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Taxes and Benefits: The Parties' Plans

Executive Summary

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Executive summary

The last five years have seen considerable policy activity in the tax and benefit sphere: in total, some £56 billion per year of giveaways and £89 billion per year of takeaways by 2015–16. Most of the main tax reforms have simply changed rates or thresholds within current structures – the increase in the main rate of VAT, cuts to the main corporation tax rate, real cuts to the rates of fuel duties and the big increase in the income tax personal allowance being the most important. Only for pensions and savings has there been a significant reshaping in terms of what is taxed and what is not. Changes to benefits have mostly been straightforward cuts in generosity, with more significant structural reform coming in the next parliament – the introduction of the single-tier pension, the introduction of universal credit and the replacement of disability living allowance (DLA) with personal independence payment (PIP).

As for what is to come, there are important areas of agreement between the main UK parties. There is apparently a huge amount of money to be extracted through a clampdown on tax avoidance (mysteriously missed by all previous clampdowns). There is yet more money to be extracted from those on very high incomes saving in a private pension. The main rates of income tax, National Insurance contributions (NICs) and VAT will not be increased. The 'triple lock' on indexation of the basic state pension will remain and most pensioner benefits will be protected. There is also a shared lack of any attempt to paint a coherent strategy for tax reform, a shared desire to impose further, often absurd, complications to the tax system, and a shared lack of willingness to set out specific benefit measures that chime with the parties' rhetoric. On that last point: on the one hand, the Conservatives have spent two years promising substantial additional benefit cuts of £12 billion a year whilst failing to come up with more than 10% of that figure in actual cuts; on the other hand, Labour's promised 'toughness' involves reducing spending by almost nothing by taking winter fuel payments from the small number of pensioners subject to the higher rates of income tax, and most likely by literally nothing by limiting the uprating of child benefit rates.

There are significant differences between the parties too. The Conservatives are promising significant income tax cuts through further increases in the personal allowance and an increase in the point at which higher-rate tax becomes payable. The first of these ambitions is shared by the Liberal Democrats, while the Labour manifesto is silent on these points. Labour and the Liberal Democrats (and the SNP) share a desire to impose a 'mansion tax', not a policy adopted by the Conservatives. Labour (and the SNP) would return the top rate of income tax to 50%. The Conservatives are alone in saying they would seek big cuts in benefit spending and generosity.

In this summary, we look at the main proposed changes to income tax, the taxation of housing, other taxes, and benefits in turn, with a particular focus on Labour and the Conservatives. The main body of this document then examines most of the specific tax and benefit policies of Labour, the Conservatives and the Liberal Democrats in some detail.

Income tax

Rates and thresholds

Since 2010, 2.6 million working-age people have been taken out of income tax as a result of a big increase in the personal allowance to £10,600 (instead of £7,765). Further increases to £11,000 in nominal terms by 2017–18 have been announced. At the same time, the higher-rate threshold has been cut substantially in real terms, more than offsetting higher-rate taxpayers' gain from the increase in the personal allowance and keeping the combined cost down to £8 billion. The number of higher- and additional-rate taxpayers has, partly as a result, increased from 3.3 million in 2010–11 to an estimated 4.9 million in 2015–16.

Conservative and Liberal Democrat plans to increase the personal allowance to £12,500 by 2020–21 would cost around £4 billion a year in current prices, relative to uprating it with CPI inflation after 2017–18.

Only 57% of adults now pay income tax, down from 61% in 2010–11, and of course further increases in the personal allowance will not help the 43% who pay no income tax. Further increases will, though, help those aged 65 and over, few of whom have benefited from the policy up to now; they have historically benefited from a higher personal allowance than under-65s, but the main allowance will catch up to that higher level in 2016–17.

In part because so many people do not pay income tax, and in part because the biggest gainers are two-earner couples where both can benefit from the higher allowance, increases in the personal allowance benefit those in the middle and upper-middle parts of the income distribution the most. Obviously, increases in the higher-rate threshold, as proposed by the Conservatives, will only benefit higher-rate taxpayers, who are typically located towards the top of the income distribution. That said, even under Conservative plans to raise that threshold to £50,000 by 2020–21, it will still be below where it would have been had it simply been uprated with inflation since 2010. Even with that increase, we calculate the number of higher-rate taxpayers would increase from 4.9 million now to 5.3 million in 2020–21. Neither Labour nor the Liberal Democrats are proposing to raise the higher-rate threshold. If it merely keeps pace with inflation, the number of higher-rate taxpayers could hit 6.4 million by 2020–21, 1.5 million more than now and double the 3.3 million there were in 2010–11. The 'no reform' option actually represents a radical, albeit gradual, change in the nature of the income tax system.

Labour's two main proposed changes to income tax rates would reintroduce a 10% starting rate, paid for by the abolition of the married couple's transferable personal allowance, and would raise the additional rate from 45% to 50%.

The first of these policies would remove one small complication from the system and replace it with another. Abolishing the transferable allowance would provide enough cash to implement a 10% band a mere £260 wide, worth a princely 50 pence a week to most income tax payers. There is no point in introducing such a band. Virtually the same result could be achieved, only very slightly more simply and progressively, through raising the tax-free allowance. Labour would ensure that those on the highest incomes would not benefit from a 10% band by further widening the effective 60% income tax band that currently stretches from £100,000 to £121,200 so that it stretched to £121,330. This band would stretch between £100,000 and £125,000 (in 2020 prices) under Conservative and Liberal Democrat plans to raise the personal allowance to £12,500. None of the parties is proposing to do anything about this ridiculous and rather hidden anomaly in the income tax system.

The proposed reintroduction of the 50% additional rate of income tax would clearly leave those with annual incomes over £150,000 worse off. The extent to which it would raise any additional revenue is unclear. HM Revenue and Customs' (HMRC's) central estimate, signed off as reasonable by the Office for Budget Responsibility (OBR), was that cutting the additional rate from 50% to 45% would cost just £110 million. Raising it again might raise this much, it might raise substantially more, or it might actually cost the exchequer revenue. We genuinely cannot be sure. The policy should be seen more as a way to reduce the highest taxable incomes rather than a way to increase revenue significantly.

Finally on rates and bands, it is important to note that, by default, major parts of the income tax system are not being increased in line with inflation. The additional rate still bites at £150,000, the same nominal level at which it was introduced in 2010. The absurd 60% rate still starts at £100,000. CPI inflation since April 2010 means that the real value of these thresholds has already fallen by 15%. If they continue not to be indexed, their real value will have fallen by 23% by 2020 – equivalent to having introduced them at thresholds of £120,000 and £80,000 respectively (and those numbers do not take account of any greater growth in incomes than in prices).

Pension taxation

There has been a dramatic reduction in the limits on tax-relieved pension contributions since 2010. In particular, the maximum amount that can be contributed annually has been cut from £255,000 to £40,000, while the maximum value of the pension pot is being cut from £1.8 million to £1 million. The OBR estimates that changes since 2010 have increased revenues by £5 billion a year in the short run (though some of that will be offset by lower taxable pension income in future years). Labour and the Conservatives both want to continue along this path. Both propose to alter the treatment of an eminently sensible part of the income tax system – allowing people to save out of pre-tax income and pay income tax when the income is withdrawn from the pension instead. Neither proposes to do anything about the excessive generosity that does exist – allowing tax-free withdrawal of 25% of pension savings which have never been subject to income tax, and allowing employer contributions to escape NICs entirely.

The Conservatives would like to reduce the annual allowance for those with taxable incomes over £150,000 so that it falls from £40,000 to £10,000 by the time income reaches £210,000. Why someone earning £150,000 should be able to save £40,000 in a pension while someone earning £210,000 should be able to save just £10,000 with tax relief is unclear. Note also that this policy discourages would-be pension savers on high incomes from increasing their incomes over this range, in a similar way to straightforward increases in their marginal rates of income tax.

Labour policy aimed at high earners is more complex still. They want to reduce the rate of income tax relief from 45% (50% under their policy) to 20% for those whose gross income including employee (but not employer) pension contributions is over £130,000 and whose gross income including employee and employer contributions is in excess of £150,000. Their way of phasing out higher-rate relief would create a substantial 'cliff edge' – some people would become significantly worse off as the result of a pay rise – and would increase complexity. More fundamentally, it is hard to see why it should be 'unfair' for those above £150,000 to get tax relief at their marginal rate but not 'unfair' for higher-rate taxpayers to do so. Labour want, in addition, to reduce the maximum amount that can be saved tax free in a pension to £30,000 a year.

Stability and predictability are important in most parts of the tax system, but none more so than the taxation of pension savings. The frequency and direction of reforms to pension taxation under this government have been concerning. The continued desire to dismantle an important and relatively sensible part of the tax system is more worrying still.

Housing and tax

Both Labour and the Liberal Democrats (and the SNP) say they want to introduce a 'mansion tax', an additional annual charge on residential properties worth more than £2 million. The Conservatives, in contrast, would like to reduce the effective tax on some owner-occupied homes by effectively increasing the inheritance tax (IHT) threshold to £1 million for married couples whose main residence is worth at least £350,000 and is bequeathed to their children or grandchildren.

There are many problems with the way in which housing is taxed at present. One such problem is the structure of council tax. As well as, ludicrously, still being based on the relative values of properties in 1991 in England and Scotland, it is regressive in the sense that the amount of tax due rises less than proportionally to the (1991) value of the property. In addition, council tax is capped: no more is paid on a property worth £10 million than on one worth £2 million (assuming they were both worth more than £320,000 back in 1991).

By increasing the annual tax on probably around 100,000–150,000 high-value properties – though nobody knows for sure quite how many – the proposed mansion tax could be seen as a partial remedy to this deficiency in council tax. But setting up an entirely separate tax is unnecessarily complicated: a sensibly reformed council tax would already entail much higher bills for the most valuable properties, whilst ironing out anomalies in the taxation of less expensive properties in the process. Labour's intention to start bringing in revenue from a brand new tax during this financial year also looks less than cautious given the need to sort out the details of valuations, administration and so on.

Labour's intention is to raise £1.2 billion annually from the tax, of which £3,000 would come from each property worth £2–3 million and the remainder from more valuable properties. If there were, for example, a total of 150,000 properties worth more than £2 million and 55,000 of those were worth more than £3 million (HM Treasury's estimates, according to the Liberal Democrats), that would imply raising £285 million from £2–3 million-properties, and properties above £3 million would face an average tax charge of around £16,600 to make up the rest of the revenue. Setting a revenue target is not a sensible way to make policy: it is not clear that the appropriate tax rate on high-value properties should be higher if there turn out to be fewer of them than expected, or vice versa.

There are problems with the structure of council tax. Neither the Conservatives, Labour nor the Liberal Democrats look like addressing them. The mansion tax would not solve those problems.

It is also hard to see the economic or social question to which the Conservatives' proposed additional IHT allowance for housing is the right answer, and it is striking that they are proposing this despite Treasury advice that 'there are not strong economic arguments' for the policy. Offering additional IHT relief for owner-occupied housing can only increase the distortions in the tax system both in favour of owner-occupation and against trading down. Tax incentives that effectively lock older people into bigger and more expensive properties do not look helpful.

Again, there are significant problems with the current structure of IHT. The fact that it is so easily avoided by the very wealthy by the simple expedient of passing on wealth at least seven years before death is one obvious issue. The fact that significant classes of assets, including farm land and certain types of business, are free of IHT creates both distortions and inequities. Again, none of the main UK parties seems to want to grapple with these issues.

Other tax proposals

By far the biggest apparent revenue-raising proposals from each of the Conservatives, Labour and the Liberal Democrats are 'clampdowns' on tax avoidance and evasion. They claim they will raise, in today's terms, £4.6 billion, £6.7 billion and £9.7 billion a year respectively from such policies. Yet none of the parties has proposed specific measures that would increase revenues by these sorts of amounts. One might think of these revenue targets as, at best, aspirational, yet the parties' fiscal plans rely on achieving them. It is not helpful to the public debate to pretend that raising such sums is easy, certain or necessarily painless. In the end, the best route to reducing avoidance is to tax similar activities similarly so that there is no tax saving to be had by dressing up one activity as another. With some small exceptions, there is no sign that any of the three main UK parties is thinking about this sort of structural reform, which would in the long term reduce opportunities for gaming the system.

There is strikingly little in the Conservative or Labour manifestos about business taxation, perhaps reflecting a significant degree of agreement and acquiescence with recent reforms. Labour would like to raise the main rate of corporation tax from 20% – which it reached just this month – to 21%. Labour have committed to keeping the UK's main rate of corporation tax the lowest in the G7, though given that the next-lowest is Canada at 26.3% this commitment is not terribly constraining. One oddity of the Labour proposal is that it would maintain a small profits tax rate of 20% such that corporation tax rates would be 20% on profits up to £300,000, 21.25% on profits between £300,000 and £1.5 million, and 21% on profits above £1.5 million. That is not a sensible tax schedule.

Part of the £1 billion or so in revenue raised from this corporation tax increase is earmarked for a small reduction in business rates. After a long period of stability, the business rates regime – which, lest we forget, raises £28 billion a year for the exchequer – has seen a lot of change and meddling in the last few years. A review of the regime was announced in the March 2015 Budget.

Labour are also proposing yet another increase in the bank levy, aimed at raising an additional £800 million. That would be the ninth increase announced since the levy was introduced in 2011. There are plausible economic reasons for having special taxes on banks: to reduce the risk they can pose to financial stability, as a charge for the effective insurance that 'lender of last resort' facilities provide, and to stand in place of VAT given that financial services are, under European law, exempt from VAT. That does not mean that changing rates every year and continuing to try to raise ever-more revenue from the bank levy is economically sensible.

Benefit proposals

There are fewer specific proposed changes to the social security system in the two main parties' manifestos. This may reflect in part the very big scale of reforms due to be implemented in any case. While Labour have said they would pause and review the universal credit programme, they have given no indication that they would abandon its planned roll-out. While the SNP have said they would want to stop the move from DLA to PIP, at an estimated cost of over £2 billion, none of the three major UK parties has indicated any such desire.

The transition to a single-tier state pension has cross-party support, as does continuing with the 'triple lock' on the state pension. Relative to a policy of CPI indexation, the triple lock has cost £1.1 billion over this parliament. Relative to a policy of earnings indexation, it has cost £4.6 billion. As the OBR has pointed out, continuing with the triple lock indefinitely is expected to be expensive, coming at a price of 0.8% of national income by the early 2060s (£15 billion in today's terms). And as we have pointed out elsewhere,[2] it has the curious feature that, in the long run, the level of the single-tier pension will depend not just on how prices or earnings grow over time but on whether years with high price growth were also years with high earnings growth. That is absurd.

There appears to be a conspiracy of silence over the future of pension indexation. Differences between the Conservatives and Labour with respect to other pensioner benefits are also more apparent than real. The former have promised to protect all the universal benefits payable to pensioners. The latter have said they would take the 'tough' decision to withdraw winter fuel payments from those paying higher and additional rates of income tax. That would save a paltry £100 million – less than 0.1% of the pensioner benefit bill – and come at the cost of greater complexity in the tax system. The Liberal Democrats would also remove the free TV licence from those aged 75 and over, saving a further £15 million. No party devoted serious attention to state provision for pensioners in their manifesto, despite the large cost of that provision, the scale of population ageing and the benefits of getting the design right.

As far as working-age benefits are concerned, Labour propose to cap the uprating of child benefit at 1% in the current year and next year. The saving in the current year, which has already started, is zero and the likely saving next year is also zero. The Conservatives propose to freeze a range of working-age benefits for two years, saving around £1 billion. On the other side of the ledger, Labour (and the SNP) propose to abolish the so-called 'bedroom tax' (the reduction in housing benefit for social tenants deemed to be 'under-occupying' their property) at a cost of £400 million or so, while the Liberal Democrats would water it down significantly.

All in all, then, there are no specific proposals for either substantive additional reform to, or savings from, the £220 billion annual social security budget – over and above the significant ones already in the pipeline – from the Conservatives, Labour or the Liberal Democrats.

The Conservatives have, though, expressed a very clear ambition to cut £12 billion from the annual social security budget within the two years up to 2017–18, or £11 billion in today's terms. They are around £10 billion short of that target in terms of any specific proposals they have made. Achieving such cuts whilst protecting most pensioner benefits would, as we have written elsewhere, be extremely challenging.[3] The amount required is around 10% of spending on social security benefits other than the state pension and universal pensioner benefits, with most of this spending going to working-age households in the bottom half of the income distribution. To provide just a few examples of policy options and what they might save:

- Abolishing child benefit and compensating low-income families through universal credit would reduce spending by around £5 billion.

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[2] Pages 14–15 of A. Hood and D. Phillips, 'Benefit spending and reforms: the coalition government's record', IFS Briefing Note BN160, http://www.ifs.org.uk/publications/7535.

[3] See J. Browne and A. Hood, 'Options for reducing spending on social security', in C. Emmerson, P. Johnson and R. Joyce (eds), *The IFS Green Budget: February 2015*, http://www.ifs.org.uk/uploads/gb/gb2015/ch9_gb2015.pdf.

- Reducing the child element of universal credit by 30% to reach its 2003–04 level in real terms would also cut spending by around £5 billion.
- Taxing DLA, PIP and attendance allowance would raise around £1½ billion.
- Making all housing benefit recipients pay at least 10% of their rent would cut spending by around £2½ billion.

There are many other options and those above are listed merely as illustrations. The point is that cutting spending by this amount, especially while protecting pensioner benefits, would undeniably be painful. It is important to remember that the majority of the net cut to the social security budget (and 40% of the gross cut) achieved over the last parliament came from changes to indexation rules, including periods of uprating less quickly than inflation. The Conservatives have already pledged to freeze most working-age benefits for two years – saving only £1 billion in the current low-inflation environment – and so the remaining £10 billion must come from policies other than below-inflation uprating.

The Conservatives have been talking about saving £12 billion from social security spending for a long time. It is disappointing that no further details have been spelt out in their manifesto.

Conclusion

With significant deficit reduction still to come, households can expect the tax and benefit changes implemented over the next parliament to reduce their incomes, on average. There are large differences between the Conservatives, the Labour Party and the Liberal Democrats in how they propose to do this. But they share a lack of willingness to be clear about the details and an inability to resist the urge for piecemeal changes that make the overall system less efficient and coherent.