Centre for Policy Studies

Pointmaker

EASE THE SQUEEZE

TAX CUTTING PRIORITIES IN AN AGE OF AUSTERITY

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SUMMARY

A responsible approach to 'tax and spend' policy should promote honest debate about the UK public finances by:

- mandating the OBR to audit 'tax and spend' promises in the main parties' manifestos;
- examining further long-term savings from government spending to cut debt and fund tax cuts.

Cut taxes to promote economic growth, by:

- cutting government spending by £17.6 billion to fund tax cuts in the near term;
- committing to reduce the tax burden in the next Parliament, not raise personal direct taxation, and apply a 1-in-1-out tax rule;
- prioritising 'economic' tax cuts to national insurance, corporation tax and business rates, over 'political' tax cuts.
- raising employers' NICs threshold by £1,000;
- freezing business rates, and exempting small businesses from business rates indefinitely;
- merging national insurance and income tax by 2020.

Cut taxes for the lowest paid and ease the middle-class squeeze by:

- cutting levies subsidising green technologies, saving £56 on the average annual energy bill;
- raising the entry threshold for employee NICs to £10,000 per year;
- consolidating income tax into two rates, 15% and 35%; starting by cutting the basic rate from 20% to 19% and the higher rate from 40% to 39%;
- committing to long-term indexation of the basic rate limit of income tax to inflation, and ruling out 'wealth taxes';
- indexing employee national insurance thresholds and limits to inflation through primary legislation;
- ruling out a new 'mansion tax';
- abolishing stamp duty for homes under £500,000 to support home-ownership, saving the average home-buyer around £7,500;
- indexing the remaining stamp duty thresholds to house price inflation through primary legislation.

INTRODUCTION: ECONOMIC CONTEXT, POLITICAL PRIORITIES

A lower spending, less taxing approach to deficit reduction

With less than 18 months until the next General Election, the main political parties are expected to articulate their future tax and spending policy priorities. Whilst businesses and families yearn for an easing of the tax burden, which tax-cutting sweeteners can we afford, and which should we prioritise?

According to data from the Office of Budget Responsibility (OBR), between 1997/98 and 2017/18, the tax burden will have increased by 49%, or 1.3 percentage points as a proportion of gross domestic product (GDP).[1]

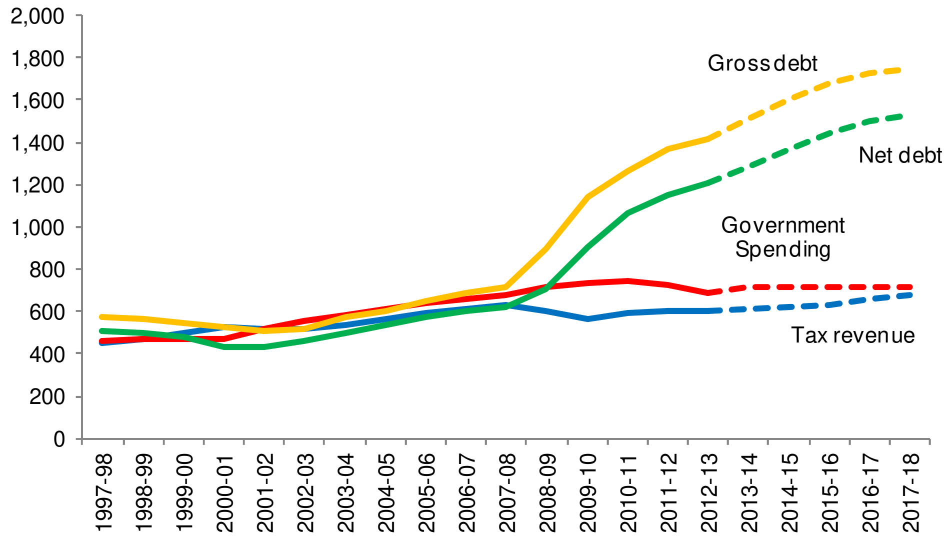
During the 13 years of Labour Government, a total of £7.1 trillion was collected in tax revenues. Tax revenue steadily increased under Labour until it peaked in 2007/08 and then declined in the last two years. In real terms (2013/14 values), tax revenue increased by 40%, from £453 billion in 1997/98 to £634 billion in 2007/08. In the last two years of Labour Government, tax revenue declined by £70.8 billion, from £634 billion in 2007/08 to £563.2 billion in 2009/10.

The tax burden has risen further under the Coalition. In 2010/11, the total tax revenue collected was £591.1 billion or 36.9% of GDP. Since 2010/11, it has increased by 3.6 percentage points or £21.3 billion, with tax revenue expected to be £612.4 billion this year. Tax revenue as a percentage of GDP has risen to 38.4%, the highest under the Coalition, surpassing Labour's peak of 38.3% in 2000/01.

The rise in total tax revenue is set to continue each year, according to OBR forecasts, which continue until 2017/18. Compared to 2010/11, tax revenue in 2017/18 is forecasted to rise by a total of £82.8 billion – an increase of 14%.

1 The data on UK tax revenue was collated by the House of Commons library from Office of Budget Responsibility data. Unless otherwise stated, all figures in this report reflect their 2013/14 value.

Chart One: UK government spending, debt and tax revenue (£billions, 2013/14 prices)



Source: Public Services Databank, OBR, October 2013.

According to a survey by the Organisation for Economic Cooperation and Development (OECD), the UK ranked 15th out of 34 countries in 2010 for the highest total tax revenue as a proportion of GDP, rising to 14th in 2011 – higher than the US, Canada, Japan, Australia, Ireland or Switzerland.[2] The only countries taxed more heavily are European.

Chart One shows the trends – actual and forecast – of UK government spending, debt and tax revenue between 1997/98 and 2017/18.

The balance between cutting public expenditure and increasing taxation was extensively considered by the Coalition in formulating its plan to cut the structural deficit. In the 2010 budget, the Chancellor announced his intention to achieve fiscal consolidation through an 80:20 ratio of spending cuts to tax rises. In his statement to the House of Commons, the Chancellor said:[3]

'The Coalition believes that the bulk of the reduction must come from lower spending rather than higher taxes. The country has overspent; it has not been under-taxed. Our approach is supported by the international evidence, compiled by the OECD, the International Monetary Fund and others, which found that consolidations delivered through lower spending are more effective at correcting deficits and boosting growth than consolidations delivered through tax increases.

That is the origin of our 80:20 rule of thumb- roughly, 80% through lower spending and 20% through higher taxes. This evidence has been available in the Treasury for some time, but was published only in a redacted form by the previous Government. We intend to follow international best practice and the Treasury's own analysis. My measures today mean that 77% of the total consolidation will be achieved through spending reductions and 23% through tax increases. I believe this gets the balance right.'

Given the economic challenges faced, the 80:20 ratio has not yet been achieved. According to the Treasury forecasts, it won't be reached until the financial year 2015/16.

Analysis by the Institute for Fiscal Studies (IFS) ahead of this year's Budget suggests that, of the 37% of total fiscal consolidation estimated then to have been achieved by the end of fiscal year 2012/13, tax rises and investment spending cuts have been heavily front-loaded compared with spending restraint. In particular, the IFS estimates that, since the March 2008 budget, 79% of the announced tax rises will have been implemented by the end of 2012/13, compared to 30% of the announced spending cuts.[4] The IFS view is that any Government after the next election will be tempted to abandon planned spending reductions and, instead, raise taxes further.

This would be economically damaging. The debate about the impact of austerity on the economic recovery has been intense, and remains contentious. However, it is widely accepted that we must bring government spending back down to sustainable levels. An approach that adopts a higher tax, higher spending strategy to close the gap in the public finances would have far-reaching implications for UK competitiveness. There is a substantial body of evidence showing the long-term dampening effect of high public spending coupled with a high tax burden. For example, tax expert Richard Teather has shown that when

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2 OECD, Revenue Statistics.

3 Hansard, 22 June 2010.

4 *Public Finances: outlooks and risks*, IFS Green Budget 2013 Chapter 5, February 2013

public spending rises above 42% of GDP it has a clear and damaging effect on jobs growth.[5]

Similarly, there is empirical evidence to demonstrate that a higher tax to GDP ratio has a negative effect on real GDP per capita growth. Analysis of OECD countries between 1965 and 2010 shows that a higher tax to GDP ratio of 10 percentage points is found to lower annual per capita GDP growth by 1.2 percentage points.[6] Similarly, a European Central Bank Working Paper Series analysed the effects of government revenue on growth in OECD and EU countries between 1970 and 2004.[7] The study showed a percentage point increase in the tax revenue to GDP ratio would decrease output growth by 0.12 percentage points. Following extensive research, the 2012 final report by the 2020 Tax Commission concluded that both the UK's public spending and tax burden needed to be reduced to 33% to optimise economic growth.

With UK public spending still currently at 48.4% of GDP (on the OECD measure) and the tax burden at a historic high of 38.4%, there is still a long way to go to deliver an economic model that realises Britain's full potential in an increasingly competitive and globalised economy. If the UK wants a dynamic economy, it needs to take the smaller government path to deficit reduction.

Who pays?

Who is bearing the brunt of the rising tax burden and the legacy of profligate government spending? Based on ONS data comparing 2009/10 to 2011/12, total tax as a proportion of gross income (including earned income and cash benefits) has increased for all households except the very poorest. Those in the bottom decile have seen total tax as a proportion of gross income decline by 0.3 percentage points. All other households have shouldered an average increase of 1.6 percentage points.[8]

Similarly, for all the political hubris, last year those earning between £10,000 and £15,000 per year paid a quarter less income tax than they did in the last year of the last government – while those earning over £1 million paid a quarter more.[9]

Analysis of the effective rate of taxation – taking into account benefits received, as well as taxation levied – shows an even starker shift over time. In 1990, households in the middle quintile group – now earning an average of £22,482 per year – paid a net rate of over 8% in taxes. By 2010/11, their effective tax rate was -20%. Only those in the top two quintiles paid substantial net taxation, with a tipping point reached at an income of around £33,000 – amongst the non-retired – where the average household became a net contributor of tax.[10] Working households with an income over £40,000 are being hit increasingly hard.

The geographical impact of these trends is also significant, given median gross weekly earnings are 10% higher in the South East and 22% higher in London than the UK average.[11] As a result, in London and the South East, the

5 R Teather, *Lower Public Spending leads to more jobs*, Institute for Economic Affairs, 23 June 2010.

6 R Bourne and T Oechsle *Small is Best – Lessons from Advanced Economies*, Centre for Policy Studies, 2012.

7 European Central Bank, Working Paper Series, No. 849, January 2008.

8 Based on ONS data provided to the Centre for Policy Studies.

9 *Income Tax Liabilities by Income Range,* HMRC, 2013.

10 R Bourne, *The progressivity of UK taxes and transfers*, Centre for Policy Studies, 2012.

11 *The Single Income Tax*, 2020 Tax Commission, May 2012, at page 167.

proportion of higher rate taxpayers (those earning over £41,450) is now almost double that in the north of England.

So, while the Government has taken over 2 million low paid workers out of income tax and the wealthy are more mobile and cushioned from the substantial additional burden they are shouldering, the squeezed middle classes are facing an increasing strain.

Tax cuts require greater spending restraint
Given the backdrop of a still huge deficit, Britain has minimal scope for tax cuts without significant extra savings in government spending. UK gross government debt stands at 94% of GDP, double its level in 2000, and is on course to top 100% of GDP in 2016.[12] Public spending remains stubbornly high.

Successive governments have benchmarked the UK economy by reference to the World Economic Forum's (WEF) international competiveness rankings. Under Labour, Britain fell from 4th to 13th. Under the Coalition it climbed back up to 8th place, but this year fell back to 10th place. The WEF blamed 'an increase of over seven percentage points in public debt' and 'a comparatively low national savings rate' for the UK dip.

Against these challenging financial conditions, is there any room for tax cuts? Even before consideration of tax cuts, public spending should be further reduced, in order to put total government spending on a more sustainable basis – below 40% of GDP – and place government debt on a downwards trajectory, to avoid it surpassing 100% of GDP. Britain has no financial cushion to allow for large tax cuts given stubbornly high levels of public expenditure.

So this paper sets out funded tax and spending proposals that will facilitate private sector growth, whilst alleviating the tax burden on lower and middle-income working families.

THE NEED FOR HONEST DEBATE

Proposal 1: Mandate the OBR to scrutinise tax and spend plans in the main parties' manifestos
The first imperative is to facilitate a more candid debate about the long term state of the public finances. Labour Shadow Chancellor Ed Balls recently called on the Treasury to mandate the OBR 'to independently audit the costings of every individual spending and tax measure in Labour's manifesto at the next election'. In particular, he suggested that any political party with at least 5% of seats in the House of Commons could request an audit from the OBR on their policy costings before a general election.[13] The proposal was supported, in principle, by Andrew Tyrie MP, chairman of the Treasury Select Committee.[14]

There are reasonable arguments against this idea, from the fact that the Chairman of the OBR is a political appointment, to the difficulty in establishing objective assumptions for the audit process.[15]

Yet if the independent OBR cannot provide some basic financial costings of political commitments when it comes to tax and spend proposals, what chance does the average voter have of making a reasonable assessment? Within set parameters, the OBR could provide some reasonable costings based on objective assumptions to encourage

[12] IMF World Economic Outlook, April 2013.

[13] Reported widely, including in the *New Statesman*, 14 October 2013.

[14] As reported in *The Guardian*, 15 October 2013.

[15] See the column by Ryan Bourne for Conservative Home, 15 October 2013.

political parties and the public to engage in a broader longer-term debate about the state of the public finances and its impact on our prosperity. The Treasury Select Committee should report on the practicability of mandating the OBR in this way, with a view to establishing a voluntary audit process that can better inform public debate.

Proposal 2: Initiate an honest debate about public spending

In terms of our underlying economic competitiveness and social priorities, the UK needs a more honest debate about the sustainability of government spending. In particular, self-imposed political constraints on consideration of contentious areas of government spending should be lifted.

To facilitate a more open public debate about social priorities and financial sustainability, the scope for potential savings should be examined in the following areas:

- Cutting the number of government departments and agencies in Whitehall;
- Ending the ring-fencing of specific departments or areas of spending;
- Ending universal welfare, including means-testing 'grey welfare' (pensioners' benefits), to return the welfare system to a safety net focused on those in greatest need rather than a means of re-distribution of wealth;
- Linking public sector pay to local cost of living; and
- Moving towards a more contributions-based model of welfare and healthcare.

The objective should be to find long-term savings to pay off the national debt sooner, as well as reduce the tax burden.

Proposal 3: Make £17.6 billion of savings in government spending to fund tax cuts

In addition to this longer-term review, the following particular savings should be made, to fund the specific tax cuts set out in this report in the near term:

- Halving the number of separate Whitehall departments, saving £8 billion per year.[16]
- Rigorously implementing public sector pay limits, saving £2.4 billion per year.[17]
- Instituting a three year cash freeze on benefits, except the state pension and pension credits, saving £3.4 billion per year.[18]
- Reducing the welfare cap from £26,000 per household to £20,000, saving £840 million per year.[19]
- Making £3 billion per year of initial savings from 'middle-class' welfare.[20]

Proposal 4: No additional taxes for 5 Years

The Conservatives should show they are different from previous Governments, which have almost always raised taxes after elections. The Chancellor has already stated that a Conservative Government would not need to raise taxes after the election to eliminate the budget deficit. In July, he told the Treasury Select Committee that:[21]

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16 D Raab, *Weight Watchers for Whitehall*, Free Enterprise Group, 2013.

17 Ibid.

18 *The Institute for Fiscal Studies Green Budget*, February 2013.

19 Treasury estimates, report in The Sunday Times, 16 July 2013.

20 For a menu of options for immediate savings, see *Osborne's Choice*, the Social Market Foundation, 2012, which identified £15 billion worth of savings; and *The End of Entitlement*, Reform, 2009, which identifies £31 billion worth of savings.

21 Reported, The Guardian, 11 July 2013.

'The further consolidation after 2015/16 is built into the tables as a spending reduction. I am clear that tax increases are not required to achieve this. It can be achieved with spending reductions'.

This important commitment should be formalised before the next election. The Conservatives should also promise to reduce the overall tax burden, if elected, between 2015 and 2020. In addition, they should pledge not to increase personal direct taxation (such as income tax, national insurance or inheritance tax); and to apply a One-In-One Out rule to any other new taxes, so that the net burden of any changes cannot increase the overall burden.

This would not rule out all new taxes, but it would prevent an increase in the overall tax burden, protect the middle classes from stealth taxes, and ensure that any new taxes are off-set by tax cuts elsewhere. Overall, this certainty would help strengthen the economic recovery and the UK's underlying competitiveness, whilst forcing a stronger focus in political debate on reducing government spending.

ECONOMY FIRST

Proposal 5: Economic tax cuts trump political ones

All tax cuts have an economic impact, but some are more overtly political than others. For example, some tax cuts might target a particular cluster of voters, rather than being designed explicitly for the best effect on economic growth, productivity and competitiveness.

The temptation to offer political tax cuts (such as those relating to inheritance tax, the personal allowance, child-care or recognising marriage in the tax system) is greatest in the run-up to a General Election. Such cuts can often have some clear economic and social merit. Yet, given the fragile state of the public finances and the challenge of raising the UK growth rate in a dynamic global economy, tax cuts that strengthen economic performance should be a higher priority.

Therefore, pledges of affordable tax cuts should first prioritise and focus on the scope for promoting business expansion, boosting trade and encouraging firms to hire. That is the surest way to increase employment and broaden economic opportunities – in a way that benefits everyone. In reality, this is not solely an economic priority, but also a social one, since there are still nearly 2.5 million unemployed and youth unemployment has remained stubbornly high – despite recent jobs growth – at 21%.

There has been extensive research on how to cut taxes to boost economic performance.[22] In the short term, the first priority should be to further reduce corporation tax, national insurance and business rates – because these are the measures most likely to generate the greatest economic gains.

Proposal 6: Cut employer's national insurance to create jobs

One of the most economically efficient ways to boost jobs growth is to reduce the costs of hiring by cutting employer national insurance contributions. Increasing the threshold by £1,000 to £8,696 per year would achieve this in a way that incentivises the hiring of young, low-paid, lower-skilled and part-time workers (compared to cutting the rate).[23] This would cost an estimated £3 billion per year.

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22 See recently, for example, *The Single Income Tax*, note 11 above; and *Sharper Axes, Lower Taxes*, IEA, 2011.

23 This measure has been endorsed by the Confederation of British Industry, *Tax in a Global Economy,* July 2013.

Proposal 7: Freeze business rates, extend small business relief

Dragon's Den star Theo Paphitis has referred to the 'ticking time bomb' of business rates choking the high street, particularly small businesses. Business rates can produce arbitrary results. Based on floor space, a boutique jewellers can pay less than a struggling butcher, who needs more space for refrigerated storage. Equally, given fierce competition from online retailers, business rates tilt the playing field against the High Street.

Revenue from business rates is at record highs. According to the Federation of Small Businesses, rates are the third biggest cost for many small businesses after rent and wages. This will only get worse when the temporary small business rate relief runs out next year, pushing up tax bills by up to £1,386.

Over the long-term, business rates should be scrapped because they distort the economy. In the short-term, the high street needs urgent relief: small businesses should be exempted indefinitely, and rates frozen for all other businesses. This would cost an average of £2.7 billion per year for the next three years.[24]

CUT TAXES FOR THE LOWEST PAID, EASE THE SQUEEZE IN THE MIDDLE

If savings in public spending are found for financially responsible economic and political tax cuts, where should the latter be directed?

For sound economic and social reasons – including incentivising work, and alleviating the cost of living – all the main political parties have targeted tax cuts aimed at low paid workers. Equally, it is right that those on very high incomes should be expected to bear a heavier burden of taxation.

However, the burden on those in between those two poles has also increased substantially. Whether measured by average salary or the more opaque definition of the middle-classes, the 'squeezed middle' has faced a significantly increased tax burden. On economic grounds, as well as a matter of fairness, there is a strong case for easing the tax squeeze on these households. This strengthens the argument that, if tax cuts are to be offered to the low paid, they must be funded through reduced government spending: middle-class Peter should not be robbed to pay working-class Paul.

Income Tax cuts

The amount of income tax revenue raised increased from 23% to 26% of GDP between 1997 and 2012.[25] According to the OBR, income tax revenue will rise by a further £31 billion over the next four years.[26]

Despite this rising burden, the Government has used increases to the personal allowance to take 2.4 million low paid out of income tax altogether.[27] In contrast, since 2010/11, the number of people sucked into paying the higher (40p) rate of tax has increased by 1.3 million or 43%, because the basic rate limit has not risen in line with inflation.[28]

The number of higher rate taxpayers has more than doubled since 1997/98, from 2.1 million to 4.3 million. So while the amount of income tax collected from the basic rate has declined by £9 billion (10%) since 2010/11, the amount collected through the higher rate – those now

24 Data from the Office of Budget Responsibility, March 2013.

25 Based on ONS data compiled by the House of Commons library.

26 OBR, *Economic and Fiscal Outlook*, March 2013.

27 Written answer to Philip Hollobone MP, 13 September 2013, Hansard.

28 HMRC, *Income Tax Liabilities statistics*, April 2013.

earning over £41,450 – has increased by £12 billion (33%), in part as a result of fiscal drag.

Those earning £41,450 may be considered affluent in certain parts of the country. However, it remains below the mean salary in London, and is increasingly sucking in middle income earners in more expensive parts of the country – rather than just the rich.

Using fiscal drag to broaden the tax base and increase the number of people paying higher marginal rates may be an expedient way to fund tax cuts for the lower paid. However, it hits middle-class earners particularly hard and has a broader negative economic impact due to incentives.

In a recent analysis of US tax policy since 1950, Karel Mertens found that lower tax rates lead to increased reported income with the effect growing over time.[29] Furthermore, he showed that raising marginal tax rates to resolve budget deficits comes at a high economic price, whereas a proportional across-the-board tax cut does not necessarily lead to greater income concentration at the top.

So, if the politicians want to further ease the burden on the low paid, how should this be achieved?

Liberal Democrat leader Nick Clegg has proposed raising still further the income tax personal allowance, so that no-one earning the minimum wage would pay income tax.[30] This would effectively extend the personal allowance in 2015/16 from £10,000 to £12,500, at an estimated 'cost' of £7.7 billion per year in lower tax revenue. As yet, there are no clear details as to how it would be funded.[31] Although touted as a measure to help the low paid, it does not target many of the very the lowest paid. The five million earning below £10,000 would gain nothing. Only around 10% of the cost of the policy would go towards those earning between £10,000 and £12,500.[32] Whilst it might make sense as a long-term ambition, right now it appears an expensive political sweetener that is poorly targeted, and won't help those at the bottom of the income ladder.

Addressing the same area, Labour party leader Ed Miliband has advocated wider adoption of a 'living wage' of £7.65 per hour. However, this would raise costs for businesses, estimated at £2,500 per year per worker, which would risk increasing unemployment. As *The Economist* recently observed in the context of Labour's proposal: 'Firms are not flush: the trade-off between pay and jobs is a real one. That means making workers more costly would be dangerous.'[33]

Proposal 8: Raise the threshold for employees' national insurance contributions

In order to further support the lowest paid, government should prioritise raising the threshold for employees' national insurance contributions, from its current level of £7,755, to keep pace with the personal income tax allowance.

As the Resolution Foundation (a think tank specialising in low pay) argues, this would better target the lowest paid.[34] Raising the

29 *Marginal Tax Rates and Income: New Times Series Evidence*, Working Paper 19171 National Bureau of Economic Research, Karel Mertens, June 2013.

30 Liberal Democrat party conference, reported 15 September 2013.

31 Nick's blog, Institute for Public Policy Research, 16 September 2013.

32 See the analysis by James Plunkett, Resolution Foundation, *The Times*, 15 October 2013.

33 *The Economist*, 9 November 2013.

34 See footnote 34.

employee national insurance threshold to £10,000 in 2014/15, in line with the income tax personal allowance, would cost an estimated £5 billion per year, saving a worker earning £10,000 a sum of £269 per year.[35]

Proposal 9: Cut the Basic Rate of Income Tax by 1%

More broadly, in the interests of economic growth and making sure hard-work pays, we need to reduce marginal rates of income tax.

Given the limitations imposed by current debt levels, this will need to be achieved incrementally. The Conservatives should adopt the medium-term aim of moving to two lower rates of income tax – reducing the basic rate of taxation to 15%, the higher rate to 35%, and abolishing the 45% rate.

As a fiscally responsible first step, given the rising cost of living and increased tax burden on middle-income earners, the basic rate of income tax (20%) on income between £9,440 and £32,010 should be cut by 1% in 2013/14. That would cost £3.7 billion per year, saving the average full time worker – earning £31,739 – £225 per year.

Proposal 10: Cut the Higher Rate of Income Tax by 1%

In addition, given the increase in the number of higher rate taxpayers, and the rising tax burden on middle-class families, the higher rate should be cut by 1% in 2013/14. That would cost around £600 million per year, and save the average high rate taxpayer – earning £68,400 – £590 per year.[36]

Proposal 11: Commit to long-term indexation of the basic rate limit and rule out a wealth tax on those earning over £50,000

Given the major impact of fiscal drag, drawing more middle income earners into the higher rate of income tax, government – and all political parties – should make a long-term policy commitment to raise the basic rate limit (which marks the higher rate threshold) in line with inflation, to ensure that tax cuts for the lowest paid are not funded by higher taxes imposed on the middle-classes.[37]

Similarly, the Liberal Democrat policy of imposing a 'wealth tax' on anyone earning over £50,000 per year has all the hallmarks of a stealth tax that would over time draw in the middle classes.[38] It should be ruled out.

National Insurance

Between 1997 and 2012, total national insurance revenue rose by a half, from £69.7 billion to £104.4 billion, an increase of 0.7 percentage points as a share of GDP and 1.5 percentage points as a share of total tax revenue.[39] Between 2004 and 2012, employee national insurance contributions rose by £1.4billion – around 3% – most of which has occurred since 2010.

Between 2009/10 and 2011/12, a significant additional burden has been shouldered by those in the fifth to tenth highest deciles, ranked by disposable income of non-retired households. In practice, that means working homes with an income over around £20,000.[40]

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35 Based on data for 2013/14, derived from *Direct effects of illustrative changes*, HMRC, March 2013. The calculation of the amount of tax saved on earnings of £10,000 dates from 2014/15, when the personal allowance is extended.

36 Ibid.

37 The indexation should follow CPI inflation, in accordance with shift in wider government policy.

38 Liberal Democrat media advice to MPs, Liberal Democrat party conference, 16 September 2013, at paragraph 3.

39 ONS data collated by the House of Commons library, October 2013.

40 The extra burden is calculated as a share of gross income, data provided by the CPS.

Proposal 12: Restrain fiscal drag in employee national insurance contributions

In order to protect middle-income families from incremental increases in their national insurance contributions, the earnings threshold and limits should be immediately indexed to inflation in primary legislation, with a power to increase the primary threshold above inflation through secondary legislation, but a requirement that any real terms increase in the upper limit be enacted only through primary legislation. That would safeguard middle income families from an increase in the tax burden through secondary legislation without proper Parliamentary scrutiny.

Proposal 13: Merge National Insurance and Income Tax

The duplication of income tax through the national insurance system has long since ceased to serve any functional purpose. It creates additional levers to increase the tax burden on individuals and employers, which impairs economic competitiveness and disproportionately hits the middle-classes.

It also obscures the true nature and scale of taxation, undermining transparency for taxpayers. It adds substantial administrative costs for government, as well as individuals and businesses. The Conservatives should pledge to abolish national insurance, and merge it with income tax by the end of the next Parliament in 2020.[41]

Stamp Duty

Under the previous thirteen years of Labour Government, stamp duty revenue from the sale of property rose from £4.9 billion in 1997/98 to a peak of £16.3 billion in 2007/08, which then amounted to 2.6% of total UK tax revenue (up from 1.1%).[42] More recently and despite the housing slump, stamp duty revenue increased by £800 million in real terms between 2009/10 and 2012/12.

The significant rise during the Labour years was largely a result of the Labour Government introducing the £125,000 (1%) and £250,000 (3%) thresholds and rates.[43] The stamp duty rate on properties over £250,000 was designed to catch the wealthy. Today, because of fiscal drag, it is a punitive tax on aspirational home-buyers.

Analysis provided by London Central Portfolio in conjunction with Cass Business School highlights the impact. The average UK home price in 2000 was £109,558. By 2012, it had reached £249,958.[44] Since 1997, the nominal cost of the average property has trebled. What does this mean in practice for home-buyers?

In 2000, 391,499 home sales were exempt from paying stamp duty. By 2012, only 152,398 escaped the tax. In 2000, only 6% of purchases under £500,000 paid the 3% rate. By 2012, 25% of households were caught. In 2000, £724 million was collected through the 3% band for homes over £250,000 – whereas in 2012, £1.9 billion was collected.

41 The case for merger, and reference to recent studies of the proposal, is set out in The Single Income Tax, note 11 above, from page 307. See also *Abolish NICs: Towards a more honest, fairer and simpler system*, David Martin, Centre for Policy Studies, November 2010.

42 HMRC Stamp Tax statistics, September 2013. Total stamp duty revenue is not broken down by land and shares until 2001/2.

43 The £125,000 threshold was introduced in 2006/07, rising from the £120,000 introduced in 2005/06, which replaced the £60,000 threshold which was introduced in 1993. The £250,000 threshold was introduced in 1997 and was then incrementally raised from a rate of 1.5% to 3%, in 2000, where it has remained since along with the £125,000 threshold and 1% rate.

44 Data provided by London Central Portfolio, residential experts, in conjunction with Cass Business School, October 2013.

To make matters worse for the squeezed middle, 2013 is the first year that the average house price has risen above the 3% threshold of £250,000.[45] Far from a tax on the rich, this year the 3% rate will hit the average home-buyer for a stamp duty bill of around £8,000 – up from £7,500 a year ago.[46]

The fiscal drag sucking in middle-class home-buyers has taken place because the thresholds have not risen in line with inflation. If the original thresholds in place in 1997 had been adjusted in line with house price inflation, the current 1% rate would today only apply to properties over £153,000 (as opposed to £125,000) and the 3% rate would only apply to properties over £1.26 million (as opposed to £250,000).[47]

International comparisons highlight the scale of these trends. According to the OECD, property taxes in Britain are the highest in the OECD, double the international average.[48] The case for reform is compelling, on grounds of fairness and economic efficiency.

Furthermore, analysis by the UK Council of Mortgage Lenders (CML) shows that more than three-quarters of stamp duty revenue now comes from purchases over £250,000.[49] There are also strong regional differences: almost half of first-time buyers in London pay the 3% rate or higher – up from a quarter six years ago. The average house price in Greater London is now £475,000.[50] Equally, the proportion of stamp duty paid by English home-buyers now accounts for 94% of the total – compared to 4% in Scotland and less than 2% in Wales. More broadly, according to the CML, 'by discouraging transactions, stamp duty reinforces inefficient use of existing housing and therefore worsens the problems caused by the shortage of supply'.

The acute shortage of homes in the UK needs to be addressed through both increased supply and tax reform. The Coalition is taking various measures to promote home-building, which will take time to bear fruit. In the short term, making it easier to buy property through state-backed mortgage guarantees carries the risk of promoting irresponsible lending and further inflating household debt. Therefore, there is a strong case for reducing the tax burden and stemming the process of fiscal drag, which will facilitate home-buying by giving purchasers back more of their own money rather than increasing the already precarious levels of debt.

Proposal 14: Rule out any 'Mansion Tax'

Given the experience of fiscal drag with stamp duty, a new property tax – often referred to as a 'mansion tax' – would risk dragging in middle-class homes over time. Given the likely increase in property prices in the future, a threshold of £1 million (or even £2 million) today would in time apply to middle-class homes, not just the super-rich. It should be ruled out.

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45 According to Land Registry data, Q3, 2013.

46 For the future effects of fiscal drag on home-buyers, see *Stamp Duty Prices*, Research Note 120, Taxpayers Alliance, August 2013.

47 Land Registry data, collated by the House of Commons library.

48 *Taxing Issues?, Reducing housing demand or increasing house supply*, Policy Exchange, November 2013.

49 *Stamp duty: growth in revenue reinforces case for reform*, Council of Mortgage Lenders, November 2013.

50 BBC reporting, based on Land Registry data, October 2013.

Proposal 15: Abolish stamp duty on homes under £500,000

The scale of fiscal drag since 1997 has been compounded by its forecasted continuation. The arrival at a tipping point where the price of an average home is caught by the 3% rate, along with regional disparities, provides a strong economic and social case for cutting stamp duty now.

Therefore, the 1% rate on properties between £125,000 and £250,000, and the 3% rate on properties between £250,000 and £500,000, should be abolished. Based on HMRC data, this would cost £2.4 billion. These changes would end the punitive fiscal drag, remove distortions in the housing market, and responsibly support home-buyers – particularly first-time buyers – by leaving them with more cash (rather than debt) to put towards a deposit.

Proposal 16: Index stamp duty thresholds to inflation

To prevent a future recurrence of recent fiscal drag, the remaining stamp duty thresholds should be indexed to house price inflation in primary legislation. This would, at the least, require any future increase in the burden of stamp duty to be imposed openly and after Parliamentary scrutiny and debate. By making the change prospective, it would not add to government debt.

Other Indirect Taxation

Other sources of indirect taxation put a strain on the cost of living for low-paid and middle income families. For example, fuel duty remains high, although the burden on middle-income households (earning between £20,000 and £40,000) has fallen. In contrast, while Air Passenger Duty places a lower overall burden on homes, it has more than doubled since 1998/99.[51]

A substantial burden has also been imposed by the range of green charges, added to energy bills, in order to subsidies various technologies and government schemes. The Department for Energy and Climate Change estimates that the average family pays £117 in green charges on their annual energy bill. According to forecasts by nPower, the green levies will inflate by a further 78% between now and 2020.

Both fuel duty and Air Passenger Duty should be cut when the public finances allow. It is also reported the government is considering transferring the green charges hidden in energy bills to general taxation.

Proposal 17: Cut Green Subsidies in Energy Bills

In addition to moving green charges from energy bills to general taxation, the government should immediately cut the share of those charges designed to subsidise particular technologies – rather than those supporting the poor or elderly – which would save £56 on the average household energy bill.[52]

51 Based on ONS data. The 2020 Tax Commission makes the case for abolishing Air Passenger Duty, footnote 11, from page 362.

52 Estimated Impacts of energy and climate change policies, Department for Energy and Climate Change, March 2013.

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ISBN 978-1-906996-81-9