Centre for Policy Studies

Pointmaker

TAX CUTS DON'T HAVE TO BE TAXING

SUMMARY

- Tax cuts don't always pay for themselves. But they aren't always as expensive as the Government thinks. Very often, the Treasury ends up making less money from raising taxes than it expects – and would find it cheaper to cut them than it imagines.
- Ahead of the Budget, this paper identifies three taxes that could be cut without costing much in lost revenue, once behavioural effects are factored in – and urges the Government to think more imaginatively about the impact of its tax decisions.
- **Stamp Duty Land Tax** is a terrible way for the Government to raise money, and generates significant productivity and welfare losses.
- Cutting or abolishing SDLT would boost housing market transactions and promote house-building. In turn, this would reduce the need for affordable housing grants and generate additional revenue levies.
- When these dynamic effects are accounted for, the cost of abolishing stamp duty on primary residences falls to £3.3bn. A significantly reformed SDLT – charged at 0% up to £500,000, 4% up to £1,000,000, and 5% beyond that – would cost just £1.6bn.
- **Spirits Duty** is levied at 177% of the EU average. Nearly three-quarters of the cost of a typical bottle goes straight to the taxman.
- Sharp increases in spirits duty in 2012 and 2013 delivered underwhelming revenues. By contrast, the last five years have seen three freezes and one cut – and the British spirits industry has thrived, while tax revenues have boomed.
- The forthcoming alcohol duty review is an opportunity for further reform. Spirits duties certainly shouldn't rise any further, and there is a strong case that they should fall.
- **The additional rate of income tax** was controversial from the start. The initial 50p rate was found in 2012 to have raised hardly any money – so little, in fact, that it may have been a net-negative.
- Today's 45p rate may still be higher than the revenue-maximising tax rate for top earners, once National Insurance and indirect taxes are taken into account. If so, the additional rate could be cut – or even abolished – without harming tax revenues.
- The paucity of available data and analysis means it is hard to be sure about this prediction. As such, The Chancellor should ask HMRC to conduct an in-depth review of the revenue-maximising tax rate on top earners before the next Budget.
- More broadly, the Treasury should develop a more sophisticated approach to the dynamic modelling of potentially pro-growth tax reforms. The Office for Budget Responsibility should also be allowed to rely on credible dynamic forecasts when it assesses the Government's fiscal plans.

This Centre for Policy Studies Pointmaker was edited by Tom Clougherty (Head of Tax), with contributions from Nick King (Head of Business), and Alex Morton (Head of Policy). It is published with financial support from the UK Spirits Alliance

INTRODUCTION

The Laffer Curve was born in November 1974, when a young economist sketched a diagram on the back of a bar napkin for Dick Cheney – at that time - a deputy chief of staff to US President Gerald Ford.

The point Art Laffer was making was an intuitively simple one: taxing someone at 0 per cent raises no revenue – but neither does taxing someone at 100 per cent – because they no longer have any incentive to work and produce.

Between those two points on the graph lies a hump-shaped curve. Initially, tax receipts will rise as tax rates increase. But at some point higher tax rates become self-defeating – they so discourage work that there's less income to tax in the first place, and the Government's receipts begin to fall.

The peak of the Laffer Curve – the top of the hump, if you like – is where you find the revenue-maximising tax rate.

Of course, it shouldn't necessarily be Government's ambition to extract as much revenue from its working population as possible. Lower rates are often fairer, and better for long-run economic growth. But there is certainly no point in the Government levying a tax above that revenue-maximising rate.

Laffer's curve had a huge impact on policy. It inspired – and was validated by – significant cuts to personal and corporate income taxes across the developed world. It became so famous that a copy of that economy-changing napkin now graces the walls of the National Museum of American History in Washington, DC. Laffer himself was recently awarded the US Presidential Medal of Freedom.

But does the Laffer Curve have anything useful left to teach us today? With marginal tax rates so much lower than they were in the 1970s, aren't we on the right side of the hump in most, if not all, cases?

Well, up to a point. It's certainly very unlikely that broad-based cuts to today's income taxes would result in a significant increase in revenue – at least on any short-term timeframe.

Yet for all that, we do still systematically under-appreciate the dynamic effects of changes to the tax system. Time and again, policymakers pursue a given reform (or decline to) without fully taking into account the way it will change people's incentives and economic decision-making.

All-too-often, moreover, we fail to properly consider the impact that cutting one particular tax (corporation tax, say) might have on other sources of revenue (such as individual earnings and dividend receipts). Suboptimal tax policy is the inevitable upshot.

With another Budget just weeks away, this CPS Pointmaker considers three separate cases in which the Government should seriously reflect on the dynamic effect of lower taxes:

First, we look at **Stamp Duty Land Tax** – which was recently the subject of an in-depth study by Alex Morton, our Head of Policy. Our analysis suggests that radically reducing stamp duty on primary residences would be far less costly in revenue terms than is commonly assumed, while also delivering significant economic welfare benefits.

Second, we consider the curious case of **spirits duty**, which currently accounts for around three-quarters of the price of a typical bottle of gin or whisky. When spirits duty was frozen in November 2017, and again the following year, revenues actually rose. Can we expect this effect to continue if spirit duty is frozen again, or even lowered?

Third, we address **the additional (45p) rate of income tax**, which some economists worry is set higher than the revenue-maximising rate. A previous cut to the additional rate did not seem to harm tax receipts; we examine the evidence on whether further cuts might have the same impact.

Needless to say, these aren't the only examples we could have chosen to present. The economic growth effects of lower corporate tax rates are, for instance, well established. And it has even been suggested that abolishing stamp duty on share transactions would lead to somewhat higher tax revenues overall.[1]

Nevertheless, the particular taxes we have chosen to highlight here – a tax on property, a tax on consumption, and a tax on earnings – should serve to illustrate the strength and breadth of the argument we are trying to make: namely, that cutting taxes doesn't always cost as much as you might think.

As it puts the finishing touches on the forthcoming Budget, that's a lesson that the Government would do well to bear in mind.

1. Stamp Duty Land Tax

Stamp Duty Land Tax, at least insofar as it relates to primary residences, is one of Britain's most hated taxes. And no wonder: stamp duty is a deeply pernicious tax that significantly raises the cost of moving house, and therefore causes people to remain in homes that are ill-suited to their needs – in terms of size, location, and a whole host of other factors.

Indeed, one study found that the overall productivity and welfare loss caused by a 2 per centage point increase in stamp duty was equivalent to 80 per cent of any revenue gains that accrued to The Exchequer.[2] All taxes affect behaviour in some way, but it's hard to think of many that have quite such a negative impact.

To make matters worse, stamp duty rates have risen relentlessly in the last two decades, with the highest marginal tax rate climbing from 1 per cent in 1997 to 12 per cent (on primary residences) today. In 2005, the median amount paid in stamp duty was £1,585 for England and £2,324 for London. Now, an average house buyer in England can expect to pay £2,400; in London, the figure is £13,500.

Government-levied transaction costs on this scale wreak havoc on the housing market – especially in those areas where mobility is most economically and socially vital. That's why a recent report from the Centre for Policy Studies, *Stamping Down*, proposed a radical overhaul of stamp duty on primary residences. (There's a case for wider reform, but our focus was strictly on people's homes).

Essentially, we presented two options. First, outright abolition of stamp duty on primary residences. Second, a new, higher threshold for stamp duty (£500,000) and reduced marginal rates above that – 4 per cent on the next £500,000, and 5 per cent over £1,000,000. This second option would take around 90 per cent of English properties out of the stamp duty net altogether, and save other house buyers a minimum of £15,000.

Stamp Duty Before Reform		Stamp Duty After Reform	
Property value	Marginal tax rate	Property value	Marginal tax rate
Up to £125,000	0%	Up to £500,000	0%
£125,000 - £250,000	2%	£500,000 - £1,000,000	4%
£250,000 - £925,000	5%		
£925,000 - £1,500,000	10%	£1,000,000 +	5%
£1,500,000 +	12%		

On a static basis – that is, without taking account of any of the behavioural effects of tax changes – both of our suggestions look expensive. You would expect the abolition of stamp duty on primary residences to cost the Treasury just over £5 billion a year, and our generous package of cuts to cost around £3.7 billion a year. It's not hard to see why a fiscally constrained Government might baulk at these costs – even while accepting the general case for reform.

However, our analysis suggests that these static estimates are wholly inadequate. That's because reforming stamp duty as we suggest would have significant behavioural effects, which in turn would reduce the fiscal cost of reform quite dramatically.

The primary behavioural effect of cutting stamp duty would be to increase the number of transactions in the housing market. Indeed, the evidence suggests that each point fall in the burden of stamp duty (as a share of the purchase price) leads to an increase in housing transactions of approximately 20 per cent.[3]

That means that abolishing stamp duty on primary residences would increase transactions by 25 per cent, while reforming it as we suggest would boost transactions by 22 per cent. The effect would be most pronounced at the highest-value end of the property market, with transactions increasing by 40 to 50 per cent.

Clearly, if property transactions increase in response to lower rates of Stamp Duty Land Tax, the size of the tax base (that is, the £ value of home purchases) would rise, and thus partially or even wholly offset the revenue effect of those lower rates.

Of course, if you abolished stamp duty altogether on primary residences, then by definition stamp duty on primary residences would no longer raise any revenue. But a proper dynamic analysis should also consider any potential secondary effects on the Government finances of a given policy reform.

Here, it is important to realise that any increase in housing transactions is very likely to result in an increase in new build homes. This is a clear and direct relationship that comes through strongly from several decades of data. Before the introduction of Help to Buy in 2013 (which skews subsequent figures), the relationship averaged out[4] at one additional new build property for every 8.5 housing market transactions.

Additional new build properties have fiscal benefits for Government. Firstly, in order to meet its housing targets, the Government currently supports development via grants to build "affordable homes". These add up to around £24,280 for each home built. If lower taxes led to more housing transactions, which in turn encouraged more new builds, such public spending might be rendered unnecessary.

Secondly, more new build housing means that the Government raises more revenue from planning gain levies, such as Section 106 agreements and the Community Infrastructure Levy. This too will help to offset any revenue cost associated with lower Stamp Duty Land Tax rates.

Taken together, these dynamic effects of cutting stamp duty would significantly reduce the fiscal cost of reform. The modelling we carried out for *Stamping Down* suggests that abolishing stamp duty on primary residences would actually cost the Exchequer £3.3 billion, rather than the £5.1 billion a static analysis would suggest. For the reformed stamp duty system we outlined, the dynamic cost was £1.6 billion, compared to a static estimate of £3.7 billion.

As it happens, these are the most conservative estimates we came up with. Modelling of this sort is necessarily imprecise, so in our headline figures we erred on the side of caution. Nevertheless, it's worth a quick look at the ranges we forecast for these dynamic effects under our reformed Stamp Duty Land Tax.

We expected additional transactions to produce revenue worth £0.6 - 1.0 billion. More new build would provide additional planning gain revenue of £1.0 - 1.7 billion, while saving the Government £0.5 - 0.9 billion on grants for affordable housing. In total, then, the dynamic effects of lower stamp duty rates would help the Government to recoup between £2.1 billion and £3.6 billion – or 60 to 95 per cent – of the lost revenue predicted by a static analysis.

In other words, our modelling suggests that a major tax cut, which would exclude 90 per cent of homes from stamp duty completely, while providing a saving of at least £15,000 to every other homebuyer, might conceivably cost the Government as little as a hundred million pounds of lost revenue. This is a perfect example of the point we are trying to make in this Pointmaker: namely, that cutting tax doesn't always cost as much as you think.

What's more, there may even be further dynamic effects that our analysis failed to capture. In a July 2019 newsletter, Ludgrove Property sensibly pointed out that additional housing transactions generate extra business revenue for estate agents, lawyers, surveyors, removals firms, and so on – all of whom contribute to the Government's coffers via corporation tax, VAT and, PAYE.[5]

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Ludgrove modelled a 36 per cent reduction in stamp duty bills across England, which they suggested would lead to a 40 per cent increase in housing market transactions. In turn, this would generate an extra £8.4 billion of property-related business revenue, along with associated tax revenue of some £2.4 billion. This money would offset an anticipated £1 billion fall in stamp duty revenue, resulting in a £1.4 billion net gain in tax revenue overall.

Obviously, Ludgrove's analysis is based on slightly different assumptions from those used in *Stamping Down*, so the results aren't directly comparable. Nevertheless, these figures do at the very least suggest that stamp duty reform might be that rare beast: a tax cut that more than pays for itself, even in the short run.

2. Spirits Duty

Tell the average supermarket customer that almost three-quarters of the price they pay for UK-produced gin or whisky will end up taken by the Treasury as tax, and they might well spit out their tipple of choice in surprise.

That £10.38 of a £14 bottle goes straight from the consumer's pocket to the taxman will strike many as desperately unfair. Nevertheless, the fact is that the UK remains among the highest tax jurisdictions in the world when it comes to spirits, with the tax rate at 177 per cent of the EU average and almost 3.7 times as much as the US duty level.

"Remains" is perhaps the crucial word here, because the UK Government has had a more enlightened attitude to spirits duty of late – seemingly realising that incessant duty rises don't necessarily lead to the increased tax revenues that the Treasury might want or expect to see.

During the final years of the last Labour Government and the early years of the Coalition, spirits were subject to some of the sharpest rises among all indirect taxes, as successive administrations tried to squeeze spirits until the pips (lemon, in a gin and tonic) squeaked. Annual duty rises of more than £1 a bottle became the norm.

The total amount of revenue raised by the Treasury was affected by these tax hikes, of course – but not necessarily in the way one might expect.

In the five years to 2013, spirits duty rose sharply, by £6.87 per litre of pure alcohol. Tax receipts rose by £536m over the same period. Yet in the last two years of this aggressive approach, increases in revenue generated by spirits duty slowed dramatically. Across 2012 and 2013, spirits duty was increased by a total of £2.70 per litre of pure alcohol – but brought in less than £100 million of extra revenue across 2013 and 2014.

By contrast, the five years to 2018 saw spirits duty repeatedly frozen, and even cut on one occasion. Overall, it rose by only 52p per litre of pure alcohol over that period. Nevertheless – and in marked contrast to the previous years – this new approach led to bumper returns for the Treasury. Revenues have grown by almost a quarter, netting the Government an extra £735 million in total.[6]

The 2018 Budget was the most recent one in which spirits duty was frozen. And although full year results for 2019 are not yet available, reassurance can be taken from the 2016 freeze, which led to the biggest ever increase in Treasury revenues the following year, with a £270 million rise in the total revenue raised.

Though we await the full annual figures, early signs for 2019 are encouraging: whereas overall alcohol duty receipts have fallen by more than 2 per cent in the financial year to date, provisional figures for spirits duty receipts show it is the only category of alcohol to have increased its returns to the Government – providing more than £3 billion to Treasury coffers between February and November.[7]

Freezing or even cutting spirits duty hasn't just meant more money raised to fund public services, however. While it is true that spirits duty contributed £3.8 billion to the Exchequer in 2018/19,[8] the more sympathetic and fairer approach taken in recent years has had knock-on benefits in terms of export growth, industry investment, and customer satisfaction. The stable duty environment has given spirits producers the ability and confidence to invest, responding to changing consumer trends, demand for new products, and the potential that exists in new markets.

The possibility of export growth was clearly recognised by then-chancellor George Osborne when he announced the first cut in spirits duty in almost 20 years at the 2015 Budget. At the time he said he was backing "one of the UK's biggest exports" – and subsequent empirical data suggests his judgment was spot on.[9]

Since that point beverage exports have risen from just over £6 billion in 2015 to a record-high £8.3 billion in the year to February 2019. Beverages, underpinned by the hugely successful UK whisky and gin industries, are one of the few areas of goods trade in which the UK can boast a surplus, with significant exports to the world's richest countries – including the USA, China, and Japan. More than 42 bottles of Scotch whisky are shipped around the world every second.[10]

The more sympathetic domestic fiscal regime of recent years has also allowed the spirits industry to invest in its businesses and staff, and to create new products that meet the demands of UK customers. More than half a billion pounds of investment has been deployed over the last five years, and 180,000 people are now employed by the spirits industry with a further 100,000 in the supply chain.

Gin distilleries are opening at the rate of one a week, all around the country, and there are more than 200 more gins on the UK market than there were two years ago. A majority of UK spirits producers expect to increase production, employment, and exports over the next 12 months with obvious implications for business revenue and its associated tax contribution.

Perhaps most importantly, this new approach is leading to UK consumers escaping increased duty rates each year – meaning they're more likely to be able to afford the drinks drinks they want to buy. Sales of gin and whisky have both increased over the last five years and Britain's on-trade sales of gin were worth £1.65 billion in the year to September 2019.

The forthcoming alcohol duty review gives policymakers the chance to continue to put the interests of consumers first. Spirits are taxed at a far higher rate per unit of alcohol than any other alcohol category, penalising those consumers who prefer to consume them. A reduction in spirits duty would lead to more responsible drinkers being able to afford their tipple of choice, while not necessarily leading to any fall in the revenue raised for the Treasury.

The appeal of this approach is clearly understood within Government: the Prime Minister himself has spoken of his ambition to "alleviate duties" and the alcohol duty review provides just the vehicle which might allow this to happen.

The attitude taken to the taxation of spirits since 2014 has been an enlightened one. It has recognised that freezing – or even cutting taxes – won't necessarily lead to a dent in the public finances.

That five year period has seen three freezes as well as one cut in spirits duty. As well as more revenue being raised (receipts are up almost a quarter), the period has seen an increase in investment, growth in jobs, a surge in exports – and consumers more likely to be able to afford their drink of choice.

In other words, it's been a win-win. The Treasury would do well to remember these lessons as they embark upon the alcohol duty review.

3. The Additional Rate of Income Tax

For more than two decades following Nigel Lawson's 1988 budget, the highest rate of income tax in the United Kingdom was 40 per cent. There was a broad consensus that this top rate balanced the desire for a progressive tax system with the need to reward work and remain competitive internationally.

Things changed when the financial crisis struck. In his 2008 Pre-Budget Report, Alistair Darling announced that there would be a new, additional rate of income tax – levied at 45p on income over £150,000 – from April 2011.[11] This was part of a package of measures designed to repair the Government's finances once the economic downturn was out of the way.

Only a few months later, Darling revisited the issue as part of his 2009 Budget. Rather than introducing a 45p additional rate in 2011, he said, the Government would introduce a 50p additional rate, which would take effect from April 2010 – in clear breach of a 2005 manifesto promise.

The 2010 Budget Report spelled out the revenue increases that the 50p additional rate was expected to deliver: £1.3 billion in 2010/11, £3.1 billion in 2011/12, and £2.7 billion in 2012/13. Significant sums, clearly – but they also revealed something important about the impact the additional rate was expected to have.[12]

Had the Treasury simply taken all taxable income over £150,000 and multiplied it by the proposed change in the tax rate (10 per cent), they would have come up with very different (and much higher) revenue estimates: £6.5 billion for 2010/11, £6.9 billion for 2011/12, and £7.5 billion for 2012/13.[13] What explains the disparity?

Part of the difference comes from a different accounting basis being used for the two sets of figures. By far the larger part, however, stems from the "behavioural impacts" of the tax expected revenue from the additional rate by £4.1 billion in 2010/11, £4.5 billion in 2011/12, and £4.9 billion in 2012/13.[14]

In other words, the Treasury's own figures when they introduced the 50p additional rate suggested that it would only deliver one-third or so of the revenue in 2011/12 that a purely static analysis would suggest.

Why? Well, it all comes down to the anticipated response of those affected by the tax. People can reduce the amount of tax they pay by working less or giving more to charity. They might retire earlier, or put more into their pension. They could incorporate and take income as dividends or capital gains, or invest in tax avoidance schemes. Some people might even move abroad, while others might never come to Britain in the first place.

It's also important to note that specific budget costings like those above don't include the various second-round effects that might also reduce tax revenue. For example, higher taxes on income will presumably lead to lower consumer spending, which hits revenue from VAT and other excise duties. Likewise, if higher income taxes reduce economic growth, then revenues across the board will suffer.

All that being said the Treasury still expected a decent yield from the 50p rate when they introduced it – amounting, in short order, to several billion pounds a year. Given the state of the public finances at the time, one can see why the additional rate of income tax might have seemed like an appealing policy option.

Yet when Darling's successor as Chancellor – the Conservative George Osborne – asked HMRC to review the impact of the 50p additional rate ahead of the 2012 Budget, the results were striking. Indeed, Osborne was able to say that the 50p additional rate had caused "massive distortions" in its first year of operation, and was "harming the British economy".[15]

Determining the exact revenue impact of the 50p additional rate was no simple task for HMRC – precisely because the behavioural response had been so large. For one thing, there seemed to have been huge amounts of forestalling – of shifting income from one tax year to another – to avoid the 50p tax rate.

The scale of those changes tells its own story about the capacity of tax measures to affect behaviour. But the challenge for HMRC was to strip out this (presumably one-off) forestalling effect and get at the lasting revenue impact underneath.[16]

When all was said and done, HMRC concluded that the 50p additional rate was yielding 83 per cent less revenue than a pure static analysis would suggest.[17] In other words, it was raising much less money than even those seemingly cautious predictions from 2010 had forecast – so little, in fact, that it could be counterbalanced by falling revenues elsewhere in the tax system.

In response to these findings, George Osborne cut the additional rate to 45 per cent from April 2013, noting that once behavioural effects were factored in, the revenue loss from doing so would only be about £100 million a year – next to nothing in national fiscal terms.

The question today is whether that 45p additional rate could actually be even lower – or whether it could be abolished altogether – without significantly affecting tax revenues.

In truth, this isn't a straightforward question with a clear empirical answer. In economic terms, it all depends on the "taxable income elasticity" of the top 1 per cent of earners. This is a statistical measure of the extent to which taxable income tends to fall when effective marginal tax rates rise (or vice versa). And the trouble is that you can make a case for quite a broad range of taxable income elasticities based on the available data.

As part of the Mirrlees Review, for example, researchers estimated that the taxable income elasticity for the top 1 per cent was 0.46, which worked out to a total revenue-maximising marginal tax rate 56 per cent. Once they had taken account of National Insurance and indirect taxes, that implied a revenue-maximising top income tax rate of around 40p – below the current level.[18] It's worth noting, too, that both NICs and VAT are levied at a higher rate now than they were then.

HMRC's review of the 50p rate reached a similar conclusion. It suggested a taxable income elasticity of 0.48. Interestingly, the Government then assumed a slightly lower elasticity when making the case for the revised 45p additional rate. A cynic might suggest they wanted to avoid the politically awkward finding that it would be better to get rid of the additional rate altogether, rather than simply cutting it to 45p.[19]

More recently, a trio of working papers from the Institute for Fiscal Studies examined the introduction of the 50p additional rate in greater detail, and found that you could credibly defend a wide range of taxable income elasticities depending on exactly how you approached the data. Some would permit a revenue-maximising top rate higher than 45p, but many others "imply that the revenue-maximising top rate of income tax would be less than 40 per cent, let alone 50 per cent." [20]

So what can we really say about the additional rate of income tax with any degree of certainty? For one thing, it's clear that tax rates do affect behaviour – and especially so among the highest earners. It's therefore unlikely that raising the top rate would yield much extra revenue. Similarly, it is quite reasonable to argue we could lower or even abolish the additional rate without suffering any corresponding revenue loss. But there's no way to be completely sure until we try it.

Ultimately, though, the ins and outs of the taxable income elasticities of the top 1 per cent are somewhat beside the point – at least for our present purposes. What's clear is that the decade-long experience of the additional rate of income seems to confirm the thesis of this Pointmaker: namely, that cutting tax doesn't (always) cost as much as you think.

Conclusion

This Pointmaker has examined three particular instances in which a tax could be reformed, cut, or even abolished without causing insurmountable revenue losses for the Government. We have looked at a property tax (Stamp Duty Land Tax), a consumption tax (spirits duty), and a tax on earnings (the additional rate of income tax). And in each case, the message has been the same: politicians and officials should take greater account of the dynamic effects of tax changes when developing and setting policy.

Addressing the iniquities of Stamp Duty Land Tax should be a priority for the new Government. Our research suggests that SDLT could be abolished for primary residences at a revenue cost of just £3.3 billion. Our proposal for a comprehensively reformed stamp duty would be even cheaper – losing the Exchequer just £1.6 billion. Bold action on SDLT might even produce secondary revenue effects that outweigh any such initial losses. Frankly, the Government has little excuse for inaction on this front.

Spirits duty is an area where policy is already heading in the right direction, with three duty freezes and one duty cut since 2014. The result has been strong revenue growth – much stronger than earlier in the decade, when duties were hiked precipitously – and an investment boom in the UK spirits industry. Just as importantly, consumers are getting the products they want at a fairer price. Looking forward, there may be scope to further cut spirits duty without hurting revenues. The Government should seriously examine this possibility as part of the forthcoming alcohol duty review.

The additional rate of income tax has been controversial from the very start. In its initial, 50p guise, the additional rate was clearly too high – the little revenue it appeared to generate could well have been outweighed by corresponding losses elsewhere in the tax system. At 45p, the additional rate is harder to judge, but there but there remains a plausible case that this is above the revenue-maximising rate for the highest earners (especially given changes to VAT, National Insurance, and capital gains tax since 2012). The Government should launch an in-depth review of the additional rate, and should not shrink from abolishing it – and returning to the 40p top rate that prevailed from 1988 to 2010 – if that's where the evidence leads.

More broadly, the Government's tax policy-making would be helped significantly by the development of a more sophisticated tax and growth economic model at the Treasury, which would allow them to more comprehensively assess the dynamic effects of changes to the tax system. Making such a model "open source" would aid transparency, and also help independent groups to develop robust research agendas on growth-promoting tax reform.

It is unfair to blame the Treasury entirely for this, however. Many within it appreciate the force of these arguments. However, the Office for Budget Responsibility – which effectively marks the Treasury's homework – prefers to stick to more static revenue estimates when making its forecasts and assessing the Government's fiscal plans. We suggest that the OBR's guidance could be updated so that it is allowed – or even encouraged - to make greater use of credible dynamic modelling as it carries out its vital work as the watchdog of the public finances.

There was a time when tax rates across the developed world were so high that broad-based tax cuts really did pay for themselves. For the most part, that isn't the situation we find ourselves in today. Nevertheless, there remain plenty of specific instances – not least those outlined in this Pointmaker – in which judicious tax reform could have very beneficial dynamic effects. As a consequence, it is still true to say that cutting tax need not cost nearly as much as you might think.

References

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11 The story of the additional rate of income tax is well covered in Antony Seely, “Income tax: the additional 50p rate”, House of Commons Library (September 2018). This section owes much to Seely’s comprehensive analysis.

12 HM Treasury, “Budget 2010”, p. 140.

13 HM Revenue & Customs, “The Exchequer effect of the 50 per cent additional rate of income tax” (March 2012), p. 14.

14 Ibid., p. 16.

15 The text of George Osborne’s 2012 budget speech is available here

16 Remarkably, the 2010/11 self-assessment data suggested that incomes for those earning £150,000 or more had risen by 14 per cent in 2009/10 but then fallen by 25 per cent in 2010/11; dividend income went up by 78 per cent and then fell by 73 per cent.

17 HM Revenue & Customs, “The Exchequer effect of the 50 per cent additional rate of income tax” (March 2012), p. 40.

18 As summarised in Institute for Fiscal Studies, *Tax by Design: The Mirrlees Review* (September 2011), p. 109.

19 See Rory Meakin, “Productivity Dirty Dozen: 12 Policy Failures”, TaxPayers’ Alliance (April 2018), p. 18.

20 James Browne and David Phillips, “Estimating the responsiveness of top incomes to tax: a summary of three new papers”, Institute for Fiscal Studies (August 2017), p. 6.

ABOUT THE CENTRE FOR POLICY STUDIES

The Centre for Policy Studies was recently named by Conservative MPs polled by ComRes as the most influential think tank in Westminster. Its mission is to develop policies that widen enterprise, ownership and opportunity, with a particular focus on its core priorities of housing, tax, business and welfare. As an independent non-profit think tank, the CPS seeks likeminded individuals and companies to support its work, but retains editorial control of all of its output to ensure that it is rigorous, accurate and unbiased.

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