

# The changing composition of UK tax revenues

IFS Briefing Note BN182

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## Executive summary

- The recession triggered a collapse in government revenues; real receipts fell by 4.4% in 2008–09 and 5.5% in 2009–10, the two single largest annual falls since at least 1956. Alongside the unprecedented austerity drive, receipts have recovered, and by 2020 will be 37.2% of national income – roughly the pre-crisis level.
- This masks changes in the composition of tax revenues. The taxman looks set to raise more from VAT but less from other indirect taxes, about the same from personal income taxes but with more of that coming from the highest earners, less from the main property taxes and substantially less from corporation taxes.
- Increased reliance on a small number of income tax payers follows a longer-run trend driven by above-average increases in top incomes. Since 2008, this reliance has been largely driven by increases in taxes on the rich and tax cuts – mostly via a higher personal allowance – for low- and middle-income taxpayers.
- Fuel duty remains frozen at 2011 levels. This political choice, combined with more fuel-efficient vehicles, has reduced revenues in real terms. The recent unwillingness to increase fuel duty even in line with inflation implies a risk to these revenues and, if continued, would lead to large revenue losses in the longer term.
- In recent times, council tax and business rates have provided a stable source of revenue. Both are now forecast to decline as a share of national income.

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<sup>1</sup> We gratefully acknowledge support from the Economic and Social Research Council (ESRC) under the Centre for the Microeconomic Analysis of Public Policy (CPP) grant number ES/M010147/1. We thank Stuart Adam for helpful comments.

- A decline of North Sea revenues that was predicted due to diminishing oil reserves has been accelerated by the very low oil price.
- There remains uncertainty over the extent to which corporate profits, especially in the banking sector, will bounce back. New taxes on banks will prop up revenues to some extent, but, overall, policy choices will lead to a decline in corporation tax receipts. This marks a break with a long-run trend that shows volatility with the economic cycle but no persistent decline in receipts.
- There is an increased reliance on smaller taxes (such as stamp duties), including a host of entirely new taxes. The latter have tended to be introduced with little consultation and insufficient consideration of how they might operate within a well-designed tax system. Sadly, there is no sign of a long-term strategy.
- There are risks to revenue streams: there is still uncertainty about the strength of the recovery, it is difficult to forecast the receipts from new taxes and there is policy risk in the sense that the government may choose to deviate from the assumptions embedded in forecasts.

## 1. Introduction

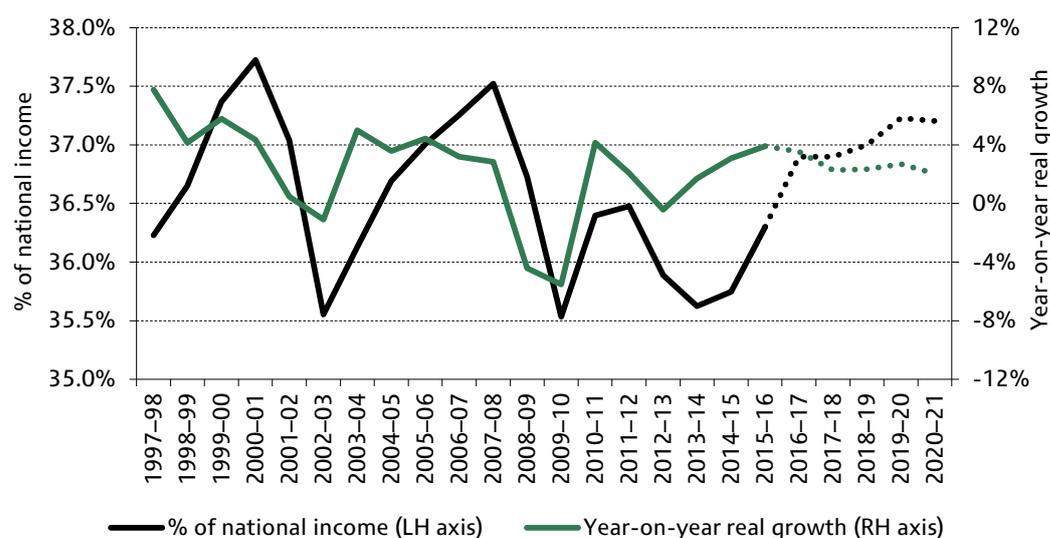
Between 2007–08 and 2009–10, total government receipts collapsed – they fell by over 9% in real terms and were 2% lower as a proportion of national income – largely as a result of the financial crisis and resulting recession (see Figure 1). By the end of this decade, government receipts are forecast to be 37.2% of national income,<sup>2</sup> a little lower than in 2007–08 (37.5%) but higher than in 2009–10 (35.8%) and 2015–16 (36.3%) and a little higher than the average level over the two decades before the recession (36.4%).

On the face of it, these aggregate numbers imply that, by 2020–21, we will be more or less back where we started, raising around the same proportion of national income in revenue as just before the crisis. However, this masks considerable changes in the composition of receipts.

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<sup>2</sup> In all of our analysis, we ignore the temporary effect of changes in the timing of corporation tax payments for large companies, which provides a temporary revenue boost in 2019–20 and 2020–21. Including this effect, government receipts would be 37.4% of national income in 2020–21.

**Figure 1. Total government receipts<sup>3</sup>**



Note: Year-on-year real growth is calculated using the national income deflator. This figure includes tax receipts, interest and dividends, and receipts from public corporations. We remove the temporary revenue effect of changes in the timing of corporation tax receipts, which boost revenues in 2019–20 and 2020–21.

Source: OBR public finances databank, <http://budgetresponsibility.org.uk/download/public-finances-databank/>.

Section 2 of this briefing note describes these composition changes, including their relation to longer-term trends and the extent to which they are driven by policy choices or changes in UK economic activity.

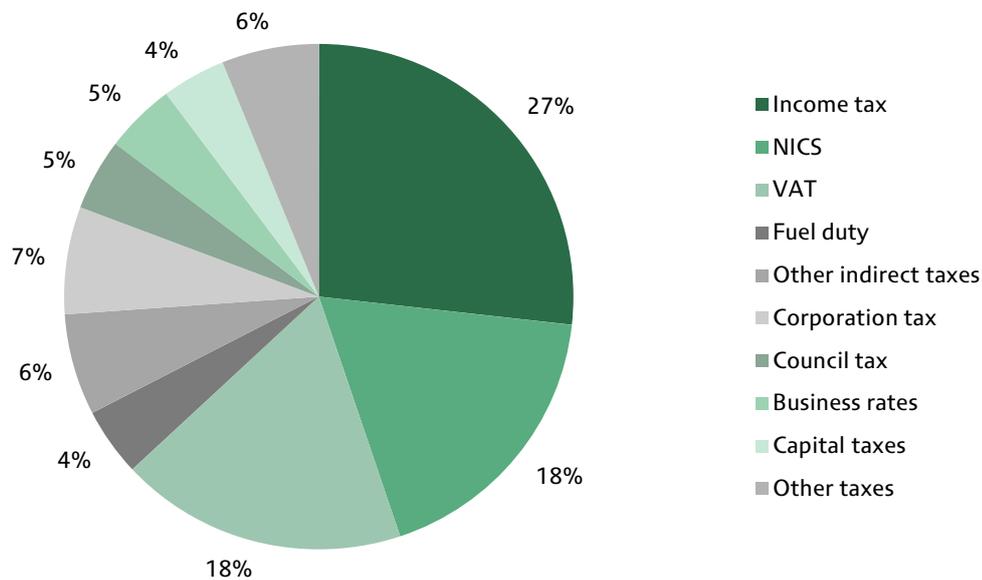
We will conclude that policy shifts mean that, in the medium term, the UK taxman looks set to: (i) be more reliant on the highest-earning income tax payers; (ii) collect more revenue from VAT and less from other indirect taxes, notably fuel duty; (iii) raise less revenue from both council tax and business rates; and (iv) raise substantially less revenue from corporation taxes. Section 3 considers the changes in ‘corporation taxes’ in more detail. Section 4 highlights the increased reliance on a set of smaller taxes, and the introduction of a host of new taxes, since the crisis. Section 5 concludes.

<sup>3</sup> In what follows, we consider only tax revenues, which make up the majority of receipts and most of the changes since the crisis. Non-tax receipts as a share of national income are forecast to increase slightly between 2007–08 and 2020–21.

## 2. Changes in the composition of tax revenue

Figure 2 shows the breakdown of UK tax revenues in 2015–16. The UK currently raises around 45% of receipts from income tax and National Insurance contributions (NICs) and 28% from VAT and other indirect taxes. Corporation tax raises 7% and the main taxes on property – business rates and council tax – contribute 5% each. The remaining revenue comes from a set of smaller taxes, including those we classify as ‘capital taxes’ (4%).<sup>4</sup>

**Figure 2. Composition of tax receipts, 2015–16**



Note: ‘Capital taxes’ includes stamp duties, capital gains tax and inheritance tax. ‘Other indirect taxes’ includes alcohol duties, tobacco duties, betting and gaming duties, air passenger duty, insurance premium tax, landfill tax, climate change levy, vehicle excise duties and soft drinks levy. ‘Other taxes’ is a residual measure, including taxes devolved to Northern Ireland and Scotland and what the Office for Budget Responsibility (OBR) defines as ‘environmental levies’. The latter are somewhat different from conventional taxes because they are generally part of government schemes such that higher revenues translate directly into higher spending.

Source: OBR, *Economic and Fiscal Outlook*, March 2016,

<http://budgetresponsibility.org.uk/efo/economic-fiscal-outlook-march-2016/>.

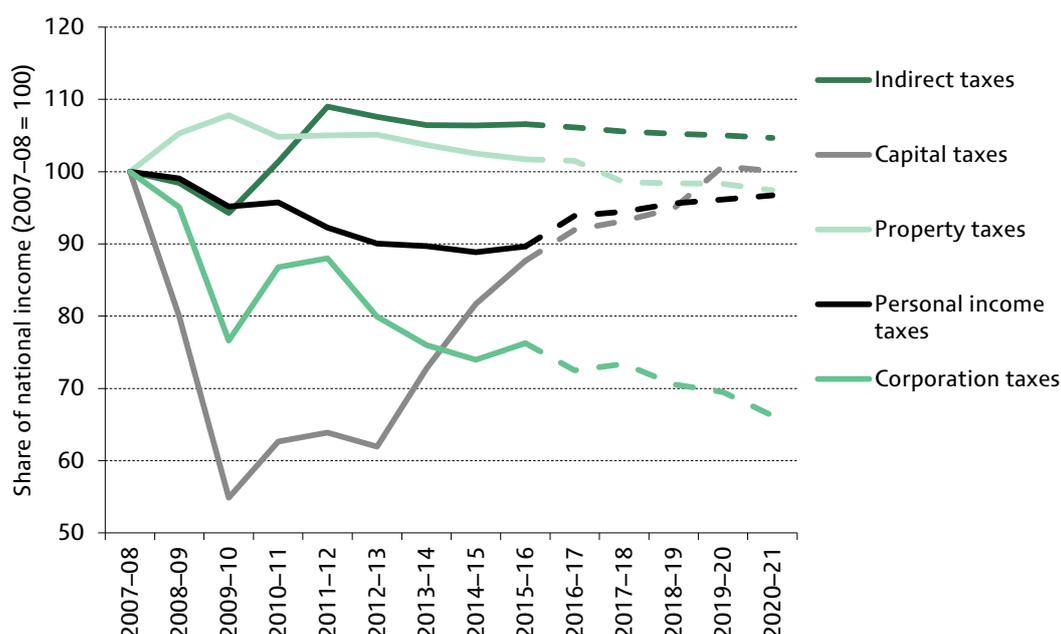
Figure 3 shows how revenues from different sources have evolved since the start of the recession. For ease of exposition, we consider taxes in broad groups. However, in doing so, we note that there is no clear-cut way

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<sup>4</sup> For a description of the UK tax system, see C. Grace, T. Pope and B. Roantree, ‘A survey of the UK tax system’, IFS Briefing Note BN09, November 2015,

<http://www.ifs.org.uk/publications/1711>.

**Figure 3. Composition of tax receipts since the recession**



Note: 'Income taxes' includes income tax, NICs (employer and employee), the payroll tax on bankers' bonuses and the apprenticeship levy. 'Indirect taxes' includes VAT, fuel duty, alcohol duties, tobacco duties, betting and gaming duties, air passenger duty, insurance premium tax, landfill tax, climate change levy, vehicle excise duties and soft drinks levy. 'Corporation taxes' includes corporation tax, petroleum revenue tax, oil royalties, windfall tax on tobacco companies, bank surcharge, bank levy and diverted profits tax. 'Capital taxes' is defined as in Figure 2. 'Property taxes' includes council tax and business rates.

Source: OBR public finances databank, <http://budgetresponsibility.org.uk/download/public-finances-databank/>; HMRC tax receipts and NICs for the UK, <https://www.gov.uk/government/statistics/hmrc-tax-and-nics-receipts-for-the-uk>; IFS revenue composition spreadsheet, [http://www.ifs.org.uk/uploads/publications/ff/revenue\\_composition%20June%202014.xls](http://www.ifs.org.uk/uploads/publications/ff/revenue_composition%20June%202014.xls); table PSA6D of ONS public finance tables, <http://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/bulletins/publicsectorfinances/previousReleases>; OBR, *Economic and Fiscal Outlook*, March 2016, <http://budgetresponsibility.org.uk/efo/economic-fiscal-outlook-march-2016/>.

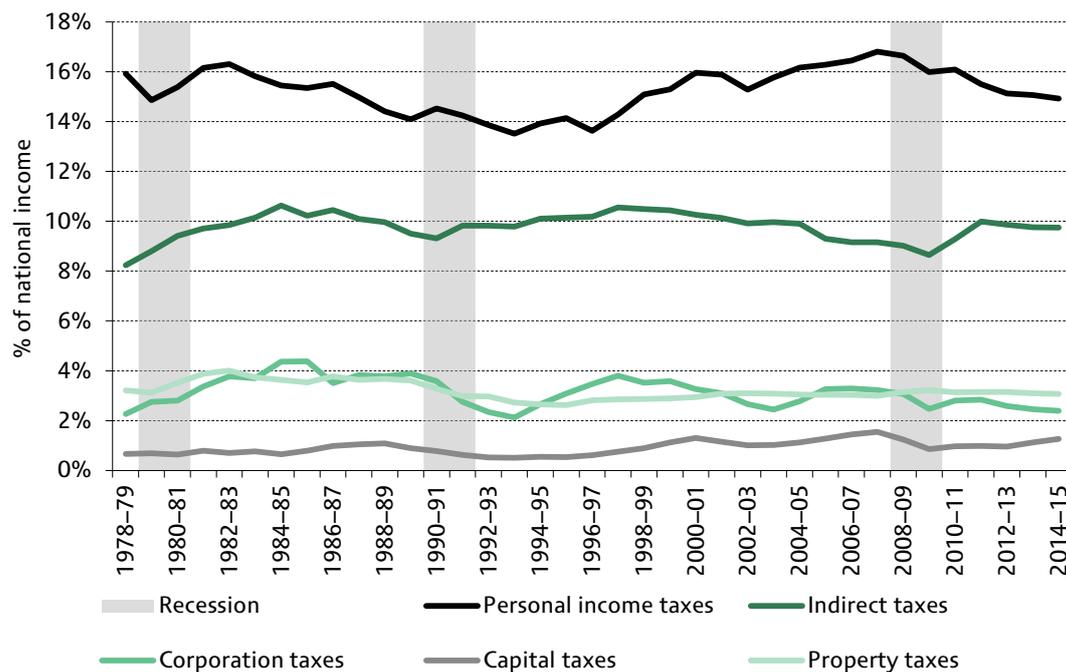
to group taxes and that these groups do not denote the economic incidence of a tax.

To date (2015–16), there have been substantial reductions in revenues from personal income, capital and corporation taxes as a proportion of national income. This has been partially offset (overall, revenues remain slightly lower as a share of national income) by more revenue from indirect taxes, driven almost entirely by the increase in the VAT rate to 20% from April 2012.

Some of these trends were largely the product of temporary economic weakness rather than permanent changes and are set to unwind partially

or entirely over the next five years. Notably, receipts from personal income and capital taxes have been depressed by weak wages and capital returns respectively and are forecast to recover to around their pre-recession levels (as a fraction of national income) by 2020–21. The overall stability of these revenues between 2007–08 and 2020–21 contrasts with the trend in the decade or so before the recession, which saw revenues from income and capital taxes increasing in importance (see Figure 4).

**Figure 4. Long-term trends in revenue composition**



Note and source: As for Figure 3.

The jump in revenues from indirect taxes is due to unwind, such that the share of national income they represent will be around the same in 2020–21 (9.6%) as in 2007–08 (9.2%). The trend towards lower indirect tax receipts that has been seen over the decade or so before the recession was halted by the increase in VAT but may restart as a result of falls in revenues from other indirect taxes.

Within both personal income and indirect taxes, the fact that revenues return to a similar fraction of national income by the end of the parliament to what they were before the crisis masks important compositional change. We address these in the following subsections.

Receipts from the two property taxes have been relatively stable as a share of national income since the early 1990s but, in a break with this trend, are

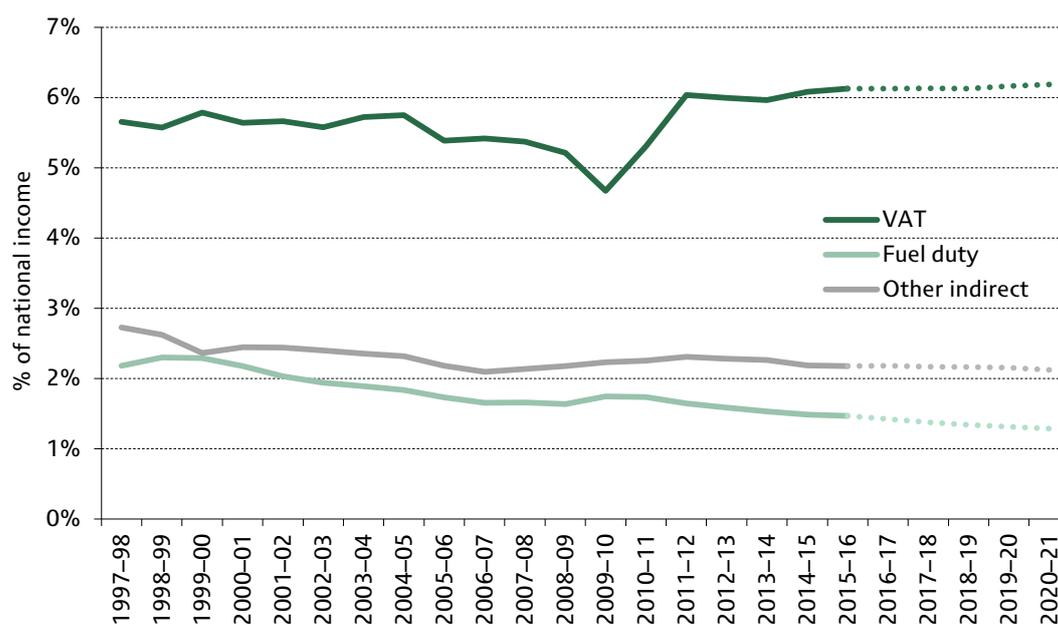
due to fall between now and the end of the parliament. For business rates in particular, this results from policy change.

A notable feature of Figure 3 is that revenues from corporation taxes have declined substantially as a proportion of national income and are forecast to continue to decline over the next five years. This results from both policy and underlying economic changes. The main contributor is onshore corporation tax, which always fluctuates with the economic cycle, but historically has not shown a systematic downward trend (offshore receipts account for a fall in the late 1980s displayed in Figure 4).<sup>5</sup> We return to these taxes in Section 3.

### *VAT more important, duties in decline*

Figure 5 shows that the change in consumption taxes is driven by a jump in VAT receipts (resulting from a rate increase from 17.5% to 20%)

**Figure 5. Indirect tax revenues**



Note: Other indirect taxes counted here are alcohol duties, tobacco duties, betting and gaming duties, air passenger duty, insurance premium tax, landfill tax, climate change levy, vehicle excise duties and soft drinks levy.

Source: As for Figure 3.

<sup>5</sup> For a discussion of corporation tax trends, see R. Griffith and H. Miller, 'Taxable corporate profits', *Fiscal Studies*, 2014, 35, 535–57, <http://www.ifs.org.uk/publications/7605>, and H. Miller, 'Corporate tax, revenues and avoidance', in C. Emmerson, P. Johnson and H. Miller (eds), *The IFS Green Budget: February 2013*, [http://www.ifs.org.uk/budgets/gb2013/GB2013\\_Ch10.pdf](http://www.ifs.org.uk/budgets/gb2013/GB2013_Ch10.pdf).

combined with an ongoing, long-run decline in receipts from fuel duty and other indirect taxes. The trend towards VAT and away from other indirect taxes fits with a much longer-term trend, documented elsewhere.<sup>6</sup>

The decline in revenue from fuel duty has been especially stark. Government policy is that fuel duty should increase in line with inflation (measured using the Retail Price Index (RPI)) each year (this is factored into the OBR's forecast, shown in the dotted line). Part of the recent and the entire forecast decline arises from structural changes towards more fuel-efficient vehicles, which have reduced petrol and diesel consumption. The OBR expects that these changes alone will lead to a reduction in fuel duty of around 0.5% of GDP (from 1.5% today) by 2033–34 as demand for fuel continues to fall.<sup>7</sup> Since 2011, this decline has been accelerated by the policy decisions at successive Budgets and Autumn Statements to freeze fuel duty in cash terms. This represents a 14% real tax cut, costing around £4.4 billion a year in 2015–16 terms. In Budget 2016, the Chancellor again froze fuel duty, despite oil (and so fuel) prices being at historic lows and the cost of driving at its lowest level in real terms since at least 1997.<sup>8</sup> Should this pattern of fuel duty freezes persist over the next five years, fuel duty revenues will grow even more slowly than the OBR forecast assumes. If governments are unwilling, or unable, to increase fuel duty even in line with inflation going forwards, this implies a much larger source of lost revenue in the longer term even than the expected loss due to increased vehicle efficiency.

Beyond fuel duty, other indirect taxes are set to decline slightly between 2007–08 and 2020–21. Within this, alcohol duties will be slightly more important as a revenue source, and tobacco duties less so. The overall

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<sup>6</sup> See section 4 in C. Grace, T. Pope and B. Roantree, 'A survey of the UK tax system', IFS Briefing Note BN09, November 2015, <http://www.ifs.org.uk/publications/1711>. The importance of VAT increased rapidly in the 1980s, and the ratio between VAT and other indirect taxes continued to increase steadily over the 20 years or so leading up to the financial crisis.

<sup>7</sup> Source: OBR, *Fiscal Sustainability Report*, July 2014, <http://budgetresponsibility.org.uk/fsr/fiscal-sustainability-report-july-2014/>.

<sup>8</sup> See P. Levell, M. O'Connell and K. Smith, 'Excise duties', in C. Emmerson, P. Johnson & R. Joyce (eds), *The IFS Green Budget: February 2016*, <http://www.ifs.org.uk/uploads/gb/gb2016/gb2016ch9.pdf>.

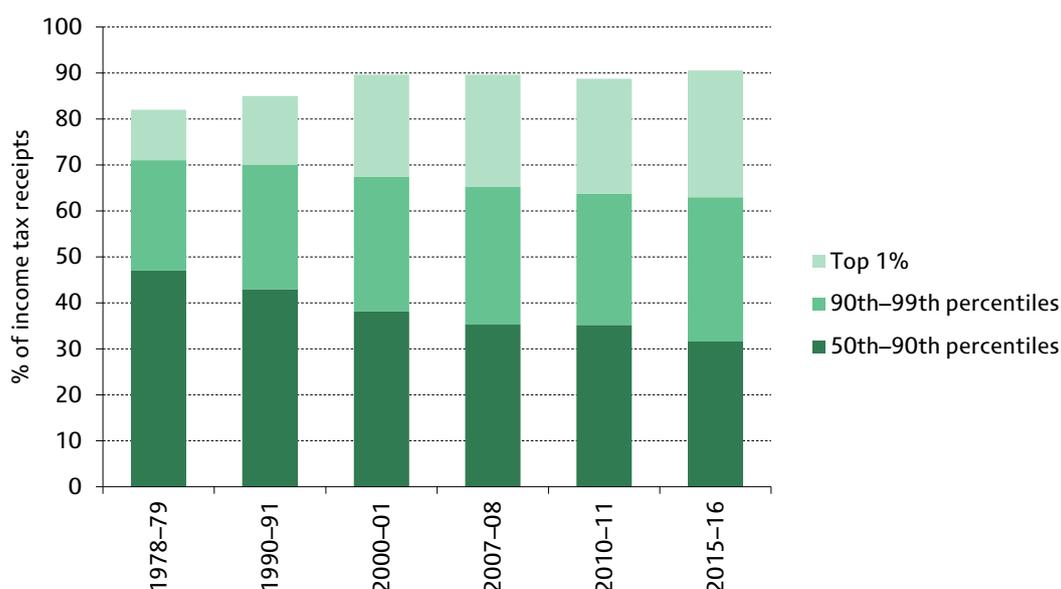
decline comes despite a boost to receipts from a large increase in the rate of insurance premium tax and the introduction of a new soft drinks levy.

### *The rich contributing more*

Like consumption taxes, personal income taxes will raise a similar proportion of national income in 2020–21 to that in 2007–08. However, within this there has been a shift towards raising a higher proportion of revenue (in particular from income tax) from the highest-earning income tax payers.

Between 2007–08 and 2015–16, the share of the adult population who pay income tax dropped from 65.7% to 56.2%.<sup>9</sup> Within the group of income tax payers, the proportion of total income tax paid by the top 1% of taxpayers (i.e. 0.66% of the adult population in 2007–08 and 0.56% of the population in 2015–16) increased from 24.4% to 27.5% (see Figure 6).

**Figure 6. Income tax contributions of the top 50% of taxpayers**



Note: The population of taxpayers changes over time.

Source: HMRC table 2.4, <https://www.gov.uk/government/statistics/shares-of-total-income-before-and-after-tax-and-income-tax-for-percentile-groups>; various Inland Revenue statistics.

<sup>9</sup> Source: HMRC table 2.1, [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/429111/Table\\_2.1.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/429111/Table_2.1.pdf); table A1-1 of Office for National Statistics, Population Projections, <http://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationprojections>.

The recent increase in the share of tax coming from the top 1% of taxpayers was driven by a series of policy changes. Some, notably the large increase in the personal tax allowance, took many low earners out of tax while also reducing payments for lower to middle taxpayers. While the personal allowance was increased, the higher-rate threshold was cut. This helps explain why the number of higher- (and additional-)rate payers rose from 3.9 million in 2007–08 to 5.0 million in 2015–16.<sup>10</sup> Meanwhile, those on the highest incomes did not gain at all from the increase in the personal allowance, since a new policy introduced in 2010 means that it is gradually withdrawn once incomes rise above £100,000. In addition, big cuts in pension tax relief and the increase in the tax rate for those earning over £150,000 will have raised more revenue from the highest earners.

The trend towards a lower proportion of income tax payments from the bottom 50% of income tax payers, and higher payments from the top 1%, is a continuation of a much longer-term trend. In 1978–79, only 11% of income tax receipts were paid by the top 1% of taxpayers, while this had more than doubled by the turn of the century (see Figure 6). The trend pre-2007 was overwhelmingly driven by the distribution of pre-tax income. Inequality increased considerably, such that the larger burden on richer taxpayers mostly reflected their higher share of total incomes.<sup>11</sup> Post-2007, the trend has been largely as a result of explicit policy choice.

It seems unlikely that this trend will unwind substantially over the next five years. The 2015 Conservative party election manifesto pledged to increase the personal allowance to £12,500 by 2020–21, another substantial increase. The tax burden on the richest will be slightly offset by a pledge to increase the higher-rate threshold to £50,000, though this is only expected to hold constant the number of higher-rate taxpayers. At the same time, two income tax thresholds affecting the highest earners – the point at which the personal allowance is withdrawn, £100,000, and the additional rate threshold, £150,000 – are, by default, fixed in cash terms. In

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<sup>10</sup> HMRC table 2.1,

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/429111/Table\\_2.1.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/429111/Table_2.1.pdf).

<sup>11</sup> The World Wealth and Income Database calculates that the share in pre-tax income of the top 1% of the UK adult population increased from 5.9% in 1979 to 15.4% in 2007 (<http://www.wid.world/#Database>).

addition, a further big reduction in pension tax relief for the highest earners, introduced in April 2016, will increase revenues from this group.<sup>12</sup>

One implication of an income tax base that increasingly relies on a smaller group of taxpayers is that the growth of receipts may be more unpredictable and risky. As the system becomes more reliant on a smaller subset of individuals, tax revenues become more sensitive to the composition of income growth, making revenues more uncertain. This includes both upside and downside risk. If the earnings of the top 1% or 10% grow more quickly than the rest of the distribution, tax revenues may increase more quickly than total earnings. In the last parliament, total earnings growth was driven more by employment growth than by average earnings growth. Previous IFS analysis calculated that the employment-heavy composition of total earnings growth cost the exchequer £6.5 billion in income tax receipts between 2010 and 2015.<sup>13</sup>

#### *Property taxes – building in declines*

Here we discuss ‘property taxes’ as the two taxes levied on the occupation of property – council tax and business rates. These are also the only two taxes that, to at least some degree, provide a source of revenues to local authorities.<sup>14</sup> Both taxes have the feature that they tend to provide a stable source of revenue across the economic cycle because they do not, by default, fluctuate with personal or corporate incomes. As a result, revenues from these taxes initially increased as a proportion of national income after the recession, though they are both forecast to raise a slightly smaller proportion in 2020–21 than in 2007–08.

Council tax rates are set by local authorities each year. Between 2010 and 2015, council tax revenues were held back by restraint in council tax rates on the part of local authorities, which were able to access extra grants

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<sup>12</sup> This measure, announced at Summer Budget 2015, means that the annual allowance for tax-exempt pension savings is tapered away as incomes increase above £150,000 until the allowance reaches £10,000. It is effective from April 2016.

<sup>13</sup> See R. Crawford, C. Emmerson and G. Tetlow, ‘Public finances: a dicey decade ahead?’, in C. Emmerson, P. Johnson and R. Joyce (eds), *The IFS Green Budget: February 2015*, [http://www.ifs.org.uk/uploads/gb/gb2015/ch5\\_gb2015.pdf](http://www.ifs.org.uk/uploads/gb/gb2015/ch5_gb2015.pdf).

<sup>14</sup> See C. Grace, T. Pope and B. Roantree, ‘A survey of the UK tax system’, IFS Briefing Note BN09, November 2015, <http://www.ifs.org.uk/publications/1711>.

from local government if they froze rates.<sup>15</sup> Going forward, councils will be allowed to increase rates by up to 4% (2% higher than during the last parliament) without winning a local referendum, as long as the extra 2% is spent increasing the social care budget.<sup>16</sup> However, the OBR forecasts that council tax receipts will still decline as a proportion of national income over the next five years, with rate rises not keeping pace with economic growth.

The default for business rates is that, in most years, tax bills increase in line with the RPI measure of inflation.<sup>17</sup> Revenues since the mid 1990s have tended to rise more quickly than RPI inflation due to a growing tax base: the value of properties added to the tax base (e.g. new developments) has been higher than that of properties removed from the tax base (e.g. demolished). As a share of national income, receipts have been roughly constant.

The stability across the economic cycle has been a source of concern to businesses since the recession because business rates bills were stable at a time when business profits were falling. One consequence of this is that business rates raised 53% of the revenue of onshore corporation tax in 2007–08 but 76% by 2012–13.

As a result of policies, announced in Budget 2016, that reduce the tax base, revenues are forecast to decline between 2015–16 and the end of the parliament.<sup>18</sup> Revenues are also expected to be lower than they would otherwise have been after 2020 as a result of a planned move, also

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<sup>15</sup> See section 7.1 of S. Adam and B. Roantree, 'The coalition government's record on tax', IFS Briefing Note BN167, March 2015, <http://election2015.ifs.org.uk/uploads/publications/bns/BN167170315.pdf>.

<sup>16</sup> See D. Innes and D. Phillips, 'Council tax rises to ease the pace of cuts to local government budgets', IFS Observation, December 2015, <http://www.ifs.org.uk/publications/8095>.

<sup>17</sup> Once every five years, properties are revalued and the rates set such that average bills increase with RPI inflation: bills increase by more (less) than the RPI for properties that have seen above- (below-)average rises in value since the last revaluation. For a discussion of business rates, see S. Adam and H. Miller, 'Business rates', in C. Emmerson, P. Johnson and H. Miller (eds), *The IFS Green Budget: February 2014*, [http://www.ifs.org.uk/budgets/gb2014/gb2014\\_ch11.pdf](http://www.ifs.org.uk/budgets/gb2014/gb2014_ch11.pdf).

<sup>18</sup> From 2017, small business rate relief will be permanently made more generous and the threshold for a higher tax rate increased.

announced in Budget 2016, to uprate business rates in line with the Consumer Price Index (which, historically, has increased less quickly than the RPI and than national income).

### **3. The decline of corporation taxes?**

This section discusses in more detail what we have loosely defined as ‘corporation taxes’. This group includes onshore and offshore corporation tax, petroleum revenue tax, oil royalties, windfall tax on tobacco companies, the diverted profits tax, bank surcharge and the bank levy.<sup>19</sup> Together, these taxes contribute 2.5% of 2015–16 national income. By the end of the parliament, these receipts as a proportion of national income are due to be a third lower than before the crisis. This results from an ongoing decline in North Sea receipts, a fall in the profitability of banks and cuts to the corporation tax rate. There is a boost from new taxes on banks.

Onshore corporation tax revenues, while volatile over the economic cycle, displayed no persistent downward trend in the 30 or so years up to the great recession despite main corporation tax rates being cut from 52% in 1981 to 28% in 2008. This was due to an increase in the size and profitability of the corporate sector, and to some extent to a broadening of the tax base.<sup>20</sup> By the end of the parliament, onshore corporation tax receipts as a proportion of national income are due to be 26% lower than before the crisis (2.0% rather than 2.7% of national income) due to a combination of weak corporate profits and policy change. This is a particularly notable change in the composition of revenues since the recession, and marks a break with recent trends.

#### *North Sea oil – scraping the barrel*

Receipts from North Sea producers represented around 0.5% of national income prior to the crisis. This was already substantially lower than the 4% raised at the height in the 1980s, and was due to decline as oil and gas

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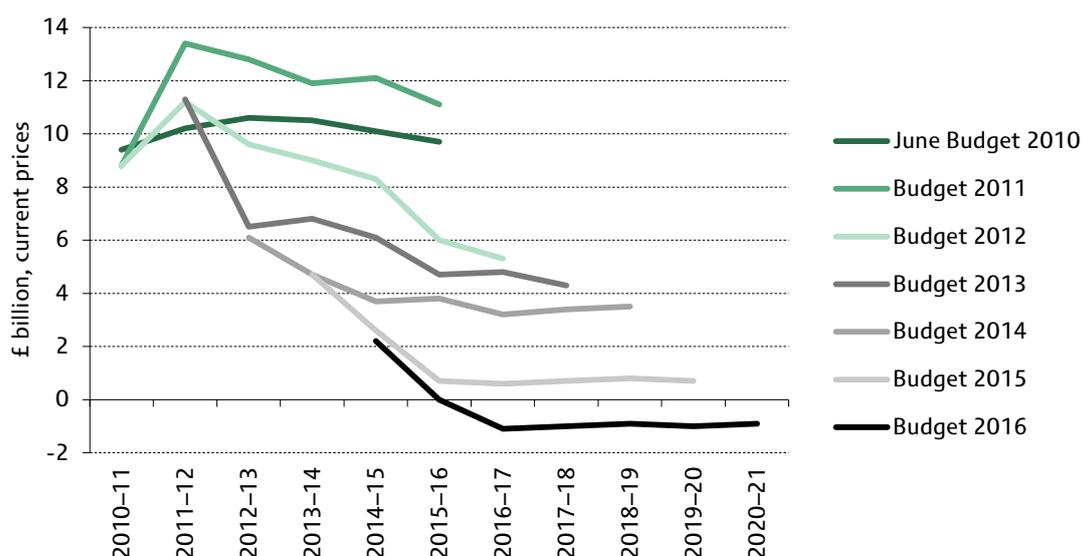
<sup>19</sup> From April 2015, profits that are judged to have been artificially diverted from the UK are subject to a higher 25% rate. The bank levy is clearly distinct from the other taxes in this group in that it is not levied on a measure of corporate profits. We include it here as part of a discussion of the changing taxation of banks’ activities.

<sup>20</sup> See R. Griffith and H. Miller, ‘Taxable corporate profits’, *Fiscal Studies*, 2014, 35, 535–57, <http://www.ifs.org.uk/publications/7605>.

reserves continued to dry up.<sup>21</sup> There has been a sharp fall in receipts, and continuing downgrades to forecast receipts, since 2011 as a result of a collapse in the world oil price.

As recently as March 2014, the government expected revenues from the North Sea to total £3.8 billion in 2015–16 and £3.5 billion in 2018–19 (see Figure 7). In Budget 2016, the out-turn estimate for 2015–16 was negligible (i.e. near zero), while in 2018–19 the North Sea tax regime is actually forecast to cost the exchequer money. The latter situation results from continued weak profitability combined with relief for decommissioning costs.<sup>22</sup> There is uncertainty over the trajectory of the oil price. However, given the underlying decline in North Sea resources (and absent the discovery of new resources that are not already factored into the forecasts), the associated tax revenues look unlikely to form a substantial part of the UK tax base in future.

**Figure 7. Revenues from the North Sea: forecasts since 2010**



Source: OBR Economic and Fiscal Outlooks, June 2010 to March 2016, available at <http://budgetresponsibility.org.uk/>.

<sup>21</sup> For more details of the North Sea oil tax regime, see H. Miller, ‘Corporate tax, revenues and avoidance’, in C. Emmerson, P. Johnson and H. Miller (eds), *The IFS Green Budget: February 2013*, [http://www.ifs.org.uk/budgets/gb2013/GB2013\\_Ch10.pdf](http://www.ifs.org.uk/budgets/gb2013/GB2013_Ch10.pdf).

<sup>22</sup> The petroleum revenue tax rate was reduced to zero in Budget 2016. This was not a particularly costly measure and does not explain the decline in revenues.

## *Onshore corporation tax – banking on a strong recovery to offset lower rates?*

As noted above, onshore corporation tax receipts are volatile and move with the economic cycle. It was no surprise that receipts fell substantially following the recession. They have been depressed in recent years as a result of a combination of continued weakness of corporate profits and the effect of losses that were accumulated in the wake of the recession and then carried forward to offset future tax liabilities.

The finance sector and, in particular, banks were an important source of corporation tax receipts prior to the crisis and have seen by far the largest fall.<sup>23</sup> As Figure 8 shows, corporation tax on financial sector profits accounted for 0.7% of national income (and 25.8% of total onshore

**Figure 8. Corporation tax payments by the financial sector**



Note: Forecasts are available only for corporation tax revenues from the finance sector as a whole, not at a more disaggregated level.

Source: OBR, *Economic and Fiscal Outlook*, March 2016,

<http://budgetresponsibility.org.uk/efo/economic-fiscal-outlook-march-2016/>; HMRC table 'PAYE and corporation tax receipts from the banking sector',

<https://www.gov.uk/government/collections/payee-and-corporation-tax-receipts-from-the-banking-sector>; HMRC table 11.1A, <https://www.gov.uk/government/collections/analyses-of-corporation-tax-receipts-and-liabilities>.

<sup>23</sup> See H. Miller, 'Corporate tax, revenues and avoidance', in C. Emmerson, P. Johnson and H. Miller (eds), *The IFS Green Budget: February 2013*, [http://www.ifs.org.uk/budgets/gb2013/GB2013\\_Ch10.pdf](http://www.ifs.org.uk/budgets/gb2013/GB2013_Ch10.pdf).

corporation tax receipts) in 2007–08, with over half of that accounted for by receipts from bank profits alone. It now accounts for just 0.3% of national income and 15.2% of onshore corporation tax. This fall has been driven almost entirely by the fall in corporation tax paid by banks.

The recovery of the formerly tax-rich banking sector remains uncertain, in part because receipts from this sector are especially dependent on the profitability of a few very large banks. Profits from the financial sector are forecast to remain depressed until 2020–21 (the last year for which the OBR produces a forecast). It is unclear to what extent there will be a resurgence in financial sector profits – in particular among the largest banks, which contribute substantially – that would buoy corporate tax receipts or whether the financial sector, and therefore the associated tax base, is permanently smaller than before the crisis.

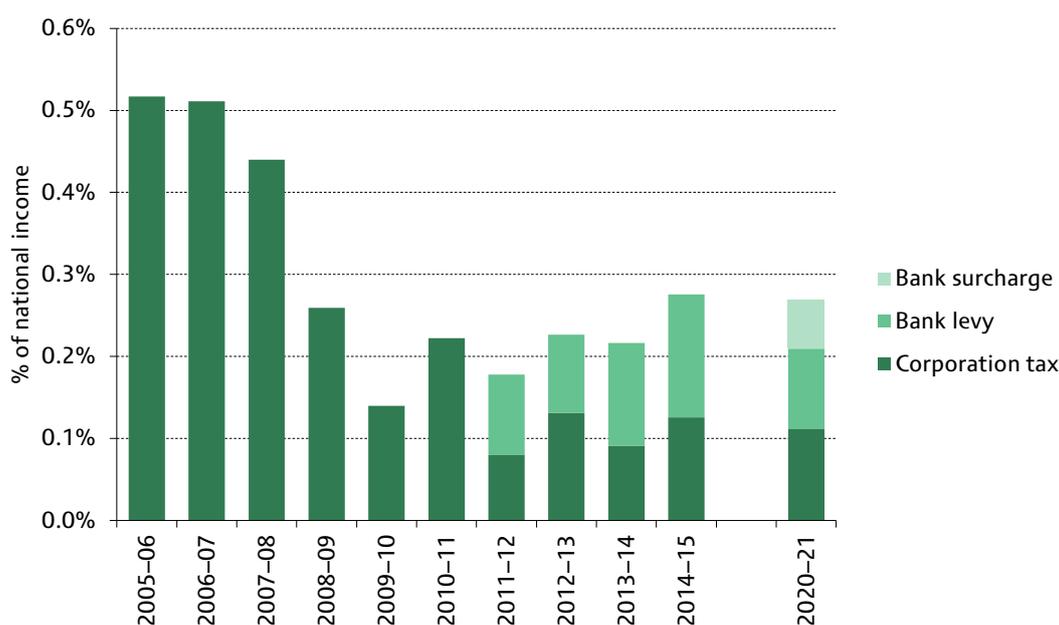
In response to the lower revenue stream coming from banks and, in part, to the view that banks should contribute to the public finance cost of the crisis, the government has introduced two new taxes that increase the revenue received from banks (see Figure 9).<sup>24</sup> There is now a bank levy (introduced in 2011) on the liabilities on large banks' balance sheets and a bank surcharge (introduced in 2016) that effectively adds an additional 8 percentage points to the rate of corporation tax on bank profits (in 2016–17, this implies that they face a tax rate of 28%). As Figure 9 shows, these measures will be sufficient to roughly maintain the proportion of national income paid in taxes by banks between 2014–15 and 2020–21, but this proportion will still be considerably below the pre-crisis peak.

Additionally, the government has placed restrictions on the share of banks' taxable profit that can be offset by carrying forward losses from previous years. From 2014, no more than 50% of banks' profits could be offset using losses. From April 2016, this cap is just 25%. (From 2016, loss offsets have also been restricted to 50% of taxable profits for all non-bank companies.) Restricting loss offsets brings revenues forward for the government and disadvantages companies (that now have to pay

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<sup>24</sup> In 2010, the government also introduced a payroll tax on bankers' bonuses. We classify this as a tax on personal income, though its rationale (that the banking sector should contribute to the fiscal consolidation) was in a similar vein to the taxes noted here.

**Figure 9. Taxes paid by banks**



Note: The 2020–21 value of corporation tax paid is calculated by assuming that corporation tax paid by banks grows at the same rate as corporation tax paid by the finance sector as a whole.

Source: OBR, *Economic and Fiscal Outlook*, March 2016,

<http://budgetresponsibility.org.uk/efo/economic-fiscal-outlook-march-2016/>; IFS revenue composition spreadsheet,

[http://www.ifs.org.uk/uploads/publications/ff/revenue\\_composition%20June%202014.xls](http://www.ifs.org.uk/uploads/publications/ff/revenue_composition%20June%202014.xls);

table PSA6D of ONS public finance tables,

<http://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/bulletins/publicsectorfinances/previousReleases>; HMRC table ‘PAYE and corporation tax receipts from the banking sector’, <https://www.gov.uk/government/collections/payee-and-corporation-tax-receipts-from-the-banking-sector>.

corporate taxes sooner and, if they go out of business, will be unable to claim all of their loss relief).

The addition of new measures has produced a system of bank taxation that is substantially more complicated than before the crisis, and one that is not underpinned by a clear strategy. Notably, the bank levy was intended to discourage banks from holding excessively risky balance sheets. There was always a question as to whether it would achieve this, or whether firms would be able to shift risk within their portfolios.<sup>25</sup> In any case, if this was the aim, there was no good reason to introduce a revenue target for the

<sup>25</sup> For a discussion, see M. P. Devereux, N. Johannesen and J. Vella, ‘Can taxes tame the banks? Evidence from European bank levies’, Oxford University Centre for Business Taxation, Working Paper 13/25, December 2013,

[http://www.sbs.ox.ac.uk/sites/default/files/Business\\_Taxation/Docs/Publications/Working\\_Papers/Series\\_13/WP1325.pdf](http://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Working_Papers/Series_13/WP1325.pdf).

levy, which implied that the rate had to be continually increased when the tax base proved much smaller than anticipated, possibly because activity was more responsive to the tax than expected. A more responsive tax base in turn implies that activities are being more discouraged than originally planned, and will be even more discouraged by higher rates. If the original rate was set at the level that was thought appropriate to deter banks from holding too much risk, there is no reason why that deterrent should be increased if the tax take turns out to be smaller than forecast. This is not a coherent way to design a tax aimed at changing behaviour.

### *Corporation tax giveaway is the main policy story*

There have been a large number of changes to corporation tax since 2010. We calculate that, taken together, policy changes announced between 2010 and Budget 2016 (including those that are due to come into place before the end of the parliament) have cost £10.8 billion a year in 2015–16 terms.<sup>26</sup> In previous work, cited at the end of footnote 26, we calculated that the cost of measures announced by the coalition government (2010–15) only was £7.9 billion.

The majority of the revenue cost is due to cuts to the corporation tax rate. The coalition government reduced both the main corporation tax rate (from 28% in 2010) and the small profits rate (from 21% in 2010) to 20% in 2015–16. In 2013, it also introduced a new lower 10% rate for the income derived from patents (the *Patent Box*). The current government plans to reduce the main corporation tax rate even further to 17% by 2020–21. Corporation tax rates across the developed world have declined substantially since the 1970s as countries have attempted to remain competitive locations for mobile activities and profits. The desire to attract and retain mobile activity has been important in the UK, which, since 2010,

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<sup>26</sup> Authors' calculations using OBR policy measures database, <http://budgetresponsibility.org.uk/data/>, and Budgets and Autumn Statements, June 2010 to March 2016. We do not count the temporary effect of changes in the timing of large companies' corporation tax payments scored in Budget 2016. We account for the long-run cost of rate cuts (including the cost of the cut to 17%, the full cost of which comes after the current forecast horizon). The methodology follows H. Miller and T. Pope, 'Corporation tax changes and challenges', IFS Briefing Note BN163, February 2015, <http://www.ifs.org.uk/publications/7590>.

has cut rates further and faster than other countries, such that the rate is now the lowest in the G20.<sup>27</sup>

Alongside rate cuts, there have been a large number of other corporation tax changes since 2010, including moves that raise revenues by broadening the tax base and by preventing avoidance opportunities.

The mix of policy changes is such that some companies will gain more than others. Broadly, highly profitable and mobile firms will see the most benefit from lower rates, although some will be affected by anti-avoidance measures, such as a new restriction on interest deductions.<sup>28</sup> Those businesses with high levels of investment or losses and multinationals with high levels of debt in the UK will benefit the least.

A permanent decline in onshore corporate tax revenues would mark a break with the previous trend, highlighted above, under which the effect of lower rates was offset by a larger, more profitable corporate sector (and, to a smaller extent, a broader tax base). It is possible that corporate revenues will be higher than currently forecast either because corporate rate cuts boost corporate activity by more or because anti-avoidance measures are more successful at raising revenues than is currently predicted. However, in the longer run, there is also likely to be continued competitive pressure on corporate taxes.

#### **4. Bigger role for smaller taxes**

While some revenue streams, and corporation tax revenues in particular, have declined, government receipts will be close to their pre-crisis level by 2020–21. By the end of the parliament, the government will rely more on

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<sup>27</sup> The aim to have ‘the most competitive corporate tax regime in the G20’ was a key part of the 2010 corporate tax roadmap (HM Treasury and HM Revenue & Customs, *Corporate Tax Reform: Delivering a More Competitive System*, November 2010, [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/81303/corporate\\_tax\\_reform\\_complete\\_document.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81303/corporate_tax_reform_complete_document.pdf)).

<sup>28</sup> Budget 2016 announced that from April 2017 the UK will introduce a new ‘fixed ratio’ rule in an attempt to limit multinational firms’ use of interest deductions to avoid tax. For a discussion of this, and other policy developments that came out of the OECD Base Erosion and Profit Shifting project, see H. Miller and T. Pope, ‘Corporate tax avoidance: tackling Base Erosion and Profit Shifting’, in C. Emmerson, P. Johnson and R. Joyce (eds), *The IFS Green Budget: February 2016*, <http://www.ifs.org.uk/uploads/gb/gb2016/gb2016ch8.pdf>.

relatively small taxes, a number of which have been introduced since 2010. This in part reflects (real or perceived) political constraints on raising the rates of the big taxes, manifested in the current government's commitment not to raise the main rates of VAT, NICs or income tax for the duration of this parliament. In addition, the government has committed to raising further the personal allowance and to not broadening the VAT base.

Part of the increased reliance on smaller taxes is due to greater revenues from existing smaller taxes, such as insurance premium tax (IPT) (whose rate will increase from 6% in 2015 to 10% in 2017) and stamp duty land tax. Revenues from the latter have been buoyed by rapid house price inflation and reforms to the treatment of both residential and non-residential properties. Overall receipts are forecast to increase by 0.2% of national income in 2020–21 relative to 2015–16.

There have also been several entirely new taxes introduced. As well as the new taxes on banks and the diverted profits tax mentioned above, the UK will start collecting an apprenticeship levy<sup>29</sup> and a soft drinks levy<sup>30</sup> from 2017 and 2018 respectively. These are forecast to raise an additional £7.3 billion in 2020–21.

## 5. Conclusion

By 2020–21, the share of national income raised through taxes will be almost back to the 2007–08 level. The amount raised from indirect and personal income taxes – accounting for 73.9% of 2015–16 tax revenues – will also be back at pre-crisis levels. Yet beneath this apparent stability are a number of notable changes in the composition of the tax base. Whether these changes have been part of a clear and coherent overarching strategy is, to put it kindly, unclear.

One of the most notable changes in the composition of revenues is the fall in the share due to come from corporation tax. In particular, by 2020–21, corporation tax receipts are due to be lower as a result of rate cuts, which

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<sup>29</sup> From April 2017, employers will face a 0.5% levy on the part of their pay bill in excess of £3 million.

<sup>30</sup> For a more detailed discussion of the soft drinks levy, see R. Griffith, M. Lührmann, M. O'Connell and K. Smith, 'Using taxation to reduce sugar consumption', IFS Briefing Note BN180, March 2016, <http://www.ifs.org.uk/publications/8216>.

are not fully offset by measures to broaden the tax base and to prevent avoidance. The overall trajectory of receipts will continue to depend on the strength of growth in corporate profits, especially in the banking sector. Revenues from business rates – the other large tax levied at the company level – have also been reduced as a result of policy changes.

A source of concern is the extent to which policy changes are being made in an ad hoc fashion with insufficient attention paid to tax design. Such ad hocery ranges from continued unfulfilled promises to raise fuel duty in line with inflation, to the introduction of the diverted profits tax, ever-shifting taxes on banks and constant fiddling with more and more smaller taxes. This lack of apparent and communicated strategy matters and is reflected in an increasingly complex tax system. New taxes have tended to be hastily introduced without consideration of the full set of effects. For example, the bank levy was introduced in 2011 to reduce banks' risk taking, consistently ratcheted up to increase the revenue take, and then reduced in response to concerns about how it was affecting banks' decisions. The bank levy is now falling as a source of revenue, but from 2016 a higher rate of corporation tax is being levied on the banking sector. More thought should be given to whether, and if so how, the banking sector should be taxed differently from other sectors.

There are risks to revenue streams over the remainder of the parliament.<sup>31</sup> These risks arise from uncertainty over general economic performance and the composition of economic growth as well as uncertainty around the impact on revenues of policies already introduced. It is difficult to forecast the behavioural effects of changes to the tax system and so their revenue yield. This is particularly the case for new taxes. Therefore, in the short run at least, the prevalence of newly-introduced taxes implies an increase in uncertainty.

There is also uncertainty created by policy risk. Inflation increases for fuel duty are built into official forecasts, but look unlikely to happen. Income tax thresholds are fixed in cash terms by default, but whether they will actually be maintained at those levels remains to be seen. These are just

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<sup>31</sup> For a detailed assessment of these risks, see R. Crawford, C. Emmerson, T. Pope and G. Tetlow, 'Risks to the rules: tax revenues', in C. Emmerson, P. Johnson and R. Joyce (eds), *The IFS Green Budget: February 2016*, <http://www.ifs.org.uk/uploads/gb/gb2016/gb2016ch5.pdf>.

two examples where revenues may deviate from the current forecasts.  
More generally, the lack of clear direction on tax policy creates inevitable uncertainty.