government to assume that the economy is back to trend no later than this year if it wants the Bank of England to keep underlying inflation no higher than 2.5%.

3.2 The public finances

Table 3.1 shows that in last November's Budget, the Treasury projected a fall in the PSBR to £26.4 billion (3.5% of GDP) in 1996-97 and to £19.2 billion (2.4% of GDP) in 1997-98. The actual out-turn for the PSBR including privatisation proceeds last year was £3.3 billion lower at £23.1 billion (3.0% of GDP) and our forecast on unchanged policies for 1997-98 is a PSBR of £14.3 billion (1.8% of GDP).

Relative to the Budget forecast, general government receipts were £2.2 billion higher in 1996-97, mainly as a result of an overshoot of £1.6 billion in corporation tax receipts and £1.3 billion in income tax receipts. VAT receipts actually undershot by £0.8 billion. On the spending side, we expect general government expenditure to undershoot by £2.4 billion, resulting in the main from undershoots of £0.6 billion in the control total and of £0.8 billion in cyclical social security. Public corporations' borrowing came in £1.4 billion worse than anticipated in November, leading to the eventual reduction in the PSBR of £3.3 billion.

The buoyancy of tax receipts in 1996-97 augurs well for a continued sharp drop in the PSBR this year. If the government is able to stick to the existing plans for the public spending control total, the PSBR should drop to £14.3 billion or 1.8% of GDP. This would be sufficient to stabilise the ratio of public debt to GDP at around 54%, but if the economy is back to trend in 1997-98, it would leave the PSBR about one percentage point higher than is sustainable in the medium term on the golden rule criterion. To plug this gap in one go, taxes would need to rise by around £8 billion, equivalent to a rise in the basic rate of income tax from 23% to 27%. A tax increase of this magnitude would be impossible for Labour to contemplate in its first Budget.

Fortunately for Gordon Brown, there would be no need to contemplate such large tax increases because in the medium term there is already a fiscal squeeze that he has inherited from the previous government. Table 3.2 shows the Treasury forecast from last November's Budget and our latest forecast for general government spending, general government receipts and the PSBR on unchanged policy.[1] The IFS / Goldman Sachs forecast for general government expenditure is higher in nominal terms into the medium term as a result of slightly higher expected inflation and an assumption of zero privatisation receipts from 1998-99 onwards. As a proportion of GDP, it nevertheless falls from 40.2% in 1997-98 to 37.8% by the end of the Parliament. As we have often said, this would represent unprecedented fiscal tightening from public spending restraint.

[1] More details of our forecasts are contained in Appendix A.

Table 3.1. Public finances, 1996–97 and 1997–98

	FSBR 1996–97	*Estimated out-turn 1996–97*	*FSBR 1997–98*	*IFS 1997–98*
Inland Revenue				
Income tax	68.1	69.4	71.8	72.8
Corporation tax	26.1	27.7	27.2	30.9
Petroleum revenue tax	1.7	1.6	1.6	1.7
Capital gains tax	0.9	1.1	1.1	1.1
Inheritance tax	1.6	1.6	1.6	1.6
Stamp duties	2.4	2.3	2.7	2.6
Total Inland Revenue	**100.8**	**103.7**	**106.0**	**110.7**
Customs and Excise				
Value added tax	47.5	46.7	50.7	49.8
Fuel duties	17.4	17.2	19.6	19.4
Tobacco duties	7.8	8.2	8.4	8.8
Spirits duties	1.7	1.6	1.8	1.7
Wine duties	1.2	1.3	1.3	1.4
Beer and cider duties	2.8	2.8	3.0	3.0
Betting and gaming duties	1.5	1.4	1.6	1.4
Customs duties and agricultural levies	2.2	2.3	2.4	2.4
Air passenger duty	0.4	0.4	0.8	0.5
Insurance premium tax	0.6	0.7	1.2	1.2
Landfill tax	0.1	0.1	0.4	0.4
Total Customs and Excise	**83.3**	**82.5**	**91.2**	**90.1**
Vehicle excise duties	4.3	4.3	4.5	4.7
Oil royalties	0.7	0.6	0.6	0.6
Business rates	14.2	14.2	14.6	14.6
Social security contributions	46.7	46.7	49.1	48.8
Council tax	9.9	9.9	10.6	10.6
Other taxes and royalties	5.8	5.8	5.5	5.5
Total taxes and social security contributions	**265.6**	**267.8**	**282.1**	**285.6**
Interest and dividends	5.0	5.0	5.1	5.1
Gross trading surplus and rents	5.1	5.1	4.9	4.9
Other receipts	5.2	5.2	7.2	7.2
General government receipts	**280.9**	**283.1**	**299.4**	**302.8**
Control total	**260.6**	**260.0**	**266.5**	**266.0**
Cyclical social security	14.3	13.5	14.1	13.2
Central government debt interest	22.2	22.1	24.8	24.8
Accounting adjustments	10.3	10.3	9.2	9.2
GGE(X)	**307.4**	**305.9**	**314.7**	**313.3**
Privatisation proceeds	-4.5	-4.4	-2.0	-2.0
Other adjustments	5.6	4.6	6.3	6.3
General government expenditure	**308.5**	**306.1**	**319.0**	**317.6**
General government borrowing	27.7	23.0	19.6	14.7
Public corporations' market and overseas borrowing	-1.3	0.1	-0.4	-0.4
PSBR	**26.4**	**23.1**	**19.2**	**14.3**

Table 3.2. Medium-term public finance forecasts: current spending plans

	1997-98	*1998-99*	*1999-00*	*2000-01*	*2001-02*
HMT (November 1996)					
General government expenditure	319	327	336	345	353
General government receipts	299	315	333	353	370
PSBR	**19**	**12**	**3**	**-8**	**-18**
GGE as % of GDP	40.5	39.6	38.9	38.2	37.4
GGR as % of GDP	38.0	38.1	38.5	39.1	39.2
PSBR as % of GDP	**2.6**	**1.5**	**0.2**	**-1.0**	**-2.2**
(IFS / Goldman Sachs)					
General government expenditure	318	330	341	351	361
General government receipts	303	323	345	364	384
PSBR	**14**	**7**	**-3**	**-13**	**-24**
GGE as % of GDP	40.2	39.9	39.3	38.5	37.8
GGR as % of GDP	38.4	39.1	39.6	40.0	40.3
PSBR as % of GDP	**1.8**	**0.8**	**-0.4**	**-1.5**	**-2.5**

On the taxation side, the IFS / Goldman Sachs forecast also shows tax revenues rising more quickly than the November Budget forecast. This represents a combination of higher tax revenues than expected in 1996-97 which can be expected to carry forward, the higher inflation in our forecast and slightly higher revenue elasticity assumptions than the Treasury appears to have used. The fiscal tightening coming from the taxation side is also considerable. We expect GGR as a proportion of GDP to increase from 38.4% of GDP in 1997-98 to 40.3% in 2001-02. This is often attributed simply to real fiscal drag (the fact that tax revenues on unchanged tax policies grow faster than GDP). While real fiscal drag is clearly the important factor, Gordon Brown also inherits significant tax increases already in the pipeline. Table 3.3 attributes the increase in GGR as a proportion of GDP over 1996-97 to real fiscal drag and discretionary tax increases. By the end of the period, an extra £6 billion will be raised annually from petrol duties, £1.5 billion from cigarette duties and £0.8 billion from corporation tax. Income tax revenues will be lower than they were in 1996-97 due to the income tax reductions of the 1996 Budget, but the

Table 3.3. Reasons for increased tax as a share of GDP

	1997-98	*1998-99*	*1999-00*	*2000-01*	*2001-02*
GGR as % of GDP	38.4	39.1	39.6	40.0	40.3
Change since 1996-97 (%)	0.5	1.2	1.8	2.2	2.4
Equivalent in £bn	**4.2**	**10.1**	**15.6**	**19.6**	**23.0**
£bn attributable to:					
Income tax	-2.6	-2.5	-1.6	-1.6	-1.6
Corporation tax	0.0	0.4	0.8	0.8	0.8
Petrol duties	1.1	2.3	3.5	4.8	6.0
Cigarette duties	0.4	0.7	1.0	1.2	1.5
Other tax changes	-1.7	-0.5	-0.5	-0.5	-0.5
Fiscal drag	7.1	9.8	12.3	14.8	16.7

Table 3.4. Effect on PSBR of windfall levy on privatised utilities

	1997–98	*1998–99*	*1999–00*	*2000–01*	*2001–02*
Windfall levy revenue (£bn)	2.5	2.5	0	0	0
Associated increased spending (£bn)	0.5	1.5	1	1	1
Net effect on PSBR (£bn)	-2.0	-1.0	+1.0	+1.0	+1.0

abolition of tax relief for profit-related pay mitigates this revenue loss from 1998-99 onward.

So far, we have made no allowance in these figures for Labour's proposed windfall levy on the excess profits of the privatised utilities (see Chapter 5). Our central scenario is a levy of around £5 billion collected over two years and spent over the lifetime of the Parliament. This would affect the time profile of the PSBR (reducing it in the next two years and increasing it thereafter, as shown in Table 3.4), but would leave the cumulative PSBR unaffected over the next five years. We would expect the Treasury to show this separately in the government accounts.

Labour has also indicated that it will allow a phased release of capital receipts, accruing from council house sales over the past 18 years, to expand and improve the stock of public sector housing. This might add around £1 billion or so on average to the PSBR in each of the next five years. Like privatisation proceeds, such spending is likely to be defined by Labour to be outside the control total.

If the government hits the spending plans outlined in the tables above, the combination of rapidly falling public expenditure and increasing revenue as a share of GDP amounts to a huge fiscal tightening. This fiscal tightening removes the need for immediate tax increases on almost any assumption of when the economy hits or has hit trend. Even if trend GDP was hit last year when the PSBR excluding privatisation proceeds was 3.7% of GDP, there is enough fiscal tightening in the spending and tax plans to bring the structural deficit back to sustainable levels. There are two sorts of risk to this rosy outlook for the public finances. First, the government might not be able to restrain public spending in the way planned by the last government, which would reduce the amount of fiscal tightening in the forecasts. The second risk is that the economy might already have moved above trend. If this is combined with less fiscal tightening on the spending side, the rules of thumb for sustainable public finances might become more difficult to meet.

3.3 Can public spending be controlled?

If the PSBR is to fall quickly during the next Parliament, it follows from the above arguments that Labour will need to adhere reasonably closely to the previous government's spending plans for at least the next two years and perhaps beyond. Labour's self-imposed fiscal strait-jacket recognises its limited room for manœuvre. There would be more room for manœuvre if the output gap turns out to be larger but this cannot be relied upon. Much will therefore

hinge on whether a Labour government can maintain such tight control over public spending.

There is plenty of room for scepticism. The plans presented by the Conservatives in last November's Budget were very tight. They imply no increase in the real level of control total spending between 1995-96 and 1998-99 and a decline in the share of public spending in GDP from 42.25% of GDP to 39% of GDP over this period. An out-turn lower than this has only been achieved twice in the last 25 years — at the height of the 1980s boom in 1988-89 and 1989-90.

In last year's Green Budget and before the election, we considered whether low public spending growth can be maintained. There are two potential sources of upward pressure on spending: (i) those areas that have been squeezed hardest in the past few years and (ii) pressures to increase spending on front-line services.

On the first of these, there seem to be no immediate pressures for a sharp rebound in spending although upward pressures do exist. Public sector pay rises, for instance, have broadly kept pace with the private sector, although average earnings growth has slipped behind. At some point, there may be a spate of 'catch-up' demands which could be difficult to fund from 'efficiency' savings. Cuts in public investment will be met partly by additional spending under the Private Finance Initiative, although longer-term upward pressures may exist, particularly since capital spending plans were cut heavily by the Conservatives. However, increasing public investment may be deemed acceptable by a Labour government committed principally to the golden rule. Local authority expenditure is constrained by the highly geared impact that increases in spending have on council tax bills, even if the capping limits imposed on local authorities are relaxed.

The fundamental issue is how a reduction in the share of public spending in GDP can be achieved while maintaining the provision of front-line services at a level and standard that the public expects or needs. The three largest areas — social security, health and education — now account for 60% of total public spending, up from 50% in 1978-79. Overall public spending control depends on whether growth in these areas can be contained. The Conservatives took several steps to limit the growth of social security; linking the uprating of benefits to prices rather than earnings should be sufficient to stabilise the share of social security in GDP even if the number of claimants continues to rise. In the process, the Conservatives effectively began the privatisation of future pension provision. This seems set to continue under Labour.

Similar choices will need to be made in health and education if the public spending plans are to be met. These are classic 'superior' goods — they have an income elasticity greater than one: as individuals and countries grow richer, they seek to spend a higher proportion of total income on retirement, healthcare and education. Spending on health, for example, has risen from 5.3% of GDP in 1978-79 to 6.8% in 1996-97, or in real terms by an average of about 3.4% per year. Whilst education spending has slipped from 5.2% of GDP to 4.9% over this period of falling pupil numbers, it still represented a real terms increase of 1.5% per year on average.

Like the Conservatives, Labour is committed to increase spending on health in real terms each year but the plans for health spending in last year's Budget were extremely tight. Total NHS spending is planned to grow by 1.5% in 1997-98, 0.3% in 1998-99 and zero in 1999-00. Much of this control is achieved by paring back investment programmes. Even so, the plans allow for much lower growth in current spending on health services than has been the norm over the last decade or more. It is doubtful whether such low spending growth can be achieved. If NHS spending continues on its existing trend growth path, the level of nominal spending by 1999-00 will be £3.5 billion higher than currently planned — equivalent to almost 2p on the basic rate of income tax. This may be too pessimistic, but if the government remains committed to comprehensive provision, and services are to be maintained at a level that the public expects of it, health spending will need at least to maintain its share of GDP. Given the experience of the last 18 years, it may need to go on rising steadily as a share of GDP. The same applies to education. Indeed, the Labour Party manifesto contained a commitment to increase the share of education spending in GDP over the lifetime of the Parliament.

Once these fundamental premisses are accepted, it is difficult to square the public spending plans that Labour has inherited with a desire to maintain the provision of front-line services at a level and standard that the public expects or needs. There are three options. Either the government meets people's aspirations for better services, in which case large areas of public spending will need to rise as a share of GDP and taxes will eventually need to rise. Or we go along the Conservatives' 'pensions route' where people are encouraged to make their own provision in certain areas, with the government guaranteeing a basic minimum. Or we can go on as we are, trying to stretch a limited amount of resources ever wider.

We expect the third outcome is the most likely. We are sceptical of Labour's claim that it will be able to find significant amounts of money within existing programmes to fund its priorities. Instead, we project real growth in control total spending of 2% a year on average over the lifetime of this Parliament — slightly above that seen during the Thatcher and Major years. On this projection, public spending stabilises at around 40% of GDP (see Table 3.5).

The figures for the PSBR in Table 3.5 show the PSBR falling to 1% of GDP by the end of the decade and to zero by the end of the Parliament. It means that the golden rule will be missed on our projections for most of the Parliament, but the PSBR is still likely to fall, not least because fiscal drag and the previous government's commitment to raise fuel and tobacco duties in real terms each year will raise the tax burden. If this is the case, an eventual overshoot in the public spending plans is unlikely to be a serious concern for UK financial markets and there is no pressing need for tax increases now.

The slippage in the public spending plans shown in Table 3.5 implies that, by the end of the Parliament, general government expenditure would be nominally £24 billion higher than it would be if the government kept to the real growth of the control total outlined in the November Budget. This increase in spending would be the same as the average annual increase that the Conservative government achieved in the 18 years of government.

Table 3.5. Medium-term public finance forecasts: public spending slippage

	1997–98	*1998–99*	*1999–00*	*2000–01*	*2001–02*
IFS / Goldman Sachs, current spending plans					
General government expenditure	318	330	341	351	361
General government receipts	303	323	345	364	384
PSBR	**14**	**7**	**–3**	**–13**	**–24**
GGE as % of GDP	40.2	39.9	39.3	38.5	37.8
GGR as % of GDP	38.4	39.1	39.6	40.0	40.3
PSBR as % of GDP	**1.8**	**0.8**	**–0.4**	**–1.5**	**–2.5**
IFS / Goldman Sachs, spending slippage					
General government expenditure	320	337	354	369	385
General government receipts	303	323	345	364	384
PSBR	**17**	**14**	**9**	**4**	**1**
GGE as % of GDP	40.6	40.7	40.7	40.5	40.3
GGR as % of GDP	38.4	39.1	39.6	40.0	40.3
PSBR as % of GDP	**2.1**	**1.6**	**1.0**	**0.5**	**0.0**

It is by no means certain that this rate of increase would be enough to maintain the current levels of provision in public services because it will be more difficult for the new Labour government to squeeze other areas of public spending in order to increase spending on health and education. Many of the usual targets for public spending reductions — for example, capital expenditure — have already been reduced to a level that would be difficult to reduce further, and if the government wishes to meet demands for substantial improvements in the provision of public services, it is difficult to imagine that these could be achieved without the share of public expenditure in GDP rising. If this were to happen, it would be unlikely that the rules of thumb for sustainable public finances could be met without increases in taxation.

The government is no doubt serious in its intent to hold down spending, but it may come under severe pressure from its back-benchers to increase public spending on front-line services as the PSBR falls. If economic growth is faster than forecast in the near term, the PSBR will fall very rapidly, as it did in the late 1980s. In these circumstances, it might prove hard for the government to refuse demands for spending increases. But if spending is allowed to grow faster in real terms than the long-term trend growth rate of the economy (i.e. 2.25% of GDP), then matching tax increases will be required once the level of economic activity had been brought back to trend. This scenario of rapid growth and a collapsing PSBR could therefore be a difficult and dangerous one for the government to handle.

4. Issues in personal taxation

The last twenty years have seen almost continuous debate about income tax, and in particular the statutory rates of that tax. Despite the fact that income tax accounts for only around one-quarter of total government revenue, cutting tax rates has often seemed to be one of the main objectives of political parties. Reductions in tax rates can be, and often have been, funded by changes to other parts of the income tax system or by increases in other taxes. The reduction in the basic rate of income tax during the 18 years of Conservative government did not coincide with an overall reduction in taxation, and too often was paid for by increases in revenue that did not leave the overall tax system improved.

We have argued in Chapter 3 that substantial net increases in personal tax in this Budget are unlikely, but changes that did not raise the overall burden of tax would be possible. It is worth noting that the June 1979 Budget, the first of the Conservative government, shifted revenue around, by cutting income tax and raising VAT. Shifting from direct to indirect tax would be unlikely under a Labour government but the restructuring of income tax remains a possibility, and it is this that is the main focus of this chapter.

While substantial change is exciting, and many governments have chosen to make changes as soon as they begin, a more measured approach would have much to recommend it. A Budget this summer which did not make major changes to the personal tax system but which raised a series of issues for discussion and mature reflection would have much to recommend it. Dramatic and decisive action is only welcome if the changes are wise. We would far rather see a 'dull' Budget now, with effort devoted to developing a coherent and practical approach to change over the next decade, than a 'flashy' Budget which lacked substantial underpinning.

Given the time constraints under which the government is operating, a Budget that does little to income tax must be a strong possibility. We do not here discuss in any detail the wider issues behind a coherent agenda for long-term reform, but we do consider the principal change to the income tax structure that the government has advocated, a new lower starting rate.

4.1 A new lower starting rate of income tax

It is rather unlikely that any significant increases in the burden of income tax for 1997-98 will be presented in this Budget, because these would lead to substantial one-off reductions in employees' July or August pay-packets (see Appendix B on timing). But this does not imply that the Labour government could do nothing to reorganise the direct tax system towards its objectives.

The key commitment on income tax changes in the Labour Party manifesto was

> *our long term objective is a lower starting rate of income tax of ten pence in the pound. Reducing the high marginal rates at the bottom end of the earning scale — often 70 or 80 per cent — is not only fair but desirable to encourage employment.*

It must be a possibility that some steps will be taken towards a 10% starting rate of income tax. We begin by looking at how a 10% starting rate could be implemented and show the trade-off between the revenue cost of such moves and the width of the new 10% band. At first sight, a 10% starting rate of tax is a conceptually straightforward adjustment to the tax system but there are a number of complex issues lurking below the surface. In particular, we examine the rather opaque interaction between a 10% starting rate of income tax and the married couple's allowance and the effect that the new rate would have on the taxation of savings. We consider measures that could fund a 10% starting rate, although we stress that there is no reason why the revenue raised from any of these measures could not be used to implement other priorities of the new government.

4.2 Moving towards a 10% starting rate

There are three principal ways in which the government could move toward the creation of a 10% starting rate of income tax. The most obvious is to reduce the current 20% lower rate while keeping the width of the band constant at £4,100. Each 1 percentage point reduction in this rate would cost the government just under £1 billion. To cut the lower rate to 10% in one move would cost £9.5 billion.

An alternative to this approach would be to introduce a 10% rate immediately, but on a narrower band of income. Under this option, one could either keep the current 20% band or abolish it and use the revenue raised to increase the width of the new 10% band. Table 4.1 shows the width of the 10% band that would be associated with a range of revenue costs. So £1 billion would fund a 10% band on £375 of income if the 20% band remained and on £1,150 if the 20% band were abolished; £4 billion would increase these band widths to £1,600 and £2,100 respectively.

For reforms of relatively low exchequer cost, a much wider 10% band is introduced if the 20% band is abolished than if it is retained as the abolition of a substantial part of the 20% band claws back some of the gains from the new 10% band. At higher exchequer costs and a wider 10% band, less money is clawed back from the 20% band so the difference between the two methods diminishes.

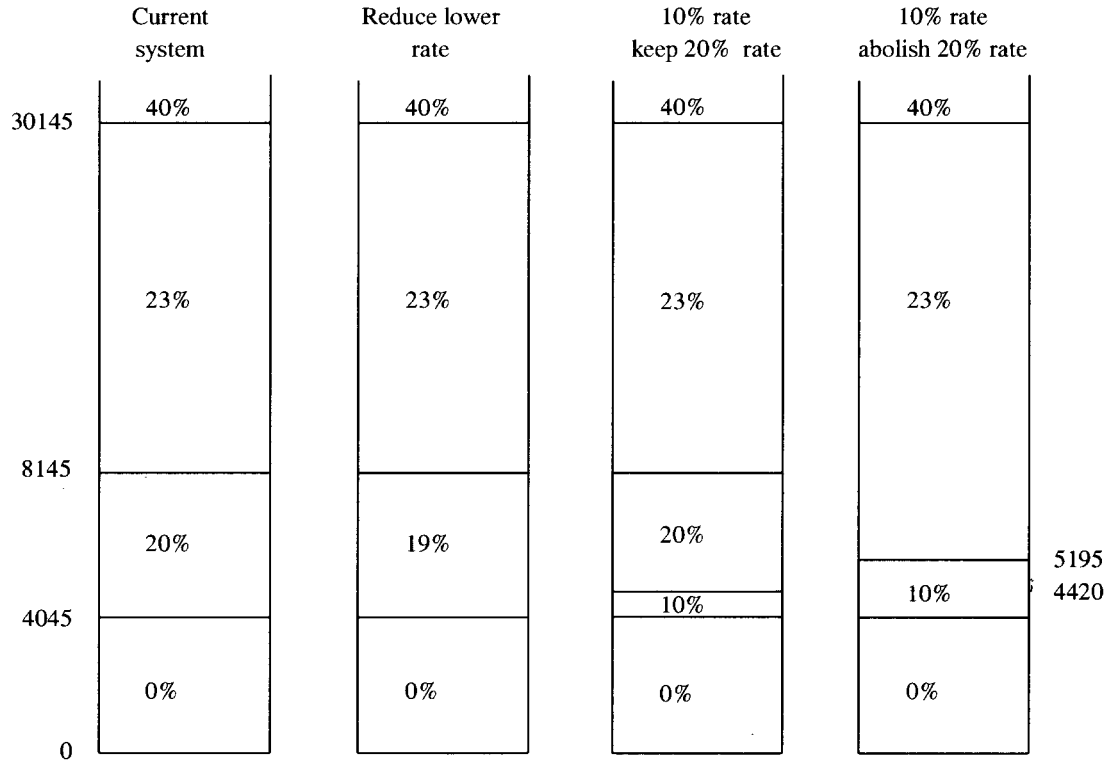
Figure 4.1 shows a representation of the marginal rates of income tax implied by the three approaches at a cost of £1 billion. The current tax system is shown in the left-hand

Table 4.1. Width of 10% band for given revenue cost

Revenue cost	*Reduced lower rate*[a]	*Starting rate of 10% with 20% lower rate* (£)	*Starting rate of 10% and abolition of 20% rate* (£)
£1 billion	19%	375	1,150
£2 billion	18%	750	1,450
£4 billion	16%	1,600	2,100
£8 billion	12%	3,400	3,600

[a]Rates are rounded to nearest 1%.

Figure 4.1. Marginal tax rate structure for a single person



Note: This figure is not to scale.

block. No tax is paid on the first £4,045 of income because the personal tax allowance is offset against this income. The next £4,100 is taxed at a marginal rate of 20%. The basic rate of income tax applies to income between £8,145 and £30,145, with all income above this level taxed at the higher rate of 40%.

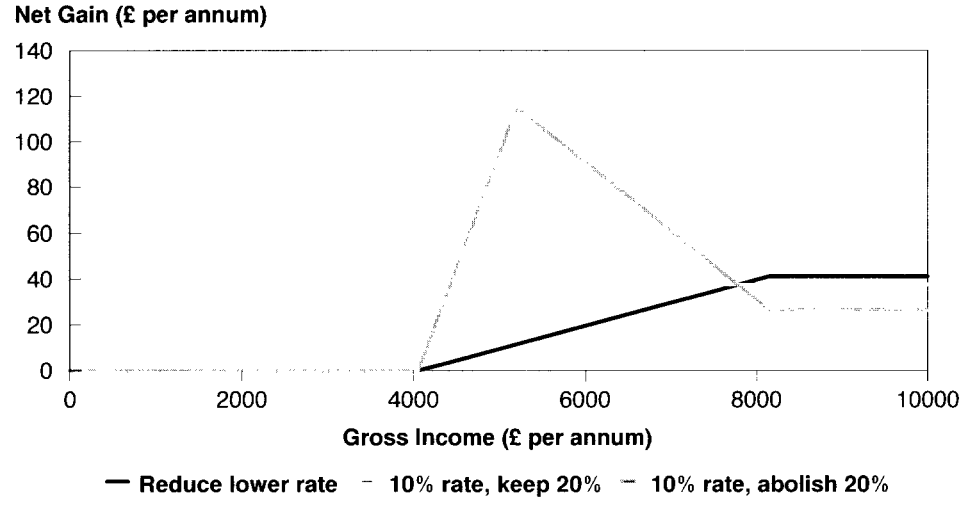
Under the first option — reducing the current lower rate — the lower rate of 20% falls to 19% but the points at which marginal tax rates change remain the same as under the current system. If a 10% rate is introduced while retaining the current 20% rate, we get another point at which marginal tax rates change. Now income between £4,045 and £4,420 is taxed at 10% as opposed to 20%. Above £4,420, the rates of tax are the same as the current system. If we introduce a 10% band and abolish the 20% rate, we produce a wider 10% band, covering £1,150 of income for the same £1 billion cost. The 10% band under this option is wider because income in the range from £5,195 to £8,145 is taxed at the basic rate of 23%, rather than the lower rate of 20% as under the current system. The revenue gained from this is used to increase the width of the 10% band.

It is apparent from Figure 4.1 that the three means of introducing a 10% band would eventually lead to the same tax system as cost of the changes increased. For £9.5 billion, we could have a 10% band replacing the current 20% band achieved by any of the three methods.

Distributional effects of a 10% tax rate

These three options produce different patterns of gains at different income levels, as shown in Figure 4.2 for a reform costing £1 billion. Those with incomes below £4,045

Figure 4.2. Distribution of gains from move to 10% band for a single person not on benefits



per year gain nothing under any of the reforms because they do not pay any income tax. If we reduce the current lower rate to 19%, the gains increase steadily as income rises between £4,045 and £8,145. This is because income in this range is being taxed at 19% rather than 20%. For all those with incomes above £8,145, the gain is a flat rate, £41[1] per year in this example.

If a 10% rate is introduced immediately, the gains rise more sharply after £4,045 as income is being taxed at 10% rather than 20%. Where the 20% band is retained, the gains reach £37.50[2] per year when income is £4,420 per year. After this point, the gains remain at this level as all additional income is taxed at the same rate as under the current system.

Where the 20% rate is abolished, the gains from the wider 10% rate continue to accrue as income increases between £4,045 and £5,195. The maximum gain will be £115[3] per year. As income continues to rise, the gains from the change start to *fall*, as income in the range £5,195 to £8,145 is being taxed at 23% rather than 20%. When income reaches £8,145, the gain from the change is reduced to £26.50[4] and all those with incomes above this level receive the same flat rate gain.

Overall, a 10% rate combined with the abolition of the 20% rate produces the most progressive results, with higher gains for those on lower incomes coupled with lower gains for those on higher incomes than under the other two options. If this is the objective of the reform, an increase in income tax allowances would be even more successful in achieving these aims, as we show in Section 4.5.

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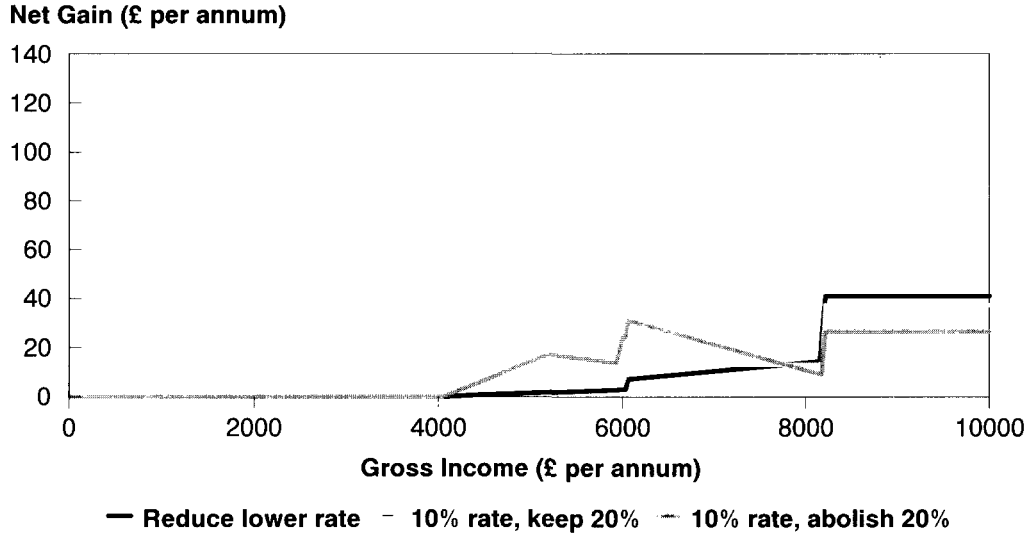
[1] (8,145 - 4,045) × (0.20 - 0.19) = 4,100 × 0.01 = 41

[2] (4,420 - 4,045) × (0.20 - 0.10) = 375 × 0.10 = 37.50

[3] (5,195 - 4,045) × (0.20 - 0.10) = 1,150 × 0.10 = 115

[4] 115 - [(8,145 - 5,195) × (0.23 - 0.20)] = 115 - [2,950 × 0.03] = 26.50

Figure 4.3. Distribution of gains from move to 10% band for a single person on housing benefit and council tax benefit



So far, we have considered the direct effect of the changes on income tax payments. But for those on means-tested benefits, cuts in income tax do not translate directly into increases in disposable income because the amount of means-tested benefits paid to claimants is decreased. For example, if the post-tax income of a person on housing benefit increases by £1 per week, the amount of housing benefit paid is reduced by 65p. If this person were also receiving council tax benefit, this would be further reduced by 20p, leaving the person only 15p better off as a result of the £1 increase in income. A person receiving family credit as well as housing benefit and council tax benefit would gain just 4.5p.

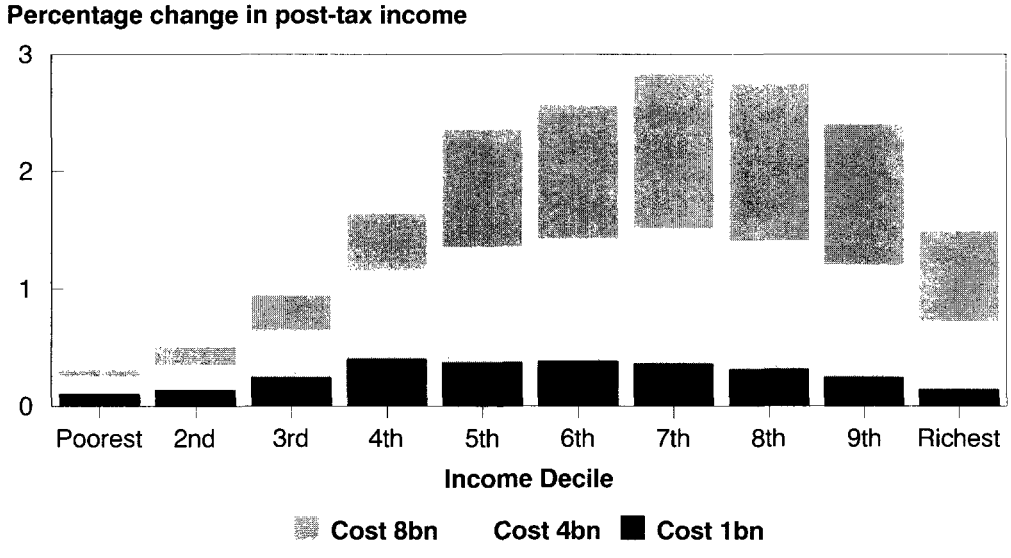
This has a large impact on the overall amount that people on means-tested benefits would gain from the introduction of a 10% starting rate of income tax. Figure 4.3 shows the cash gains for a single person on housing benefit and council tax benefit. As in Figure 4.2, the numbers are based on a package that costs £1 billion.

The gains for those with incomes below £8,000 are much lower than those in Figure 4.2 due to the withdrawal of means-tested benefits. For example, where the gain was £115 (income level of £5,195) for the reform introducing a 10% rate and abolishing the 20% rate, it is reduced to £17.25. Once entitlement to means-tested benefits ends (housing benefit is exhausted at just over £8,000 for this example), the gains rise to those shown in Figure 4.2. The main point is that the poorest groups of taxpayers often receive means-tested benefits and these groups will gain significantly less from the introduction of a 10% starting rate than those on higher incomes.

The overall distributional effect of a 10% starting rate is shown in Figure 4.4. We have implemented the starting rate by abolishing the current lower rate and replacing it with a 10% band, which produces the most progressive results. For a £1 billion package, the decile with the maximum gain, in percentage terms, is the fourth decile. However, as more money is spent on the reform, the results are less progressive. If £4 billion or £8

billion were spent, the largest gains would go to the seventh decile, as only those with incomes above the new 10% band gain as it is progressively widened.

Figure 4.4. Distributional effect of a 10% tax rate



4.3 Complexities arising from a 10% band

There are a number of wider issues that are raised by the introduction of a 10% rate of income tax. The first concerns the interaction between the married couple's allowance and a 10% starting rate. In addition, the basic rate of tax on savings and on dividends and the rate of advance corporation tax are the same as the current lower rate of tax, namely 20%. This raises the issue of what would happen to these rates if a new 10% band were introduced.

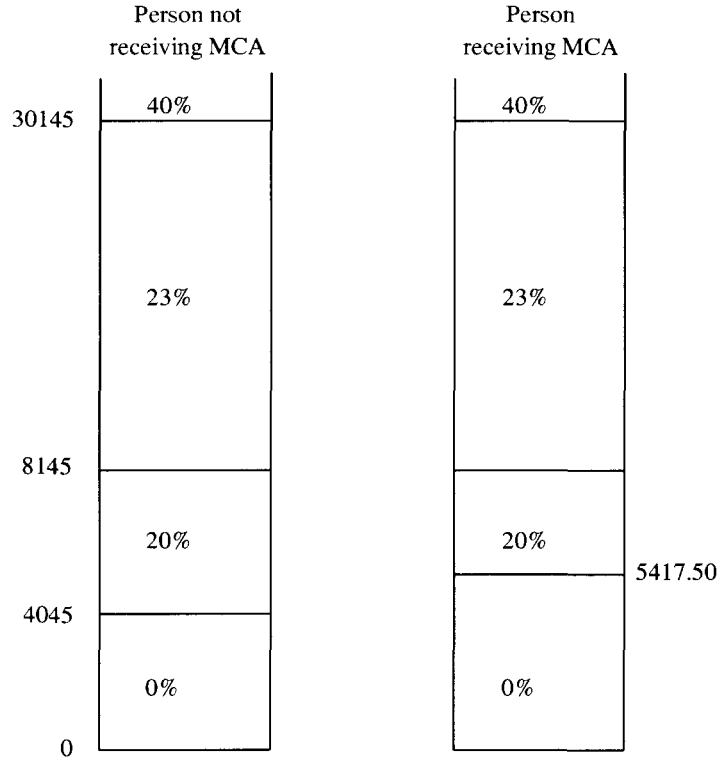
The married couple's allowance

The married couple's allowance (MCA) is an additional allowance, on top of the individual personal allowance (PA), which is available to married couples. An equivalent allowance, the additional personal allowance (APA), is available to lone parents and cohabiting couples with children. The operation of the MCA means that the way in which we describe the tax system does not correspond to the way that the tax system actually works. In particular, it is possible that the formal tax system could contain a 10% tax rate, but that those receiving the MCA would never pay income tax at this marginal rate. We can see why this would be the case by looking at the effect of the MCA in the current tax system.

Figure 4.5 illustrates the effect of the MCA on the current income tax structure. The left-hand block shows the effective tax structure for someone not receiving the MCA, and is the same as the current tax system for a single person considered in Section 4.2. The personal allowance is £4,045 a year, so all income in the range £0 to £4,045 is untaxed. The formal width of the 20% band is £4,100, so the next £4,100 of income —

that is, income between £4,045 and £8,145 — is taxed at the lower rate of 20%. Above this point, income is taxed at the basic rate of 23% until the basic-rate limit is reached at £30,145.

Figure 4.5. Impact of MCA on the effective tax structure



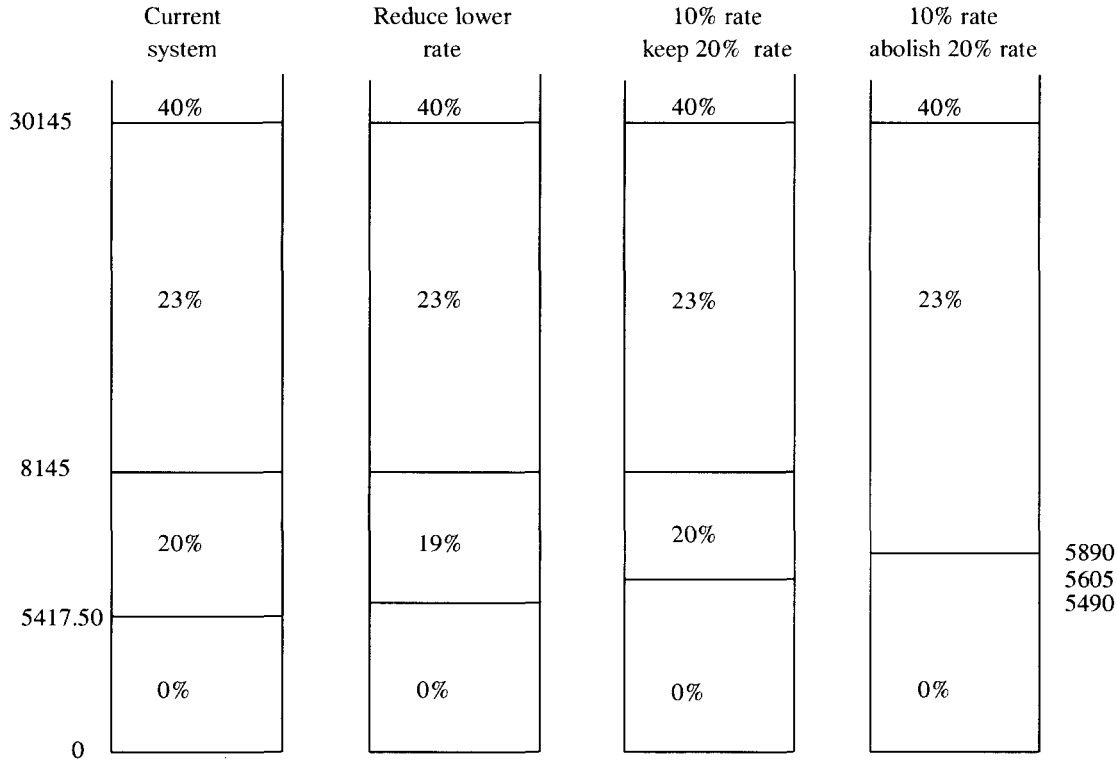
Note: This figure is not to scale.

The right-hand block shows how the MCA affects the tax paid by a person. It increases the point at which people start paying tax from £4,045 to £5,417.50, but it does not affect the points at which people start paying basic- or higher-rate tax. So people start paying tax at 20% when their income is £5,417.50 and move to paying at 23% when their income is £8,145. So the *effective* band of income taxed at 20% is only £2,727.50, rather than £4,100. The MCA has, in effect, 'eroded' the width of the 20% band.

Why does the MCA have this effect? While the MCA is formally an allowance of £1,830 restricted to 15%, this description is quite misleading. The MCA is implemented as a tax credit worth £274.50. The £274.50 figure comes from multiplying the value of the allowance, £1,830, by the restriction rate, 15%. The implementation of a tax credit is quite straightforward. First, a person's initial tax liability is calculated ignoring the existence of the credit (the gross tax liability). So in the case of the MCA, a person's tax is calculated in the same way as for a single person. Then the gross tax liability is reduced by the value of the credit. Anyone whose gross tax liability is lower than the value of the credit pays no tax. To have a gross tax liability of £274.50, one would need to have £1,372.50 of income taxed at 20%.[5] We can now see where the £5,417.50

[5] 274.50 ÷ 0.20 = 1,372.50

Figure 4.6. Impact of MCA on the effective structure of move to 10% starting rate



Note: This figure is not to scale.

number in Figure 4.5 originates. It is the personal allowance, £4,045, added to the range of income over which the MCA stops people paying tax, £1,372.50.

The impact of the MCA is to erode the width of the lower rate of tax. Where the width of this lower rate is too narrow, this erosion can completely remove the band from the effective tax system. If we introduce a 10% lower rate at a cost of £1 billion, as discussed in Section 4.2, the interaction of this new lower rate with the MCA leads to what might first seem a rather odd result. Figure 4.6 illustrates that, under such a reform, *no one* receiving the MCA actually ends up paying tax at the new 10% rate. This is because the new 10% band width is smaller than the amount of income necessary to stop the MCA completely eroding the band. The 10% band would have to be £2,745[6] wide, which would cost over £5 billion, before anyone receiving the MCA would begin to pay tax at a marginal rate of 10%. So while the formal change to the tax system is to introduce a 10% band, the effect on people receiving the MCA is the same as an increase in their tax allowance.

The basic rate of tax on savings

In the November 1995 Budget, Kenneth Clarke reduced the basic rate of tax on income from savings to 20% from 25%. This move was, in part, an administrative simplification made necessary by the introduction of the 20% lower rate in 1992. Where tax on savings was deducted at source (e.g. a bank paying tax on interest payments before the interest

[6] 274.50 ÷ 0.10 = 2,745

is debited to the depositor's account), it was paid at the basic rate of income tax. Higher-rate taxpayers had to make an additional payment, while lower-rate taxpayers could reclaim the difference between tax at the basic rate and tax at the lower rate. By 1995, one-fifth of all taxpayers (about 5 million individuals) paid at the lower rate and there was a very high administrative burden for reclaiming relatively small overpayments of tax. In reality, many people never reclaimed the tax owed, but while administrative costs were avoided, this could hardly be described as a desirable system.

Setting the basic rate of tax on savings equal to the lower rate of tax effectively removed this problem. Tax could now be deducted at source at a rate of 20% for all lower- and basic-rate taxpayers and no further adjustments were necessary. The introduction of a 10% band would leave the government with a number of options. The first would be to lower the basic rate of tax on savings to 10%. The second option would be to leave the basic rate of tax on savings at 20% and expect those paying at the new 10% rate to reclaim tax overpayments made at source. The final option would be to keep the rate of tax on savings at 20% for those paying tax at the new 10% starting rate.

For a narrow 10% band, the reclaim issue would not be large, but if the band were widened, the problem would grow. It would be desirable to avoid the problem completely in the first place. However, the main obstacle to reducing the basic rate of tax on savings to 10% is the cost, which would be about £1 billion. Much of this money would go to richer basic-rate taxpayers with relatively large amounts of savings. The final option, of keeping the 20% rate on interest income, avoids the reclaim problem and does not involve any cost to the government, but would lead to the rather odd situation in which savings were taxed more heavily than other income for 10% rate taxpayers and less heavily for basic-rate taxpayers.

Tax on dividends and advance corporation tax

As well as the basic and lower rates of tax on interest income being set at 20%, the basic and lower rates of tax on dividend income and the rate of advance corporation tax (ACT) are also 20%. The effect of cuts in the ACT rate is discussed in detail in Chapter 5. The main issue with respect to income tax is that, since cutting the ACT rate raises revenue, part of the cost of achieving a lower starting rate of income tax could be met from this source. But there is no special reason for believing that any revenue generated from a lower ACT rate would best be used to cut income tax. And it would be possible to leave the ACT rate unchanged while cutting the starting rate of income tax, leaving lower-rate taxpayers to reclaim excess tax paid directly from the Revenue.

4.4 Funding revenue-neutral changes

We now consider a number of measures that could be employed by the Chancellor if he wished to raise revenue to fund a 10% starting rate of tax. Note that in all cases, we consider the impact of these changes in relation to the present tax system and not one in which a 10% starting rate had been introduced. So, while adding the results here to the results shown in Section 4.2 will give a fairly accurate impression of the overall effect of a package, there may be some additional interactions between the reforms which would lead to slightly different results.

It should also be noted that though we present this section in the context of the introduction of a 10% tax rate, there is no necessary connection between any of the measures outlined here and a 10% rate. All of these measures could be introduced whether or not a 10% tax rate existed, and any revenue generated from these changes could be used to implement any of the government's priorities.

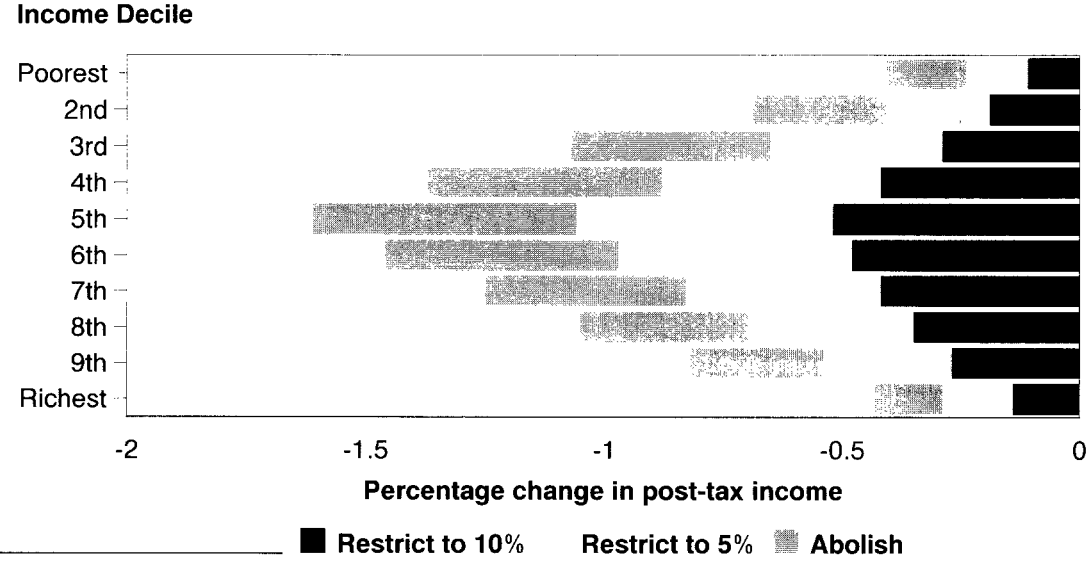
Restricting the married couple's allowance

One of the options for raising money to finance a 10% lower rate of tax would be to restrict the MCA further. The value of the allowance has been eroded gradually since its introduction in 1990. It was fixed at £1,720 until the 1995 Budget. Since then, it has been increased to £1,830 to take account of inflation. In April 1994, it was restricted to 20 per cent and in April 1995 to 15 per cent.

There is clearly scope for funding a 10% starting rate of tax at least in part through the imposition of further restrictions on the MCA. Given that the value of the MCA has been reduced quite substantially in recent years by the previous Conservative government, a precedent can be claimed for restricting it further. In addition, restricting the MCA further would help to ameliorate the erosion of the starting rate tax band that was highlighted above. Note, however, that there is no requirement for the rate of the MCA restriction to change with a change in tax rates — we already have a system where the MCA is restricted to a rate (15%) that differs from any rate of income tax.

Figure 4.7 illustrates the effects of restricting the MCA to 10% or 5% or abolishing it altogether. A 10% restriction would raise just over £1 billion, a restriction to 5% would result in around £2.2 billion more tax revenue for the government, and abolishing the MCA altogether would raise an additional £3.5 billion. Inevitably, it is married couples[7] who will lose out from such a measure, and those families in the middle of the distribution lose proportionately more than those at the top. For example, abolishing the MCA altogether would result in average losses of 1.6% of net income in decile 5,

Figure 4.7. Distributional effects of restricting the MCA



[7] And unmarried parents, as the APA is restricted/abolished in parallel.

compared with 0.4% for the richest tenth. This is because all current eligible taxpayers would lose the same cash amount under each restriction (£91.50, £183 or £274.50, depending on whether the restriction is set at 10% or 5% or whether the allowance is abolished altogether). These absolute amounts constitute a smaller proportionate loss as income rises.

However, losses at the very bottom of the income distribution are relatively small; for example, the bottom decile loses 0.4% from abolition of the MCA. This results from married couples in this part of the distribution being much less likely to pay income tax and therefore benefit from the allowance.

Restricting mortgage interest tax relief

Like the MCA, the real value of mortgage interest tax relief (MITR) has been eroded over time. A nominal £30,000 ceiling has been in operation since 1983 and relief has been restricted gradually to its current level of 15%. There is no reason why the rate of relief in MITR should necessarily be the same as a rate of income tax, so reducing the starting rate of tax should not automatically lead to further restrictions on MITR.

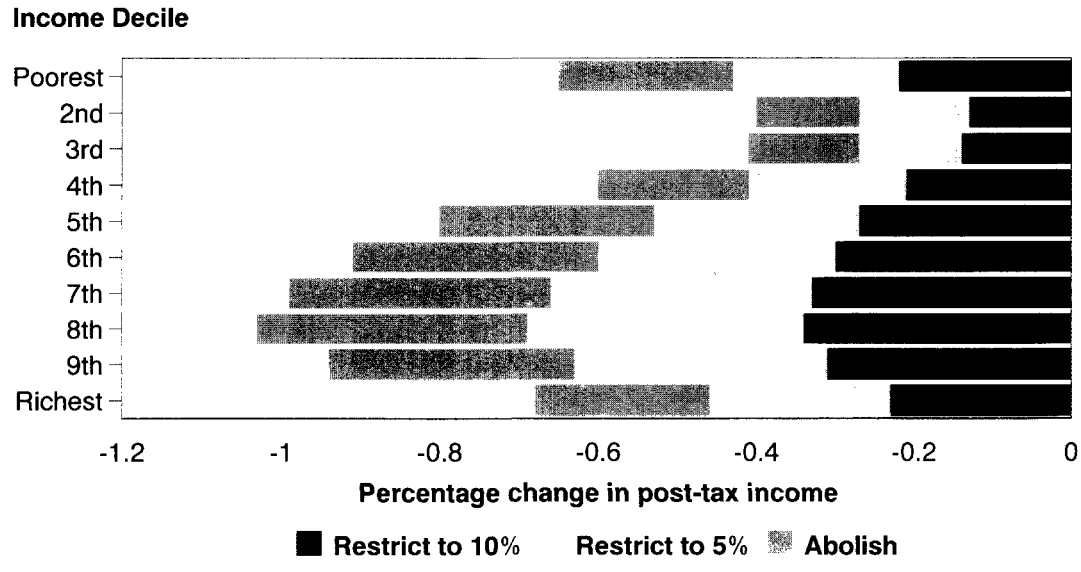
A government wishing to fund income tax cuts might see MITR as an attractive tax relief to cut because there are sound economic reasons why it should never have been introduced into the tax system. On introduction, it reduced the costs of mortgages for owner-occupiers, distorted individuals' housing tenure choices and distorted their asset-holding choices towards owner-occupation. But over time, these distortions led to the value of MITR becoming absorbed into higher house prices. Mortgagers who bought after the introduction of MITR benefited little because they had larger mortgages to service.

So if MITR is further restricted or abolished, people who bought properties after its introduction will be genuine losers. This serves to highlight that adding 'incentives' into the tax system can often fail to achieve the original purpose, that it is expensive and that the measures are difficult to remove from the system. Of course, that losers will be created does not mean MITR cannot be further restricted, and the current low rates of interest and rising house prices mean that now is one of the best times to take action on MITR.

The revenue gained from further restricting MITR to 10% or 5% or its complete abolition would be around £1 billion, £2 billion or £3 billion, respectively. Distributional effects are shown in Figure 4.8. Losses increase as we move up the income distribution as the value of people's houses rises and there are more home-owners, until decile 8 where the £30,000 limit makes a significant impact on losses relative to income levels.

Losses at the bottom end of the income distribution are larger than one might first expect, which reflects the low incomes of mortgagers in these poorer groups making their proportionate losses relatively large. These groups are mainly the short-term unemployed, for whom income support does not cover the increase in their mortgage payments. It would be possible to compensate this group by changing the income support rules to cover their mortgage interest payments, as is the case for the longer-term unemployed. However, people with mortgages have much shorter expected unemployment spells and higher expected in-work earnings relative to other unemployed groups, so the problem may not be thought to be as great as for groups likely to remain poor in the longer term.

Figure 4.8. Distributional effects of restricting MITR



Restricting the personal allowance

Another area in which there has been much recent speculation about the possibility of generating extra revenue is the potential for restricting the personal tax allowance. Here, we will consider the effects of three different options for implementing a restriction — a restricted allowance at 23%, a tax credit at 23% and a tax credit at 20%. These measures raise additional tax revenue of £1.9 billion, £1.5 billion and £4.8 billion, respectively. The actual impact of these changes remains rather opaque, which is often given as a reason, but a dubious one, for using this means to raise revenue.

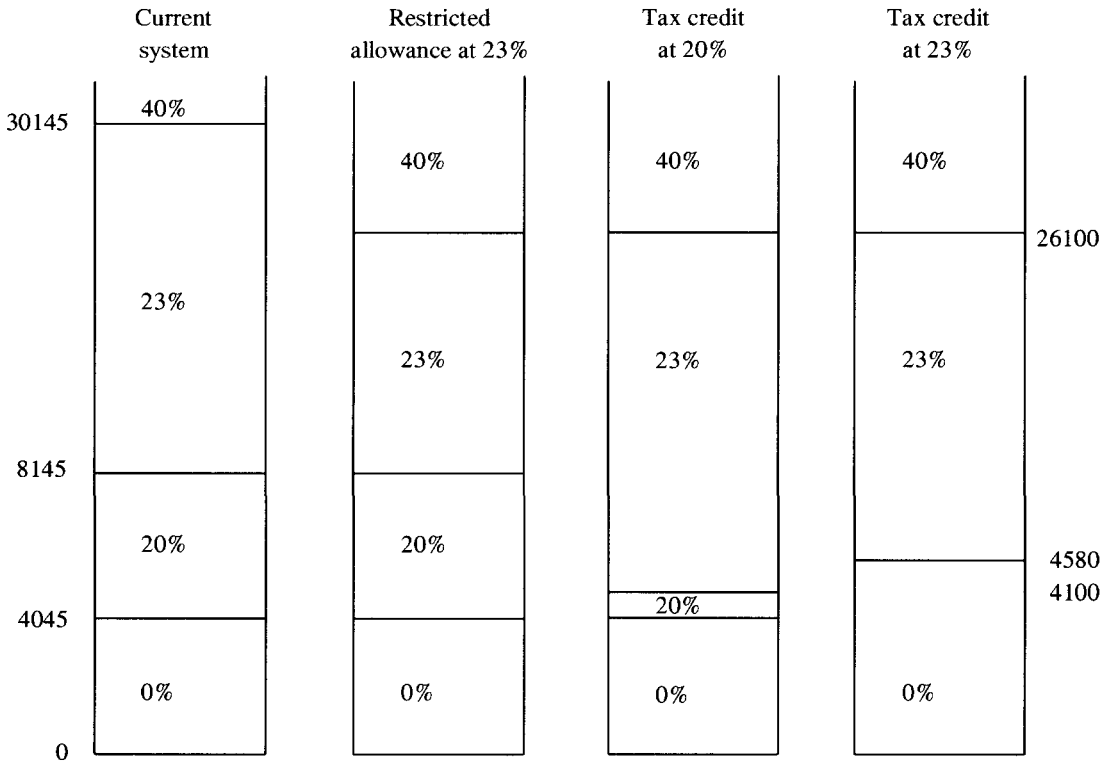
Figure 4.9 provides a graphical illustration of what there restrictions would mean in terms of the effective tax system. We show the changes for a single person to avoid the added complexity of the interaction with the married couple's allowance, but the general results are the same for those receiving the MCA.

Again, the current effective tax system for a single person is shown in the first block. The second block shows the effect of making the personal allowance a restricted allowance at 23%. This effectively lowers the point at which people start paying higher-rate tax from £30,145 to £26,100. This fall is £4,045, which is the size of the current personal allowance. So the effect of a restricted personal allowance at 23% is *identical* to a reduction in the basic-rate limit of £4,045. Current basic-rate taxpayers with incomes over £26,100 and all higher-rate taxpayers would lose from the change. All other people paying tax at the basic rate and those paying at the lower rate would be unaffected by this change.

The third block shows the impact of turning the personal allowance into a tax credit at 20%.[8] In this case, the levels of income at which people start paying basic and higher-

[8] A restricted allowance at 20% would have an identical effect.

Figure 4.9. Impact of restricting personal allowances on effective tax structure for a single person



Note: This figure is not to scale.

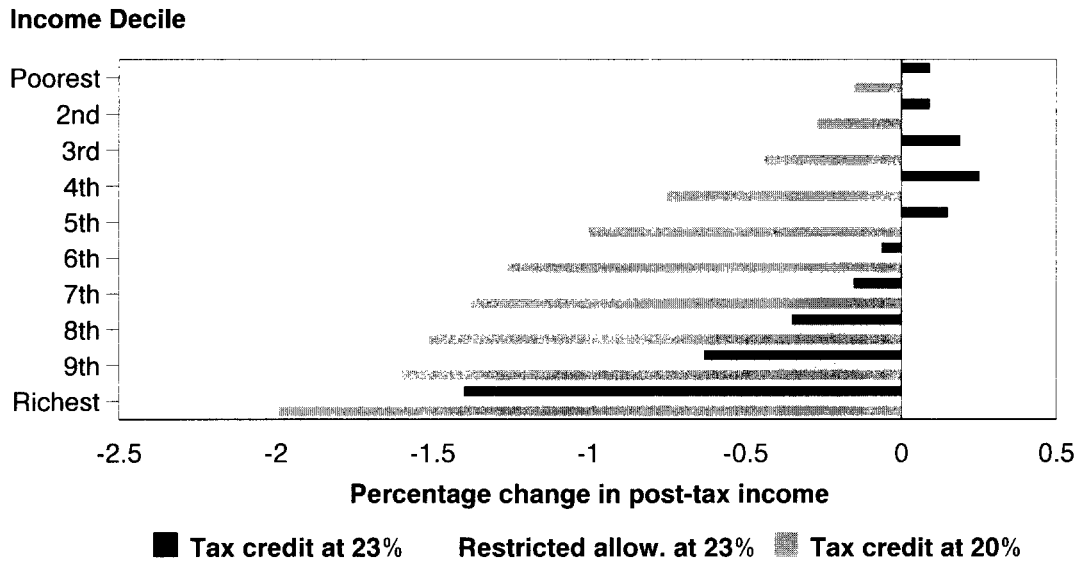
rate tax both fall by £4,045. So people start paying basic-rate tax when their income exceeds £4,100, rather than £8,145 as under the present system. This means that, while the formal 20% band would still cover £4,100, the effective 20% band would only cover the £55 of income between £4,045 and £4,100. Everyone with income above £4,100 would be worse off under this change.

Finally, the last block in Figure 4.9 shows the impact of a tax credit at 23%. This tax credit is more generous than the 20% tax credit considered above, so this has the effect of pushing up the point at which people start paying tax. As we saw in Section 4.3, this increase in the point at which people start paying income tax erodes the effective width of the lower rate of tax. With a 20% tax credit, the effective 20% band was only £55 wide; with a 23% tax credit it disappears altogether. People now start paying tax when their income is £4,580 and are taxed at 23%.

A person with an income of £4,580 would be *better off* than under the present system as they would pay no tax while currently they pay £107 per year. Indeed, everyone whose income is between £4,045 and £8,145 would gain from a tax credit at 23%. There would be no change for those with incomes between £8,145 and £26,100. Those with incomes above £26,100 lose from the change.

The distributional effects of these three changes are shown in Figure 4.10. The tax credit at 20% generates the largest losses across the income distribution as it raises the most revenue. Losses also rise with income levels. If the personal allowance is restricted to 23%, higher-rate taxpayers lose the most and there are no losses at the bottom of the

Figure 4.10. Distributional effects of restricting the personal allowance



income distribution because no one pays higher-rate income tax. Gains to poorer groups resulting from a 23% tax credit are also illustrated in Figure 4.10, with the losses at the top end being virtually identical to those resulting from restricting the personal allowance to 23%.

'Clawback' from higher-rate taxpayers

It might be deemed undesirable that the introduction of a 10% starting rate of tax will benefit higher-rate taxpayers, particularly if part of the rationale for its introduction is redistribution. One way to offset the gains to higher-rate taxpayers, raising money for the exchequer at the same time, is to lower the basic-rate limit.

In Section 4.2, we saw that a 10% starting rate accompanied by the abolition of the 20% lower rate, which cost £1 billion, would mean that higher-rate taxpayers would gain £26.50 a year. The Chancellor could offset these gains completely by lowering the point at which individuals start to pay higher-rate tax. Such a move would reduce the cost of the change by £60 million, or 6% of the cost, but it would also draw more people into paying tax at the higher rate.

Restricting tax relief on pension contributions

The taxation of pensions, and saving more generally, is not an area for change without much thought and work. In particular, the highly substitutable nature of many savings vehicles makes any tax distinction between them quite as likely to generate shifting between assets as it is to generate a change in underlying real behaviour.[9] It would be depressing to see changes made in the Budget simply in a short-run attempt to fund reductions in income tax.

[9] See Banks (1996) for discussion with respect to PEPs and TESSAs in the UK.

Table 4.2. The tax treatment of pensions

	1 Current	*2 Current*	*3 Current*	*4 Restricted*	*5 Restricted*	*6 PEP*	*7 PEP*
Current tax status	Basic-rate	Higher-rate	Higher-rate	Higher-rate	Higher-rate	Higher-rate	Basic-rate
Future tax status	Basic-rate	Higher-rate	Basic-rate	Higher-rate	Basic-rate		
Earn	100	100	100	100	100	100	100
Income tax	23	40	40	40	40	40	23
Net	77	60	60	60	60	60	77
Refund	23	40	40	17.92	17.92	-	-
Fund	100	100	100	77.92	77.92	60	77
Income	10	10	10	7.79	7.79	6	7.70
Fund after 1 year	110	110	110	85.71	85.71	66	84.70
Tax on withdrawal	25.30	44	25.30	34.28	19.71	—	—
Net withdrawal	84.70	66	84.70	51.43	66	66	84.70

The largest numbers in the official table of tax expenditures in *Inland Revenue Statistics* (Inland Revenue, 1996) are for tax relief for occupational pension schemes, shown as £8 billion for 1996-97. It is little wonder that the taxation of pensions in particular, and savings in general, attracts attention. But this is a misleading figure, albeit accurately calculated. If both contributions and all fund income were taxed, as is the basis of the calculations, it would make saving in the form of a pension massively more heavily taxed than saving in a PEP, a TESSA or a house. It would also impose tax on purely inflationary income, which cannot be defended from the point of view of tax theory. The result would be substantial reduction in pension saving by the well advised, cutting any potential revenue gains and penalising the less well off and less well advised.[10] Any such change would be inconsistent with a desire to encourage savings generally. Major reform here certainly requires careful thought and consultation.

In the short term, one particular reform has been much discussed, and that is to remove higher-rate relief from pension contributions. Table 4.2 gives a simplified picture of the current pension tax regime and some alternatives to it. Consider an individual earning 100 and wanting to save it for one year and then spend the proceeds. A basic-rate taxpayer could simply pay tax on the 100 when receiving the earnings, leaving 77 to spend which could be kept under the mattress, while a higher-rate taxpayer would have 60 if the money were simply hoarded.

Column 1 of Table 4.2 shows what the basic-rate taxpayer could achieve by investing in a pension, rather than simply holding on to the money. For illustrative purposes, we assume the pension fund will make a return of 10% in a year. A tax refund of 23 would

[10] See Dilnot and Johnson (1993) and Dilnot (1996) for further discussion.

be given, making a pension fund of 100, which would earn 10, producing a total fund of 110. Tax on withdrawal would be 25.30, leaving 84.70, 10% more than the 77 if the money were left alone. For a higher-rate taxpayer, both while earning and in retirement, the corresponding figures are given in column 2, producing an outcome of 66, once again 10% more than the result with no investment. For an individual who is a higher-rate taxpayer in work but a basic-rate taxpayer in retirement (column 3), the result of giving pension contribution relief at the higher rate is the same final withdrawal as for the person who is a basic-rate taxpayer throughout. The current tax regime for pensions allows individuals to smooth their income, and therefore taxation, across their lifetimes, and effectively treats pensions as earnings when they are received rather than when paid; this confers a high rate of return on forgone consumption for those whose marginal income tax rate falls over time.

Now consider columns 4 and 5 of Table 4.2, which show the impact for the individuals shown in columns 2 and 3 of restricting pension contributions relief to the basic rate. Rather than a tax refund of 40 (60 × 40/60), the new refund would be 17.92 (60 × 23/77). This produces a final net withdrawal of 51.45 for the individual paying higher-rate tax throughout and of 66 for the basic-rate taxpayer in retirement who paid higher-rate tax while at work. Columns 6 and 7 show the working of a Personal Equity Plan (PEP) for comparison.

Clearly, any individual who expects to be a higher-rate taxpayer in retirement would be better off investing in a PEP, or even simply holding on to the money, than investing in a pension under this regime, which would effectively tax capital twice. The higher-rate taxpayer is 8.57 worse off (60-51.43) as a result of the pension investment. The basic-rate taxpayer in retirement under this regime achieves a return equivalent to a PEP, since, as in a PEP, tax rate smoothing is no longer possible. Given the flexibility of a PEP, or other real investments such as property, a pension would seem much less attractive even for higher-rate taxpayers who expect to be basic-rate taxpayers in retirement.

So even if it were possible, such a regime is open to substantial criticism. In practice, there would be significant problems of implementation. Restricting relief for employee contributions is quite easy and would be possible for employer contributions to personal money purchase schemes. However, for most occupational schemes, which are still defined benefit schemes, employers do not make individual-specific contributions. It would be absurd simply to restrict higher-rate relief for employee contributions, since we would expect a rapid shift from employee to employer contributions. And with an income tax system that already has four rates (0%, 20%, 23% and 40%), choosing any of the rates to impose on employer contributions creates inequity. It is also worth noting that any shift to taxing contributions would be likely to encourage unfunded arrangements.

One element of the tax treatment of pensions for which it is hard to find any coherent defence is the tax-free lump sum. There is little doubt that this should not exist in an ideal world, but it is hard to remove. Any change needs to be phased in over a long period to avoid disappointing the expectations of those close to retirement who cannot change their saving plans in time to adjust. This means that plausible changes raise very little revenue in the short term, while probably creating very significant opposition. In the long run, the potential revenue to be had could be as much as £1 billion per year.

One way of reducing the cost of pension tax reliefs without appearing to impose dramatic changes would be to freeze the pensions cap, currently £84,000, or move to increase it by less than price inflation. Such a change would make final salary schemes much less attractive for young workers, and might shift substantial amounts of saving into PEP-type forms, bringing significant cash-flow gains to government, since in a PEP the tax is paid at the beginning of the saving period, rather than at the end as under a pension.

4.5 Are there merits in a 10% starting rate?

One question that we have not addressed thus far is why we should want to introduce a 10% starting rate of tax in preference to increased income tax allowances. Indeed, as we have pointed out above, the introduction of a 10% rate of tax is effectively an increase in an allowance for those receiving the MCA. And there are clear advantages to extending allowances in preference to creating new lower rates of tax.

For simplicity in the tax system, an increase in allowances is better because it moves those with the lowest income tax liabilities out of tax altogether. Allowance increases also avoid the proliferation of different marginal rates of tax and the complexity that accompanies them. Where there is concern over the distributional impact, increases in tax allowances concentrate the gains from income tax cuts on those with the lowest incomes.

Where there is concern for work incentives at the bottom end of the earnings scale, allowance reductions will produce higher incomes in work at lower earnings levels. But those on means-tested benefits gain far less from any tax change than those not on benefits. So if the objective is to increase incomes for low-paid workers, significant changes can only be achieved by altering the benefit system rather than by altering the tax system.

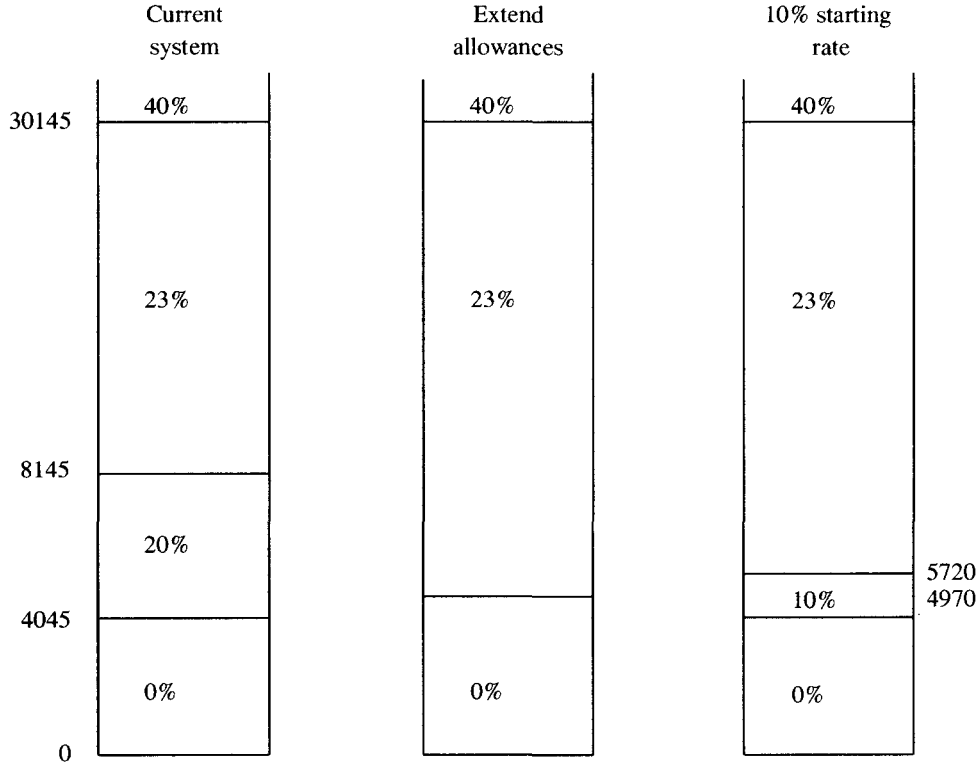
A simpler, more effective alternative to a 10% rate

We have argued that an increase in allowances is preferable to a 10% starting rate of tax. We will now illustrate this point by comparing two potential reforms, one involving an allowance increase and one involving a 10% starting rate of tax. In both cases, the changes are funded by the abolition of MITR, which raises £3 billion. In addition, we have altered the benefit system to allow income support to cover mortgage interest payments for all claimants to compensate low-income recipients for the loss of MITR.

The £3 billion raised, alongside the abolition of the 20% band, allows allowances to be extended by £925. The basic-rate limit has been adjusted to prevent higher-rate taxpayers gaining more than basic-rate taxpayers from the allowance increase.[11] The resulting tax system for a single person is shown in the central block in Figure 4.11. A person would start paying tax at £4,970 and would immediately pay at the basic rate of 23%. They would start paying tax at 40% once their income exceeded £30,145.

[11] This last point is necessary as a result of the fact that the basic rate limit is quoted in terms of taxable income, which is gross income minus the personal allowance. This keeps the numbers paying higher-rate income tax the same.

Figure 4.11. Effective tax structure of alternative proposals for a single person



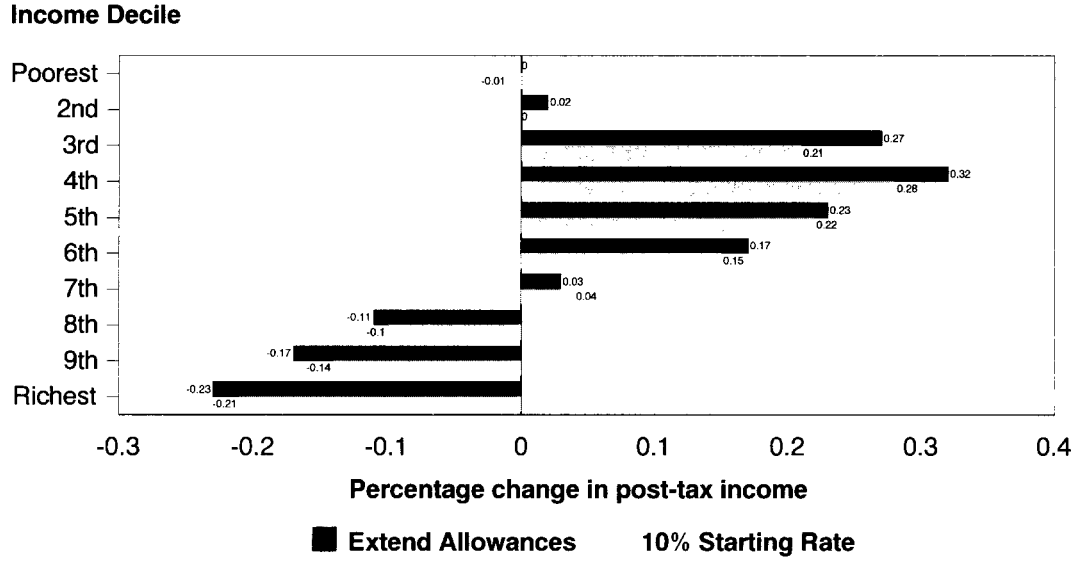
Note: This figure is not to scale.

For the reform with a 10% starting rate, the width of the 10% band is £1,675 with the current 20% lower rate abolished. As noted in Section 4.2, the implementation of a 10% starting rate in this way produces more progressive results than any of the alternatives. The right-hand block in Figure 4.11 shows the effective tax structure for a single person under this package.

So how do the results of the two packages compare with each other? First, under the reform that increases allowances, the structure of the tax system is more straightforward. There are only two marginal tax rates, 23% and 40%. The bulk of people pay tax at the same marginal tax rate of 23%, which makes the treatment of taxes at source easier to handle. In addition, 1.8 million people stop paying tax altogether, compared with only 0.5 million people moving out of tax with a lower starting rate caused by accident by the interaction between the married couple's allowance and the new 10% lower rate (see Section 4.3).

The distributional outcome of each package is shown in Figure 4.12. As we would expect, the packages produce similar results. The bottom two deciles are basically unaffected by the changes; deciles 3 through to 7 gain on average from the changes, while the richest three deciles lose. However, the allowance change produces the more progressive results. The poorest six deciles are better off with higher allowances than with a 10% starting rate of tax, while the richest four deciles are worse off. If targeting tax cuts toward those towards the bottom end of the earnings distribution is one of the government's objectives, then an increase in allowances is preferable to a 10% starting rate, even where the latter is implemented in the most progressive way possible.

Figure 4.12. Distributional impacts of extending allowances or creating a 10% starting rate



So increasing allowances produces a simpler, more progressive tax system than a reduced starting rate of income tax. It also moves many more people out of the income tax net altogether. And, as we pointed out in Section 4.3, for those receiving the married couple's allowance, the formal 10% starting rate is in effect an increase in allowances. If it were not for this, the 10% starting rate would be even less progressive relative to an allowance increase and no one would be moved out of the income tax net.

4.6 Conclusions

At first sight, the implementation of a 10% starting rate of tax seems straightforward and desirable, but on closer examination, a large number of issues arise. Given the objectives outlined in the Labour manifesto (fair taxation and increasing work incentives for those on low incomes), increasing allowances or reforming means-tested benefits will always be more effective for the same cost than introducing a 10% starting rate of tax. They will also avoid the unnecessary complication of the tax system.

There is little justification for the proliferation of marginal rates of income tax. So if a 10% band is introduced, it makes sense to remove the current 20% band because the existence of four marginal tax rates would merely reduce the simplicity of the tax system further. Indeed, there is a strong case that we should abandon both the 10% and 20% rates of income tax and concentrate the money saved on the extension of income tax allowances.

The current 20% lower rate of tax came into existence just prior to the 1992 general election. The proposal for a 10% starting rate emerged as part of the Labour Party's campaign for the 1997 general election. There must be a strong suspicion that adjustments to rates of income tax make better slogans than more sensible reforms to the direct tax system. It is to be hoped that, in power, politicians will at least implement

these policies in the most coherent way possible, given the constraints imposed by election promises, although it would be preferable if parties resisted advocating ill-judged, though soundbite-friendly, policies in the first place.

5. Issues in the taxation of companies

5.1 Introduction

With the election of a new Labour government, changes to company taxation are back on the political agenda. Most immediately, the Chancellor is committed to introducing a one-off windfall levy on the privatised utility companies; indeed, one of the major reasons for having a summer Budget is to introduce the legislation needed to impose this windfall tax. Labour's Business Manifesto also promised to review corporate taxation, capital allowances and the taxation of capital gains. Although we would expect a thorough review of these issues to take longer than a couple of months, we may expect some indications of where the Chancellor's thoughts are heading in his Budget speech. There is also a possibility that the Chancellor will seek to raise some additional tax revenue from the corporate sector in this Budget.

If he does, the main attraction of raising taxes on companies and/or shareholders is that these measures are little understood by the majority of the electorate. This temptation may be very powerful for a Chancellor who has ruled out some of the more transparent ways of increasing tax revenue. There are, however, some disadvantages of increasing taxes on companies. If the main rationale for increasing taxes is macroeconomic — i.e. to restrain the growth of consumer spending — then higher taxes on companies are a very indirect and poorly targeted way of curbing the consumer. Moreover, company investment is likely to be adversely affected by any net increase in the tax revenue taken from companies and shareholders. An increase in company taxation runs directly counter to the Labour Party's stated aim of raising the level of business investment.

The world has changed a lot since a Labour Chancellor last contemplated company taxation in the UK. Lord Lawson's reform of corporation tax in 1984 saw a dramatic reduction in the statutory rate of corporation tax, from 52% to 35%, which was financed by restricting the value of capital allowances and abolishing stock relief. A similar rate-cutting, base-broadening reform of corporate income tax occurred in the US in 1986, and this approach has since been mirrored in many other countries. Table 5.1 shows how statutory corporate tax rates have generally fallen since 1980. There is no prospect of reverting to the 52% corporate tax rate and 100% first-year allowances for investment spending that Britain had in the 1970s.

It is worth considering briefly why corporate tax rates have fallen around the world. High on the list of suspects is the growing importance of multinational firms whose activities are geographically mobile. Other things being equal, multinational companies will obviously prefer to locate in low-tax jurisdictions. But even at a given level of total corporate tax revenue, multinational firms will tend to be attracted to locations with a lower statutory tax rate and broader tax base. First, they tend to be relatively profitable companies: at a given level of total corporate tax revenue, relatively profitable firms tend to pay a lower share of this revenue under a low-rate, broad-base system than under a

Table 5.1. Statutory corporate tax rates, 1980–96

	1980	*1990*	*1996*
Australia	50	39	36
Canada	46	38	38
France	50	37	33α
Germany	56	50	45
Ireland	45	10	10
Italy	25	36	37
Japan	40	40	37.5
Spain	33	35	35
Sweden	57	30	28
UK	52	34	33
US	46	34	35

Note: These are the national rates of corporate income tax, ignoring special surtaxes and local corporate income taxes. Where different rates are levied on retained and distributed profits, the rate for retained profits is given. The rate given for Ireland applies to manufacturing firms only.

Source: Price Waterhouse.

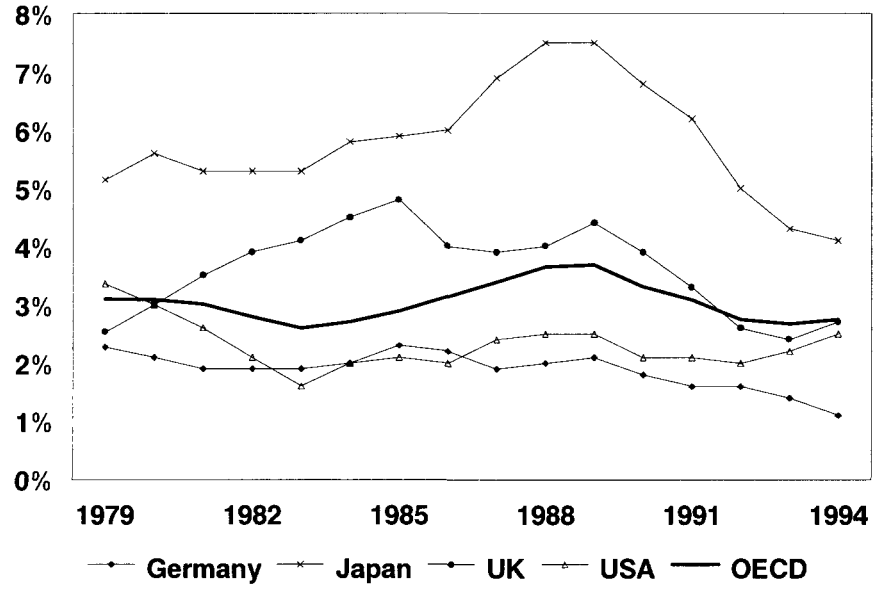
high-rate, narrow-base system.[1] Second, operating in a low statutory tax rate location allows multinationals to reduce their world-wide tax bill by shifting income into the low-rate jurisdiction and by shifting deductible costs into higher-rate jurisdictions. Certain types of transfer pricing arrangements on intra-group transactions and tax-efficient financial structures are two ways in which this can be achieved. Although tax avoidance rules limit the extent to which international companies can exploit these opportunities, it is unlikely that they prevent any benefit accruing to multinationals.

These international considerations seriously constrain the Chancellor's room for manœuvre on corporation tax. Britain has been successful over the last decade in attracting a disproportionate share of inward investment into Europe, and the manufacturing sector has become particularly dependent on investment by foreign multinational firms. Even if he wanted to, we doubt that the Chancellor could raise the statutory rate of corporation tax by more than a few percentage points without seriously jeopardising the attraction of Britain as a location for inward investment.

Interestingly, as we pointed out in last year's Green Budget, the revenue raised by governments from taxes on corporate income has shown no corresponding tendency to decline as a share of GDP, despite these reductions in corporate tax rates (see Figure 5.1). In part, this reflects the deliberate broadening of corporate tax bases which has been used to finance statutory rate cuts. The buoyancy of corporate tax revenues also

[1] The reason is that generous allowances tend to skew corporate tax liabilities away from the normal return on capital invested, and on to economic rents or excess returns. Narrow tax bases therefore tend to focus tax payments on relatively profitable firms.

Figure 5.1. Corporate tax as a share of GDP, 1979–94



Source: *OECD Revenue Statistics*, various years.

reflects the recovery in corporate profitability from the depressed levels experienced in the 1970s. Many commentators have suggested that competition between governments for inward investment will eventually result in declining revenues from company taxation. As yet, there is no sign of corporate tax revenues collapsing imminently, and we expect corporation tax to remain a significant source of revenue for the UK government for some years to come.

5.2 Raising revenue from the corporate sector

In the financial year 1996-97, corporation tax raised more than £27 billion for the exchequer, or almost 10% of total general government receipts.[2] Given the complexity of the corporate tax system, there are various more or less ingenious ways in which the Chancellor could raise additional revenue from companies or their shareholders. In this section, we consider some of the leading contenders.

Most straightforwardly, the Chancellor could simply increase the statutory rate of corporation tax. The corporation tax rate was 35% between 1986 and 1989, and was reduced from 35% to 33% between 1989 and 1991. Reversing these cuts would raise about £1.7 billion annually in additional tax revenue. Although such a rise in the corporate tax rate would go against the global trend, an increase on this limited scale would probably not have a major impact on inward investment, particularly if the government continues to pursue a less antagonistic line towards the European Union. However, a rise in the statutory corporation tax rate has the disadvantage of being a highly visible way of raising revenue, and sends an unfortunate signal to the business

[2] This is back to the share of total receipts reached at the height of the last boom, in 1989-90.

community. If the Labour government really wants to establish itself as the party of business, an immediate increase in the rate of corporation tax may not be the best way of announcing its arrival.

More revenue could also be raised by widening the corporate tax base, for example by further restricting the value of capital allowances. Kenneth Clarke extracted an estimated additional £675 million per year in his last Budget, by cutting the value of capital allowances for plant and machinery with an anticipated economic life in excess of 25 years. However, lower capital allowances make investment spending more expensive for companies, and Labour has favoured more generous rather than less generous capital allowances in the recent past. We doubt there will be any widespread reductions in the main rates of capital allowances for plant and machinery and industrial buildings. If anything, we would expect some modest *increases* in capital allowances, although targeted in such a way as to keep their overall cost very low. Some possibilities are discussed in Section 5.3.

Perhaps the most likely source of additional revenue from the corporate sector would come from changes to the tax treatment of company dividends. Under the current 'partial imputation' system, *a part* of the company's corporation tax liability is treated as if it were a prepayment of the shareholders' income tax on their dividend income. This part, called advance corporation tax (ACT), is currently set at 20% of the gross dividend, which just covers the shareholders' income tax liability for basic- and lower-rate taxpayers. Higher-rate taxpayers have to pay an additional income tax charge when they receive dividend income.[3] Conversely, tax-exempt shareholders, including pension funds, can claim a tax rebate when they receive dividend income, equivalent to the part of corporation tax that is being treated like a prepayment of income tax, from which they are exempt.

We explain how this system works in more detail in Section 5.4, but it is a safe bet that very few voters understand advance corporation tax. One surprising aspect is that a lower rate of ACT raises revenue for the government. The main reason is that a lower rate of ACT reduces the value of the tax credits that are repaid to pension funds and other tax-exempt shareholders. In effect, a lower rate of ACT means that a smaller part of corporation tax is being treated like a prepayment of income tax, from which these shareholders are exempt.

Gordon Brown could therefore raise more revenue from shareholders by announcing that he is reducing the rate of advance corporation tax. This is exactly what Norman Lamont did in 1993, when the ACT rate was lowered from 25% to 20%. We estimate that a further reduction to 15% would raise about £1.5-£2 billion per year for the exchequer.[4] There is no compelling logical reason not to do this, simply because there is

[3] Unless they are holding the shares in a tax-exempt Personal Equity Plan.

[4] Although not in the first year. In the first year, there is a one-off reduction in corporation tax receipts, as firms offset past ACT paid at a high rate against their current mainstream corporation tax payments, but pay ACT on current dividends only at the lower rate. This one-off effect would broadly offset the revenue gain from lower tax credits to shareholders, and the net effect on the PSBR in the first year could even be negative.

no compelling logical reason why any *particular* fraction of corporation tax should be treated like a prepayment of income tax.[5]

Of course, this still amounts to an increase in tax on pension funds and other shareholders, and may require firms or employees to make higher contributions to pension funds, at least in the longer term. Like any other net increase in taxes paid by companies or shareholders, there would be an adverse effect on share prices and company cash flows. It is also likely that there would be some reduction in company investment, if only because firms would be able to finance less investment spending from internal resources.[6,7] On the other hand, there is no reason to believe these effects would be any worse than if the same amount of revenue were raised from a higher corporation tax rate, and a lower rate of ACT has the effect of reducing the current tax distortion that favours dividend payouts over retained profits. A further reduction in the rate of ACT, which is currently equal to the starting rate of income tax, would also be consistent with Gordon Brown's plan to reduce this starting rate of income tax. On balance, changes to the ACT system seem the most likely route through which additional revenue would be squeezed out of the corporate sector, if that were the objective, and we discuss the possible changes in more detail in Section 5.4.

5.3 Capital allowances

Capital allowances are a deduction allowed under corporation tax and given to reflect the approximate cost of depreciation associated with owning and using most capital assets. The main capital allowance rates are currently 25% per year on a declining-balance basis for most plant and machinery, and 4% per year on a straight-line basis for industrial buildings.[8] Reducing the generosity of these allowances increases the amount of revenue raised from corporation tax, but at the cost of increasing the 'cost of capital', which is the rate of return before tax that firms require, in order to earn an acceptable after-tax rate of return for investors. This runs the risk of reducing the level of investment carried out by the corporate sector.

It is unlikely that there will be any significant change to the main rates of capital allowances, although it is possible that some smaller adjustments could be made. In the last Budget, for example, Kenneth Clarke announced that capital allowances for plant and machinery with long lives (i.e. of 25 years or more) would be reduced, from 25% to

[5] Indeed, it is debatable whether any part of corporation tax should be treated in this way. There is no relief from any part of corporate income tax for tax-exempt shareholders in the US. This has not prevented the successful growth of private pension funds there.

[6] Note that these disadvantages stem from the presumed net increase in taxes on companies and shareholders. They would lose much of their force in the context of a revenue-neutral reform of ACT, with the additional government revenue used to finance a lower rate of corporation tax or more ambitious reforms of company taxation.

[7] Dividend taxation has only a small impact on the cost of capital for firms. Most investment is financed from retained profits. Since this involves exchanging lower dividends today for higher dividends in the future, taxes on dividends do not affect the cost of capital for investment financed from retentions, provided the tax treatment is not expected to change.

[8] The declining-balance method means that for £100 of investment, £25 is written off in the first year, while £18.75 is written off in the second year (25% of the remaining balance of £75) and so on. The straight-line method would simply write off £4 per year for 25 years for the same £100 of investment.

6% per year. The change was intended to bring the treatment of long-lived plant and machinery more closely into line with the treatment of buildings and more closely into line with the true economic lives of these assets. A disadvantage is that there is now a dramatic reduction in the depreciation allowance granted for an asset that is deemed to have 25, rather than 24, years of useful economic life, since the net present value of the capital allowance almost halves as a result of this change. This gives companies an incentive to report somewhat shorter asset lives at this margin, and will lead to socially unproductive disputes over borderline cases.

This change resulted in higher government revenue — an increase estimated by the Treasury to be £675 million per year by 1998-99.[9] It was designed to affect larger companies, since only those investing over £100,000 per year in this type of asset are covered by the change, and clearly affects only those industries where assets are expected to last at least 25 years. This will include, amongst others, the utility companies, with their networks of pipes and cables designed to last 40 years or more, airlines, rail companies, breweries and the petroleum industry.

Rather than restricting capital allowances in the next Budget, it is more likely that the new Chancellor will be looking for changes that seek to encourage investment. Labour's Business Manifesto (p. 9) states that

> *we need to raise the quality and quantity of investment in business ... we have set up a review of corporate taxation to investigate how the tax system can encourage investment for the long term*

This review will certainly find that corporation tax raises the cost of capital and so tends to discourage business investment. However, the root cause of this disincentive is not that capital allowances for depreciation are too low, but rather that there is no tax allowance at all for the cost of using retained earnings to finance investment. Proposals to remove this tax bias have been put forward by the IFS Capital Taxes Group, and advocated more recently by the Institute for Public Policy Research's Commission on Public Policy and British Business.[10] Unfortunately, these proposals run counter to the trend of rate-cutting, base-broadening corporate tax changes that we described above.

Increasing capital allowances significantly and permanently for all companies and all types of capital investment has the same drawback, and would probably be prohibitively expensive. For example, just raising capital allowances for plant and machinery from 25% to 40% would cost about £2 billion in the first year alone. We are more likely to see some more limited change which would be much less expensive but which would reflect the Labour Party's desire to encourage investment. This could be achieved in various ways: for example, by targeting higher allowances at 'incremental' investment rather than all investment; by giving higher allowances only for the first, say, £100,000 of a company's investment; by giving higher allowances only to smaller companies; by targeting more generous allowances at specific types of investment, such as research and development (R&D) expenditures; or by raising allowances only for a limited period.

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[9] This estimate is based on the surprising assumption that as much as 25% of investment in plant and machinery will only qualify for capital allowances at the new lower rate.

[10] See IFS Capital Taxes Group (1991), Bond, Devereux and Gammie (1996) and Commission on Public Policy and British Business (1997).

The first strategy aims to give higher allowances only to additional, or incremental, investment, over and above that which the firm would have made in the absence of the new allowances. At first glance, this tactic has some appeal, since the cost to the exchequer would theoretically be confined to this additional investment, rather than wasting resources by giving more generous allowances for the bulk of investment that would have gone ahead in any event. In practice, though, it is extremely difficult to design workable rules that approximate this incremental portion of investment, without producing very diverse effects for different companies and perverse incentives for some firms. For example, if more generous allowances were granted only to investment over and above the firm's average level of investment in some previous years, this would be of no benefit to firms that are not expanding and creates a *disincentive* for some companies to invest this year. This results because this year's higher level of investment would be incorporated into next year's average base level, so reducing the level of capital allowances potentially available in future years.[11]

Another strategy would be to increase capital allowances only for the first, say, £100,000 of investment, an option that has been advocated in the past by the CBI. This would be a particularly wasteful way to 'encourage' investment, since all firms that routinely invest more than £100,000 would simply receive a hand-out from the exchequer, with no effect on their cost of capital for investment at the margin. Small firms, spending less than £100,000 on investment, would benefit from a reduction in the cost of capital, but in cash terms these small companies would actually gain less than larger firms from this proposal. The cost to the exchequer would be greatly increased by giving the extra allowance to large companies as well.

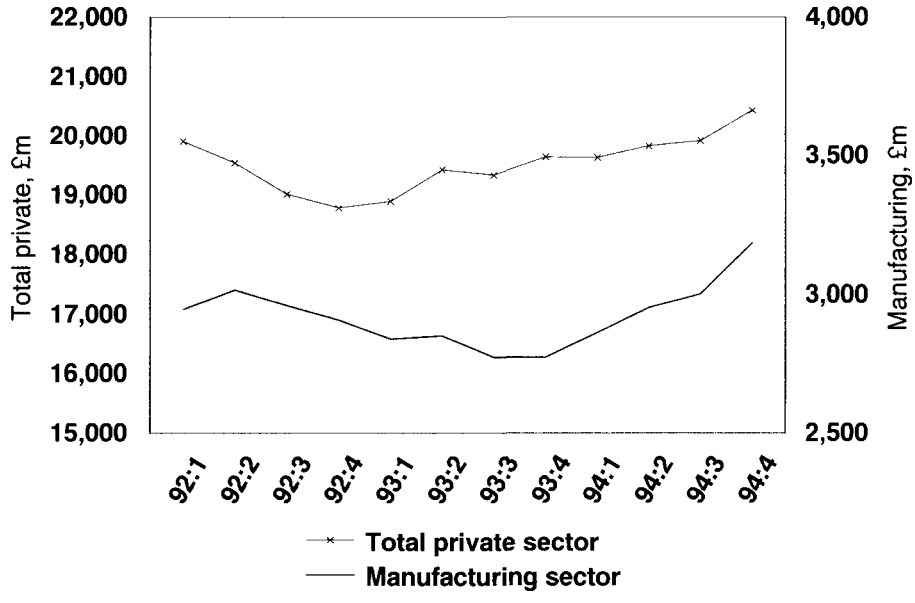
If the aim is to encourage investment by smaller firms, it would be much more sensible to give higher capital allowances only to small firms. This could be achieved without too much difficulty, and would ideally be based on a relatively stable measure of firm size, such as turnover or employment, rather than a volatile measure, such as profits. By targeting higher allowances on small companies, this approach could either be much less expensive for the government or allow much more generous changes for these firms. The same applies to changes targeted at particular types of investment spending, rather than particular types of firms. A leading candidate would be R&D expenditures, where several countries have followed the US lead and introduced some form of tax credit for R&D spending to encourage investment in research. Whether it is sensible for governments to favour particular types of firms or particular types of investment in this way is quite another matter.

A final option, which has a recent precedent, would be to raise capital allowances for a limited period only. The Labour Party appears to favour this option, stating in its Business Manifesto (p. 9) that

> *to improve the timing of investment we have, in the past, proposed extending capital allowances specifically designed to bring forward new investment, and we will review this option in government*

[11] The difficulties of targeting tax concessions to incremental investment are illustrated by the US experience with a tax credit for incremental R&D expenditure, whose design has been subject to frequent revisions. See Griffith, Sandler and Van Reenen (1995).

Figure 5.2. Gross domestic fixed capital formation in the UK, 1992–94



Note: Figures given are in 1990 prices.

Source: *Economic Trends*, May 1997.

This approach was tried by Norman Lamont, who raised capital allowances for investment spending between November 1992 and October 1993, so lowering the cost of capital for investment carried out during that particular period.[12] This gave firms an incentive to bring forward investment into the period during which the higher allowances could be claimed. We might expect to have seen higher investment in the second half of 1993, followed by lower investment in the first half of 1994, but there is no sign of any significant impact in the aggregate investment data (see Figure 5.2).

This evidence suggests that small temporary changes to capital allowances do not even have a significant effect on the timing of investment. Even if they did, it is hard to see what is gained from government interference in the timing of investment decisions. If there is a problem with UK investment, it has been with the overall level of investment over a very long period, not with the timing of investment. Temporary changes would do little for either the quality or the quantity of investment. Whilst there might be a case for such measures in the depths of a recession, the UK economy is hardly in need of a 'kick-start' at present. More importantly, the prospect of temporary changes to capital allowances does nothing to contribute to the climate of greater stability which, as the Business Manifesto also points out, is '*a pre-condition for increased investment*'. We would hope that the government's review of corporate taxation will produce some more substantial and considered proposals for reform than this one.

[12] For the first year of the investment, the capital allowance was temporarily raised to 40% (declining balance) for plant and machinery (reverting to 25% in later years); and to 20% (straight line) for industrial buildings (reverting to 4% in later years).

5.4 The taxing question of dividends

Once again, there is much speculation that changes to the tax treatment of dividends may be announced in the Budget. There are several alternative methods that could be used to raise revenue. This section discusses who would be affected by these alternatives and how much they would raise. The revenue implications are discussed in Appendix C.

The current system

The UK operates what is known as a partial imputation system for the taxation of companies and shareholders. It is designed to reduce the 'double taxation' of dividend income which arises when there is no integration between corporate and personal income taxes. Companies are liable to tax at a rate of 33% on their taxable profits, but this tax is paid in two instalments. If the company pays a dividend out of its profits, advance corporation tax (ACT) is payable at a rate of 20/80ths of the actual dividend payment (known as the net or cash dividend), or 20% of the dividend plus the ACT (known as the grossed-up or gross dividend). The company has to pay ACT soon after it pays the dividend, but can normally deduct that ACT payment from its total corporation tax bill when it comes to settle up with the Inland Revenue later.[13] The tax due after ACT has been offset is known as mainstream corporation tax (MCT).

Shareholders receiving a dividend will usually receive credit for the ACT paid on the dividend in calculating their income tax liability. In other words, part of the tax payment made by the company is imputed to the shareholder, reducing the extent to which the profits behind the dividend are taxed twice. For example, a firm that earns £100 of taxable profit will have to pay £33 in corporation tax, leaving £67 to distribute as a dividend. When the dividend is paid, the first instalment of corporate tax is made, in the form of £16.75 of ACT (20/80ths of the cash dividend of £67), leaving £16.25 to be paid by the firm in MCT later (i.e. the difference between the total tax bill of £33 and the £16.75 that has already been paid). That is the case regardless of the tax status of the shareholder who receives the dividend.[14]

Table 5.2 shows how the ACT already paid by the company is then imputed to shareholders, for shareholders in different personal income tax positions. If a shareholder receives a dividend of £67, ACT of £16.75 has already been paid by the company. Since the rate of tax on (gross) dividend income is 20% for basic- and lower-rate taxpayers, those shareholders will not owe any more tax, as shown in the middle column of the table. Higher-rate taxpayers, on the other hand, have to pay an extra £16.75 in income tax, making their total tax payment £33.50 (40% of the gross dividend). Tax-exempt shareholders with no income tax liability receive a refund of £16.75 from the Inland Revenue.

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[13] Usually nine months after the end of the company's accounting period.

[14] The situation is more complicated if the company is in a 'surplus ACT' position (and not paying a foreign income dividend). This means that it cannot offset all of the ACT paid against corporation tax, because its UK taxable profits are too low in relation to its dividend payments. For most companies, ACT affects only the timing and not the overall level of corporate tax payments. But for firms in a permanent surplus ACT position, ACT constitutes an additional layer of company tax.

Table 5.2. Current imputation system

	Tax status of shareholder		
	Exempt	*Basic-/lower-rate*	*Top-rate*
(1) Cash dividend received	67.00	67.00	67.00
(2) Tax credit (20/80ths of (1))	16.75	16.75	16.75
(3) Gross dividend ((1)+(2))	83.75	83.75	83.75
(4) Income tax owed (on (3))	0.00	16.75	33.50
(5) After tax value of dividend ((3)-(4))	83.75	67.00	50.25

Note: The tax rates used in this example are: corporation tax rate of 33%; ACT of 20%; basic/lower rate of personal tax on dividend income of 20%; and top rate of personal tax of 40%.

This last point is particularly important, since it means that every £67 of post-corporation-tax profits paid out by companies to tax-exempt shareholders is worth £83.75 to these shareholders. This is made up of a dividend of £67 and in effect a £16.75 repayment of corporation tax. This status is enjoyed by pension funds and by insurance companies managing pension assets, as well as by charities and by individuals investing through Personal Equity Plans. Since no part of corporation tax is repaid to tax-exempt shareholders when profits are retained by firms, these shareholders have a sizeable tax preference for profits to be distributed. Moreover, since no corporation tax is refunded to taxpaying shareholders, investors have an incentive to arrange their share ownership through tax-exempt institutions such as pension funds or through Personal Equity Plans.

Lowering the rate of ACT

What would happen if the rate of ACT were lowered in the forthcoming Budget to, say, 15% instead of 20%? This would actually raise revenue for the government, as was the case when Norman Lamont lowered the ACT rate from 25% to 20% in 1993. To see how this works, it is simplest to think of the tax payment made by the company first, and then the effects on shareholders. At the lower rate of ACT, the company would make a smaller payment of ACT, but subsequently it could only deduct this smaller amount of ACT from its total corporation tax bill. The company would therefore have to make a higher mainstream corporation tax payment later.[15] Returning to our numerical example, the company earning £100 of profit still has a total corporation tax bill of £33, but at a 15% rate would pay ACT of £11.82 (15/85ths of the cash dividend of £67), leaving £21.18 to be paid by the firm in MCT later. So lowering the rate of ACT does not

[15] This discussion again assumes that the company is not in a surplus ACT position. Firms in a permanent surplus ACT position would pay less tax in total if the ACT rate were reduced.

Table 5.3. Reducing the rate of ACT to 15%

	Tax status of shareholder		
	Exempt	*Basic-/lower-rate*	*Top-rate*
(1) Cash dividend received	67.00	67.00	67.00
(2) Tax credit (15/85ths of (1))	11.82	11.82	11.82
(3) Gross dividend ((1)+(2))	78.82	78.82	78.82
(4) Income tax owed (on (3))	0.00	11.82	31.53
(5) After tax value of dividend ((3)-(4))	78.82	67.00	47.29

Notes: The tax rates used in this example are: corporation tax rate of 33%; ACT of 15%; basic/lower rate of personal tax on dividend income of 15%; and top rate of personal tax of 40%.

reduce the amount of tax paid by most companies, but does change the timing of those payments.[16]

Now consider the tax position of the shareholders. Table 5.3 shows how their tax payments would differ if the rate of ACT were reduced to 15%, assuming that the rate of tax on dividend income for lower- and basic-rate taxpayers is also lowered to 15%[17] but that the top rate of tax remains at 40%. At the lower rate of ACT, the dividend tax credit would cover a smaller proportion of a top-rate taxpayer's total income tax liability, and so instead of paying the difference between 40% and 20%, the top-rate shareholder would have to pay the difference between 40% and 15% (i.e. £19.71 rather than £16.75). Basic- and lower-rate shareholders are indifferent to the change, since the tax credit would still cover their full dividend income tax liability, but the government would gain further revenue from tax-exempt shareholders. This is because the value of the tax credit would be lower and so a smaller amount of revenue would have to be repaid to tax-exempt shareholders. The after-tax value of the £67 dividend to these shareholders would fall to £78.82, rather than the current £83.75.

Given the current level of dividend payments in the UK, reducing the rate of ACT (and the dividend income tax rate for basic- and lower-rate taxpayers) to 15% could raise over £2 billion per year for the exchequer. Although it would be possible in theory to reduce the ACT rate while leaving the 20% basic/lower rate of dividend income tax unchanged, there would be significant administrative difficulties in collecting the additional 5% tax from basic- and lower-rate shareholders. Historically the rate of income tax on dividend income for basic-rate shareholders and the ACT rate have remained in line in practice.

If the Chancellor simply wanted to raise revenue from shareholders without changing the ACT rate and other rates of income tax, an alternative would be simply to restrict the

[16] This is true except in the first year. There would be a one-off reduction in corporation tax receipts in the fiscal year in which the rate of ACT is reduced, since in that year ACT is paid at the new lower rate whilst the ACT set-off against corporation tax may be based at the previous higher rate.

[17] This rate was also lowered from 25% to 20% in 1993.

repayment of the dividend tax credit to some or all tax-exempt shareholders. If no repayment were allowed, a cash dividend of £67 would be worth £67 to these tax-exempt shareholders, as it is to basic- and lower-rate taxpayers, rather than the current £83.75. This could raise as much as £6 billion in extra revenue if it were applied to all tax-exempt shareholders and assuming there were no behavioural responses to the move. However, a tax increase on this scale would clearly have further consequences for companies and pension funds.

As we pointed out in last year's Green Budget, the value of companies on the stock market would be affected, since this reflects the post-tax value of the stream of current and future dividends paid by companies to shareholders. The lower post-tax value of dividends paid to pension funds would also have implications, either for the level of contributions needed from firms or employees to maintain a given final pension, or for the level of pension provision itself.

The response of companies and pension funds to these changes would result in some offsetting reductions in government revenue. However, these losses would only partially offset the main revenue gain. In one extreme scenario, all of the loss to pension funds from lower dividend tax credits could be made up by higher company contributions to pension schemes. These higher contributions would be offset against corporation tax at 33%, but even in this case, two-thirds of the revenue gain from lower credits remains in the government's hands. This would reduce the revenue raised from a cut in the rate of ACT to 15% to about £1.5 billion; while the revenue gain from restricting repayment of the tax credits would fall to about £4 billion.

What might the effect be on company investment? Increasing the taxation of company dividends raises the cost of capital for investment financed by new equity. However, only a small fraction of corporate investment is financed by new equity. There is no effect on the cost of capital for the majority of corporate investment, which is financed from retained profits. The main effect on investment would come through the reduction in the amount of cash available to finance investment spending, if firms have to increase their pension contributions or pay higher cash dividends to compensate shareholders for the reduced value of the dividend tax credit. If it is more expensive for firms to raise external finance for their investment projects, then there would be some reduction in business investment.

If the Chancellor chose not to change the tax treatment of dividends for shareholders, he could achieve a similar effect by changing the taxation of dividend payments at the company level. This would also raise revenue, but would have a more direct effect on company cash flows. One simple approach would be to charge a higher rate of corporation tax on distributed profits than on retained profits. Split-rate corporate income taxes are operated in some countries, although it is more common for the lower tax rate to be applied to distributed profits. Less transparently, a similar effect could be achieved in the UK by reducing the rate at which firms can offset ACT payments against their mainstream corporation tax. For example, firms could still be charged ACT at 20%, but only allowed to offset some part of that payment. Either of these approaches would raise revenue and discourage firms from distributing profits. However, we would then be in the bizarre situation of having an imputation system whose effect is to encourage dividend payments, operating alongside another mechanism introduced to have the opposite effect.

This highlights the fact that simply reducing the value of the tax credit on dividends is a way of taking more tax revenue from the corporate sector. It can be presented as a way of reducing the tax bias in favour of dividend payments that currently applies to tax-exempt shareholders, but if the goal is to reduce distortions rather than to increase taxation, the revenue raised should be returned to companies, for example in the form of a lower corporation tax rate. Labour has claimed to be concerned about the level of business investment. How the government acts on company taxation provides a clear test of this commitment.

5.5 The windfall tax

The Labour government is committed to introducing a one-off windfall levy on the privatised utility companies. Gordon Brown has stated that the windfall tax will be levied on utility companies that have been privatised since 1979 and that are licensed and regulated by statute. This clearly includes the 10 water and sewerage companies (WASCs) privatised in 1989, the 12 regional electricity companies (RECs) privatised in 1990, the power generators privatised in 1991 and British Gas. It is also likely to include British Telecom, and may well include BAA, as well as the more recently privatised Railtrack and British Energy. Gordon Brown has also said that the windfall tax will 'comfortably' raise the £3 billion required to fund Labour's commitments on job creation and training schemes.

There is no doubt that the government has an electoral mandate to impose a windfall tax. It is possible that the legality of the tax could be challenged, either under UK or more likely under European laws, but there are considerable doubts about whether such a legal challenge would be successful. This will clearly depend on the specific form that the windfall levy takes, and the need for the levy to be legally watertight will be a major consideration in its implementation. However, even if it were thought that a legal challenge would succeed, there are also potential political and public relations dangers for any company that sought to hole the new government's flagship tax policy. Changes to the regulatory environment could potentially have a much greater impact on these companies in the medium term than any one-off windfall tax, and, in reforming the regulatory framework, the government is unlikely to look too kindly on firms that put legal difficulties in the way of the windfall tax.

Important questions of detail remain to be answered. How much revenue will the windfall tax raise? Will this be paid in one or more instalments? Which companies will be liable to the tax? And how will their liability be calculated? Press reports have suggested that Tony Blair favours a cautious approach, raising somewhere in the order of £3-£5 billion, whilst Gordon Brown may prefer a substantially higher figure. The higher the total windfall tax bill, the greater is the risk of provoking some form of legal challenge. Also, the higher the total revenue collected, the more likely it is that the tax will be collected in more than one instalment and from a wider range of companies. Just how each firm's liability will be calculated remains anyone's guess at present. What we do know is that plausible alternatives can deliver vastly different outcomes for individual companies and sectors. As we explain below, this is a question where normal economic principles of what constitutes a reasonable tax base can offer very little guidance.

A more fundamental question is 'who really pays the windfall tax, i.e. which people are made worse off as a result?'. We consider this issue below, before discussing the

possible impact on utility prices and investment. Finally, we consider some possible windfall tax bases, paying particular attention to the difficulties that would arise if a measure of 'excess' financial returns to shareholders were to be used.

Who really pays the windfall tax?

To understand who is really paying the windfall levy, consider what would happen to share prices in the utility companies if Gordon Brown were to stand up on Budget day and announce that he had been persuaded by critics of the windfall levy, and as a result he had changed his mind and had no intention of introducing such a levy so long as he was Chancellor. Share prices in the utility sectors would certainly rise, and the people who happened to be owning those shares on the day would enjoy a substantial capital gain.

This is not going to happen, but it does illustrate that much of the effective incidence of the windfall tax falls on shareholders in the companies concerned. Corresponding to the hypothetical capital gains in the scenario sketched above, someone has already suffered a real capital loss.

The second important point that this illustrates is that the shareholders who make capital gains in our imaginary scenario are not necessarily the same shareholders who have suffered the capital losses caused by the prospect of the windfall levy over the last three or four years. Company shares are traded in huge quantities on the stock market. The composition of 'the shareholders' in a particular company is continuously changing. The shareholders who have really paid the windfall levy are those who have been unlucky enough to be holding utility shares on days when new information about the scale of the windfall levy, or the likelihood of it being imposed, has been discounted into share prices.

Not only is this group of unlucky losers different from the group that would gain if Gordon Brown were to change his mind at the last moment; they are still less likely to be the same group of shareholders that benefited from high returns when the utility companies were first privatised. In some cases, shares sold on the first *day* of trading amounted to more than one-quarter of the shares issued. Penalising an arbitrary group of shareholders who owned utility shares in the mid-1990s on account of windfall gains enjoyed by their predecessors in the 1980s is difficult to reconcile with any principles of equity in taxation.

To summarise, the windfall tax is in effect an arbitrary capital levy that falls on a group of shareholders in the utility companies, whether or not those individuals have earned high returns.

Impact on prices and investment

Provided there is no doubt that the windfall levy will be imposed once and only once, and provided the tax base chosen is one that cannot be manipulated by changes to company behaviour, the windfall tax is likely to have only a limited impact on both prices and investment. It is this presumption that the windfall tax will not be shifted on to current or future consumers that underpins our conclusion that most of the burden of the windfall tax will be borne by shareholders.

Given these conditions, the windfall levy has the character of a 'lump-sum' tax. It does not affect the cost of producing additional output, what economists like to call marginal costs; nor does it affect demand conditions. It follows that the windfall levy does not alter the prices that firms should charge in order to maximise profits. If firms maximise their profits by charging a particular price in the absence of a lump-sum tax, they cannot do better than to continue to charge the same price in the presence of a lump-sum tax. Raising their prices in response to a lump-sum tax would only serve to further reduce their profits.

This suggests that unregulated firms would not want to raise their prices to 'pay for' a windfall tax. Where firms' prices are subject to regulation, they are currently obliged to charge a price that is below their profit-maximising price. Given half a chance, they would certainly seek to raise their prices, but provided the windfall levy does not alter their marginal costs or demand conditions, there is no economic reason why the regulators should allow them to raise prices or lower standards of service. If Gordon Brown seeks to prevent the windfall levy being passed on to consumers, then under these conditions he has economic reason on his side.[18]

The only serious caveat to this discussion concerns the impact of the windfall tax on the cost of capital for the utility companies. There are two quite distinct reasons why the windfall tax might increase the cost of capital. One is that money used to pay the windfall tax cannot also be used to finance investment spending. This implies that a higher proportion of investment must be financed from external sources, notably through higher borrowing. If this increase in borrowing raises the cost of borrowing, this increase in the cost of capital represents a legitimate reason for higher prices and also implies some reduction in the level of investment.

For many companies, this would be a serious consideration. However, for the utility companies, the probability that they will be allowed to go bankrupt is virtually nil. Unless higher borrowing implies a higher probability of defaulting, there is little reason why higher borrowing should imply a higher cost of capital. Thus for the regulated utilities, this effect on the cost of capital is unlikely to be significant. Certainly the recent levels of dividend payments, special dividends and share repurchases in this sector do not indicate that these firms are expecting serious difficulties in financing their planned investment.

The second factor influencing the cost of capital is the risk premium, which depends, *inter alia*, on the risk of these companies being the target for further windfall levies or more onerous regulation in the future. To the extent that the imposition of the windfall levy signals greater regulatory risk, this will add to the cost of capital for the regulated utilities. This is why it is important for the government to rule out any possibility of returning to the utilities sector for a second bite of the cherry in the future.[19]

From the standpoint of economic efficiency, as opposed to equity, this is the one potential Achilles' heel of the windfall tax proposal. The 'lump-sum' nature of the

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[18] There is, though, a certain irony in Gordon Brown relying on the much criticised regulatory mechanisms to prevent the windfall tax affecting consumer prices.

[19] This 'once and for all' requirement does not preclude the possibility of the windfall levy being paid in instalments. The critical point is that how much is to be paid must be set in stone now, with no possibility of it being increased if a company continues to be successful in the future.

windfall levy collapses if there is serious threat of another levy in the future. Thus far, the Chancellor has been careful to affirm that the windfall levy is a one-off tax resulting from past levels of profits. Provided Gordon Brown gives the market no reason to doubt his word on this, the impact of the windfall tax on the cost of capital is unlikely to be large, and the effects on utility prices and investment are likely to be similarly modest.

Alternative tax bases

As we explained above, the burden of the windfall levy does not necessarily fall on shareholders who have enjoyed large capital gains in the past, either at the initial privatisation or at the time of past regulatory reviews. Given this inherently arbitrary starting-point, normal equity criteria give little guidance as to what form the windfall levy should take. Efficiency considerations only suggest that, in order to emulate a lump-sum tax, the base should be historically fixed and not subject to current manipulation by the companies concerned. Nevertheless, the choice of the tax base will be of considerable importance to individual companies and their current shareholders.

It seems likely that the windfall tax will bear some relation to the profits that have accrued to an investor who purchased shares in the company when it was privatised and who has continued to hold those shares until comparatively recently. There are two leading contenders for assessing those profits. One approach focuses directly on the financial return made by this shareholder, combining the dividend income received over the period with the hypothetical capital gain. In this context, a measure of 'excess returns' could be calculated by comparing this financial return with the return that could have been earned over the same period by investing in the stock market index. The second approach focuses instead on the underlying profits that have been earned by the company over the same period. This would be closer to how taxes on companies, such as corporation tax, are normally assessed. In this context, a measure of 'excess profits' could be calculated by comparing these actual profits with the 'normal' profits that could have been earned over the same period in a competitive industry.

Both the exact definition of the base used, and the exact time period over which this base is calculated, will have a significant effect on the final amount that each company is expected to pay. Table 5.4 shows how a windfall tax of £5 billion would be allocated between the different sectors that might be liable to the tax, according to some alternative tax bases. At first glance, it is clear that using a different base can lead to very different results. For example, the water companies would pay £570 million of the levy if it were based on a simple measure of firm size, such as total sales in a particular year, but almost three times that amount (£1.4 billion) if it were based on a measure of excess shareholder returns from privatisation up to December 1995. Even changing the time period covered but using the same base can have dramatic effects on the size of these hypothetical tax bills. For example, using excess shareholder returns, but changing the end of the time period covered from December 1992 to December 1995, reduces the tax bill for BT from £1.5 billion to zero, and increases the RECs' combined bill from £640 million to £2.2 billion. This gives the government some latitude to select a particular time period according to how much tax it wants different sectors to pay.

Table 5.4. Estimated distribution of a £5 billion windfall levy

(£ million)	Firm size (1995)	Excess shareholder returns (December 92)	Excess shareholder returns (December 95)	Excess pre-tax profits (to 1995)
WASCs	570	1,060	1,400	360
RECs	1,400	640	2,230	850
Generators	890	420	860	720
BT	1,260	1,520	0	2,760
Others	880	1,360	510	310

Notes:

The WASC sector contains the 10 water and sewerage companies privatised in 1989. The REC sector contains the 12 regional electricity companies privatised in 1990. During the period, the RECs wholly owned the National Grid. The electricity generators include National Power, PowerGen, Scottish Power, Scottish Hydro-Electric and Northern Ireland Electricity. 'Others' includes British Gas and BAA. The very recently privatised British Energy and Railtrack are excluded due to a lack of available data.

Firm size is based on total sales in 1995.

Excess shareholder returns are taken from Goldman Sachs, *UK Weekly Analyst* (11 April 1997). They are based on a measure of shareholder returns that accounts for both dividend income and capital gain, assuming that the dividends are reinvested in the company, relative to the return from the FTSE All-Share index. Shareholder returns on each company are then weighted in proportion to the value of the shares that were issued.

Excess pre-tax profits are based on company accounting data, as described in Dilnot and Giles (1996). They allow a deduction for normal profits estimated at 10% of the net book value of total assets employed.

Table 5.4 highlights how sensitive measured shareholder returns are to timing, and yet there is no definitive answer to the question of when the clock should be stopped. There are some arguments in favour of stopping at the first regulatory review, since during the first years of privatisation the regulatory regimes were both finding their feet and designed to reset prices for the future rather than to recoup excess profits earned in the past. Equally, there are arguments for stopping at the first of Labour's Budget submissions that proposed a windfall levy, or the first take-over of one of the privatised utilities, or the first time that the market discounted a significant amount of the windfall levy into share prices. Any one of these points is a plausible cut-off, but the only guide from economic theory is that the cut-off should not allow the companies to manipulate the size of their tax liability. There can be little doubt that the companies involved will use the consultation period with the Treasury to make their cases for whichever reasonable choice of period gives them the lowest tax bill.

Apart from being acutely sensitive to timing, another disadvantage of measures based on shareholder returns is that they depend on the company's share price. This is a rather subjective indicator of the expected *future* stream of company profits, rather than an objective measure of profits that have actually been earned in the past. Although the share price is the right way to calculate the capital gain when an individual makes an investment in shares, the windfall levy is not a tax on capital gains that individuals have

actually made, but rather it is a tax on the companies themselves. As such, it would be more conventional to base the tax on an objective measure of company profits.

Other problems with a tax based on excess shareholder returns relate to the way that they are actually measured. Conventional measures include dividend payments and special dividends, but often ignore equivalent distributions of cash from the company in the form of share repurchases or capital repayments. This differential treatment would be unsatisfactory as a tax base. Another problem relates to the question of how to value a dividend received by an investor five or ten years ago. Conventional indices commonly calculate total returns by assuming that dividends are reinvested in the same company. Again, this is unsatisfactory for tax purposes, since many shareholders do not in fact reinvest dividends, and logically not all shareholders could do this. It would be more appropriate to mark up dividends received in the past by a risk-free rate of interest, which would simply approximate the benefit to shareholders of deferring the tax charge on those dividend receipts.

A further problem with any measure of excess returns is that it is not obvious what 'normal' return should be deducted. In the case of shareholder returns, the total return from a broad index of companies (e.g. the FTSE All-Share index) is often suggested as a bench-mark for normal returns. However, this would only be a good approximation of the normal return for investments in the privatised utilities if the risk attached to investing in these companies were similar to the risk of investing in the market as a whole. Measures of risk can be estimated, and a leading measure is known as the company's 'beta'.[20] A beta of one indicates a similar risk to investing in the market as a whole. Some of the utility companies do have betas close to one, in particular the RECs, but others, such as BT and British Gas, do not. Therefore the use of a market index as a bench-mark for normal returns would be more suitable for some companies than for others.

The principal alternative to a tax based on shareholder returns would be one that used excess profits. This could be based on information previously supplied by the companies, either in their corporation tax calculations or in their regulatory accounts. 'Excess' profits could be measured as the difference between an actual measure of profits and an estimate of 'normal' profits, i.e. the required return on capital invested. This would be sensitive to how the capital assets employed by the firm are valued and the choice of a required rate of return, but this approach does have the advantage of being based on past profits that have actually been earned by the company. One attraction of a tax based on company profits for the new US owners of some of the RECs is that the windfall tax might then be creditable against their US tax bills.

To conclude, normal economic principles provide few clues as to how tax liabilities to the windfall tax should be assessed. A tax based on shareholder returns would appear to be most closely related to the arguments that have been put forward by the Labour Party to rationalise the levy.[21] However, given that the windfall tax will not be levied on the individuals who have actually enjoyed these returns, this connection is hardly

[20] Beta measures the sensitivity of the return on a share to the return on the market as a whole. It is given by the covariance between the return on that share and the market return, relative to the variance of the market return.

[21] For a further discussion of the arguments put forward for the windfall tax, see Chennells (1997).

compelling. Legal advice seems likely to outweigh any economic considerations on the choice of the tax base, since the government will undoubtedly be looking for a levy that is legally watertight.

5.6 Capital gains tax

One of the more surprising suggestions in the Labour Party's Business Manifesto is the possibility of introducing a two-tier capital gains tax, with a higher tax rate applied to capital gains where assets have only been held for a short period of time. This proposal is deeply flawed at both the conceptual and the pragmatic levels.

Underlying this proposal is a worthy desire to encourage firms to take a long-term view of investment decisions. There is some evidence that UK firms impose very high 'hurdle' rates of return and/or very short payback periods in investment appraisals. But there is no compelling evidence that this has anything to do with the length of time that shareholders hold their shares, and it is hard to think of reasons why the two should be at all related. If UK managers are overly cautious about long-term investment decisions, it is much more likely to be related to macroeconomic instability and/or to the unusually high threat of being ousted in a hostile take-over bid that faces UK managers, compared with their continental European or even their American competitors. Reform of capital gains tax will have no effect on these sources of 'short-termism'.

Even if one believed that longer holding periods would be beneficial, the second problem is that a two-tier capital gains tax will have almost no impact on shareholders' behaviour. The reason is simply that hardly any shareholders pay capital gains tax. Pension funds do not pay capital gains tax, nor do insurance companies in relation to their pension business. Individual shareholders do not pay capital gains tax on shares or unit trusts held in Personal Equity Plans, and individuals making real capital gains of less than £6,300 per year[22] do not pay capital gains tax at all. In the latest year for which the Inland Revenue has published figures (1994-95), there were only 85,000 taxpayers who paid capital gains tax, compared with 25 million taxpayers paying income tax; and capital gains tax raised only £800 million, compared with £63 billion raised from income tax. Tapering the rate of capital gains tax would add considerably to the complexity of an already complex tax, and would be more good news for the tax planning industry. But it could not be expected to make any significant difference to the environment for long-term investment.

[22] £12,600 for married couples.

6. Indirect taxation

If the Chancellor were to want to raise taxes and damp down consumption, increases in indirect tax would be possible and could take rapid effect. Recent years have seen large rises in duties on fuel and tobacco, with environmental and health arguments used to support the change. The two problems with most indirect tax increases from the perspective of governments are that they tend to hit the less well off relatively hard and that they cause a one-off jump in inflation.

We begin this chapter by considering the main excise duties and in particular discussing the tax treatment of alcoholic drinks, which continues to be complex and difficult to defend. We then discuss VAT, and the impact of cutting the rate of VAT on fuel from 8% to 5%. Finally, we discuss the general question of 'environmental' taxes.

6.1 Excise duties

There are two main issues concerning the way in which alcohol is taxed in the UK: the first is to do with the structure of relative tax rates within the group of alcoholic drinks; the second is to do with the level of the UK's taxes compared with those in Europe and the consequent incentives to cross-border shop.

In the Autumn Budget last year, Kenneth Clarke made a number of changes to alcohol duties. He cut duty on spirits by 4%, taking roughly 26 pence off the cost of a bottle (this includes the consequent VAT changes). The duties on beer and wines were frozen in nominal terms for the second Budget running, effectively cutting the real rates of duties applied. Nevertheless, the original disparity in the taxation of drinks by alcoholic content was so marked that these changes have done little to close the gap between spirits and beer and wine.

Table 6.1 shows the rates of duty per litre of pure alcohol following the changes made by Kenneth Clarke in November 1996, as well as the rates set in the previous two Budgets.

There are a number of economic justifications for taxing alcohol; these relate to the effects that over-consumption of alcoholic drinks may have on the ability to make informed, rational decisions regarding further consumption, and to the differences between the private and social costs of consumption. The second argument is that the private cost paid by the consumer is less than the social costs felt by society more

Table 6.1. Rates of duty per litre of pure alcohol for beer, wine and spirits

	Beer (3.9% abv)	*Wine (12% abv)*	*Spirits (40% abv)*
December 1994	£10.82	£11.70	£20.60
November 1995	£10.82	£11.70	£19.78
November 1996	£10.82	£11.70	£18.99

Table 6.2. Estimated annual revenue evaded on smuggled goods

	UK duty-paid goods (%)	*Legitimate personal imports (%)*	*Smuggled goods (%)*	*Revenue evaded (£m)*
Beer	95.5	2	2.5	110
Wine	88	9.5	2.5	50
Spirits	93	5	2	50

Source: HM Customs & Excise Press Release, 49/96, 19 September 1996.

widely. If the difference in these costs is related to the volume of pure alcohol consumed, then the form in which the alcohol is drunk (beer, wine or spirit) should be irrelevant. Without evidence that 1 millilitre of alcohol consumed as a spirit is more socially costly than 1 millilitre consumed as wine or beer, then the current structure of alcohol duties remains hard to rationalise.

The second major issue that the Chancellor faces when setting the UK's excise duty rates relates to cross-border shopping. This is a major concern to the UK drinks industry and, to the extent to which it may or may not limit the Chancellor's ability to raise revenues, it is also a major concern to the government. Table 6.2 shows HM Customs & Excise's estimates of the annual revenue evaded on smuggled goods and the market shares of domestic sales versus legitimate and illegally imported alcohol.

While the amounts lost to smuggling are substantial, they nevertheless represent a small proportion of total receipts from alcohol taxation which were £9.5 billion in 1995-96. Furthermore, making the plausible assumption that alcohol is a normal good (demand rises with real income), at least some of the goods smuggled will represent additional consumption (because the average price has fallen given access to European markets) rather than substituting entirely for domestic demand. As a result, these figures may overestimate the revenue losses.

To some extent, differences in excise duty rates between the UK and the near continent may contribute to cross-border price differentials and therefore add to the incentive to cross-border shop. For example, as at 1 August last year, the rate of duty on beer with 5% alcohol by volume (abv) in France was 15% of that in the UK, the rate on wine at 11% abv was 2% of the UK's and the rate on spirits at 40% abv was 60% of the UK's.

Despite this, it remains unclear that reducing UK excise duty rates is the way to regain lost revenues.[1] The essential issue is whether or not a reduction in duty can increase domestic sales enough to offset the lower tax revenue per unit sold. This argument depends upon two main factors: first, the proportion of the final price accounted for by taxes (because if taxes are a small part of the overall cost of an item, tax changes will not affect the price much) and, second, the extent to which quantities demanded respond to price changes (as this will govern the rate at which domestic demand might pick up).

[1] For a discussion, see Crawford and Tanner (1995).

In the case of beer, for which demand is relatively unresponsive to price changes and for which tax forms a smaller proportion of the final price than it does for other forms of alcohol, a cut in real duties, holding everything else constant, will be likely to result in lower real excise duty revenues. This is also the case for wines. For spirits, however, demand seems to be much more price-responsive and taxes make up a large part of the final price. This makes the argument that cutting tax rates will yield an overall increase in duties much more plausible in the case of spirits than for beer or wine, because the consequent boost to domestic demand is more likely to more than compensate for the reduced revenue per bottle. Even taking into account all other sources of tax revenues associated with domestic beer sales (e.g. corporation taxes, income taxes etc., which is tantamount to making the assumption that the resources previously directed towards brewing cannot be directed to other forms of economic activity), it remains unlikely that a positive overall revenue effect could result from a cut in beer duties since there would have to be a related tax gain of something in the order of seven times the duty. Estimates from the Brewers and Licensed Retailers Association published last year suggest that related taxes are the equivalent of about four-and-a-half times the duty per pint.

The second main change to alcohol duties in the last Budget concerned the way in which alcoholic soft drinks are taxed. The new generation of alcoholic drinks, known as alcopops or FABs (flavoured alcoholic beverages), are usually classified and charged duty as coolers, being made wines at strengths of up to 5.5% abv (exceptions are those drinks in this range that are beer-based, which are charged beer duty). In the last Budget, it was decided that coolers have been undertaxed compared with beer and other drinks and that (possibly as a result) the drinks industry has continued to introduce new brands in this area. The existing rate for coolers exceeding 1.2% abv was £23.41 per hectolitre for drinks not exceeding 4% abv and £42.14 for those exceeding 4% but not exceeding 5.5% abv, compared with beer duty at 4% and 5.5% of £43.28 and £59.51 respectively. To bring the taxation of these drinks into line, the rates of duty were increased to £43.28 and £59.51 respectively from 1 January 1997.

Tax policy towards the other two main dutiable goods — tobacco and petrol — is likely to remain in line with the previous government's commitments to minimum real increases, year on year, of 3% and 5% respectively. Both of these taxes are designed to alter behaviour by discouraging consumption of the good in question. In the case of tobacco, the aim is to reduce the proportion of the population who smoke to one in five by 2000. For petrol, the aim is to reduce car-related emissions of carbon dioxide and other pollutants. In general, taxes that are designed to change behaviour by altering relative prices effect the greatest change when there is a close substitute for the taxed good, and in the case of road fuel duties, further incentive to reduce petrol consumption may be given by simultaneous reductions in duties on alternative, greener fuels. In the 1994 and 1995 Budgets, the tax on road fuel gas, which produces markedly less emissions of major pollutants than other road fuels, was frozen. In 1996, the duty was cut by 25% to make the cost per mile of road fuel gas lower than that of petrol or diesel, and thus to help finance the cost of vehicle conversion. A similar incentive to switch from leaded to unleaded petrol was highly successful in the past. Graduating vehicle excise duty according to fuel efficiency and/or measured emissions standards recorded in the new MOT test remains a so far unexercised option which the Chancellor may wish to take up, given the manifesto pledge that '*the review of vehicle excise duty to promote low-emission vehicles will be continued*'.

6.2 VAT

The incoming government has made one clear commitment to change VAT — that the rate of VAT on domestic energy will be reduced from 8% to 5%. And the European Commissioner for the single market has not raised any legal objections. This reduction will cost around £400 million. The main reason given for the reduction is distributional. Domestic fuels are a necessity and their consumption rises less than proportionately with income. Poorer households, therefore, allocate a greater proportion of their weekly budgets to fuel than richer households, and, consequently, the immediate incidence of the tax on their standard of living is greater. The 3 percentage point reduction in the VAT rate will reduce the proportionate burden of this tax for poorer households more than it will for richer households, although richer households will gain more in absolute terms. The absolute and percentage gains per week by income decile are given in Table 6.3.

Of course, within these income groups there is further variation in gains, particularly with respect to age, since even within an income band, older households tend to spend a greater proportion than others on fuel and so will gain more than the group average. This was behind one of the main arguments put forward as to why additional compensation for VAT on fuel was required for recipients of the state pension.

Reform in other areas of VAT may be unlikely, particularly in view of the government's recent manifesto commitments not to extend VAT to food, children's clothing, books and newspapers, and fares. The only other presently zero-rated goods upon which no explicit manifesto commitments have been made are new housing (the zero-rating of which costs around £2,150 million per year) and drugs and prescription charges (costing

Table 6.3. Distributional impact of reducing VAT on domestic fuels to 5%

Income decile	*Average gain*	
	(£ per week)	*(% of post-tax income)*
Poorest	0.37	0.46
2nd	0.39	0.32
3rd	0.37	0.27
4th	0.36	0.22
5th	039	0.20
6th	0.42	0.17
7th	0.40	0.14
8th	0.43	0.12
9th	0.45	0.11
Richest	0.47	0.07
All	**0.40**	**0.15**

Note: These figures do not take indexation of benefits into account.

Table 6.4. Estimated revenues forgone: VAT exemption

	1996–97
Rent on domestic dwellings	3,000
Rent on commercial properties	1,300
Private education	1,050
Health services	450
Postal services	450
Burial and cremation	100
Finance and insurance	50
Betting and gaming	700
Small traders	100

Source: HM Treasury, *Tax Ready Reckoner*, August 1996.

around £700 million per year). International passenger transport is also zero-rated (£1,150 million) but air transport is subject to a specific tax of £10 for domestic and European flights and £20 for other journeys (these rates were announced in the November 1996 Budget to apply from November 1997).

Apart from zero-rating, there is also a third class of goods — those that are exempt from VAT. Exemption means that the producers of the listed goods do not charge VAT on their sales but do pay VAT on their inputs. The estimated revenues forgone for exempt goods are given in Table 6.4.

6.3 Environmental taxes

Despite the less-than-completely-green credentials of the cut in VAT on domestic fuels, where the distributional consequences are presumably thought to be more important than the environmental ones, environmental taxes are one area in which the new government might be expected to be active. As an example, the Labour Party's election manifesto promised a review of vehicle excise duty (which is currently a flat rate) to promote low-emission vehicles.

This might be partly, although rather cynically, because environmental taxes are relatively easy to sell to the electorate. But environmental taxes do have a clear and a strong economic rationale, which is that they provide an efficient tool for correcting the prices of environmentally damaging goods for the social costs of their consumption that individuals ignore when making their decisions. Further, they have a number of obvious advantages over the direct regulation of emissions: they encourage abatement where the costs of doing so are lowest, and provide a continuing incentive towards green behaviour rather than encouraging minimum compliance, for example. But a further interesting aspect of environmental taxes is that, since they raise revenue, they might bring a 'double dividend'. The argument is as follows.

Environmental taxes aim to be corrective taxes in the sense that they raise the prices of goods whose current prices are too low in relation to the overall costs of their consumption. As long as they are well designed, they will bestow a first dividend because the combination of the revenue that they raise and the environmental benefits that they confer outweighs the welfare loss consumers feel at the price rise. This assumes that the revenues are redistributed to consumers as a lump sum and so have no efficiency consequences. The second dividend arises if it is possible to do something more creative than simple lump-sum redistribution with the revenues raised. The government already uses a distortionary tax system to raise revenue, so existing taxes have two of the same characteristics as environmental taxes: they raise revenue and they impose a welfare cost by changing prices. Focusing on these two aspects of taxes, a second dividend could occur if a revenue-neutral swap was made between an existing tax and the environmental tax, where the environmental tax raised the same revenue at a lower distortionary cost than the tax it replaced. This would mean that, even ignoring the environmental benefit, a welfare gain is achieved by introducing the environmental tax, hence the term 'double dividend' and the popular notion that, by taxing 'bads' such as pollution instead of 'goods' such as labour, we could reduce unemployment, say, as well as improving our environment.

Naturally, if the existing tax system already represents the least distortionary way of raising a given amount of revenue, then the second dividend is not on offer. But this sort of tax system is much more of a theoretical bench-mark than a situation that is likely to occur in reality. So, supposing our existing tax system is not as efficient as possible, then the whole issue becomes the familiar problem of public economics: 'given a certain tax revenue requirement, what is the best way to raise that revenue?'. Of course, whichever tax system is chosen, the incidence will fall ultimately upon individuals and may distort their choice of goods consumed, hours worked, shares held and so on, but if some taxes are less distorting than others, then it should be possible to minimise these effects.

The problem, in practice, is that, since we do not seem to know enough to design a tax system that is optimal, given a revenue requirement, in the first place, it may be difficult to identify the appropriate taxes to swap for the environmental one. Whether or not, for example, the use of the proceeds of the landfill levy, which was introduced in 1995, to fund a reduction in the rate of employer National Insurance contributions delivers a second dividend is a difficult question to answer either theoretically or empirically. Nevertheless, despite the practical problems involved with eliciting the potential second dividend associated with environmental taxes, the single overall dividend provides sufficient justification for their implementation as long as the tax is a well-designed one that bears as accurately as possible on the pollutant of interest. Fiscal instruments may, of course, represent rather blunt tools in this respect.

7. Welfare-to-work

7.1 Introduction

> *We are determined not to continue down the road of a permanent have-not class, unemployed and disaffected from society ... Labour's welfare-to-work programme will attack unemployment and break the spiral of escalating spending on social security.*
> (Labour manifesto, p. 19)

Social security spending is set to reach virtually £100 billion in 1997-98 (£99.3 billion according to the most recent Social Security Departmental Report).[1] It is not surprising that the government wants to control spending on it. But how much of the budget might actually be affected by welfare-to-work policies? Table 7.1 shows the distribution of spending by client group.

Table 7.1. Benefit expenditure by broad groups of beneficiaries

	Planned spending, 1997-98 (£m)
Elderly people	42,430
Long-term sick and disabled	23,940
Short-term sick	1,210
Family	18,740
Unemployed	7,160
Widows and others	2,240

Source: *The Government's Expenditure Plans 1997–98 to 1999–2000*, Social Security Departmental Report, March 1997, Table 5.

The most obvious group to be affected by welfare-to-work policies are, of course, the unemployed. Spending on them is planned to be a relatively modest £7.2 billion. Clearly, the £42.4 billion spent on the elderly is not amenable to being reduced by any labour market policies. The other two big areas of spending are on the long-term sick and on the family. Within the 'family' budget is £7 billion of child benefit and £2.4 billion of family credit, accounting for about half of the total. Most of the rest is made up of benefit payments to the one million or so lone parents dependent on means-tested benefits.

In terms of numbers of recipients, also, the unemployed are relatively small compared with the combination of other groups of working age. In 1997-98, there were forecast to be around 1.8 million recipients of jobseeker's allowance. This compares with about 1 million lone parents on income support, 1.6 million recipients of incapacity benefit and almost 2 million recipients of disability living allowance. Suffice to say at this point that tackling the numbers

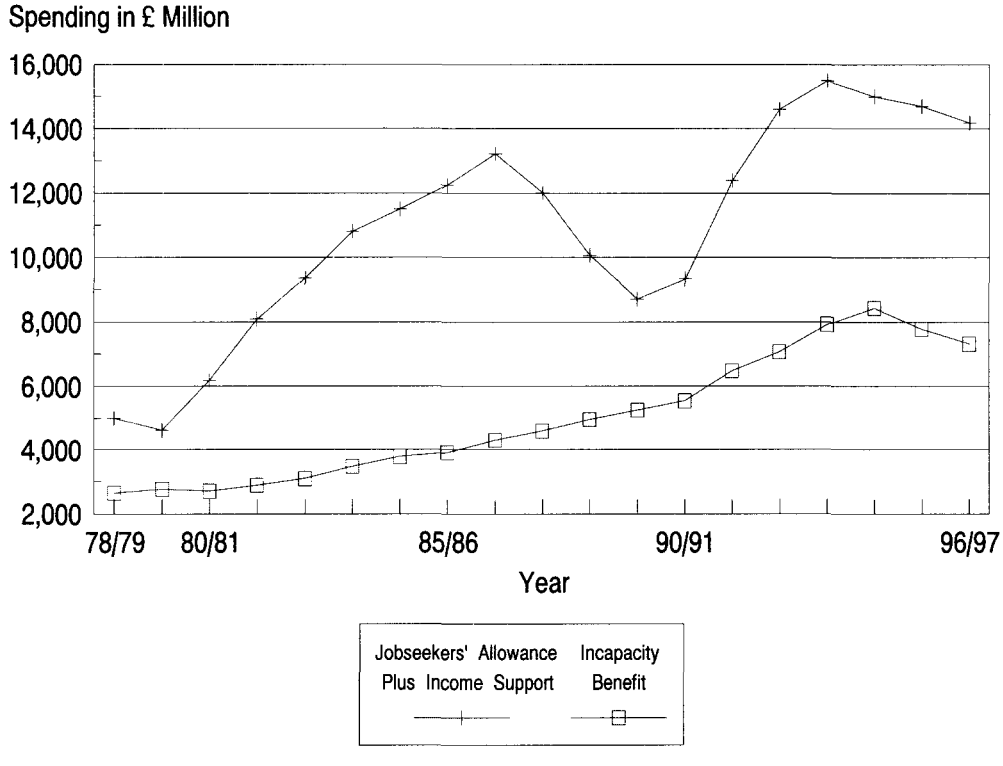
[1] Source: *The Government's Expenditure Plans 1997–98 to 1999–2000*, Social Security Departmental Report, March 1997, Table 3.

of unemployed is only a small part of tackling the whole social security budget. Tackling the 700,000 who have been unemployed for a year or more is a still smaller part.

Nevertheless, spending on programmes for the unemployed has risen considerably in recent years. Figure 7.1 presents total spending on jobseeker's allowance and income support for those under the age of 60, and on incapacity benefit, since 1978. Combined spending on jobseeker's allowance and income support has tripled over the period, from approximately £5 billion in 1978-79 to almost £15 billion in 1996-97. Spending on incapacity benefit has also witnessed a steady rise over the period, from just under £3 billion to over £7 billion.

There is a particular concern expressed both by the government and by many commentators over long lengths of benefit receipt. To be unemployed for a year is qualitatively different from being unemployed for just three months. Skills deteriorate, attachment to the labour market decreases and the chances of

Figure 7.1. Annual spending on jobseeker's allowance, income support and incapacity benefit (1996 prices)



Notes: Figures for jobseeker's allowance are for unemployment benefit prior to 1996-97. Figures for income support are for supplementary benefit prior to 1988-89. Figures for incapacity benefit are for invalidity benefit prior to 1995-96. Figures for income support include only the cyclical component paid to those under the age of 60. Figures for 1996-97 are estimates.

Sources: *The Growth of Social Security*, Department of Social Security, HMSO, 1993, Table 9a; *The Government's Expenditure Plans 1997-98 to 1999-2000*, Social Security Departmental Report, March 1997, Table 1; *Economic Trends Annual Supplement 1996/97*, Office for National Statistics, HMSO, August 1996, Table 2.1; *Economic Trends*, no. 521, Office for National Statistics, HMSO, April 1997, Table 3.1.

Table 7.2. Claimant unemployment by age and duration, January 1997

	18–24		*25–49*		*50 and over*		*All ages*	
Duration	*Num (thous.)*	*% of age-group*	*Num (thous.)*	*% of age-group*	*Num (thous.)*	*% of age-group*	*Num (thous.)*	*% of unemp.*
Men and women								
Up to 6 months	281.6	58.7	469.2	42.6	117.5	38.0	884.1	46.3
6-12 months	92.4	19.3	186.7	17.0	52.4	16.9	332.6	17.4
12-24 months	68.1	14.2	179.5	16.3	48.6	15.7	296.3	15.5
Over 24 months	37.8	7.9	265.9	24.1	91.1	29.4	394.8	20.7
Total	479.9	100.0	1101.3	100.0	309.5	100.0	1907.8	100.0
% of unemployed	25.2		57.7		16.2		100.0	
Men								
Up to 6 months	194.0	57.3	355.7	40.4	86.7	36.9	645.5	44.1
6-12 months	64.9	19.2	144.6	16.4	38.6	16.4	248.8	17.0
12-24 months	50.3	14.9	147.7	16.8	36.4	15.5	234.5	16.0
Over 24 months	29.4	8.7	231.9	26.4	73.3	31.2	334.6	22.9
Total	338.6	100.0	880.0	100.0	235.0	100.0	1463.5	100.0
% of unemployed	23.1		60.1		16.1		100.0	
Women								
Up to 6 months	87.6	62.0	113.5	51.3	30.7	41.2	238.6	53.7
6-12 months	27.5	19.5	42.1	19.0	13.7	18.4	83.7	18.8
12-24 months	17.8	12.6	31.8	14.4	12.2	16.4	61.8	13.9
Over 24 months	8.4	5.9	33.9	15.3	17.8	23.9	60.2	13.5
Total	141.3	100.0	221.3	100.0	74.5	100.0	444.3	100.0
% of unemployed	31.8		49.8		16.8		100.0	

Notes: Claimant unemployment is the number claiming unemployment-related benefits. 'All ages' includes some under the age of 18.
Source: *Labour Market Trends*, Office for National Statistics, March 1997, Tables 2.5 and 2.6.

getting a job fall dramatically. Table 7.2 shows the numbers receiving unemployment-related benefits in January 1997 by age-group and duration of receipt.

Almost half of all recipients have been receiving benefit for less than six months and about a fifth have durations of over two years.[2] Durations are generally

[2] This does not take any account of repeat spells in welfare programmes. In addition, the table shows duration to date rather than completed duration, which will underestimate the

Table 7.3. Lone mothers on income support, 1993

Age of youngest child	*Total fatherless*	*Unmarried*	*Widowed*	*Divorced*	*Separated*
Under 5	545,600	331,400	1,900	52,700	157,600
5-10	286,600	102,300	4,700	73,400	105,600
11-12	54,500	12,700	2,100	20,000	19,500
13-15	72,500	11,800	4,800	31,900	23,800
16+	29,900	5,200	2,900	13,700	8,100
All	989,100	463,400	16,400	191,700	314,600

Note: Figures are for Great Britain only.

Source: Annual Statistical Enquiry, 1993, Table 20.23.

longer for men than women, while duration tends to increase with age group for both men and women. About a quarter of recipients are under the age of 25, although this proportion is slightly lower for men and higher for women. Long-term unemployment seems to be more of a problem for older groups than for younger ones.

Since they form such a large chunk of the welfare-receiving population, a breakdown of lone parents receiving income support is provided in Table 7.3. This shows the distribution of lone parents on income support by the age of their youngest child. Well over 80% have children of under secondary-school age; more than half have a child of pre-school age.

We continue in this chapter with a brief description of the UK social security system as it affects relevant groups. We then consider some of the aims of welfare-to-work policies. Next we consider some types of policies that might be tried and consider some of what is known about the success of similar policies. The final section makes a number of positive recommendations for welfare-to-work policies.

7.2 The benefit system

The social security system is designed to pay benefits to those in need. This includes payments to those out of work because they cannot find a job, because they are medically incapable of working or because they have childcare responsibilities. Payments may also be made to individuals in work where their in-work income is insufficient to meet their needs and to encourage people to take work rather than be unemployed. But in providing these incomes, the system creates a new set of problems in terms of the disincentives to work.

The main benefit for the unemployed is jobseeker's allowance (JSA), which replaced the old unemployment benefit and income support for the unemployed. It is means-tested after six months of unemployment and for those

length of any completed welfare spell. On the other hand, since this is a cross-section of recipients at a given point in time, spells with longer durations are over-represented in the sample, leading to an overestimate of spell lengths.

with an inadequate contributory record, but not means-tested for the first six months of unemployment. The means-tested element is withdrawn pound for pound as income, including that of any spouse, rises.

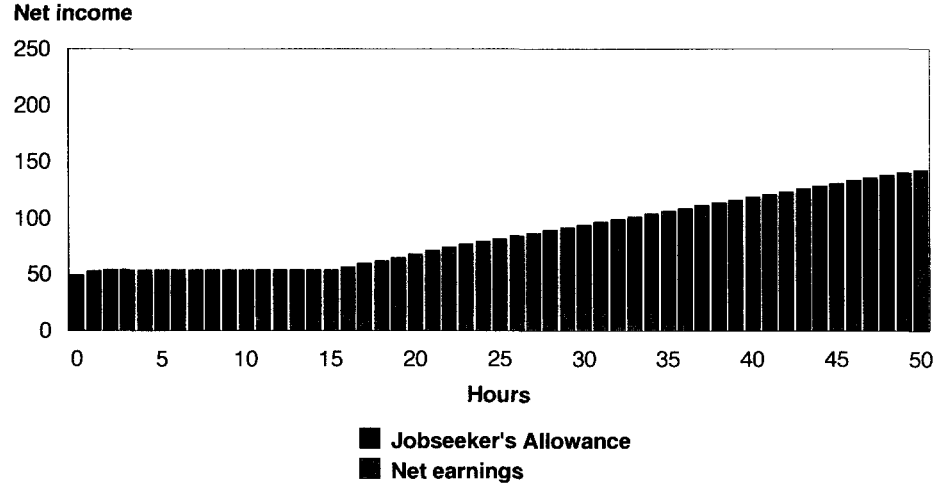
But the JSA is, as we have seen, far from being the only benefit available to those who are out of work. Lone parents not in employment receive income support. They do not need to be available for or looking for work.

It was precisely to limit the availability of out-of-work benefits that invalidity benefit (IVB) was replaced by incapacity benefit (ICB). The number of people receiving IVB spiralled through the 1980s and early 1990s. One policy response was to phase out the earnings-related element of IVB. The medical and work tests for ICB are tougher than they were for IVB, and ICB is taxable whereas IVB was not. Since replacing IVB, there has been some fall in spending, which is forecast by the Department for Social Security to continue.

In addition to these benefits, most recipients will receive council tax benefit and housing benefit. The latter is especially important, covering the rents of those in rented accommodation. For those on income support, full rent is paid.[3] The benefit is then withdrawn at a rate of 65 pence in every pound of net income (after income tax and National Insurance contributions) that is received. As we show below, withdrawal of this benefit can have a very substantial effect on incentives.

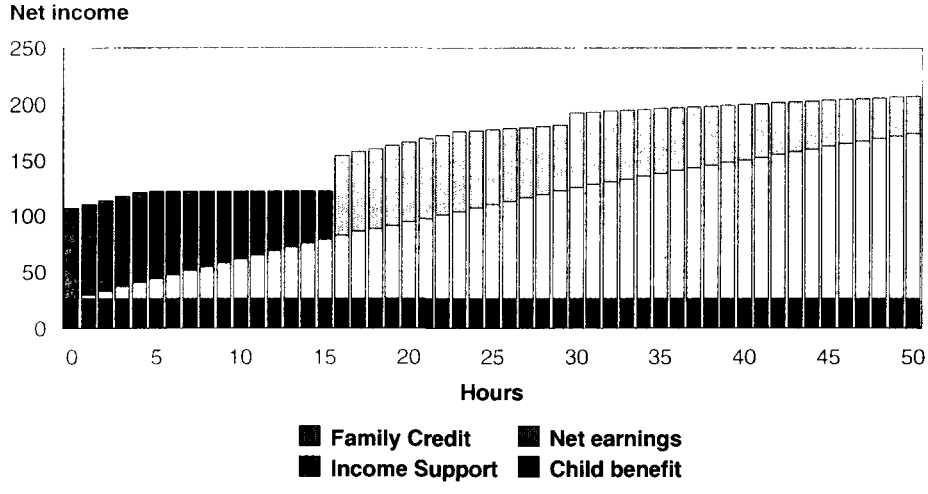
Figure 7.2. Various budget constraints

Budget constraint for single person earning £3.50 per hour

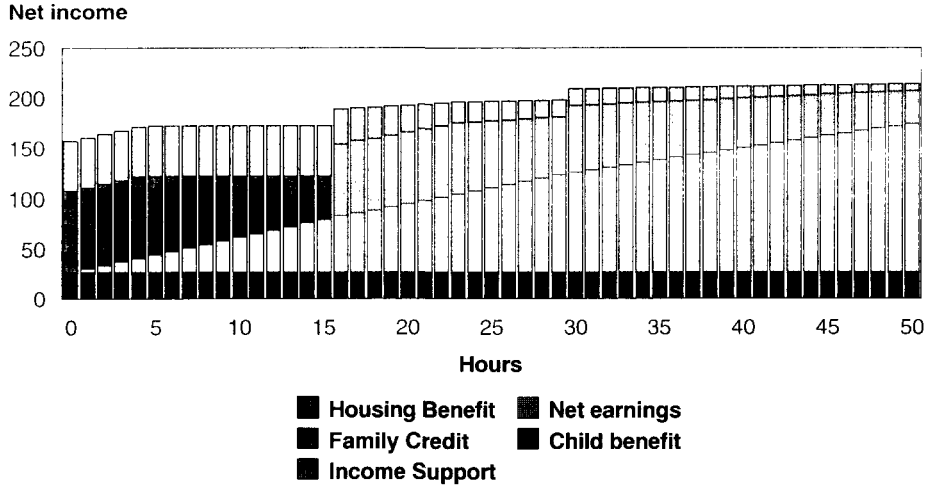


[3] For tenants in the private rented sector, housing benefit is only guaranteed to be paid up to the value of a 'local reference rent' based on the average rent levels for different-sized accommodation in a locality.

Budget constraint for single parent with two children earning £3.50 per hour



Budget constraint for single parent with two children earning £3.50 per hour and with rent of £50 per week



Also available in work is family credit, a benefit designed specifically to help people back into work. It is paid only to claimants with children and becomes available once one or other of a couple is working 16 hours a week or more. It is designed to make being in work financially attractive relative to being out of work. Once earnings rise above a certain level, the family credit is withdrawn at a rate of 70 pence in the pound. Figure 7.2 illustrates the need for the benefit and possible pitfalls by showing the operation of the tax and benefit system for three types of family. In each case, we assume earnings of £3.50 per hour.

In each diagram, hours worked are shown along the horizontal axis going from zero to 50. Net income is displayed on the vertical axis. At zero hours, net income in each case is equal to the relevant income support or jobseeker's allowance rate plus, in the final instance, housing benefit. As earnings rise, income support is lost pound for pound until 16 hours of work, at which point

Table 7.4. Income at different hours of work by family type

Hours of work at £3.50 an hour	*Single person*	*Single parent with two children*	*Single parent with two children and rent of £50 per week*
0	49.15	106.90	156.90
15	54.15	121.90	171.90
16	56.00	154.10	188.43
25	81.77	177.22	196.53
40	118.52	199.80	211.29

eligibility ends altogether. At each hours point after this, the height of the relevant bar relative to the height of the bar at zero hours is a measure of the size of the gain to working that number of hours. Table 7.4 complements the diagrams with income figures for selected levels of hours of work.

The first diagram shows the system for a single person with no housing costs — possibly living with his parents. The second is for a single parent with two children, also with no housing costs. The third is the same as the second, but introduces a rent of £50 per week.

A number of points are illustrated. For the single person, there seems to be little need for an in-work benefit because his out-of-work benefits are so low that anything approaching full-time work would leave him financially much better off in work than out.

For the lone parent, out-of-work benefits are higher and family credit provides a relatively generous bonus to working 16 hours. However, for those who receive below the maximum family credit payment at 16 hours, there is little incentive to work additional hours because the family credit is being withdrawn at a rate of 70p for every pound (after tax) that is earned.

Finally, the introduction of housing costs adds an extra dimension. Housing benefit is payable both in and out of work, being tapered at a rate of 65p in the pound once income rises above income support levels. The trouble is that family credit counts as income for housing benefit purposes and so, as soon as income is raised by receipt of family credit, a large chunk is lost as a result of housing benefit withdrawal.

7.3 The objectives of welfare-to-work

The aim of welfare-to-work initiatives is to reduce work disincentives for employees, to encourage employers to provide jobs, and to offer help and encouragement to individuals to enter and succeed in the labour market. To create a context for the analysis below, consider six types of policy around which a welfare-to-work programme might be based:

1. Social security benefits to those out of work can be made low, hard to claim and subject to stringent work availability tests or workfare requirements.

2. The benefit system can be structured so as to provide financial incentives for people to take work, by increasing benefits at certain levels of income or number of hours of work.
3. Unemployed individuals can be offered help in finding work.
4. Employers can be offered incentives to take on the unemployed.
5. Training can be offered so that skills are improved and potential wages increased.
6. Childcare can be provided or subsidised to increase the net income from working.

Each of these policies can be evaluated in terms of the objectives of providing a minimum income guarantee, encouraging recipients into work and minimising total budgetary costs. As a means of reducing the budgetary costs, welfare-to-work policies may have conflicting effects. Reducing the number of recipients of out-of-work benefits will reduce the cost of these benefits. On the other hand, in-work subsidies and earnings-enhancing measures raise budgetary costs. In particular, some subsidies may be paid to low-paid workers who would not otherwise have received any benefit. Indeed, there will be an additional cost (dead-weight loss) whenever welfare-to-work policies provide assistance to those who would have found employment in their absence. Finally, welfare-to-work schemes may include increased monitoring of the eligibility of recipients and the fulfilment of programme requirements which may raise administrative costs. In principle, one cannot say for sure that even a 'successful' welfare-to-work policy will actually save money.

7.4 Assessment of the British system and alternatives

Reduction in benefit levels

In some circumstances, reductions in benefit levels have been shown to be an effective means to reduce recipiency levels and the length of time on benefits.[4] In Britain, benefit levels have seen considerable reductions already in recent years. The jobseeker's allowance is less generous than the unemployment benefit it replaced in that it is available on a non-means-tested basis for a period of just six months rather than the previous twelve. The continued uprating of benefits in line with prices rather than earnings growth has ensured that benefit levels remain low. The earnings-related element of invalidity benefit was phased out with the introduction of incapacity benefit, and the latter is taxable while the former was not. Finally, the available levels of housing benefit for tenants in the private rented sector have been reduced by making the maximum available equal to a 'local reference rent' and then, for single people, by making the

[4] For a review of the literature on unemployment benefit, see Atkinson and Micklewright (1991). For a review of the effects of AFDC (Aid to Families with Dependent Children) benefit levels, see Moffitt (1992).

maximum amount available equal to the reference rent for a room in a shared property.

Further plausible reductions in benefit levels might have little effect in encouraging recipients into work. For individuals without children, out-of-work benefits are so low that anything approaching full-time work would lead to a financial improvement. The benefit levels are higher for lone parents, but reductions in the level of support run the risk of inadequate provision for children. Overall, there appears to be little scope for further reductions in benefit levels, both because the size of feasible reductions would not have a great effect on total budgetary costs and because they might seriously endanger the objective of a minimum income guarantee. This does not rule out further changes in the stringency of conditions associated with benefit entitlement.

Costly claimant process

One method suggested to reduce the welfare caseload is to make the claim process and receipt of benefit so costly in time, effort and unpleasantness that only the truly needy will find it worth while participating. For example, the tougher medical and work tests introduced when incapacity benefit replaced invalidity benefit may have been a deterrent for some potential claimants. In addition, the recent switching of funds from benefit claims helplines to hotlines for the reporting of potential benefit frauds and the accompanying advertising campaign may have increased the social stigma felt by some recipients from claiming benefits. But such costs for welfare recipients do not necessarily hit the least needy.

Workfare

The term workfare has come to mean a variety of requirements that may be placed on recipients in return for their benefit. Such requirements may include jobsearch activities, subsidised employment or training programmes. The aims of workfare are twofold. First, by removing the 'leisure bonus' of social security, it seeks to encourage social security recipients who have employment opportunities to move into a job. Second, by providing work experience or training, workfare aims to enhance earnings capabilities and make private sector employment more attractive. In practice, workfare schemes combine both these effects, making it impossible to identify separately the incentive effect and the human capital effect.

Much work has been undertaken to evaluate the impact of workfare programmes in the US. Mandatory workfare programmes have generally achieved higher participation rates than voluntary alternatives, even when such beneficial programmes as training are on offer.[5] The important issue is whether participation leads to positive returns. The evidence suggests moderate success. For example, the Manpower Demonstration Research Corporation (MDRC) conducted several large-scale field experiments in the US in the late 1980s to

[5] Mead, 1990.

evaluate the performance of welfare-to-work programmes.[6] Although the experiments could reveal little about the relative merits of different aspects of the schemes, they did illustrate how compulsory workfare requirements can influence welfare behaviour. The programmes were found to contribute modestly to moving recipients into work more quickly, increasing their earnings capacity and reducing the long-term use of welfare. These positive impacts were found to persist and to grow over the five years following the programmes. A cost-benefit analysis showed that, although the initiatives cost money up front, the investment generally paid off in future savings in five years or less. There was no evidence that once people had applied for welfare, they were deterred from completing the application process by the obligation to participate in a work programme. The effectiveness of workfare was much less for the AFDC[7] group of single mothers. It also showed little success in West Virginia, where high rates of unemployment illustrated the limitations of such schemes in the face of inadequate labour demand.

The introduction of the jobseeker's allowance was specifically designed to make the obligation to look for work clear. Recipients have to be capable of and available for work, they have to be actively seeking work and they must have a current 'jobseeker's agreement' with the Employment Service which states the type of work being sought and the steps being undertaken to obtain that work. In addition, several of the jobsearch schemes become compulsory after one year of JSA receipt (listed fully in Table 7.5 below). Failure to complete a compulsory scheme can result in sanctions such as reduction or withdrawal of benefit for a period of time. Benefit payments may also be withheld for leaving a job or losing a job through misconduct, for turning down a job or training offer, or for failing to take appropriate steps to obtain work. This type of compulsory jobsearch element has typically been successful in reducing welfare dependency and there is a strong case for its continuation.

The evidence above suggests that extending programme obligations to include work and training could be a cost-effective method of encouraging recipients to move into work. The government's main welfare-to-work proposal is the requirement for under-25s who have been unemployed for six months or more to take up one of four options: a private sector job with a £60 a week rebate for the employer for six months; non-profit voluntary sector employment with a weekly wage equal to the benefit plus a fixed sum for six months; full-time study for those without qualifications; or a job with the environment task force. Although not explicitly stated, one possible reason for targeting workfare towards the youngest age-group is that those with least work experience are likely to benefit most from employment or training. Such a scheme is likely to be beneficial as long as the demand for labour is sufficient to draw participants back into unsubsidised employment. In addition, care should be taken to avoid worker displacement in the private sector (see section on wage subsidies and employment bonuses below).

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[6] Evaluations of the MDRC experiments can be found in Gueron and Pauly (1991) and Friedlander and Burtless (1995).

[7] Those participating in the Aid to Families with Dependent Children programme.

A further extension of the workfare requirements could be to lone parents on income support with a youngest child of at least school age or of secondary-school age. However, the evidence from the US described above suggests that workfare schemes have few benefits for single mothers. Moreover, since over half of lone parents on income support have a child of pre-school age, and over 80% have children under secondary-school age, targeting these groups would affect only a small proportion of lone parents.

The benefit system structure and effective tax rates

As the diagrams in Figure 7.2 illustrate, the benefit system discourages work at a number of different earnings levels by reducing benefit payments almost pound for pound with additional earnings. That is, the system imposes an effective tax of almost 100% at some levels of work. There are two possible approaches to reduce this disincentive: first, to permit some initial earnings which do not reduce the level of out-of-work benefits; second, to offer in-work benefits which offset the reductions in out-of-work benefits when employment is undertaken.

Encouraging part-time or casual work for recipients of out-of-work benefits would help to maintain links with the labour market, reducing the potential deterioration of working skills and providing greater opportunities for permanent or full-time employment. Greater incentives could be provided by reducing the benefit withdrawal rate with earnings or by allowing an earnings disregard before any benefit is deducted. At present, there is little incentive for recipients of jobseeker's allowance or income support to take part-time or casual work, as their benefit is reduced almost pound for pound with any earnings received. The only exception to this is the 'back-to-work bonus' available to individuals who have received JSA or income support for at least 13 weeks and who have received some earnings that reduced the amount of benefit they received. The bonus repays the deducted benefit up to a maximum of £1,000 when the individual leaves the programme for employment.

The evidence on the effectiveness of such policies is mixed. A change in the benefit withdrawal rate from 67% to 100% in the AFDC programme in the US in 1981 led to no discernible increase in welfare participation or reduction in work.[8] A monthly disregard for earnings and a benefit withdrawal rate of 62% in the Minnesota Family Investment Program was shown to modestly increase the number of welfare recipients who worked relative to no disregard and a withdrawal rate of 100%.[9] Hence only a very significant reduction in the withdrawal rate is likely to make working worth while for workers who command only low wages. However, this would considerably raise the income level at which individuals would be eligible for the programme, drawing in a substantial number of new recipients. The introduction of an earnings allowance, particularly one allowing occasional earnings of some size, could be much more beneficial in encouraging temporary work without drawing a large number of additional recipients into the programme.

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[8] Moffitt, 1986.

[9] Greenberg, Michalopoulos, Robins and Wood, 1995.

Family credit is the main in-work cash benefit available to those with children working 16 hours a week or more. It is means-tested and benefit is withdrawn at a rate of 70 pence for every pound (after tax) that is earned. There is also currently a pilot scheme called earnings top-up which expands the scheme to individuals and couples without children. Family credit pays a bonus for working 16 hours and hence encourages labour-force participation. On the other hand, the high withdrawal rate for higher earnings creates a disincentive for longer hours of work and may induce reductions in labour supply for those who would otherwise work a little longer than the 16 hours.

Evaluations of the impact of family credit conclude that it does have a large impact on the probability of working, but has relatively little impact on the probability of working full-time as opposed to part-time.[10] A similar scheme has been tested in the Canadian Self-Sufficiency Project. This programme provides an earnings supplement based on individual rather than household income for long-term welfare recipients who find a job of 30 hours or more. Benefits are withdrawn at a rate of 50% with additional earnings. Initial evaluations of the project suggest that the programme significantly increases labour market attachment and reduces welfare participation.

Another scheme very similar to family credit is the earned income tax credit (EITC) in the US. The EITC provides a tax credit available to workers on low incomes with children, although it is based on annual earnings rather than hours. For example, the maximum subsidy for a couple with children is currently 40% so that at earnings of $9,000, a credit of $3,600 is received. The subsidy is constant as earnings rise to $12,000 and is then withdrawn at a rate of 16% or 21% depending upon circumstances. As with family credit, the EITC encourages labour-force participation, but it creates work disincentives for the 70% of EITC recipients whose incomes lie in the region where the credit is constant or being phased out. Several studies have identified these conflicting effects. Eissa and Liebman (1996) found that the 1986 expansion of the scheme had positive participation effects for single women with children, but no change in the hours worked by those already in the labour force. Work by Scholz (1996) estimates that the 1993 expansion of the scheme led to both an increase in labour-force participation and a reduction in hours of work by those already in the labour market, but suggests that the magnitude of the participation effect is large enough to offset the decrease in the hours worked by workers.

An additional work disincentive arises in the family credit scheme because of its calculation on the basis of household rather than individual income. This means that a second earner in a household on family credit faces a very high marginal tax rate when deciding whether to work due to the withdrawal of the spouse's benefit. An earnings disregard for second earners in such households would help to reduce this disincentive.

Latest DSS estimates of the take-up of family credit suggest that only 69% of those who are entitled receive it, with those with low entitlements less likely to claim.[11] This may be due to ignorance of the scheme or an unwillingness to take

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[10] Bingley and Walker, 1996.

[11] Source: *The Government's Expenditure Plans 1997–98 to 1999–2000*, Social Security Departmental Report, March 1997.

up benefits while in work. In contrast, take-up of the EITC is estimated to be over 80%, which is probably due to the fact that it is administered through the tax system rather than the benefit system and is claimed in the end-of-year tax return which must be automatically filed by most workers. The problem with the EITC is the large number of individuals receiving the benefit who appear not to be entitled to do so. Official estimates for 1988 suggest that 30% of EITC claimants were ineligible.[12]

There has been much talk of importing an EITC-type approach to the UK but there are a number of drawbacks in implementing a tax credit. The payment of the benefit after the end of the tax year might cause problems for low-income households, although it might emphasise the benefit of entering the labour force without making explicit the high marginal tax rates. Assessment and payment would probably need to operate through the PAYE system rather than annual tax returns, increasing the administrative burden on employers and requiring them to know considerably more about their employees' family and financial circumstances. Finally, if family credit is to continue to be calculated on a household rather than an individual basis, a tax credit would require tax returns dependent upon spouse's income which is in contradiction to the current system of independent taxation.

An additional disincentive to work is the withdrawal of housing benefit at a rate of 65 pence in the pound once income rises above income support levels. Since family credit counts as income for housing benefit purposes, a large chunk of the family credit will be lost in reduced housing benefit, reducing the incentive to qualify for family credit by working. In addition, council tax benefit adds another 20 percentage points to withdrawal rates. The problem has grown since the deregulation of private sector rents in 1988 and the policy of moving social sector rents up towards market levels which has vastly increased spending on housing benefit. Many paying reasonable levels of rents now need to be earning considerable wage levels to escape housing benefit.

Possible remedies again raise the choice of increasing earnings disregards or reducing withdrawal tapers. Increasing disregards provides bigger incentives for individuals to work to the level of the disregard, while cutting withdrawal rates potentially raises the numbers in receipt of housing benefit and facing work disincentives at higher levels of earnings. An alternative answer is to cut rents by increasing subsidies to councils and Housing Associations, but this would be an expensive policy if substantial differences are to be made to work incentives.

Jobsearch assistance

Assistance in seeking and attaining work holds the potential of a cheap alternative to continued payment of out-of-work benefits or the costs of training or employment creation. Evaluations of jobsearch assistance have been very positive. In particular, studies from France, the Netherlands and the US show that such measures are fairly simple to organise, are not very costly and lead to a speedier return to work. In the UK, pilot evaluations of the

[12] EITC take-up figures and ineligibility proportion from Scholz (1996).

counselling and interviews in the jobseeker's allowance programme suggest that these measures have reduced long-term unemployment.[13]

The jobseeker's allowance programme provides a wide range of jobsearch services which are available after certain periods of JSA receipt. These are summarised in Table 7.5. Judging from past experience, the variety of jobsearch assistance currently provided with the jobseeker's allowance is a cost-effective means of moving recipients into employment.

It may also be beneficial to extend the provision of such services to those income support recipients caring for children who may be willing to work if a job were available. One of the policies outlined in Labour's manifesto is to offer lone parents a proactive employment service to develop a package of jobsearch, training and after-school care as soon as their youngest child is in the second term of full-time school.

Table 7.5. Jobseeker's allowance schemes

Scheme	*Description*	*Timing*	*Planned spending, 1997–98 (£m)*
Travel to Interview	Pays the cost of travelling to a job interview	Available after 13 weeks	1.6
Job Search Plus	Three-day programme to improve jobseeking skills	Available after 13 weeks	5.4
Job Interview Guarantee Scheme	Employers guarantee interviews to people nominated by the Employment Service	Available after six months	1.0
JobClub	Jobsearch assistance involving attendance for 4½ days a week for 20–26 weeks	Available after six months	26.6
Work Trials	Opportunity to try a job for up to 15 working days without leaving JSA; pays some meal and travel expenses	Available after six months	1.0
Jobplan	Workshop for five days to build confidence and enhance jobseeking skills	Compulsory after 12 months	9.3
Workwise / Worklink	Four-week programme for 18- to 24-year-olds to enhance jobseeking skills	Compulsory after 12 months	5.0
1-2-1	Six interviews with a senior Employment Officer to appraise position	Compulsory after 12 months	11.8
Restart	Two-week course of intensive work search	Available after 18 months Compulsory after 2 years	5.0

[13] OECD, 1995.

A similar scheme was implemented in the Work Incentive Program in the early 1970s in the US, which required all single mothers in the AFDC programme with school-age children to register and participate in welfare employment programmes. These typically involved only low-cost jobsearch assistance. In most cases, the programmes led to consistent and measurable increases in employment and earnings, with the impact continuing for at least three years. The budgetary costs of the programmes were generally more than offset by projected savings within two to five years of welfare enrolment. The evaluations also showed that those with little or no recent work history benefited most, although the most disadvantaged long-term recipients showed little benefit, suggesting that this type of recipient may require more substantial help.[14]

Wage subsidies and employment bonuses

Wage subsidies for former benefit recipients can be paid either directly to the employee or to the employer in the form of tax rebates. The subsidies improve employment probabilities either by reducing the individual's reservation wage to accept a job or by increasing employer demand through the lower wage cost. Temporary subsidies targeted on the longer-term unemployed are argued to raise work motivation and experience levels to enhance future employment probabilities and earnings capacity. Unlike means-tested in-work benefits, they do not create disincentives for additional hours of work. The major drawback of wage subsidies is the potential displacement and substitution effects, when a subsidised worker is hired at the expense of laying off or not hiring someone who is not subsidised. In addition, there may be dead-weight effects when firms receive a subsidy for hiring someone they would have hired anyway.

Most past British work subsidy schemes have been criticised for suffering from considerable dead-weight loss, including the New/Young Worker Scheme and the Workstart pilot schemes, although the latter did appear effective in favourably changing employers' perceptions of the long-term unemployed.[15] Other schemes in Sweden, Australia, Ireland and all over Europe have been widely criticised for their substantial displacement and dead-weight losses. Yet many schemes have had significant positive effects. Marginal employment subsidies were found to reduce the duration of unemployment in Italy.[16] Evidence from Australia indicates high retention rates in employment for young people after a six-month wage subsidy has been terminated.[17] The New Jobs Tax Credit in the US was found to have a large employment effect, although was less successful when targeted towards disadvantaged groups.[18] Overall, the evidence suggests that wage subsidies can enhance the movement out of

[14] Gueron, 1991.

[15] For a general review, see Adnett and Dawson (1996).

[16] Felli and Ichino, 1988.

[17] OECD, 1994.

[18] Haveman and Saks, 1985.

unemployment and into employment, but such schemes incur considerable dead-weight loss and are therefore expensive.[19]

There have been two recent wage subsidy schemes in the UK. The National Insurance contributions holiday exempted employers hiring an individual who had been on JSA for two or more years from paying employer Class 1 contributions for the first 52 weeks of employment. In addition, the pilot Jobmatch scheme paid people unemployed for over two years a weekly allowance of £50 for six months when they take up a part-time job or move into self-employment. Labour's welfare-to-work proposals include a £75 a week tax rebate for six months for employers hiring individuals who have been unemployed for more than two years and a £60 a week tax rebate for six months for employers hiring an individual under the age of 25 who has been unemployed for at least six months. Such schemes are likely to enhance the employment probabilities for these groups, but there is a danger that they will merely displace other individuals who might otherwise have been hired. Consequently, the schemes may prove to be very expensive.

The Jobfinders' Grant provides a back-to-work bonus for individuals who have been on JSA for two or more years and pays a grant of £200 for taking a job that would not otherwise have been considered. Employment bonuses are argued to increase the intensity of jobsearch. A study comparing employment bonuses and wage subsidies in Illinois[20] found that both increased re-employment probabilities, but that the bonuses were more widely used and therefore less cost-effective. The suggested explanation is that wage subsidies require employer involvement and increase the stigma involved in their use, so that they tend only to be used by those who need the incentive to attain employment. Employment bonuses may not therefore be an effective welfare-to-work tool.

Investment in human capital: training and education

Training programmes account for a significantly greater share of public expenditure than employment services in most European countries. The rationale for such policies is based upon training market failures, such as imperfect credit markets and information asymmetries which mean that profitable training may not be undertaken in the private sector. Training unskilled unemployed individuals also has the advantages of reducing unemployment and helping to offset widening wage differentials.

The evaluations of workfare schemes described above generally found that training played only a small role in improving employment opportunities. However, investments in training were found to be most successful for actual and potential long-term benefit recipients. More specific training programmes for the unemployed have had rather mixed results. As reported in the OECD *Employment Outlook* (1995), positive outcomes have been found for highly

[19] There have also been several studies attempting to assess the effects of wage subsidies on total employment in the economy as a measure of the displacement effects. However, few consistent or significant conclusions have been reached. See Adnett and Dawson (1996, p. 15) for a brief review.

[20] Dubin and Rivers, 1993.

targeted and relatively small programmes designed to meet the needs of specific groups. Examples of such success include the on-the-job training in the US Job Training Partnership Act in Canada and the centres for vocational orientation and training in the Netherlands. Other evaluations in the Netherlands, the US, Germany and Sweden have shown that training programmes that are broadly targeted on the unemployed are generally ineffective.[21] In addition, pressure to create training places may have detrimental effects on training quality, as highlighted in recent evaluations of Australia's entry-level training in the Working Nation programme.[22]

In the UK, a 'Training for Work' scheme is available to individuals after six months of receipt of jobseeker's allowance. This is directed at full-time training in new skills, with an additional training allowance of £10 a week plus some travel and childcare costs being paid. Planned spending on the scheme was £439 million in 1997-98, which dwarfs the expenses of all the other employment services listed in Table 7.5. Youth training is currently guaranteed to all 16- to 18-year-olds not in full-time education and not in a job. In 1995-96, nearly 280,000 young people were involved in youth training which has an objective that all entrants should achieve an NVQ Level 2 qualification.

Training and education play a major role in Labour's welfare-to-work proposals. One of the options for the under-25s unemployed for more than six months is full-time study, while the Target 2000 programme increases education opportunities for under-18s. However, past experience of youth training in the UK has not been entirely positive. The Youth Training Scheme now has a long history, but potential beneficiaries have generally negative perceptions of the scheme.[23] Of particular concern is the completion rate of just 46%. Between April 1994 and January 1995, 22% of leavers from Youth Training were known to be still unemployed six months later.

Childcare assistance

In addition to the potential benefits for children in the provision of good-quality childcare facilities, there are several arguments that childcare should be subsidised in order to enable mothers to continue working. First, the costs of child-rearing fall disproportionately on women and subsidies would help to redress this inequity. Second, there may be imperfect information about the benefits of returning to work — for example, ignorance of the effects on future pension rights. Finally, even though a mother may calculate that investment in childcare now will be more than offset by higher future earnings, imperfect capital markets may mean it is not possible to borrow against that expectation.[24]

In a recent study of lone parents in 20 countries, lone mothers in the UK were found to have low rates of employment, among the lowest rates of full-time

[21] Adnett and Dawson, 1996.

[22] Australian Government Publishing Service, 1996.

[23] Dearing, 1996.

[24] Duncan, Giles and Webb, 1995.

work and a lower rate of employment than married and cohabiting mothers.[25] Although the demand for women's labour, average taxation rate and high in-work benefits favoured lone parents' employment in the UK, the very high cost of childcare created the strongest disincentive to paid work of any of the countries studied. Other work, by Jenkins and Symons (1995),[26] also found significant work disincentive effects for childcare costs in the UK. This clearly identifies the need for government assistance in the childcare area if mothers of young children are to find it beneficial to work.

Although not introduced specifically as a welfare-to-work measure, the current scheme of nursery vouchers worth £1,100 a year to all parents with four-year-old children can help with the costs of childcare for these parents. The government has proposed to abolish this voucher scheme and to use the money saved to guarantee nursery places for all four-year-olds and to set targets for universal provision for three-year-olds whose parents want it. Although both voucher schemes and the provision of places provide some incentive to work, the programmes are not designed with the sole aim of encouraging employment and a large part of the cost is not targeted on improving work incentives. In addition, the policy helps only parents of four-year-olds and provides no assistance to mothers of younger children or to mothers of older children facing short school hours and school holidays. Indeed, support for pre-school children of all ages may encourage mothers to return sooner to work after the birth of a child, thereby reducing the deterioration of work skills with time out of the labour force.

A recent report used cost and behavioural simulations to estimate the impact of four possible childcare subsidy schemes.[27] The first was an earnings disregard for childcare in the family credit programme. This was found to be very cost-effective but also benefited very few women. Second, a blanket introduction of child allowances for under-fives was found to be expensive and ill-targeted, although a system of childcare vouchers could achieve positive results at very modest cost. Third, although full state subsidy of all childcare costs was estimated to be extremely expensive, even a relatively mild income test would greatly reduce the cost and focus the benefit more sharply. Finally, tax relief on childcare costs had little beneficial effect as it channelled money towards those already well-placed in the childcare market. All this suggests that a means-tested subsidy of childcare costs may be the best method to enhance work incentives at minimum cost.

In addition, 're-employment advisers' to help potential working mothers to find suitable childcare have also been advocated as a means to improving work incentives. Indeed, part of Labour's proposal of proactive employment services for lone mothers would include development of after-school care. Given the large barrier posed to work by the costs of childcare, such assistance could prove a cost-effective means of enhancing the employment opportunities of parents and particularly mothers.

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[25] Bradshaw et al., 1996.

[26] Jenkins and Symons, 1995.

[27] Duncan, Giles and Webb, 1995.

7.5 Summary

Welfare-to-work policies can be evaluated in terms of the three objectives of providing a minimum income guarantee, encouraging benefit recipients into work and minimising total budgetary costs.

Reducing benefit levels and making the claimant process as costly as possible run counter to the first objective of ensuring a minimum income guarantee for all. Workfare policies also run this risk if they are not carefully targeted on those who are truly capable of fulfilling the requirements. The remaining options are fairly neutral with respect to this first objective.

Workfare, in-work benefits such as family credit, jobsearch assistance, wage subsidies, training for the unemployed and childcare assistance are all potentially beneficial for encouraging benefit recipients to move into employment. Jobsearch assistance appears to provide the greatest returns for all groups of benefit recipients, while training schemes must be carefully targeted. The adverse effect on hours of work of in-work benefits must also be borne in mind when any expansions of family credit are contemplated.

The most cost-effective options appear to be workfare and jobsearch assistance. Childcare assistance need not be too expensive if carefully targeted. Benefit reductions and making the claimant process costly are unlikely to generate significant falls in budget costs. The potential dead-weight loss involved in in-work benefits and wage subsidies from the payment of benefits to those who do not necessarily require them could make these options very costly, while poorly targeted training could also prove expensive.

All this suggests several positive steps forward:

- In the light of the current buoyant labour market, workfare requirements may well be beneficial, especially for the young, who stand to gain most from work experience. But it is doubtful that imposing such requirements on lone parents would generate large movements into employment for this group and it might run the risk of discouraging some lone parents from claiming the support they genuinely need.
- The provision of training for the young may draw positive returns, but only if it is well-targeted and designed to fit future employment possibilities. Indeed, it may be better for training funds to be carefully allocated on this basis across all types of benefit recipients rather than restricting the lion's share of the opportunities to one particular group.
- If employment of some type is the highest priority rather than long hours or full-time work, expansion of the family credit programme to individuals without children could prove an effective means of achieving this. In addition, an earnings disregard for second earners in the family credit programme or a small and flexible earnings disregard for jobseeker's allowance and income support might also encourage involvement in some type of work.
- Time-limited wage subsidies, although likely to be expensive, could also be a means of encouraging some involvement in employment and would be particularly beneficial if targeted on groups who would gain most from work experience, such as the young.

- The most cost-effective policy for encouraging lone parents into work could be a mandatory programme of jobsearch assistance, although without the requirement of active jobsearch on the part of income support recipients. The aim of such a scheme would be to ensure that lone parents are fully aware of the opportunities available to them. Most importantly, such a package should include advice on obtaining suitable childcare arrangements.
- The employment of lone parents could also be encouraged by the further provision or subsidy of childcare. To make efficient use of resources, subsidies could be tied to a work requirement and be available to mothers of children of all pre-school ages.

  There is a high degree of overlap between these suggestions and the Labour Party's manifesto promises for welfare-to-work. The implementation of these promises could well prove to be a considerable step forward in providing opportunities and incentives for many current benefit recipients in Britain to move into employment. But many of these suggestions would involve considerable initial budgetary costs and it is by no means clear that large budgetary savings will eventually be made.

Appendix A. Forecasting the PSBR

This appendix outlines the methods we have used to forecast the state of the public finances for 1997-98 and beyond. So early in the financial year it is not possible to base any forecast for the 1997-98 PSBR on tax revenues collected to date. We base our PSBR forecast for this financial year and for the medium term on a macroeconomic forecast supplied by Goldman Sachs and the IFS model of tax elasticities. In the medium-term analyses, we present two scenarios for the public finances. The first takes the spending plans in the November Budget and assumes the real growth in the control total is the same as that in the FSBR. The second assumes that real control total growth exceeds that of the FSBR and averages 2% over the Parliament.

A.1. Method for modelling tax receipts

Our modelled receipts approach estimates levels of tax revenues in the current year (T) by taking receipts in the previous year (T-1) and multiplying the growth in the tax base by an estimate of the tax elasticity with respect to the tax base. To this we add any known budgetary changes that affect year T which have been announced by the government.

For example the approach would be as follows for the 1997-98 tax forecast:

$$\text{Tax revenues (1997-98)} = \text{Tax revenues (1996-97)} \times \frac{[\text{1997-98 tax base}] \times \text{Elasticity}}{[\text{1996-97 tax base}]} + \text{Budgetary changes}$$

Table A.1 shows the elasticities we have used in forecasting tax revenues. As can be seen, income tax receipts are more responsive to nominal wage growth than to employment growth and relate negatively to the growth in the proportion of part-time employees. Both of these factors are a result of the progressive nature of income tax. For the excise duties, we find that goods such as wine with a relatively high income elasticity of demand are far more responsive to growth in overall consumers' expenditure than goods such as beer and tobacco where demand is less income-elastic.

Table A.1. Tax bases and elasticities for model forecasts[a]

Tax	*Tax base*	*Elasticity of tax changes to change in tax base*
Income tax	Nominal wages	1.56
	Lagged employment	1.18
	Proportion of part-time employees	-0.26
	Lagged error correction model[b]	-0.22
Corporation tax	Nominal gross profits	1.0
VAT	Nominal consumers' expenditure	1.1
National Insurance	Nominal wage bill	1.05
Fuel	Real consumers' expenditure	1
Tobacco	Real consumers' expenditure	0.25
Beer	Real consumers' expenditure	0.85
Wines	Real consumers' expenditure	1.5
Spirits	Real consumers' expenditure	0.95

[a] The derivation of these tax base elasticities is discussed in more detail in last year's Green Budget.

[b] The model used to estimate income tax receipts is described in more detail in last year's Green Budget.

Table A.2 gives our working assumptions about the out-turn for the macroeconomic indicators which form the tax bases outlined above. Reasons for these assumptions are given in Chapter 2.

Table A.2. Main macroeconomic assumptions

(% growth)	*1997–98*	*1998–99*	*1999–00*	*2000–01*	*2001–02*
GDP	3.5 %	2.4 %	2.3 %	2.3 %	2.3 %
Consumers' expenditure	4.4 %	3.0 %	2.8 %	2.5 %	2.0 %
Corporate profits (lagged)	12.0 %	8.0 %	7.0 %	6.0 %	5.0 %
Employment (lagged)	0.9 %	0.9 %	0.5 %	0.5 %	0.5 %
Average earnings	4.9 %	5.3 %	4.8 %	4.5 %	4.5 %
GDP deflator	2.0 %	2.4 %	2.8 %	2.5 %	2.5 %
Money GDP (£bn)	789	827	869	911	955

A.2. Revenue forecasts for fiscal 1997–98

Table A.3 presents a range of tax receipts and public spending forecasts for 1996–97 and 1997–98. The latest estimate for the PSBR in 1996–97 is £23.1 billion, £3.3 billion lower than forecast by the Treasury in the FSBR last November. The undershoot on the PSBR is mainly accounted for by stronger

Table A.3. The public finances, 1996–97 and 1997–98

(£ billion)	*FSBR (Nov. 1996) 1996–97*	*Estimated out-turn 1996–97*	*FSBR (Nov. 1996) 1997–98*	*IFS modelled receipts 1997–98*	*IFS forecast 1997–98*
Income tax	68.1	69.4	71.8	72.8	72.8
Corporation tax	26.1	27.7	27.2	30.9	30.9
Petroleum revenue tax	1.7	1.6	1.6	1.7	1.7
Capital gains tax	0.9	1.1	1.1	1.2	1.1
Inheritance tax	1.6	1.6	1.6	1.5	1.6
Stamp duties	2.4	2.3	2.7	2.4	2.6
Total Inland Revenue	**100.8**	**103.7**	**106.0**	**110.5**	**110.7**
Value added tax	47.5	46.7	50.7	49.8	49.8
Fuel duties	17.4	17.2	19.6	19.4	19.4
Tobacco duties	7.8	8.2	8.4	8.8	8.8
Alcohol duties	5.7	5.7	6.1	6.1	6.1
Betting and gaming duties	1.5	1.4	1.6	1.4	1.4
Customs duties and agricultural levies	2.2	2.3	2.4	2.3	2.4
Air passenger duty	0.4	0.4	0.8	0.5	0.5
Insurance premium tax	0.6	0.7	1.2	1.2	1.2
Landfill tax	0.1	0.1	0.4	0.4	0.4
Total Customs and Excise	**83.3**	**82.5**	**91.2**	**90.1**	**90.1**
Vehicle excise duties	4.3	4.3	4.5	4.7	4.7
Oil royalties	0.7	0.6	0.6	0.6	0.6
Business rates	14.2	14.2	14.6	14.6	14.6
Social security contributions	46.7	46.7	49.1	48.8	48.8
Council tax	9.9	9.9	10.6	10.4	10.6
Other taxes and royalties	5.8	5.8	5.5	5.4	5.5
Total taxes and social security contributions	**265.6**	**267.8**	**282.1**	**285.1**	**285.6**
Interest and dividends	5.0	5.0	5.1	5.1	5.1
Gross trading surplus and rent	5.1	5.1	4.9	5.2	4.9
Other receipts	5.2	5.2	7.2	5.3	7.2
General government receipts	**280.9**	**283.1**	**299.4**	**300.7**	**302.8**
Control total	260.6	260.0	266.5	266.1	266.0
Cyclical social security	14.3	13.5	14.1	13.2	13.2
Central government debt interest	22.2	22.1	24.8	24.8	24.8
Accounting adjustments	10.3	10.3	9.2	9.2	9.2
GGE(X)	**307.4**	**305.9**	**314.7**	**313.3**	**313.3**
Privatisation proceeds	-4.5	-4.4	-2.0	-2	-2
Other adjustments	5.6	4.6	6.3	6.3	6.3
GGE	**308.5**	**306.1**	**319.0**	**317.6**	**317.6**
General government borrowing	27.7	23.0	19.6	16.8	14.7
Public corporations' market and overseas borrowing	-1.3	0.1	-0.4	-0.4	-0.4
PSBR	**26.4**	**23.1**	**19.2**	**16.4**	**14.3**

tax revenues in the latter part of 1996-97 than was forecast in the FSBR. Public spending and borrowing by public corporations combined is also estimated to have been £1 billion lower than the FSBR forecast.

Income tax and corporation tax revenues were particularly strong in the first quarter of 1997 and the out-turns for these taxes were £1.3 billion and £1.6 billion higher than the FSBR forecast respectively. VAT came in lower than expected at £46.7 billion although the growth of VAT revenues over 1995-96 was a healthy 8.4%. These revenue out-turns form a large part of the difference between the IFS forecasts for tax revenues in 1997-98 and those contained in the FSBR. We expect income tax revenues to be £1 billion higher than the Treasury expected, corporation tax revenues £3.7 billion higher and VAT revenues £0.9 billion lower. There is little difference between the IFS and the FSBR forecasts for most of the other taxes, particularly those that yield little revenue.

On the spending side, we expect the out-turn for general government expenditure will be £2.4 billion lower in 1996-97 than was planned in November. Some of this undershoot is accounted for by a combination of lower net departmental outlays (by £1.2 billion) and lower local authority borrowing (by £0.5 billion). In addition, we expect there will also be adjustments to other parts of the accounts when they are published. We have suggested in Table A.3 that the control total undershot by £0.6 billion and cyclical social security by £0.8 billion and that other adjustments account for the rest of the expected fall in general government expenditure. For 1997-98, we have consolidated part of this undershoot in the control total and also expect the expenditures on cyclical social security to be almost £1 billion lower than in the FSBR. This reflects rapidly falling numbers of claimants receiving benefits associated with unemployment.

A.3. The public finances in the medium term

Over the medium term, the PSBR will principally be affected by two sets of factors: developments in the macroeconomy and discretionary government policy decisions. For this Green Budget, we are only presenting one set of macroeconomic forecasts but we calculate the path for the PSBR on the basis of two different spending assumptions. The macroeconomic assumptions are outlined in Table A.2.

Public finances in the medium term: no policy changes

On the basis of no policy changes, the projection of the PSBR into the medium term calculates tax revenues using our modelling framework described above. It also assumes that all tax increases announced prior to and in the 1996 Budget are implemented.[1] These amount to £6.2 billion a year by the end of the Parliament.

[1] See Table 3.3 for a breakdown of the effects of these discretionary tax increases.

For public spending, we assume that the control total increases by an amount that makes the real increase the same as that implied in the 1996 Budget. As our forecast for the GDP deflator is consistently slightly higher than that in the FSBR, our forecast for nominal control total spending is higher than the Treasury's from 1998-99 onward. A summary of the assumptions in the forecast is shown in Box A.1 and Table A.4 shows the path of tax revenues, public spending and the PSBR on these assumptions. Table A.5 shows the path of the public finances as a share of GDP.

Box A.1. Central medium-term forecast

Central macroeconomic forecast.

Government sticks to the path of real expenditure implicit in its pre-announced spending plans.

No discretionary changes in taxation apart from those already announced.

Table A.4. The PSBR in the medium term: central medium-term forecast

(£ billion)	*1997–98*	*1998–99*	*1999–00*	*2000–01*	*2001–02*
Income tax	73	80	87	94	101
Corporation tax	31	34	37	39	41
Value added tax	50	53	55	58	61
Excise duties	34	38	41	44	48
Other taxes and royalties	49	52	54	56	58
Social security contributions	49	52	55	58	61
Other receipts	17	16	16	16	16
General government receipts	**303**	**323**	**345**	**364**	**384**
Control total	266	275	284	293	303
Cyclical social security	13	13	14	14	15
Central government debt interest	25	25	24	25	25
Accounting adjustments	9	10	11	11	11
GGE(X)	**313**	**323**	**334**	**343**	**354**
Privatisation proceeds	-2	0	0	0	0
Other adjustments	6	7	7	7	7
GGE	**318**	**330**	**341**	**351**	**361**
General government borrowing	15	7	-3	-13	-24
Public corporations' borrowing	0	0	0	0	0
PSBR	**14**	**7**	**-3**	**-13**	**-24**

Note : Figures may not sum due to rounding.

Table A.5. The public finances in the medium term: central medium-term forecast (as % of GDP)

	1997–98	*1998–99*	*1999–00*	*2000–01*	*2001–02*
General government receipts	38.4 %	39.1 %	39.6 %	40.0 %	40.3 %
Control total	33.7 %	33.2 %	32.6 %	32.2 %	31.7 %
GGE(X)	39.7 %	39.1 %	38.5 %	37.8 %	37.0 %
GGE	40.2 %	39.9 %	39.3 %	38.5 %	37.8 %
PSBR	**1.8 %**	**0.8 %**	**-0.4 %**	**-1.5 %**	**-2.5 %**

Public finances in the medium term: higher spending scenario

The planned growth of public expenditure outlined in the FSBR last November was unprecedentedly tight. It is therefore important to forecast the public finances on the basis that public expenditure growth matches the last government's record over 18 years. In this alternative public spending scenario, the macroeconomic forecast and tax revenues are identical but it is assumed that the control total overshoots by £2 billion in 1997-98 and grows by 2.3% in real terms thereafter. A summary of the assumptions is contained in Box A.2, and the path of the PSBR is shown in nominal terms and as a proportion of GDP in Tables A.6 and A.7 respectively.

Box A.2. Public spending slippage

Central macroeconomic forecast.

Government allows higher-than-planned increases in spending.

No discretionary changes in taxation apart from those already announced.

Table A.6. The PSBR in the medium term: public spending slippage

(£ billion)	*1997–98*	*1998–99*	*1999–00*	*2000–01*	*2001–02*
Income tax	73	80	87	94	101
Corporation tax	31	34	37	39	41
Value added tax	50	53	55	58	61
Excise duties	34	38	41	44	48
Other taxes and royalties	49	52	54	56	58
Social security contributions	49	52	55	58	61
Other receipts	18	16	16	16	16
General government receipts	**303**	**323**	**345**	**364**	**384**
Control total	269	281	296	310	325
Cyclical social security	13	13	14	14	15
Central government debt interest	25	25	26	27	27
Accounting adjustments	9	10	11	11	11
GGE(X)	**316**	**330**	**347**	**362**	**378**
Privatisation proceeds	-2	0	0	0	0
Other adjustments	6	7	7	7	7
GGE	**320**	**337**	**354**	**369**	**385**
General government borrowing	17	14	9	4	1
Public corporations' borrowing	0	0	0	0	0
PSBR	**17**	**14**	**9**	**4**	**1**

Note : Figures may not sum due to rounding.

Table A.7. The public finances in the medium term: public spending slippage (as % of GDP)

	1997–98	*1998–99*	*1999–00*	*2000–01*	*2001–02*
General government receipts	38.4 %	39.1 %	39.6 %	40.0 %	40.3 %
Control total	34.0 %	34.0 %	34.0 %	34.0 %	34.0 %
GGE(X)	40.0 %	39.9 %	39.9 %	39.7 %	39.6 %
GGE	40.6 %	40.7 %	40.7 %	40.5 %	40.3 %
PSBR	**2.1 %**	**1.6 %**	**1.0 %**	**0.5 %**	**0.0 %**

Appendix B. Timing of the Budget and the Finance Bill

Two major considerations affect the timing of the first Labour Budget. The later it is held, the more time there is for the preparation of measures and for Parliamentary Counsel to prepare the corresponding legislation. But a later Budget reduces the time available to enact the legislation prior to the summer recess.

When will the Finance Bill be enacted?

The Labour government's majority gives it virtual freedom to dictate the pace at which a Finance Bill passes through Parliament. It would, therefore, be possible to enact a Finance Bill between early July and Parliament rising for the summer.

The Chancellor could leave enactment of a Finance Bill until the autumn. This would leave the detail of a windfall tax open to consultation and lobbying in the mean time. Deferring a Finance Bill until the autumn would also put it into a busier parliamentary period when other Ministers will be seeking parliamentary time for their measures. In addition, if the Chancellor wants to change income tax rates, allowances and reliefs for the current tax year, 1997-98, he will want these to have immediate effect under appropriate Budget Resolutions. For a Summer Budget, however, the Provisional Collection of Taxes Act 1968 limits the effect of such Resolutions to four months. Accordingly, the Chancellor would want to enact such changes before Parliament rises for the summer recess. A Finance Act before Parliament rises for the summer could then be followed by a March 1998 Budget and a second Finance Bill between April and July 1998, which should be a less busy parliamentary period.

What considerations apply to the timing of the Budget?

Most Spring elections in the recent past have been followed by some legislative action by the Chancellor. In 1983, there was no post-election Budget but the new Chancellor, Nigel Lawson, announced on 23 June 1983 that he intended to reintroduce the changes in income tax thresholds and the higher £30,000 mortgage interest tax relief (MITR) limit that had been dropped by agreement with the Labour Opposition from Sir Geoffrey Howe's pre-election Budget. A Finance Bill was published on 1 July and received Royal Assent on 26 July 1983. However, in 1983, the changes in income tax thresholds etc. involved no change in PAYE codes, which had taken effect after Sir Geoffrey Howe's March Budget.

In 1997, changes in income tax allowances for 1997-98 would require changes in PAYE codings. If these only took effect late in August, that may be thought undesirably late into the tax year if such changes increase taxation for some employees. The precedent for an early June Budget is Sir Geoffrey Howe's

1979 Budget. This was held on 12 June 1979 with the Finance Bill achieving Royal Assent on 26 July 1979. In 1979, effect was given to changes in PAYE codes on the first pay day after 12 July 1979.

What measures could be enacted in a June or July Budget?

Income tax: The experience of 1979 demonstrates that it is possible to adjust rates and allowances after the beginning of the tax year. The 1979 Budget, however, reduced income tax across the board. In 1997, changes in allowances and reliefs might be expected to increase taxation for some, and if such changes involved an alteration in PAYE codes, this would point to an early Budget.

PAYE codes would be affected by changes in personal allowances or their restriction to a particular tax rate. Gross pay for PAYE purposes might also be affected by a change in the relief for pension contributions. Mortgage interest payments no longer, however, affect PAYE deductions.

The introduction of a 10% income tax rate would not require any adjustment to the MITR rate (currently 15%). However, the MITR rate could be adjusted, for example to 10%, to take effect for interest payments after the Budget.

Corporation tax: In 1979, Sir Geoffrey Howe reduced the basic rate of income tax from 33% to 30%, with a consequent adjustment in the advance corporation tax (ACT) rate and dividend tax credit. This adjustment was backdated to 6 April 1979, even though it meant that companies had accounted for ACT at the wrong rate between 6 April and 12 June 1979, and that dividend vouchers showed a tax credit of 33/67ths rather than 3/7ths. The appropriate adjustments nevertheless proved possible to implement then, and would presumably be equally possible in 1997 if the lower rate of income tax on dividend income were, say, reduced from 20% to 15%.

Some changes affecting corporation tax liabilities, such as changes in capital allowance rates, are easily implemented with legislation at short notice. However, changes involving more complex legislation are more likely to be trailed for future action than attempted immediately.

Capital gains tax: It seems unlikely that any significant legislative changes could be made to capital gains tax (CGT) within the time frame of a June or July Finance Bill. Sir Geoffrey Howe in 1979 signalled his intention to review CGT to eliminate inflationary gains from charge (although he only took the first steps towards this goal in 1982). Gordon Brown could in turn signal his intention to review the tax with a view to benefiting long-term gains in some way, leaving decisions on the detail until another occasion. He could, however, adjust the annual CGT exemption for 1997-98 if he wished.

Inheritance tax: Reversing some of the changes made by the previous government may not be difficult but may still involve more legislation than the Chancellor would want in a June or July Finance Bill. He could relatively easily adjust rates or thresholds or reduce the 100% exemptions for business property and agricultural property reliefs. If the Chancellor prefers to give the matter longer consideration but believes that some forestalling announcement is needed, he could follow the 1974 precedent, when capital transfer tax was

announced in the March 1974 Budget but only enacted in the 1975 Finance Act.

Conclusion

The government's majority gives it parliamentary freedom to pursue what tax measures it wants. The practical constraints the Chancellor faces are the liability to formulate the detail of measures and to generate the legislation, and the time frame within which legislation can be enacted — bearing in mind the date from which it is to take effect. There is likely to be limited scope for detailed measures in any Finance Bill prior to the summer recess. If the Chancellor has greater ambitions to reform the tax code, he may have to be content with announcing the measures he intends to bring forward in 1998.

Appendix C. Revenue implications of changes to dividend taxation

One potential source of revenue from companies would be to change the tax treatment of company dividends. There are several ways of manipulating the taxation of dividends in order to raise revenue, only two of which are discussed in detail in the main text. This appendix discusses more of the options, and presents some estimates of the amount of revenue they would raise, given certain simplifying assumptions.

Under the current 'partial imputation' system, a part of the company's corporation tax liability is treated as if it were a prepayment of the shareholders' income tax on their dividend income. This part, called advance corporation tax (ACT), is currently set at 20% of the gross dividend, which just covers the shareholders' income tax liability for basic- and lower-rate taxpayers. Higher-rate taxpayers have to pay additional income tax when they receive dividend income, while tax-exempt shareholders can reclaim a dividend tax credit, equivalent to the part of corporation tax that is being treated like a prepayment of income tax.

As a result of this system, lowering the rate of ACT actually raises revenue for the government. This is because a lower rate of ACT means that the company makes a smaller payment of ACT when it pays a dividend, but it can only deduct that smaller payment from its total corporation tax bill, and so has to make a higher tax payment later. Therefore, provided the company is not in a 'surplus ACT' position, the change in the rate of ACT only changes the timing of the company's tax payments, rather than its total tax bill. The extra tax revenue comes from the fact that higher-rate taxpayers have to pay more income tax — since the dividend tax credit accounts for a smaller part of their total tax liability on the dividend payment — and from the fact that tax-exempt shareholders, such as pension funds, receive a smaller refund from the Inland Revenue.

Table C.1 considers the revenue implications of some alternative possibilities. The revenue estimates shown here are based on the current level of dividend payments in the UK, which gave rise to almost £12 billion of ACT revenue in 1996-97. For each range of values given, the higher estimate assumes that companies do not respond to the change in ACT by increasing their cash dividend payments or their contributions to pension funds, while the lower estimate assumes that companies do respond by increasing pension contributions. In an extreme scenario, if all of the loss from lower dividend tax credits is made up by higher company contributions to pension schemes, which can be deducted from taxable profits and would otherwise have borne corporation tax at 33%, up to one-third of the revenue could be lost in the long run. Neither estimate assumes that companies increase their dividend payments to compensate for the change in tax treatment. If part of the change is offset

Table C.1. Estimates of tax revenue implications of reforms

Reform	*Revenue effects*
(a) Cut ACT rate to 15%	£1.5-£2.3bn
(b) Cut ACT rate to 10%	£2.9-£4.3bn
(c) Cut ACT rate to 5%	£4.2-£6.2bn
(d) Cut ACT rate to zero	£5.2-£7.8bn
(e) Making dividend credit non-refundable	£4-£6bn
(f) Move to a classical system	£6.8-£10.2bn

Notes:

Options (a)-(d) assume that the basic/lower rate of tax on dividend income is lowered in line with the cut in ACT. Option (e) leaves rates of dividend income tax and ACT at their current levels, but no longer allows any exempt shareholders to reclaim the tax credit accompanying their cash dividend. Option (f) leaves corporation tax and dividend income taxes at their current levels, but abolishes ACT, moving from a partial imputation system to a classical system.

The lower estimate assumes that increased contributions are made by firms to company pension schemes; the upper estimate ignores any potential effects on pension contributions. Both are based on the current level of ACT of £12 billion, which implies cash dividend payments of £48 billion. It is assumed that these are paid in the ratio 50:25:25 to tax-exempt, top-rate shareholders and basic-/lower-rate shareholders respectively.

through higher dividend payments, this would result in somewhat bigger revenue gains for the exchequer.

The total amount of revenue raised by each of these possibilities depends on the proportion of shareholders in each taxpaying category and on the amount of profits that firms pay out in dividends. These estimates do not take account of surplus ACT, which acts like an additional layer of tax for companies whose dividend payments are high relative to their UK taxable profits. A reduction in the rate of ACT reduces the rate at which companies accumulate surplus ACT, assuming that their dividend payments do not increase, but also reduces the rate at which companies can offset any stock of surplus ACT they might have.

Options (a)-(d) in Table C.1 involve cutting the rate of ACT, and also cutting the rate of tax on dividend income for lower- and basic-rate shareholders to the same level. The top rate of income tax is left unchanged at 40%. As a result, revenue is gained from both tax-exempt shareholders and top-rate taxpayers from the reduction in the value of the dividend tax credit.

Option (e) involves restricting repayments of the tax credit to tax-exempt shareholders; companies still make payments of ACT and taxpayers still receive a dividend tax credit, but the tax credit is no longer repaid to those shareholders who are tax-exempt. Repayments of the tax credit currently cost the exchequer approximately £6 billion, which would be the maximum saving from such a change.

The final option is to abolish ACT altogether, which is similar to option (d), but to leave the rate of tax on dividend income for lower- and basic-rate taxpayers at 20%, which would add revenue of about £2.4 billion to the upper estimate given for option (d). Other alternatives do exist, such as restricting the amount of ACT that can be offset against corporation tax at the *company* level, rather than changing the tax treatment of dividend income for shareholders.

The estimates given here are long-run estimates of the overall effect on tax revenues of changes to the tax treatment of dividends. In the first year, there would be a short-run reduction in corporation tax receipts that would broadly offset the gain from lower credits. This is due to the fact that, in the first year of a change, ACT is paid at the new lower rate but some of the ACT set off against corporation tax would be based on ACT paid at the previous higher rate.

A separate reason why the first-year revenue effect might be negative results from the method used to value pension fund assets. This is based on the net present value of the flow of investment income to the fund, which falls as a result of the reduction in the value of dividend income to pension funds. In order to keep to minimum funding requirements, it has been suggested that companies may have to make up a large shortfall in the first year of any change. Any arrangement that requires a large one-off adjustment in circumstances where the real flow of income into the fund (including contributions) is unchanged would seem to be in need of review. In any case, since over half of companies operating schemes are either not paying into their schemes or are paying at a reduced rate due to the high returns earned in recent years, this suggestion would appear to exaggerate the potential revenue loss to the government.

Appendix D. Tax revenues ready reckoner

Table D.1: Direct effects of illustrative changes in taxation, 1997–98

(£ million)	*Cost/yield (non-indexed base)* *1997–98*	*1998–99*
Income tax		
Rates		
Change standard rate by 1p	1,300	1,900
Change lower rate by 1p[a]	1,200	1,000
Change higher rate by 1p	260	600
Allowances		
Change personal allowance by £100	430	630
Change married couple's allowance by £100	110	160
Lower-rate band		
Increase lower-rate band width by 10%	230	310
Basic-rate limit		
Change basic-rate limit by 1%	55	110
Change basic-rate limit by 10%		
increase (cost)	490	960
decrease (yield)	630	1,200
Allowances, bands and limits		
Change all main allowances, lower-rate band and basic-rate limit:	290	450
increase/decrease by 1%	2,750	4,250
increase by 10% (cost)	3,050	4,750
decrease by 10% (yield)		
National Insurance contributions		
Rates		
Change main employee rate by 1p	2,000	2,350
Change highest employer rate by 1p	2,525	3,025
Change Class 2 rate by £1	85	120
Change Class 4 rate by 1p	0	220

(continues)

[a]Revenue changes in the full year are lower because corporation tax changes are included in this value. Advance corporation tax changes in the first year would be offset by opposite changes to mainstream corporation tax in subsequent years.

Note: The revenue effect is computed for changes to the 1997-98 tax system and relates to the first-year (1997-98) and the full-year (1998-99) effects.

Table D.1. Direct effects of illustrative changes in taxation, 1997–98 *(continued)*

(£ million)	*Cost/yield (non-indexed base)* *1997–98*	*1998–99*
Corporation tax		
Change full rate by 1%	650	850
Change smaller companies' rate by 1%	85	120
Capital gains tax		
Increase annual exempt amount by £500 for individuals and £250 for trusts	—	5
Inheritance tax		
Change inheritance tax rate by 1%	19	35
Increase inheritance tax threshold by £5,000	15	28
VAT		
Change VAT rate by 1%	2,655	2,785
Excise duties		
Beer up 1p a pint	120	125
Wine up 5p a bottle	35	40
Spirits up 25p a bottle	25	25
Cigarettes up 5p a packet	175	185
Petrol up 1p a litre	280	310
Derv up 1p a litre	140	155
VED up £5	130	130
VAT	*1996–97 effect*	
Extend VAT to:		
Food	7,550	
Passenger transport	2,650	
Construction of new homes	2,200	
Books, newspapers, etc.	1,200	
Water and sewerage services	900	
Children's clothing	800	
Prescriptions	750	

Note: The revenue effect is computed for changes to the 1997-98 tax system and relates to the first-year (1997-98) and the full-year (1998-99) effects.
Source: *Tax Ready Reckoner and Tax Reliefs*, HM Treasury, July 1996.

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