Institute of Economic Affairs

IEA BUDGET SUBMISSION

Summary

- The annual budget should be abolished in its current form. It should be replaced by a simple statement outlining the tax rates, allowances and borrowing levels required to finance the government's spending obligations as outlined in the previous Autumn Statement. New tax legislation should be introduced to parliament separately and debated by both houses of parliament.

- The government should commit to maintaining the current system of income tax relief for pension contributions, rather than creating a so-called 'equalised' rate of tax relief.

- The tax-free lump sum available from pension funds should be abolished.

- The government should not introduce a so-called 'mansion tax'. Furthermore, marginal rates of stamp duty land tax should be significantly reduced over a five year period. Eventual abolition is desirable.

- The government should either replace council tax with a tax on imputed rent for homes worth more than £1 million, or introduce a tax on imputed rent on all but primary residences and for all foreign-owned residences.

- Child benefit should be abolished. It should be replaced with a system of fully-transferable household tax allowances. This system could be integrated with means-tested payments for lower-income households.

- Inheritance tax should be abolished in its current form. A lower rate of tax of 20 per cent should be introduced on lifetime gifts received over £500,000, with generous allowance for small gifts received by low earners in individual years.

- The 40p income tax threshold should be increased significantly.

- The government should correct for significant fiscal drag seen in recent times by imposing a 'double-lock' on the uprating of thresholds over the next parliament (raising thresholds by the rate of increase in prices or wages, whichever is higher). Thereafter, thresholds for all taxes (not just income taxes) should be automatically updated in line with wage growth.

RECOMMENDATIONS FOR THE BUDGET

'Abolition' of the Budget

The annual budget has moved far beyond its original purpose. It has become a broad economic statement with the potential for policy announcements in a wide range of fields which are not usually the responsibility of the Treasury. This creates a great deal of economic uncertainty and centralises power to the Treasury. The process also means that new tax legislation is rushed through without proper scrutiny.

We recommend replacing the annual budget in its current form with a statement outlining the tax rates and allowances necessary to fulfil (alongside borrowing requirements) the government's public spending obligations as outlined in the previous Autumn Statement. This would mean new tax legislation would have to be introduced separately and debated fully by both Houses and the relevant Select Committees, as with other legislation. This would return the budget to its proper function, raise the level of scrutiny of the budget decisions and raise the level of scrutiny of tax legislation. At the same time, authority over other issues raised in the budget would remain, rightly, with other departments.

The taxation of pensions

Higher rate tax relief must be preserved

Last year's budget saw a radical shift in pension policy, as the government significantly altered policies which had previously strongly incentivised the purchase of an annuity. These changes should be welcomed, as they give savers much more freedom and flexibility. From next year, all those over the age of 55 will be able to access the entirety of their pension pots, subject to income tax at their marginal rate.

However, over the past few years a number of commentators have suggested complementing this liberalisation with significant changes to the tax incentives surrounding pension saving. In particular, the system of pension income tax relief has been singled out as an area for reform and making 'savings', with ministers such as Mark Hoban and Steve Webb advocating the replacement of the existing pension income tax relief regime (which occurs at a taxpayer's marginal rate) with an equalised tax relief at either 30 or 33 per cent.

We believe that this change would be extremely damaging, and that the government should give a clear indication that they would not make such a change – both because it is misguided in principle and unworkable in practice. It is wrong in principle because the purpose of both the ISA and pension fund tax systems is to ensure that the returns from saving are tax-free. The two models are different but, under the pension fund model, the intention is that all taxpayers are able to defer tax until the time at which consumption takes place. If tax relief were restricted to 20 per cent or 'equalised' at 30 per cent, higher rate taxpayers could end up obtaining tax relief of 30 per cent on a contribution that is then used to buy a pension that is taxed at 40 per cent. In other words, they could find themselves effectively paying a 'fine' to make pension contributions. It is certainly true that the opposite can occur under the current system, and indeed is probably more likely: an individual can obtain tax relief at 40 per cent and then pay tax at 20 per cent when they receive their pension income. However, this is, in fact, an important feature of the current system, because it plays an important role in ensuring that those with volatile incomes do not pay higher overall tax rates over their lifetimes than those with the

same lifetime income spread more evenly. The current system of pension fund tax relief therefore facilitates income smoothing and makes the tax fairer over an individual's lifetime.

There are also practical problems with proposals to 'equalise' 'tax relief[1]'. In order to prevent simple avoidance mechanisms and to ensure equity, employer's contributions would have to be taxed as a taxable benefit at the employees' marginal rate and then a credit of 30 per cent given. Otherwise, in respect of higher-paid employees, employers would cut pay and make pension contributions on behalf of employees (thus saving the employee 40 per cent tax); in respect of lower-paid employees, employers would cease contributions, provide pay increases and allow employees to take advantage of 'tax relief' at 30 per cent. Complicated measures would need to be undertaken to avoid this, which would be particularly problematic in defined benefit schemes and especially in the public sector. There would also need to be actions to prevent someone approaching retirement as a basic rate taxpayer from making pension contributions receiving 30 per cent tax relief and then taking the contributions out of the fund and paying tax at 20 per cent the following year.

In principle and in practice, then, the system of tax relief should be maintained. The only feasible way to implement the proposed system would be to prohibit employer contributions altogether.

Abolition of tax-free lump sum

The tax-free pension lump sum available from pension funds remains the one great anomaly left in the UK tax system. It has no justification and should be abolished.

Since contributions are already subject to tax relief, the abolition of the tax-free lump sum would help move the whole system towards neutrality. The savings could be used to reduce or abolish other damaging taxes such as stamp duty, inheritance tax and capital gains tax. The tax-free lump sum is said to cost the Treasury £4 billion a year.

The existence of the tax-free lump sum creates complexity in the tax system because its exploitation (especially by higher earners) leads to the necessity for limits to be put on pensions saving (such as the lifetime limit, the special limit for those withdrawing funds from their pensions and the annual limit).

The immediate and complete abolition of the tax-free lump sum might be seen as an unjustified retrospective tax change. We therefore propose the following:

- A limit of £100,000 should be put on the tax-free lump sum taken from any pension fund with immediate effect. Anything over this amount (whether in relation to a defined benefit or defined contribution scheme) would be taxed at 20 per cent and not otherwise count as taxable income (thus not reducing the basic rate per cent band).

- Accrual of tax-free lump sums in both defined benefit and defined contribution schemes should cease with immediate effect (though a de minimis level of, say, £10,000 would not be objectionable).

The combination of these two reforms would leave the pensions tax system on a long-term sustainable footing and it would ensure that the system was fair and facilitated appropriate income smoothing and income deferment which is the proper purpose of a pension system.

[1] Though the phrase 'tax relief' is often used by the proponents of this change, it would no longer be a system of tax relief as such but a complex system of subsidies for and penalties on pension saving.

Property taxation

No case for a mansion tax

Substantial changes to the taxation of property have been both mooted and delivered within this Parliament. The idea of a so-called 'mansion tax' continues to be considered by several political parties. As we have previously argued, this would in effect be a wealth tax which only operates on property, though it would take no account of an individual's mortgage position, or the number of properties an individual owns. It would be a particularly pernicious tax, as it would apply year-after-year. It would certainly be an obvious example of 'double taxation' and would amount to a significant policy attack on property rights per se. History suggests that a new tax would inevitably lead to the temptation for politicians to expand the base over time, not least through the threshold limit not keeping pace with house price inflation. It would also promote expensive avoidance schemes, with the potential for substantial legal challenges. For these reasons, we believe there is no case for a mansion tax in the UK.

Reducing Stamp Duty

Nevertheless, there is a case for substantial reform of property taxation. The Chancellor began this process in the Autumn Statement when he announced the overhaul of the slab structure surrounding stamp duty land tax. This was a worthy reform in making the system more coherent, and eliminating cliff edge effects which distort the property market as property values pass certain thresholds. However, stamp duty remains a highly distortive tax and yet is forecast to be an even more significant revenue raiser in future. Meanwhile, a desire for the reform not to be costly in terms of lost revenue has led to penal top marginal tax rates on expensive properties (10 per cent on property values between £925,000 and £1.5 million, and 12 per cent beyond that).

Given the highly distortionary effects of stamp duty, it should be the aim of government to eliminate it. The first step should be to reduce rates towards those which existed as recently as 1997. This could begin with a pre-announced five-year programme. Recognising the broad fiscal framework in which we are operating we propose that the 2 per cent and 5 per cent rates are reduced by 0.2 percentage points per year, whilst the 10 per cent and 12 per cent rates are reduced by 1 percentage point per year. This would leave a framework, assuming indexation of the thresholds in the interim, of 0 per cent on the first £125,000 of the property price, 1 per cent on the next £125,000, 4 per cent on the next £675,000, 5 per cent on the next £575,000 and 7 per cent on anything beyond that.

Introduction of a limited tax on imputed rents

A far less economically damaging tax on property, which could help finance reductions in stamp duty, would be taxation of imputed rent. At the moment property is exempt from VAT and the owner occupier use of property (the imputed rent) is not taxed. This means renters (or landlords) pay tax on rent from property but owner occupiers do not pay tax on the value of the services they obtain from property. There is a strong case for abolishing council tax entirely and replacing it with a tax on the imputed rent from owner-occupied property or allowing local councils to determine their own tax base

and forms of taxation. However, working within the current system, we propose two (mutually exclusive) options for reform.

- Council tax remains for properties under £1 million, but is abolished for properties worth over £1 million and replaced with a tax on imputed rent. The tax charge on imputed rent could then be set such that the income tax charge would be equivalent to the current council tax charge for properties of £1 million in the particular council area. Properties worth more than a £1 million would face a proportionally higher tax bill given the higher value of imputed rent.

- It could be recognised that primary residences should be exempt from any tax on imputed rent but that all other properties (second homes, foreign-owned residences, and so on) should be subject to a tax on imputed rent at the highest marginal rate of tax. There would be a case for offsetting mortgage interest against the imputed rent.

Child benefit

The coalition's incoherent reforms

The reforms made to child benefit (the introduction of a tapered withdrawal for 'high earners') earlier in the Parliament have substantially increased the marginal tax rates of families where the highest earner has an income of between £50,000 and £60,000. The rationale for this means-testing has always been unclear. Child benefit was always supposed to be a tax rebate to recognise the cost associated with children, and the fact that having children lessens an individual's ability to pay taxes on income. No such rationale now exists in the tax system. But parents earning income within this band also now face significant disincentives to work or take a promotion that might increase their income. Someone with three children, for example, now faces an effective marginal tax rate of 66.75 per cent so that they only keep 33.25p of every extra £1 earned over that range. On top of this, hundreds of thousands more people have been dragged into the complex self-assessment income tax system. Furthermore, because the benefit is withdrawn based on the income of the higher-earner in the household, the system reinforces the discrimination against single-earner families.

Abolition of child benefit and replacement with transferable household tax allowances

The system should be completely overhauled. Child benefit should be abolished (saving £12 billion) and be replaced with a system of transferable household tax allowances. The tax allowance within any household with dependents would be determined by the number of adults, the number of dependent adults (for example, disabled adults, elderly parents) and children. The allowance for the second adult would not be as high as the allowance for the first adult, allowances for children would be less than allowances for adults, and so on. Tax would then be charged on household income less household allowances. Such a system is common in other EU countries which do not have the structural anti-family bias (and, in particular, anti-one-earner family bias) of the UK tax and benefits systems and which often experience better social outcomes. A tax credit would be paid if household earnings were less than the total household tax allowance ensuring that the system was not biased against low-income households. Minor changes would need to be made to the child tax credit system to ensure consistency, though, in the long term, the two systems could be integrated.

Recognising the attraction of the independent taxation of husband and wife (or non-married) couples when there are no dependents, any couple household could opt to have the adults taxed as single people without transferability of allowances. It is likely that this would be the option chosen for

households without children. However, the proposal would restore the household as the basic unit of taxation where there are dependents, recognising also that the family – and not the taxpayer - is the prime vehicle for redistributing income between those who are earning and those who are not earning. This proposal should be a long-term aim, since it would involve a considerable reduction in government spending and taxation and provide incentives for self-sustaining family formation.

Inheritance Taxation

There is a case to be made for the complete abolition of Inheritance Tax (IHT). However, radical reform is possible in a way that would remove some of the tax's worst features, including the very high marginal rate. At the moment IHT avoidance schemes are common. This reinforces the unfairness of the tax because two people in similar situations may pay different amounts of tax depending on the extent to which they can use avoidance schemes. Because the tax is levied once and the sum of money raised from an individual is often very large, the incentive to take action to avoid the tax is strong.

In fact, in many ways the IHT is not a tax on inheritance at all – rather, it's an estate duty and capital transfer tax: in other words, it is charged on an estate and not charged to those who inherit an estate. Many countries have abolished taxes on the transfer of assets but those that retain it generally tax the recipient of assets rather than the donor. It is, indeed, more logical to tax the recipient of a gift rather than the donor as it is the recipient who is benefiting from it.

We propose the following:

- Each individual is granted a £500,000 lifetime gifts and inheritance allowance (indexed according to the provisions below).
- Once this allowance is exhausted (in the vast majority of cases on the occasion of inheritance) any further gifts received would be taxed at a flat rate of 20 per cent.
- The following gifts/inheritances would not count towards reducing the lifetime allowances:
    - All transfer between husband and wife
    - Any gifts, including to children, that do not take an individual above their annual personal allowance (of course, there would have to be different provisions if the system of household tax allowances proposed above were introduced).

The broad principle would be that those receiving substantial gifts would pay IHT on the same basis as if they had received substantial income in that year, but with the tax limited to 20 per cent. This would make the process much less bureaucratic and make avoidance much less worthwhile. Regarding enforcement of lifetime limits, the tax authorities would have a relatively small number of families for which monitoring would be required.

Overall, this is a sustainable reform that should appeal to all sides of the debate on the issue of taxing inheritances and would certainly be an improvement on the status quo. It would also encourage the dispersal of wealth.

Abolition of two higher rates of tax

After the financial crash, two adjustments to the tax systems were made which are potentially damaging. The first was the introduction of the 50p rate of income tax (now 45p). The second was the withdrawal of the personal allowance for individuals earning over £100,000. This creates a marginal tax rate of 62p over a significant range of income. The thresholds above which these rates apply have not been indexed.

These rates – especially the 62p rate – are penal. Furthermore, the 62p rate has no place in a rationally designed tax system. Individuals earning just over £100,000 pay higher marginal rates of tax than individuals earning £150,000 (or for that matter £1,000,000) – premier league footballers have a lower marginal tax rate than those in the lower leagues.

The 45p tax rate should be abolished. Furthermore, the withdrawal of the personal allowance should be abolished too. The fiscal cost of these measures would be around £1 billion (though subject to wide uncertainty) and £3.2 billion respectively.

Arresting and reversing fiscal drag

Fiscal drag refers to a situation where inflation or earnings growth pushes more individuals into higher tax brackets, the thresholds for which do not rise as rapidly. The phenomenon does not just apply to income tax. The threshold for inheritance tax has not even been adjusted for inflation in this parliament.

In recent years, there has been a significant fall in the real and wage-adjusted value of the 40p income tax threshold – seeing increasing numbers dragged into that band. In fact, the wage-adjusted value of this threshold has fallen consistently since 1980, such that the threshold is now 43 per cent lower relative to wages than in 1978/79. This has led to a huge increase in the number of people paying higher tax rates over the last 25 years. In 1990 around one in fifteen income taxpayers paid the higher rate (1.7 million people). This had increased to about one in ten by 2010 (3.3 million) but has since increased significantly to one in six income taxpayers (4.6 million) by 2013/14, as the coalition government has allowed the higher rate threshold to fall not just relative to inflation but from £43,875 in 2010 to £41,865 in nominal terms.

The Prime Minister has pledged that a future Conservative majority government would increase the higher rate starting threshold to £50,000 by the end of the next Parliament. However, given their expectations of inflation and real wage growth, the Treasury still expects the number of income taxpayers paying higher tax to increase 5.5 million by 2020 (vs. 6.3 million without the policy announcement). Furthermore, this is a not a coherent policy. The value of the threshold relative to prices or earnings will depend on inflation and wage growth during the period.

Double lock for tax thresholds

In order to restore lost ground, we propose a 'double lock' for all tax thresholds (for example income thresholds, inheritance tax and stamp duty thresholds and so on). Over the next parliament, they should be increased by inflation or wage growth, whichever is higher. Other ambitions regarding tax thresholds such as increases in the personal allowance should not be implemented. Furthermore, there should be a one-off, £4,000 increase in the higher-rate tax allowance to partially compensate for recent reductions.

Eliminating fiscal drag in the long term

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Legislation should be implemented to raise all tax thresholds (not just those relating to income tax) in line with wage growth in the long term. Such indexation would be automatic unless over-ruled by a specific vote in parliament.

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