THE ECONOMY 2030 INQUIRY
SHAPING A DECADE OF CHANGE

Tax planning

How to match higher taxes with better taxes

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The Economy 2030 Inquiry

The Economy 2030 Inquiry is a collaboration between the Resolution Foundation and the Centre for Economic Performance at the London School of Economics, funded by the Nuffield Foundation. The Inquiry's subject matter is the nature, scale, and context for the economic change facing the UK during the 2020s. Its goal is not just to describe the change that Covid-19, Brexit, the Net Zero transition and technology will bring, but to help the country and its policy makers better understand and navigate it against a backdrop of low productivity and high inequality. To achieve these aims the Inquiry is leading a two-year national conversation on the future of the UK economy, bridging rigorous research, public involvement and concrete proposals. The work of the Inquiry will be brought together in a final report in 2023 that will set out a renewed economic strategy for the UK to enable the country to successfully navigate the decade ahead, with proposals to drive strong, sustainable and equitable growth, and significant improvements to people's living standards and well-being.

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The UK's tax take is rising. From an average of 33 per cent of GDP over the 2000s and 2010s, it has now jumped to 37 per cent and is forecast to approach 38 per cent (and over £1 trillion) by 2027-28: a rise of 5 percentage points or nearly £4,200 per household.

But this increase in the quantity of taxation has not been matched by an increase in its quality. The mismatch between tax-cutting rhetoric and tax-rising reality over the 2010s and 2020s has left no space for a consistent, coherent strategy for the tax system. U-turns and fiscal fudging have been too common, and reform side-lined too often. The same taxes have been slashed and then surged, while well-understood problems with our tax system have been reinforced rather than addressed.

British taxes are not only higher than they were; they are also likely to stay that way. This reality makes crafting a well-designed tax system even more important to maintaining public support and contributing to a broader economic strategy. To that end this report, part of The Economy 2030 Inquiry, sets out the key directions that the tax system should move in. A broad-ranging agenda of specific tax cuts and tax rises – replacing parts of the tax system worth over 1 per cent of GDP with roughly equivalent increases elsewhere – demonstrates that it is possible to focus on the quality, not just the quantity, of tax. This agenda could, of course, be amended in either direction as politics rightly continues to debate the exact level of tax and spending amid a structurally higher-tax world.

The tax system needs clear directions of travel, contributing to a broader strategy of raising growth and lowering inequality

As the events of 2022 showed – with the announcement and swift scrapping, amid market turmoil, of the largest package of tax cuts since 1972 – the need for sufficient tax revenue cannot be wished away. But the Trussonomics mess was an extreme illustration of a wider problem: pretending taxes are coming down, when there are structural reasons they have headed up.

Britain is a country that is ageing, slow-growing and now seeing interest rates rise. It is also one living with the legacy for public services of having held the tax to GDP ratio down during the 2010s, in contrast to rises in comparable countries. The right reaction to taxes reaching a seven-decade high for these structural reasons is not to pretend a major tax-cutting era is just around the corner, but to focus on improving the economic efficiency, equity and predictability of the tax system.

Beyond the striking example of September 2022, the cost of this rhetoric and reality mismatch is tax policy unmoored from a strategy, and poorly-done as a result. Instead of stability to support badly-needed higher business investment, Corporation Tax has been a great source of policy uncertainty, going from a standard rate of 28 per cent in 2010 to 19 per cent in 2017 (and a pledge to go to 17 per cent), only to rise back to 25 per cent in 2023, alongside frequently changing investment allowances. The existential challenge to Fuel Duty posed by electric vehicles has been ignored, while we have spent the last decade with a policy of raising it in line with inflation and a reality of that rise being cancelled every year. Instead of being reformed, Council Tax – an unfair, near-poll tax only weakly linked to three-decades-old property values – was cut in the 2010s but is now being increased to record highs relative to incomes, as a result of unsustainable local government finances. A long-term political competition to be seen to lower Income Tax has led to repeated increases in National Insurance, worsening the bias in the tax system against salaried employment, while the Income Tax personal tax allowance was greatly increased in the 2010s only to see its real-terms value slashed in the 2020s by threshold freezes. And short-term fixes such as the 'High Income Child Benefit Charge' have led to some taxpayers facing far higher marginal rates than their peers.

Tax policy making does need to include an element of political pragmatism, but the UK cannot afford to merely opt for the easiest policy choices every time. A long-term strategy is needed, one that provides a degree of certainty for businesses and individuals by setting out broad principles and directions for reform. Such an approach will also help policy makers wrestle with the inevitable trade-offs that tax policy throws up, and guide decisions at each fiscal event despite ever-changing circumstances. And this strategy cannot be derived solely from an economics textbook, or simply seek to achieve some idealised goal like simplicity: the tax system has to contribute to and be a full part of our overall economic strategy, recognising that the UK desperately needs a period of strong, shared growth.

A number of principles can help achieve these goals. Taxes should fall first on externalities such as pollution and congestion, and favour the taxation of land or housing that is in relatively fixed supply. With UK investment levels consistently among the lowest in the G7, we should reduce barriers to corporate investment (including by reducing uncertainty), and we should lower transaction taxes to boost dynamism and the ability of workers to move to better jobs. After 15 years of stagnant wages, we should avoid piling all tax rises on employment, including by reforming the tax system to account for recent decades' huge rise in household wealth. And the same economic activity in different guises (such as the same work being done by an employee, a self-employed person or a business owner) should generally be taxed at the same rate, for reasons of both efficiency and fairness. These goals and principles – together with a degree of pragmatism – inform the tax cuts and tax rises that we set out below.

Supporting growth means major reform of taxes on business, externalities and property

Corporation Tax policy is one of several determinants of how much UK firms will invest. But the UK has discouraged investment through both policy design and instability, most recently via the welcome new policy of letting firms pay for plant and machinery out of pre-tax profits (i.e. full expensing) being announced as only temporary (it is set to end in March 2026). The Government should immediately make this permanent (as we have set out in a separate paper): the objective is to increase the level of investment and not just bring forward its timing. Ideally, all investment, including buildings would be paid for out of pre-tax profits. This significant growth policy would be costly to begin with, but costs could be offset by reducing the limit on how much interest is tax deductible by a firm, thereby reducing the bias towards debt financing in the tax system. Beyond this, governments should commit to keeping the Corporation Tax regime – both its rate and allowances – broadly stable over time. broadly stable over time.

The damage from inefficient business taxes does not stop there. Business rates combine a neutral tax – one on the value of land – with a bad one – one on the value of business structures. Reform here should exempt new structures and improvements from the base of business rates so that it gradually becomes a land tax, but while avoiding a windfall for current landowners. In addition, Stamp Duty on non-residential properties discourages transactions that might put them under more productive management, and its rates should be halved. This can be paid for by reforms to VAT: the UK's high VAT registration threshold is a disincentive to growth and the formation of multi-employee firms, and it should be slashed from its current turnover level of £85,000 to £30,000 to align it with the future threshold for separate 'Making Tax Digital' rules.

Taxing externalities can help reduce upward pressure on other taxes while supporting national policy goals such as net zero. Most importantly (as we have set out in a separate paper), a per-mile 'Road Duty' system needs to be rapidly rolled out for electric vehicles, to mirror Fuel Duty and limit congestion as the cost of driving falls. This should be accompanied by cutting VAT on non-home electric vehicle charging to match the treatment of at-home charging so that different drivers do not face different electricity tax rates; reforming Vehicle Excise Duty; and facilitating local Congestion Charges in cities and large towns. The annual drama of whether or not Fuel Duty will rise as planned should be ended, and lower fuel prices mean the temporary 5p cut should also end. In future, Fuel Duty should see small monthly increases that equate to a predictable 2 per cent rise in duty each year, matching the Government's long-term inflation target.

To support its net zero objectives, the Government should also aim to raise more revenue via consistent carbon pricing where possible, although in places consistency points to lowering some charges to cut the cost of electricity relative to gas. In the 2020s, the priority within the Emissions Trading Scheme should be to phase out the £2.4 billion a year of free emission allowances, while accounting for un-priced emissions embedded in key categories of imports via a Carbon Border Adjustment Mechanism. At the same time, the relative costs lumped on electricity and gas need rebalancing (as the Government has acknowledged): we suggest scrapping the Carbon Price Support which is an extra tax on marginal electricity production, continuing to rebalance Climate Change Levy rates (for businesses) away from electricity, and shifting residential electricity levies towards gas prices or moving them to general taxation.

Efficient residential property taxes have an important place in our tax system, but those we have are neither efficient nor fair. Council Tax needs a complete overhaul. This needs to be pragmatic given decades of political failure in this area (with some exceptions in Wales and Scotland), but politicians do need to bite the bullet given the risk to popular consent as a very unfair tax is set for a few years of significant increases. Revaluations are needed in each nation – with England and Scotland still using 1991 property values – and values should then be updated annually to avoid repeating a history of revaluation delays. Council Tax should also move away from its internationally-unusual banded approach to a fully proportional tax on property values. Crucially, however, these key goals of revaluation and proportionality in England can be delivered without major overnight redistribution of tax burdens across councils: they should be done in a way that initially affects only the distribution within council areas, with the implication that different parts of the country would have very different property tax rates. A separate, more gradual, convergence is then needed via the local government finance settlement process – which is already overdue a review – with English council funding calculations gradually shifted from a 1991 Council Tax base to an up-to-date proportional property tax base.

The UK's other main residential property tax – Stamp Duty Land Tax (and devolved equivalents) – is a bad tax. By making it more expensive to move, it results in a sub-optimal allocation of housing, and subsequently also affects the labour market by reducing workers' effective options. The current Government is mindful of this and has increased the tax-free threshold to £250,000. But, in another example of poor policy making (likely driven by the need to appear to be on track to hit future fiscal targets), the Stamp Duty threshold is currently due to fall at the end of March 2025. Instead, this higher threshold should be made permanent, and Stamp Duty rates for main homes should be halved; together, this would cost £3.4 billion a year.

Rather than singling earnings out for tax rises, we need consistent taxation of incomes and wealth

Reasonable people can disagree about how high the tax rates on income should be, but should agree they should be consistent across different forms of income. That is not what the UK's tax system does today, harming both efficiency and equity. The top marginal tax rate for employees' wages is 53.4 per cent when employer National Insurance (NI) is accounted for, and corporate dividends are taxed at similar levels – up to 54.5 per cent when the main rate of Corporation Tax is included. But even among those on high incomes, marginal tax rates faced by individuals can be far lower or far higher than this, ranging all the way from zero or 10 per cent for some large capital gains, to 28 per cent for private equity managers, to 67 per cent for employees facing the withdrawal of the personal allowance, to over 100 per cent for some parents, with many more rates in between.

Significant change is needed to tackle this variation which, in general, leaves employees paying higher taxes than those taking their income in other ways. Employer NI is a key source of this inconsistency, applying as it does only to wages. And, while the basic rate of Income Tax has been steadily cut over time, the employer NI rate rose in 2003, 2011 and (briefly) 2022, and its threshold remains lower than other personal tax thresholds. The UK's tax strategy should aim to narrow the huge gaps in rates of taxation for different forms of income, with both tax cuts and tax rises.

The first tax cut element of this package would see a 1-percentage-point cut to the employer NI rate (to 12.8 per cent), costing £8 billion a year. In contrast, and to match tax rates on employee earnings – and accounting for employer NI and Corporation Tax – the basic rate of tax on dividends should be raised from 8.75 per cent to 20 per cent, although the higher rates should be reduced by around 2 percentage points. Capital Gains Tax needs major reform. Inflation indexing should be reintroduced, representing a significant tax cut and returning the regime to one that existed prior to its complete phase-out in 2008. As a result, only real gains would be taxed, but they should be taxed at higher rates. The tax rates for gains made on shares should be raised to match the rates on dividends, giving a top rate of 37 per cent (below the maximum 2007-08 Capital Gains Tax rate of 40 per cent). For rates of capital gain below 8.2 per cent a year, and with inflation of 2 per cent a year, this top rate plus indexation would mean lower effective taxation than the 28 per cent rate without indexing that George Osborne oversaw between 2010 and 2016.

For capital gains on assets other than shares – i.e. predominantly real estate – higher marginal tax rates are warranted (as is partially the case in the current system). For parity with wages, these rates should range from 40 to 53 per cent, yet moving to inflation indexing means even these rates are estimated to produce an overall net tax cut for residential property. This tax cut would be offset for property by reforming the taxation of rental income, which should start to attract NI, so that rental income is treated the same as the wages that tenants earn. Fair NI rates for this income would be 20 per cent for basic-rate taxpayers and 8 per cent for those with higher incomes, but phasing in could be appropriate (for example, in the form of 2 per cent rises each year).

The same NI rates would be appropriate for self-employment income, where there is currently a tax gap relative to employees of £6 billion a year. But given past failures and the important priority of reducing the VAT threshold, a sensible focus would be to raise the NI rate only for high self-employment incomes, from 2 per cent to 8 per cent, so that high-income partners, for example, face an equivalent marginal tax rate to employees. In 2019-20, higher and additional-rate earners made up only 15 per cent of self-employed taxpayers but accounted for a narrow majority of self-employment income; in part, this reflects the UK's strength in high-value-added services, but it also indicates the scale of the unfairnesses here. Finally, some forms of income can go entirely or significantly untaxed. The writing-off of capital gains at death or after leaving the UK needs to be ended, and the treatment of the foreign income of 'non-doms' needs major reform.

The end result of these changes would be that incomes from employment, self-employment (with the exception of low incomes), dividends, real capital gains and rents would all face almost identical marginal rates of tax. Our proposals imply a top rate of roughly 53 per cent (slightly below the rate that currently applies to top-earning employees and similar to the 52 per cent top tax rate that applied to self-employment income in 2012), a higher rate of between 48 and 49 per cent, and a basic tax rate of 40 per cent (with the latter two also matching how employee earnings are currently taxed, having factored in employer NI).

Even those worried about high tax rates should support the changes above, not least because they provide the means to address the much higher effective tax rates some face as a result of repeated attempts to raise tax revenues without raising headline rates. In particular, the withdrawal of the Personal Allowance beyond £100,000 makes the Income Tax schedule regressive at high incomes, with marginal tax rates (excluding NI) falling from 60 per cent to 45 per cent at £125,140. This withdrawal should be abolished, though with the threshold for the 45 per cent additional rate lowered to £100,000, at a net cost of £2.5 billion before accounting for behavioural change. In addition, the effect of the High Income Child Benefit Charge between £50,000 and £60,000 leads to marginal tax rates that can top 100 per cent, and this should be abolished, at a cost of around £4 billion.

Finally, our pensions and Inheritance Tax systems also need reform to be more consistent and more progressive. Given the UK's large and primarily passive rise in wealth levels relative to GDP, which has created patterns of winners and losers based to a great extent on luck – such as large swings in interest rates or being born to the right parents – policy should aim to raise more revenue overall from these wealth-related taxes, but reform is also needed within them. For pensions, a key priority should be rebalancing the complicated NI treatment of pension contributions: we should extend employer NI to employers' contributions (helping to fund the lowering of the employer NI rate) while introducing NI relief for personal contributions to help lower earners build up their savings. At the same time, the £270,000 cap on poorly-justified tax-free pension withdrawals should be gradually reduced based on date of birth.

Inheritance Tax should be tightened so that it cannot be so easily avoided by the wealthy and well-advised: pension pots should be included, and reliefs for business and agricultural property scrapped or very tightly focused (noting for example that only 4 per cent of Business Relief claimants accounted for 53 per cent of its cost in 2019-20). The complicated Residence Nil-Rate Band should also be abolished. These changes (together with Capital Gains Tax at death) should be used to replace Inheritance Tax's high, flat rate of 40 per cent with a more popular banded structure, with rates of 20, 30 and 40 per cent, for example (as well as helping to fund the Stamp Duty cuts noted above). Ideally, Inheritance Tax should be entirely replaced by a lifetime, recipient-based acquisitions tax similar to Ireland's.

Conclusion

Tax policy alone is not going to resolve the UK's low growth and high inequality woes. But the design of the tax system should be part of the answer rather than part of the problem. A tax strategy's job is to provide a roadmap for our tax system that looks beyond whether each Budget happens to see taxes rise or fall, in this case to how the UK can move over time to more efficient and fairer taxation. The political challenges involved should not be discounted, but neither should the problems with the status quo or the prize for doing better, especially in a higher-tax world. Clearly, policy makers need to also consider how much revenue they want the tax system to raise overall, not least given current pressures on public services. That may affect the scale and mix of the tax rises and cuts set out here, but the direction of travel towards a better tax system should be kept constant nonetheless.

This set of recommendations would have a significant impact on the UK's economic potential. There would be more physical investment by businesses, a more dynamic commercial property market, more small business growth and more formal employment. The tax system would raise more from sin taxes to keep down taxes elsewhere and help achieve net zero and faster transport, while protecting low-to-middle income households. Council Tax reform would reduce income and wealth inequality, while Stamp Duty cuts would improve the efficiency of the housing market and the ability of workers to move to better jobs. Sub-national government would be empowered through better-functioning property taxes and congestion charges. The clearest tax barriers to working more would be cut down, and major distortions to personal investment choices and the structure of employment and remuneration removed. The employment and pension savings of low earners would be supported, and the role of inherited property wealth tempered and more widely distributed.

These are the rewards if the UK's tax policy debate can escape from the tension between the rhetoric of tax cuts and reality of tax rises. It is time for better taxes.

Recommendations and estimated costings in 2027-28

<table>
<tr><th></th><th>Tax rises</th><th>Tax cuts</th></tr>
<tr><td rowspan="2">Businesses</td><td>Cut the VAT registration threshold to £50,000 then £30,000 (+£1.5bn*)</td><td>Make Corporation Tax full expensing permanent (-£5bn*)
No Business Rates on new structures/improvements (-£2bn*‡)
Halve non-residential Stamp Duty rates (-£2bn‡)</td></tr>
<tr><td colspan="2">Extend full expensing to all capital but restrict debt interest deductibility (0)</td></tr>
<tr><td rowspan="2">Externalities</td><td>Create Road Duty for EVs (+£3bn*)
Reform up-front VED (+£1bn)
Encourage local congestion charges (-)
End free carbon permits & introduce carbon border adjustment (+£2bn)</td><td>Cut non-home EV charging VAT to 5% (-£0.5bn*)
Scrap the Carbon Price Support (-£0.5bn)
Shift Climate Change Levy rates towards fossil fuels (0)
Shift other levies away from electricity bills (-)</td></tr>
<tr><td colspan="2">Uprate Fuel Duty by 2%pa with small monthly rises (0)</td></tr>
<tr><td rowspan="2">Homes</td><td></td><td>Keep current Stamp Duty threshold (-£1.5bn‡)
Halve main home Stamp Duty rates (-£2bn‡#)</td></tr>
<tr><td colspan="2">Reform Council Tax (0‡)</td></tr>
<tr><td rowspan="2">Incomes</td><td>Apply CGT at death and exit (+£2bn)
Reform non-dom taxation (+£2bn)
Raise NI for higher self-employed incomes (+£1.5bn)
Raise the basic rate of dividend tax (+£2bn)
Introduce NI for rental income (+£2bn*)</td><td>Cut the employer NI rate from 13.8% to 12.8% (-£8.5bn)
Scrap Child Benefit withdrawal (-£4.5bn)
Scrap Personal Allowance withdrawal (-£2.5bn†)
Lower the top 2 rates of dividend tax (-£1bn)</td></tr>
<tr><td colspan="2">Reintroduce CGT inflation indexing but raise marginal rates (+£7.5bn#)</td></tr>
<tr><td rowspan="2">Pensions and inheritances</td><td>Extend employer NI to employer pension contributions (+£8.5bn§)
Lower the pension tax-free lump sum cap (+£0.5bn*)
Include pensions in Inheritance Tax (+£0.5bn*)
Abolish Inheritance Tax agricultural/business relief (+£1.5bn)
Abolish Inheritance Tax's residence nil-rate band (+£2bn)</td><td>Scrap personal NI on personal pension contributions (-£4bn)
Add 20% & 30% Inheritance Tax bands below £1.5m (-£2bn#)</td></tr>
<tr><td colspan="2">Replace Inheritance Tax with a recipient-based tax (-)</td></tr>
</table>

NOTES: Full notes on page 86.

Section 1

Taxes are rising but not improving

Taxes are rising sharply in the UK – by 5 per cent of GDP between 2019-20 and 2027-28 – and are likely to stay up. Higher taxes make it more important to design taxes well and have a tax strategy; both have been lacking in the UK recently – taxes have been increased sharply amid cosmetic or temporary tax cuts, with no recognition of the structural forces that are pushing taxes up.

Instead, our tax strategy should support the UK's overall economic strategy, which in turn should be aimed at raising the UK's low GDP growth rate and ensuring that the benefits of growth are spread widely. Tax reform can do this by influencing investment, mobility and wages, as well as by redistributing money. Taxes on pollution and land are efficient, but will not raise enough money by themselves. They must be complemented by taxes on income and consumption, set to balance fairness, efficiency and the need to raise money. Taxes on wealth and inheritance can help here, by taxing good luck more than other taxes can. Crucially, a tax strategy must be politically sustainable, which means that they must command public understanding and support. In a world of high taxes, this is truer now than ever.

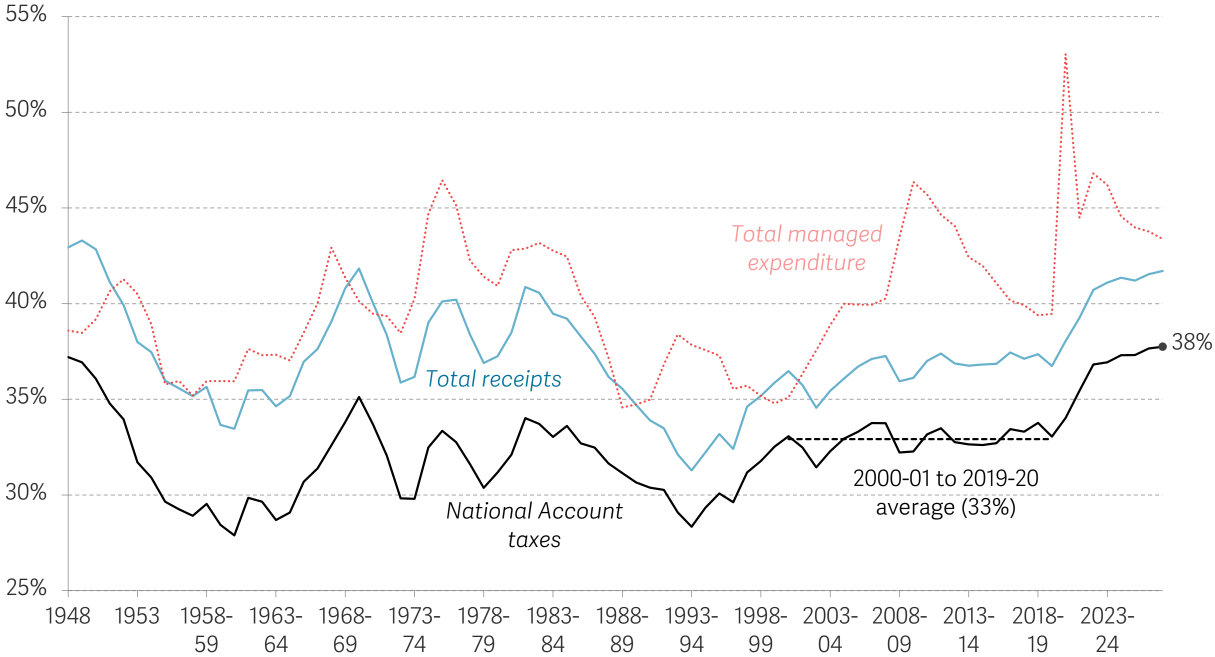
The UK's tax system has been raising more revenue, but at the same time getting worse in many respects. Policy makers frequently claim to be cutting taxes, or to want to, but in practice taxes have reached a historic high. The result has been a system that has diverged a long way from sound principles and from supporting an economic strategy for the UK, divergences that matter more when overall taxes are high. This Section explains how we got into our current high-tax, bad-tax situation, and then sets out some principles for how we might chart a course to a better system.

Taxes have gone up and will likely stay up

The UK's tax take is rising. From an average of 33 per cent of GDP over the 2000s and 2010s, it has now jumped to 37 per cent and is forecast to approach 38 per cent (and over £1 trillion) by 2027-28: a 5 percentage point rise, or nearly £4,200 per household (Figure 1).

FIGURE 1: **Tax as a proportion of GDP has jumped to its highest levels since the 1940s**

Total taxes and spending as a proportion of GDP: UK



SOURCE: Analysis of OBR, Economic and Fiscal Outlook, March 2023.

Barring a major change in the scope of the State, taxes are likely to stay high. Britain is ageing and faces pressures to increase spending on public service and debt interest, while previous strategies of cutting defence spending or public investment have, respectively, run out of road or would harm economic growth and hence revenues.[1] Real-terms cuts in unprotected department pencilled in for 2025-26 and beyond seem unrealistic given public disquiet about the state of public services.

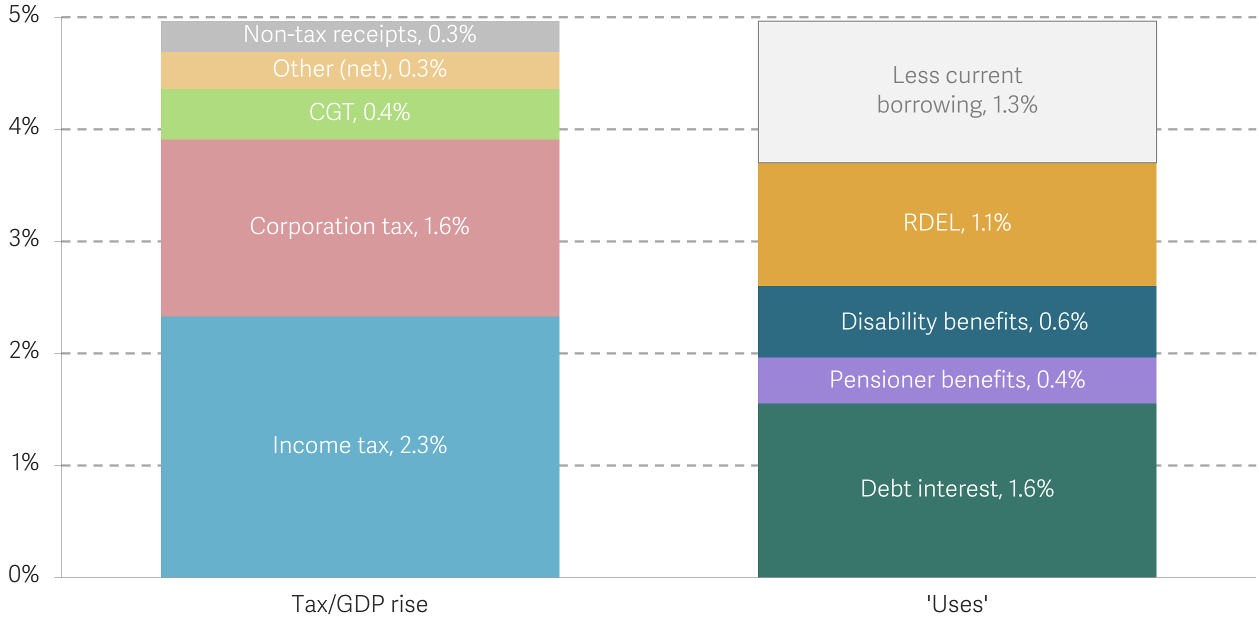
Consistent with this, Figure 2 shows both the composition of and the spending counterparts to this 5 percentage point increase in the tax-GDP ratio. More than half of the increase in taxes corresponds to a widely agreed aim to balance the current budget and a rise in debt interest payments following the rise in world (and especially UK) interest rates – a rise that will be more pronounced if the further rises in interest rates

1 See: K Shah, J Smith & D Tomlinson, Under pressure: Managing fiscal pressures in the 2020s, Resolution Foundation, February 2022, and: F Odamtten & J Smith, Cutting the cuts: How the public sector can play its part in ending the UK's low-investment rut, Resolution Foundation, March 2023.

since these forecasts were made persist. The remainder is driven by increased spending on pensions and disability benefits, and increases in departmental spending, both of which would be very difficult to cut.

FIGURE 2: **The majority of the five percentage point tax rise might be attributed to rising debt interest and balancing the current budget**

Decomposition of change in total taxes and spending as a proportion of GDP between 2019-20 and 2027-28: UK



SOURCE: Analysis of OBR, Economic and Fiscal Outlook, March 2023.

High taxes make it more important than ever to have a good tax system, but policy has often been chaotic rather than strategic

The very large tax rises we have seen in recent years were not announced as part of an overall tax or economic strategy. For example, in late 2022, the Government announced and then scrapped the largest package of tax cuts since 1972. More broadly, the politicians that have controlled tax policy since 2019 often announced small, high-profile tax cuts at the same time as overall tax rises, or expressed a wish to cut taxes at some point in the future without explaining how this would be financed.[2] As Figure 2 shows, a large part of the ongoing tax increases is driven by income tax, and in particular a freezing of thresholds for different tax bands, which has yielded a great deal more than expected when announced because of the strength of inflation and nominal pay. The lion's share of the rest comes from Corporation Tax which, as Section 2 shows, has experienced considerable (and unhelpful) volatility recently.

2 See, for example: J Elgot, Rishi Sunak pledges 20% tax cut by end of decade in last-gasp pitch to members, The Guardian, July 2022.

Tax policy making does need to include an element of political pragmatism, but the UK cannot afford to merely opt for the easiest policy choices every time. A long-term strategy is needed, one that provides a degree of certainty for businesses and individuals by setting out broad principles and directions for reform. Such an approach will also help policy makers wrestle with the inevitable trade-offs that tax policy throws up, and guide decisions at each fiscal event despite ever-changing circumstances.

Our tax strategy should support our economic strategy

A tax strategy will help produce better policy, but it is important to note that such a strategy cannot be derived solely from an economics textbook, or simply seek to achieve some idealised goal like simplicity: the tax system has to contribute to and be a full part of our overall economic strategy. The Economy 2030 Inquiry is about establishing such a strategy, the overarching aims of which are to raise the rate of productivity growth in the UK and ensure that everyone benefits from this. The recent record on both is very poor: output per hour grew by just half a per cent per year since 2005, half the rate of the 25 richest OECD countries (0.9 per cent), and income inequality in the UK was higher than any other large European country in 2018.[3]

A combination of carefully chosen tax cuts and tax rises can influence many of the elements of economic strategy that the Economy 2030 Inquiry is developing – such as investment, mobility, high wages and widely shared growth. But we should be realistic about what it can and cannot achieve. The tax system is just one of many influences on growth and inequality: tax cuts will not solve all the economy's problems, any more than badly-designed tax rises could be expected to raise revenues at no economic cost.

Increasing growth and promoting efficiency

It is widely accepted that taxes on negative externalities, such as pollution or congestion, can be used both to raise revenues and make the economy more efficient.[4] Fuel Duty is an example of a tax that currently raises substantial revenue and limits the costs that drivers impose on others by congesting roads and polluting the atmosphere. Although some taxes on externalities fall disproportionately on lower-income households, the impacts can in principle be offset by redistributing some of the revenues they raise.

Of course, there are problems in relying on such taxes to generate all the revenue that a government needs: when successful in limiting externalities, the revenues such taxes can raise are accordingly lower. And other regulations and technological innovations

3 Resolution Foundation & Centre for Economic Performance, LSE, Stagnation nation: Navigating a route to a fairer and more prosperous Britain, Resolution Foundation, July 2022.
4 D Fullerton, A Leicester and S Smith, Environment Taxes, in J Mirrlees et al (eds), Dimensions of Tax Design, Volume 1 of the Mirrlees Review, OUP, September 2020.

can intervene to reduce the harmful behaviour, further limiting revenue (for example, the electrification of road transport achieved through a mixture of regulation and technological progress will soon drastically reduce the scope for Fuel Duty to raise revenue).[5] But taxing externalities is an obvious place to start.

Once all externalities have been appropriately taxed, the next best thing from a growth and efficiency perspective is to tax things which are in fixed supply, the quantity of which can therefore not be affected by the tax. This essentially means taxing land values or land rents.[6] Taxes on immovable property are relatively high in the UK – at 3 per cent of GDP they were the second-highest in the OECD in 2019 – but these include taxes on buildings, the quantity of which can indeed adjust in response to the tax. Land taxes can be progressive, in the sense that they are capitalised into land prices and hence are ultimately paid by the owners of the asset at the point when they are increased.

Finally, taxes should generally not distort the choices firms make about how to produce goods – taxes should fall on consumption rather than production.[7]

Raising revenue without creating too many distortions

Modern states cannot raise all the revenues they require merely by taxing pollution and land. That means that economic activity that is desirable and responsive to the level of taxes – i.e. not just externalities and land – must also be taxed. The tax system must therefore introduce distortions that make the economy smaller and less efficient.

The trick is to design the tax system so as to minimise distortions while raising revenue from those who can afford to pay. For example, the same economic activity or payment can have different legal or accounting definitions and hence different treatments in the tax system. Many people will view this as unfair. But it also has economic consequences: when the tax rates on these activities are different, despite the activities being substantially the same, the system encourages activity to be labelled with the lower tax rate, reducing revenues and requiring higher tax rates overall. Moreover, this relabelling can itself be administratively and economically costly.

For example, the tax system has become more biased in favour of self-employment over time: while Income Tax rates have been steadily cut, employer National Insurance (NI) rose in 2003, again in 2011, and rose again in 2022 before a U-turn and replacement with a threshold freeze from 2023. In the absence of a strong justification, substantially similar income flows or economic activities should be taxed at the same rates.

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5 J Marshall & A Corlett, Where the rubber hits the road: Reforming vehicle taxes, Resolution Foundation, June 2023.
6 C Goodhart et al., Post-Corona balanced budget fiscal stimulus: The case for shifting taxes onto land, Vox EU, January 2022. For a contrary view, see: M Feldstein, The Surprising Incidence of a Tax on Pure Rent: A New Answer to an Old Question, Journal of Political Economy, April 1977.
7 This is a classic conclusion of public economics. See: P Diamond & J Mirrlees, Optimal taxation and public production I: Production efficiency, American Economic Review, 1971

Another example is designing the system to tax economic good luck, which, by definition, people cannot control, and the better-off tend to have more of. Taxing wealth – either inherited or acquired – may on the face of it be just another way of taxing saving, which we don't want to do. However, a substantial part of wealth does not reflect saving or perceived risk-adjusted returns but rather is down to windfall gains from the fall in global interest rates and consequent rise in asset prices, to randomness in investment returns that is not priced into investments, or to inheritance. Taxing wealth appropriately, by affording lower taxes on work and investment, can accordingly help to boost growth and fairness (moreover, capital gains can be a hidden form of income, as we discuss on Section 5).[8]

Spreading the benefits of growth

Most rich countries' tax systems are progressive, in that post-tax inequality is lower than pre-tax inequality. Both pre- and post-tax, the UK is relatively unequal, with the highest inequality of any major European country.[9] The UK's tax system does a middling job in reducing inequality from this relatively high starting point. In 2019 the UK's pre- and post-tax Gini coefficients for working-age households were 0.45 and 0.36, with the 0.09 point reduction due to progressive taxation and benefits smaller than about two-thirds of OECD countries for which data are available.[10]

Ensuring that the benefits of growth are widely shared can and should be an aim of tax policy, just as of benefits policy. But in some cases, this can conflict with the aim of boosting growth. For example, there is a case for modifying corporate taxes to boost investment, but the tax changes required may benefit business owners disproportionately. In other cases, economically efficient tax changes, such as the changes to Council Tax that we set out below, might also disproportionately benefit or limit costs to low-to-middle income households.

Commanding public support

Finally, taxes are decided by democratically elected politicians. A strategy that efficient and fair on paper but is politically unsustainable in practice is not an effective strategy. This means that a tax strategy must command sufficient public understanding and consent to be implemented by elected politicians and, crucially, be sustainable enough that households and firms can make plans expecting the system not to change unduly. With taxes having increased so much and looking likely to stay high, the issue of legitimacy is more important now than ever.

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8 F Guvenen et al., Use it or lose it: efficiency and the redistributional effects of wealth taxation, Quarterly Journal of Economics, January 2023.

9 Resolution Foundation & Centre for Economic Performance, LSE, Stagnation nation: Navigating a route to a fairer and more prosperous Britain, Resolution Foundation, July 2022

10 Analysis of OECD Income Distribution Database

History is replete with examples of policy decisions – the U-turn on increasing the rate of NI on self-employment earnings in 2017, or the inability of successive Chancellors to maintain the real value of fuel duty – where it is clear that political or popular views are preventing efficiency-improving tax changes. Reforms such as extending VAT to food and using the proceeds to increase benefits or cut other taxes could be fair and efficient on paper, but seem prohibitively unpopular to be tried.[11] Well-designed and well-articulated tax reforms can boost growth equitably and thereby earn legitimacy.

From strategy to action

With these principles in hand, the rest of this paper sketches out a tax strategy and some early priorities that are guided by them:

- Section 2 sets out reforms to business taxes;
- Section 3 sets out an improved approach to taxing externalities;
- Section 4 deals with fair and efficient taxation of residential property;
- Section 5 explains how we should tax incomes more consistently;
- Section 6 addresses consistency in the taxation of pensions and inheritances; and,
- Section 7 concludes.

11 Chapter 9 of S Adam et al., Tax by design, Institute of Fiscal Studies, September 2011.

Section 2

Supporting business investment and dynamism

A key aim of our economic strategy should be to boost GDP growth by increasing the UK's low business investment rate. The Corporation Tax rate is one of several factors that influence investment, but the stability and certainty of the tax regime is also important, given that investment decisions have long-term paybacks. Recent years, however, have seen the rate of Corporation Tax change several times, and investment allowances were cut in the early 2010s before being repeatedly and temporarily expanded at short notice since. The UK should immediately make permanent its recent (temporary) move to full expensing of investment in plant and machinery. Going further and broadening which types of investments can be fully expensed to all business capital is desirable, but may be costly; any lasting costs should be defrayed by tightening the limits on tax deductibility of interest, reducing the tax system's bias towards debt financing. Crucially, governments should also commit to keeping the Corporation Tax regime stable over time. Such a package could increase the capital to output ratio of the business sector by as much as 8 per cent in the long term, generating enough growth to pay for itself.

Business rates combine an efficient tax on land with an inefficient one on business structures. The rate on newly built structures should be cut to zero, stimulating investment further. Property transactions taxes (Stamp Duty and its analogues) lead to business structures changing hands less frequently than they should, harming dynamism and productivity; the rates of these transaction taxes should be halved, at a cost of up to £2 billion.

The UK's VAT registration threshold is the highest in the world. This means that the Treasury is missing out on VAT revenue; moreover, the prospect of crossing the threshold deters small firms from growing. A sharp cut in the threshold, from £85,000 to around £30,000, could raise £2 billion a year and provide a small boost to economic activity.

The UK's low growth in, and mediocre levels of, labour productivity are in part attributable to low rates of business investment and business dynamism.[12] The tax system is one of several drivers, and may even not be the most important one, but it is a factor that governments can control. Furthermore, the role of the tax system in promoting investment, dynamism and growth has become more salient as rates of, or the proportion of GDP raised by Corporation Tax, business rates, VAT and property transaction taxes have increased or become more volatile.[13] In this section, we consider how targeted tax cuts, and even one tax rise, can form part of a coordinated strategy to increase business investment and growth.

Corporation Tax – unfinished business

The UK suffers from a longstanding lack of investment, both private and public.[14] One factor affecting firms' investment decisions is Corporation Tax – both the rate and the base it is levied on. This happens in two ways. First, when a firm decides to invest in equipment with a view to making profits, the need to pay Corporation Tax on those profits makes the investment less attractive in the first place – just as it does for any activity a firm might undertake to increase profits, and there is strong evidence that rates and allowances of Corporation Tax affect investment in the real world.[15] Second, there is a more direct impact of Corporation Tax on investment through investment allowances. These allowances permit firms to deduct some or all of the cost of an investment from the measure of profits that firms pay tax on; by doing so, this can reduce or eliminate the negative impact of Corporation Tax on investment.[16]

Recent policy changes mean that the UK tax system deters investment now more than it used to. In the previous tax year (2022-23), the UK's statutory corporate tax rate of 19 per cent was the lowest among G7 countries and towards the bottom of the pack of corporate tax rates for OECD countries. But after the large rise to 25 per cent that took effect from 2023-24 – announced by Rishi Sunak as Chancellor in the Spring 2021 Budget, scrapped by his successor Kwasi Kwarteng, but then reintroduced by Jeremy Hunt – the

12 For evidence on the UK productivity problem, see: Resolution Foundation & Centre for Economic Performance, LSE, Stagnation nation: Navigating a route to a fairer and more prosperous Britain, Resolution Foundation, July 2022. Our suggested reforms to Corporation Tax were also discussed in P Brandily et al., Beyond Boosterism: Realigning the policy ecosystem to unleash private investment for sustainable growth, Resolution Foundation, June 2022, and some of the text here draws directly on that.

13 For detail on the volatility of the corporate tax system, see: P Brandily et al., Beyond Boosterism: Realigning the policy ecosystem to unleash private investment for sustainable growth, Resolution Foundation, June 2022.

14 For business investment, see: P Brandily et al., Beyond Boosterism: Realigning the policy ecosystem to unleash private investment for sustainable growth, Resolution Foundation, June 2022. For public investment, see: F Odamtten & J Smith, Cutting the cuts: How the public sector can play its part in ending the UK's low-investment rut, Resolution Foundation, March 2023

15 On average, higher corporate tax rates reduce investment (see: K Hassett & R Hubbard, Tax policy and business investment. In andbook of Public Economics, Elsevier, 2002; S Djankov et al., The effect of corporate taxes on investment and entrepreneurship, American Economic Journal: Macroeconomics, 2010; JC Suárez Serrato & O Zidar, Who benefits from state corporate tax cuts? A local labor markets approach with heterogeneous firms, American Economic Review, 2016; X Giroud & J Rauh, State taxation and the reallocation of business activity: Evidence from establishment-level data, Journal of Political Economy, 2019). See also Chapter 17 of S Adam et al., Tax by design, Institute of Fiscal Studies, September 2011.

16 Also see: S Adam & H Miller, Taxing work and investment across legal forms: pathways to well-designed taxes, Institute for Fiscal Studies, January 2021.

UK is now slightly above the OECD average (although still the lowest among the G7 countries).[17] In addition, investment allowances were cut throughout most of the 2010s and the permanent system of allowances is now among the least generous in the OECD.

These changes increased the anti-investment bias of the UK corporate tax system, and so other measures in the 2023 Spring Budget aimed to limit some of these distortions by introducing, on a temporary basis, investment allowances that cover all of a firm's qualifying plant and machinery (so-called 'full expensing'). This eliminates the tax bias against these forms of investment, which make up about a third of total business investment. But the change is only temporarily – the allowances are set to expire in three years – and the UK's permanent investment allowances are among the least generous in the OECD. Although the Government stated its intention to make full expensing permanent if fiscal conditions allow, the risk is that firms use the current low rate simply to change the timing of investment rather than the overall level. This would make it an expensive tax cut – over £10 billion at its peak – with the OBR estimating that it will have no impact on the long-run size of the capital stock.

A sensible reform would be to make permanent the full expensing announced in the 2023 Spring Budget, with immediate effect. We would expect that the long-run annual cost of a permanent relief will be substantially less than the £10 billion the OBR has scored for the temporary one, for three broad reasons. First, a permanent relief would be less likely to change merely the timing of investment – the fact that firms are expected to bring forward investment so it happens while the policy is in operation is part of the reason the cost is high in the final year of the temporary scheme. Second, the cost of full expensing is partly offset in the long run by firms having lower yearly depreciation allowances – firms can't claim tax relief on the same investment through both full expensing and depreciation allowances.[18] Third, and most importantly, higher investment allowances can be expected to boost investment, GDP and hence other tax revenues. Indeed, in principle, these impacts could be large enough that overall tax revenues are unchanged.[19] Here, it is important to note that a policy of full expensing is much more likely to pay for itself than a cut to the headline rate of Corporation Tax because it cuts taxes only on new investment, whereas cutting the headline rate lowers the burdens on installed capital,

17 Figure 12 of P Brandily et al., Beyond Boosterism: Realigning the policy ecosystem to unleash private investment for sustainable growth, Resolution Foundation, June 2022.
18 This does not reduce the present value of the fiscal cost to zero, however, because claiming the reliefs earlier costs the Exchequer money
19 We obtain this result from the steady state of a simple neoclassical model in which firms maximise the present discounted value of post-tax profits subject to a CES production function. For details, see: P Brandily et al., Beyond Boosterism: Realigning the policy ecosystem to unleash private investment for sustainable growth, Resolution Foundation, June 2022. For evidence of potentially self-financing corporate tax cuts, see J Cloyne et al., Short-Term Tax Cuts, Long-Term Stimulus, NBER working paper 30246, July 2022. CBI, The case for a permanent investment deduction, March 2023 estimates that full expensing would boost GDP by 2 per cent, and T Clougherty, K Pomerleau and D Bunn, After the Super-Deduction: Assessing Proposals for the Reform of Capital Allowances, Centre for Policy Studies and Tax Foundation, September 2022, estimates that permanent full expensing would boost GDP by 2.5 per cent.

and because it full expensing reduces the marginal cost of capital for investment more for each pound of tax revenue foregone.

However, full expensing of plant and machinery would mean that the corporate tax system would encourage firms to invest in these capital goods more than other sorts (such as buildings). Although this could be justified if these kinds of investment are more tax-elastic or create greater spillovers than other kinds of investment, there is little evidence that this is the case. We therefore recommend that full expensing is broadened to cover all types of business investment. This could at least double the gross short-run fiscal costs, given that currently allowable investment is less than one-half of the total, but it would have a commensurately larger impact on growth as more investment is tax-relieved, and the tax distortion between different kinds of investment is removed.

The corporate tax system also allows interest payments to be deducted against Corporation Tax, up to a limit (of £2 million a year of interest payments).[20] This encourages firms to finance themselves with debt rather than equity, and means that fully-deductible, debt-financed investment is actually subsidised by the tax system. It is a major expense. For the sake of an illustrative overestimate, UK non-financial corporates had gross debts of £1.6 trillion in 2021, which would result in annual interest payments of £80 billion at an interest rate of 5 per cent, in turn reducing tax receipts by £20 billion if all of these payments were set against the headline rate of Corporation Tax. However, limiting the tax deductibility of interest can have major implications for firms that already have large debts, and can favour firms that are able to shift debt across corporate entities in different jurisdictions.[21] If the Government is uncertain about the ability of full expensing to pay for itself, then it may want to consider substantially tightening the limits on the tax-deductibility of interest (for example, by reducing the upper limit).

Reforming business rates to boost construction and high streets

The UK raises relatively large sums from business rates – around 1.4 per cent of GDP in 2019, the second highest among OECD countries for which data are available, and nearly three times the average within these other countries of 0.5 per cent of GDP.[22] Receipts are expected to be £29.9 billion in 2023-24.

Business rates act like a tax on business inputs in the form of structures and land.[23] As we discussed earlier, taxing land is efficient – the part of business rates that is in effect

20 The limit is, roughly speaking, a maximum of 30 per cent of taxable profits. See: https://www.gov.uk/guidance/corporate-interest-restriction-on-deductions-for-groups
21 OECD, Limitation on Interest Deductions.
22 S Adam, Business rates:reform, reduce or replace?, Institute for Fiscal Studies, June 2022.
23 The taxation of non-domestic property varies across the countries of the United Kingdom. England and Wales have a common system. In Northern Ireland, the system is separate but still referred to as 'business rates'. In Scotland, they are officially called 'Non-domestic rates'. The systems are similar enough for the foregoing discussion to apply to all nations of the United Kingdom.

a land tax component results in lower land values or land rents, rather than a lower quantity of land – but the part of business rates that is a tax on the structures on the land is a disincentive for businesses to invest in or use structures. In this sense, business rates may indeed (as widely alleged) 'harm high streets' – they do not just lower the rents that high-street occupants pay, but may also discourage the construction and upgrading of buildings.

There are other features that are less than ideal. The structure of business rates is superficially progressive in that lower-valued properties and some properties used by smaller businesses are taxed less. But this is inefficient, encouraging the subdivision of properties into smaller units, or the use of properties by smaller businesses, which are, on average, less productive. It can also create very high marginal rates at the boundaries of different business rates bands.[24] Furthermore, there are numerous reliefs for charities, local newspapers and so on. These may encourage different businesses to use properties, and can be judged on the merits of this, but will also in part benefit the property owner to the extent that they are able to increase rents to compensate.

There are several ways business rates should be reformed to better encourage growth. The overarching aim of reform of business rates should be to separate and ultimately lower the taxation of business structures – which should be as low as possible (as set out in Section 2) – from the taxation of land, which can go higher if need be. In principle, this can be achieved by valuing the land and structure separately and only taxing the land component (pro-rating the rental value if necessary). This sort of reform would have a desirable geographic impact – and obviate the need for reliefs in low-value areas – given that poorer areas will have lower land values and hence the effective tax rate on business structures is higher. Some estimates suggest, for example, that land comprises 90 per cent of the total value of commercial property in London, compared to under 60 per cent in the East Midlands.[25]

In practice, any reform is complicated by the difficulty of valuing land and structures separately. However, what works in the other direction is that it would not be inefficient to continue to tax existing structures at the same rate as land because, being already built, the decision to build them has already been taken.

We therefore propose to exempt new structures from business rates so that the tax gradually becomes a tax only on non-domestic land, as is the case in, for example, Australia and Denmark. This would require the rateable value of all existing business property to be apportioned to structures and land. This could be done by, at the next

24 Figure 6 in A Corlett et al., Replacing business rates: taxing land, not investment, September 2018.
25 Figure 10 in A Corlett et al., Replacing business rates: taxing land, not investment, September 2018.

valuation point, the surveyor assessing the replacement cost of the structure as a fraction of the sale price of the property, or (in principle equivalently), assessing the annual depreciation or user cost of the structures as a fraction of the total rent. After that point, the part of the property value that corresponds to any new construction or improvements would not be liable for business rates. Depreciation of existing structures would be reflected in the tax base, such that eventually the tax base would converge towards a land-only base.

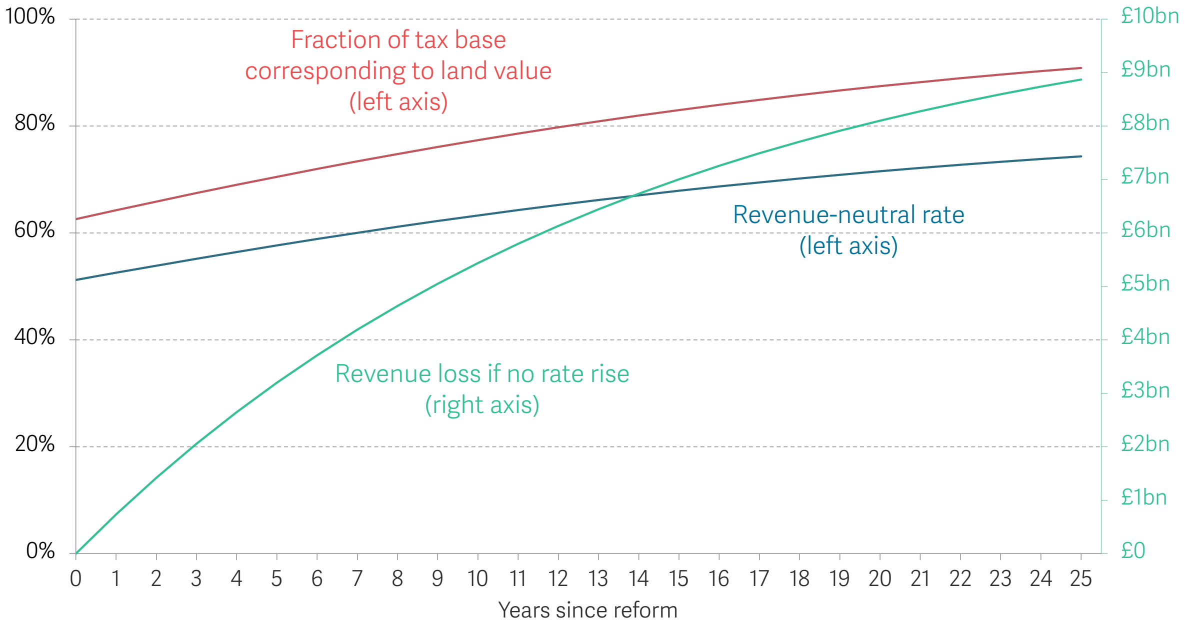
Structures represent around 37 per cent of the combined value of structures and land owned by UK corporations.[26] This provides an indication of how much of the business rates base corresponds to structures, which we would eventually not tax, compared to land, which could be taxed at a higher rate (in principle up to 100 per cent). Simple simulations (assuming that the value of structures and land grow in line with GDP – 1.7 per cent in the long run – and that structures depreciate at 5.3 per cent) suggest that the multiplier would need to increase from 51p to 74p to keep revenues unchanged (see Figure 3). Alternatively, the rate could be kept constant, leading to a gradual fall in revenues – perhaps £3 billion per year across the UK after five years and £9 billion in the long run – as new and improved structures form an increasing fraction of total business property values. Part of the cost could be defrayed by limiting reliefs for particular activities or small business, for example by lowering or at least freezing the current threshold for small business rate relief.

The simulations and costing above assume no behavioural response in the form of more construction, or any other kinds of investment or activity that become more productive once the complementary asset is cheaper. A simple model suggests that this reform could raise business investment in structures by around 30 per cent in the long run, enough to boost GDP by slightly less than 1 per cent. This would in turn increase revenues by a similar proportion, or around £9 billion in today's money – about one-third of total business rates receipts, and roughly the same as the gross cost of the reform. So this reform to business rates could finance itself in the long run.

26 ONS, Blue Book, September 2022. This includes agricultural properties, which are not subject to business rates.

FIGURE 3: **Business rates should gradually become a land tax**

Projected change in tax base and revenue-neutral tax rate if business rates exempted new structures: UK



NOTES: The blue line assumes a depreciation rate of 5.3 per cent of existing structures and an increase in land values of 1.7 per cent per year, in line with the OBR assumption for the trend growth rate of GDP. The red line also assumes that structures grow in line with GDP.
SOURCE: Analysis of ONS, Blue Book,2022, OBR, Economic and Fiscal Outlook, March 2023.

Boosting business dynamism by halving non-residential Stamp Duty

Just as with the residential version (that we discuss in Section 4), there is evidence that non-residential Stamp Duty Land Tax (non-residential SDLT) substantially reduces the volume of transactions of business property, although this effect will be attenuated by the fact that leases attract lower rates of non-residential SDLT than outright sales, and that short leases are exempt.[27] To the extent that it does discourage transactions, then, non-residential SDLT may inhibit the reallocation of business capital to its most productive user, as well as effectively taxing further improvements to the property.[28] There is evidence that business dynamism – the reallocation of labour and, in this case, capital across firms, and ideally from less to more productive firms – is an important driver of productivity growth, and moreover has fallen in recent years, especially since 2008.[29]

Non-residential SDLT raises around £4 billion per year, about one-seventh the revenues raised from business rates. We recommend the halving of non-residential SDLT at a cost

27 Stamp Duty Land Tax applies in England and Northern Ireland. In Wales, there is Land Transaction Tax and in Scotland there is Land and Buildings Transaction Tax. The systems are similar enough that these reforms can be enacted throughout the United Kingdom.
28 For an estimate of the deadweight costs of taxes on the transfer of business property, see L Cao et al., Understanding the economy-wide efficiency and incidence of major Australian taxes, Treasury Working Paper, April 2015
29 For evidence of the link between declining dynamism and productivity growth in a US context, see R Decker et al., Declining Dynamism, Allocative Efficiency, and the Productivity Slowdown, American Economic Review, May 2017.

of £2 billion per year, assuming no behavioural response. This could boost commercial transactions by around 20 per cent, defraying around £0.5 billion of the fiscal cost.[30]

Slashing the VAT threshold

The turnover threshold at which UK firms must register for VAT has been set at £85,000 since 2017-18. It has, accordingly, been declining in real terms and is set to decline further as the threshold is frozen until 2025-26, by which point it will be one-quarter lower in real terms than 2017-18. Nonetheless, the level remains high in international terms – the highest in the OECD in 2022.[31] For example, all German companies are expected to register for VAT, although a special scheme for firms with turnover less than €22,000 acts as a de facto threshold.

VAT, as a tax on value added, discourages economic activity to some extent. However, the existence of a registration or payment threshold is a separate distortion. At the point of crossing the threshold, the substantial fixed costs of registration and filing must be paid.[32] Moreover, all of a firm's infra-marginal turnover becomes liable for VAT at the point the marginal pound of turnover crosses the threshold. And there is evidence that the UK's high threshold acts as a significant drag on the turnover, and hence expansion, of firms just below it. The OBR estimates that increased bunching below the £85,000 threshold during the period of the freeze will increase the amount of lost turnover from £110 million to £350 million.[33]

A sharp lowering of the threshold, for example to £30,000, could raise substantial revenue in a static sense – around £2 billion per year. It may also boost economic activity if it reduced bunching below the threshold, which is likely if the new threshold is set very low, and if this offsets the disincentive effect of the higher marginal tax rate on firms newly liable for VAT, which will tend to penalise growth well below the threshold. The net effects are most likely to be positive if the threshold is set so low that a sole trader's business would not be viable at the threshold. Figure 4 shows that a nominal threshold of £30,000 would converge with the projected National Living Wage within 10 years, a threshold below which it is unlikely that a sole trader's turnover would be viable.

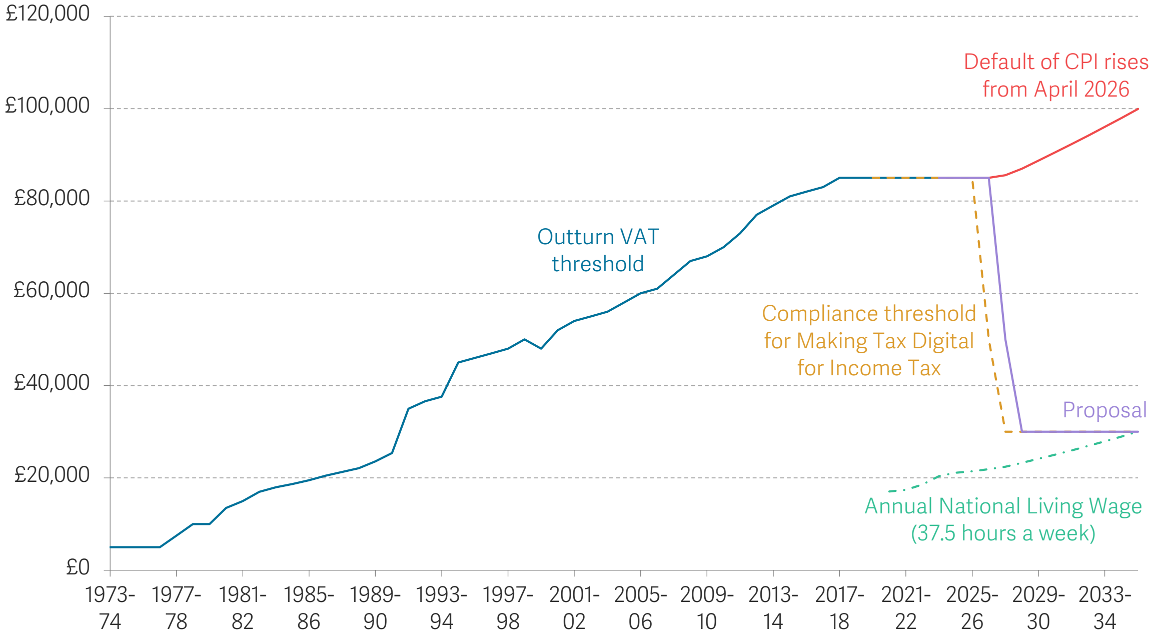
Finally, a low threshold would remove some of the tax benefit from working for a company as a self-employed sole trader rather than as an employee. If this did encourage more of the workforce to become employees, then more of the workforce would be

30 HMRC, Responsiveness of commercial transactions to Stamp Duty Land Tax, November 2021 says that 'our preferred regression estimates that a 1 per cent change in the Effective Tax Rate (ETR) (tax paid ÷ value of transaction) leads to a 11.7 per cent change in commercial transactions.' The average effective rate of non-residential Stamp Duty was 3.4 per cent in 2022-23. The boost to transactions from a halving of rates would therefore be 11.7 * 0.034/2 = 20 per cent
31 Figure 2.3 in OECD, Consumption Tax Trends 2022, November 2022
32 However, the existence of a Flat Rate Scheme for small businesses – essentially a turnover tax – can mitigate these costs a great deal.
33 OBR, The impact of the frozen VAT registration threshold, March 2023

brought under the scope of employment regulation, facilitating improved employment rights both on paper and in practice.[34] Expanding VAT registration might also be expected to cut fraud, not least because businesses paying VAT have a strong incentive to ensure that their suppliers also pay appropriate VAT. It makes sense to align the threshold for VAT registration with that of Making Tax Digital for Income Tax – which will require detailed quarterly digital accounting – which currently has an annual threshold of £85,000 but is set to fall to £30,000 from 2027-28.

FIGURE 4: **A sharp cut in the VAT threshold would make non-registration unviable**

Outturn and future scenarios for VAT registration threshold, the compliance threshold for Making Tax Digital for Income Tax, and the projected National Minimum Wage: UK



SOURCE: Analysis of IFS, Fiscal Facts.

In this Section we have set out a package of broadly revenue-neutral reforms to business taxation which will boost investment and dynamism in the economy, while reducing the scope for fraud and improving the enforceability of employment.

34 See: L Judge and H Slaughter, Enforce for good, Resolution Foundation, April 2023; and: N Cominetti et al., Low Pay Britain 2023, Resolution Foundation, April 2023

Section 3

Taxing externalities

Taxing externalities can help reduce upward pressure on other taxes while supporting national policy goals such as net zero. Most importantly, a per-mile 'Road Duty' system needs to be rapidly rolled out for electric vehicles, to mirror Fuel Duty and limit congestion as the cost of driving falls. This should be accompanied by cutting VAT on non-home electric vehicle charging to match the treatment of at-home charging so that different drivers do not face different electricity tax rates; reforming Vehicle Excise Duty; and facilitating local Congestion Charges in cities and large towns. The annual drama of whether or not Fuel Duty will rise as planned should be ended, and lower fuel prices mean the temporary 5p cut should also end. In future, Fuel Duty should see small monthly increases that equate to a predictable 2 per cent rise in duty each year.

To support its net zero objectives, the Government should also aim to raise more revenue via consistent carbon pricing where possible, although in places consistency points to lowering some charges to cut the cost of electricity. In the 2020s, the priority within the Emissions Trading Scheme should be to phase out the £2.4 billion a year of free emission allowances, while accounting for un-priced emissions embedded in key categories of imports via a Carbon Border Adjustment Mechanism. At the same time, the relative costs lumped on electricity and gas prices need rebalancing (as the Government has acknowledged): we suggest scrapping the Carbon Price Support which is an extra tax on marginal electricity production, continuing to rebalance Climate Change Levy rates (for businesses) away from electricity, and shifting residential electricity levies towards gas prices or general taxation.

As explored in Section 1, externalities are a good basis for taxation. Taxing externalities can improve the outcomes of markets by making consumers or producers account for the costs that their choices impose on third parties, and revenue raised in this way reduces the need for more economically harmful taxes elsewhere. But the UK is facing the loss of a major externality tax in the form of Fuel Duty, as well as the potential decline of tobacco duties.[35] Given this, and the national goal of moving to net zero emissions, tax reforms that can both raise money and also help achieve other policy goals should be particularly sought. Below, we set out a pragmatic range of steps that are consistent with this, while taking into account the political and distributional considerations.

A 'Road Duty' is needed for electric vehicles, and large urban areas should develop Congestion Charges

Fuel Duty is expected to raise £24 billion in 2023-24, but the transition to electric vehicles (EVs) is proceeding at pace – and these are not currently due to face any equivalent tax. This is a fiscal problem for the Treasury; a congestion problem, given that it makes driving cheaper; and a distributional problem, as the remaining motoring taxes become concentrated on those who cannot afford the higher up-front cost of EVs or have housing situations that are less convenient for EV charging.[36]

As we have set out at greater length in a companion paper, a per-mile 'Road Duty' for EVs (but not fossil fuel vehicles) should be introduced, at around 6p per mile (plus VAT) in order to provide approximate parity with Fuel Duty.[37] This should be delivered via the digital systems embedded in new cars (i.e. with mileage logged at least monthly over the cell network, and informed by GPS as well as mileometers). Payment would ideally be made monthly via the same system that drivers already use for Vehicle Excise Duty. And the Government should aim to have this up and running by around 2027, given the growing fiscal hole – which will reach an estimated £9 billion in 2030-31 – and the growing normalisation of very-low-tax driving.

A flat per-mile charge is a departure from the theoretical ideal of road pricing, given that congestion in fact varies significantly by time and place. However, aiming for a more complicated system – which would create significant winners and losers across the

35 Tobacco duties are projected by the OBR to raise less in 2027-28 than in 2023-24 in cash terms (both around £10 billion), despite increases in duty rates over this period, and the Government has an ambition to reduce smoking prevalence to below 5 per cent of adults by 2030.

36 This section draws heavily on: J Marshall & A Corlett, Where the rubber hits the road: reforming vehicle taxes, Resolution Foundation, June 2023.

37 We leave open the question of how far (if at all) such a Road Duty should vary by electric vehicle type. It could be argued that a large tax differential between fossil fuel vehicles and EVs is warranted to drive a green transition, or that taxing hydrocarbons more than electric-powered transport is in line with the polluter pays principle. Neither of these is a good reason not to proceed with a per-mile tax on EVs. First, the shift to EVs is being driven not just by price considerations but by consumer demand and regulations that will end the sale of pure petrol or diesel cars from 2030, and mandate increasing EV sales from 2024. Second, the biggest externality from driving is estimated to be not CO_2 emissions but congestion – with each person's decision to drive having a negative impact on other drivers – and EVs contribute to congestion just as much as hydrocarbon-powered vehicles.

country and different parts of the population relative to Fuel Duty – would be a risk to political deliverability. But a GPS-linked 'Road Duty' system would have the benefit of facilitating locally-determined Congestion Charges in the country's major urban areas – which could piggy-back on this technology and thus avoid the need for separate payment systems and physical enforcement such as number-plate recognition, and charge per-mile rather than per-day.

Reforms to VAT and Vehicle Excise Duty can make road taxation fairer

Although taxes on EVs need to go up overall, the fairness of the tax system between EV drivers needs to be improved.[38]

Drivers who can charge their vehicles at home can benefit from cheaper charging costs than those who use public chargers, but at the moment they also benefit from lower VAT on electricity, as residential power is taxed at only 5 per cent compared to 20 per cent elsewhere.[39] VAT on non-home charging needs to be cut to 5 per cent. This would cost around £0.5 billion a year initially, but will eventually reach perhaps £1.5-3 billion, although this depends on (highly uncertain) future charging costs.

The distribution of motoring taxes can also be improved by revisiting how Vehicle Excise Duty (VED) should apply to EVs. From 2025, EVs will pay the flat annual VED charge (but not the one-off charge that applies when a new car is purchased). This is a welcome and significant change, but the initial payments within VED also need to be reinvented for the electric car era. These payments are currently linked to the emissions of petrol and diesel cars, but an appropriate replacement would be linked to the weight of EVs, given that heavier vehicles do more damage to roads (and people) and in general take up more space. As well as better reflecting the externalities of different vehicles, it would help reduce energy needs, while also making the future VED system more progressive: it would be odd for owners of new cars to pay no VED, unlike drivers of older cars. An up-front EV VED system should raise around £1 billion a year in the medium-term.

Fuel Duty (and Road Duty) uprating can clearly be done better

As discussed in Section 1, the main focus of Fuel Duty policy in recent years has been an annual performance regarding rises that never come. The Government's default policy – reflected in the OBR's fiscal forecasts – is that Fuel Duty will rise each April in line

38 This again draws heavily on J Marshall & A Corlett, Where the rubber hits the road: reforming vehicle taxes, Resolution Foundation, June 2023.
39 A Corlett & J Marshall, Shrinking footprints: the impacts of the net zero transition on households and consumption, Resolution Foundation, March 2022.

with (forecast) RPI inflation.[40] But there has been no nominal rise (and some cuts) since January 2011, and even in the 2000s default policy was frequently overruled.

This approach to tax policy – what the Treasury Select Committee has dubbed a "fiscal forecast fiction" – is not desirable.[41] Consistently doing the opposite of what HM Treasury has asked the OBR to assume that it will do creates uncertainty for businesses and households about their future costs, and undermines the integrity of fiscal forecasts.

But the freeze is also substantively an odd policy decision. Estimates of the external costs of the marginal mile driven suggest that Fuel Duty is lower than what would be most efficient, given the effects of congestion, emissions and other factors.[42] Fuel Duty is currently one third lower in real-terms than in 2011-12 (and similarly lower compared to average earnings), a decline that cannot be justified by any change in the relevant externalities. And over the same period the UK has set its net zero goal and made a wide-ranging and substantial policy effort to achieve that – with Fuel Duty policy actively working in the opposite direction.

In the near-term, the most important Fuel Duty policy is the future of the 'temporary' 5p Fuel Duty cut that is currently set to expire in March 2024. This 5p is equivalent to over 9 per cent of the current Fuel Duty rate, and costs around £2 billion a year, so is an important policy choice. Its expiration should go ahead (or at least take place gradually) – noting that nominal petrol prices in mid-June 2023 were at their lowest since October 2021 and were down a quarter since their peak in mid-2022.[43] Beyond this decision, however, the Government's longer-term policy on annual uprating can clearly be improved.

To make Fuel Duty rises more palatable, we agree with the Institute for Fiscal Studies that this uprating should be done monthly rather than annually, greatly reducing the size of any individual rise and effectively removing the policy choice from the annual Budget cycle.[44] To make uprating even more routine and automated, we suggest that it also be linked not to actual inflation but to the Bank's inflation target of 2 per cent per year. Fuel Duty would therefore rise by around 0.165 per cent every month (currently less than 0.01p). Such an approach would have the benefit of automatically delivering downward pressure on headline inflation when other prices were rising quickly, while conversely only delivering above-inflation rises when inflation was below target (and these are often times when oil prices are falling). Rather than exacerbating volatility in the cost of driving, a constant uprating factor would improve stability and predictability.

40 Specifically, the OBR's forecast for upcoming Q2 annual RPI inflation.
41 House of Commons Treasury Committee, Fuel Duty: Fiscal forecast fiction, January 2023.
42 Department for Transport, TAG Data Book, May 2023.
43 Analysis of DESNZ, Weekly road fuel prices, June 2023.
44 S Adam & R Stroud, A road map for motoring taxation, IFS, October 2019.

Such an approach should also apply to the proposed new Road Duty applying to EVs – potentially building in a good uprating policy from the start of this new tax, and maintaining parity between it and Fuel Duty – although that should not distract from the key priority of introducing Road Duty in the first place.

Over the next four years, the fiscal effect of a 2 per cent uprating would not differ significantly overall from the current forecast for RPI-linked uprating (with expected RPI being below 2 per cent in some years and above it in others), but compared to a – very plausible – world where the Fuel Duty rate stays at its current level of 52.95p, around £4 billion a year is at stake by 2027-28. If not raised through Fuel Duty, this revenue will need to be raised through increases in other taxes.

The UK should apply more consistent carbon pricing and lower charges on electricity

Given the urgent need for decarbonisation, and the UK's specific net zero targets, the most obvious externality tax at present would be carbon pricing. The UK already has a functioning carbon price in the form of the UK Emissions Trading Scheme (ETS), which has budded off from the EU ETS. This cap and trade approach can ensure that traded carbon budgets are met and also raise revenue – to the tune of £6 billion a year at present.[45] However, the UK ETS is limited in the scope of emissions that are priced, and is currently forecast to cover only 18 per cent of emissions in 2030.[46]

There are at least some ways in which ETS pricing should be extended to more emissions. A priority should be to reduce the scale of free allowances that are given out to support certain industries that were deemed at risk of being undercut by competitors based in other countries without carbon prices. The value of these free allowances totalled £2.4 billion in 2021.[47] In the EU ETS, there is a schedule for phasing these out beginning in 2026 and due to complete in 2034.[48] Options are also under review in the UK.[49]

Free allowances should be phased out. This could be particularly rapid for aviation, where the risk of carbon leakage is considered to be minimal.[50] But for other industries, phase-out needs to be accompanied by other ways of preventing domestic production being undercut by non-level competition from beyond the EU. The EU has decided to introduce a Carbon Border Adjustment Mechanism which will attempt to do this for iron, steel, cement, aluminium, fertilisers and electricity (while also raising some limited

45 OBR, Economic and fiscal outlook, March 2023.
46 Rt Hon Chris Skidmore MP, Mission Zero: Independent Review of Net Zero - final report, September 2022.
47 Rt Hon Chris Skidmore MP, Mission Zero: Independent Review of Net Zero - final report, September 2022.
48 European Parliament, Climate change: deal on a more ambitious Emissions Trading System (ETS), December 2022.
49 UK ETS Authority, Developing the UK Emissions Trading Scheme (UK ETS), March 2022; DESNZ & HMT, Addressing carbon leakage risk to support decarbonisation, March 2023.
50 UK ETS Authority, Developing the UK Emissions Trading Scheme (UK ETS), March 2022; Frontier Economics, Economic Research On The Impacts Of Carbon Pricing On The UK Aviation Sector, February 2022.

revenue). The UK should adopt a similar Carbon Border Adjustment Mechanism, and will no doubt have to explore how closely this should align with the EU's to reduce duplicative reporting and costs for in scope British exporters (and whether this will have any broader implications for the UK ETS).[51] A Carbon Border Adjustment Mechanism would directly raise some revenue, but that is not the point of the policy and it is the reduction in free allowances that would be most important fiscally.[52]

Beyond these steps, however – and some other options such as the treatment of biomass power plants, maritime and international aviation emissions which we do not explore here – it is not clear that a major expansion of the UK ETS is desirable for now.[53] A formal carbon price could in theory be applied to road transport fuels: the EU is implementing this from 2026 (via an ETS II), accompanied by a Social Climate Fund to support vulnerable households. However, Fuel Duty can be seen as already performing this role, at a rate that comfortably exceeds the current carbon price. As we have set out, in the context of introducing a separate Road Duty for EVs, charging non-EVs considerably higher road taxes than EVs is not necessary to drive the transition to EVs, and would risk being particularly regressive: for now, the priority should be the road tax reforms we set out above. Another potential expansion of carbon pricing would be to farming and land use, which are projected to rapidly grow as a proportion of total emissions, as other sectors decarbonise. But the potential use of major price mechanisms would be controversial at present, particularly given the scale of recent food price inflation and the ongoing post-Brexit process of subsidy reform.[54] New Zealand's attempts to apply greenhouse gas pricing to agriculture could be a useful lesson that can inform what the UK does in future.[55]

The most important outstanding option for ETS expansion is fossil fuel use in buildings (i.e. primarily for heating). Decarbonising heating is a key net zero challenge, but homes and businesses using electricity for heating (e.g. for heat pumps) pay a carbon price within the cost of electricity (including a special Carbon Price Support charge), but do not face a carbon price for burning gas themselves: meaning that current UK taxes are actually discouraging electrification. The EU is extending carbon pricing to buildings (as with road transport). However, to introduce a new tax on gas bills in the UK would no doubt be politically challenging in the current circumstances, and – as with cars – may not be particularly necessary if (as expected) there is a ban on new boilers in the 2030s and a corporate mandate to ramp up heat pump sales. Given the existing tax

51 S Bhalotia et al., Trading up: the role of the post-Brexit trade approach in the UK's economic strategy, Resolution Foundation, June 2023.
52 Figure 18 in European Commission, Impact Assessment Report – Proposal for a regulation of the European Parliament and of the Council establishing a carbon border adjustment mechanism, July 2021.
53 Transport and Environment, A pricey omission: not charging ships for their pollution costs the UK dearly, January 2023.
54 A Corlett & J Marshall, Shrinking footprints: the impacts of the net zero transition on households and consumption, Resolution Foundation, March 2022.
55 NZ Ministry for the Environment, He Waka Eke Noa - Primary Sector Climate Action Partnership, October 2022.

system, there may also be lower-hanging fruit that can reduce the cost of electricity relative to gas (and support the cost-effectiveness of EVs), and the Government has already committed to making progress in such 'rebalancing'.[56] We therefore make three recommendations:

1. The Carbon Price Support should be abolished. This is an added carbon tax (of £18 per tonne) on electricity generation, and played an important role in phasing-out coal power. But it is no longer clear why British electricity production should face a higher carbon price than other sectors (and imported electricity).[57] Abolition would cost the Exchequer around £400 million in 2027-28.

2. Rates of the Climate Change Levy (CCL) – the tax paid on the business use of energy – should be rebalanced away from electricity and towards fossil fuel use. From 2024, CCL rates will be aligned on business electricity and gas use at 0.775p per kWh (following some years of convergence), but the electricity rate should be lowered or even abolished – with the foregone revenue offset by further increases in fossil fuel rates (noting that recent UK ETS carbon prices of around £70 per tonne would suggest a CCL rate for gas of around 1.5p per kWh).[58]

3. Other electricity levies should be shared with gas use or moved to general taxation. For example, the legacy cost of renewable obligations certificates (closed to new entrants in 2017) is projected to add £8 billion to electricity bills in 2024-25.[59] At the very least, these charges should be spread over both electricity and gas bills. The alternative of shifting levies entirely towards gas would clearly have an even larger effect on electrification incentives (with modelling in 2021 suggesting this would lower the cost of electricity by 14 per cent while raising the cost of gas by 13 per cent), but would place the burden on an ever-shrinking group of households that will include those unable to afford the switch to heat pumps or equivalent.[60] Moving some or all levies from residential bills onto the public balance sheet, to be funded out of general taxation, would improve the distributional impact, but would require explicit tax rises or cuts in spending elsewhere (although this is the situation at the time of writing, as the Energy Price Guarantee in effect has removed the levies from household bills). We do not take a firm view here about the form of rebalancing, but it is clear that electricity costs should be reduced through levy reform.

56 DESNZ, Responding to the Independent Review of Net Zero's Recommendations, March 2023.
57 UCL, Impact of Carbon Price Support on British energy bills, January 2020.
58 This assumes average emissions of 220 gCO2eq/kWh. See: Parliamentary Office for Science and Technology, Carbon Footprint of Heat Generation, May 2016.
59 OBR, Economic and fiscal outlook, March 2023.
60 ECIU, Energy bills: getting the balance right, February 2021.

To conclude, to continue to raise significant revenue from taxing externalities the Government should be clear that EV drivers will face a tax comparable to Fuel Duty; that Fuel Duty will rise over time; and that the direction of travel will be for more carbon pricing in various forms, but lower levies on electricity.

Section 4

Fairer and more efficient taxation of homes

Residential property taxes have an important place in our tax system. It is efficient to tax land and immovable property because supply is inelastic in the short run, so taxing it has smaller impacts on behaviour than other taxes. However, our main property tax – Council Tax – needs urgent reform to play a role in lowering inequality and making the housing market more efficient. The flat tax bills within bands, the small differences in tax bills between bands, and the severely out-of-date valuations have resulted in a highly regressive tax with respect to property values.

There have been many calls to change Council Tax to a proportional (or progressive) tax levied on up-to-date property values, but resolving the significant unfairnesses in the current system is extremely hard without creating significant losses for some. Pragmatic reform is therefore needed. Revaluations are needed in each nation, and property values should then be updated annually. Council Tax should move away from bands to a fully proportional tax on property values. But these key goals of revaluation and proportionality in England can be (and probably need to be) delivered without major redistribution of tax burdens across councils: to start with, they would affect only the distribution within council areas. A separate, more gradual convergence is then needed in the local government finance settlement process, with council funding calculations gradually shifted from a 1991 Council Tax base to an up-to-date proportional property tax base. We estimate that the majority of households would be better off under a locally specific Council Tax rate compared to the current system, with low-to-middle income households being more likely benefit.

Our other main residential property tax – Stamp Duty Land Tax – is overwhelmingly considered to be a bad tax. By putting a tax on transactions, it makes it more expensive to move house, resulting in inefficiencies within the housing market as it discourages people from moving to homes more suitable for their needs. But it also creates inefficiencies in the labour market: by making it more expensive to move, people may be less likely to relocate to access better jobs elsewhere. This dampening of labour mobility results in a less efficient allocation of workers and reduces worker power by potentially preventing people from accessing better, higher paying jobs somewhere else. Abolishing Stamp Duty completely would address these issues, but the lost tax revenue would be significant (£14 billion by 2027-28) and would need to be made up elsewhere. Instead, we suggest changes to both Stamp Duty thresholds and rates. First, the Stamp Duty reliefs that are due to end on 31 March 2025 should be made permanent to prevent tax rises for those unable to purchase their home before this date. Second, Stamp Duty rates should be halved for main homes. Based on the average house price, these changes – costing a combined £3 billion a year – would reduce the cost of moving in England by almost £4,000 on average – with greater gains to movers and first-time buyers in more expensive parts of the country such as London and the South East.

As discussed in Sections 1 and 2, it is generally efficient to tax immovable property and land for several reasons, principally because the supply of land is relatively inelastic in the short run, meaning that taxes on immovable property and land tend to distort behaviour less than other forms of taxes. For this reason, residential property taxation should be an important part of the UK's tax system – as it has been for centuries.

But, as the Mirrlees Review noted, deciding how to tax residential property is difficult because housing has elements of both a consumption good and an investment good, and any proposal for reform needs to consider that residential property is affected by many different taxes.[61] In this section, we discuss the two largest taxes (in terms of revenue) relating to residential property – Council Tax, and Stamp Duty Land Tax (SDLT); we discussed business property in Section 2, and we discuss the tax treatment of rental income and housing capital gains in Section 5. As we discuss below, something like Council Tax – a tax that relates to the value of residential property – is a worthwhile addition to the tax system, but Council Tax itself needs extensive reform. On the other hand, an important principle of taxation is not to distort markets by discouraging transactions, but this is exactly what SDLT does; there is little that can be said in favour of it other than the revenue it brings in.

61 Chapter 16 of J Mirrlees et al., Tax by design, Institute for Fiscal Studies, September 2011.

Council Tax is the sixth largest tax in the UK, but it is not fit for purpose

In 2021-22, Council Tax – together with the domestic rates system that persists in Northern Ireland – raised £39.4 billion; making it the sixth-largest tax in the UK.[62] It is also set to grow considerably in the next few years.[63]

There are good economic reasons for levying a tax on residential property based on its value: residential property provides consumption benefits, like a car or other consumer durable, so we should tax it like any other consumption good. Furthermore, an annual tax based on the value of a house is preferable to charging VAT on sales of new homes. However, Council Tax is flawed and needs immediate reform.

In its current form, Council Tax in England and Scotland places households into eight bands – from A to H – based on the estimated value of the property on 1 April 1991 (regardless of whether or not it existed at the time). In Wales, a revaluation took place in 2003 when a new top band – band I – was also introduced. Fixed ratios between bands – rising with property values, but not in proportion to them by any means – determine tax differentials.

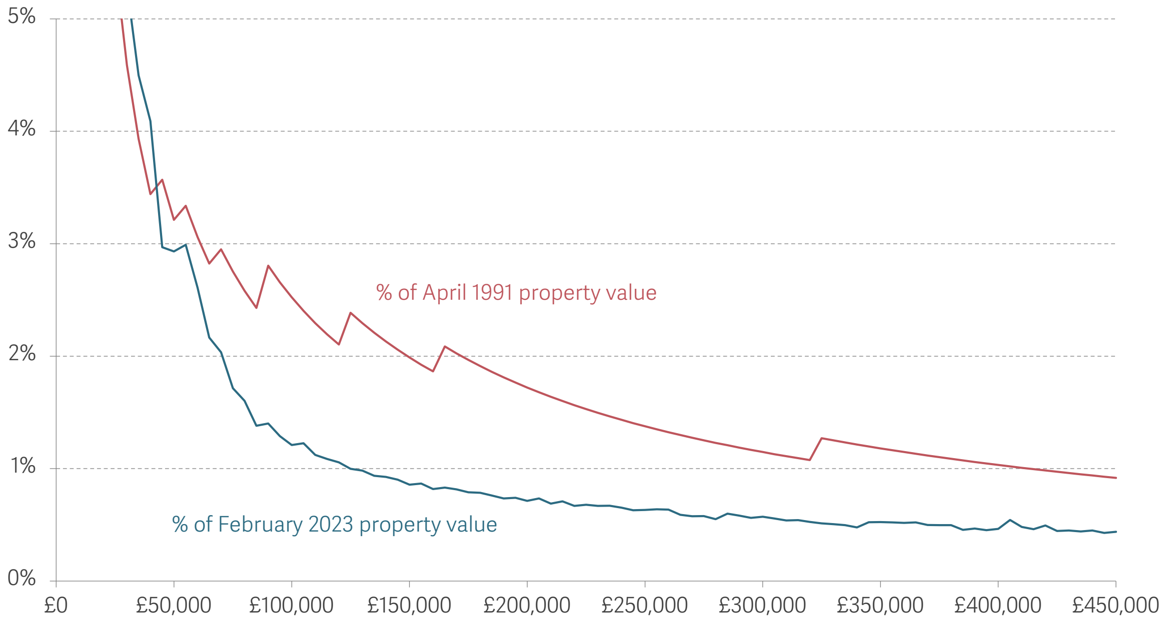
The combination of flat tax bills within bands, small differences in tax bills between bands, and severely out-of-date valuations have resulted in a highly regressive property tax. First, the existence of bands in which Council Tax bills are exactly the same means that the lowest-value property in each band has a significantly higher effective tax rate (i.e. tax as a proportion of property value) than the highest-value property in each band. Second, Council Tax's regressivity is amplified by the fact that the Council Tax differences between bands are much smaller than the differences in property values themselves. In particular, in any given area of England, the largest Council Tax bills (those applying to band H) are three times as large as the smallest Council Tax bills (those applying in band A).[64] By contrast, typical property values were eight times as high (£1.2 million and £150,000 respectively).[65] Third, Council Tax bands in England are based on the value that properties had in April 1991 – over 30 years ago. Since then, the relative prices of different properties have changed significantly, meaning that Council Tax liabilities bear even less relation to current property values. All of these points are shown in Figure 5: the regressivity is shown by the fact that average tax rates are lower for higher-valued properties; the impact of the banding structure is visible in the saw-toothed profile for

62 OBR, Economic and fiscal outlook, March 2023.
63 The average Band D Council Tax bill in England is set to increase by 5.1 per cent in 2023-24 – from £1,966 to £2,065 – and there will be larger increases across Wales and Scotland. These Council Tax rises are not expected to be a one-off: between 2022-23 and 2027-28, English Council Tax bills may rise by 25 per cent, compared to price inflation of 7 per cent and average wage growth of 13 per cent. See: OBR, Economic and fiscal outlook, March 2023.
64 Department for Levelling Up, Band D Council Tax Live Tables, Housing and Communities, March 2023.
65 Analysis of Wave 12 Understanding Society.

tax rates against 1991 values, and the nature of the changes in property prices since 1991 means that Council Tax looks even more regressive relative to today's property values than it did against those in 1991.

FIGURE 5: **Council Tax is regressive with respect to property values**

Annual Council Tax bill as a percentage of current and 1991 property value: England



NOTES: The red line (annual Council Tax bill as a percentage of property values at 1 April 1991) is based on the average 2023-24 billing authority in England. The blue line (average Council Tax bill as a percentage of property values at 1 February 2023) is calculated by matching the average 2023-24 Council Tax bill in each region and Band to properties in Wave 12 Understanding Society. Property values from Understanding Society Wave 12 have been uprated to 1 February 2023 using HM Land Registry's February 2023 House Price Index.
SOURCE: Department for Levelling Up, Band D Council Tax Live Tables, Housing and Communities, March 2023, analysis of Wave 12 Understanding Society.

Council Tax reform is urgently needed to address regressivity

There have been many suggestions on how to reform Council Tax.[66] All agree that Council Tax reform will be challenging, both practically and politically, but that does not mean we should continue with the status quo. A fairer Council Tax system would improve the living standards low-to-middle incomes. As discussed above, Council Tax in its current form is regressive with respect to property value, but given that higher-income people tend to live in more valuable homes it is also regressive with respect to income. Furthermore, a well-designed, progressive, property tax could help curtail wealth inequalities by levying a higher tax on those with significant property wealth. Finally, it is argued that the single

66 For example, see: J Mirrlees et al., Tax by design, Institute for Fiscal Studies, September 2011; L Murphy, A Poor Tax: Reforming Council Tax in London, Institute for Public Policy Research, May 2019; A Corlett & L Gardiner, Home Affairs: Options for reforming property taxation, Resolution Foundation, March 2018; Fairer Share, The Proportional Property Tax Manifesto, 2021.

person discount encourages the over consumption of housing, distorting the operation of the housing market. But, as there is little support for Council Tax in its current form with its unfairness broadly recognised, reform would restore trust in the tax system and UK institutions more generally.

With that in mind, we are proposing a complete overhaul to the current Council Tax system. First, a revaluation is needed as soon as possible in England and Scotland (Wales should be commended for changes planned for 2025, based on April 2023 values).[67] From then on, revaluations should happen annually. To avoid creating disincentives to make home improvements which may increase the property's value, such as improving insulation, revaluations should not include home improvements until the property is sold. Frequent, regular revaluations would mean that the changes in bills would be small, gradual and routine. Box 1 outlines how revaluations and proportional property taxes are applied in other countries – specifically in various US states and Ireland.

BOX 1: **Property taxes linked to unbanded, annually-updated valuations are internationally normal**

In **New York City**, the Department of Finance is responsible for determining the market values of all properties. When it comes to property-tax assessment, there are four main property classifications, but typically, only two of them are relevant to the majority of homeowners. Class 1 properties encompass one- to three-unit family homes, while Class 2 properties include rental buildings with four or more units, co-ops, and condominiums. The remaining tax classes cover utilities, commercial buildings, and various non-residential properties.

The Department of Finance assesses the market value of Class 1 properties every year through the use of statistical modelling which analyses the prices of similar properties (based on factors such as location, size, style, and age) that were sold in the past three years. The assessed value is then calculated by multiplying the market value by the level of assessment, which is 6 per cent for Class 1 properties. However, by law, the assessed value of a Class 1 property cannot increase by more than 6 per cent per year or 20 per cent over five years, unless the value increases are due to new construction or renovations. In addition, the assessed value cannot exceed 6 per cent of the property's market value. Due to these caps, most

67 Northern Ireland's domestic rates system is based on 2005 values.

Class 1 properties are assessed at less than 6 per cent.[68]

In **Florida**, property appraisers establish the market value of property each year as of 1st January. Each county in Florida has its own property appraiser which is responsible for identifying, locating, and fairly valuing all property within the county for tax purposes. The market value is the estimated value that a knowledgeable buyer and seller would agree upon in an arm's length transaction. The appraiser considers factors such as property size, location, condition, and comparable sales in the area.[69]

Property owners in Florida may be eligible for exemptions and additional benefits that can reduce their property tax liability, such as the Save Our Homes (SOH) assessment limitation which limits the annual increase in the assessed value of homesteaded properties[70] to 3 per cent or the change in CPI, whichever is less. If a change in ownership occurs for a homestead property protected by the SOH cap, the property will lose the SOH benefit and will be subject to assessment at just value on the following January. However, most Florida homestead owners are able to transfer their SOH benefit from their old homestead to a new homestead, lowering the tax assessment and, consequently, the taxes for the new homestead. This is referred to as the 'Save Our Homes Portability Transfer'.[71]

A typical **California** property tax bill consists of many taxes and charges including the 1 per cent rate, voter–approved debt rates, parcel taxes, Mello–Roos taxes, and assessments. The 1 per cent rate and the voter–approved debt rates tend to be the largest components of the property tax bill and are levied as a percentage on the assessed value of the property which includes the land and any improvements made to the land, such as buildings, landscaping, or other developments.

Under California's tax system, when property is purchased, the county assessor assigns it an assessed value that is equal to its purchase price, or "acquisition value." Each year thereafter, the property's assessed value increases by 2 per cent or the rate of inflation, whichever is lower. This process continues until the property is sold, at which point the county assessor assigns it an assessed value equal to its most recent purchase price. However, when property owners undertake property improvements, such as additions or upgrades, these are assessed at market value in that

68 New York City Department of Finance, Notice of Property Value (NOPV), accessed 20 June 2023.
69 Wakulla County Property Appraiser, FAQ, accessed 20 June 2023.
70 A property is considered a homestead property when someone owns property and makes it their permanent residence or the permanent residence of their dependent. See Florida Department of Revenue, Property Tax Exemptions and Additional Benefits, accessed 20 June 2023.
71 Florida Department of Revenue, Property Tax Exemptions and Additional Benefits, accessed 20 June 2023.

year and increase by up to 2 per cent each year thereafter. The unimproved portion of the property continues to be assessed based on its original acquisition value such that the property's assessed value would be the combined value of the two portions.[72]

An annual Local Property Tax (LPT) is charged on residential properties in **Ireland**. The tax is based on the market value of the property on the valuation date. The value of the property on this date will be used to calculate the LPT for the following three years. The LPT is a self-assessment tax, based on the owners own assessment of the market value of the property. An online valuation tool is provided to help owners use information about properties that are a similar type, age and size to provide an accurate valuation. Properties valued below €1.75 million then fall into 19 valuation bands which determine the LPT charge. Properties worth more than €1.75 million are assessed on the actual value of the property rather than from a valuation band. The LPT charge for these properties is the total of: 0.1029 per cent of the first €1.05 million of market value of the property, 0.25 per cent of the portion between €1.05 million and €1.75 million, and 0.3 per cent of the portion above €1.75 million.[73]

These revaluations should happen even if nothing else changes to Council Tax, but revaluation would also allow for a system where tax liabilities depends directly on the property value, rather than in bands. There is a debate about whether such a tax should be a simple proportional property tax, where the tax depends on a fixed fraction of the property's value, or should be progressive with respect to property prices.[74] For now, we consider the impact of a proportional property tax.

A national flat-rate proportional property tax would be progressive, but would create big losers

Moving to a national flat-rate proportional property tax would significantly improve the progressivity of Council Tax with respect to property values. But the overwhelming drawback is that it would mean very significant tax rises for some, with the biggest losers located in areas that have seen rapid increases in property values since 1991.

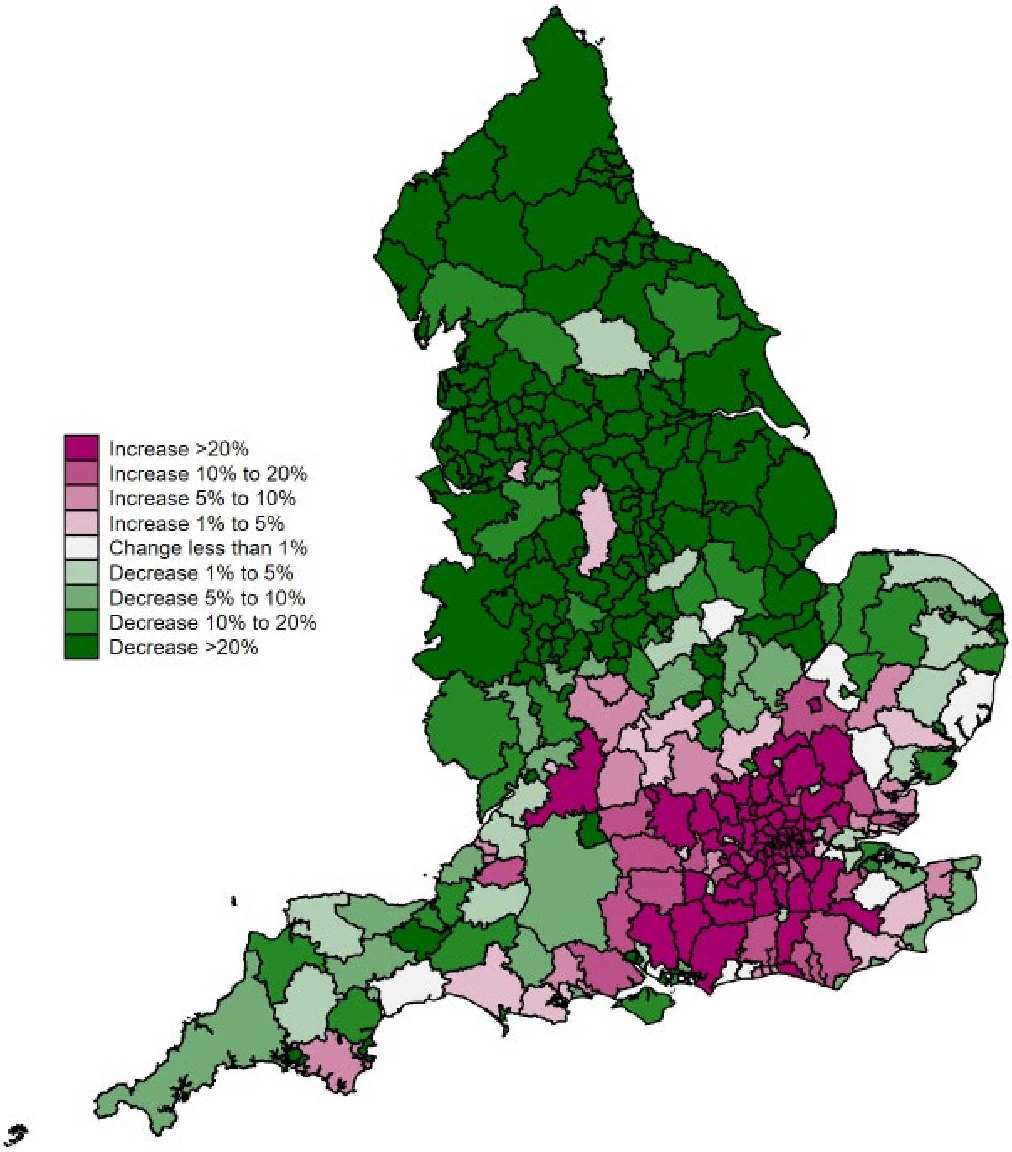
Analysis by the Institute for Fiscal Studies shows which local authorities would see the biggest changes in average Council Tax bills under a fixed percentage tax rate on updated property values. The tax rate has been determined so that it would raise the same

72 Legislative Analyst's Office, Understanding California's Property Taxes, November 2012, accessed 20 June 2023.
73 Citizens Information, Local Property Tax, accessed 20 June 2023.
74 The Institute for Fiscal Studies and Fairer Share have both called for a proportional property tax; the Resolution Foundation has previously called for a progressive one. For more information see the sources cited in footnote 64.

revenue across England as a whole as the current Council Tax system.[75] The biggest losers would be in inner London, with increases estimated at 410 per cent in Westminster, 358 per cent in Kensington & Chelsea and 166 per cent in Wandsworth (see Figure 6), all local authorities with very high property values.

FIGURE 6: **Households in London and the South East would be the biggest losers from a proportional property tax**

Changes in average tax bills if Council Tax was replaced with a national proportional tax on property values, by local authority: England, 2018-19



NOTES: Institute for Fiscal Studies analysis based on retaining existing Council Tax discounts, premiums and exemptions.
SOURCE: S Adam et al., Revaluation and reform: bringing council tax in England into the 21st century, Institute for Fiscal Studies, March 2020.

75 S Adam et al., Revaluation and reform: bringing council tax in England into the 21st century, Institute for Fiscal Studies, March 2020. That report describes the scenario we examine in Figure 7 as one where the basis for Council Tax becomes current property values and the funding formula for local government fully adjusts to reflect this new tax base.

Initially, changes to Council Tax should avoid redistributing between local authorities

201 local authorities in England would see their average Council Tax bill fall under a national flat-rate proportional property tax, and 125 would see their average Council Tax bill increase. In fact, 64 local authorities would see their average Council Tax bill increase by over 20 per cent, and 23 would see an increase of over 50 per cent. The creation of some households who would face significant increases in Council Tax bills is the main reason for political failure in reforming Council Tax.

Therefore, we recognise that moving immediately to a national flat-rate proportional property tax would be very difficult. An alternative is to move away from regressive Council Tax bands to a proportional property tax, but one where the rate of tax varies between local authorities.[76] In principle, these rates could be chosen so that each local authority raises the same under a flat-rate tax as it currently does under Council Tax, the outcome of this is shown in Figure 7 below.

In reality, this sort of calculation is complicated considerably by the existence of 'precepts', whereby Council Tax bills charged by local authorities include payments levied by other organisations, such as upper-tier county councils, fire services and police and crime commissioners, which tend to cover a wider geography. The existence of these precepts means that while the average bill charged by each local authority would be unchanged, the average overall bill (which encompasses these precepts) would change.[77] This means there would be some redistribution of tax bills within county, police and fire authority areas (e.g. from Cambridge to poorer parts of Cambridgeshire), but not across them.

Overall, a proportional property tax where the rate of tax varies between local authorities would result in fewer big losers: only 15 local authorities would see their average Council Tax bill increase by more than 20 per cent, and none would see their average Council Tax bill increase by more than 50 per cent.

A proportional property tax on annually updated values could result in volatile Council Tax bills and receipts, particularly during periods of fast house price growth. To limit potentially large changes, billing authorities should aim for some stability and

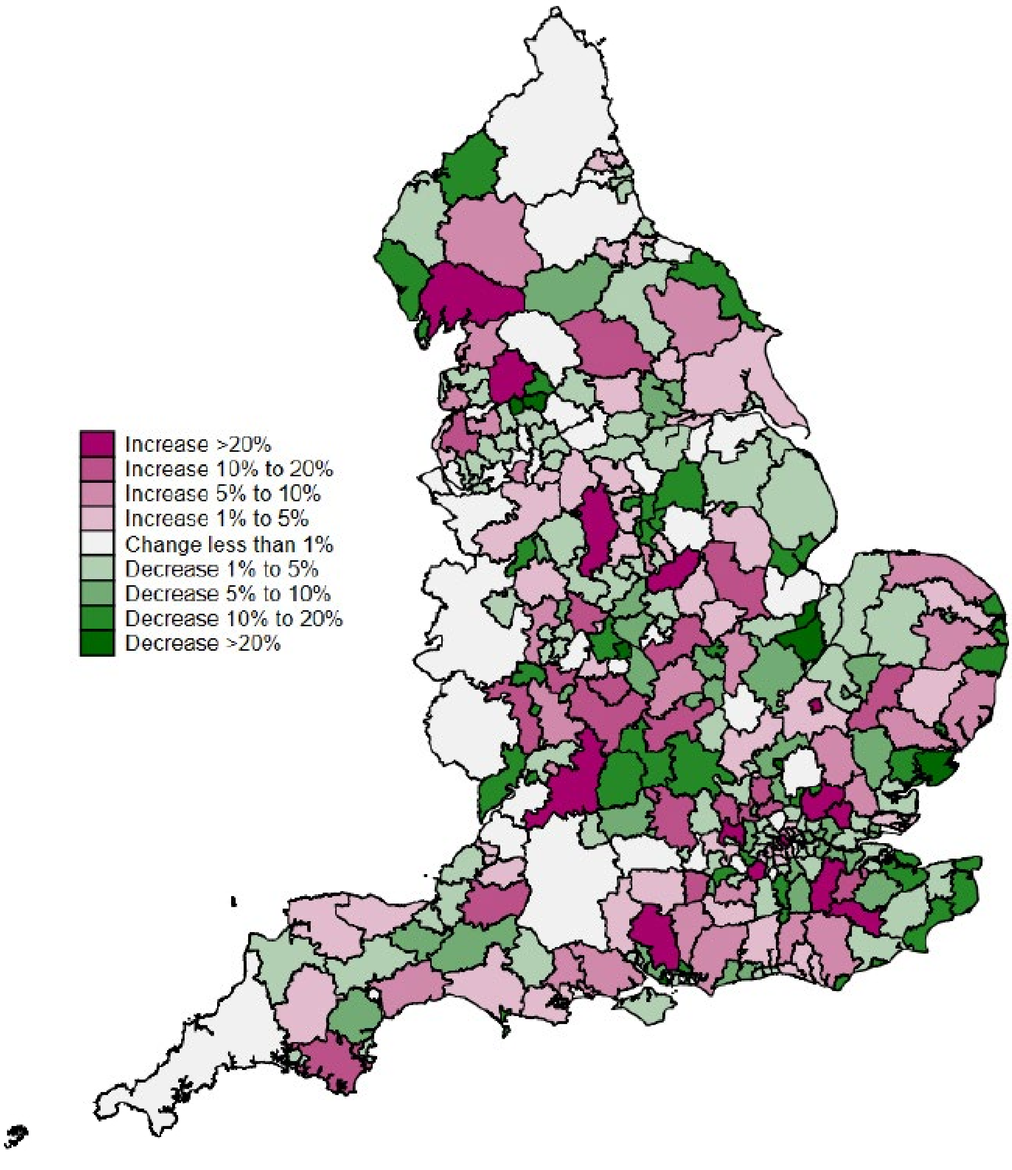
76 This is discussed more in: S Adam et al., Revaluation and reform: bringing council tax in England into the 21st century, Institute for Fiscal Studies, March 2020. That report describes the scenario we examine in Figure 8 as one where the basis for Council Tax becomes current property values, but the funding formula for local government does not adjust at all to reflect this new tax base.

77 To understand this, consider the average tax bill for residents of a lower-tier district council where the tax base falls, but which is part of wider county, fire and police authorities where the tax base rises. They would pay, on average, the same Council Tax to the lower-tier district which would set a higher rate to raise the same revenue as before. But they would, on average, pay less Council Tax to the county council and fire and police authorities which would set their tax rate lower to raise the same revenue as before given their larger tax bases. As a result, these residents would see their average Council Tax bill fall while the opposite is true for residents in a lower-tier district where the tax base rises. For example, under this system, the average Council Tax bill in Fenland would fall by 26 per cent while the average Council Tax bill in Cambridge would rise by 32 per cent. See: S Adam et al., Revaluation and reform: bringing council tax in England into the 21st century, Institute for Fiscal Studies, March 2020.

predictability in bills and receipts by changing the tax rate. Appropriate constraints on overall changes to receipts could be implemented.

FIGURE 7: **A flat-rate proportional property tax that varies between local authorities would result in fewer areas with large losses**

Changes in average tax bills if Council Tax was replaced with a proportional tax on property values that varies between local authorities, by local authority: England, 2018-19



NOTES: Institute for Fiscal Studies analysis based on retaining existing Council Tax discounts, premiums and exemptions.
SOURCE: S Adam et al., Revaluation and reform: bringing council tax in England into the 21st century, Institute for Fiscal Studies, March 2020.

The analysis that follows shows how households would be impacted by a proportional property tax. Due to data limitations, the analysis is based on regional-specific rates so that each region raises the same revenue as it does under the current system. This should be seen as an approximation to the impact of local authority-specific rates.

The regressivity of the existing Council Tax system means that the majority of households would be better off under a proportional property tax on up-to-date values (compared to the current system), despite differences in the effective tax rate across regions. But, as Figure 8 shows, it is low-to-middle income households that would be most likely to be better off: 84 per cent of households in the bottom income quintile in the North East would be better off under this reformed system, compared to 40 per cent of households in the top income quintile.

FIGURE 8: **Most households, and especially low-to-middle income households, would be better off under a regionally specific flat-rate property tax system than Council Tax**

Proportion of households that would be better off or unaffected from moving from the current Council Tax system to a regionally specific flat-rate system, by income quintile and region: GB, 2023-24

NOTES: Income quintiles are calculated using total net household income (before housing costs). Rental property values have been imputed using Council Tax bands and regional information. House price values have been uprated using HM Land Registry's February 2023 House Price Index. Single person Council Tax discount has been included in both the current and new system, but other exemptions and discounts have not.
SOURCE: Analysis of Wave 12 Understanding Society.

However, even with regionally specific Council Tax rates, some people will see very large rises in their bills. Our analysis indicates that around 13 per cent of households would face a Council Tax bill increase of over £500, and 7 per cent would see an increase of over

£1,000. Inevitably, these will be households living in high-value properties. On the most part, those in expensive homes tend to have high incomes: 29 per cent of people in the top income quintile would see their Council Tax bill increase by over £500. But living in an expensive house does not always mean its occupants have the immediate resources to hand to pay higher bills: we also estimate that 5 per cent of households in the bottom income quintile would see bills rise by over £500. Therefore, it might be prudent to cap the annual increase in Council Tax for current occupiers (at £500, for example). This would reduce the immediate shock by enabling households to spread bill increases over a number of years.[78] The cap would not be applied to new buyers; such a rule might act as a disincentive to move for those occupiers with a lower Council Tax bill in their current property, but our proposal to cut SDLT (discussed below) would help offset this.[79]

While a proportional property tax that varies between local authorities would be a considerable improvement on the current Council Tax system, it would not be fully progressive with respect to property values. This is because local authorities with larger tax bases would be able to set lower tax rates than those with smaller tax bases. This would result in very different property tax rates across the country meaning that a household occupying a £350,000 property in the North East would be charged a higher tax rate than an equivalent household in the South East. The final step in reforming Council Tax should be to close these differences by adjusting the local government finance settlement process to better reflect each local authority's tax base. This would achieve a fully progressive property tax with respect to property values. This could be transitioned in over many years by including the new tax base under a flat Council Tax rate to the funding formula (alongside the old 1991-valuation Council Tax base) and adding more weight to it over time. This formula is long overdue a review anyway, as part of the Fair Funding Review, which was first promised in 2016.

Smaller changes could be made to the Council Tax system to encourage efficient use of housing and ease administration burdens

Smaller changes could also be made to Council Tax. For example, local authorities could have greater autonomy over various discounts and exemptions. In recent years, local authorities have been given the power to levy higher taxes on second homes and some empty homes; this power should be extended to other discounts and exemptions, such as the 25 per cent single occupant discount and the Council Tax exemption for students. Discounts for single occupants encourage inefficient use of the housing stock, and exempting students from Council Tax may result in higher tax burdens for non-student

78 £500 increases in Council Tax bills may still be unmanageable for some. For those individuals, it should be possible to allow people to roll up liabilities (with interest) either until the property is sold or until death, in order to alleviate cash-flow problems, or local authorities could use the Council Tax Rebate schemes to provide relief.

79 In principle, these changes in Council Tax liabilities should be reflected in house prices. For example, a buyer may put in a lower offer on a property to account for, and potentially offset, much higher Council Tax bills throughout the duration of their occupancy.

residents – particularly in areas with a high density of student households. Instead, local authorities may wish scrap the single occupant discount altogether, and explore implementing a generous, but not a full, discount for students.

Finally, previous research has discussed the case for Council Tax to be charged to owners rather than renters. In the long run, this choice might have little impact on the actual incidence of tax – as we would expect rents to rise if landlords, not tenants, were paying Council Tax – but there is a strong case for change just on administrative grounds. For example, some housing associations manage tens of thousands – or even over 100,000 – dwellings each, and could deal with administration centrally, rather than each household managing its own Council Tax. Given that owners change less frequently than tenants, the number of changes in Council Tax arrangements would also be drastically reduced, and so the administrative savings for individuals and for councils could be considerable. We therefore propose piloting moving some social housing and private renting to an 'owner-pays' basis.[80]

Stamp Duty on residential properties dampens transactions

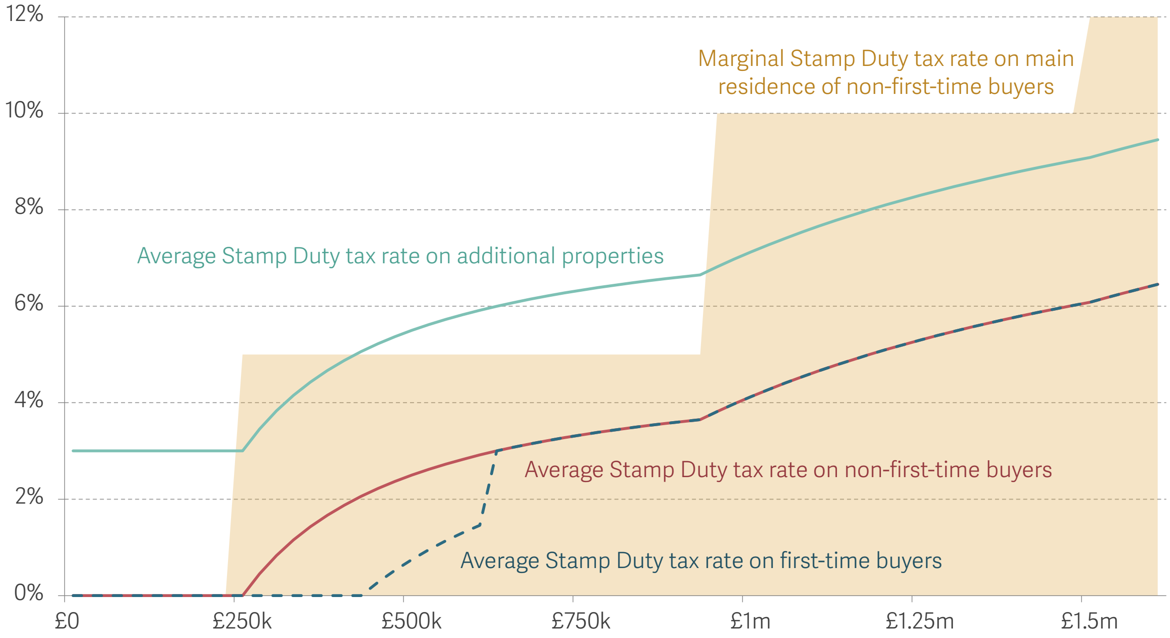
Britain's other main residential property tax is Stamp Duty Land Tax (SDLT). SDLT on residential property raised £10 billion in 2021-22 and is forecast to raise £14.3 billion by 2027-28.[81] Marginal rates of SDLT in England and Northern Ireland range from zero for values up to £250,000 (£450,000 for first time buyers), to 5 per cent up to £675,000, all the way up to 12 per cent above £1.5 million – giving the tax a very progressive structure (see Figure 9).

80 Transitioning to an 'owner-pays' basis would require changes to be made to Council Tax Rebate systems. It is likely that, under an 'owner-pays' system, rents would rise, at least in part. All else equal, this could leave low income renters worse off if they had previously been receiving help with their Council Tax bill. But so long as Housing Benefit or its Universal Credit equivalent can rise – or be actively increased – to compensate, then this should be easy to fix.

81 OBR, Economic and fiscal outlook, March 2023.

FIGURE 9: **Unlike Council Tax, SDLT is progressive with respect to property values**

Average and marginal Stamp Duty tax rate by property purchase price: England and Northern Ireland, 2023-24 and 2024-25



SOURCE: Analysis of HMRC, Stamp Duty Land Tax.

However, although it is better designed that it used to be, SDLT is still a damaging tax because it distorts the housing market by discouraging property transactions. Because it increases the costs incurred by the purchaser without increasing the pay-off accruing to the seller, it means that some otherwise mutually beneficial transactions do not happen. This will affect the housing market – it means people are discouraged from downsizing or upsizing their homes (Box 2 discusses some of the evidence) – but will also affect the labour market if it makes people less likely to relocate for work reasons; this both harms the UK's overall productivity and reduces worker power if people are less able to access higher paying, more suitable jobs.

BOX 2: **There is clear evidence that SDLT dampens property transactions**

Previous research that used administrative data on all property transactions in the UK from 2004-2012 shows that property transaction taxes cause large distortions in the housing market in terms of property prices, the volume of transactions and the timing of transactions. It found that the temporary 1 per cent reduction in SDLT under the 2008-09 stamp duty holiday increased housing market activity by 20 per cent in the short run. Less than half of the stimulus effect was reversed after the tax was reintroduced.[82] Another study found that the two-percentage point increase in SDLT between £125,000 and £250,000 in place before December 2014 reduced the annual rate of mobility by 2.6 percentage points, or a 37 percent fall in residential mobility.[83]

A more recent study found that the Stamp Duty Holiday announced during the Covid-19 pandemic increased the number of property transactions.[84] The scheme was due to end at the end of March 2021; as a result, the highest levels of transactions were observed in the months closest to the end date, with transaction levels were almost 30 per cent higher in December 2020 as compared to December 2019; 50 per cent higher in February 2021 than in February 2020.[85]

Abolishing SDLT would in principle, therefore, provide a boost to growth, but the massive £14.3 billion a year shortfall in revenue would need to be made up elsewhere. Instead, we suggest that, in addition to making permanent the higher SDLT threshold announced in the Growth Plan 2022, SDLT rates for movers and first-time buyers should be halved.[86] These cuts would come at a cost of around £3.4 billion in 2027-28.[87]

In the long-run, we would expect these cuts to be at least partially capitalised in higher house prices, but the higher thresholds for first-time buyers does give them an edge in the housing market. Across the country, the cuts would have the most impact in London and the South East, reflecting that property prices are typically much higher in these regions than in other parts of the country. For example, the average non-first- time buyer in London would see the cost of moving fall by almost 14 times more than the average non-first-time buyer in the North East (£9,560 and £700 respectively) (see Figure 10).

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82 M Best & H Kleven, Housing Market Responses to Transaction Taxes: Evidence From Notches and Stimulus in the UK, The Review of Economic Studies 85(1), January 2018.

83 C Hilber & T Lyytikäinen, Transfer Taxes and Household Mobility: Distortion on the Housing or Labor Market?, SERC Discussion Paper 216, London School of Economics, June 2017.

84 As part of its Plan for Jobs, the Government temporarily increased the Nil Rate Band of Residential SDLT, in England and Northern Ireland, from £125,000 to £500,000 from 8 July 2020 until 31 March 2021. Increasing the Nil Rate Band to £500,000 meant that nearly nine-out-of-ten people getting on or moving up the property ladder paid no SDLT at all. The Stamp Duty Holiday was later extended to the end of June 2021, with a lower threshold – £250,000 – until the end of September 2021. For more information see: HM Treasury, Stamp duty holiday continues to help hundreds of thousands of jobs after further 21.3 per cent boost in September, October 2020.

85 K Scanlon, C Whitehead & F Blanc, Lessons from the stamp duty holiday, London School of Economics, July 2021.

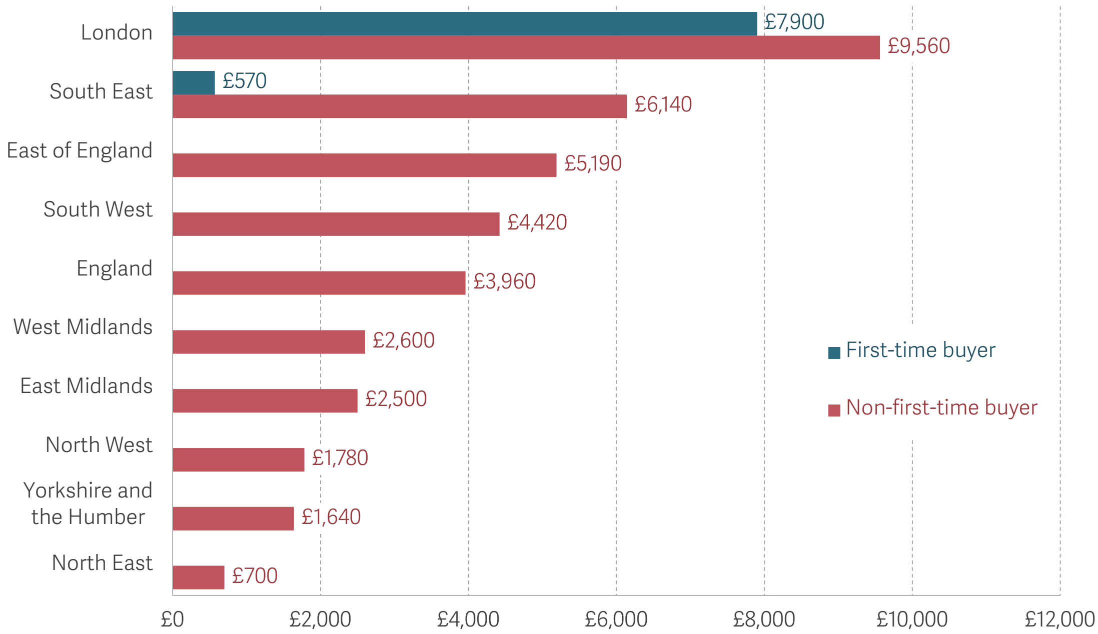
86 From 23 September 2022, the threshold from which SDLT must be paid was doubled to £250,000 for all home purchases. The threshold at which first-time buyers begin to pay SDLT was increased, from £300,000 to £425,000, and the maximum value of a property on which first-time buyers' relief can be claimed was also increased from £500,000 to £625,000. These reliefs are due to end on 31 March 2025. For more information see: HM Treasury, The Growth Plan 2022, September 2022.

87 Analysis of: HMRC, Direct effects of illustrative tax changes bulletin (January 2023), HM Treasury, Autumn Statement 2022 Policy Costings, and: OBR, Economic and fiscal outlook, March 2023. The aim of these changes is to rebalance demand towards owner occupation (by making homes more accessible to first-time buyers) and to increase mobility among owner occupiers (by decreasing the cost of moving), so there should be no change to the rates on properties bought by second home owners or buy-to-let investors: the existing higher rate on additional dwellings is intended to address concerns about housing affordability, particularly in areas where demand outstrips housing supply, by discouraging the purchase of properties solely for investment purposes or as second homes.

Similarly, the average first-time buyer in London and the South East would benefit from these proposed cuts, while the average first-time buyer outside these regions would see no benefit, because they would not be liable for SDLT even without these proposed cuts.

FIGURE 10: **Stamp Duty cuts would benefit those buying homes in more expensive parts of the country**

Stamp duty saving on main residences resulting from proposed cuts on an average-priced house, by region of England



SOURCE: Analysis of Stamp Duty Land Tax rates; ONS, House Price Index.

This section has outlined that our two main property taxes – Council Tax and SDLT – both need reform. Our proposals address their core problems while being pragmatic in their design and implementation.

Section 5

Taxing incomes more consistently

Reasonable people can disagree about how high the tax rates on income should be, but should agree they should be consistent across different forms of income. That is not what the UK's tax system does today, harming both efficiency and equity. The top marginal tax rates for employees' wages is 53.4 per cent when employer National Insurance (NI) is accounted for, and corporate dividends are taxed at similar levels – up to 54.5 per cent when the main rate of Corporation Tax is included. But marginal tax rates faced by individuals can be far lower than this, from zero or 10 per cent for some large capital gains, or 28 per cent for private equity managers. Other tweaks to our tax system mean that marginal tax rates rise to 67 per cent for employees facing the withdrawal of the personal allowance, to over 80 per cent for some parents seeing Child Benefit withdrawn.

We set out below a comprehensive package of reforms that brings the taxation of these different sources of income closer to each other, ending the bias against employee earnings. The end result would be that incomes from employment, self-employment (with the exception of low incomes), dividends, real capital gains and rents would all face almost identical marginal rates of tax. Our proposals imply a top rate of roughly 53 per cent (slightly below the rate that currently applies to top-earning employees and similar to the 52 per cent top tax rate that applied to self-employment income in 2012), a higher rate of between 48 and 49 per cent, and a basic tax rate of 40 per cent (with the latter two also matching how employee earnings are currently taxed, having factored in employer NI).

Those worried about high tax rates should support the changes above, not least because they provide the means to address the much higher effective tax rates some face as a result of repeated attempts to raise tax revenues without raising headline rates. In particular, the withdrawal of the Personal Allowance beyond £100,000 makes the Income Tax schedule regressive at high incomes, with marginal tax rates (excluding NI) falling from 60 per cent to 45 per cent at £125,140. This withdrawal should be abolished, though with the threshold for the 45 per cent additional rate lowered to £100,000, at a net cost of £2.5 billion before accounting for behavioural change. In addition, the effect of the High Income Child Benefit Charge between £50,000 and £60,000 leads to marginal tax rates that can top 100 per cent, and this should be abolished, at a cost of around £4 billion.

Income taxes – in various forms – account for the majority of tax revenue. It is therefore particularly important for growth and equity that they are designed well. But debate is often limited to relatively simple arguments such as whether particular Income Tax rates should be slightly higher or slightly lower: these are certainly important, but can easily overshadow more fundamental questions about the effective rates of tax actually faced by different groups of people. As set out in Section 1, a system of (reasonably) consistent tax rates should generally be favoured for both growth and equity over one where large differences distort behaviour, encourage tax planning, and lead to obvious unfairness. Below, we discuss where the current system fails to achieve that – with the result that employee earnings are effectively taxed higher than most other forms of income – and set out how to fix it.

Tax rates across different forms of income vary hugely, requiring significant reform

In marked contrast to the ideal of taxing different forms of income equally, at present it is quite possible for two people doing similar work and producing the same economic output to end up with very different tax bills. It is also common for tax rates to be lower for some people with very high incomes than for people who earn less. All of this is bad for income inequality and the ability of the government to raise revenue, bad for basic fairness across taxpayers, and leads to skewed business decisions.[88]

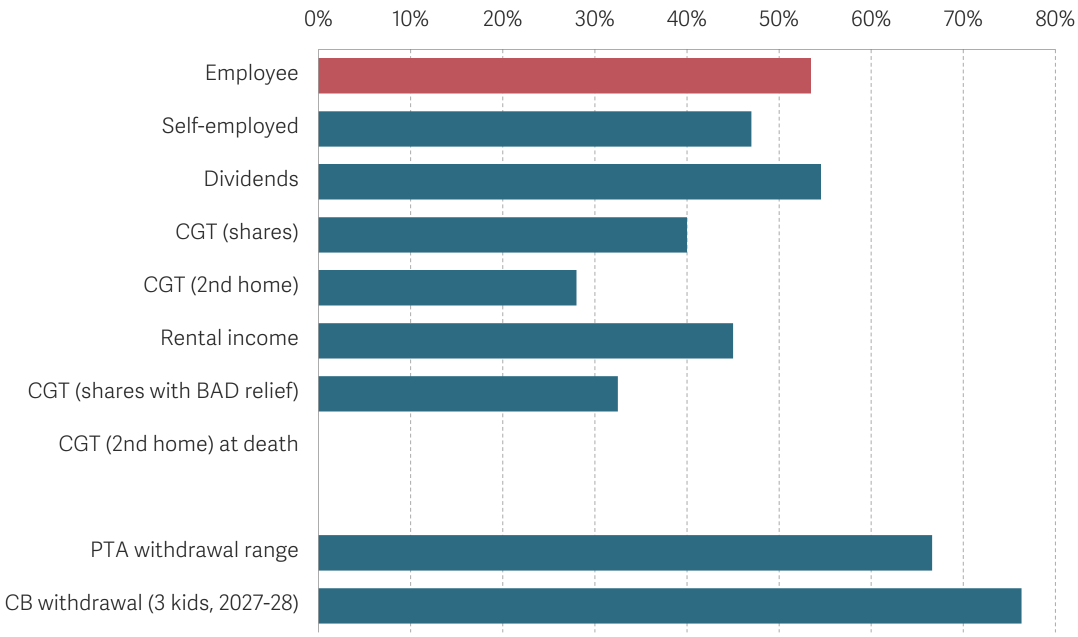
The problem is illustrated in Figure 11, which shows the effective marginal tax rate on different forms of income for 'additional rate' taxpayers (people with incomes above £125,140), as well as two specific high marginal rates that apply to somewhat lower earners (the personal allowance withdrawal and Child Benefit withdrawal). An obvious reference point is the marginal tax rate for employee salaries, as that is the most common form of income. For top earners, this equates to 53.4 per cent, due to the combination of Income Tax (45 per cent), employee National Insurance (NI, 2 per cent)

88 Some of the issues in this section are also discussed in: S Adam & H Miller, Taxing work and investment across legal forms: pathways to well-designed taxes, Institute for Fiscal Studies, January 2021.

and employer NI (13.8 per cent but removed before the calculation of other taxes). But this is not applied consistently to other forms of income. The total tax rate on self-employment income tops out at 47 per cent, and on gains from residential property, just 28 per cent. Some capital gains can go entirely untaxed. And at the other extreme (though affecting higher rather than additional rate payers), some employees have a marginal tax rate of 67 per cent while a parent with three children could face a tax rate of 76 per cent in 2027-28. As we set out below, this inconsistency in tax rates is neither warranted nor inevitable.

FIGURE 11: **The 'top' marginal tax rate for an employee is 53 per cent, but across the tax system tax rates range from zero to over 100 per cent**

Existing marginal tax rates for additional rate taxpayers plus those affected by the personal allowance or Child Benefit withdrawals: UK excluding Scotland



NOTES: For employee earnings we include the impact of employer NI. For dividends and CGT from shares (including those benefiting from Business Asset Disposal Relief), we include the impact of Corporation Tax. The PTA (personal tax allowance) and CB (Child Benefit) withdrawal examples assume employee earnings.

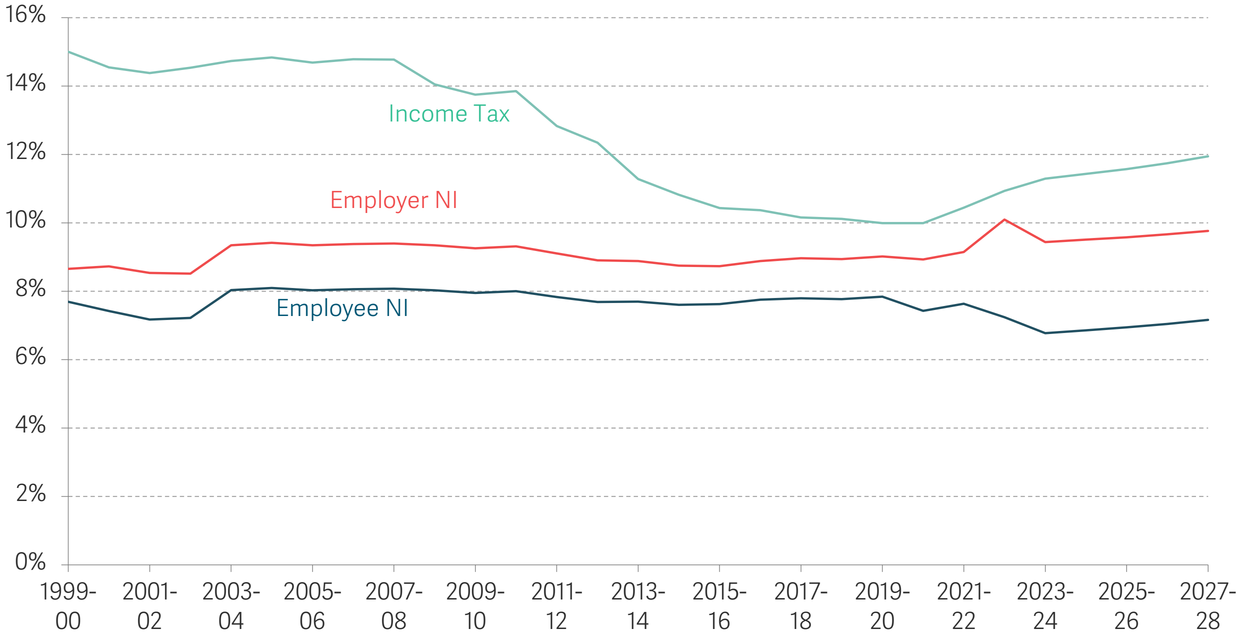
Similar inconsistency is found when looking at marginal rates for basic and higher rate taxpayers (with the former shown later in Figure 16), with basic-rate-paying employees facing a higher tax rate than those receiving other forms of income. The rest of this section discusses the treatment of different forms of income in more detail, with the goal of bringing them into alignment.

Reducing rather than raising the employer NI rate would reduce the bias against employment

4. An important cause of inconsistency in the tax treatment of different incomes is employer NI, given that this tax applies only to the earnings of employees (and, as we discuss in Section 6, it does not even cover all forms of their remuneration). Although theory and some empirical evidence suggest that the tax is ultimately equivalent to one on employees' wages, hiking it has proven to be a politically easier way for governments to raise taxes than changing Income Tax rates.[89] Although the basic rate of Income Tax has been steadily cut over time, the employer NI rate rose in 2003, 2011 and (briefly) 2022. As Figure 12 shows, the effective Income Tax rate on a typical employee's salary is projected to be considerably lower in 2027-28 than in 2007-08, and employee NI will be lower too, but employer NI will be at its highest since at least 1999-00 – with the exception of the period in 2022 when the headline rate briefly stood at 15.05 per cent (as a precursor to the now-abandoned Health and Social Care Levy).

FIGURE 12: **The last twenty years have brought significant cuts to a typical employee's Income Tax and employee NI bills, but employer NI has risen slightly**

Effective tax rates as a proportion of salary for a median-earning employee: UK excluding Scotland



SOURCE: Analysis using median earnings figures from ASHE/NESPD and tax history from HMRC and IFS.

In the context of the revenue-raising income and pension policies that we discuss below, we suggest that the employer NI rate should be cut by 1 percentage point – from 13.8 per

89 The OBR has noted that "While the statutory incidence of employer NICs … is on businesses, we assume the economic incidence of the tax is passed through entirely to lower real wages in the medium term" – OBR, Economic and fiscal outlook, October 2021.

cent to 12.8 per cent – taking it back to where it was from 2003-04 to 2010-11, and costing £8 billion a year.[90]

This would represent a slight levelling-down of tax rates: leaving the marginal tax rates on top-earning employees as 53 per cent (rather than 53.4 per cent), and lowering the overall tax rate for basic-rate employees from just over 40 per cent to just under (39.7 per cent).

In isolation, this change would be expected to boost employee compensation by around 0.5 per cent.[91] This could help employers to fund a higher wage floor and other higher standards with a reduced employment impact,[92] or help accommodate greater auto-enrolment pension contributions.[93] However, Section 6 discusses funding this marginal rate cut with a broader employer NI base which may act in the opposite direction.

The basic rate of dividend tax should rise but higher ones should be reduced

At present, dividend tax rates are 8.75 per cent, 33.75 per cent and 39.35 per cent for basic, higher and additional-rate taxpayers respectively. But, accounting for the fact that profits have already faced Corporation Tax (and assuming this is paid at the main UK rate) gives an actual top tax rate of 54.5 per cent (as Figure 11 showed). Compared to the 53 per cent rate that we think should be a lodestar – following the suggested employer NI cut discussed above – the additional rate of tax for dividends therefore deserves a small cut (from 39.35 to 37 per cent), as does the higher rate (from 33.75 to 32 per cent).[94]

However, the 8.75 per cent basic rate for dividends only equates to 31.6 per cent tax if we include the main Corporation Tax rate (and 26.1 per cent using the small profits rate), considerably lower than the basic overall tax rate on wages of roughly 40 per cent. A fair basic tax rate for dividends would be 20 per cent – neatly matching the basic rate of Income Tax.

These would be significant changes. Around 4 million UK taxpayers a year receive dividend income, totalling over £60 billion.[95] The basic-rate tax rise we propose would raise an estimated £2 billion a year – although such a large rate change may need to

90 Two other ways in which employer NI could be cut are via its ‘Employment Allowance’ or its threshold. The ‘Employment Allowance’ is a per-employer allowance to reduce bills by up to £5,000. But this £3 billion tax relief is poorly-justified; artificially encourages there to be more, smaller companies; and now includes a means-testing cliff-edge to withdraw it from firms with tax liabilities above £100,000. If anything, it should be scrapped or cut to allow a slightly lower headline rate. The choice between cutting the employer NI rate and raising its threshold is more balanced, but the former helps to align tax rates, while there is a concern that a threshold rise would increase the incentive for firms to favour many low-hour roles over a smaller number of full-time jobs.

91 OBR, Economic and fiscal outlook, October 2021.

92 N Cominetti et al, Low Pay Britain 2023: Improving low-paid work through higher minimum standards, Resolution Foundation, April 2023.

93 P Brandily et al., Beyond Boosterism: Realigning the policy ecosystem to unleash private investment for sustainable growth, Resolution Foundation, June 2023.

94 In this section we try to keep recommended tax rates to integer percentages, rather than recommending perfect alignment.

95 HMRC, Property, interest, dividend and other income: 2020 to 2021, March 2023.

be phased in over time, despite the opportunity this would present for forestalling – while the higher-rate cuts would cost around £1 billion. But dividend tax rates are also important because we propose directly using these tax rates for some capital gains, as we now explore.

CGT rates for shares should match those for dividends, but inflation-indexing should be introduced to CGT

As Figure 11 showed, CGT offers particularly striking opportunities to pay lower tax rates than apply to employee earnings. But CGT reform needs to treat some assets differently from others to account for the role of other taxes. Specifically, as with dividend income, the presence of Corporation Tax should be taken into account (as the current CGT system does to a degree), and so we first discuss shares before moving onto the ideal CGT treatment of other assets.

At present, capital gains on shares are taxed at a basic rate of 10 per cent and a higher rate of 20 per cent, though with another 10 per cent rate available via Business Asset Disposal Relief or Investors' Relief, and a 28 per cent rate for 'carried interest' (discussed further below).

A simple principle for CGT on shares is that rates should match those applied to dividends. This can be demonstrated by the case of a personal service company. Here, the owner has a choice between taking profits out of the company dividends, or liquidating the company and getting hold of the same profits as a capital gain. There is no good reason for these to be taxed in different ways: as we discussed in Section 1, business and investment decisions should not be driven by arbitrary tax differences. Given our policies above, equalisation would mean a basic CGT rate for shares of 20 per cent (up from 10 per cent) and higher and additional rates of 32 and 37 per cent respectively (both up from 20 per cent).

However, alongside these higher marginal CGT rates, an inflation allowance should be (re)introduced to the CGT regime so that purely inflation-tracking capital gains are removed from the tax base. As a result, only 'real' capital gains would be taxed. For example, if shares had risen in value by 10 per cent but the Consumer Price Index had risen by 5 per cent over the same period, then only half of the gain would be taxable.[96]

96 One question related to CGT inflation-indexing is whether it would be desirable to account for inflation in the taxation of all investment returns. In short, we note first that the existing exemption of most bank account interest and ISA income can be seen as doing this; and second that removing paper capital gains from taxation tackles this issue for dividends and rental income, if losses can be offset against different forms of income.

This is not a new idea.[97] Inflation-indexing existed in full in the UK from 1988 to 1998 and was only completely phased out for individuals in 2008. Since then, governments trying to reduce the burden of CGT have tried a poorly-justified taper relief system, followed by various iterations of low headline CGT rates that have encouraged income to be taken in this form.[98] One argument for abolishing inflation-indexing was that it was complicated, but technology has greatly reduced that objection: given an acquisition date and disposal date, the effect of inflation-indexing can now be calculated instantly. And it is important not to understate the impact of inflation-indexing. Our proposed increase to the top rate of CGT is large, on paper, from 20 per cent to 37 per cent. But, after inflation indexation with assumed inflation of 2 per cent a year, any nominal return of up to (an impressive) 8.2 per cent a year would attract a lower tax bill than under the CGT regime under George Osborne, where the rate was 28 per cent.

Introducing inflation-indexing and higher rates of CGT would lead to a complicated pattern of winners and losers. Table 1 shows some of our estimates based on published HMRC statistics, although the limited data available makes this only approximate, and the rates of future inflation and gains are clearly unpredictable. For realised capital gains on listed shares in 2019-20, we estimate that around half of total gains were 'paper' gains – i.e. only matching inflation. As a result, even significant rate rises would leave the total tax bill for these assets lower than at present. For unlisted shares, inflation is estimated to be a lower fraction of gains (around a fifth), and so the impact of indexing would be more likely to be outweighed by the effect of higher marginal tax rates.[99] Indeed, as noted above, it is precisely these cases where there is little justification for having a very different tax treatment to those that apply to earnings, dividends or self-employment income.[100]

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97 See also S Adam & H Miller, Taxing work and investment across legal forms: pathways to well-designed taxes, Institute for Fiscal Studies, January 2021; S Nanda & H Parkes, Just tax: reformingthe taxation of income from wealth and work, IPPR, September 2019.
98 A Corlett, A Advani & A Summers, Who gains? The importance of accounting for capital gains, Resolution Foundation, April 2020.
99 A lot of these capital gains are better thought of as business income closely related to people's work, rather than as a return on savings, and the capital gains can represent personal service companies being wound up or sold. See: A Corlett, A Advani & A Summers, Who gains? The importance of accounting for capital gains, Resolution Foundation, April 2020.
100 Introducing inflation-indexing would increase the potential extent of losses in the CGT system (i.e. where someone is making gains under the current system that are less than the rate of inflation over that period), and there are good arguments for allowing these losses to be offset against other gains as well as more broadly changing the CGT regime to be more symmetrical about the treatment of losses relative to gains, so as not to discourage riskier investments – although there are also concerns that the use of losses can be open to abuse. For discussion, see: S Adam & H Miller, Taxing work and investment across legal forms: pathways to well-designed taxes, Institute For Fiscal Studies, January 2021. We do not take a view on whether or how far the treatment of losses could be made more generous without inviting abuse of the system, but it should be considered as part of the major CGT reform we recommend.

TABLE 1: **Inflation-indexing and higher CGT rates would together mean a net tax rise, but not for all asset types**

CGT outturn statistics and model results by asset type, based on 2019-20 data: UK

Asset type	2019-20 realised gains (£bn)	Average gain per disposal	Estimated CPI inflation / gains	Current marginal tax rates	Proposed marginal tax rates	Modelled net tax rise
Listed UK & non-UK shares	£7bn	£14,000	48%	10%/20%	20%/32%/37%	-8%
Unlisted UK & non-UK shares	£38bn	£259,000	20%	10%/20%	20%/32%/37%	84%
Other financial assets	£9bn	£41,000	64%	10%/20%/28%	20%/32%/37%	-35%
Agricultural/commercial/industrial land & buildings	£2bn	£154,000	36%	10%/20%	40%/ 48%/ 53%	62%
Residential/land & buildings	£8bn	£61,000	88%	18%/28%	40%/ 48%/ 53%	-78%
Other non-financial assets	£3bn	£145,000	26%	10%/20%	40%/ 48%/ 53%	87%
Total	£67bn	£65,000	38%			27%
Memo: OBR forecast for CGT receipts in 2027-28:	£26bn				Memo: 27% of that:	£7bn

NOTES: This is based on HMRC data relating to disposals on the length of ownership periods and gains as a percentage of disposal proceeds. Inflation of 2.5 per cent a year is assumed, matching the forecast average rate from 2008-09 to 2027-28. Data is limited for the 'other' categories.
SOURCE: Analysis of HMRC, Estimated number of taxpayer disposals, disposal proceeds and gains by asset type and period of ownership in the tax year 2019 to 2020

Part of aligning marginal rates would be the abolition of Business Asset Disposal Relief and Investors' Relief, which allow some gains to be taxed at only 10 per cent (with a cap). It can be argued that these reliefs are designed to encourage innovation and therefore boost growth, but we believe that these reliefs are badly designed for that purpose and that the investment-driving and mobility-increasing tax cuts we set out in earlier sections would be much better-justified pro-growth tax policies.[101]

Another area of special treatment that would be swept away by these suggested changes would be that of 'carried interest' – which is a form of performance bonus for private equity managers. These 'gains' are currently taxed at a flat rate of 28 per cent. In our proposals, the marginal rate would generally be 37 per cent and inflation-indexing would be of relatively little value in these cases. There would therefore be a tax rise for this group, worth perhaps £300 million a year (given gross carried interest gains of £3.4 billion in 2020-21) – but one that we believe should be tolerable and hard to argue with, given that high-earning employees get taxed at a rate of 53 per cent overall on their bonuses. Indeed, there is currently discussion about whether the treatment of carried interest as a capital gain has a basis in law at all, with the alternative being to tax this remuneration like other income.[102]

101 P Brandily et al., Beyond Boosterism: Realigning the policy ecosystem to unleash private investment for sustainable growth, Resolution Foundation, June 2023.
102 See: D Neidle, Carried Too Far? A Challenge to the Tax Treatment of Carried Interest in the Private Equity Industry, British Tax Review 1, 2023; and: Financial Times, Labour donor to challenge UK tax authority over private equity payouts, June 2023.

Given a reintroduction of inflation-indexing, property capital gains (excluding main homes) and rental income should be taxed at significantly higher rates

CGT rates on assets other than shares ought to be higher than for shares, given that there is no Corporation Tax to account for with the former. To match the overall tax rates faced by employees, marginal CGT rates on assets other than shares should be 40, 49 and 53 per cent depending on income, alongside the introduction of inflation-indexing.

As shown above in Table 1, the majority of gains beyond shares are accounted for by residential property (excluding main homes); and here, inflation-indexing would be particularly valuable, with inflation accounting for the large majority of gains (an estimated 88 per cent in this modelling). As a result, even with a top CGT rate of 53 per cent and even covering a period in which house prices grew significantly, our proposals are likely to mean a net CGT cut overall for residential property. For example, with inflation of 2 per cent a year, a tax rate of 53 per cent – the rate we propose for the richest taxpayers – with indexing works out lower than a 28 per cent rate without, so long as average returns per year are below 4.2 per cent.

This result only adds to the need to reform the taxation of rental income. This income is taxed at regular Income Tax rates, but currently attracts no NI. For alignment with other income sources, a marginal tax rate rise of 20 per cent is needed for basic rate taxpayers, and roughly 8 per cent for others, to match our benchmark rates of 40, 49 and 53 per cent. Rather than create special Income Tax rates for this income (and, given the self-employment income proposals we discuss below), we propose that this should be done via NI. Landlords should pay a new class of NI with (ultimately) a basic rate of 20 per cent and a rate above £50,270 of 8 per cent.[103]

Raising the overall basic marginal tax rate on rental income from 20 per cent to 40 per cent would clearly be a significant change for lower-income landlords and would no doubt need to be phased in, e.g. by 2 per cent a year. But there is fundamentally no good reason why landlords should not pay NI equivalent to that paid by their working tenants, particularly given a CGT cut to take paper gains out of taxation.

Self-employment income should attract more National Insurance

Unlike rental income, self-employment income already attracts some National Insurance. But there is a large gap with employees, which HMRC estimated to be worth £6 billion in

103 Unlike other classes of NI at present, this should not exempt those above State Pension Age. We do not explore whether it should have any bearing on entitlements, but note that not all forms of NI do. We also do not explore what extra tax-free threshold, if any, should apply for this NI. There is a strong case for reforming all NI to move to a per-person, annual basis: see A Corlett & D Finch, Double take: workers with multiple jobs and reforms to National Insurance, Resolution Foundation, November 2016.

2022-23 – and this is not justified by any differences in state entitlements. That tax gap is partly due to a lower basic personal NI rate of 9 per cent rather than the 12 per cent paid by employees (though the self-employed do pay a flat 'Class 2' charge of around £180 a year). But it is largely due to a lack of any equivalent of employer NI.[104]

As with landlords' rental income and real capital gains, parity with employment income would require a basic NI rate for self-employment income of 20 per cent (up from 9 per cent) and a rate of 8 per cent for higher earners (up from 2 per cent). That would be a fair outcome (if Class 2 NI were also abolished) and resolve a very significant labour market distortion in the UK. However, this would be a very large change, and previous attempts at remedying this unfairness have not gone well.[105] Our view is that the reform priority for relatively low-income self-employment should be slashing the VAT registration threshold from £85,000 to £30,000 (as discussed in Section 2): a significant change both for many individual self-employed workers and for some sectoral business models based on atomised self-employment. Therefore, we suggest a less radical change to NI focused on higher earners. We suggest that the 2 per cent Class 4 NI rate on earnings above £50,270 a year should be increased by 6 percentage points to 8 per cent. As illustrated in Error! Reference source not found., this would broadly align treatment with the marginal rates on employment (also shown) and dividends (discussed earlier). This would raise an estimated £1.4 billion in 2027-28, and leave the top self-employment tax rate only slightly higher than it was (briefly) in 2012-13 when a top Income Tax rate of 50 per cent combined with a NI rate of 2 per cent.

The rationale here is simply one of fairness: it is hard to think why a lawyer earning £200,000 a year through a partnership should be taxed much less than an equivalent high-salaried employee. And there are important efficiency considerations: there will be economic pros and cons to different legal structures (such as the inability of limited liability partnerships to retain profits for investment) but these should not be driven by arbitrary tax differences.

Opportunities to pay zero tax (in CGT and for non-doms) must be closed

Having discussed how to reduce differences in how various sources of income should be taxed, we should also note that the same income under different circumstances can

104 H Miller, Lack of employment rights doesn't justify lower taxes for the self-employed, Institute for Fiscal Studies, June 2018.
105 Philip Hammond, when Chancellor, attempted to raise the basic self-employed NI rate from 9 per cent to 11 per cent in 2017, but was forced to U-turn (see his announcement here), and Rishi Sunak, when Chancellor, said that "it is now much harder to justify the inconsistent contributions between people of different employment statuses. If we all want to benefit equally from state support, we must all pay in equally in future," and: "there's currently an inconsistency in contributions between self-employed and employed. […] it does throw into light the question of consistency and whether that is fair to everybody going forward," but never returned to the issue (reported in: The Guardian, UK Covid-19 death toll reaches 578 after biggest recorded daily rise – as it happened, 26 March 2020).

also be taxed in very different ways, particularly as this is very relevant for CGT reform. Indeed, in contrast to some of the high marginal tax rates we have discussed, the option of paying zero tax is available in some circumstances.

First, CGT is not currently due at death, and all gains up to that point are henceforth ignored by the tax system. This is a significant distortion – encouraging people who have made substantial capital gains not to sell their asset during their lifetime – and a big hole in the CGT system. Under the current CGT regime, HMRC estimates that CGT at death would raise £1.6 billion a year, using 2020 asset values.[106] There is no justification for taxing gains if they are realised one day before death but not thereafter, and the existence of Inheritance Tax (IHT, discussed further in Section 6) does not change this.[107] Any major CGT reform such as we have set out must include ending this forgiveness at death.

One simple option would be to deem death a disposal, and therefore require any CGT to be paid at that point. A more generous alternative would be a so-called 'no gain, no loss' basis (already used for transfers between spouses), whereby CGT would only be due when the asset is eventually sold – with the base price being what the deceased paid rather than (as now) the value at death (again, after an allowance for inflation). One downside of this second approach is that it raises the question of how IHT should account for a future tax liability when determining the net value of the estate.[108] Any reform here would be an improvement on the status quo, but one option would be to give estates a choice of whether to pay CGT up-front (and hence reduce any IHT bill) or whether to use the 'no gain, no loss' basis (but take no account of future CGT when calculating IHT).

Second, CGT on assets excluding real estate can be avoided by becoming a non-resident (and not returning within five years). This is obviously a significant loophole that will mostly benefit individuals with substantial gains, and closing off this avenue would become even more important if CGT rose overall for unlisted businesses. Many countries have a CGT exit charge, such as in Australia, where assets are deemed to have been disposed of when someone becomes a non-resident, thereby triggering CGT. The UK should implement something similar, while also allowing the converse i.e. rebasing asset values when people enter the country, although we do not attempt to set out detailed implementation designs here.

Finally, it is well-known that the tax treatment of 'non-doms' is generous. People with this status pay no tax on their foreign income and capital gains, so long as these are not

106 Office of Tax Simplification, Capital Gains Tax review first report: Simplifying by design, November 2020.
107 See also: J Mirrlees et al., Tax by design, Institute for Fiscal Studies, September 2011.
108 The OTS suggested that "executors calculate ***notional*** capital gains on death" (emphasis added). Office of Tax Simplification, Capital Gains Tax review first report: Simplifying by design, November 2020.

brought to the UK (and IHT is limited to UK assets). It has been estimated that abolishing the non-dom regime and the existing, limited 'remittance basis charge' would have raised £3.2 billion in 2017-18, accounting for some behavioural impacts but excluding IHT.[109] This report does not explore this topic in depth, but our tentative conclusions are that offshore income and gains should only be exempted for a much shorter period after arrival (rather than exempting people who have lived in the UK for up to 15 years out of the past 20), that the antiquated domicile test should be entirely replaced by a residence test, and that such reform (as well as related IHT changes) would raise substantial revenue which could lower tax rates elsewhere.

The withdrawal of the Income Tax personal allowance and the High Income Child Benefit Charge both produce very high tax rates and should be abolished

The proposals in this section include some significant tax rises on high-income individuals, to level up the tax treatment of different income sources. But there are parts of the tax system applying to relatively well-off individuals that imply very high marginal rates, albeit over small bands of income. In particular, some of the highest marginal rates in the tax system are caused by the Income Tax personal allowance withdrawal and Child Benefit withdrawal – the effects of which were illustrated in Figure 11.[110]

The tapering away of the Income Tax personal allowance from high-income individuals was first introduced in 2010. This results in a 60 per cent Income Tax band between £100,000 and £125,140 (the band is twice the size of the personal allowance of £12,570). This leads to Income Tax having marginal rates of 40 per cent just below £100,000; then a 60 per cent band; and then a fall to the 'additional rate' of 45 per cent; so marginal tax rates for someone with an income of £100,000 are therefore higher than for someone on £150,000 (see Figure 14). When combined with employee and employer NI, the true marginal tax rate in this £100,000-£125,140 range is 67 per cent: far higher than our benchmark of 53 per cent which applies above that. Because the £100,000 figure has not been changed in the 13 years since the policy was introduced, the number affected has been growing over time, and is forecast to reach just over 1 per cent of all adults by 2026-27.[111]

Given the high rates of income inequality in the UK, offering tax cuts to those with incomes above £100,000 would not normally be a priority. But in the context of our other proposals – and indeed to avoid adding tax rate rises on top of these particularly

109 A Advani, D Burgherr & A Summers, Reforming the non-dom regime: revenue estimates, CAGE Policy Briefing 38, 2022.
110 The benefit system obviously causes its own high marginal effective tax rates, but these are not the subject of this report.
111 Figure 1 in I Delestre & T Waters, A deepening freeze: more adults than ever are paying higher-rate tax, Institute for Fiscal Studies, May 2023.

high rates – we propose that this personal allowance withdrawal should be abolished entirely.[112] However, this should be accompanied by a lowering of the additional rate threshold from £125,150 to £100,000, effectively lowering marginal rates from 60 per cent to 45 per cent (rather than 40 per cent). This is included in Figure 15. The net cost, without assuming any behavioural change, would be around £2.5 billion, although a marginal rate change of this size should have a non-negligible dynamic effect.

There are options short of abolition. The personal allowance taper rate – i.e. the speed at which the allowance is reduced, which determines the 60 per cent marginal rate – could be reduced, or high earners allowed to keep some proportion of their personal allowance. And the withdrawal range could be moved up the income distribution, either as a one-off or via annual uprating. But full abolition would be preferable.

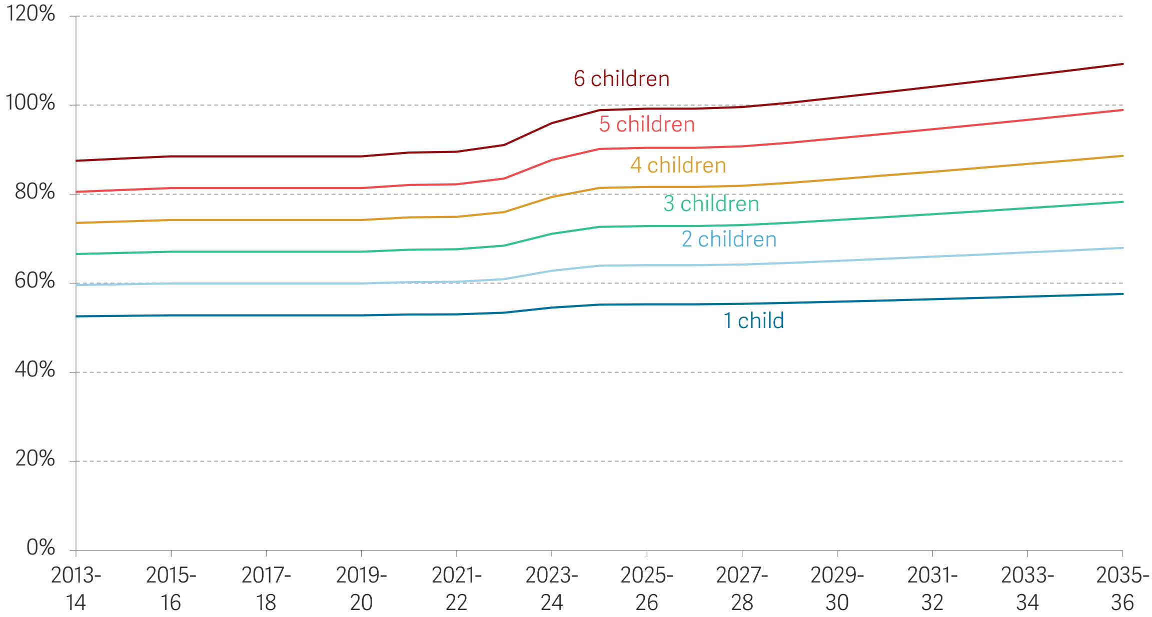
Similar thinking can be applied to the withdrawal of Child Benefit from parents earning over £50,000, with a tapering away between £50,000 and £60,000. The marginal tax rates produced by this withdrawal depend on the number of children a person has, and the value of Child Benefit, as set out in Figure 13. Including Income Tax and employee NI (but excluding employer NI and student loan repayments), the marginal rate in 2024-25 for an affected parent is projected to be 55 per cent for someone with 1 child (or 61 per cent including employer NI), rising to 99 per cent for someone with 6 children.[113] The withdrawal also requires those affected to self-assess, creating additional administrative costs for both taxpayers and HMRC.

112 The immediate withdrawal of free childcare entitlements and tax-free childcare at £100,000 could also be reformed, although it is not clear how many families are affected in practice.

113 The impact of this policy is also gradually worsening because of the Government's decision not to index the £50,000 threshold where the HICBC starts, nor the end of the taper, at £60,000. By not indexing the first of these, more people are being affected by the withdrawal as nominal earnings rise. By not indexing the second, the marginal rate applying in this £10,000 band is increasing, as the value of Child Benefit rises in nominal terms. See: M Brewer, K Handscomb & G Kelly, Inconsistent Incentives: How the overlap between Universal Credit and the High Income Child Benefit Charge limits work incentives, Resolution Foundation, December 2022; T Waters & T Wernham, Reforms, Roll-outs and freezes in the tax and benefit system, IFS Green Budget 2022, October 2022.

FIGURE 13: **Every time Child Benefit rises, the marginal tax rates produced by its withdrawal also rise**

Marginal tax rates at an income of £59,000 due to Income Tax, employee NI and Child Benefit withdrawal: UK excluding Scotland



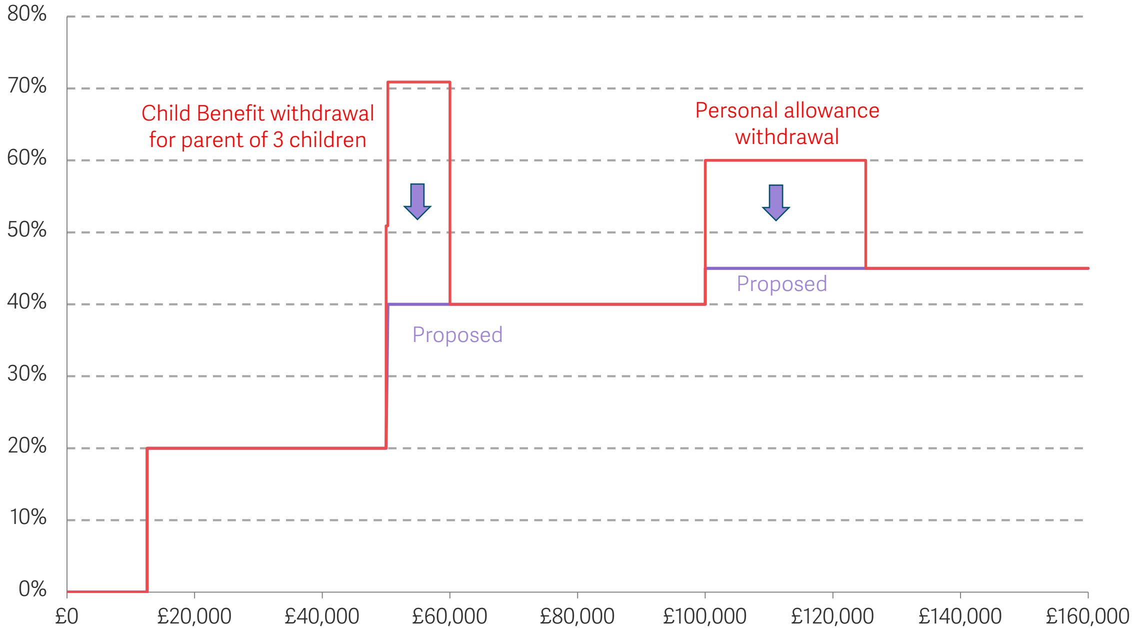
NOTES: Projections based on OBR March 2023 CPI forecasts, and 2 per cent inflation thereafter.

As with the personal allowance withdrawal, it would be possible to move the Child Benefit withdrawal range further up the income distribution (e.g. to begin at £60,000). But, in the context of our revenue-raising proposals, it should be abolished entirely. We estimate the cost of this to be over £4 billion in 2027-28, again, prior to any behavioural impacts.[114]

114 Analysis of DWP, Family Resources Survey, using the IPPR Tax Benefit Model.

FIGURE 14: **The withdrawal of Child Benefit and the personal allowance create high marginal tax rates**

Existing and proposed marginal tax rates due to withdrawal of the Income Tax personal allowance and the High Income Child Benefit Charge, 2024-25: UK excluding Scotland



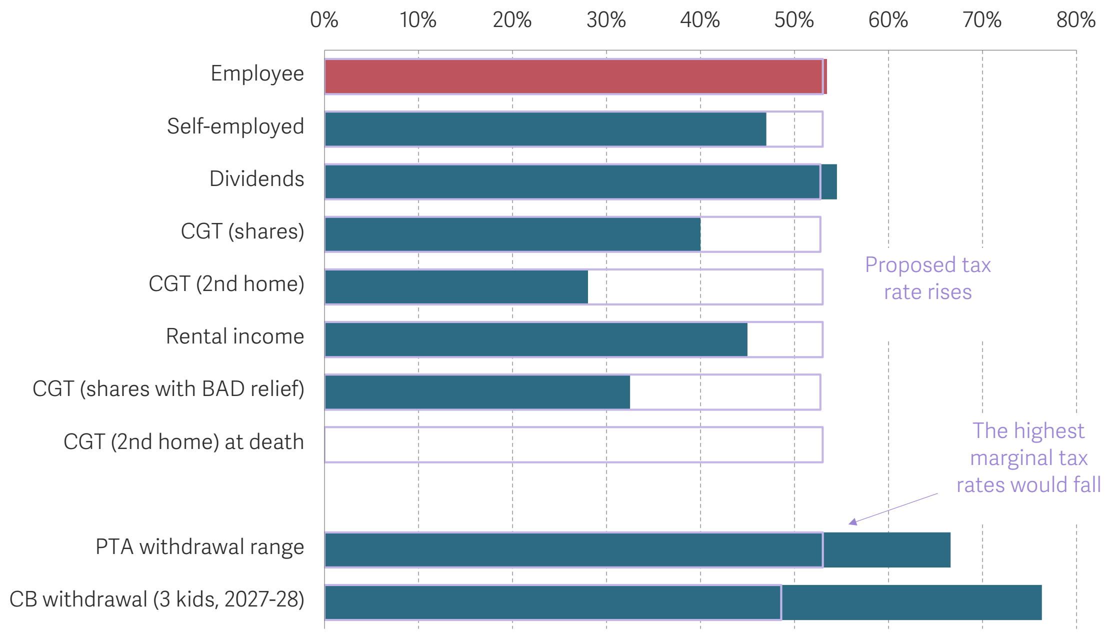
NOTES: Child Benefit figure based on OBR March 2023 CPI forecasts.

Together these changes would remove many arbitrary distortions and inequities from the tax system

Figure 15 and Figure 16 demonstrate the results of all of these proposed reforms: a consistent tax treatment of different forms of income. Marginal tax rates for incomes beyond £100,000 can currently range from zero to 67 per cent, but if all these changes were made, then there would be consistency at 53 per cent, slightly below the current overall tax rates for top wages and dividends. Income from employment, self-employment, dividends, real capital gains and rents would all face almost identical marginal rates of tax.

FIGURE 15: **The 'top' marginal tax rate for an employee is 53 per cent, but across the tax system tax rates range from zero to over 100 per cent**

Existing and proposed marginal tax rates for additional rate taxpayers plus those currently affected by the personal allowance or Child Benefit withdrawals: UK excluding Scotland



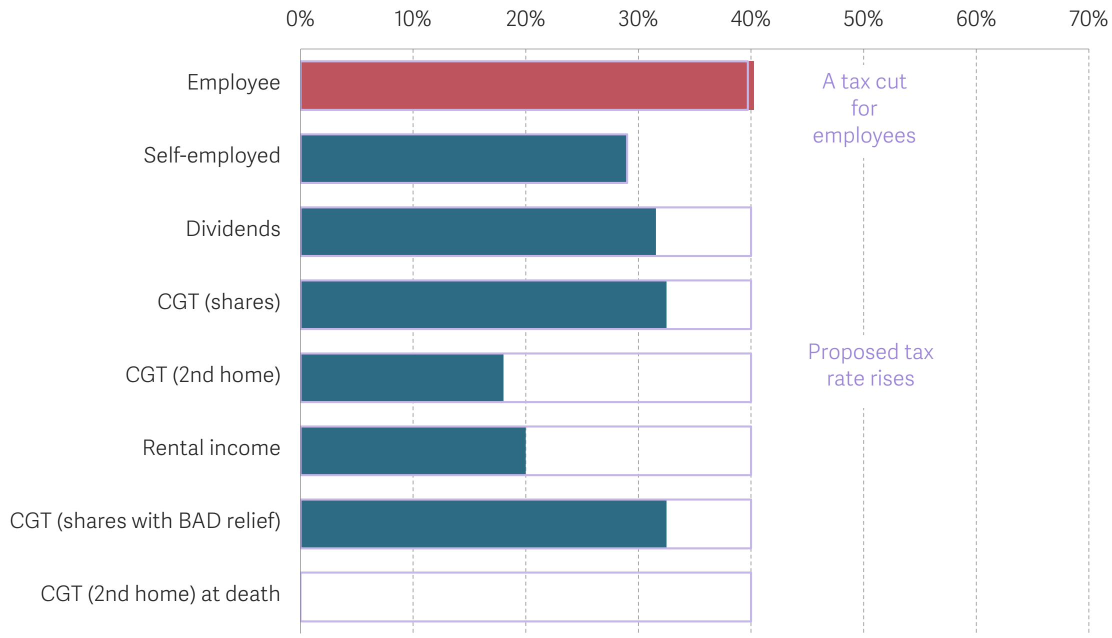
NOTES: For employee earnings we include the impact of employer NI. For dividends and CGT from shares (including those benefiting from Business Asset Disposal Relief), we include the impact of Corporation Tax. The PTA (personal tax allowance) and CB (Child Benefit) withdrawal examples assume employee earnings.

There would be similar outcomes for higher rate incomes (with consistent rates of 48 to 49 per cent). The same is shown for basic rate incomes in Figure 16, with consistent overall tax rates of 40 per cent, and with the pragmatic exception – for the medium-term – of basic rate self-employment income (given the VAT threshold reduction that we propose).

We have set out here a broadly revenue-neutral package of tax changes aimed at producing a more efficient and fairer system of personal taxation, with the principal aim of preventing employees paying higher taxes than those taking their income in other ways. Some of the suggested reforms involve large changes in the marginal rates applying to some forms of income, but this programme of reform is economically easier to justify than the status quo, with its accumulation of historic baggage and clear unfairnesses. The package here would overall be a redistribution of tax burdens away from most employees and towards the very top; make the tax system more transparently fair; and deliver a broader tax base that can more easily raise as much or as little as needed without presenting obvious avoidance opportunities.

FIGURE 16: **Our proposals would align tax rates for basic rate payers across most forms of income**

Existing and proposed marginal tax rates for basic rate taxpayers: UK excluding Scotland



NOTES: For employee earnings we include the impact of employer NI. For dividends and CGT from shares (including those benefiting from Business Asset Disposal Relief), we include the impact of Corporation Tax.

In the next section we now turn to two final areas in which a greater consistency of wealth-related income taxation is needed: pensions and inheritances.

Section 6

Taxing pensions and inheritances more consistently

Our tax system badly needs to respond to the UK's large, and primarily passive, rise in wealth levels relative to GDP in recent decades, a change that has created patterns of winners and losers based to a great extent on luck – such as the timing of changes in interest rates, or being born to the right parents. This rise in the stock and importance of household wealth has not been matched with a rise in the revenues from taxes on wealth, and policy should aim to correct this by reforming our existing wealth-related taxes.

For pensions, a key priority should be rebalancing the complicated NI treatment of pension contributions: extending employer NI to employers' contributions (potentially helping to fund our suggested lowering of the employer NI rate) while introducing NI relief for personal contributions to help lower earners build up their savings. At the same time, the £270,000 cap on poorly-justified tax-free pension withdrawals should be gradually lowered.

Inheritance Tax should be tightened so that it cannot be avoided by the wealthy and well-advised: with pension pots included, and reliefs for business and agricultural property scrapped or very tightly focused. The complicated Main Residence Nil-Rate Band should also be abolished. These changes (together with Capital Gains Tax at death) could help fund Stamp Duty cuts, for example, but should also be used to replace Inheritance Tax's high, flat rate of 40 per cent with a more popular banded structure, e.g. with rates of 20, 30 and 40 per cent. Ideally, Inheritance Tax should be entirely replaced by a recipient-based acquisitions tax – similar to Ireland's – that was not limited to transfers around the time of death.

Household wealth has risen much faster than GDP over the past four decades, but this has not been accompanied by a commensurate change in the role of wealth-related taxes.[115] The proposals in Section 4 would make the taxation of residential property fairer, although would mean that less revenue was raised, given our proposed Stamp Duty cuts, while those in Section 5 would raise more from investment income. But, just as the previous section showed how greater consistency in the tax treatment of income would be both more efficient and fairer than the status quo, so the same applies for the UK's pension and inheritance tax systems. Reforms are needed to reduce unwanted economic distortions, and, together with the property and investment income tax options that this report has already explored, to reflect the country's wealth inequalities without deterring productive investment. The end result can be more consistent taxation among the relatively wealthy; targeted tax cuts for low-to-middle earners; and more revenue to fund genuinely pro-investment and pro-earnings tax cuts.

Some pension tax reliefs should be rebalanced and reduced

Section 5 set out a goal of having very similar marginal tax rates applying to different forms of income. In general terms, trying to apply the same principle to pension income is complicated, for many reasons: private pension income is a mix of deferred earnings, inflationary returns and real returns; there are employer and personal contributions to consider; Defined Benefit and Defined Contribution schemes work in very different ways; and there are a mix of relevant taxes to consider, including Income Tax, personal National Insurance, employer National Insurance and (within pension funds) the impact of Corporation Tax on dividends. However, the current scheme lies very far from the principle of consistency, and so here we set out some specific steps that could be taken to make the system fairer between different sorts of pension savers, and ensure that pension income is not taxed too differently from other income on balance.[116]

Historically, the large tax advantages to saving in a pension were seen as necessary to persuade people to lock away their money until retirement. Pensions are a key component of total household wealth, and, if anything, the country will need increases in pension saving to fund greater investment and ensure that more people are well-provided for in retirement.[117] But the recent success of auto-enrolment demonstrates that policy options involving the setting of default contributions can have far greater

115 See: M Broome & J Leslie, Arrears fears: the distribution of UK household wealth and the impact on families, Resolution Foundation, July 2022; and Resolution Foundation, A New Generational Contract: The final report of the Intergenerational Commission, May 2018.

116 For more on the issues raised in this sub-section, see chapter 14 of J Mirrlees et al., Tax by design, Institute for Fiscal Studies, September 2011, and S Adam et al., A blueprint for a better tax treatment of pensions. Institute for Fiscal Studies, February 2023. Note that there are arguments for applying some NI to income from pensions: see Resolution Foundation, A New Generational Contract: The final report of the Intergenerational Commission, May 2018.

117 P Brandily et al., Beyond Boosterism: Realigning the policy ecosystem to unleash private investment for sustainable growth, Resolution Foundation, June 2022.

impacts than plausible tax incentives, and without giving unnecessary tax breaks to those fortunate enough to be able to save very heavily in pensions.[118]

The tax-free pension cap should be lowered

If there is any principle behind how we currently tax pension savings and pension income, then it is that we exempt the money put in from up-front income taxation but then later tax the money that comes out.[119] In practice, we do not do this in a consistent manner because of NI (as we discuss below), but even within Income Tax, a significant exception to this principle is the tax-free lump-sum which allows a quarter of pension savings to be drawn down free of Income Tax. This feature is not well-designed to achieve any worthwhile economic or social pensions objective, stemming as it does from early twentieth century decisions about civil service pensions, rather than reflecting any part of our pensions or tax strategy.[120] It is overwhelmingly regressive, being of the most benefit to pensioners who face higher marginal tax rates and who have the largest pots. And this £5 billion a year policy could be seen as providing an unhelpful encouragement towards early retirement.[121]

Spring Budget 2023 introduced a cap on the tax-free lump sum of £268,275, as a mitigation of removing the Lifetime Allowance. The Government's current plans are for this amount not to automatically rise in line with inflation, which means it will over time affect more and more people; but we think it should be actively cut. A cap of £100,000 would affect only around one-in-five new retirees, while reducing the cost by around 40 per cent or around £2 billion a year.[122]

Any cut in the cap would need some grandparenting-in, however – for example, done gradually based on date of birth. Lowering the cap by £1,000 per month of birth would mean a tax rise of £400 per month or £4,800 per difference in birth year for higher-rate taxpayers (and half that for basic-rate payers) for those who are affected by the lower cap (i.e. those whose total pension pots are at least four-times as large as the reduced cap). This would be a significant impact, but perhaps a plausible speed of change, with a reduction in the cap to £200,000 spread over roughly six years of birth cohorts, and a reduction to £100,000 spread over a 14-year age range.

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118 H Karjalainen, On a roll? The first decade of automatic enrolment into workplace pensions, Institute for Fiscal Studies, September 2022.
119 For more on this, see the works cited in footnote 116.
120 House of Commons Library, Pension lump sums, August 2014.
121 See: L Murphy & G Thwaites, Post pandemic participation? Exploring labour force participation in the UK, from the Covid-19 pandemic to the decade ahead, Resolution Foundation, February 2023. The costing comes from S Adam et al., A blueprint for a better tax treatment of pensions, Institute for Fiscal Studies, February 2023, which estimates it cost £5.5 billion in 2022-23 terms under the pre-2023 Budget changes.
122 We suggested this in: G Bangham et al., Unhealthy finances: How to support the economy today and repair the public finances tomorrow, Resolution Foundation, November 2020. Costing is from: S Adam et al., A blueprint for a better tax treatment of pensions, Institute for Fiscal Studies, February 2023.

There is a risk of any reform here being controversial while raising little short-term revenue. But phasing out a notably regressive and unwarranted tax break could fund growth-enhancing tax cuts, or help avoid the need for new tax rises on low and middle earners.

The National Insurance relief on pensions should be rebalanced

Beyond the tax-free lump sum, a welcome focus for pension tax relief reform would be the messy NI treatment of pension contributions. The goal here should be to improve the horizontal and vertical equity of pension tax relief, and to add further consistency to the tax treatment of different income streams.

There are four different ways that the NI system treats contributions to a pension, as there are separate rules for employer NI and employee NI, and for employers' contributions and employees' contributions.

At present, employer NI of 13.8 per cent effectively applies to all employee contributions, but does not apply to employer contributions. Given that employer NI does not apply in retirement, the neutral approach would be to charge employer NI on employer contributions.[123] This would remove a large distortion between employee and employer contributions to a pension, which benefits those workers who can take advantage of this through a salary sacrifice scheme. The cost of exempting employer contributions was an enormous £12.9 billion in 2019-20, and may rise to around £16 billion by 2027-28 (or slightly lower, if the employer NI rate were reduced as we suggest).[124] In the context of our other proposals, we suggest ending this by applying employer NI in full, although smaller steps could be taken. Note, however, that nearly half of the relief is accounted for by the public sector, and so these additional costs might need to be met by the Treasury to avoid causing public spending cuts elsewhere, and this would leave a net £8 billion revenue increase.

Personal NI for employees is also inconsistent between employer and worker pension contributions – it is applied to the latter but not the former. In this case, the best solution is a levelling-down: removing employee (or self-employed) NI from all pension contributions. This would cost around £4 billion a year.[125] Because personal NI has a regressive structure, with a basic rate of 12 per cent for employees and a rate of 2 per cent for higher earners, this extra relief would be tilted towards low-to-middle earners. This may in turn help alleviate the short-term living standards impact of raising minimum

123 In Section 5, we proposed essentially extending a form of employer NI to some of the self-employed. Delivering parity between self-employed and employee pension contributions (i.e. by applying employer NI in all cases) would therefore be fair.

124 This uprates in line with the OBR's March 2023 employers' social contributions forecast, which is more conservative than their wages forecast.

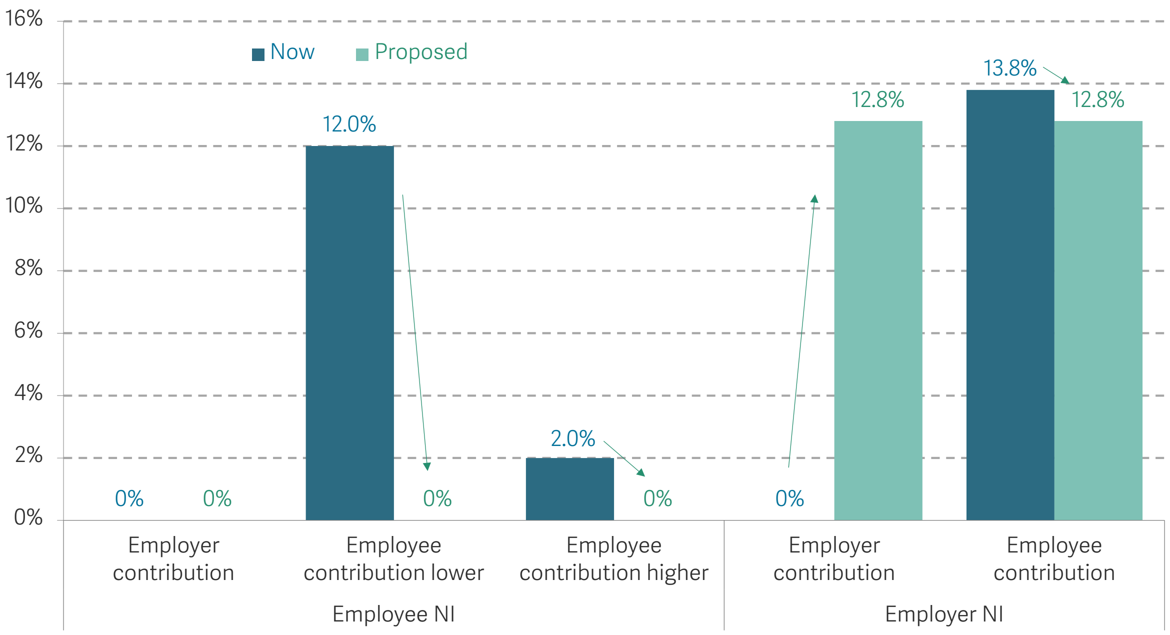
125 Based on an estimate of £3.3 billion in 2022-23 terms, in: S Adam et al., A blueprint for a better tax treatment of pensions, Institute for Fiscal Studies, February 2023.

auto-enrolment contributions, as we have suggested in another Economy 2030 paper.[126]

These NI relief changes are illustrated in Figure 17, with reform delivering a consistent exemption of pension contributions from employee NI, and a consistent application of employer NI to both employee and employer contributions, while rebalancing pension tax relief towards low-to-middle earners.

FIGURE 17: **The National Insurance treatment of pensions is messy, but should be rebalanced to the advantage of personal contributions and lower earners**

Marginal NI rates on pension contributions for employees, 2023-24 and proposed: UK



SOURCE: Analysis of contemporary and proposed marginal tax rates.

Inheritance taxes should play a role in containing the need for high taxes elsewhere

There are often calls for Inheritance Tax (IHT) to be cut, or even abolished.[127] The tax is perceived poorly by the public in general, as it is inevitably associated with death and giving; it has a perceived high marginal rate even if the effective rate is zero or low for most estates; and it is – correctly – seen as avoidable for the very wealthy. Even excluding tax-free lifetime giving, the effective IHT rate paid by estates worth over £10 million is – at 10 per cent – far lower than that faced by estates of £1-2 million and half the average rate

126 P Brandily et al., Beyond Boosterism: Realigning the policy ecosystem to unleash private investment for sustainable growth, Resolution Foundation, June 2022.

127 S Wingate, Economists dismiss Tory push to scrap inheritance tax, The Independent, June 2023. There are wider discussions of the issues raised in this sub-section in: R Boadway, C Emmerson & E Chamberlain, Taxation of Wealth and Wealth Transfers, in S Adam et al (eds), Dimensions of Tax Design, OUP, September 2010; chapter 15 of J Mirrlees et al., Tax by design, Institute for Fiscal Studies, September 2011; and A Corlett, Passing on: options for reforming inheritance taxation, Resolution Foundation, May 2018.

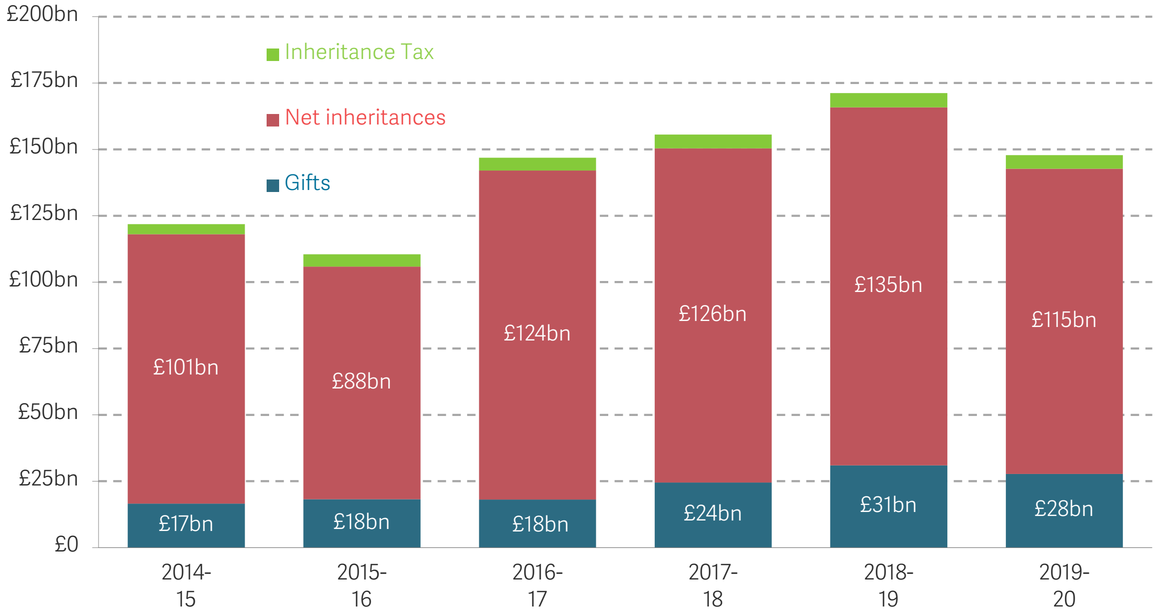
paid by estates worth £2-3 million.[128] And IHT's salience is likely to rise: IHT thresholds are due to be frozen until April 2028, contributing to a projection that the proportion of estates triggering a tax bill will rise from 4 per cent to over 6 per cent by 2026-27.[129]

Fundamentally, however, we believe that inheritance taxes are good for the UK. Inheritances are a form of income, yet one that is not a function of personal effort or output, and every pound raised via inheritance taxation is a pound that does not need to be raised via taxing earned income. The UK has high wealth inequality, with the richest tenth of families owning around half of total wealth,[130] and the degree to which home ownership (for example) is determined by one's parents has grown over time.[131] The current system of IHT is in no way a significant burden on households in aggregate, with only around 1 in 17 deaths leading to an IHT bill. Compared to an estimated flow of inheritances and gifts of around £150 billion a year pre-pandemic (see Figure 18), the £5 billion raised via IHT represented an overall effective tax rate of only 3 per cent. And with a total IHT threshold of £1 million for couples, it remains quite possible for someone to inherit tax-free almost four averagely-priced homes (the average house price being around £285,000) or what another person could earn from a lifetime of minimum wage labour (which at current levels would pay £917,000, before tax).[132]

128 See chart A in Office of Tax Simplification, Inheritance Tax Review – first report: overview of the tax and dealing with administration, November 2018.
129 OBR, Economic and fiscal outlook, March 2023.
130 M Broome & J Leslie, Arrears fears: the distribution of UK household wealth and the impact on families, Resolution Foundation, July 2022.
131 J Blanden et al., Intergenerational home ownership, The Journal of Economic Inequality, April 2023.
132 ONS, UK House Price Index: April 2023, June 2023. Earnings figure based on working from age 21 to 66, 37.5 hours a week, at the current National Living Wage of £10.42.

FIGURE 18: **Inheritance Tax revenue is tiny compared to the estimated £150 billion a year flow of inheritances and large gifts**

Nominal value of total inheritances and gifts received: UK



NOTES: Net inheritance and gift figures conservatively adjusted to account for Northern Ireland. Dates refer to survey periods but respondents may report receipts from the last two years (but annualised). Excludes trusts. Tax figures are based on when tax is received. Includes inheritances of £1,000 or more; and gifts of £500 or more.
SOURCE: Analysis of ONS, Wealth and Assets Survey; OBR.

However, change is needed to improve the system and the public's opinion of it. This should involve reform in three main respects: broadening the base of the tax and cutting reliefs; moving away from a flat tax rate; and moving to a recipient-based tax.[133] We explore these below.

Business and agricultural property reliefs should be scrapped or heavily restricted

In addition to the vertical inequity in IHT that we explained above, different inheritances can be taxed very differently, causing horizontal inequity and distorting decision making.

A key cause of this unfairness is the presence of Business Relief and Agricultural Relief, which can potentially exempt all business assets from IHT. In the case of Business Relief, this dates back to 1976, though initially only 30 per cent relief was provided (and the top rate of Capital Transfer Tax, as it was then, was 75 per cent) – whereas 100 per cent relief has been available since 1992.[134] In 2022-23, Business Relief cost an estimated £770

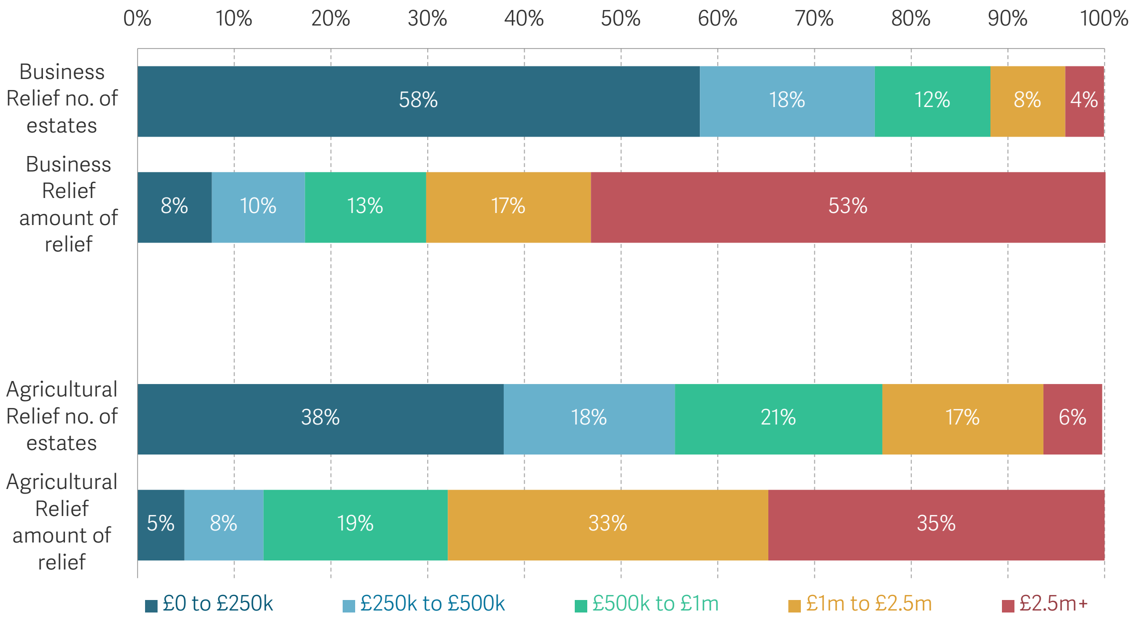
133 The rest of this section develops ideas previously explored in A Corlett, Passing on: options for reforming inheritance taxation, Resolution Foundation, May 2018.
134 E Chamberlain, A review of agricultural property relief and business property relief, British Tax Review, 2016.

million and Agricultural Relief cost £375 million.[135]

These reliefs are very concentrated among a small number of estates. In 2019-20, only around 1,170 estates claimed Agricultural Relief and 2,820 claimed Business Relief. Within these, 71 estates claiming over £2.5 million of Agricultural Relief (on top of nil-rate bands) accounted for 35 per cent of its cost, while 53 per cent of Business Relief's cost was accounted for by 113 estates (the top 4 per cent of claimants).[136] This is set out in Figure 19.

FIGURE 19: **A small number of estates account for the majority of the cost of Business and Agricultural Reliefs**

Distribution of Business and Agricultural Reliefs by amount of relief: UK, 2019-20



NOTES: Amount of relief refers to asset value (in excess of nil-rate bands) rather than tax saved.
SOURCE: Analysis of HMRC FOI request.

It is clear that these reliefs are not good for horizontal equity between different wealth classes, nor good for vertical equity and public opinion about IHT. But do they perform a useful economic function? The argument for them would be that otherwise some farms and businesses – or parts of them – might need to be sold at death, and that this process would damage useful linkages of people, properties and intangible capital. (It should be noted that this line of thinking does not apply in the case of inherited 'AIM' shares, for which an entirely different argument is needed if the relief is to be justified: that we should subsidise this part of the London Stock Exchange to maintain its liquidity.) But it is not clear at all that this is a problem worth using over £1 billion of tax relief per year to

135 HMRC, Non-structural tax reliefs, January 2023.
136 Analysis of FOI request.

avoid. The OECD suggests that "the macroeconomic benefit of relief for family-business assets is unclear. Liquidity risks tend to be confined to a small number of businesses, and evidence shows that heirs who inherit a business tend to perform less well than their parents."[137]

There is a good case for these reliefs to be scrapped entirely, particularly in the context of the UK's high IHT thresholds, the potential rate cuts we discuss below, and the existing facility to spread IHT payments over 10 years (as well as the option of taking out a mortgage).[138]

However, there are many steps short of abolition that could nonetheless dramatically reduce the extent of relief:

- A 'farmer' test and 'family business' test could be introduced to better align the reliefs with the situations that are evoked in their defence. For example, small AIM shareholdings could be excluded on the basis that the donor operated no significant control over such companies and had no working relationship with them.
- A cap could be applied to the value of assets covered by relief. This could ensure, for example, that a £1.5 million farm passing from father to daughter could be inherited tax-free, but that £100 million of agricultural land would receive only minimal tax relief.[139] The skewed nature of existing relief means that a cap of £1 million, for example, (which would be in addition to other nil-rate bands) would raise over £500 million in 2027-28 while only affecting around 12 per cent of Business Relief claims and 23 per cent of Agricultural Relief claims, or around 600 estates a year in total.[140]
- The minimum ownership period for qualification could be increased beyond two years (e.g. to five) to tackle artificial avoidance, particularly by trusts.[141]
- IHT could be applied later if the inherited assets are sold on within a minimum period, given that the relief would no longer serve any reasonable purpose. Such provisions are internationally common.[142]

Such restrictions could significantly reduce the cost of these reliefs. But it could be preferable, simpler and less distortionary to have no relief than very restricted relief, and complete abolition of Agricultural and Business Relief would raise up to £1.5 billion per year in 2027-28.

137 OECD, Inheritance Taxation in OECD Countries, May 2021.
138 The possibility of introducing long-term income- or profit-contingent loans, building on the approach used for student loans, could also be considered.
139 The majority of farms in England have a net value of under £1.5 million: Defra, Balance sheet analysis and farming performance, England 2021/22 - statistics notice, February 2023.
140 Note that a cap might be combined across Agricultural Relief and Business Relief, but these statistics are based on separate data for each.
141 E Chamberlain, A review of agricultural property relief and business property relief, British Tax Review, 2016.
142 OECD, Inheritance Taxation in OECD Countries, May 2021.

Inherited pension pots should be taxed

Pension wealth is typically not included in IHT. This is generally not an issue for defined benefit pensions, which cannot be bequeathed in the same way as other wealth.[143] But it is certainly a problem for defined contribution pensions which, if not used to purchase an annuity, are not fundamentally different from any other savings pot. There is therefore now a strong and entirely unjustified tax incentive for retirees to draw down other wealth before touching their pension savings.

This IHT exemption should simply be ended as soon as possible, and we do not believe there are any significant practical barriers to doing this. It is not easy to estimate how much revenue this would raise: if all relevant pension wealth were to be passed on rather than used in retirement then the tax difference would be around £2 billion a year, but in reality only a fraction of this is at stake.[144] There is no need to continue with such an obvious horizontal inequity and distortion that will increasingly affect tax planning.

Applying IHT to transfers of pension pots does raise the question of when and how Income Tax should be paid (given the existence of up-front Income Tax relief for pension savings). We do not dwell on that question in detail, but suffice it to say that Income Tax should apply in some form – as it already does in most cases – in addition to new IHT, and the current exemption for deaths under 75 should be ended.[145] As with the CGT question discussed in Section 5, the basic principle is that existing tax liabilities should not be erased at death, while inheritances should also be taxed.

The Residence Nil-Rate Band should be scrapped

The Residence Nil-Rate Band (RNRB) is a supplemental tax-free band in IHT, first introduced in 2017. For couples, it takes the potential tax threshold from £650,000 to £1 million – but (leaving caveats aside) the extra allowance only applies to main residences and only when these are passed on to direct descendants. It is a large tax relief – costing £1.75 billion in 2022-23.[146]

The RNRB does significantly reduce how many estates pay any IHT.[147] And it is not as top-heavy as Business Relief is, for example, in part because it is at least partially withdrawn from estates worth over £2 million.

143 There are exceptions, but note that transfers between spouses do not attract IHT in any case, so for them the tax-free nature of inherited defined benefit pension entitlements is consistent.
144 S Adam et al., Death and taxes and pensions, Institute for Fiscal Studies, December 2022. Also see A Advani et al., Revenue and distributional modelling for a wealth tax, Wealth Tax Commission, December 2020.
145 See S Adam et al., Death and taxes and pensions, Institute for Fiscal Studies, December 2022; and G Bangham et al., Unhealthy finances: how to support the economy today and repair the public finances tomorrow, Resolution Foundation, November 2020.
146 HMRC, Non-structural tax reliefs, January 2023.
147 Office of Tax Simplification, Inheritance Tax Review: second report, July 2019.

But it is hard to argue why main homes should be favoured over other assets among the small proportion of the population that pay IHT – particularly given that these also benefit from an exemption from Capital Gains Tax.[148] And it is hard to argue why transfers to siblings or niblings, for example, should be taxed very differently from transfers to children or grandchildren. The RNRB is also complicated, for example due to the well-intentioned downsizing provisions that mean that the relief can apply to non-housing wealth so long as the deceased previously owned a home.[149] As with the withdrawal of the Personal Allowance and Child Benefit, tapering away of the RNRB also leads to some regressivity in marginal rates (see Figure 20).

We suggest scrapping the RNRB entirely, in part to fund tax cuts elsewhere such as for Stamp Duty, and to fund other IHT cuts.

Inheritance Tax should move from a flat rate to a progressive rate structure

Abolishing the RNRB would significantly increase the number of estates facing an IHT bill, with previous estimates suggesting a rise of 70 per cent.[150] This could potentially be offset by raising the basic Nil-Rate Band (£650,000 for a couple). However, we think this should not be a priority. As noted above, the proportion of estates facing IHT is still low in absolute terms. The UK's thresholds are very generous compared to most other IHT systems, except for those in Italy and the US.[151] And survey results suggest the typical person thinks tax should be paid from around £300,000: a key reason IHT is unpopular is that the vast majority of people greatly overestimate the proportion of deaths that lead to IHT bills.[152]

To improve public support for raising money via IHT, a priority – given a tightening of reliefs (and CGT at death) – should be to reintroduce a progressive rate structure. Prior to 1988, the UK's estate taxes did have progressive rate structures – and these are more common around the world than flat rates.[153] Specifically (though different choices could easily be made), the RNRB could be replaced with a 20 per cent band, for value between £650,000 and £1 million (for couples), as well as a 30 per cent band up to £1.5 million. Voters could therefore be reassured that even if they did pay IHT, it would not be at a 40 per cent marginal rate. And even at £1.5 million, the effective tax rate would be only 15 per cent, weakening the arguments for Agricultural and Business Property Reliefs.

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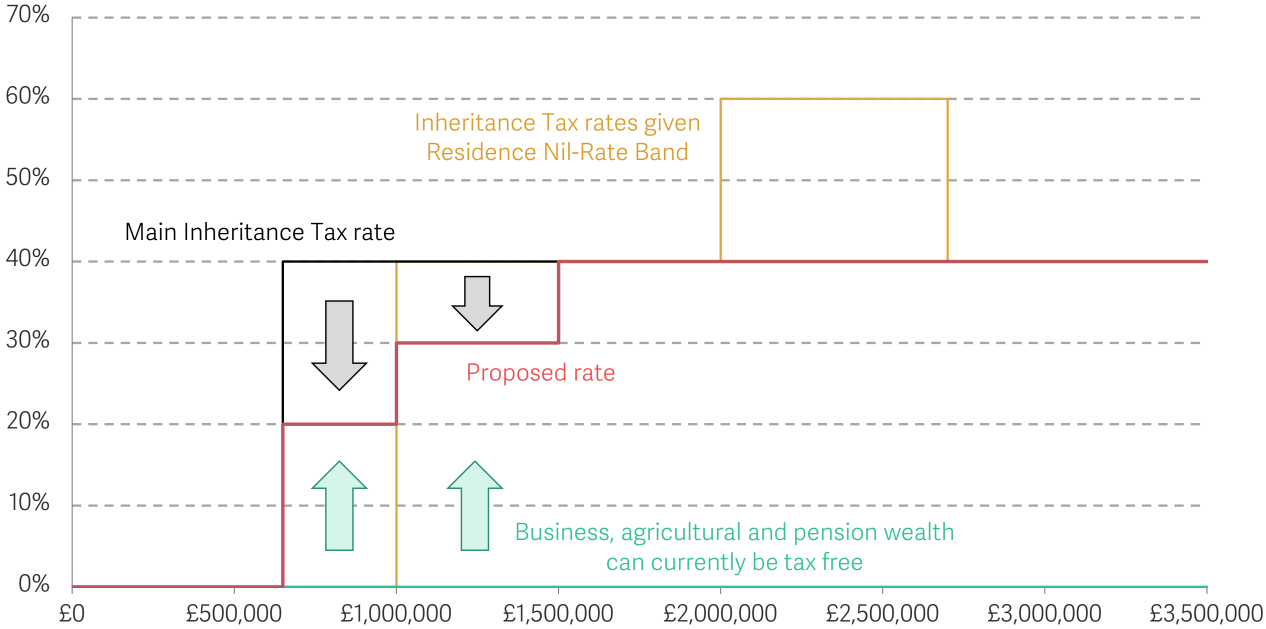
148 We explore the lack of CGT on main homes further in: A Corlett & J Leslie, Home county: options for taxing main residence capital gains, Resolution Foundation, December 2021.
149 Office of Tax Simplification, Inheritance Tax Review: second report, July 2019.
150 Office of Tax Simplification, Inheritance Tax Review: second report, July 2019.
151 OECD, Inheritance Taxation in OECD Countries, May 2021.
152 D Goss & B Glover, The Inheritance Tax Puzzle: Challenging assumptions about public attitudes to inheritance, Demos, June 2023.
153 A Corlett, Passing on: options for reforming inheritance taxation, Resolution Foundation, May 2018; OECD, Inheritance Taxation in OECD Countries, May 2021.

FIGURE 20: **We propose adding 20 and 30 per cent bands to Inheritance Tax, funded by removing reliefs**

Marginal Inheritance Tax rates based on a married couple's combined tax treatment: UK, 2023-24



Rough estimates suggest that abolishing the RNRB, Agricultural and Business Reliefs and the exemption of pension wealth would more than cover the cost of introducing these lower tax bands, with revenue left over to help fund our proposed Stamp Duty cuts.[154]

The UK should ideally replace IHT with a lifetime tax on recipients

The measures above would improve the existing system of IHT. But there is a strong case for more fundamental reform. Many have suggested that IHT on estates should be replaced entirely with a tax levied formally on recipients (which in previous work we dubbed a 'Lifetime Receipts Tax').[155] The main features of this would be an annual allowance for small gifts (e.g. £3,000), a lifetime tax-free allowance (e.g. £125,000) and a progressive rate structure beyond this.

This approach would have a number of advantages. First, while IHT may only apply to transfers made within seven years of death, a broader tax would potentially include all gifts and therefore could not be avoided simply through giving earlier in one's life. Second, taxing recipients rather than estates would bring practical benefits such as removing the

154 See APPG on Inheritance and Intergenerational Fairness, Reform of inheritance tax, January 2020 for another proposal to slash reliefs while lowering marginal rates, as well as: A Advani et al., Revenue and distributional modelling for a wealth tax, Wealth Tax Commission, December 2020.

155 See, for example: A Corlett, Passing on: options for reforming inheritance taxation, Resolution Foundation, May 2018; T Atkinson, Inequality – What can be done?, OUP, 2015; S Adam et al., Tax by design, Institute of Fiscal Studies, September 2011; C Roberts et al., A Wealth of Difference: Reforming the taxation of wealth, IPPR, October 2018.

current need for policy to transfer tax allowances within marriages and civil partnerships, which is complicated and unfair on cohabiting couples; and reporting transfers when they are received rather than retrospectively at death. But, third, it could also change perceptions of inheritance taxation. The charge levelled against IHT that it is a double taxation of savings would hold less weight if it was explicitly a tax on the income of recipients.[156] And there is greater public support for applying inheritance taxes to people who have previously received inheritances (or otherwise have higher incomes and/or wealth) than for others.[157] Indeed, such an approach would also encourage donors to spread their bequests more widely (to take advantage of per-person tax allowances and tax rates).

An international study by the OECD concluded that "a recipient-based inheritance tax may be more equitable than an estate tax on the total wealth transferred by donors" and "a particularly fair and efficient approach would consist of taxing beneficiaries on the gifts and bequests they receive over their life through a tax on lifetime wealth transfers", and there are many international examples to draw on.[158] A good example is Ireland's Capital Acquisitions Tax, which has existed since 1974. This applies a 33 per cent tax on gifts and inheritances received beyond a lifetime allowance of €335,000 (around £290,000) for receipts from one's parents (other smaller allowances are also available).[159]

Given the scale of reforms that are warranted within the existing IHT system – including but not limited to the questions of scope, reliefs and rates we have discussed above – it may well be worth ripping up existing IHT legislation and starting again with a new system that delivers all of these desirable changes at once and is fit for the coming decades and the increased flow of inheritances that they will bring.[160] This can potentially be an economically efficient way to raise revenue, reduce concentrations of wealth and improve the perceived fairness of the tax system.

This section has considered how the taxation of pensions and inheritances should be reformed. Our aim has been both to improve the workings of these taxes, by removing unjustifiable differences in tax liability between individuals in similar circumstances, but also to respond to the huge growth in the importance of household wealth relative to income, something that has not been reflected in the tax policy making of many recent governments.

156 This would also help to conceptually divide CGT at death from inheritance taxes.
157 D Goss & B Glover, The Inheritance Tax Puzzle: Challenging assumptions about public attitudes to inheritance, Demos, June 2023.
158 OECD, Inheritance Taxation in OECD Countries, May 2021.
159 A recent government-commissioned report has suggested this threshold should be reduced. Foundations for the Future: Report of the Commission on Taxation and Welfare, September 2022.
160 L Gardiner, The million dollar be-question: inheritances, gifts, and their implications for generational living standards, Resolution Foundation, December 2017.

Section 7

Conclusion

Over the previous five sections we have set out a broad-ranging agenda of specific tax cuts and tax rises – replacing parts of the tax system worth over 1 per cent of GDP with roughly equivalent increases elsewhere – to improve the tax system and support a broader economic strategy designed to boost growth while lowering inequality. A summary list of our recommendations is set out in Table 2. Different viewpoints, fiscal situations and (in the case of property taxes) nations will no doubt point towards different priorities and scales of change within these options, so it is important to note that each of these tax changes would be a useful contribution to achieving those goals in their own right; for the most part, these changes do not represent a package deal. But, as discussed in Section 1, it is useful to have a tax strategy and directions of travel that are broadly shared.

TABLE 2: **This report has recommended a wide-ranging set of tax rises and tax cuts**

Policy recommendations and their estimated costings in 2027-28

<table>
<tr><th></th><th>Tax rises</th><th>Tax cuts</th></tr>
<tr><td rowspan="2">Businesses</td><td>Cut the VAT registration threshold to £50,000 then £30,000 (+£1.5bn*)</td><td>Make Corporation Tax full expensing permanent (-£5bn*)
No Business Rates on new structures/improvements (-£2bn*‡)
Halve non-residential Stamp Duty rates (-£2bn‡)</td></tr>
<tr><td colspan="2">Extend full expensing to all capital but restrict debt interest deductibility (0)</td></tr>
<tr><td rowspan="2">Externalities</td><td>Create Road Duty for EVs (+£3bn*)
Reform up-front VED (+£1bn)
Encourage local congestion charges (-)
End free carbon permits & introduce carbon border adjustment (+£2bn)</td><td>Cut non-home EV charging VAT to 5% (-£0.5bn*)
Scrap the Carbon Price Support (-£0.5bn)
Shift Climate Change Levy rates towards fossil fuels (0)
Shift other levies away from electricity bills (-)</td></tr>
<tr><td colspan="2">Uprate Fuel Duty by 2%pa with small monthly rises (0)</td></tr>
<tr><td rowspan="2">Homes</td><td></td><td>Keep current Stamp Duty threshold (-£1.5bn‡)
Halve main home Stamp Duty rates (-£2bn‡#)</td></tr>
<tr><td colspan="2">Reform Council Tax (0‡)</td></tr>
<tr><td rowspan="2">Incomes</td><td>Apply CGT at death and exit (+£2bn)
Reform non-dom taxation (+£2bn)
Raise NI for higher self-employed incomes (+£1.5bn)
Raise the basic rate of dividend tax (+£2bn)
Introduce NI for rental income (+£2bn*)</td><td>Cut the employer NI rate from 13.8% to 12.8% (-£8.5bn)
Scrap Child Benefit withdrawal (-£4.5bn)
Scrap Personal Allowance withdrawal (-£2.5bn†)
Lower the top 2 rates of dividend tax (-£1bn)</td></tr>
<tr><td colspan="2">Reintroduce CGT inflation indexing but raise marginal rates (+£7.5bn#)</td></tr>
<tr><td rowspan="2">Pensions and inheritances</td><td>Extend employer NI to employer pension contributions (+£8.5bn§)
Lower the pension tax-free lump sum cap (+£0.5bn*)
Include pensions in Inheritance Tax (+£0.5bn*)
Abolish Inheritance Tax agricultural/business relief (+£1.5bn)
Abolish Inheritance Tax's residence nil-rate band (+£2bn)</td><td>Scrap personal NI on personal pension contributions (-£4bn)
Add 20% & 30% Inheritance Tax bands below £1.5m (-£2bn#)</td></tr>
<tr><td colspan="2">Replace Inheritance Tax with a recipient-based tax (-)</td></tr>
</table>

NOTES: Rounded to nearest £0.5bn. Costings are static except for residential Stamp Duty changes.
* = costing changes significantly in future years. † = net of lowering additional rate threshold to £100,000.
‡ = policy may vary across UK nations. § = net of public. # = including interaction with some other policies spending impact.

We have not attempted to set out the perfect future tax system; instead, we have focused on plausible changes for the medium term given the starting point that we have. And we have not been comprehensive: we have taken as a given the freezing of many thresholds until April 2028, for example, and not discussed what should happen to thresholds beyond this. Many tax policy questions, however, such as the desired rates of income taxes, or how much should be raised by property or inheritance taxes, would be more straightforward to grapple with following the tax system improvements we have set out. Clearly, policy makers need to also consider how much revenue they want the tax system to raise overall, not least given current pressures on public services. That may affect the scale and mix of the tax rises and cuts set out here, but the directions of travel towards a better tax system should be kept constant nonetheless.

Tax policy alone is not going to resolve the country's growth woes, and there are limits to the acceptable pace of change in moving towards lower inequality and higher efficiency in the tax system. Other reports for the Economy 2030 Inquiry are setting out policy recommendations in other areas that can pull in the same direction, and help together deliver strong, shared growth.

That said, our set of recommendations would have a significant impact. There would be more physical investment by businesses, a more dynamic commercial property market, more small business growth and more formal employment. The tax system would raise more from sin taxes to keep down taxes elsewhere and help achieve net zero and faster transport, while protecting low-to-middle income households. Council Tax reform would reduce inequalities in income and wealth and help close regional disparities, while Stamp Duty cuts would improve the efficiency of the housing market and the ability of workers to move to better jobs. Sub-national government would be empowered with respect to property taxes and congestion charges. The most obvious tax barriers to working more would be cut down and major distortions to investment and legal structure choices removed. The employment and pension savings of low earners would be supported, and the role of inherited property wealth tempered and more widely distributed.

It is tempting for politicians to try and avoid the creation of winners and losers that usually results from tax policy changes, but everyone is a loser if tax reform does not play its role in a much-needed economic strategy.

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