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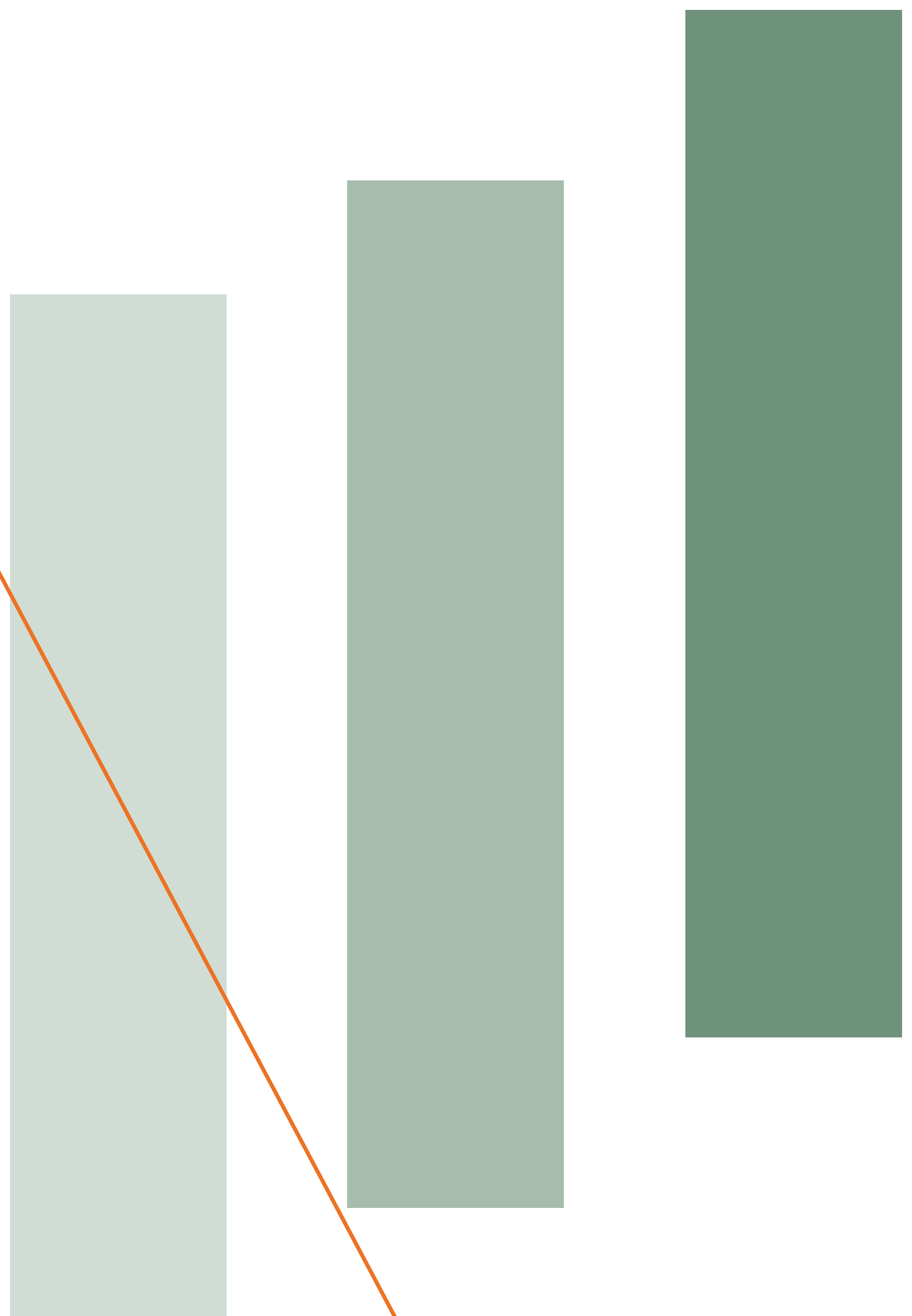
BRIEFING

COALITION TAX POLICY



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SMART IDEAS
for CHANGE

Introduction

Once again, tax is in the news. A fierce debate is raging about the wisdom of the 50 per cent top rate of income tax, while the Coalition government is committed to raising the income tax personal allowance to £10,000.

This paper considers the arguments for three specific proposals for reforming the personal tax system:

- increasing the personal allowance
- removing the 50 per cent tax rate on top incomes
- introducing a tax on high-value properties (a 'mansion tax').

The paper assesses both the economic basis for these proposals and the extent to which they could promote greater social justice by contributing to a more progressive tax system. Before discussing the particular merits of the three tax reform proposals, it is worth briefly setting out some general principles of taxation against which we might judge these proposals. These are outlined in box 1 below.

Box 1: Principles of good taxation

- Collection and compliance costs should be kept to a minimum, which is easier to achieve in a simple and transparent tax system
- Broadly, the tax system should treat similar people and activities in the same way, although this can be difficult to achieve in practice
- The negative effects of tax on welfare and efficiency, such as deadweight costs, should be minimised

Source: Maxwell and Vigor (2005); Mirrlees Review (2010)

These are general principles which apply, regardless of the particular objectives that different tax systems try to achieve. In addition, this paper argues that the UK tax system should have three further goals. First, it should provide a sustainable source of revenue to fund long-term investment in public services, infrastructure and social security payments. Sustainability requires a broad tax base with revenue raised from a range of different economic activities. The risks of relying too heavily on one source of revenue are demonstrated by the considerable fall in tax receipts following the financial crash of 2008.

Second, the overall tax system should be as progressive as possible while meeting the requirements of simplicity, equity, efficiency and sustainability. Clearly the balance between these competing objectives is a matter of political choice, but this paper is based on the premise that reforms should aim to at least maintain, if not increase, the existing level of progressivity in the tax system rather than diminish it. This should apply across the system as a whole; it does not require that every individual tax operates in a progressive way. Importantly, the point of a progressive tax system is not to create a burden on the rich; rather, the goal is to use the tax receipts generated from wealthier individuals to improve the outcomes of the less well-off. Third, the tax system should seek to maximise tax receipts within the constraints of economic efficiency, simplicity and sustainability. Kenworthy (2011) stresses that the total amount of tax raised can be just as important as the progressivity of the system, since a progressive system that raises too little will not provide sufficient resources to properly pursue social justice.

We now turn to an examination of the three tax reform proposals under consideration.

1. Increasing the income tax personal allowances

Raising the personal allowance for income tax to £10,000 has been a flagship Liberal Democrat policy since 2009, when it replaced their previous plan to cut the basic rate of income tax by 4 percentage points. Raising the personal allowance to £10,000 affects primarily working-age people (those aged 16 to 64), since people aged 65 and above already have personal allowances close to or above that level [1].

After the 2010 general election, the £10,000 personal allowance proposal became Coalition policy (HM Government 2010). There is no timescale for achieving this, with the 2011 stating that 'the personal allowance will increase from 2013-14 by at least the equivalent of the RPI, until the government's goal of increasing the personal allowance to £10,000 is achieved' (HM Treasury 2011: 52). The longer the government takes to raise the allowance to £10,000, the less value this nominal figure will have in real terms. Liberal Democrat Treasury Minister, Danny Alexander, has recently said that he would like to see the allowance raised even further, so that anyone working full time on the minimum wage would not pay income tax, equivalent to an allowance of around £12,500 [2].

Nevertheless, in line with its commitment in the Coalition agreement, the government increased the personal allowance by £1,000 to £7,475 in 2011-12, and by a further £630 in 2012-13 so that the allowance in that tax year will stand at £8,105 (HM Treasury 2010). Table 1 sets out the projected costs of these increases. The total value of the combined increase for basic rate taxpayers with incomes over £8,105 will be £326 a year in 2012-13, or £6.27 a week (compared to an allowance of £6,475 in 2010-11).

Table 1: Estimated cost of announced increases in the personal allowance

	2011-12	2012-13	2013-14
Budget 2010: personal allowance increased by £1,000 in 2011-12 to £7,475	£3.34bn	£3.58bn	£3.62bn
Budget 2011: personal allowance increase by £630 in 2012-13 to £8,105	—	£1.05bn	£1.21bn
Total cost of combined measures	£3.34bn	£4.63bn	£4.83bn

Source: HM Treasury (2011)

In 2011-12, the benefit of the increase in the personal allowance to higher rate taxpayers was offset by a reduction of £2,400 in the basic rate limit – the amount an individual can earn above the personal allowance before the higher rate of tax applies. Consequently, higher rate taxpayers did not gain anything. In 2012-13, the basic rate limit will be reduced by £630, meaning that there will be no change in the higher rate threshold (which is the sum of the personal allowance and the basic rate limit). Therefore, all taxpayers earning between £8,105 and £115,000 will gain £48 a year [3].

1 In 2011-12, the personal allowance is £9,940 for individuals aged 65 to 74; and £10,090 for individuals aged 75 and over. However, these additional allowances are gradually withdrawn once income exceeds £24,000, so people over 65 with incomes above that will level would benefit from an increase in the personal allowance.

2 See http://www.newstatesman.com/blogs/the-staggers/2011/09/alexander-treasury-chief. The personal allowance would need to be £12,646 in order for a minimum wage worker working 40 hours a week to be lifted out of income tax altogether, on 1 October adult minimum wage rate of £6.08 an hour.

3 From 2010-11, the value of the personal allowance is reduced by £1 for each £2 of income above £100,000.

Table 2: Income tax rates and allowances, 2010-2011 to 2012-13

	2010-11	2011-12	2012-13
Personal allowance	£6,475	£7,475	£8,105
Basic rate limit	£37,400	£35,000	£34,370
Higher rate threshold	£43,875	£42,475	£42,475
Additional rate threshold	£150,000	£150,000	£150,000

Source: HM Treasury (2011)

The Coalition argues that raising the personal allowance achieves two goals. First, it demonstrates 'fairness' by removing many low earners from income tax altogether and reducing the tax bills of many low and middle income households. The combined changes to the personal allowance announced by the Coalition government are estimated to take 1.1 million people out of income tax altogether (HM Treasury 2011). Second, the Coalition argues that a more generous allowance improves work incentives for low earners by increasing the value of their take-home pay. This dovetails with the Coalition's benefit reform programme designed to create a simpler means-tested 'universal credit' with lower marginal deduction rates for low earners in receipt of financial support.

While the policy of raising the personal allowance to £10,000 may appear attractive on these grounds, there are important criticisms of the progressivity and efficiency of such a move.

Raising the allowance is regressive in its impact since it is a broad tax cut that increases the incomes of wealthier families by a greater proportion than lower income families, on average. Using the IPPR Tax-Benefit Model [4], we have modelled two illustrative increases in the personal allowance. First, we model the impact of increasing the personal allowance to £10,000 from £7,475 in 2011-12. Second, we model the impact of increasing the allowance to £12,500, in line with the aspiration outlined by Danny Alexander. In both cases, we have assumed that these increases are accompanied by a commensurate reduction in the basic rate limit, leaving the higher rate threshold unchanged[5] , as set out in table 3.

Table 3: Parameters used to model the impact of illustrative increases in the personal allowance

	Current 2011-12 system	Modelled system 1	Modelled system 2
Personal allowance	£7,475	£10,000	£12,500
Basic rate limit	£35,000	£32,475	£29,975
Higher rate threshold	£42,475	£42,475	£42,475
Additional rate threshold	£150,000	£150,000	£150,000
Annual gain to taxpayer with earnings above the modelled personal allowance and below £100,000	—	£505	£1,005

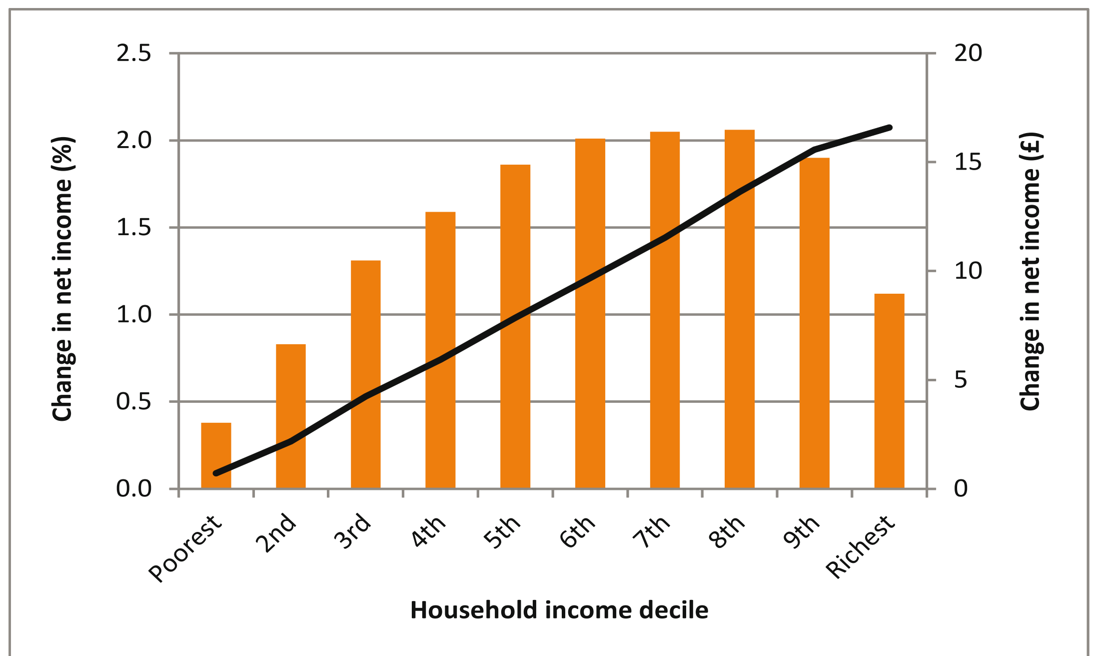
4 The IPPR Tax-Benefit Model uses data from the Family Resources Survey to assess the impact of tax and benefit changes on different types of families.

5 In our modelling, this produces a considerable gain for households in the top income decile. In practice, this could be offset by lowering the higher rate threshold.

In both modelled systems, anyone earning less than the existing personal allowance of £7,475 receives no benefit from the increase in the allowance. Those earning between £7,475 and the modelled personal allowance gain a proportion of the maximum amount set out in table 3.

Figures 1 and 2 show the distributional impact of the modelled systems for households, rather than for individual earners. Household income comes from many sources, including post-tax earnings from one or more adults, benefits and private pensions. In the charts, the bars show the impact on household income in percentage terms and the line shows the impact in cash terms.

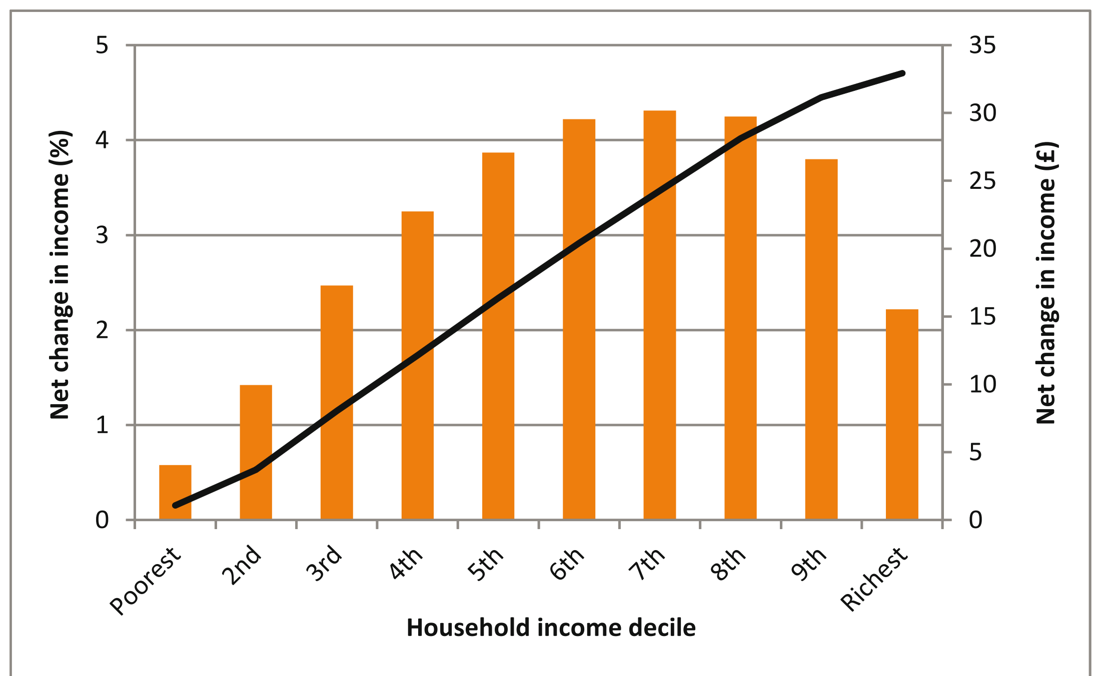
Figure 1: Distributional impact of raising the personal allowance to £10,000 in 2011-12



Source: Authors' calculations using the IPPR tax-benefit model

On average, households in every income decile gain something from both illustrative changes. In both cases, the percentage terms gains are lowest for the poorest 10 per cent of households and rise further up the distribution until the 7th and 8th deciles, then fall for the richest fifth of households. For example, in figure 1, the average gain for households in the 7th decile are £16 a week, or 2.1 per cent of their income, compared to a gain of £4 for households in the 3rd income decile. The poorest 10 per cent of households gain very little in both simulations – just 72p a week if the allowance is raised to £10,000; and £1 if the allowance rises to £12,500. Overall, households in the bottom half of the distribution (not just the poorest households) do less well than those in the top half of the distribution in both simulations.

Figure 2: Distributional impact of raising the personal allowance to £12,500 in 2011-12



Source: Authors' calculations using the IPPR Tax-Benefit Model

This distributional pattern emerges for a number of reasons. Households in the bottom half of the income distribution would see their incomes increase by a relatively small amount on average because fewer households in this part of the income distribution pay enough tax to fully benefit from a bigger personal allowance. Workless households and those with only earners on less than £7,475 are concentrated in the bottom half of the distribution and would see no benefit from the change. Low-income pensioner households, who would also see little gain, are also concentrated in this part of the income distribution. Overall, around a quarter of adults live in households where nobody earns enough to pay tax (Mirrlees Review 2010). As the Institute for Fiscal Studies makes clear, 'income tax cuts are not well targeted to help the poorest in society' (Adam et al 2010: 35).

The increase in the personal allowance also focuses resources on full-time workers, while many part-time low-wage workers would see little gain, and this feeds through to the distributional impacts on households. If the personal allowance was raised to £10,000, a full-time worker earning the minimum wage will receive the maximum benefit of £505 a year [6]. Anyone working less than 32 hours a week at the minimum wage will only receive a proportion of this income boost and anyone working less than 24 hours a week will see no benefit at all, although the change does improve work incentives for people earning less than £10,000. This means that low-earning families where one adult works full-time will be better off than families where two adults work part-time, even if both families are working

6 At 35 hours a week and 52 working weeks a year, annual gross pay at the minimum wage (£6.08 an hour at 1 October 2011) is £11,066.

the same hours in total. This has important implications for the incentives for part-time work and for families who would prefer to share work and care responsibilities.

Households further up the income distribution are more likely to be working, have two earners, and have earners who are taking home more than the modelled higher personal allowance. They are therefore more likely to see the full benefit of the increase in the personal allowance. A number of these households will benefit twice because they have two workers on earnings above the new personal allowance. There is nothing wrong with this – having two earners in a household is important for avoiding in-work poverty and enabling work and care to be distributed more evenly within households. There is no argument for limiting the gains of an increase in the personal allowance to just one earner (and no practical way to do this without joint assessment).

But these features of the income distribution inevitably mean that raising the personal allowance is a relatively inefficient way to achieve the policy's stated goals of taking low earners out of income tax, improving their work incentives and increasing the take-home pay of low-to-middle income households. We estimate that the cost of the illustrative £10,000 allowance modelled above would be approximately £13 billion. The Resolution Foundation has estimated that two-thirds of the projected cost of increasing the personal allowance from £7,745 to £8,105 in 2012-13 will be spent on households in the top half of the income distribution (Whittaker 2011). If similar proportions applied to the change we have modelled, approximately £8.7 billion worth of tax cuts would accrue to the top half of the income distribution. Similarly, the Institute for Fiscal Studies' analysis of the original Liberal Democrat's proposal estimated that only seven per cent of the money spent increasing the personal allowance would go on taking 3.6 million low earners out of income tax altogether (Adam et al 2010).

Raising the income tax personal allowance is therefore an untargeted and expensive way to improve the work incentives of low earners and increase the incomes of low-to-middle income households. The Coalition is committed to spending approximately £1 billion in 2012-13 on increasing the personal allowance to £8,105. The stated goals of the Coalition's personal allowance policy could be better achieved by measures directly targeted at low-to-middle income working families, with strong limits on gains to families in the top half of the distribution.

In the June 2010 budget and the October 2010 Comprehensive Spending Review, the Coalition announced a total of £18 billion cuts in benefit and tax credit spending. IPPR has estimated that half of these cuts will fall on working families, by reducing the value of tax credits that support the incomes of low-to-middle income families (IPPR 2010). This will not only reduce the real incomes of many low-to-middle income families but also have a negative effect on work incentives. Therefore these changes directly contradict both the goals behind the policy of raising the personal allowance and the Coalition's welfare reform programme: increasing work incentives by enabling low earners to keep more of their earnings before benefits and tax credits are withdrawn. The main changes to financial support for low-to-middle income working families are set out in box 2.

Box 2: Changes to financial support for low-income working families

Measures announced in June 2010 budget

- Switch to CPI indexation for increasing tax credits
- Rate at which tax credits are withdrawn when earnings rise increased from 39p for every extra £1 earned to 41p

Measures announced in the 2010 comprehensive spending review

- Freeze in the basic and 30 hour elements of the working tax credit for three years from 2011-12
- Reduction in support for childcare in the working tax credit from 80 per cent of eligible costs to 70 per cent
- Increase the working hours requirement for couples with children to 24 hours

Additional changes to housing benefit, council tax benefit and child tax credits were also made in the June 2010 budget and October 2010 CSR, which will affect some working families. The coalition has sought to ameliorate the impact of some of these changes on families with children by raising the child element of the child tax credit by above-inflation rates in both 2011-12 and 2012-13, which will benefit working families with children.

Instead of spending £1 billion next year to pay for a tax cut when two-thirds of the money spent will go to the wealthiest half of households, the Coalition should consider using this money to reverse some of the damaging cuts to financial support to low-to-middle income families. This would be a more effective way to maintain strong work incentives for these families than cutting the income tax personal allowance. As a priority, the Coalition should reverse its decision to reduce support for childcare costs through the tax credits system. From April 2011, the government has cut this support from 80 to 70 per cent of eligible childcare costs, saving £350 million in 2012-13. This means that a family claiming support for the maximum eligible childcare costs for two children (£300 a week) is £30 a week worse off.

There is no clear rationale for this change when childcare costs in the UK are among the highest in the OECD [7] and rising at an above-inflation rate [8]; and when affordable childcare is vital to enable many parents to work. There is growing evidence that reducing the financial support available for childcare may have an impact on employment levels among some parents (Save the Children and the Daycare Trust 2011; Hirsch 2011). Unlike a general tax cut that disproportionately benefits the wealthiest half of families, financial support for childcare costs is well-targeted at low-to-middle income working families and directly supports the real costs of work.

Freezing the basic and 30-hour elements of the working tax credit is estimated to save £750 million 2012-13. CPI in August 2011 was 4.5 per cent and, if we assume that it stays at a similar level in September 2011, when tax credits are uprated for the following tax year, this means that the basic element will be worth approximately £85 a year less than if it had been increased in line with CPI inflation; and the 30-hour element will be worth approximately £35 a year less. Although these may sound relatively small numbers, the cumulative impact of a three-year freeze will be significant.

7 http://fullfact.org/blog/childcare_costs_savethechildren-2961

8 http://www.daycaretrust.org.uk/pages/childcare-costs-surveys.html

Freezing these elements of the working tax credit reduces work incentives by lowering the total income available to low-to-middle income working families relative to out-of-work benefits. As the value of working tax credits are gradually eroded over the next three years, the relative gains of low-to-mid wage work will diminish. This is particularly important given the scale of low pay in the UK, and emerging evidence about the stagnation of low and median earnings in the last decade (Cooke and Lawton 2008; Plunkett 2011). Financial work incentives are not the only influence on people's decision to work, but they can be particularly important for low-to-middle incomes families and these policy decisions directly contradict the stated intentions of the government's other tax and benefit reforms.

In the longer term, the Coalition should reconsider its plans to gradually increase the personal allowance to £10,000. Although these plans stem from a well-founded concern to improve living standards and work incentives for low-to-middle income families, our analysis has shown that using the income tax system to do this is inefficient and costly, with most of the benefits accruing to the wealthiest half of families. The Coalition should consider alternative mechanisms for helping low-to-middle income families. This should not be limited to increased spending on tax credits, but should include replacing direct financial support for childcare through the tax credit system with free, publicly-funded, universal childcare and early years education.

2. The 50 per cent additional rate of income tax

The additional rate of income tax at 50 per cent on incomes over £150,000 was introduced by the Labour government in the 2009 budget. The objective was to generate additional tax revenue from the wealthiest taxpayers to help secure the public finances in the wake of the fall in tax revenues generated by the recession.

In the 2009 budget, the Treasury estimated that the new tax rate would raise an additional £1.8 billion in 2011-12, rising to £2.4 billion in 2012-13. The tax applies to around 275,000 individuals, roughly the top one per cent of all income taxpayers. Although this is a very small proportion of taxpayers, the tax rate levied on this group is important because their incomes are so large. This means that the tax they pay is out of all proportion with the size of the group: before the 50 per cent rate was introduced, around a quarter of all income tax was paid by the top one per cent of taxpayers (Mirrlees chapter 4). This should be seen in the context of very substantial increases in incomes enjoyed by the wealthiest one per cent of taxpayers over the last three decades and the impact this has had on levels of economic inequality in the UK (Brewer et al 2008; Bell and Van Reenen 2010).

A number of business leaders and economists have called for the 50 per cent rate to be abandoned by the Coalition government [9]. The Chancellor George Osborne has said he would like to scrap the tax and has asked HM Revenue and Customs (HMRC) to review how much additional revenue the tax is generating and report by the end of the 2011-12 tax year [10]. Many Liberal Democrats view the 50p rate as an appropriate 'crisis measure' but not a long-term part of the UK income tax regime (Newby 2011).

Opponents of the 50 per cent rate make two arguments. First, they argue that the rate will not raise significant additional revenue, and could even reduce the overall revenue generated from the richest taxpayers. In theory, there is a point at which raising income tax rates fails to generate additional revenue (or causes revenues to fall) because

9 See http://www.ft.com/cms/s/0/d92b0bc4-d7e9-11e0-a5d9-00144feabdc0.html#axzz1Y0k2LUbG
10 http://www.bbc.co.uk/news/business-14515518

individuals respond by either reducing their working hours or effort (or stopping working altogether); or take steps to reduce their taxable income through illegal tax evasion measures, or more commonly, legal tax avoidance measures. These could include contributing more to a pension (although new rules make this hard in practice in the UK) or charity; designating income as capital gains; or relocating to a country with a more favourable tax regime. Previous studies have found that high earners are more likely to respond to increases in the top rate of income tax by investing in avoidance measures, rather than by reducing their labour supply (Mirrlees Review 2010). There is little evidence that imposing higher rates of income tax on high earners causes them to cut their working hours or work less hard.

The highest tax rate that can be imposed before further increases would achieve no increase in revenue is called the **revenue-maximising tax rate**. In work for the Mirrlees Review, Brewer, Saez and Shephard (2010) estimated that the revenue-maximising tax rate for the top one per cent of taxpayers was 56 per cent. Once national insurance contributions and indirect taxes have been factored in, this is equivalent to a revenue-maximising income tax rate of 40 per cent, the rate that high earners were previously paying on incomes over £150,000 before April 2010. This suggests that raising the top rate of income tax to 50 per cent will raise no additional revenue – taxpayers affected by the move will opt to reduce their taxable income to such an extent as to completely offset (or even outweigh) any additional revenue raised from the new rate.

However, as the Mirrlees Review is careful to point out, “there is no escaping the uncertainty around the estimate of a 40 per cent revenue-maximising income tax rate” (Mirrlees Review 2010: 109). The estimates are based on how people adapted to the changes in the top rate of income tax in the 1980s, the last time that the top rate was altered. However, the ability of the top one per cent of taxpayers to respond to tax changes is potentially very different in the 2010s. For example, there are now more complex tax avoidance products available but more anti-avoidance measures are also now in place. Differences in the capital gains tax regime and in pension tax relief rates may make it easier or harder to reduce taxable income. In the 1980s, tax rates were lowered and the revenue generated from the richest taxpayers increased, suggesting that raising the top tax rate would have the opposite effect. However, lots of other things changed in the 1980s which led to increases in top incomes, such as privatisation and the ‘big bang’ in the finance sector [11].

Even if nothing has changed since the 1980s, the 40 per cent revenue-maximising income tax rate was the central estimate, and there was only a two-thirds chance that the true rate lay somewhere between 33 and 57 per cent, a relatively wide margin. Furthermore, the top rate of income tax was reduced from 60 to 40 per cent in the 1980s, so we have no specific observation for how top earners might respond to a 50 per cent rate.

The impact of the one-off payroll tax on bankers’ bonuses levied in 2009-10 may suggest that additional revenue can be raised by increasing taxes on the incomes of high earners[12]. The Treasury originally estimated that this tax would raise £550 million whereas the final amount was £1.3 billion. A one-off tax is much easier to avoid, so it could be considered surprising that it raised more than expected. This may be an indication that the revenue benefits of a higher top rate of tax cannot be completely wiped out by tax avoidance measures.

11 See http://www.guardian.co.uk/commentisfree/2009/apr/20/income-tax-rates

12 See http://touchstoneblog.org.uk/2011/04/the-impact-of-the-50p-income-tax-rate/

The best conclusion to draw from the available evidence is that we simply do not know how taxpayers are responding to the 50 per cent rate, and therefore how much additional revenue it is raising. It is sensible for HMRC to review the operation of the additional rate of income tax and publish detailed statistics about the revenue generated after the rate has been in place for a full tax year. Until then, it is too early to say whether the 50 per cent rate should be abolished or retained on the grounds of the additional revenue it generates.

HMRC should also investigate the extent to which high earners have responded to the 50p rate by taking steps to avoid the higher rate of tax. Previous studies suggest that the usual response to higher marginal tax rates among high earners is to reduce taxable incomes rather than labour supply. If it is found that revenues are significantly below predicted levels and this is primarily because taxpayers have acted to reduce their income tax liability through avoidance measures, then this does not necessarily negate the argument for a 50 per cent rate but rather strengthens the argument for additional anti-avoidance measures.

Nevertheless, it may be that there are other ways to raise additional revenues from wealthy taxpayers beyond the headline rate of income tax. This could include restricting the rate of tax relief that higher rate taxpayers can claim on pension contributions to the basic rate, which may generate up to £7 billion a year in additional revenue (Newby 2011). The previous Labour government planned to limit pension tax relief for higher earners so that it tapered down to 20 per cent for people earning more than £150,000 a year. This was overturned by the Coalition, which has instead reduced the annual tax-free allowance for pension contributions considerably from £255,000 to £50,000 and the lifetime allowance from £1.8 million to £1.5 million (Thurley 2011). This will help to limit the amount of tax relief that higher earners can claim but still awards them a greater subsidy for pension saving than is given to basic rate taxpayers.

In the longer term, tax relief on pensions could be replaced with an additional state-funded pension contribution, since there is little evidence that tax reliefs provide an effective incentive to save, especially among low and middle earners (Pensions Policy Institute 2004; Dolphin 2011). The Liberal Democrat policy of aligning capital gains and income tax rates and personal allowances could also be a positive move to remove the incentive to classify income as capital gains (Newby 2011).

The second argument that opponents of the 50 per cent rate make is that it risks stifling growth and job creation. As we have already highlighted, high earners do not tend to respond to an increase in the top rate of tax by working less hard or stopping working altogether, so the 50p rate is unlikely to affect the wealth and job creation abilities of the top one per cent in this way.

Opponents of the 50 per cent rate argue that job creation will be damaged because the higher tax rate will cause many top earners to relocate to a country with a more favourable personal tax regime, or it will dissuade such people from moving to the UK. The evidence base for such assertions is weak. First, research by the High Pay Commission has found that senior executives are no more mobile than other employees (High Pay Commission 2011). Second, table 4 shows that the tax regime for high earners in the UK is broadly comparable to those in other OECD countries. Although the UK is towards the top of the table, five countries have higher top tax rates and 18 countries have a top rate of tax above 46 per cent. Table 4 also shows there is no clear relationship between the top rate of tax and employment rates. Employment is both higher and lower than the UK in countries which have higher top rates of tax and in those that have a lower top rate.

Table 4: top marginal rate of tax in OECD countries

Country	Top marginal rate of tax - %	Employment rate (2010) - %
Denmark	62.8	75.0
Hungary	62.0	55.9
Belgium	59.5	62.5
Sweden	56.5	74.5
Finland	55.0	69.3
UK	51.0	72.4
Italy	50.7	57.8
Netherlands	50.0	76.0
France	49.8	64.4
Greece	49.6	60.7
Portugal	48.4	70.0
Norway	47.7	77.5
Japan	47.7	77.5
Switzerland	47.5	81.0
Germany	47.5	72.4
Luxembourg	47.0	65.9
Australia	46.5	74.5
Canada	46.4	73.7
US	43.2	69.8
Spain	43.0	59.9
Austria	42.7	73.1
South Korea	38.5	67.7
New Zealand	38.0	75.5
Iceland	35.7	82.3
Turkey	35.6	47.5
Poland	34.9	60.2
Czech Republic	31.1	66.0
Slovak Republic	29.9	59.0
Mexico	29.6	63.4

Source: OECD [13]

13 OECD Table I.7: Top marginal combined personal income tax rates7, available at http://www.oecd.org/document/60/0,3746,en_2649_34533_1942460_1_1_1_1,00.html#pir and OECD StatsExtracts http://stats.oecd.org/Index.aspx? Note: the table shows the 'all-in' rate, which includes social security contributions collected via payroll (National Insurance Contributions in the UK).

The top one per cent of taxpayers are more likely to work in finance and in associated business services that serve the finance industry, such as corporate law and accountancy (Bell and Van Reenen 2010; Brewer, Sibieta and Wren-Lewis 2008). It is not clear that high earners in these sectors invest in activities that would generate shared prosperity and employment. Relatively few 50p taxpayers are owners of SMEs or mid-sized firms that may be expected to generate job growth.

Calls for the abandonment of the 50p rate are part of a broader agenda that focuses on tax cuts, alongside further deregulation and other supply side measures, as stimulants of economic growth. However, the central problem in the UK economy is that demand is weak. Unemployment is rising, retail sales are flat, and consumer and business confidence is falling. None of these poor economic indicators can be realistically pinned on the 50 per cent tax rate. The risk is that continued debates about the right rate at which to tax very high incomes obscures the need for a much broader strategy for growth and investment.

The government should wait until the HMRC review of the operation of the 50 per cent tax rate is complete before making a decision about the future of the tax rate. HMRC should publish full details of its review to enable independent scrutiny of the results. Where possible, HMRC should include an assessment of how much revenue was not collected due to tax avoidance measures. If the 50 per cent tax rate can be shown to have generated significantly less revenue than projected and the majority of this can be shown to be the result of tax avoidance measures, the Coalition should retain the 50 per cent rate and launch a new package of anti-avoidance measures. In the longer term, the Coalition should look again at the tax reliefs available to the wealthiest taxpayers.

3. Property taxes and the ‘mansion tax’

The uncertainty over the future of the 50p tax rate has revived debate about the Liberal Democrat’s proposal for a ‘mansion tax’ – a property tax on high-value homes. Business Secretary Vince Cable has said that if the 50p rate is scrapped it should be replaced by another tax on wealthy individuals [14]. Cable first announced the ‘mansion tax’ policy at the Liberal Democrat 2009 spring party conference, proposing a 0.5 per cent annual levy on property valued at over £1 million, affecting 250,000 homes. The threshold was raised to £2 million in the Liberal Democrat’s 2010 general election manifesto, after party members raised concerns about the impact of the policy in marginal seats in the south. The revised plans were estimated to affect just 70,000 properties and raise approximately £1.7 billion.

The mansion tax policy formed part of Liberal Democrat tax reform plans to create more ‘fairness’ in the tax system, and was one way that the increase in the personal allowance discussed above was to be funded. Vince Cable also framed the ‘mansion tax’ as a way to penalise non-productive investment; and address some of the weaknesses of the council tax regime:

‘We have seen the super-rich pouring their money not into job creating businesses but into acquiring mansions. And remember too that under our unfair council tax, Messrs Mittal and Abramovich in their £30m palaces pay the same as a band H family’s home though their properties may be worth 40 or 50 times as much’ (Vince Cable’s speech to Liberal Democrat conference 2009)

14 http://www.telegraph.co.uk/finance/personalfinance/consumertips/tax/8679485/Vince-Cable-mansion-tax-should-replace-50p-rate.html

There is certainly a strong case for reforming the system of property taxation in the UK. The main broad-based property tax operating in Britain is council tax, which suffers from a number of weaknesses that suggest it is in need of reform (Mirrlees Review 2010). First, it is a regressive tax in the sense that the more a property is worth, the less as a proportion of its value is paid in council tax. Second, the system of council tax bands fails to sufficiently differentiate between homes of different value. The bottom band covers a large number of properties, while the top band covers properties with hugely different values – a source of unfairness recognised by Vince Cable. Third, the valuations, carried out in 1991, are so out-of-date that they bear little relation to current property values. Fourth, discounts for second and empty homes encourage the inefficient use of properties. These weaknesses also contribute to the particular unpopularity of council tax. Adding a very limited 'mansion tax' to a broken council tax system can only be a stop-gap measure until a more comprehensive review of property taxation is undertaken.

The Mirrlees Review proposed an alternative to council tax that could help to improve the system of property taxation. A 'housing services tax' (HST) would be a flat-rate tax levied on the estimated rental value of both rented and owner-occupied domestic properties (Mirrlees Review 2010). It would therefore be similar to the system of domestic rates that operated in Britain until 1991 and still operates in Northern Ireland.

A HST recognises the value of the 'services' that we get from living in a house, in the same way as we get a 'service' from any other consumer durable, like a fridge or a car. We pay VAT on the purchase price of a fridge or a car when we buy it which is essentially a tax on the value that we get from using the fridge or car over its lifetime. No such tax is levied on the value we get from our home. In fact, the UK is alone in the OECD in not levying VAT on property construction or sales. Yet because a house has a very long lifetime, it is difficult to estimate the value of the lifetime services it will offer to residents. Therefore, an annual charge is more appropriate.

Mirrlees suggests a rate of 0.6 per cent levied annually would raise about the same amount as council tax currently does, and would be equivalent to a 12 per cent VAT on the value of housing services. They estimate that, for homes worth less than £250,000, tax bills would fall, while rising for homes worth more than £250,000.

A HST could also replace stamp duty land tax (SDLT), a badly designed property tax. The SDTL is a transaction tax levied on house purchases, which disincentivises moving house. It could therefore be adding unnecessary inflexibilities to the labour market, and encouraging people to live in homes that are too large for them. It also has a very odd structure whereby the tax rate is levied on the whole house value not just the value above a certain threshold, so it arbitrarily discourages transactions of certain values. There is a strong case for SDLT to be abandoned and the revenue raised from other sources.

Currently, the asset value of housing remains untaxed for owner-occupiers and a HST would not address this directly as it is a tax on the consumption value of a home, not its value as an asset [15]. Since capital gains tax is not levied on primary residences, increases in the asset value of domestic property are not taxed, unlike gains from assets held in other forms, like equity investments (beyond the tax-free allowance held in ISAs). This means that someone who rents their home but has built up considerable cash savings pays income tax on the interest, but someone who bought a property and sells it for a considerable profit pays no tax on their gains. This seems particularly unfair when the

15 Landlords are taxed on their rental income, although they receive no allowance for 'normal' returns.

value of domestic properties has risen in real terms by an average 2.9 per cent a year since 1975, and although property can be a risky asset, over the last four decades it has been a source of a significant and sustained increase in wealth for many people (Mirrlees Review 2010).

There is no economic justification for setting the threshold for taxing the asset value of homes at the very high level of £2 million, which captures the asset value of just the 70,000 most expensive properties. It is clearly a symbolic threshold designed to demonstrate a desire to increase tax receipts from those most able to pay while placing no additional burden on the vast majority of the electorate. However, this avoids the important question of how property should be taxed within a progressive, fair and efficient tax system.

The Coalition should therefore make clear that a 'mansion tax' is the first part of a broader property tax reform programme. Such a programme would represent a considerable political challenge, since there is no widespread public acceptance that main residences are a legitimate basis for taxation. Even more distant on the political horizon is the idea of taxing the value of land, despite a strong economic case for doing so [16].

Taxes on property, land and other forms of wealth are generally less popular than taxes on income, and, therefore, attempts to reform wealth taxes tend to be politically unattractive to governments. Progressives have consistently failed to make a good case for the taxation of property and other forms of wealth, and have preferred to focus on reforming income tax and indirect taxation. Yet the weaknesses of the UK's property tax regime are so serious that they undermine the fairness, efficiency and progressivity of the overall tax system, and contribute to a tax system that necessarily levies significant taxes on labour, while leaving wealth relatively untaxed. This is particularly important as inequalities in wealth are considerably larger than those in income, and have risen over the last three decades (National Equality Panel 2010).

There is a strong case for progressives to pursue a programme of reform across the wealth tax system, including taxes on property, land and inheritances, and for ensuring the wealth taxes are not limited to the 'super-rich' as there is no clear justification for this. The introduction of a 'mansion tax' should be seen as the first small step in that process, which is ultimately designed to partly shift the burden of taxation from income to wealth. Such a broad shift is likely to be progressive, given the very unequal ownership of property, land and other forms of wealth in the UK. It could also help promote the more efficient use of resources and achieve greater equity between different groups of taxpayers.

16 See Maxwell and Vigor (2005) for a full outline of the economic case for taxing land values, but broadly, the case is that: (1) the supply of land is fairly limited and not very responsive to price, and so can be taxed at a reasonable rate without having any major impact on supply and demand; (2) the ownership and location of land is well-established, and it cannot be moved, so it is easier to work out tax liabilities and harder to avoid them; and (3) a land value tax captures increases in the value of land result of developments external to the land, which are often paid for by taxpayers.

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