The Centre for Economic Justice

JUST TAX

REFORMING THE TAXATION OF INCOME FROM WEALTH AND WORK

Shreya Nanda
and **Henry Parkes**

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SUMMARY

Taxation is the means by which governments raise revenue and fund the welfare and public services on which a civilised society depends. The IPPR Commission on Economic Justice identified a need to move to a higher tax, higher spend economy – with future public spending challenges likely to increase over time. We also seek a tax system that is more progressive – so that those with the greatest ability to pay contribute the most – as well as more transparent and efficient. The UK is one of the most unequal countries in the developed world, and income inequality could be set to worsen as capital and property ownership become more important sources of income generation. Redistribution is essential for economic justice.

This briefing paper focusses on two sets of proposals designed to make the taxation of income simpler, more progressive and better able to raise public money. The proposals are united by the principle that income, regardless of source, should be taxed equally across individuals. It is profoundly unjust that those who work for their incomes are taxed more highly than those whose income is derived from wealth. This situation is all the worse when we consider that the wealthiest are less likely to generate their income from labour than the rest of us. Among the richest 1 per cent, over one-quarter of total income is generated from dividends and partnership income alone. Economic justice demands change.

First, we propose that **income from wealth should be taxed the same as income from work.** Capital gains should be taxed at the same rates as income from employment, and the separate reliefs applied to capital gains tax (CGT) should be abolished. A similar policy was last implemented by Conservative chancellor Nigel Lawson. Capital gains tax rates are substantially lower than they were pre-2008, and are currently taxed at much lower rates than income from work. Lower tax rates for the wealthy than for ordinary earners are fundamentally unfair; they also distort economic behaviour and create opportunities for tax avoidance. We estimate that these changes could raise up to £120 billion of additional revenue over five years, falling to £90 billion when accounting for potential behavioural effects. Removing the exemption of capital gains upon death could raise up to an additional £25 billion over the same time period, falling to £15 billion with behavioural effects. There are inevitably large uncertainties around these estimates, but even if the behavioural effects were larger, or we introduce an indexation or rate of return allowance (RRA), we would still expect these changes to raise significant sums. Our proposal would substantially increase revenues, while making the tax system fairer.

Second, we propose **a fundamental reform of the income tax system, taxing all sources of income (earnings, dividends and savings) together and equally under a single tax schedule, with a gradually rising marginal tax rate as income rises**. The current system of tax band dates from the pre-computer age and is no longer fit for purpose; we believe it is time to follow other countries such as Germany which already use this fairer approach. We argue that, among other advantages, this system would be significantly more transparent, would eliminate the 'tax cliffs' endemic in the current system, and would have the potential to raise significant revenue in a progressive manner. Our illustrative modelling shows a schedule that would be tax neutral while enabling an increase in take-home pay for around 80 per cent of taxpayers, as well as further schedules that could raise substantial sums while avoiding the pitfalls of alternate proposals – such as very

high marginal rates of income tax, or expecting those in the poorest households to contribute more.

It is widely acknowledged that modelling the effects of changing capital gains tax is complex, mainly because of the behavioural impacts where there is a high degree of uncertainty. We are deeply indebted to our colleagues from the Institute for Fiscal Studies, the London School of Economics, the New Economics Foundation, the University of Warwick and HM Revenue and Customs who have contributed their expertise to our work. Any errors, of course, remain our own. Nonetheless, taken together, we believe that these proposals amount to a transformation of the taxation of income which would move us towards a more economically just system, and warrant serious consideration for any government interested in raising revenue in a progressive manner.

1. INTRODUCTION

Taxation is the means by which governments raise revenue and fund the welfare and public services on which a civilised society depends. The IPPR Commission on Economic Justice identified a need to move to a higher tax, higher spend economy – with future public spending challenges likely to increase over time (CEJ 2018). We also seek a tax system that is more progressive – so that those with the greatest ability to pay contribute the most – as well as being more transparent and efficient. The UK is one of the most unequal countries in the developed world (Joyce and Xu 2019), and income inequality could be set to worsen as capital and property ownership become more important sources of income generation. Redistribution is essential for economic justice.

This briefing paper focusses on two sets of proposals designed to make the taxation of income simpler, more progressive and better able to raise more public money. The proposals are united by a simple principle that income, regardless of source, should be taxed equally across individuals. Currently, this is far from being the case. If wealthy people make their fortune purely from the buying and selling of second or third homes, they will pay lower rates of tax on that income than an ordinary worker struggling to get on to the property ladder. If someone lives purely off dividends from inherited shares, they will pay lower rates of income tax than workers earning the same amount through work. We think this is fundamentally unfair, distorts economic behaviour, and creates opportunities for tax avoidance.

This situation is even worse when we consider that the wealthiest people are less likely to generate their income from labour than the rest of us. Among the richest 1 per cent, recent analysis has found that over one-quarter of total income is generated from dividends and partnership income alone (Joyce et al 2019). Combined with the fact the wealthiest are more able to avoid their tax obligations by shifting their income and offshoring, this means that those who obtain their income from wealth may end up paying a lower proportion of their income in tax than average and low-income workers.

First, we propose that **income from wealth should be taxed the same as income from work**. This would entail bringing capital gains into the income tax schedule, taxed at the same rates. Modelling the impacts of this on total revenue are complex. However, we estimate this could raise up to £120 billion over five years, falling to £90 billion when accounting for potential behavioural effects. Removing the exemption of capital gains upon death could raise up to an additional £25 billion over the same time period, falling to £15 billion with behavioural effects. Although there are limitations to our methodology, this estimate is a substantial sum, such that even if behavioural impacts were larger, these changes would still raise significant funds, while also improving fairness in the system.

Second, we propose a formula-based system for income tax, with a single, gradually-rising tax schedule which is applied to all sources of income regardless of origin. We propose illustrative tax schedules which could raise in excess of £15 billion for the Exchequer, while protecting the lowest paid

and avoiding marginal rates of income tax no higher than 50 per cent for the highest earners.

One year on from the final report of the IPPR Commission on Economic Justice, which included these two tax policies, this briefing sets out how their adoption could lead to greater economic justice alongside more sustainable public finances.[1] We believe both reforms warrant serious consideration for any government wishing not only to raise significant revenue but to make the taxation of income fairer.

THE IPPR COMMISSION ON ECONOMIC JUSTICE

The IPPR Commission on Economic Justice was established in 2016 and its final report, *Prosperity and justice: A plan for the new economy*, was published in September 2018 (CEJ 2018). A diverse group of commissioners included the Archbishop of Canterbury, the head of the City of London Corporation, and the general secretary of the TUC. *Prosperity and justice* contained 73 radical proposals to reshape the UK economy, and argued that 'hardwiring' the economy for justice would also generate stronger growth.

1 Although for the purposes of the analysis we consider these proposals separately due to modelling and data limitations, we believe they are complimentary and should be considered together.

2. REFORMING CAPITAL GAINS TAX

THE CASE FOR REFORM

In the UK, income from wealth – for instance, in the form of dividends and capital gains – is taxed more lightly than income from work. This is true both in aggregate and on an individual level. Our current tax rates on dividends and capital gains are the result of multiple reforms and have not always been as low as they are today; the highest capital gains tax rate was 40 per cent between 1988 and 2008 but is just 20 per cent today on most assets (non-residential), and 28 per cent on property.

Having different tax schedules for income from wealth and work is problematic for several key reasons.

First, it is unfair. Two people who earn the same amount but from different sources can make very different contributions in tax (*horizontal* fairness). But, because those with greater incomes get more of their income from wealth, there is also a *vertical* equity problem: whereby people on larger incomes (where there is a mixture of different income sources, such as capital gains and dividends) can have lower average tax rate than people on lower incomes (who are more likely to just get income from work).

What is more, there are strong positive returns to wealth. This means that, left untaxed, those who own capital are likely to experience exponential increases in their wealth. A lower rate of tax on income from wealth exacerbates a dynamic where those who already hold capital can use it to get richer, while those who don't face rises in the cost of living and are left further and further behind. This is antithetical to economic justice and corrodes the idea of a fair social contract. It means that people's life chances are ever more determined by the wealth of the family they are born into.

Many of the capital gains made today are, in fact, 'rents' (Roberts et al 2018). Primary residences are exempt from capital gains tax and we do not propose this exemption is removed, but property speculators and owners of multiple homes have benefited from rising property prices and lower taxes on capital gains than employment income. House prices have increased dramatically over the past four decades as a result of both commodification and financialisation, and much activity within the financial sector is speculative. As a result, many of the gains generated from these activities are not the result of genuine risk-taking to induce participation, but rather non-productive gains that increase inequality without expanding the productive potential of the economy, or 'economic rents'. In the UK, the share of national income accruing to rentiers has increased substantially since the 1980s: from around 1 per cent in 1986 to almost 10 per cent in 2000 (Epstein 2005). Since 2008, the programme of electronic money creation – known as 'quantitative easing' – has accelerated asset price inflation. It is efficient to tax economic rents, as doing so does not reduce productive economic activity. And it is intuitively unfair that those who were lucky enough to own capital such as second homes before a period of

asset price inflation should be getting wealthier, while those who are forced to work for a living are struggling to make ends meet.

Taxing income from different sources differently is economically inefficient. Equalising these tax rates would spread taxation evenly across types of activity and investment in different assets (Mirrlees et al 2011), minimising the total amount of distortion created by the tax system.

A lower rate of tax on income from work is also unsustainable in terms of the tax system. Having differential rates of tax on different types of income creates opportunities for avoidance that diminish tax revenue. Partners and the self-employed can shift income from earnings to other, more lightly taxed forms of remuneration in the form of dividends and capital gains. The amount of tax paid on earnings varies tremendously depending on the source and overall income, but work is always more heavily taxed (see box in this chapter). Capital gains have grown relative to income over time, and technological change is likely to increase returns to capital relative to labour (Roberts et al 2019). If these trends continue, income tax rates will have to rise ever higher to attempt to collect an equivalent amount of revenue from a declining tax base; and the burden of taxation will increasingly be borne not by the wealthiest but by those who earn their income from work.

Raising taxes on wealth to the same level as those on work is a necessary step to interrupt this cycle, restore a sense of justice to our economic system, and ensure that our tax system is sustainable for the future.

Some argue that taxing capital gains and dividends at the same rate as income raises the issue of double taxation; for example, in relation to corporation tax. However, double taxation is arguably a normal feature of any tax system (Roberts et al 2018) – for example, people pay tax on their income and then are taxed again when they spend it in the form of VAT. Moreover, the Tax Policy Centre in the US found that the burden of corporation tax is borne by workers as well as firms (Nunns 2012). This suggests that the real burden of taxation on income is higher than that suggested by income tax and national insurance contributions alone.

The argument that lower rates of tax on income from wealth are needed to encourage entrepreneurship does not stand up to scrutiny either. As described above, much of the lightly-taxed income from wealth is in fact 'economic rent', meaning that the person receiving the income would still participate in the market with lower returns. And as we show below, entrepreneur's relief – an exemption from capital gains tax targeted to encourage entrepreneurship – has been shown to be ineffective, while significantly reducing revenues and deepening inequality. In this chapter, we focus on reforms to capital gains tax that would form part of this broader proposal to tax income from wealth and work the same.

CAPITAL GAINS TAXATION OVER TIME

Historically, capital gains tax rates have been higher than they are today. CGT was introduced in its current form in 1965, with gains taxed at 30 per cent. An allowance for inflation was introduced in 1982. Under Nigel Lawson in 1988, capital gains moved to being taxed at income tax rates, up to a top rate of 40 per cent. Taper relief was introduced by Gordon Brown in 1998. This reduced the tax rate for assets held for longer periods, on the grounds that this would reduce short-term speculation and encourage long-term investment. The IFS criticised this, arguing that it was an ineffective way of reducing speculation and that it undermined the primary purpose of capital gains tax as they defined it – to prevent the wealthy from converting their income to capital gains and avoid paying income tax (Dilnot and Giles 1995).

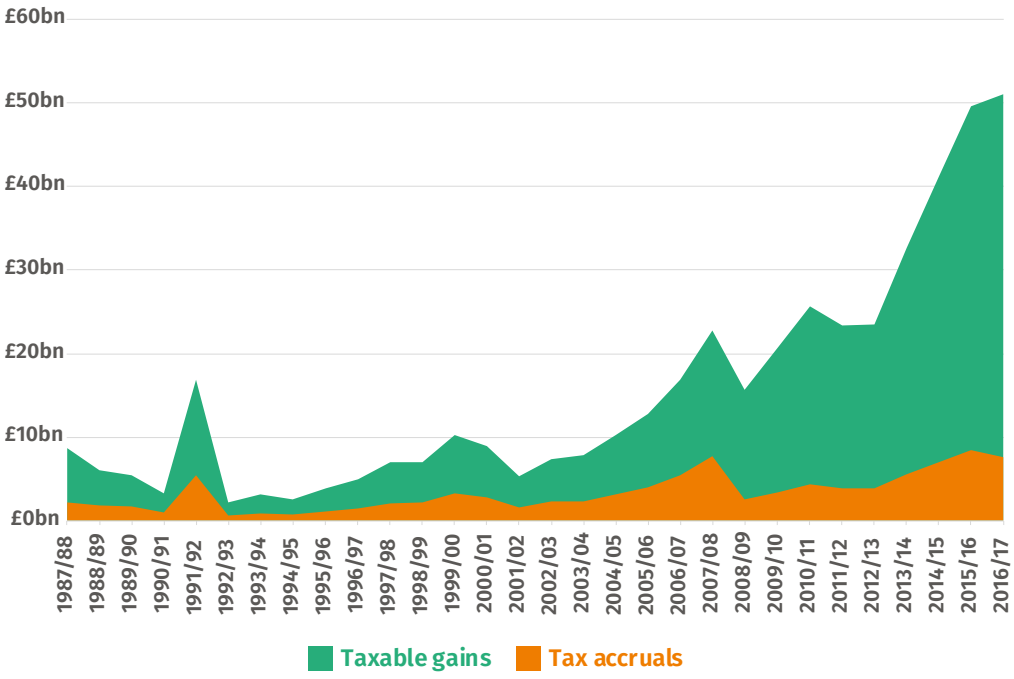
Taper relief was abolished in 2008. At the same time, entrepreneurs' relief was introduced. This is a tax relief applied to certain types of assets – those relating to a business you own, a business you work for, or a business you have lent assets to (all under certain conditions). Gains subject to entrepreneurs' relief are taxed at 10 per cent.

Also in 2008, the main CGT rates went from equalling income tax rates (10, 22 and 40 per cent) to a flat 18 per cent – a tax cut for most capital gains taxpayers. In 2010, George Osborne added a higher rate of 28 per cent, but in 2016 those rates were cut to 10 per cent for basic rate taxpayers and 20 per cent for higher and additional rate payers for most assets.

The effects of these changes can be seen in figure 2.1. The removal of taper relief in 2008 expanded the size of the tax base, contributing to the increase in the amount of taxable gains after 2008. However, due to the cuts in tax rates and the introduction of entrepreneurs' relief, the amount of tax collected has not risen concurrently.

FIGURE 2.1: THE SIZE OF THE TAX BASE HAS RISEN CONSIDERABLY SINCE 2008, BUT THE AMOUNTS OF TAX COLLECTED HAVE NOT RISEN IN LINE

Capital gains and taxes accrued (£bn), 1987–2017



Source: Authors' analysis of 'Estimated taxpayer numbers, gains and tax accruals by year of disposal' HMRC (2018a)

THE CURRENT TAXATION OF INCOME FROM WEALTH AND WORK

Tax rates on income from wealth are much lower than tax rates on the same amount of income earned from working.

Table 2.1 demonstrates the additional tax paid on income over and above income from work if it comes from different sources, which depends on

earnings from employment. So, for example, if you had no employment earnings, you would pay 2 per cent tax on the £20,000 of dividends, whereas if you were earning £100,000 from work you would pay 29 per cent on that additional £20,000. Additional earnings from work are always taxed more highly, and these figures exclude employer NICs which mean work is taxed higher still.

TABLE 2.1: PERCENTAGE OF TAX PAID ON ADDITIONAL £20,000 FROM DIFFERENT INCOME SOURCES BEYOND INCOME FROM EMPLOYMENT

	Earnings from employment				
	£0	£15,269*	£50,000	£100,000	£200,000
Receiving additional £20,000 in dividends	2%	7%	29%	29%	34%
Receiving £20,000 profit from selling non-residential assets	4%	4%	8%	8%	8%
Receiving £20,000 profits from selling a second home	7%	7%	11%	11%	11%
Making £20,000 from working and earning more	14%	32%	42%	62%	47%

Source: Authors' analysis of the income tax, dividend income tax and capital gains tax schedules
*** Earnings of a full-time employee on the national living wage**

OUR PROPOSAL

We propose that capital gains tax and separate rates of tax for dividends should be abolished, and income from dividends and capital gains should be incorporated into the income tax schedule. This reform would involve removing most exemptions, allowances, and reliefs that currently exist for both capital gains tax and dividend taxes. In previous papers, we have argued that the exemption on primary homes should be maintained, with property wealth taxed separately via a property tax (Murphy 2018).

Our modelling considers changes to capital gains tax only. We propose the following changes, which we have incorporated into our modelling.

Tax capital gains at the same rates as income

Currently, capital gains on most assets are taxed at 10 per cent for basic rate taxpayers, and 20 per cent for higher and additional rate taxpayers. Capital gains on residential property are taxed at 18 per cent and 28 per cent respectively.

We propose that capital gains should instead be taxed under the income tax schedule – currently 20 per cent for basic rate taxpayers, 40 per cent for higher rate taxpayers, and 45 per cent for additional rate taxpayers. To truly equalise taxes on income from work and wealth, capital gains tax rates would need to be equal to income tax *plus* national insurance contributions. We do not model the implications of this more radical policy here, but it could be implemented at a later stage, or by reforming the income tax system in line with the proposal set out in the second half of the paper.

Removal of the annual exempt amount

Currently, capital gains taxpayers receive a separate annual exempt amount of £12,000, meaning that individuals with earnings from both work and capital gains will pay a lower average rate of tax compared to people who only have earnings from work alone. We propose removing this in order to bring the taxation of capital gains in line with the taxation of income from work.

There should, however, be a *de minimis* allowance, such as £1,000, to prevent an overly burdensome tax declaration process. This is not included in our modelling, but we would anticipate its impact to be small.

Removal of entrepreneurs' relief

Entrepreneurs' relief is a tax relief applied to certain types of assets to encourage entrepreneurship – those relating to a business you own, a business you work for, or a business you have lent assets to (all under certain conditions). Gains subject to entrepreneurs' relief are taxed at 10 per cent. This means a lower tax bill for higher rate taxpayers, who would otherwise pay tax on those gains at 20 per cent. It has been heavily criticised for being expensive, regressive, and ineffective (Roberts et al 2018; Corlett 2018). It is claimed on 46 per cent of all capital gains and is therefore costly (HMRC 2018f and 2018g), is concentrated among wealthy individuals, and there is little evidence it has genuinely had an effect on entrepreneurship (Corlett 2018). It allows claimants "to be charged tax at just 10 per cent on what is effectively a return to their labour" (Johnson 2014). We therefore propose that the relief is removed.

Rate of return and indexation allowances

There is a risk that taxing capital gains unadjusted for inflation could reduce the real value of gains, discouraging saving. To ensure that real gains are taxed, and to therefore avoid disincentives to holding assets, an indexation allowance for inflation could be introduced.

We have also considered the introduction of a rate of return allowance (RRA), to be applied as suggested in the Mirrlees Review (Mirrlees et al 2011). This would mean that only capital gains above a given annual rate of return would be subject to taxation. The purpose of an RRA is to avoid distortion of consumption and saving today and tomorrow. It is not just inflation that affects decisions over spending and saving today and tomorrow: people are also impatient and prefer current spending to future spending. Charging tax on all gains could make saving less attractive relative to current spending, distorting decision-making and reducing economic efficiency. An approximation of the value today of money received in the future (the 'consumer discount rate') can be given by the level of return had the money been held in bonds instead.

Choosing to introduce an indexation allowance or RRA has revenue implications and also increases the bureaucratic burden for both taxpayers and collectors. We therefore provide options for these two different allowances as well as no allowance in our modelling.

Removal of exemption at death

Capital gains made on assets held until death are exempt from CGT altogether and essentially 'cancelled' to the benefit of the inheritor, though they are liable to inheritance tax if the assets were gifted less than seven years prior to death and above the relevant thresholds. If they later sell the assets, inheritors are liable for CGT on gains arising since the inheritance only. This creates a strong incentive to hold on to assets until death (Hunter 2015).

This relief therefore exacerbates wealth inequality as it stands, and we propose it is scrapped. Tax could be levied either at inheritance or at the point at which the asset is sold. However, as this policy interacts with inheritance tax policy decisions, we provide results with and without the removal of the exemption.

In addition, we propose the following changes, which are not modelled in this paper.

Charging capital gains tax on bonds

Qualifying corporate bonds are currently exempt from CGT, as are all government bonds, without any economic justification. Indirectly, this encourages firms to pursue debt over equity financing – an unwelcome distortion to the economy (Blakeley 2018). We therefore propose that CGT is extended to the sale of all bonds.

Removing other miscellaneous reliefs

There are a range of other smaller CGT reliefs, such as the Enterprise Investment Scheme, which we also proposing scrapping but which our modelling does not include. These schemes complicate the tax system, reducing the tax base and creating opportunities for avoidance with often limited economic justification.

METHODOLOGY

In this section, we outline our modelling of the static impact of the changes, followed by a discussion of potential behavioural impacts which dampen our estimates.

Taxing capital gains at the same rate as income

The latest HMRC statistics (2016/17)[2] break down taxable gains by the size of the gains and income of the person paying (HMRC 2018g).[3,4] We model revenue raised under the current tax system, contrast it with modelled revenue raised in the counterfactual,[5,6] and calculate the percentage increase, which we then apply to the future CGT revenue forecast. This requires us to make a number of assumptions.

The data are published under broad bands which do not align with the income tax schedule, so it requires us in some cases to 'split' reported capital gains between two income tax brackets. In the absence of more granular data, we assume that the number of gains is distributed equally across an income bracket. The effect of any such splitting is small, as most capital gains are unambiguously in the top bracket for income tax.

We treat residential and non-residential assets separately since they are subject to different CGT rates. Data on gains are not available by asset type, so we apply the total split for the number of taxpayers and total gains (HMRC 2018c) uniformly across the distribution.

The assumptions above, combined with our omission of entrepreneurs' relief, mean our modelled revenue estimate is too high in the baseline: £9.8 billion, compared to £7 billion in reality (HMRC 2018b). However, we are only interested in the modelled percentage increase in revenue between the baseline and the counter-factual (102 per cent) which we then apply to the future forecast up to 2024/25.[7] This implies additional revenue of £10 billion in 2021/22, rising to £13 billion in 2024/25.

2 Trusts, which in 2016/17 accounted for 7 per cent of capital gains and 8 per cent of capital gains tax accruals (HMRC 2018a), are not considered separately in this analysis. We have calculated the impact using data for individuals, and assumed that revenues for trusts will rise in proportion. In reality, trusts pay capital gains tax at the higher rate, so this is likely to be a slight overestimate.

3 This refers to income above the tax free allowance and does not include income from capital gains.

4 A taxpayer's tax bracket is determined by their total taxable income including their capital gains and we have conducted our modelling on that basis.

5 CGT is a UK-wide tax and we do not propose devolving here. As a result, we do not consider the slightly different income tax schedule in Scotland, though the impacts on any estimates would be small.

6 We have not incorporated the removal of the personal allowance for earners earning over £100,000.

7 There is currently no official forecast for 2024/25, but we assume revenue will grow in line with the historic growth rate from 1999/2000 to 2023/24.

Annual exempt amount

HMRC last estimated the direct cost of the annual exempt amount (AEA) in 2016. They have not produced an estimate since 2016, stating: "We are reviewing the method for calculating the cost of the annual exempt amount and have therefore moved the entry to the costs unknown table" (HMRC 2019a). This estimate is therefore likely subject to considerable uncertainty, but it remains the best estimate available. The cost was estimated at £3.9 billion in 2016/17. We make two adjustments to this figure.

We first update this estimate to account for expected increases in the AEA threshold over time, which we expect to increase in line with the consumer price index (HMRC 2018e). We assume the cost of the relief will increase in proportion with the increase in the threshold.[8]

Second, we adjust for the expected growth in the number of CGT taxpayers, which has grown broadly linearly in the financial years 1987/88 to 2016/17 (HMRC 2018a). We project this trend forward. Implicit here is the assumption that the number of individuals and trusts whose capital gains fall below the AEA will grow in line with the number of capital gains taxpayers.

Taking these adjustments together, we estimate the cost of the AEA to be £4.6 billion in 2021/22, rising to £5.1 billion in 2024/25.

Entrepreneurs' relief

Here, we take the HMRC estimate of the cost of the relief (HMRC 2019b) and assume this will grow in line with the CGT revenue forecast. This suggests that the relief will cost £2.5 billion in 2021/22, rising to £3.2 billion in 2024/25.

Rate of return allowance and indexation allowance

We have modelled two potential options for an allowance. The first is based on the 10-year UK government bond yield, as suggested in the Mirrlees Review (Mirrlees et al 2011). This is taken to represent the consumer discount rate. Second, we have considered an allowance for inflation, based on the consumer price index (CPI). Under an allowance, capital gains made would be compared to the bond yield or inflation rates over the same period allowing for compounding effects, and only the portion above the allowance would be taxed.

To examine the impact of introducing a rate of return allowance (RRA) or indexation allowance, we have used official statistics on the value of disposals and chargeable gains in 2015/16 (HMRC 2018d).[9] From these, we can infer the original price of the asset and thus the size of the return. These statistics are broken down by duration of ownership, so we can estimate the compound average return per annum for each period.[10] Separately, we have taken data on bond yields (Investing 2019) and inflation (ONS 2019) and calculated the compound average annual rate of each over the same set of periods.

For each period of ownership, we have then compared the average capital gain per annum to the average bond yield and the average rate of inflation. For example, for assets held for between six and seven years, the average capital gain per annum was 10.3 per cent, while the average bond yield was 2.6 per cent and the average rate of inflation was 2.2 per cent. We have then used this to infer what proportion of the total capital gains would *on average* have been taxable over that

8 This assumes implicitly that everyone affected by AEA earns capital gains above the AEA. If a significant proportion earn capital gains below the AEA, then this will overestimate the increase in cost.

9 The latest available at the time our analysis was conducted.

10 The final category given is assets held for "25 years or more". In the absence of any other information, we have assumed that these were held for up to 35 years. This category contains 12 per cent of chargeable gains, so our results are not hugely sensitive to this assumption.

period, had a rate of return allowance or indexation allowance been applied.[11] For example, in the same period, we have inferred that 75 per cent and 78 per cent of capital gains respectively would have been taxable under the two options. We have then aggregated this over all periods,[12] yielding the result that 51 per cent of capital gains would have remained taxable under a rate of return allowance, and 69 per cent under an indexation allowance.

We have then simply applied these fractions to our revenue estimates, and assumed that revenues would fall in proportion to them.[13] This implies that our revenue raised would fall by £4.8 billion in 2021/22 under an RRA based on bond yields, and by £3 billion under an indexation allowance.

By comparing *average* capital gains to *average* bond yields and inflation, we are implicitly assuming that gains above and below the allowance largely cancel each other out. For example, if there were an RRA of 4 per cent, and an individual made a capital gain of 2 per cent in one year and 6 per cent in another, these two would cancel out. This would only be true if taxpayers were allowed to claim back gains below the RRA as 'losses' to offset against future gains above the RRA. Unless this was permitted, which we are not recommending here, we are likely to be overestimating the cost to the Exchequer of introducing an RRA, and therefore underestimating the overall revenue raised under an RRA policy.

Since 2015/16 (the year on which this analysis is based), UK 10-year government bond yields have fallen and are currently below 0.5 per cent. If this persists, a rate of return allowance is likely to have a smaller impact on capital gains accrued from this point onwards. However, for the period under consideration (2020/21 to 2024/25) the majority of gains will still have been accrued before the present date (September 2019), and so overall, we would still expect a rate of return allowance to have a significant impact on the amount raised.

Death relief

HMRC last estimated the cost of the death relief in 2011/12 at £0.6 billion (HMRC 2012), but have since stopped producing this estimate, stating: "Information on the usage of this relief is not required in tax returns and cannot be reliably estimated from other data sources, and the cost of collection for statistical purposes is disproportionate" (HMRC 2019a). However, it remains the best estimate available. We have uplifted this in line with the projected increase in number of deaths (ONS 2017 and 2018a), as well as for the forecast rise in CGT revenues. These adjustments imply that the cost of the relief will grow to £1.9 billion by 2024/25.

SUMMARY OF RESULTS

Despite the aforementioned limitations, we believe that the approach taken here allows us to estimate ballpark figures for the potential direct impacts on revenue from the proposed reforms.

Table 2.2 shows the direct impacts of all our proposed changes, if implemented together and in this order. Interactions between the changes mean that the impacts given here are different from the impacts of these changes if implemented individually. We have accounted for this by assuming that, where two changes interact, revenues from one change will rise in proportion with the revenue effects of another. We do not anticipate changes in year one, as most

11 Capped at zero.

12 Weighted by the total amount of chargeable gains accrued in each period.

13 This particular part of our method will somewhat underestimate the actual impact of introducing an allowance, since introducing an allowance would, all else being equal, reduce the chargeable gains made by each taxpayer, and so reduce the average tax rate paid.

CGT payments are made in the year following accruals. These changes would raise up to £120 billion of additional revenue over five years, when considering direct impacts only, or £140 billion if the exemption on death is also removed.

TABLE 2.2: DIRECT IMPACTS OF CHANGES (£bn), IMPLEMENTED TOGETHER IN ORDER OF THE TABLE, MARGINAL IMPACTS

Financial year		2020/21	2021/22	2022/23	2023/24	2024/25	Total (£bn)
Tax capital gains at the same rates as income		0	+10	+11	+12	+13	+45
Remove the annual exempt amount		0	+9	+10	+10	+10	+39
Remove entrepreneur's relief		0	+8	+8	+9	+9	+33
Introduce a rate of return allowance	**RRA based on bond yields**	0	-18	-19	-20	-22	-79
	Indexation allowance	0	-11	-12	-13	-14	-50
	No allowance	0	0	0	0	0	0
Total	**RRA based on bond yields**	0	9	10	10	11	**39**
	Indexation allowance	0	16	17	18	18	**68**
	No allowance	0	27	29	30	32	**118**
Total with removal of death relief	*RRA based on bond yields*	*0*	*12*	*13*	*13*	*14*	*52*
	Indexation allowance	*0*	*20*	*21*	*22*	*23*	*86*
	No allowance	*0*	*33*	*35*	*37*	*39*	*143*

Source: Authors' analysis based on methology above

POST-BEHAVIOURAL IMPACT

The direct figure is unlikely to be the true amount raised by the policy, because behavioural changes will have a potentially large impact on revenue. The potential behavioural impacts from the proposed changes to CGT are as follows.

Substitution/switching to other forms of income

Changes to CGT rates mean that people may make different decisions about the form in which to take their income in order to minimise their total tax bill. Bringing different tax rates more in line means that this avoidance will reduce and this effect would have an upwards impact on overall tax revenues.

Lock-in effect

Capital gains accrue through increases in asset value, but they are only liable for CGT when assets are actually sold. By delaying disposal, investors can continue investing the full amount of gains previously made, rather than the post-tax value, and therefore make more money overall. As a result, it is more profitable to delay disposals, and therefore delay paying tax. We would therefore expect that increases in CGT would have the effect of discouraging asset sales – encouraging investors to stay 'locked-in' to their current investments instead of switching to ones that are potentially more profitable. This could potentially affect productivity in the long run, although it would be very challenging to disentangle these effects from other drivers of productivity.

Deferring disposals until death

Currently, capital gains are not paid by inheritors, and so higher capital gains tax rates could create a greater incentive for people to hold on to their assets until death. If the relief on capital gains at death is removed, this will not be an issue.

Moving abroad

Owners of UK land and property are required to pay UK CGT, even if they live abroad. The same is not true for owners of other UK assets, such as shares in UK companies. As such, there is a risk that people could move abroad prior to making a sale in order to reduce their capital gains tax bill.

Ideally, these measures would be accompanied by action against tax havens and cooperation with other countries to align CGT rates and prevent a race to the bottom. Alternatively, CGT could be introduced on owners of other UK assets, regardless of residence.

Transition effects

There is a risk that if people believe the policy change will be overturned, they may hold out from selling their asset. This depends on how credible the commitment is by the government, as well as whether the opposition promises to overturn it and the perceived likelihood this will happen. It is worth noting that both Labour and Conservative governments have both successfully raised CGT rates in the recent past.

Long-run steady state effects

In addition to the lock-in effect described above, capital gains taxes may reduce investment, by reducing the size of potential gains to investors. However, this should be balanced against the potential for greater public spending. There is also evidence that capital gains tax has a limited impact on investment decisions, with other factors taking a more important role (Seely 2016). And, while keeping CGT rates low may encourage productive investment, it also acts as a tax break for activity which isn't very productive. If we want to stimulate productive investment, there are more cost-effective ways to do so (Adam 2008).

ESTIMATING THE POST-BEHAVIOURAL EFFECTS

We are aware of three previous attempts to estimate the post-behavioural effect of changes to capital gains tax in the UK.

1. The June 2010 budget (HM Treasury 2010): this estimated the impact of increasing the higher rate of capital gains tax from 18 per cent to 28 per cent.[14]
2. The March 2016 budget (HM Treasury 2016): this estimated the impact of reducing the basic rate of capital gains tax from 18 per cent to 10 per cent, and the higher rate from 28 per cent to 20 per cent.
3. The HMRC tax ready reckoner (HMRC 2019c):[15] this estimates the impact of marginal changes to capital gains tax rates, entrepreneurs' relief, and the annual exempt amount.

We have chosen to use the June 2010 budget estimates, as these are the only ones to give estimates of both the direct and post-behavioural impacts of the changes, and to explain what factors are included in the modelling. They also have the advantage of having been scrutinised by the OBR as part of the budget

14 The estimates also covered the increase in the lifetime limit for entrepreneurs' relief from £2 million to £5 million. However, in the OBR Policy Measures Database, the estimates are listed under the heading "Capital Gains Tax: reduce basic rate to 10 per cent and main rate to 20 per cent excluding residential property and carried interest", suggesting that the impact of the change to the entrepreneurs' relief is negligible.

15 Although these are labelled "direct impacts of illustrative changes", the CGT estimates do incorporate behavioural effects.

process, and we can compare them to outturn data to see how they performed. CGT revenues actually turned out to be 31 per cent higher than estimated one year after implementation, and 43 per cent higher four years after (OBR 2019c). But we cannot say without further analysis whether this was due to overestimating the size of the behavioural impact, or another cause, such as underestimating the size of the future potential tax base.

Of the above behavioural effects, the 2010 budget estimate only accounted for lock-in effects and substitution effects. This means that it may underestimate the size of the total behavioural effect, although the suggestions provided above should mitigate some of the other behavioural effects.

Lock-in effect

To estimate the lock-in effect, the Treasury drew on literature on econometric evidence on the responsiveness of capital disposals to changes in capital gains tax rates. The Treasury estimates only cover the first few years after implementation and therefore incorporate the revenue lost in the short term due to delayed disposals, but do not account for the fact that these revenues will still be received further down the line. These estimates are therefore likely to overestimate the size of the lock-in effect in the longer term.

Substitution effect

For substitution effects, the Treasury looked at the net impact on income tax and capital gains tax revenues. They do not incorporate stamp duty revenues into their estimates. They model a revenue-increasing behavioural impact as a result of bringing capital gains tax rates more in line with income tax rates.

Application of linearity

In the Treasury analysis, the effect of behavioural impacts was assumed to be linear, such that the impact of a 10 per cent rise in tax rates would be 10 times larger than the impact of a 1 per cent rise. The Treasury estimated the following effects from raising the capital gains tax rate on higher-rate taxpayers from 18 per cent to 28 per cent, as shown in table 2.3.

TABLE 2.3: 2010 BUDGET ESTIMATES OF THE IMPACT OF INCREASING THE CAPITAL GAINS HIGHER TAX RATE

Financial year	2010/11	2011/12	2012/13	2013/14	2014/15
Static Exchequer impact (£m)	0	925	900	1100	1325
Post-behavioural Exchequer impact (£m)	0	725	825	850	925

Source: Budget 2016 policy costings (HM Treasury 2010)

To apply these figures to our own estimates, we have taken the ratio between the direct and post-behavioural impacts estimated by the Treasury, and applied these to our own estimates. These range from 92 per cent in year three to 70 per cent in year five of implementation (an 8–30 per cent reduction in revenues due to behavioural effects).

We have not applied any behavioural effects to our estimates of the impact of introducing a rate of return allowance or indexation allowance. In reality, these would likely have a positive behavioural effect on revenues.

Caveats to our approach

This approach assumes that the size of the behavioural impact relative to the direct impact is the same for these tax rates and higher tax rates, as well as for

higher-rate taxpayers and non-higher-rate taxpayers. In reality, the behavioural impact is likely to be larger for higher changes in tax rates; and we are proposing to raise tax rates not to 28 per cent, but to up to 45 per cent. We are therefore at risk of overestimating the revenue raised from these changes after accounting for behavioural effects.

We are also assuming that the size of the behavioural effects relative to the direct effects will be the same for changes to tax reliefs as to changes in rates. Tax reliefs in most cases mean that the current tax rate is effectively zero. By removing these reliefs, we are therefore starting from a lower tax rate and hence the behavioural effect is not likely to be as large, at least at first; and we are, therefore, in less danger here of overestimating the revenue raised. However, reliefs also cover different types of decisions that are not covered by the standard econometric evidence – for example, decisions about bequests. The impact of this on the accuracy of our estimates is harder to predict. There is therefore a larger amount of uncertainty associated with our estimates of the behavioural effects of removing tax reliefs than of increasing tax rates.

RESULTS

Table 2.4 shows the post-behavioural impact of each of our proposed changes, if implemented individually. These estimates therefore contain no interaction effects.

TABLE 2.4: RAISING CAPITAL GAINS TAX RATES TO INCOME TAX RATES ALONE WOULD RAISE £36 BILLION OF ADDITIONAL REVENUE OVER FIVE YEARS

Post-behavioural impacts of changes, implemented individually

		2020/21	2021/22	2022/23	2023/24	2024/25	Total (£bn)
Tax capital gains at the same rates as income		0	+8	+10	+9	+9	+36
Remove the annual exempt amount		0	+4	+4	+4	+4	+15
Remove entrepreneur's relief		0	+2	+3	+2	+2	+9
Introduce an allowance	RRA based on bond yields	0	-5	-5	-6	-6	-22
	Indexation allowance	0	-3	-3	-4	-4	-14
Remove death relief		0	+1	+1	+1	+1	+5

Source: Authors' analysis based on methodology outlined above.
Note: Impacts include both additional CGT and income tax revenue.

Table 2.5 shows the post-behavioural impacts of all our proposed changes, if implemented together and in this order. Interactions between the changes mean that the impacts given here are different from the impacts of these changes if implemented individually.

TABLE 2.5: POST-BEHAVIOURAL IMPACT OF CHANGES (£bn), IMPLEMENTED TOGETHER IN ORDER OF THE TABLE, MARGINAL IMPACTS

These changes would raise significant revenue over five years

		2020/21	2021/22	2022/23	2023/24	2024/25	Total (£bn)
Tax capital gains at the same rates as income		0	+8	+10	+9	+9	+36
Remove the annual exempt amount		0	+7	+8	+7	+6	+28
Remove entrepreneurs' relief		0	+5	+7	+5	+5	+22
Introduce a rate of return allowance[16]	**RRA based on bond yields**	0	-14	-17	-16	-16	-63
	Indexation allowance	0	-9	-11	-10	-10	-40
	No allowance	0	0	0	0	0	0
Total	**RRA based on bond yields**	0	5	8	5	4	**23**
	Indexation allowance	0	10	14	11	10	**46**
	No allowance	0	19	25	21	20	**86**
Total with removal of death relief	*RRA based on bond yields*	*0*	*7*	*10*	*7*	*6*	*31*
	Indexation allowance	*0*	*13*	*18*	*14*	*12*	*57*
	No allowance	*0*	*23*	*30*	*25*	*23*	*102*

Source: Authors' analysis based on methodology outlined above
Note: Impacts include additional CGT and income tax revenue.

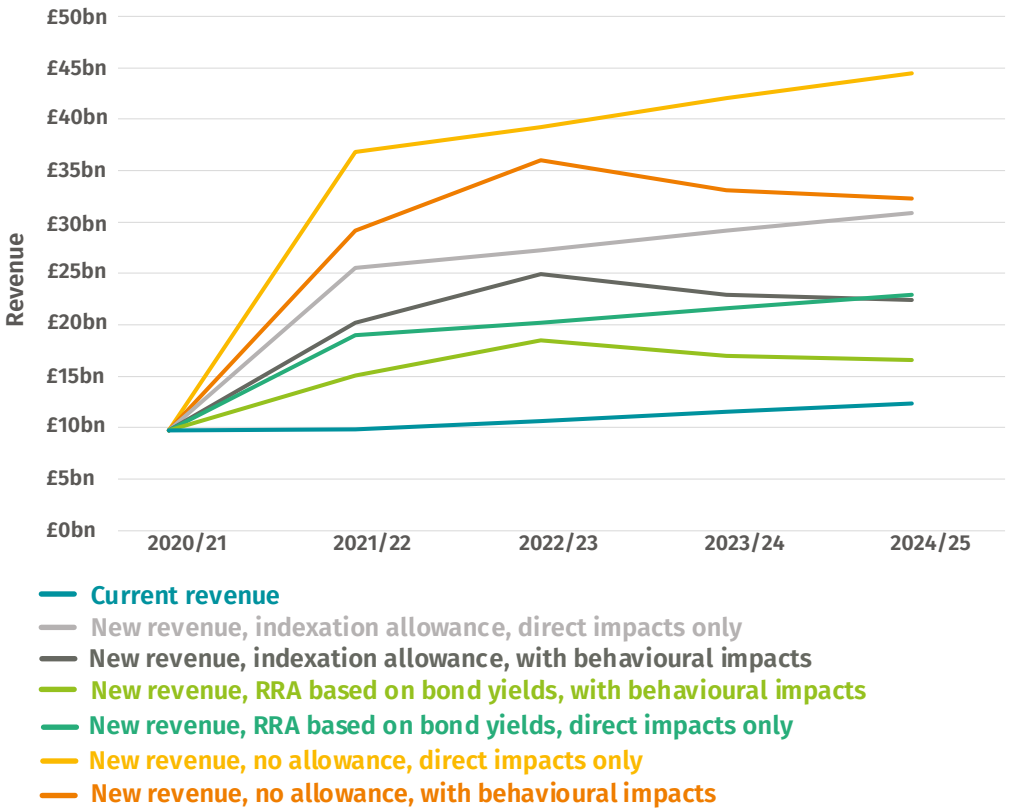
CONCLUSION

We propose that income from wealth should be taxed the same as income from work. This would entail taxing capital gains under the income tax schedule and ending separate tax reliefs for capital gains, other than the exemption on first homes. We have estimated the direct impact of these proposed reforms using HMRC data on capital gains and HMRC estimates of the direct cost of tax reliefs. We have estimated the behavioural impact of these reforms by deriving a 'behavioural multiplier' from Treasury estimates in the June 2010 budget. In total, we estimate that these changes would raise £20 billion over five years with a rate of return allowance based on bond yields, £50 billion with an indexation allowance, and £90 billion with no allowance. Removing the exemption on death would raise additional revenue. There are significant uncertainties around these estimates, but, even if the behavioural effects were larger, we would still expect these changes to raise significant sums, as well as making the system fairer.

16 The above estimates do not apply behavioural effects arising from introducing an RRA which we would expect would increase revenues further and so in this respect our estimates are conservative.

FIGURE 2.2: OUR PROPOSALS WILL RAISE SIGNIFICANTLY MORE TAX REVENUE OVER FIVE YEARS THAN UNDER THE CURRENT SYSTEM

Projected additional revenue under different scenarios, pre- and post-behavioural impacts



Source: Authors' analysis using methodology outlined above
Note: Impacts include additional CGT and income tax revenue.

3. REFORMING INCOME TAX

THE CURRENT SYSTEM OF TAXING THE INCOME IN THE UK IS FLAWED

The previous chapter considered the unequal tax treatment of income from wealth and income from work. But there are further problems with how income is taxed in the UK, arising from how different types of income are treated and the schedule under which they are taxed. In our previous discussion paper, *Tapering over the tax* (Stirling 2018), we identified the following issues with the system of income taxation in the UK.

Non-aligned rate schedules

Despite much of the tax base being identical for income tax and national insurance contributions, the two rate schedules differ considerably, and the threshold for tax-free earnings under NICs is below that of income tax. This can lead to issues with transparency – for example, when the government claims that by raising the personal allowance it is lifting people out of tax altogether, when in reality they will still be liable to pay NICs (House of Commons Library 2015a). Similarly, the marginal NIC rate drops from 12 to 2 per cent at £50,000, meaning that the increase in marginal tax rates is lower than many perceive it to be by focussing only on the 'headline' marginal income tax rate.

Inconsistent treatment of earnings

Within income tax, a number of separate allowances and tax rates on savings, dividends and earnings create perverse incentives for individuals to reclassify their employment status or income source solely for tax purposes. This can lead, for example, to lower average rates of tax for those individuals paying themselves through dividends – often people with large amounts of wealth and the resources to seek financial advice.

Tax cliffs

The level of earnings at which the tax rate changes – leading to so-called 'tax cliffs' – can induce distortionary behaviour. The abrupt transitioning from one marginal rate to the next can affect incentives and influence employment decisions that have the potential to move income either side of a cliff. For incomes below a tax cliff, the financial incentives for promotion, or changing the number of hours worked, differ considerably depending on the proximity of an individual's income to a cliff in the rate schedule. Tax cliffs allow the schedule to be more easily 'gamed' by the self-employed or by company owners who receive income through dividends. By controlling the timing of income to avoid breaching key tax thresholds, income can be managed and smoothed across multiple years to minimise an individual's liabilities (Kleven and Waseem 2013; le Maire and Schjerning 2013).

Non-identical tax bases

Income tax is paid on most forms of income, while NICs are only paid on income from paid employment. Different types of income in the economy can therefore incur a highly variable tax liability depending on the type of economic activity that generates them. Labour is taxed too highly relative to capital.

Different units of taxation

Income tax liabilities are accrued on a per-person, annual basis, whereas NICs are accrued on a per-job, weekly basis. This means that NICs in particular can have variable and arbitrary effects, depending on the manner in which someone is employed. Having multiple jobs can lead to a reduced tax liability, compared with an identical income from a single job, since the primary threshold is applied to earnings from each individual job separately, rather than a person's overall income. With the rise of the 'gig economy' and the growing propensity for many people to have multiple low-paid, flexible jobs, the chancellor could see receipts eroded significantly over time unless the tax schedule is brought into line with the modern economy.

We therefore propose two major changes to the income tax schedule to address these issues.

1. **The rates and allowances for employee NICs and income tax should be combined into a single tax schedule, which is applied to all incomes (savings, income, dividends) on an individual, annual basis.**
2. **The present schedule of flat marginal tax bands should be replaced with a marginal tax rate that rises gradually for the whole of the income distribution, between lower and upper thresholds.**

These proposals would take away the problem of non-alignment as employee NICs are abolished, ensure earnings are treated consistently regardless of source with a single unit of taxation, remove the 'tax cliffs', and make the tax base identical with equal treatment of income from labour and capital. A system of gradually-rising marginal tax rates is already used for parts of the tax schedule in Germany.

In this paper, we present illustrations of the above proposal, and the implied fiscal and distributional impacts. In devising these schedules, we prioritised the following conditions.

- Maximising the number of net 'winners' as a result of moving to the new schedule. We aim to ensure that between 70 and 80 per cent of income taxpayers are better off under the new schedule.
- Setting the top rate of tax no higher than 50 per cent. This rate is familiar to recent UK voters, since it was the top rate as recently as 2014, and it also featured in the Labour party's 2017 manifesto.
- Ensuring that there is a single threshold of income, below which as many people on relatively lower incomes contribute less under the formula-based schedule, and above which as many people on relatively higher incomes contribute more, compared with the present schedule. This requires that a small number of top-income taxpayers see their average rate of income tax fall very slightly under the neutral formula-based proposal. It also requires that there is a tax-free allowance no smaller than the current allowance under employee NICs. In merging income tax and NICs, we propose setting the new tax-free allowance at the lower level where NICs start to be paid today, since higher-earning households tend to benefit more from higher tax-free allowances than poorer households (Corlett et al 2014).

A REVENUE-NEUTRAL CHANGE TO INCOME TAX

In this section, we provide an illustration of what such a schedule would look like in England, Wales and Northern Ireland,[17] which would be approximately revenue neutral in 2019/20.

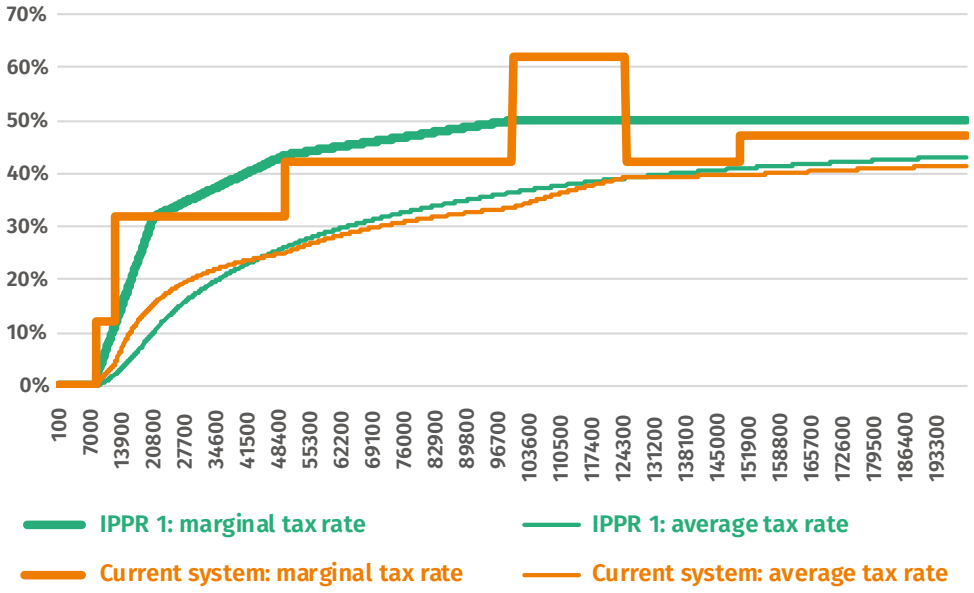
Our illustrative schedules are applied to income from earnings only. While we propose that dividend and savings income, as well as capital gains, are brought into the same schedule, we are not able to model them here due to data limitations.

An initial tax-free allowance is set at £8,600, the equivalent annual income of the primary threshold in employee NICs. Between this tax-free allowance and incomes of £100,000, our schedule uses three progression zones where the marginal rate increases gradually at different rates for each zone, for every pound of income earned. The first zone would see the marginal rate of tax start at 2 per cent and rise to 32 per cent (the same as the effective marginal rate on incomes above £12,500 in the present system) for annual incomes of £21,000. For incomes between £21,000 and £50,000, the marginal rate rises from 32 per cent to 44 per cent, before rising a further seven percentage points in the final progression zone up to £100,000. The top marginal rate of tax would remain at 50 per cent for the rest of the income distribution.

The table below details how this would impact on take-home pay for groups at different points in the income distribution.

FIGURE 3.1: A FORMULA-BASED SCHEDULE PRODUCES A MORE EVEN INCREASE IN MARGINAL AND AVERAGE TAX RATES

Effective marginal rate and average rate for taxation for income under an illustrative formula-based schedule and the current schedule, 2019/20



Source: Authors' analysis using 'HMRC rates and allowances' (HMRC 2019e). The current system represents the effective tax rates from income tax and class 1 employee NICs combined.

17 Income tax is a devolved matter in Scotland and has been excluded from this analysis. If this proposal were taken forward in the rest of the UK, NICs would need to remain in Scotland or else the tax base would be eroded.

TABLE 3.1: EFFECT OF DIFFERENT TAX SCHEDULES ON KEY PERCENTILES OF ALL TAXPAYERS, 2019/20

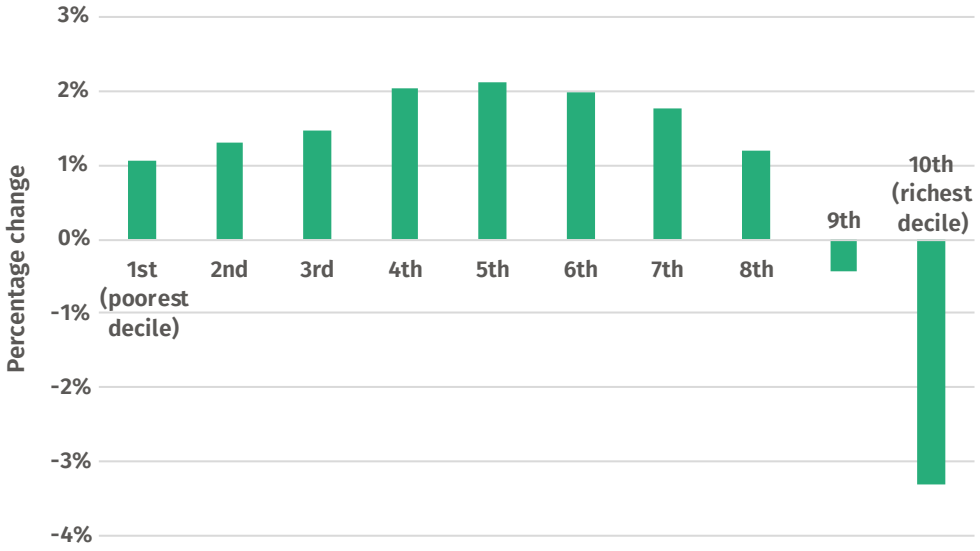
Gross income	Position in income distribution	Net income after tax		Difference
		Current system	IPPR system	
£18,500	25th percentile	£16,080	£17,110	**£1,030**
£26,200	50th percentile	£21,316	£22,378	**£1,062**
£39,500	75th percentile	£30,360	£30,810	**£450**
£59,200	90th percentile	£42,826	£42,106	**-£720**
£188,000	99th percentile	£110,625	£107,585	**-£3,040**

Source: Authors' analysis using 'Table 2.4: Shares of total income tax liability' (HMRC 201dx) and 'HMRC rates and allowances' (HMRC 2019e)

This illustrative scenario is progressive. The average tax rate under our system is lower for all people with incomes below £44,800 (an estimated 80 per cent of taxpayers). The benefits are maximised for taxpayers on or around the UK median for gross income; around £26,200 for taxpayers. For example, a person earning around £26,000 would see their average income tax fall by four percentage points compared with the current system, allowing them to keep more than £1,000 more per year in take-home pay.

FIGURE 3.2: A FISCALLY NEUTRAL TRANSITION COULD BOOST INCOME FOR MOST FAMILIES[18]

Effects of moving to an illustrative formula-based tax schedule compared with a world where the 2017/18 schedule remains in place, disposable household income after housing costs by equivalised income deciles, 2019/20



Source: Authors' analysis using the IPPR tax and benefit model based on 'Family Resources Survey: Financial year 2017/18', dataset (DWP 2019)

18 Modelling assumes transitional protection for self-employed universal credit (UC) claimants whose UC entitlement would fall due to the minimum income floor, despite not receiving an increase in income from the tax cut.

Our distributional analysis of household income demonstrates this. Households in the top two deciles would have to contribute more in tax, while households in the middle of the distribution would on average gain over £600 per annum.

Comparing our illustrative scenario to the present system, all families in the bottom half of the distribution would take home more of their income after tax, but the gains get smaller for lower-income households. This reflects the fact that earnings from employment above the tax-free allowance make up an increasingly small share of their overall income. In practice, our reforms would likely be more progressive still. Our modelling results don't show the effects of taxing income from dividends and savings at the same level as earnings, or the impacts of bringing capital gains into the income tax schedule, which would be likely to disproportionately affect individuals with higher incomes and higher stocks of wealth. Overall, tax revenues could be higher as there would be significantly diminished opportunities for tax shifting. These effects together could enable lower rates still for lower-earning taxpayers while remaining tax neutral overall.

Nonetheless, there is likely to be a limit to what can be achieved at the bottom end of the income distribution through reforms to income taxes alone. The best way of achieving greater progressivity for the very poorest families would be to increase generosity in the welfare system, paid for by increased revenue from the highest-income families, including through income taxes.

RAISING TAX REVENUE

In 2017, both Labour and Liberal Democrat parties outlined proposals to increase the tax base in the UK by £6 billion. The Liberal Democrat proposal was to raise the rate of tax by 1 per cent for each current tax band, while Labour proposed to lower the threshold for the additional rate to £80,000 and introduce a new top rate of tax at 50 per cent for incomes above £123,000.[19] Our modelling suggests that these plans, implemented in England, Wales and Northern Ireland, would raise £5 billion and £6 billion respectively, compared to the baseline in 2019/20.

In general, Labour's proposals are open to the critique that they make the UK tax base vulnerable by increasing its reliance on just 5 per cent of income taxpayers (Miller and Roantree 2017). The Liberal Democrat proposals avoid the problem of drawing all additional income from such a narrow base of taxpayers. But, because they rely on an unreformed version of the existing system of thresholds and bands, they increase tax liabilities even for the very poorest taxpayers. Neither proposals tackle the issues we have identified with income tax, such as 'tax cliffs' or the inconsistent treatment of earnings.

For a government that is prepared to take seriously the need to raise significant additional revenue over the coming decades, a formula-based tax schedule presents considerable advantages compared with the current system. Because the effect of our formula-based illustration is to redistribute the tax burden from lower to higher earners, there is significant scope to increase revenues by giving slightly less back to those individuals that stand to gain.

We present a second formula-based schedule that would raise comparable amounts to the Liberal Democrat and Labour proposals: just over £6 billion in 2019/20 in England, Wales and Northern Ireland.

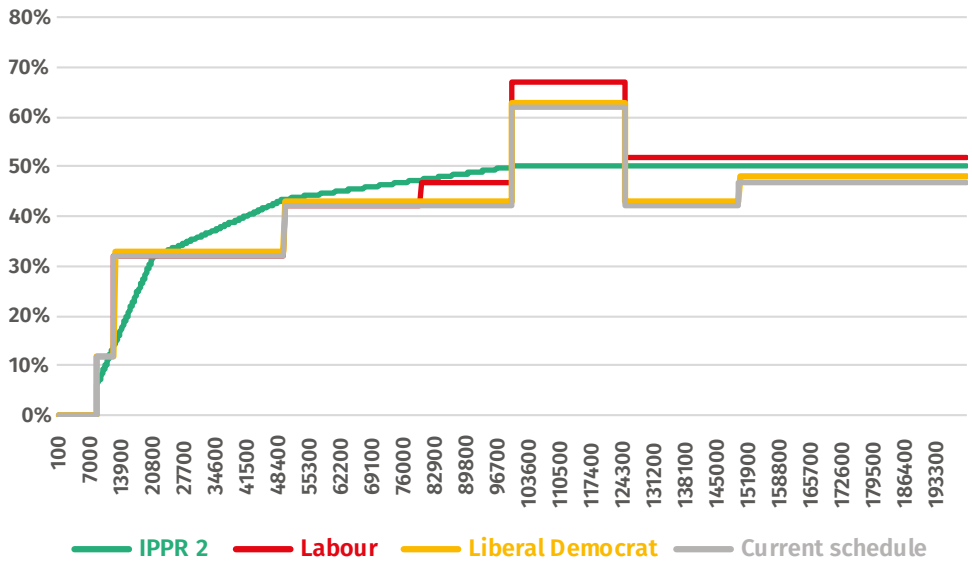
Our illustrative, formula-based scenario raises comparable amounts to the Labour and Liberal Democrat proposals. However, it avoids the pitfalls of overly narrowing the tax base, while also still creating a significant majority of 'winners' through the reform. The schedule is identical to our revenue-neutral scenario,

19 We have updated the upper threshold to £125,000 in our modelling.

except that the starting rate is 6 per cent, and the first zone of progression is slightly less steep. Under this scenario, the £6 billion in revenue is raised with less vulnerability to income shifting compared with Labour's proposals, as it draws on a wider spectrum of the tax base; however, those earning £42,000 or less would still see a rise in their take-home pay.

FIGURE 3.3: A FORMULA-BASED TAX CAN RAISE AS MUCH REVENUE AS BOTH THE LABOUR AND LIBERAL DEMOCRAT MANIFESTO PROPOSALS BY RAISING THE STARTING RATE OF TAX AFTER THE TAX-FREE ALLOWANCE

Effective marginal rate for taxation of income under an illustrative formula-based schedule, the current schedule* and the Labour and Liberal Democrat party UK manifesto proposals, 2019/20



Source: Authors' analysis using the IPPR tax and benefit model based on 'Family Resources Survey: Financial year 2017/18', dataset (DWP 2019), *Funding Britain's Future* (Labour 2017) and *Our Plan* (Liberal Democrats 2017)

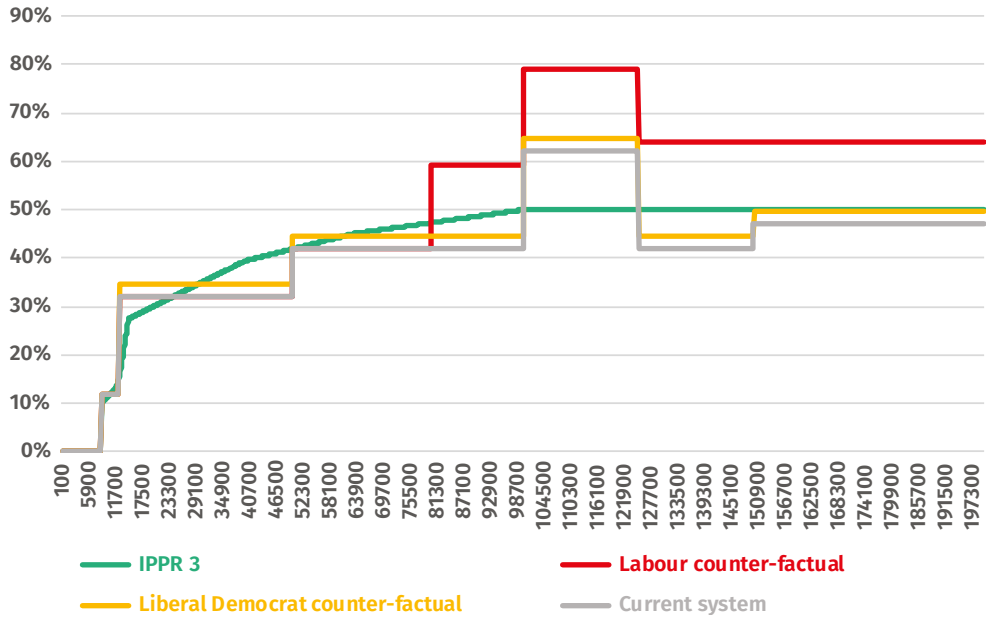
***Note: The current system represents the effective tax rates from income tax and class one employee NICs combined**

In order to stress-test the revenue-raising potential of a formula-based schedule, we also conducted a third illustrative scenario aimed at raising more than double this level of additional receipts – around £15 billion per year. This would raise overall taxation by less than a single percentage point of GDP, so it is not implausible that increases on this scale could be required to meet future government needs; for example, tackling the care crisis, placing the NHS on a sustainable financial footing and more broadly reversing austerity (Quilter-Pinner and Hochlaf 2019).

Despite this, the scenario shows that these revenues could be found while avoiding very high marginal rates of taxation and without reducing take-home pay of taxpayers earning £37,500 or less compared to the 2019/20 schedule.

FIGURE 3.4: A FORMULA-BASED TAX CAN RAISE AROUND £15 BILLION WITHOUT EXCESSIVELY HIGH TOP RATES OF TAX

Effective marginal rate for taxation of income under an illustrative formula-based schedule, the current schedule and Labour and Liberal Democrat counter factual scenarios*, 2019/20



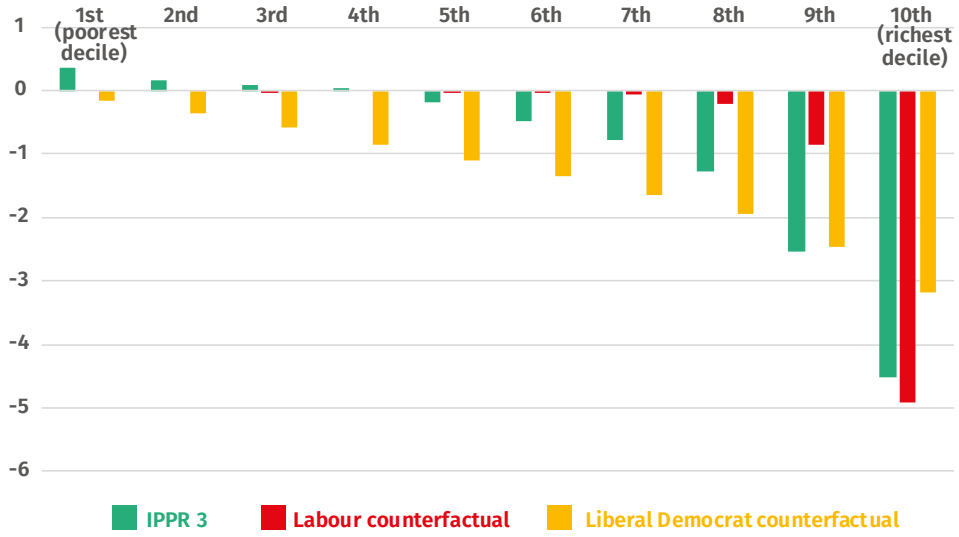
Source: Authors' analysis using the IPPR tax and benefit model based on 'Family Resources Survey: Financial year 2017/18', dataset (DWP 2019), ***Funding Britain's Future*** (Labour 2017) and ***Our Plan*** (Liberal Democrats 2017)

By contrast, attempting to raise similar levels of funds by extending the approach of the Labour party or Liberal Democrats would lead either to extremely high top rates of tax, or losses for the UK's poorest households, respectively. Under our proposed schedule, tax rates can be changed to raise revenue in a way that avoids these pitfalls, which could have welfare implications and are also politically difficult.

The impacts are estimated as follows for different income groups.

FIGURE 3.5: A FORMULA-BASED TAX CAN RAISE AROUND £15BN AND STILL INCREASE-POST TAX INCOMES FOR THE POOREST 40 PERCENT OF HOUSEHOLDS

Distributional effects of raising £15 billion per year from counter factual Liberal Democrat and Labour proposals, an illustrative IPPR proposal, and compared with a world where the 2019/20 schedule remains in place, disposable household income after housing costs by equivalised income deciles, 2019/20.



Source: Authors' analysis using the IPPR tax and benefit model based on 'Family Resources Survey: Financial year 2017/18', dataset (DWP 2019)

CONCLUSION

We have identified a number of issues with the current system of income taxation and proposed a set of reforms which address these, introducing a formula-based system which taxes all sources of income equally. Our illustrative modelling shows that significant tax revenue could be raised through such a system in a progressive way, avoiding the potential pitfalls of very high marginal tax rates for the highest earners or making the lowest earners any worse off.

A FAIRER, MORE EFFECTIVE INCOME TAX SYSTEM

Taken together, we believe that these proposals amount to a transformation of the taxation of income which would move us towards a more economically just system; and warrant serious consideration for any government interested in raising revenue in a progressive manner.

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