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Over-taxation by Inflation

DAVID R. MORGAN

Post-Budget Edition Supplement

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PRESS COMMENTS ON THE FIRST EDITION OF

Over-taxation by Inflation

'An extremely clear exposition of what has happened [has been] published by the Institute of Economic Affairs. It is a pamphlet called *Over-taxation by Inflation*, by Dr. David Morgan . . . No-one who has read Dr. Morgan's pamphlet can fail to be convinced by the argument.'

John Pardoe, *Hansard*, 3 March, 1977

'. . . as Dr. Morgan proves conclusively, the incentive which the absence of indexation gives to the politician to indulge in inflation has long ago become the dominant consideration.'

Leader—*Daily Telegraph*

'The author shows conclusively that while the great majority of the population suffers some increase in taxation when inflation pushes up money income, the impact in percentage terms is greatest within any tax band for those who are worst off.'

Economic Correspondent, *The Times*

'Dr. Morgan would like to see Britain increase personal and dependent allowances, and all taxable income bands, at the time of the budget every year, in line with the rate of inflation . . . This, he argues, would force government to legislate all real tax increases separately.'

Frances Cairncross, *Guardian*

Post-Budget Edition—Supplement

Over-taxation by Inflation

DAVID R. MORGAN

1. In Britain inflation has been accompanied by inadequate adjustments in tax allowances and bands so that real rates of taxation have increased sharply.
2. This inadequate adjustment is inequitable as between taxpayers, and tends to bear more harshly on low-income and large families than on higher-income and smaller families.
3. Incomplete adjustment transfers more revenue to government than taxpayers know or wish to pay. Between 1973-74 and 1975-76, personal taxes more than doubled.
4. These sharp increases in tax rates have occurred while politicians have appeared to make concessions to taxpayers by altering allowances and bands in *money* terms that do not even restore their *real* value to taxpayers.
5. Inflation is taxation by misrepresentation. Large increases in tax revenue induced by inflation exonerate politicians from asking the electorate explicitly for higher tax rates.
6. The lack of indexation has permitted government in Britain to continue its practice of separating decisions on expenditure from decisions on tax-raising. It is unique among Western industrialised countries, where the two are normally considered together in budgeting, and has contributed to a bloated public sector.
7. Increasing resistance to unlegislated increases in tax rates has emerged in Britain, in the form of wage bargaining on take-home pay and increased tax avoidance and evasion.
8. An increasing number of countries in Europe, as well as Canada and Australia, have introduced various forms of tax indexation in the last five or ten years, despite less rapid inflation than in Britain.
9. Tax indexation would make the government more accountable to the electorate and tend to limit the expansion in government expenditure, as the electorate became more aware of the tax- 'cost' of expanding government services.
10. The March 1977 Budget failed to restore the real personal tax rates of 1973-74. It reduced taxes by £2·25 billion instead of the £5·75 billion required for this purpose. The family man received least benefit, even in money terms, and in real terms is relatively worse off than other taxpayers.

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The Chart on the front cover is the Chart on the Budget Edition cover, revised to reflect the March 1977 Budget changes.

PREFACE TO THE SECOND (POST-BUDGET) EDITION

Dr David Morgan has now revised his calculations in the light of the March 1977 Budget and indicated the implications for the analysis in his *Hobart Paper* (Postscript, pp. 81-94).

The Tables, Charts and his Commentary speak for themselves. It seems that the Budget may represent a fundamental change in fiscal policy. Such improvement as there is seems to be due to the lessons that the politicians have finally learned from successive failures or perhaps to the IMF 'shackles'. If it is the latter that restrains government from even more overspending, what is in store after the IMF loan is repaid? Will government expenditure resume its euphoric expansion?

It would seem that as a guide to the trend in government expenditure the White Papers are now almost useless for analytical purposes. They now seem to be public relations documents characterised by obscurantism. According to the *Financial Statement and Budget Report* government expenditure seemed to be due to rise by 11 per cent; if GDP in money terms is likely to rise by about 14 per cent, the so-called 'massive cuts' in government expenditure look like another exercise in misleading advertising by government.

The reduction in the public sector borrowing requirement was directly imposed by the IMF. Even so, the reduction is hardly dramatic: in money terms down from £8·8 to £8·5 billion. Dr Morgan emphasises the meagre improvement for the take-home pay (in real terms) of the average wage-earner: indeed, if his gross wages in 1977-78 rise by 10 per cent—the figure that seems to have emerged recently—his real take-home pay will fall by nearly 2 per cent, and that of the family man with more than the average number of children will fall by more.

Not least it may occur to the Liberal Party, in particular to Mr John Pardoe, their Shadow Chancellor, that they might ask for indexed tax bands and allowances, if not indexation itself, in return for their support for the Government.

May 1977 ARTHUR SELDON

POSTSCRIPT

Indexation and the 1977-78 Budget: Recognition Without Resolve

Proponents of personal tax indexation can rejoice and, at the same time (or shortly thereafter), despair over the Chancellor's 1977-78 Budget Speech. Rejoice because the Chancellor accepted almost all the arguments put forward for indexation.

> '... all these objectives [lower inflation, improved industrial and trading performance] will require some reduction in the present burden of income tax. [columns 266-7] . . . it is desirable to readjust the balance between direct and indirect taxation. In recent years the share of direct taxes has risen under successive Governments, mainly because inflation has eroded the real value of income tax thresholds. [column 271] . . .
>
> . . . substantial income tax relief is desirable. . . . In a nutshell, the effect of inflation has been to put too high a proportion of the tax burden on to the income tax; to impose tax on too low a level of income; and to bring too many people into the higher rates of tax at each successive level, starting at a level not very far above average earnings. The effect has been to weaken the incentive to work throughout the economy. . . . The greatest hardship falls on the poorer members of our society.' [column 279][1]

These excerpts encapsulate all the main arguments in favour of indexation (except the financial profligacy of government that lack of indexation promotes—an understandable omission).[2] Yet agreement with all the arguments in favour did not yield indexation.

Moreover, the *ad hoc* adjustments introduced were, on even the most favourable comparisons, extremely modest steps towards rectifying the problems generated by inflation unaccompanied by indexation; and, in some respects, exacerbated them. Indeed the £2·25 billion income tax reduction in the budget actually strengthens rather than weakens the case for indexation. To appreciate why, it is necessary to plough through some tax arithmetic that, perhaps understandably, is omitted from official press releases accompanying the budget.

[1] All column numbers in square brackets refer to *Hansard*, 28 March 1977 (London: HMSO).

[1] But see the statement of the Australian Treasurer above, p. 46.

The Chancellor provided a fairly precise inflation forecast: 13-14 per cent annual average rate for the 1977-78 financial year.[1] With this forecast, it is possible to update the Tables in the text, taking account of the changes in the 1977-78 budget.

1. *Taxable income bands*

Table IX and Chart I show the decline in the real values of the upper-income bands since the introduction of the unified rate scale in April 1973. (Table IX updates Table V, p. 34.)

TABLE IX

REAL VALUE OF UPPER LIMIT OF TAXABLE INCOME BANDS

April 1973	*March 1977*[(a)]	*March 1978*[(b)]
£	£	£
5,000	2,623	2,844
6,000	3,410	3,791
7,000	3,935	4,265
8,000	4,460	4,739
10,000	5,247	5,687
12,000	6,296	6,635
15,000	7,870	7,583
20,000	10,493	9,953

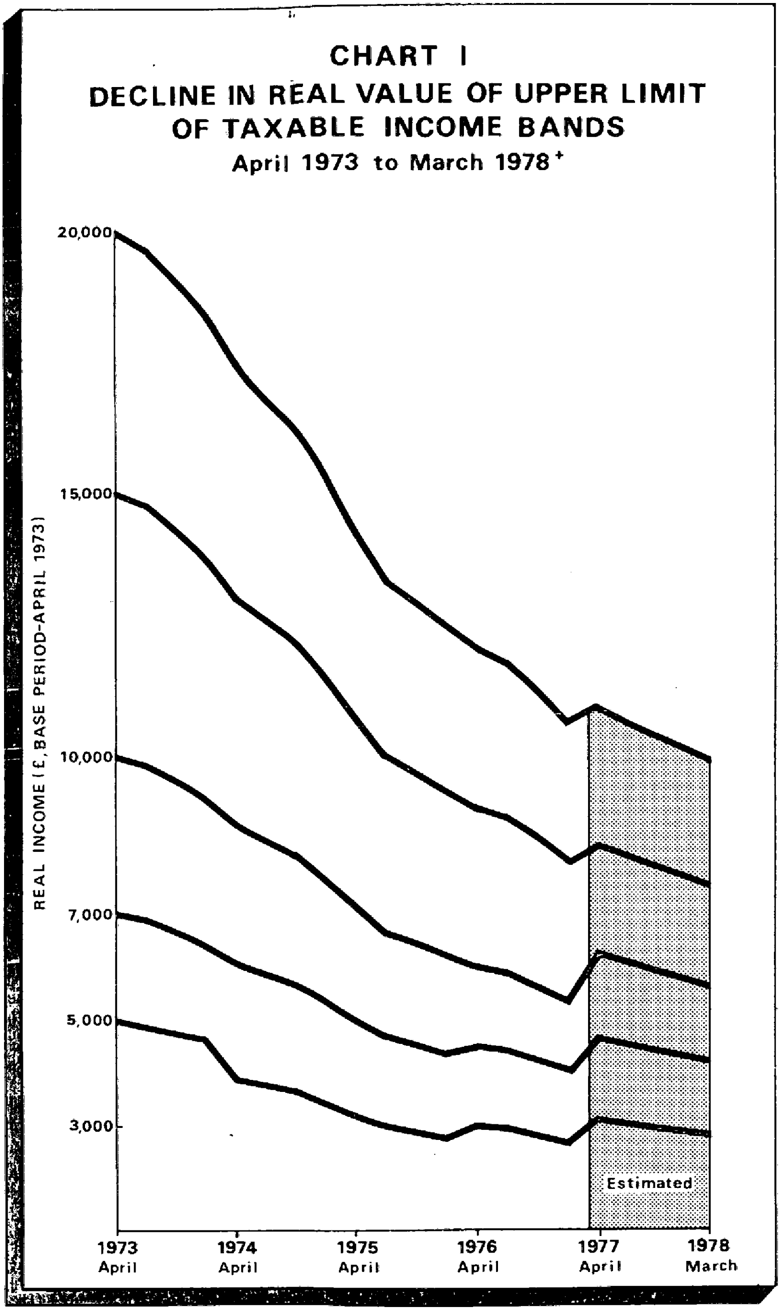
(*a*) Calculated on the basis of 1976-77 bands, deflated by the Index of Retail Prices.

(*b*) Calculated on the basis of the bands announced in the 1977-78 budget, deflated in line with the Chancellor's forecast of inflation.

At the end of 1976-77, the real widths of all taxable income bands were, on average, only 54 per cent of their legislated values. The upward adjustments introduced in the 1977-78 budget imply that by the close of the financial year, the real widths will, on average, equal 57 per cent of their legislated values. These adjustments are not useless from the taxpayer's point of view (for the lower—but not the upper—income bands, they imply average real widths during 1977-78 close to those prevailing early in the 1976-77 financial year), but they are exceedingly modest. *The truth is that the real widths of bands are still only just over half their originally legislated widths.*

Table X shows what bands would be for 1977-78 had their

[1] Derived by assuming a constant decline from the current rate of 16 per cent to the Chancellor's estimate of 13 per cent by the fourth quarter of 1977 and 'single figures' by the second quarter of 1978 [columns 249 and 286]. The rate adopted for purposes of calculation below is 13·6 per cent.



* April, July, October and January figures only plotted.

TABLE X

INDEXED AND ACTUAL TAXABLE INCOME BANDS, 1977-78

Indexed Bands[(a)] £	*Current Actual Bands* £
0—10,100	0— 6,000
10,100—11,100[(b)]	6,000— 7,000
11,100—12,100	7,000— 8,000
12,100—14,100	8,000— 9,000
14,100—16,100	9,000—10,000
16,100—20,100	10,000—12,000
20,100—24,200	12,000—14,000
24,200—30,200	14,000—16,000
30,200—40,300	16,000—21,000
Over 40,300	Over 21,000

(*a*) Includes adjustment for average 1977-78 inflation, using the Chancellor's forecast. Rounded to nearest £100.

(*b*) Imputed to take account of the new band introduced in 1974-75(then at 38 per cent, now at 40 per cent).

original real values been maintained under indexation. (Table X updates Table VII, p. 51.)

Bands for 1977-78 would have been just over double their original values if there had been indexation since the unified income tax scale was introduced in April 1973. Their actual values vary between no more than 66 and 52 per cent of the indexed values.

2. *Personal and married allowances*

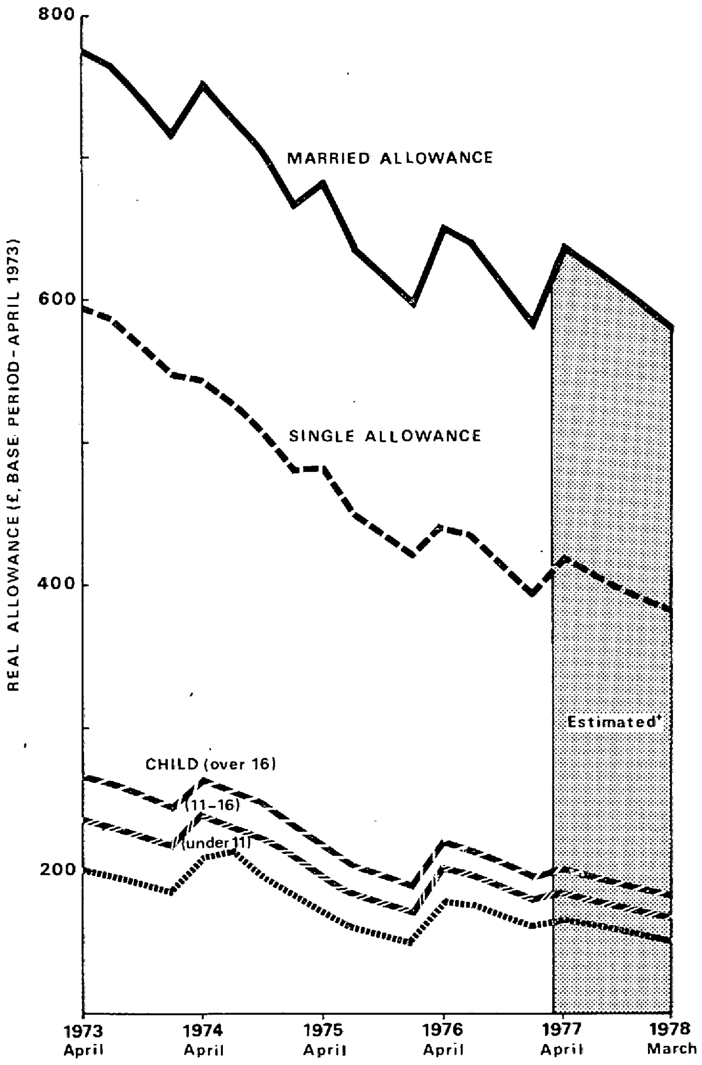
Chart II updates the chart in the text (p. 35) showing changes in the real value of personal and dependent allowances. It is clear that the adjustments in these allowances for 1977-78 are even more modest than those for taxable income bands.

First, reconsider the change in the real value of dependent allowances since the unified tax scale (Table XI—updates Table IV, p. 34).

By the close of the 1976-77 financial year the real values of allowances were on average only 70 per cent of their originally legislated values, despite increases in their money values in each budget since 1973-74.[1] Further discretionary increases

[1] The child allowances were not increased in the 1975-76 Budget.

CHART II
PERSONAL INCOME TAX: DECLINE IN REAL VALUE OF PERSONAL AND DEPENDENT ALLOWANCES
April 1973 to March 1978



* Index of Retail Prices data up to February 1977. Thereafter the Chancellor of the Exchequer's inflation estimate for 1977-78.

TABLE XI

DECLINE IN REAL VALUE OF ALLOWANCES, APRIL 1973 TO MARCH 1978 (ESTIMATED)

(£: April 1973=100.0)

Allowance	*April 1973*	*Real Value as at:* *March 1977*[(a)]	*March 1978*[(a)]
	£	£	£
Single allowance	595	385	380
Married allowance	775	570	580
Child allowance[(b)]			
Not over 11	200	160	150
11-16	235	175	165
Over 16	265	190	180

(*a*) Deflation procedure and 1977-78 inflation assumptions as for Table IX. Rounded to nearest £5.

(*b*) Based on required level of child allowance for two-child family that would provide equivalent net income gains to those provided by the change to the child benefits scheme (Section 3 below).

announced in the 1977-78 budget will not alter this trend. By the close of 1977-78 the real value of the marriage allowance will remain around 75 per cent of its legislated value: and the real value of the single and child allowances will decline further—to 64 per cent and 69 per cent respectively.

The Chancellor explained that he was granting a 'substantially larger' increase in the married allowance to provide the family man with 'special help' during the transition to the child benefit scheme:[1] a proportionate adjustment marginally *below* his own inflation forecast (12·9 per cent compared with 13·6 per cent).

The increase in the married allowance was 'substantially larger' than the increase in the personal allowance. The Chancellor emphasised the role of the personal allowance in freeing the very poor from tax liability; and he said that 'the highest priority . . . must be to raise the tax threshold so as to maintain [its] real value'.[2] He then announced an increase of less than 9 per cent—below his own expectation of the 1977-78 inflation rate.

Table XII shows the value of allowances in 1977-78 required to maintain their legislated values (compare with Table VI, p. 50).

[1] [Column 280].

[2] [Columns 280 and 281].

TABLE XII

INDEXED AND ACTUAL ALLOWANCE VALUES, 1977-78

	Indexed Value[(a)]	*Actual Allowances for 1977-78*
	£	£
Single allowance	1,200	805
Married allowance	1,560	1,225
Child allowance		
Under 11	405	320[(b)]
11-16	475	355[(b)]
Over 16	535	385[(b)]

(*a*) Rounded to nearest £5. Includes adjustment for average 1977-78 inflation.

(*b*) Child allowances for basic rate taxpayer with two children that would provide the same net income as 1977-78 transition to child benefits.

The actual allowances for 1977-78 are, on average, less than 75 per cent of the indexed values.

3. *Child allowances and benefits*

The biggest losers from the 1977-78 tax changes are (as usual with an unindexed tax system) large family taxpayers. This conclusion seems to contradict the much-heralded 30p a week gain families were told to expect under the transition from a system of taxable family allowances and child tax allowances to a system of tax-free child benefits. To understand why families will lose heavily from the transition, it is necessary to examine the old and new systems.

Under the old system the family received:

(*a*) child tax allowances; plus

(*b*) taxable family allowance (£78 for each child after the first) diminished by

(*c*) a reduction of child tax allowances by £52 from the second child on ('clawback').

Under the new system the family receives:

(*a*) smaller tax allowances; plus

(*b*) tax-free child benefit, and

(*c*) no 'clawback'.

The net effect for a family is a reduction in tax allowances of £104 a year (regardless of the number, or the age, of children) and an increase in cash payments for children of £52. For a basic rate (35 per cent) taxpayer, this provides a tax increase of £36·40, yielding a net gain of £15·60 or 30p a week.

What percentage increase in total net income from child benefits and allowances does this 30p a week increase represent over net income from 1976-77 benefits and allowances? The answer depends on the number and age of children. For the basic rate taxpayer with two children, the figures are as follows:

Two Children Aged:	*Percentage Increase in Net Income from Child Benefits and Allowances*
	%
Under 11	6·4[1]
11-16	5·8
Over 16	5·4

For the same taxpayer with four children, the increase is even smaller:

Four Children Aged:	*Percentage Increase in Net Income from Child Benefits and Allowances*
	%
Under 11	3·0
11-16	2·8
Over 16	2·6

The reason for the trend of percentage increases in these two illustrations is straightforward. All taxpayers within the first income band receive the same absolute increase in total net income as a result of child benefits and allowances (£15·60), regardless of the number or age of children. Since the initial income benefit is higher the older the children and the larger their number, the percentage increases are correspondingly lower for these categories (the taxable income is lower).

Had the old system been retained, what percentage increases in family allowance, clawback, and child tax allowances would have produced the same percentage increases in total

[1] For example, in 1976-77 the total net income for this group from child benefits and allowances equalled £242·50, of which £78 derived from the family allowance. The remaining £164·50 derived from the net reduction in taxable income equal to £487, the child allowance of £600 being reduced by the taxable income increase of £78 (because of family allowance) and the taxable income decrease of £52 ('clawback'). £15·60 represents a 6·4 per cent increase on this aggregate net income gain.

net income? The answer is simply those percentages appearing above. Thus

—*the increases in child tax allowances implicit in the transition to child benefits are substantially below the rate of inflation;*

—*the larger the number of children the smaller the implicit increase—less than 3 per cent for the taxpayer with four children over 16;*

—*the transition to child benefits is camouflaging a substantial decline in the real value of benefits and allowances granted to the vast majority of taxpayers with children (i.e. basic rate taxpayers).*

How do higher-rate taxpayers with children fare? Previously, high-income taxpayers had the option of not claiming family allowances, and keeping their tax allowances intact. For most taxpayers facing a marginal rate of 60 per cent or above, it did not pay to claim family allowances, thereby retaining the full value of child tax allowances. Now that option is unavailable, leaving them worse off.

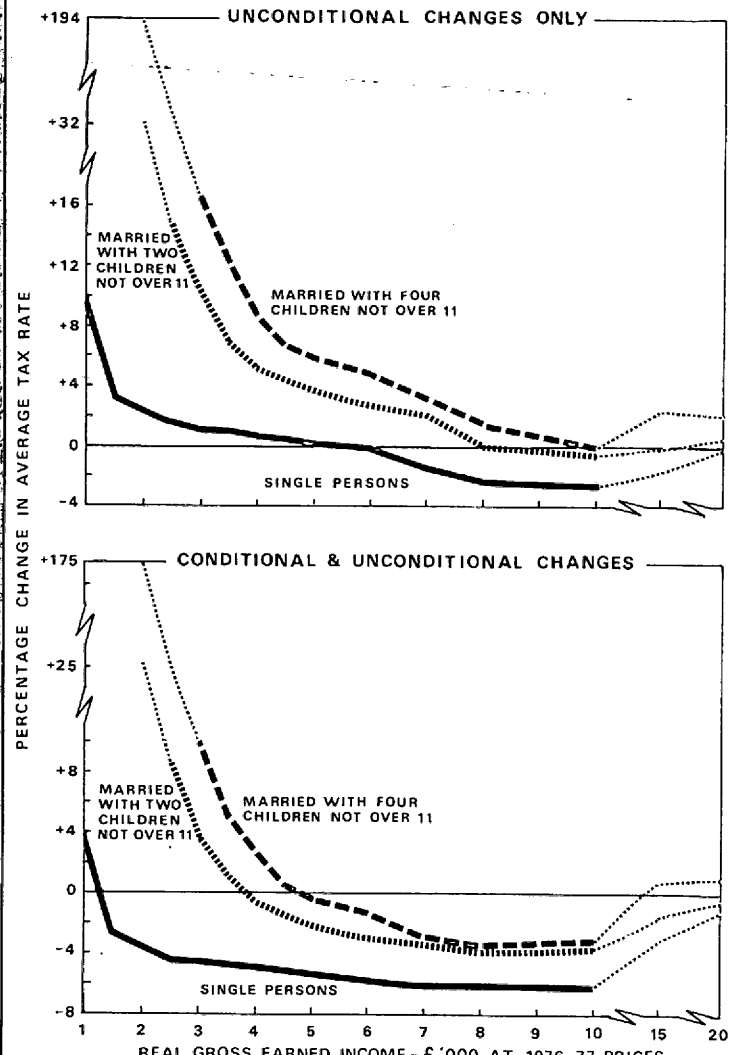
4. *The unconditional package as a whole*

Notwithstanding the Chancellor's clear recognition of the severe distortions caused by inflation and partial adjustment of allowances and bands, the unconditional package represents an extremely modest and, in several important respects, inconsistent response. Certainly it is grossly inadequate when viewed against the cumulative eroding effect of inflation over the past four financial years. But even on a far less demanding comparison—that is, with the previous financial year—the package is disappointing: a small increase in the real width of some taxable income bands, bare maintenance of the real marriage allowance, continued erosion of the real personal allowance, and a considerable decline in real child allowances. A poor exchange for indexation.

The net effect of these adjustments, 'costing' the Exchequer £1·29 billion on a full-year basis, will be to *increase* the real tax rates borne by the overwhelming majority of taxpayers in 1977-78 as compared with 1976-77. This is the seemingly irresistible luxury of non-indexation: a nominally huge 'give-away' accompanied by increased real tax rates. Chart IIIA sets out the proportionate increase in tax rates in 1977-78 over 1976-77 borne by equivalent real incomes[1] for three taxpayer categories.

[1] That is, money incomes 13·6 per cent higher than 1976-77 incomes.

CHART III
PERCENTAGE CHANGES IN AVERAGE TAX RATES ON EQUIVALENT REAL INCOMES
1977-78 Tax Schedule



All single taxpayers paying the basic rate will bear increases in real tax rates as a result of reduction in the real value of the personal allowance. Higher real incomes will face lower real rates, since the increase in taxable income bands outweighs the decline in the allowance. The largest gain occurs around real gross incomes (expressed in 1976-77 prices) of £10,000.[1]

Married couples with young children have little to look forward to, particularly those on low incomes. Basic rate taxpayers with two young children face proportionate increases in rates (expressed in relation to *total* income, that is, *including* tax-free child benefits) ranging from 32 per cent at the lowest incomes to 2 per cent at higher incomes. Taxable income band adjustment offsets the sharp decline in the real value of total child benefits around £10,000 of real income. This beneficial effect does not carry through to higher-income taxpayers, because they have lost their 1976-77 option of refusing family allowances and retaining the full value of child tax allowances.

Married taxpayers with large families are particularly hard hit, especially those with the lower incomes. The adjustment of taxable income bands is not sufficient to offset the drastic decline in total real child benefits at any income level. The Chancellor intended to compensate those most adversely affected by inflation and non-indexation. The unconditional changes do not achieve this object.

5. *The conditional package*

The conditional package provides real, if modest, tax relief to a large majority of taxpayers, although with important exceptions. Tax-*rate* adjustment differs in one fundamental respect from allowance adjustment; it does not discriminate between categories of taxpayer (married, married with two children, and so on). Hence if, as in 1977-78, child allowances are subject to disproportionately low adjustment, there is nothing tax-rate adjustment can do to offset this increased *relative* burden on taxpayers with children.

Chart IIIB is equivalent to Chart IIIA in all respects except that allowance has been made for the conditional reduction in the basic rate from 35 per cent to 33 per cent. The pattern

[1] Married couples, i.e. those with no dependent children (not shown in Chart IIIA), paying the basic rate face largely unchanged real rates because of the virtual maintenance of their real allowance. The percentage declines in real rates for higher-income married taxpayers are larger than those for single taxpayers.

mirrors that of Chart IIIA. The basic rate adjustment is sufficient to compensate all but the lowest-income single taxpayers for inadequate adjustment of the personal allowance. This is not true for family taxpayers. A reduced basic rate is not sufficient to compensate married taxpayers with two children earning real incomes up to £3,500 for the erosion of their child benefits. For taxpayers with four children, this is even more marked—real incomes up to £4,500 bearing higher real tax rates.

The 'average taxpayer' (married with two young children) earning £4,000 per annum in 1976-77 (approximate average earnings) experiences a very small reduction in his average tax rate. If this average taxpayer limits his gross wage claim (and settlement) in 1977-78 to 10 per cent, he will experience a *fall* in real take-home pay of almost 2 per cent, as the figures below show:

	Income (before receipt of child benefit)	*Family Allowance or Child Benefit*	*Taxable Income*	*Tax Liability*	*Net Income (including family allowance or child benefit)*	*Net income expressed in 1976-77 prices*
	£	£	£	£	£	£
1976-77	4,000	78	2,445	855·75	3,222·25	3,222·25
1977-78	4,400	130	2,809	926·97	3,603·03	3,171·68

6. *Conclusions*

A tax reduction of £2·25 billion appears impressive, and indeed represents a real tax cut for a large majority of taxpayers. Yet, when account is taken of inflation it is clear that the real tax cut is extremely modest and distributed in a manner at least partly inconsistent with the Chancellor's expressed intention of helping people most adversely affected by the interaction of inflation and personal taxation.

There is, however, a more important conclusion to be drawn from the 1977-78 tax exercise: the massive adjustment necessary to reverse the cumulative increase in tax burdens generated by four years of only partial tax adjustment for inflation. Taking each year separately, commentators can be accused of 'nit-picking' to rail against an adjustment of, say, dependent allowances that may be only 5 or 6 per cent below the preceding or prospective rate of inflation. Yet these incomplete adjustments, seemingly modest when considered individually, constitute huge increases in tax burdens when considered

TABLE XIII

1977-78 TAX CUTS REQUIRED TO RESTORE 1973-74 REAL TAX RATES

	1973-74[a]	1974-75	1975-76	1976-77[b]	1977-78[c]
			(billions of £'s)		
1. Income from employment,[d] self-employment and rent	56·7	71·0	87·6	98·8	109·2
2. Index of Retail Prices	100·0	117·9	146·9	169·3	192·5
3. Real income from employment, self-employment and rent (1 ÷ 2) ..	56·7	60·2	59·6	58·4	56·7
4. Income tax receipts[e]	7·4	10·4	15·2	17·1	19·9[f]
5. Average aggregate personal tax rate (4 ÷ 1 × 100)%	13·0	14·6	17·4	17·3	18·2

(*a*) Last three quarters of 1973 plus first quarter of 1974; same basis for other financial years.

(*b*) Increase of 2·4 per cent assumed for first quarter of 1977.

(*c*) Increase of 10·5 per cent over 1976-77 assumed.

(*d*) *Source:* Central Statistical Office press releases, 19 December 1975 and 18 March 1976.

(*e*) *Source: Financial Statement and Budget Report*, various years. Includes surtax.

(*f*) Official forecast pre-budget changes.

together (along with incomplete band adjustment) and over a number of years. To restore the legislated real personal tax rates of 1973-74 in 1977-78 would have implied a tax cut approximately 2½ times larger than that proposed for 1977-78 (conditional and unconditional cuts): i.e., almost £5·75 billion, rather than the proposed £2·25 billion.

This conclusion is calculated as follows:

If aggregate income from employment and self-employment (including rental income) increases by 10·5 per cent in 1977-78, *real* aggregate income (measured in terms of 1973-74 retail prices) from these sources in 1977-78 will be equal to that prevailing in 1973-74, namely £56·7 billion (quarterly data for 1976 and earlier years taken from Central Statistical Office press release on GDP, 18 March, 1977). With this income measure as a proxy for the base of personal taxation, the aggregate average personal tax rate in 1973-74 was 13 per cent. Hence restoration in 1977-78 of the real tax rates prevailing in 1973-74 would imply that the *real* value of personal tax receipts in 1977-78 would be equal to the real value of receipts in 1973-74: in money terms, 1977-78 personal tax receipts of approximately £14·2 billion. The official 1977-78 forecast of personal tax receipts before the budget changes was £19·9 billion.[1] Hence, the required tax cut for 1977-78 is £5·7 million. (The basis for these calculations is shown in Table XIII, p. 93). Of the required additional £3·5 billion cuts, approximately £2 billion would be necessary to offset the decline in real allowances and bands, the remainder to offset discretionary increases in the statutory marginal tax rates.

The Chancellor fully recognised these problems and claimed that the 'heart' (his term) of the 1977-78 budget was correction of these inflation-induced distortions. Yet the arithmetic shows that for important taxpayer categories and income groups the erosion continues. Only full tax indexation can be expected to halt it. A modest, but far from useless, initiative, which could be readily implemented, would be to require that indexed allowances and bands be published every year in the *Financial Statement and Budget Report:* far less preferable to indexation, of course, but perhaps a path to it.

[1] *Financial Statement and Budget Report, 1977-78*, p. 22.