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Deficit Reduction and the Role of Taxes

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Challenging ideas – Changing policy

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Further details of the model are available from Kayte Lawton: k.lawton@ippr.org or at www.ippr.org/research/teams/project.asp?id=3956

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Deficit Reduction and the Role of Taxes

Main points

- Deficit reduction will involve many tough decisions but the ultimate test of a government that wishes to be seen as progressive is: who will pay? The most vulnerable members of society must be protected from the effects of most of the cuts.
- If the new coalition government proposes that 80 per cent of deficit reduction should be achieved through public spending cuts and 20 per cent through tax increases, it will be impossible to protect the poorest in society. The Government should consider a greater role for higher taxes.
- Cumulating evidence that frontline services are being badly hit by cuts is, in any case, likely to lead the Government to abandon plans that imply real cuts in spending of 25 per cent or more for most government departments, at which point it will be forced to think again about the scale of tax increases.
- Whether taxes go up now or at a later date, increasing the standard rate of VAT is not progressive.
- A better option – one that shares the burden of deficit reduction around a large proportion of the population but in a progressive way – would be to increase the basic and higher rates of income tax, something that has not been done in the UK since the mid-1970s. A 3p increase in the basic and higher rates of income tax would raise £15 billion – around one-fifth of the amount needed to eliminate the structural deficit.
- The Coalition should not be deflected from its commitment to align rates of capital gains tax with income tax rates. Only the rich will pay more tax as a result of this change, which will be a key test of its claim to be a progressive government.
- Other options for increasing tax revenues include a carbon tax (though this would be regressive and would have to be accompanied by some form of compensation for those on low incomes), higher taxes on banks and other financial institutions in the form of levies on their liabilities and on their profits and remuneration, and a broad-based financial transactions tax.

Introduction

Deficit reduction is one of the biggest challenges – perhaps *the* biggest challenge – facing the Conservative-Liberal Democrat Coalition Government. The ultimate test for a government that wants to be seen as progressive is: who will pay? Are the poorest in society protected from the worst effects of deficit reduction?

There are tough decisions to be made about the timing and pace of deficit reduction and about the mix of spending cuts and tax increases. Much has been written about scale and timing, so this paper focuses instead on the spending cuts versus tax increases debate and, in particular, on the potential role of tax increases in deficit reduction.

The Labour Government's last Budget, published in March 2010, estimated public sector net borrowing (PSNB) would be £166.5 billion in 2009–10 and projected borrowing would fall from £163 billion in 2010–11 to £74 billion in 2014–15, or from 11.1 per cent of GDP to 4.0 per cent[1]. Subsequently, data from the Office for National Statistics (ONS) have shown that borrowing in 2009–10 actually came in at £156.1 billion.

Table 1: Public sector net borrowing

	Actual		Projections				
	2008–09	2009–10	2010–11	2011–12	2012–13	2013–14	2014–15
£ billion	96.5	156.1	163	131	110	89	74
% of GDP	6.7	11.1	11.1	8.5	6.8	5.2	4.0

Source: Budget 2010, p.189, Tables C3 and C4[2] and Office for National Statistics, Public sector finances, April 2010[3]

The new Government has already announced plans to cut public spending immediately by £6.2 billion, though an extra £500 million is to be invested in further education, apprenticeships and social housing, so the net spending cut is £5.7 billion, or about 0.4 per cent of GDP. It has also set a date – June 22 – for an 'emergency budget', when it will set out more details of its fiscal plans.

The Chancellor has also established an Office for Budget Responsibility (OBR) to make independent assessments of the public finances and the economy ahead of every Budget and Pre-Budget Report. In its first report[4], published on June 14, the OBR downgraded the outlook for UK output (GDP) growth contained in March's Budget; nevertheless it also produced lower forecasts for public sector net borrowing in 2010–11, and in every year out to 2014–15. (Note that these forecasts are based on the Labour government's plans and exclude any measures implemented by or announcements made by the Coalition.)

Table 2: Public sector net borrowing

	Actual		Projections				
	2008–09	2009–10	2010–11	2011–12	2012–13	2013–14	2014–15
£ billion	96.5	156.1	155	127	106	85	71
% of GDP	6.7	11.1	10.5	8.3	6.6	5.0	3.9

Source: Office for Budget Responsibility

The OBR did, though, forecast that the structural (or cyclically-adjusted) deficit – the borrowing which will not go away even when the economy returns to operating at full capacity – will be a little higher than expected in the last Budget. This is largely because it has made lower

1 Unless otherwise stated, all the borrowing figures in this paper are on the basis which excludes the temporary effect of financial interventions.
2 http://webarchive.nationalarchives.gov.uk/20100407010852/ ; www.hm-treasury.gov.uk/d/budget2010_complete.pdf
3 www.statistics.gov.uk/pdfdir/psf0510.pdf
4 http://budgetresponsibility.independent.gov.uk/d/pre_budget_forecast_140610.pdf

assumptions about the trend growth rate of the UK economy than did the previous Labour Government. It should be emphasised, though, that the differences are small and well within the normal margins of forecasting error.

Table 3: Cyclically-adjusted public sector net borrowing (% of GDP)

	Actual		Projections				
	2008–09	2009–10	2010–11	2011–12	2012–13	2013–14	2014–15
Budget	5.8	8.4	7.3	5.3	4.1	3.1	2.5
OBR	6.4	8.8	8.0	6.1	4.7	3.5	2.8

Source: Budget 2010 and Office for Budget Responsibility

The Coalition says in its *Programme for Government*: 'We will significantly accelerate the reduction of the structural deficit over the course of a Parliament' (p.15)[5]. Not until the budget on June 22 will the country find out exactly what this means, but it could involve reducing the structural deficit by around 7 per cent of GDP, or £100 billion, over the next four years. Some of this improvement will come about through increases in tax receipts not taken into account when identifying the structural element of the deficit (such as stamp duties, as the housing and financial markets recover), but over £75 billion will have to be found through discretionary measures.

A start has already been made with the £5.7 billion of net spending cuts and the planned increase in employees' national insurance contributions from April 2011 – but a lot more is required.

The balance between tax increases and public spending cuts

The coalition agreement states that 'the main burden of deficit reduction [will be] borne by reduced spending rather than increased taxes' (p.15). Precise figures will only be available with the budget on June 22 but the Conservatives have favoured a 4:1 ratio between spending cuts and tax increases and the Liberal Democrats a 2½:1 ratio (with Labour opting for 2:1). If these ratios are applied to a target of £75 billion of discretionary cuts, they imply the following:

Table 4: Projected spending cuts and tax increases

	Spending cuts (£bn)	Tax increases (£bn)
Conservatives	60	15
Liberal Democrats	53.5	21.5
Labour	50	25

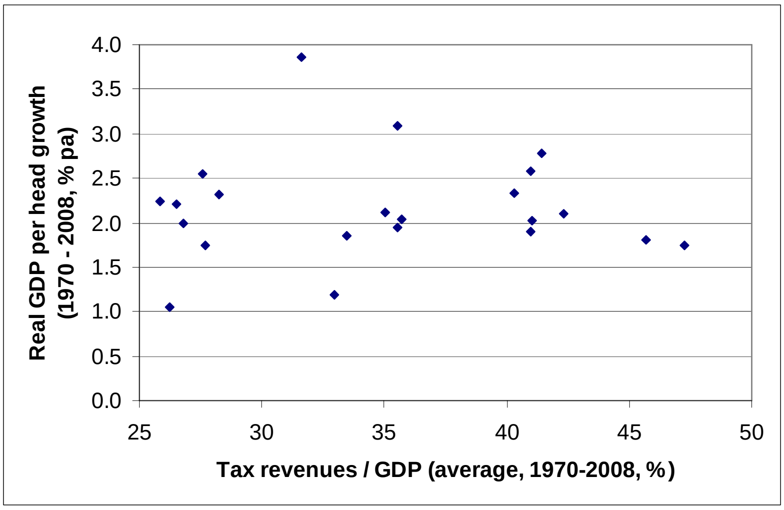
Alistair Darling's rationale for Labour's proposed 2:1 split between spending cuts and tax increases was that he 'thought it was the right balance'[6]. But the Institute for Fiscal Studies has noted that it is the balance that will roughly return the ratios of spending and revenues to GDP to their pre-crisis levels[7]. In other words, deterioration in the fiscal deficit caused by higher spending has been roughly twice as large as the deterioration caused by lower revenues, so there is some crude logic in applying the same ratio to the measures used to repair the damage.

The Conservatives, though, argue public spending should bear a bigger proportion of the deficit reduction. In part, this view is based on what happened in the Canadian deficit reduction programme of the 1990s, which they are using as something of a roadmap. It also reflects an underlying view that the 'state' has become too big and that increases in the share of taxation in GDP lead to a poorer economic performance. In fact, data from the Organisation for Economic

[5] www.cabinetoffice.gov.uk/media/409088/pfg_coalition.pdf
[6] Oral evidence to Treasury Committee, 16 December 2009, www.publications.parliament.uk/pa/cm200910/cmselect/cmtreasy/uc180-iii/uc18002.htm
[7] IFS Green Budget: February 2010 (p.40), www.ifs.org.uk/budgets/gb2010/10chap2.pdf

Co-operation and Development (OECD) show there is no correlation between the size of the state, in terms of tax revenue, and real per-capita GDP growth.

Figure 1: Tax take and GDP per head growth across the OECD



Source: OECD statistics[8]

Rather than starting by taking an – inevitably arbitrary – view on the balance between spending cuts and tax increases, the Government would do better to begin with an assessment of where in society the burden of deficit reduction should fall. Given the scale of the problem, it may be reasonable to assert, as George Osborne has done, that 'we are all in this together' but some people – the top half in the income and wealth distributions, and particularly the rich – can and should bear the brunt of the cost. The better-off in society benefited most in the boom years and were able to insulate themselves from the worst effects of the recession. It is only right that they should make the biggest sacrifices now. This will not be the case if 80 per cent of the burden of deficit reduction is borne by public spending cuts.

It may also not be practicable to implement £60 billion of public spending cuts over the next four years, particularly if one of the largest areas of spending – the National Health Service – is protected from cuts. Even if the Coalition stuck with Labour's aggregate spending plans, government departments other than health and international development would face a 15 per cent cut in real spending over the next four years. Increasing both the pace of deficit reduction and the share of the burden carried by spending cuts, will mean real cuts in spending of about 25 per cent in departments that are not ring-fenced.

Clearly, this is not going to be achieved by efficiency savings alone. Nor will cancelling unpopular ideas like ID cards be enough. Frontline services will have to be cut. In Canada in the 1990s, thousands of nurses lost their jobs, class sizes in state schools increased and there were massive cuts in the army. The incidence of cuts in the UK will be different but the Defence Secretary has already said that resources for the armed forces will be reduced. Investment in the country's transport infrastructure is also likely to be cut and further education colleges will close. The very real effects this will have on people's lives may make it impossible politically for the Government to implement such measures year after year – particularly the nearer we get to the next election.

It may be, therefore, that whatever the current intentions of the Government regarding the split between spending cuts and tax increases, it will eventually be forced to consider a larger role for

[8] Available from http://stats.oecd.org/index.aspx

tax increases, even though they too would be unpopular (suggesting it might be better to make them sooner rather than later).

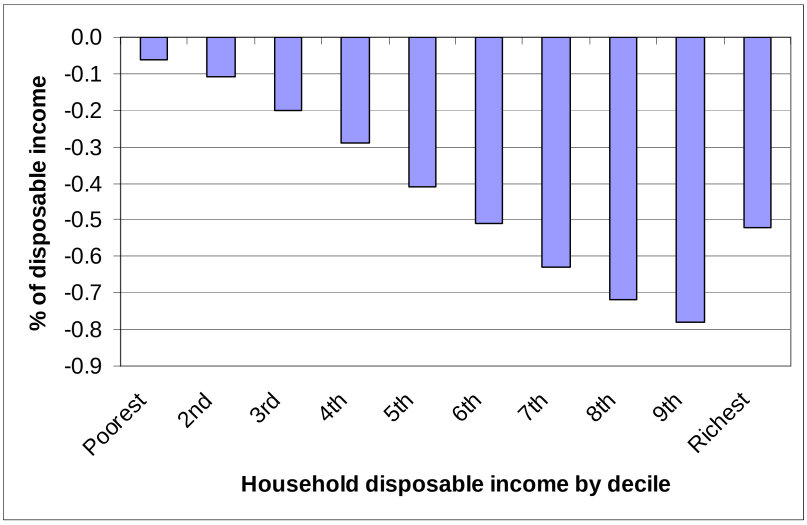
National Insurance contributions

The last Labour Government was planning to increase the main rate of National Insurance contributions for employees from 11 per cent to 12 per cent, with effect from April 2011, while at the same time increasing the starting rate at which contributions are paid by £570. It also planned to increase employers' National Insurance contributions by 1 percentage point, from 12.8 to 13.8 per cent. These changes would together have increased revenues by over £8 billion.

During the general election campaign, the Conservatives proposed scrapping all planned increases in National Insurance contributions. However, the Coalition appears likely to go ahead with the increase in contribution rates for employees (raising revenues of close to £4 billion), while cancelling the increase for employers, though this will not be confirmed until the budget on June 22.

The distributional effects of increasing National Insurance contribution rates for employees are shown in Figure 2. This is clearly a progressive tax change – those earning higher incomes, apart from those in the very top decile (who have a large proportion of unearned income which is not subject to national insurance), lose proportionately more than those on lower incomes.

Figure 2: Distributional effect of an increase in employees' National Insurance contributions to 12 per cent



Source: ippr tax-benefit model

Value-added tax

None of the major political parties proposed an increase in value-added tax (VAT) during the general election campaign, but they did not rule one out either. A number of economists have suggested that the task of reducing the Government's budget deficit is so immense that VAT will have to increase, if not in the June 22 budget, then in 2011. A figure of 20 per cent for the standard rate of VAT is widely talked about, though probably as much because it is a convenient round number as for any other reason[9]. If the standard rate of VAT were to be increased from 17.5 per cent to 20 per cent, revenues would go up by over £11 billion in 2011–12.

[9] A BBC survey of 28 economists who advise HM Treasury found that 24 of them thought VAT would increase during the current parliament, with 17 expecting the standard rate to go up to 20 per cent before the end of 2011.

There is some debate about whether VAT is a regressive tax. Official data suggest it is, showing that its burden falls more heavily on low income households than it does on those with higher earnings.

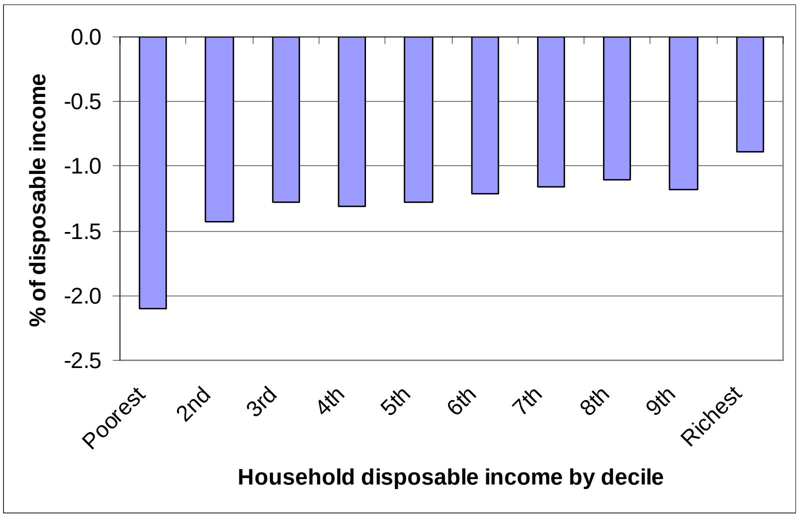
Table 4: VAT as a percentage of disposable income, 2008–09

All households	Quintile groups of all households				
	Bottom	Second	Third	Fourth	Top
7.0	10.8	8.4	7.4	7.2	5.8
Source: Office for National Statistics[10]					

In part, this is because those on the highest incomes consume a lower percentage of their income and have more left over for savings compared with those on higher incomes. But it also reflects the presence in the bottom income quintile of people whose spending is greater than their income. Students, for example, will borrow to spend (in anticipation of higher earnings in the future), while some retired people will run down their savings to boost their spending power. The Institute for Fiscal Studies has argued that VAT is a progressive tax if households are ranked according to expenditure rather than income (because the lowest spending households spend proportionately more on zero-rated goods such as food)[12]. Even then, it is less progressive than other taxes, particularly income tax.

The regressive nature of VAT in relation to incomes is confirmed when the distributional effects of an increase in VAT are modelled. The biggest losers, relative to disposable income, are households in the lowest income deciles.

Figure 3: Distributional effect of an increase in VAT to 20 per cent



Source: ippr tax-benefit model

This does not mean that the standard rate of VAT cannot be higher in the UK. Most countries across Europe have higher rates of VAT than the UK. This includes the Scandinavian economies, which are more equal societies because transfers of income to the poorest sections of society are correspondingly higher. If a higher rate of VAT were to be introduced here, it should be accompanied by measures such as higher levels of tax credits to ensure that the poorest in

[10] Andrew Barnard *The effects of taxes and benefits on household income, 2008/09* www.statistics.gov.uk/articles/nojournal/Taxes_Benefits_0809.pdf
[12] www.ifs.org.uk/publications/4732

society are largely insulated from its effects. Inevitably, this would mean the increase in revenues is lower and therefore it would be better to look at other options for increasing tax revenues.

Income tax rates

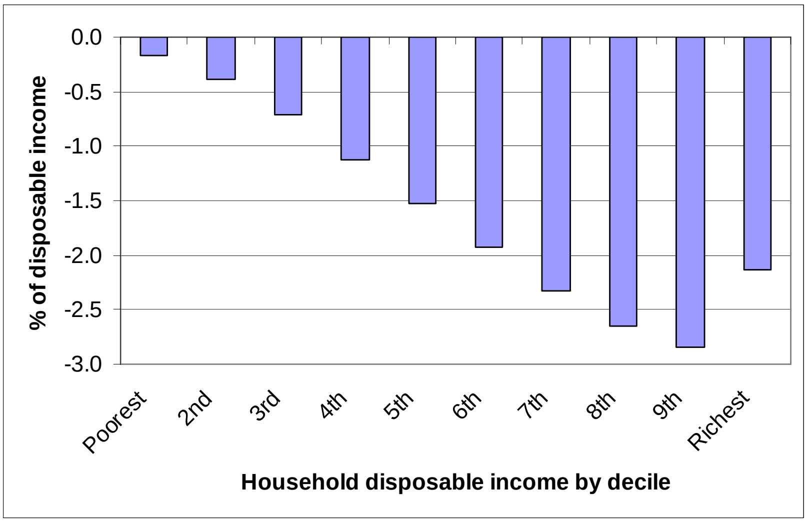
The one tax increase that none of the main political parties are prepared to talk about is an increase in the basic rate of income tax. Ever since Denis Healey cut the basic rate from 35 per cent to 34 per cent in 1977, politicians have been mortally afraid of proposing an increase in the basic tax rate (though this has not stopped either Conservative or Labour governments increasing the employees' National Insurance contribution rate, which has very similar – though not identical – effects).

Yet, if the Government wants to raise extra revenues to help close the fiscal deficit, and it wants to do so in a way that spreads the burden across much of society while ensuring that the poorest households are unaffected, an increase in the basic rate of income tax would be a straightforward solution. And this argument has even greater weight if the Government can make significant progress towards its aim of increasing the personal tax allowance to £10,000, so that those on the very lowest incomes are unaffected by the tax increase.

An increase in the basic rate of tax to 22 per cent would raise additional revenues of £8 billion a year, while only returning the tax rate to the level that applied between 2000–01 and 2007–08 (though there was a lower starting rate throughout this period and national insurance contributions are higher now). An increase to 23 per cent would return the basic rate to the level that last applied under a Conservative Government, in 1997, and raise revenues of £12 billion – almost one-sixth of the amount needed to close the structural deficit. This may seem a huge move, but the change need not – indeed should not – be made all at once. Given that employee National Insurance contributions are going up in April 2011, the basic rate of tax could, for example, be increased by 1 percentage point a year, from 20 to 23 per cent, between April 2012 and April 2014.

The distributional effects of increasing the basic rate of tax by 3p are shown in Figure 4. For the most part of the income distribution, this is a progressive tax change – those earning higher incomes lose proportionately more than those on lower incomes. This ceases to be true at the very top end because anyone with a taxable income above the higher rate threshold will pay the same extra amount in absolute terms, and so a diminishing amount, as income increases, in proportional terms.

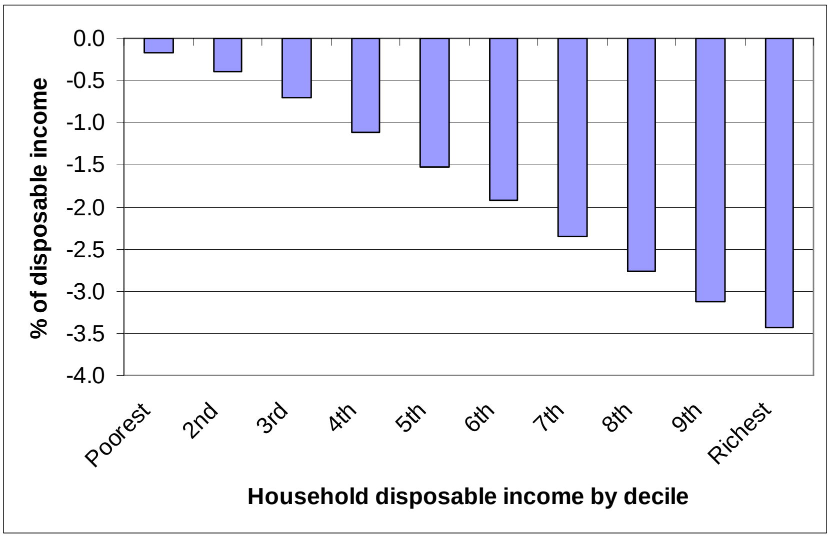
Figure 4: Distributional effect of increasing the basic rate of income tax to 23p



Source: ippr tax-benefit model

This effect can be avoided by also increasing the higher rate of tax, say from 40 per cent to 43 per cent. The increase in revenues would then be £15 billion – one-fifth of the amount needed to close the structural deficit.

Figure 5: Distributional effect of increasing the basic rate of income tax to 23p and the higher rate to 43p



Source: ippr tax-benefit model

Capital gains tax

The coalition government has said that it will 'seek ways of taxing non-business capital gains at rates similar or closer to those applied to incomes, with generous exemptions for entrepreneurial business activities'[13]. This has already caused something of a stir, even before any detailed proposals have been put forward.

In fact, this is exactly the type of progressive idea for closing the deficit that the Government should be coming up with (although the proceeds from this change – likely to be around £2 billion – are actually earmarked to finance an increase in the personal income tax allowance, not to close the deficit). Indeed, it would be reasonable to judge the progressive credentials of the Government on its willingness to pursue this change in the face of concerted opposition from the Conservative backbenches and in the right-wing press.

Increasing capital gains tax rates is a good idea not just because it raises additional revenue but also because it reduces unfairness in the tax system. It is wrong that the top rate of tax on capital gains is so much lower than the top rate of tax on incomes. Furthermore, because the gap is so large, it encourages high earners with willing accountants to find ways of converting income into capital gains. As private equity boss Nicholas Ferguson said three years ago, it is unfair that highly-paid executives in his industry pay a lower rate of tax than their cleaning ladies do[14].

The burden of any increase in capital gains tax will fall on the rich. The vast majority of people in the UK either have no capital gains, or gains that are small enough to be covered by the annual allowance of £10,100 when they are realised. ISAs and private pensions also provide legitimate means of not paying capital gains tax. In 2007–08, the peak year for receipts, only 247,000 individuals paid capital gains tax (while 32,500,000 paid income tax). Of these, over half were

[13] www.cabinetoffice.gov.uk/media/409088/pfg_coalition.pdf
[14] See, for example, www.thisismoney.co.uk/news/article.html?in_article_id=420989&in_page_id=2

basic rate tax payers who, at worst, are likely to see their capital gains tax rate increase from 18 to 20 per cent (or 23 per cent if income tax is increased as proposed above)[15]. The remaining 120,000, who appear likely to have to pay 40 (or 43) and 50 per cent under the Coalition's proposals, represent just 0.4 per cent of the wealthiest taxpayers.

A carbon tax

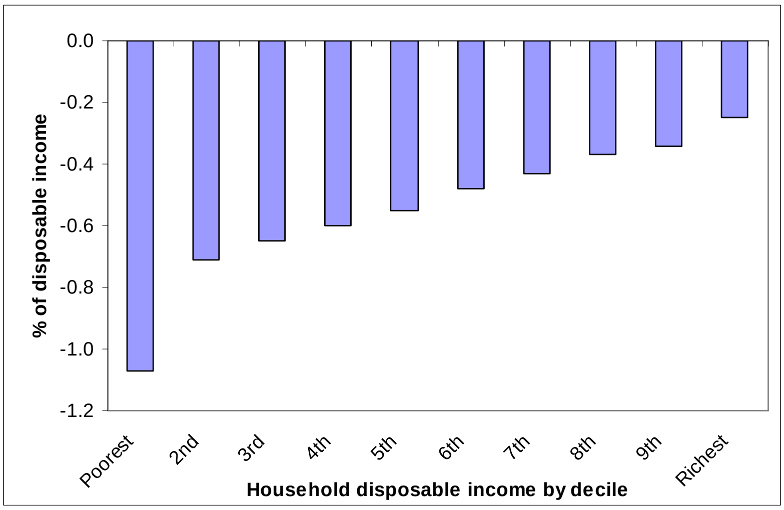
The main appeal of a carbon tax is that it would help to reduce government borrowing while also playing a part in reducing carbon emissions. The main problem is that it is regressive.

A carbon tax is a tax on the carbon content of fuels. In effect, therefore, it is a tax on the carbon dioxide (CO_2) emissions that result from burning fossil fuels. It has been suggested that the UK should impose a carbon tax on domestic fuel, including electricity. A carbon tax set at £25 per tonne of CO_2 would raise about £3 billion in a full year.

A carbon tax would also help reverse the trend over the last decade for environmental taxes to fall as a share of GDP and of total tax revenues. In 2008 they were equal to 2.7 per cent of GDP compared with 3.5 per cent in 1998, and 7.1 per cent of total taxes and social contributions compared with 9.7 per cent in 1998[16].

However, a carbon tax would be regressive and unfair on poorer households. Because they spend more of their incomes on fuel, the tax would take a higher proportion of their income compared with richer households. Those in the lowest income decile would lose, proportionately, almost four times as much as those in the highest decile.

Figure 6: Distributional effect of a carbon tax of £25 a tonne of CO_2



Source: ippr tax-benefit model

Measures would have to be introduced alongside a carbon tax in an effort to ensure that low income families would not lose out. This would reduce the net revenue gains and might be complex. Even then, it would be hard to fully compensate all households. Pensioners living in energy-inefficient homes, for example, would probably see their fuel bills increase by more than the value of any compensation they might receive.

[15] www.hmrc.gov.uk/stats/capital_gains/table14-3.pdf
[16] www.statistics.gov.uk/CCI/nugget.asp?ID=152

Taxes on financial institutions and their activities

New Chancellor George Osborne has said that he will introduce a levy on banks in the UK, even if international agreement cannot be reached for a global bank tax. In a recent leaked report[17], the International Monetary Fund proposed two new taxes on financial institutions:

1. *A financial stability contribution (FSC):* A levy paid by all financial institutions, initially at a flat rate but eventually at a variable rate according to their riskiness and their contribution to systemic financial risk. Money raised by the levy could be placed in a special fund, which should build up to 2 to 4 per cent of GDP, or it could be incorporated into general government revenues. The UK, with its relatively large financial sector, would need a fund at the top end of the range – 4 per cent of GDP, or just under £60 billion. If this fund were to build up over 10 years, the FSC would have to raise around £6 billion a year.
2. *A financial activities tax (FAT):* A levy on the sum of the profits and remuneration of financial institutions. It could be levied on all profits and remunerations (and so be roughly equivalent to a value-added tax), or only on those profits and remunerations that are judged to be 'excessive'. The IMF report does not suggest what would be an appropriate amount of money to raise through a FAT but assuming a 6.6 per cent share of financial services in the economy (the average between 2000 and 2007) and a low rate of FAT at 2 per cent, revenues would be around £2 billion. Alternatively, applying FAT at the current standard rate of VAT would raise around £17 billion.

Since the financial collapse in 2008, there has also been renewed interest in financial transactions taxes (also known as FTTs, Tobin taxes or Robin Hood taxes). These would be levied on trading in bonds, currencies and all types of derivative instruments (the UK already has a transactions tax on trading in shares – stamp duty). The revenues that could be raised from these taxes will depend on the rate at which they might be levied and their effect in reducing trading volumes; but they are potentially huge. Even assuming a low rate of tax and a high impact on trading volumes, a broad-based financial transactions tax in the UK might raise up to £25 billion (after allowing for consequent reductions in income and corporate tax)[18]. As well as making a contribution to deficit reduction, this would allow more resources to be made available for fighting poverty and climate change.

It is difficult to assess the ultimate distributional effects of taxes on financial institutions and financial transactions, but they are likely to be highly progressive. The initial incidence of financial transactions taxes, for example, would fall disproportionately on high-frequency traders – hedge funds and investment banks' proprietary trading desks. Hedge funds would probably pass some of the tax onto their customers – primarily wealthy individuals, but their own profits and hedge fund managers' bonuses would also suffer. Similarly, banks might endeavour to pass on to their consumers any extra levy on their activities, but the IMF's economists argue that – in the case of the new taxes they propose – this would be difficult. It is more likely that the burden will be shared by their employees and by their shareholders (as a result of lower profits and dividend payments).

[17] IMF (2010) *A Fair and Substantial Contribution by the Financial Sector: Interim report for the G20*, available at http://news.bbc.co.uk/1/hi/8633455.stm

[18] This is estimate is based on work by Dean Baker et al, www.cepr.net/documents/publications/ftt-revenue-2009-12.pdf and Stephan Schulmeister et al, www.wifo.ac.at/wwa/servlet/wwa.upload.DownloadServlet/bdoc/S_2008_FINANCIAL_TRANSACTION_TAX_31819$.PDF

Appendix: ippr's tax-benefit model

ippr's tax and benefit model combines data on expenditure patterns taken from the UK's Expenditure and Food Survey (EFS) and information on individual and family income from the Family Resources Survey (FRS) with current parameters of the tax and benefit system (tax rates, thresholds, benefit levels and so on). It also incorporates behavioural effects (for example, the effect of higher duties on the consumption of different goods and services and the effect of higher income taxes on hours worked).

The taxes and benefits modelled include:

- Personal taxes: income tax, national insurance contributions and council tax
- Tax credits: working tax credit and child tax credit
- Means-tested benefits: income support, income-based jobseeker's allowance, housing benefit, council tax benefit and pension credit
- Non means-tested benefits: pensions, incapacity benefit, disability living allowance, contribution-based jobseeker's allowance and child benefit
- Existing expenditure taxes: VAT, vehicle excise duty, excise duties
- New taxes on expenditure: a carbon tax on domestic energy use

The model does not cover wealth or transactions taxes, such as stamp duty, inheritance tax and capital gains tax (although we hope to develop it so that it does). It also does not cover taxes on businesses.

The model can be used to analyse the distributional effect of reforms to taxes on income, expenditure taxes, council tax and income transfers (benefits and tax credits). It also calculates the impact on government revenues and spending and on poverty levels.

See www.ippr.org.uk/research/teams/project.asp?id=3956 for more information.