RIGHTFULLY REWARDED

Reforming taxes on work and wealth

Sam Robinson and Ryan Shorthouse

bright blue

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Ryan is the Founder and Chief Executive of Bright Blue. He became the Chief Executive at the start of 2014. Under his leadership, Bright Blue has grown significantly in size, reputation and impact. The organisation has been shortlisted for the 2016, 2017, 2018 and 2019 UK social policy think tank of the year and UK environment and energy think tank of the year in the prestigious annual Prospect Magazine awards.

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Tax reform in the 2020s

This report has been commissioned by a high-profile cross-party, cross-sector commission established by Bright Blue to advise on reforms to the tax system in the years ahead to support post-COVID economic growth, the restoration of the public finances, and the achievement of better economic, social and environmental outcomes.

Bright Blue's project on tax reform aims to build and articulate a coherent vision, with clear principles and policies, for a tax reforming agenda in the 2020s, focussing in particular on four areas of tax policy: carbon taxation, property taxation, business taxation, and work and wealth taxation.

Bright Blue has commissioned independent experts to provide original analysis and policy recommendations in each of these four areas of tax policy, which the commission will consider before publishing a strategic vision for a tax-reforming, rather than just tax-cutting, agenda over the next decade.

The members of the commission include:

- The Rt Hon David Gauke, Former Secretary of State for Justice
- The Rt Hon Sir Vince Cable, Former Secretary of State for Business
- The Rt Hon Lord Willetts, President of the Advisory Council and Intergenerational Centre at the Resolution Foundation
- The Rt Hon Dame Margaret Hodge MP, Former Chair of the Public Accounts Committee

- The Rt Hon Andrew Mitchell MP, Former Secretary of State for International Development
- James Timpson OBE DL, Chief Executive of the Timpson Group
- Luke Johnson, Entrepreneur and Chairman, Risk Capital Partners
- Emma Jones CBE, Entrepreneur and Founder, Enterprise Nation
- Mike Cherry OBE, National Chairman, Federation of Small Businesses
- Mike Clancy, General Secretary, Prospect trade union
- Victoria Todd, Head of the Low Incomes Tax Reform Group
- Sam Fankhauser, Professor, University of Oxford
- Christina Marriott, Interim Director of Policy and Advocacy, British Red Cross
- Helen Miller, Deputy Director and Head of the Tax Sector, Institute for Fiscal Studies
- Giles Wilkes, Former Special Adviser, Number 10 Downing Street
- Caron Bradshaw, CEO, Charity Finance Group
- Pesh Framjee, Global Head of Social Purpose and Non Profits, Crowe UK
- Robert Palmer, Director, Tax Justice UK
- The Rt Hon Lord Adebowale CBE, Chair, Social Enterprise UK

The views in this report on work and wealth taxation are those of the authors and do not necessarily reflect those of Bright Blue or members of our tax commission detailed above.

Executive Summary

Despite signs of economic recovery beginning to take place, the Omicron wave has disrupted and dampened economic activity in the UK once again. And the pandemic will cast a long shadow in the years to come. Public spending has soared.

There are, then, two overriding objectives for UK economic policy: in the short-term, stimulating post-COVID economic growth, and in the longer-term, repairing the damage to the public finances of measures to protect people and businesses during COVID-19.

Tax policy, especially taxes on individual's work and wealth, can support both objectives. The taxation of an individual's work and wealth comprise the vast majority of tax revenue in this country.

Reforming how we tax work and wealth will have profound economic and moral implications. It not only affects the performance of the UK economy, but this Government's central objective of 'levelling up' the country to ensure people on more modest incomes and deprived locations enjoy greater opportunities.

This report is guided by two key principles:

- **Lower taxes on an individual's work.** The Government should lower taxes on work to aid post-COVID economic growth and reward effort and enterprise. This will lead to one or a combination of the following effects: stronger work incentives; higher take-home pay; or, reduced overhead costs on businesses. These effects will increase consumer spending or corporate investment.

- **Increase taxes on an individual's wealth.** Taxes on wealth should be increased, to some extent, in order to offset in part the losses in revenue from lowering taxes on work, as well as respond to rising wealth levels and the increasing role of luck and inheritance in life outcomes.

Essentially, a centre-right Government that is committed to 'levelling up' the UK should rebalance the tax system from income associated with work and effort and onto income associated with privilege and luck.

The new Health and Social Care (HSC) Levy on employees, the self-employed and employers – effectively a new form of National Insurance Contributions (NICs) of 1.25% on annual earnings from work or self-employment above the 'Primary Threshold' of £9,568; on employers for income above the 'Secondary Threshold' of £8,840; and, dividend income above the Dividend Allowance of £2,000 – that comes into force this year, was a significant and surprising tax rise for a Conservative Government to implement. It cannot be abolished, but it can be made much fairer. Any detrimental impact on workers and employers can be mitigated.

Tax is an incredibly politically sensitive policy area. The Treasury is inherently conservative in changing taxation policy. To do what we propose around work and wealth taxation, there will be difficult and potentially unpopular decisions along the way. But the long-term reward would be a tax system that makes the UK more efficient and equitable.

Admittedly, the revenue implications of the policies we are proposing are uncertain; they depend on the rates and rules set by policymakers and the behavioural responses of those affected. But, overall, we are suggesting that reforms should aim for revenue neutrality in the short-term.

The specific policy recommendations we propose are as follows:

Taxes on an individual's work

Tax cutting

Recommendation one: The Government should prioritise significantly lowering the rate of the employer element of the HSC Levy from 1.25% on income above the existing employer NICs threshold as soon as possible. Then, if the public finances allow, the rate of employers NICs should then also be cut.

Revenue raising

Recommendation two: The HSC Levy should be broadened to apply to pensions and rental income.
Recommendation three: End the exemption from Class 1, 2 and 4 NICs for those working above the SPA.

Taxes on an individual's wealth

Revenue raising

Recommendation four: To reduce the discrepancy between tax on capital gains and tax on earnings, the Government should narrow the gap in headline rates between CGT and Income Tax, by creating two main rates for all capital gains of 18% at the basic rate and 28% at the higher rate, with modifications only for assets that have already paid Corporation Tax.
Recommendation five: The Government should end the CGT base cost uplift on death, meaning CGT liability will be assessed on the uplift in the value of assets from when they were acquired rather than their present value.

Recommendation six: Replace Inheritance Tax with a Lifetime Receipts Tax (LRT). The LRT should have a starting lifetime allowance of £125,700. The headline rates should mirror Income Tax rates from now, with the threshold set at ten times the Income Tax salary thresholds.

Recommendation seven: Business Property Relief and Agricultural Property Relief in IHT, or the new LRT, should only apply where the donor had a demonstrable working relationship to the business or farm and for at least two years after acquisition.

Tax cutting

Recommendation eight: To ensure that CGT targets only the real returns to investments, and does not punitively target paper gains, narrowing the gap between CGT and Income Tax rates should be paired with the reintroduction of inflation indexation on CGT liabilities.

Recommendation nine: Capital losses should be able to be carried back for up to three years and set against taxable income with relief restricted to CGT rates.

Chapter 1: **Introduction**

As the UK – gradually and fitfully – finally comes out of the COVID-19 pandemic, a key policy priority should be ensuring and strengthening the nation's post-COVID economic growth. With an annual decline in GDP of 9.9% in 2020, the pandemic caused the sharpest recession in over 300 years.[1] Indeed, GDP has only just recovered to pre-pandemic levels, and the latest Omicron wave has disrupted and dampened economic activity yet again.

Extensive governmental support has been provided throughout the crisis to keep businesses and jobs afloat. Estimates by the National Audit Office illustrate the scale of this support, with central government having spent or guaranteed a total of £370 billion as of September 2021 in measures responding to the impact of the pandemic.[2]

Once we finally get a grip over COVID-19, there are two distinct tasks that tax policy must address. The focus in the immediate term should be on stimulating economic activity. Although economic activity has picked up considerably since the pandemic first swept the country – the number of payrolled employees and vacancies have both rebounded past pre-pandemic levels[3] – several of the largest sectors have yet to

1. Daniel Harari and Matthew Keep, "Coronavirus: economic impact", https://researchbriefings.files.parliament.uk/documents/CBP-8866/CBP-8866.pdf (2021).
2. National Audit Office, "COVID-19 cost tracker", https://www.nao.org.uk/covid-19/cost-tracker/ (2021).
3. ONS, "Earnings and employment from pay as you earn real time information, UK: December 2021", https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/bulletins/earningsandemploymentfrompayasyouearnrealtimeinformationuk/december2021 (2021).

recover, and average weekly working hours still stand below their pre-pandemic level.[4] Overall GDP only recovered its previous January 2020 peak in November 2021.[5] Even before the recent arrival of Omicron, GDP growth was only 0.2% in October 2021.[6]

Although the full economic impact of the Omicron variant is not yet clear, what is apparent is that it has put the fragile, nascent economic recovery at risk. In the week leading up to the New Year, retail footfall was at 75% of the level seen in the equivalent week in 2019 and 86% for the previous week before Christmas. According to a survey of 3,000 chief financial officers, sales in the first quarter of 2022 are expected to be 7.4% lower than predicted. Investment plans could be scaled back by as much as 10%, while a clear majority report finding it much harder than normal to recruit employees.[7]

So, while there have been encouraging signs of economic growth in 2021, the economic recovery from COVID is still far from assured, especially as a result of the Omicron wave. More can be done to support the economy as it adjusts to the impact of Omicron.

The longer-term objective will be to repair the public finances. After extensive borrowing during the pandemic, public sector debt now exceeds total GDP for the first time since 1960-61.[8] In the long term, fiscal consolidation will be necessary, although the scale of it is still uncertain and unclear. Given the extensive role spending cuts played during the last 'age of austerity' in the years after the 2008 global financial crisis, as well as a current lack of public support for renewed spending cuts on a similar scale,[9] post-COVID fiscal consolidation will

4. ONS, "Average actual weekly hours of work for full-time workers (seasonally adjusted)", https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/timeseries/ybuy/lms (2021).
5. ONS, "GDP monthly estimate, UK: October 2021", https://www.ons.gov.uk/economy/grossdomesticproductgdp/bulletins/gdpmonthlyestimateuk/october2021 (2021).
6. ONS, "GDP monthly estimate, UK: October 2021", https://www.ons.gov.uk/economy/grossdomesticproductgdp/bulletins/gdpmonthlyestimateuk/october2021 (2021).
7. Valentina Romei, "UK business confidence takes a sharp hit from Omicron", *Financial Times*, 6 January, 2022.
8. ONS, "Coronavirus (COVID-19) in 10 charts", https://www.ons.gov.uk/peoplepopulationandcommunity/healthandsocialcare/conditionsanddiseases/articles/coronaviruscovid19in10charts/2020-09-24 (2020).
9. Ipsos MORI, "Two in three support increasing national insurance for social care reform or to reduce NHS backlog", https://www.ipsos.com/ipsos-mori/en-uk/two-three-support-increasing-national-insurance-social-care-reform-or-reduce-nhs-backlog (2021).

need to be achieved to a large extent through tax policy.

The Government has, admittedly, begun this task. Last year, the Chancellor announced a rise in the main rate of Corporation Tax from its current 19% to 25% from April 2023; a four-year freezing of Income Tax bands from 2022 to 2026; and, most strikingly, the introduction of a new Health and Social Care Levy from April 2022 that operates effectively as a rise in National Insurance. Taken together, these measures are expected to raise around £40 billion a year.[10]

But while raising revenue is crucial and necessitates tax reform, simply squeezing more money out of the tax system without improving its design would be a mistake. The Government should not pass up the opportunity to recalibrate the tax system to better reward work while responding to long-term economic trends, in particular the rising importance of wealth.

The focus of this report is on how tax policy can support the twin economic goals of growth and fiscal sustainability. In particular, this report focuses on the taxation of an individual's work and wealth, which comprise the vast majority of tax revenue in this country. Reforming how we tax work and wealth has profound economic and moral implications. It not only affects the performance of the UK economy, but this Government's central objective of 'levelling up' the country to ensure people on more modest incomes and deprived locations enjoy greater opportunities. Generally, we think there we can make a compelling argument, alongside detailed recommendations, for reducing overall taxation on an individual's work and raise taxation on an individual's wealth.

The report is structured as follows:

- **Chapter Two** outlines the leading taxes on an individual's work
- **Chapter Three** proposes and justifies reforms to the leading taxes on an individual's work

10. IFS, "Autumn Budget and Spending Review 2021", https://ifs.org.uk/budget-2021 (2021).

- **Chapter Four** outlines the leading taxes on an individual's wealth
- **Chapter Five** proposes and justifies reforms to the leading taxes on an individual's wealth
- **Chapter Six** concludes the report, making the case for reducing taxation on work and increasing taxation on wealth.

Chapter 2:
Taxes on an individual's work

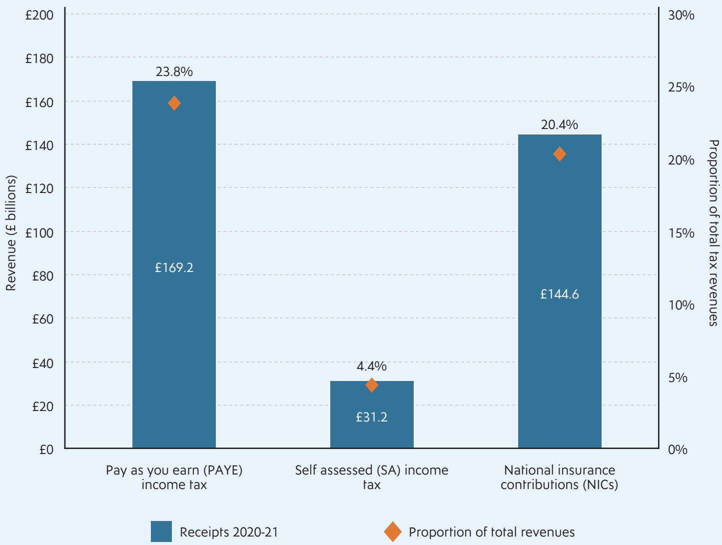
The two main taxes on an individual's work in the UK are Income Tax and National Insurance Contributions (NICs).

In September 2021, the Government added a third major tax on work in the form of the Health and Social Care (HSC) Levy. This will operate as a surcharge on NICs from April 2022 to April 2023, after which it will become a separate tax.[11]

The UK's total national accounts tax revenue in 2020-21 was £709.8 billion, of which £344.9 billion – 48.6% – was raised by Income Tax (PAYE and self-assessed) and National Insurance Contributions (NICs).[12]

11. GOV.UK, "Build back better: our plan for health and social care", https://www.gov.uk/government/publications/build-back-better-our-plan-for-health-and-social-care (2021).
12. OBR, "Public finances databank – November 2021", https://obr.uk/public-finances-databank-2021-22/ (2021).

Chart 2.1. Income Taxes and NICs, revenue and percentage of tax receipts, 2020-21



Source: OBR, "Public finances databank: November 2021" (2021).

Understanding Income Tax

Income Tax is applied to any taxable income above a personal allowance, which in the 2021-22 tax year stands at £12,570 per annum.

Admittedly, Income Tax is not levied exclusively on earnings from work. Some state benefits, such as Jobseeker's Allowance (contribution-based or income-based), are liable to Income Tax, as are most pensions. Certain forms of investment income are also covered, such as rental income and interest on savings above the Personal Savings Allowance of £1,000 per annum at the basic rate and £500 at the higher rate.[13]

Income from dividends also attracts tax, although there are two

13. GOV.UK, "Income Tax", https://www.gov.uk/income-tax (2021).

adjustments to the standard Income Tax system when determining liabilities on dividend income. First, there is a £2,000 'dividend allowance' in addition to the personal allowance. Second, dividend income is taxed at slightly lower rates than ordinary income. Otherwise, the taxation of dividends uses the Income Tax system.

For example, imagine someone received £40,000 of non-dividend income and £5,000 in dividend income, for total income of £45,000. With the personal allowance of £12,570, this leaves £27,430 of taxable non-dividend income that is taxed at the basic rate of 20%; and, once the dividend allowance is taken into account, £3,000 of dividend income that is taxed at the basic rate of 7.5%.

The forms of income liable to Income Tax are summarised in Box 2.1 below.

Box 2.1. Forms of income liable to Income Tax

Earned income

- Wages and salaries from employment
- Profits from self-employment
- Income from pensions
- Benefits-in-kind such as company cars or medical insurance

State benefits

- Bereavement Allowance (previously Widow's pension)
- Carer's Allowance
- Contribution-based Employment and Support Allowance (ESA)
- Incapacity Benefit (from the 29th week you get it)
- Contribution-based and income-based Jobseeker's Allowance (JSA)
- Pensions paid by the Industrial Death Benefit scheme
- State Pension
- Widowed Parent's Allowance

Investment income

- Rental income
- Income from a trust
- Interest on savings over the Personal Savings Allowance
- Dividends from company shares above the Dividend Allowance

Income Tax, then, is not purely a tax on work. However, given that over 90% of Income Tax liabilities fall on earnings, the tax overwhelmingly falls on work rather than wealth.[14]

The tax is progressive, meaning that the marginal tax rate increases along with income. In other words, those on higher income pay proportionately more Income Tax than those on lower income. Table 2.1 below shows the headline tax rates for 2021-22, in comparison to headline tax rates on dividend income, which is covered by dividend taxation. Dividends are income received by shareholders from company profits.

Table 2.1. Basic Income Tax rate structure, 2021-22

Band	Headline marginal tax rate – earnings and interest	Headline marginal tax rate – dividends
Basic rate – £12,570 to £50,270	20%	7.5%
Higher rate – £50,270 to £150,000	40%	32.5%
Additional rate – above £150,000	45%	38.1%

14. HMRC, "Income Tax liabilities statistics", https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/921031/Income_Tax_Liabilities_Statistics_June_2020_-_Commentary.pdf (2020).

There are a number of allowances and reliefs that can reduce a person's Income Tax liability. These include:

- **Marriage Allowance.** The Marriage Allowance lets the lower earner in a couple (in a marriage or civil partnership) transfer £1,260 of their personal allowance to their partner, as long as the lower-earning partner earns below the personal allowance and the higher-earning partner pays Income Tax at the basic rate.[15]
- **Personal Savings Allowance (PSA).** The PSA means that basic rate taxpayers do not have to pay tax on the first £1,000 of savings income they receive, and higher rate taxpayers do not have to pay on their first £500 of savings income. There is no allowance for additional rate taxpayers.
- **Dividend Allowance.** The first £2,000 of dividend payments a taxpayer receives are tax-free.
- **Trading Allowance.** The Trading Allowance is a tax exemption of up to £1,000 a year for income from self-employment or casual work.
- **Property Allowance.** The Property Allowance is a tax exemption of up to £1,000 a year for income from land or property.
- **Blind Person's Allowance (BPA).** The BPA adds £2,520 to the annual personal allowance for those who are registered blind.
- **Pension contributions relief.** Tax relief is available for private pension contributions up to 100% of annual earnings. This relief is applied automatically for most employees, as employers take pension contributions out of the employee's pay before Income Tax is applied.
- **Charity donations relief.** Donations to charity are tax free, and tax relief is available through Gift Aid or a Payroll Giving scheme.

Additionally, some costs can be deducted for the purposes of Income Tax. For self-employed people, legitimate business expenses

15. GOV.UK, "Marriage allowance", https://www.gov.uk/marriage-allowance (2021).

can be set against trading income. Employees are able to claim for business travel, food and hotel expenses as well as equipment or fees for professional bodies needed for work.

When individuals place money into their pension, the government offers a tax relief to them. Contributions are typically taken out of pre-tax salary, which means that the amount an English saver can expect to receive in the form of a tax relief is the same as their marginal rate of tax. Additional rate taxpayers therefore claim pension tax relief at a 45% marginal rate; higher rate taxpayers can claim 40%; and basic rate taxpayers 20%. And so, a post-tax pension contribution from a saver of £800 would actually equal £1,000, assuming they pay the basic rate of tax at 20%. For a pre-tax pension contribution, no tax is applied to the contribution.

Box 2.2. The evolution of Income Tax

Income Tax was originally introduced in 1799 as a temporary measure to fund the Napoleonic Wars,[16] but has since become a mainstay of the UK tax system.

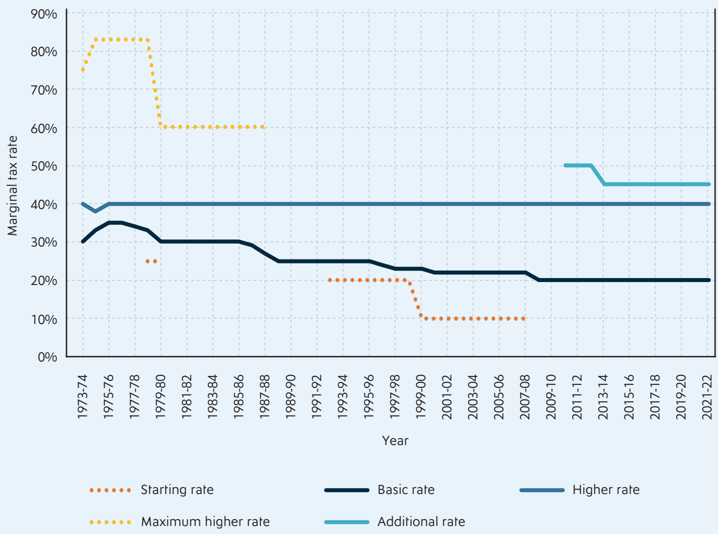
While the basic principles of Income Tax as a proportional levy on incomes above a personal allowance have remained similar throughout its history, the rates and thresholds of Income Tax have varied under successive governments.

The most notable trend in Income Tax over the last 50 years has been a sustained decline in the effective Income Tax rate on workers. Employees on half of median earnings paid no Income Tax in 2017, whereas in 1975 they faced an effective Income Tax rate of 15%. Similarly, employees on median weekly pay had an effective Income Tax rate of 10% in 2017, compared to 25% in 1975.[17]

16. UK Parliament, "War and the coming of income tax", https://www.parliament.uk/about/living-heritage/transformingsociety/private-lives/taxation/overview/incometax/
17. Adam Corlett, "The shifting shape of UK tax", https://www.resolutionfoundation.org/app/uploads/2019/11/The-shifting-shape-of-UK-tax.pdf (2019).

Indeed, over time the rate structure of Income Tax has changed considerably. Before 1988-89, there was no additional rate above and beyond the basic and higher rates. Instead, a range of higher rates applied. Typically, these increased in increments of five percentage points, with some exceptions. Since 1988-89, there has been a single higher rate. The evolution of the different rates is shown below in Chart 1.2 below.

Chart 2.2. Income Tax rates on ordinary income, 1973-74 to 2021-22



Source: IFS, "Fiscal facts: Income tax" (2021). Current rates are displayed in solid blue lines. Discontinued rates are displayed in dashed orange lines.

Since 2010, there have been a number of changes to Income Tax thresholds and rates. The personal allowance has increased well above inflation, from £6,475 a year in 2010-11 to £12,570 at present. The value of the personal allowance was, however, frozen for the next four years at Budget 2021. Changes to the personal allowance have been accompanied by changes to the higher rate threshold: under the Coalition Government, the threshold was considerably lower in 2015-16, at £31,785 above the personal allowance, than it was at the start of the Parliament in 2010-11 (£37,400). This was followed by several above-inflation increases to the threshold to bring it back up to £37,700 above the personal allowance (or £50,270 in total) as of 2021-22.[18]

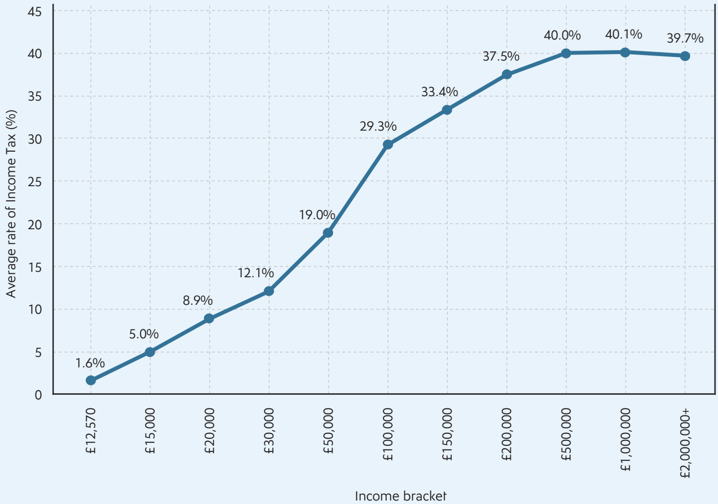
Rates have also changed markedly in this period. First, the additional rate was reduced from 50% to 45% from 2013-14. Second, the 'starting rate' of 10% – which applied to income above £2,230 in 2007-08 – was axed from 2007-08 onwards, simplifying the rate structure.[19]

Income Tax presents a number of advantages to the Exchequer. First, it is easy to collect. The majority of Income Tax revenues are raised through the pay-as-you-earn (PAYE) system, meaning they are deducted automatically from payslips without the need for self-assessment. Second, the tax has a broad base, as it is levied on most forms of income and applies across age groups. Third, Income Tax is highly progressive. Statistics from HMRC indicate that in 2020-21, the average rate of Income Tax rose steadily from 1.6% for those earning between £12,500 and £15,000, up to around 40% for those earning £500,000 or more.

The average rate of Income Tax differs from the headline rate (or 'marginal' rate) as it expresses the total proportion of tax taken at a given income level, rather than the tax that would be taken on an additional £1 of income. This can be seen in Chart 2.3 below.

18. OBR, "Income tax", https://obr.uk/forecasts-in-depth/tax-by-tax-spend-by-spend/income-tax/ (2021).
19. Ibid. See also: IFS, "Fiscal facts", https://ifs.org.uk/taxlab/data-item/ifs-fiscal-facts (2021).

Chart 2.3. Average rates of Income Tax by income bracket, 2021-22



Source: HMRC, "Income Tax liabilities statistics: tax year 2018 to 2019 to tax year 2021 to 2022" (2021).

However, Income Tax does come with disadvantages. While taxes on personal income perform strongly on both revenue raising and equity grounds, there is evidence that they have a relatively large impact on economic growth. A review of tax structures by the OECD found that "Corporate taxes are found to be most harmful for growth, followed by personal income taxes, and then consumption taxes. Recurrent taxes on immovable property appear to have the least impact."[20] This has led some, such as the Tax Foundation, a Washington-based think tank specialising in tax policy, to argue for a shift in the tax burden away from income taxes and towards consumption and property taxes.[21]

20. Åsa Johansson, Christopher Heady, Jens Arnold, Bert Brys and Laura Vartia, "Tax and economic growth", https://www.oecd.org/tax/tax-policy/41000592.pdf (2008).
21. Tom Clougherty, Daniel Bunn, Elke Asen and James Heywood, "A framework for the future: reforming the UK tax system", https://taxfoundation.org/uk-tax-reform/#_ftn7 (2020).

Understanding National Insurance Contributions (NICs)

NICs are technically a form of social security contribution (SSC) rather than a tax. This is because unlike most other taxes, NICs are – at least nominally – tied to specific state benefits. Revenues from NICs are paid into a 'National Insurance Fund' (NIF) and ostensibly used to pay for contributory benefits such as the Basic State Pension.

In practice, however, the link between NICs and contributory benefits is extremely weak. There are several reasons for this. One is that rising contributions do not necessarily lead to rising benefits. Some groups, such as employees earning below the 'primary threshold' at which 'Class 1' NICs are payable, but above the 'Lower Earnings Limit', as explained in Tables 2.2 and 2.3 below, receive entitlements despite not paying NICs.[22]

There are also several cliff-edges that mean there is no benefit from additional contributions. Individuals must pay NICs for ten years to qualify for the State Pension, and for 35 years to qualify for the full amount of State Pension. Therefore, someone contributing for less than ten years would receive no State Pension, while another person who has 35 years of contributions/credits gets nothing more for continuing to contribute.[23]

Finally, the NIF is officially separate from other parts of government. But governments have often topped up the NIF with general taxation in years where the NIF was insufficient to finance benefits, and conversely used it to reduce the national debt in years where the NIF has run a surplus. The official separation between the NIF and other government spending is, then, meaningless in practice.[24]

Far from functioning as a social insurance scheme as originally envisaged, NICs (or SSCs) in practice function as a second tax on income.

22. IFS, "National insurance contributions explained", https://ifs.org.uk/taxlab/taxes-explained/national-insurance-contributions-explained?tab=tab-574 (2021).
23. Ibid.
24. Ibid.

Box 2.3. The evolution of NICs

NICs are based on the 'contributory principle'. In other words, that benefits received should in some way reflect contributions paid in.

The scheme was first introduced under the National Insurance Act 1911 by the then Liberal Government as a basic social insurance scheme. Initially, this involved two schemes running in parallel: one for health and pensions, and a second for unemployment. Employers bought the relevant 'stamps' at the post office and attached them to contribution cards on behalf of their employees to indicate entitlement to benefits.

NICs were considerably expanded in the wake of the famous 1942 Beveridge Report, which laid the foundations for the modern social security system and the NHS. The National Insurance Act of 1948 consolidated the separate schemes into one single stamp to cover all benefits.

Originally, workers and employers paid NICs at a flat rate in return for a number of flat rate benefits for unemployment, sickness and retirement. In 1975, the flat-rate stamps system was phased out in favour of an earnings-based contributions system and collected by PAYE, in much the same way as Income Tax. This is how NICs operate today, with the exception of the flat-rate Class 2 NICs.[25]

NICs are payable by employees, the self-employed, and employers. Depending on employment status, different types of NICs apply.

Although employers NICs are paid from a company's turnover, it is effectively a tax on the work of each individual employed, hence its inclusion in this report on taxation on an individual's work.

Indeed, both employers and employees pay 'Class 1' NICs. In the majority of cases, this is deducted at source – in other words, the employer deducts 'Class 1' NICs contributions from the employee's pay.

Self-employed people pay 'Class 4' NICs, which are a proportion of trading profits, as well as a small amount from flat-rate 'Class 2'

25. Lord Murphy, " National Insurance: history and application", https://www.cipp.org.uk/resourceLibrary/national-insurance-history-and-application.html (2019).

NICs. This is done via the self-assessment system. Finally, 'Class 3' contributions cover voluntary payments for those wishing to add to their NICs record, as well as statutory payment deductions (mostly related to statutory maternity pay), personal pension rebates, state scheme premiums, investigation settlements and repayments.

Relative to Income Tax, NICs are targeted more exactly at earnings from employment or profits from self-employment. NICs have not traditionally been levied on other forms of income, although work-related expenses can be deducted. However, the introduction of the new Health and Social Care Levy – first as an addition to NICs in 2022-23 – will apply to income wider than just work, as will be explained later in this chapter.

Beside the scope of the tax, another key difference between NICs and Income Tax is that liability for NICs is age-restricted. Once a taxpayer reaches the State Pension Age (SPA), which currently stands at 66, they are no longer required to pay NICs on income or profits. NICs also do not apply to pension income.

Table 2.2 illustrates employee/employer NIC rates for 2021-22, while Table 2.3 outlines the NIC rates for the self-employed. In broad terms, employees pay a rate of 12% on annualised income between £9,568 and £50,270, then 2% above that amount, while employers then contribute 13.8% on annualised income above £8,840.[26] Self-employed individuals start paying flat-rate Class 2 NICs on annualised profits above £6,515, as well as Class 4 NICs at 9% on profits above £9,568 and 2% above £50,270.

26. ICAEW, "National insurance thresholds for 2021/22", https://www.icaew.com/insights/tax-news/2020/dec-2020/national-insurance-thresholds-for-202122 (2020)

Table 2.2 Employee/Employer Class 1[27] NIC rates, 2021-22

Band	Annualised earnings	Employee Class 1 rate	Employer Class 1 rate
Lower Earnings Limit (LEL)	£6,240	0%	0%
LEL- Primary Threshold (PT)	£6,240 – £9,568	0%	N/A
PT-Upper Earnings Limit (UEL)	£9,568 – £50,270	12%	N/A
Secondary Threshold	£8,840	N/A	13.8%
UEL	£50,270	2%	13.8%

Table 2.3. Self-employed Class 2 and Class 4 NIC rates, 2021-22

Band	Annualised earnings	Self-employed class 2 and 4 rates
Small Profits Threshold (SPT)	£6,515	0%
SPT – Lower Profits Limit (LPL)	£6,515 – £9,568	£3.05 per week
LPL – Upper Profits Limit (UPL)	£9,568 – £50,270	9% + £3.05 per week
Above UPL	Above £50,270	2% + £3.05 per week

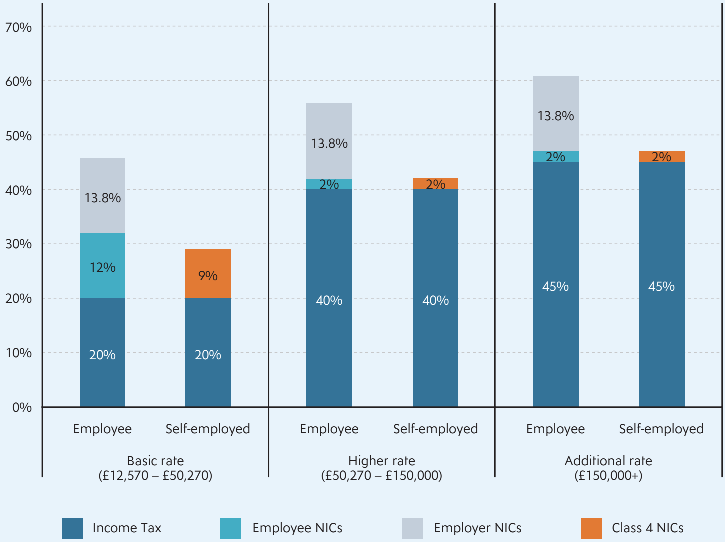
27. NIC classes are broken down by employment status. Class 1 NICs are paid by employees; Class 1A and 1B are paid by employers on employees' expenses or benefits; Class 2 NICs are paid by self-employed people earning £6,515 or more a year; Class 3 NICs are voluntary contributions; and, Class 4 NICs are paid by self-employed people earning £9,569 or more a year.

NICs offer similar advantages to Income Tax insofar as they are easy to collect – the majority of employees pay their NICs through the PAYE system and therefore do not have to interact directly with HMRC. In addition, they are broad-based, applying to the earnings of all working-aged adults above an annualised rate of £9,568. Admittedly, the rate structure of NICs is not as progressive as that of Income Tax: the 2% rate for those earning above £50,270 means that the average effective rate of NICs decreases after that point in the income distribution. Despite this, the distributional impact of NICs is still broadly progressive: NICs as a proportion of income increase steadily from 0.8% in the bottom decile to 14.8% in the ninth decile, and it is only in the top decile that this falls back to 13.4%.[28]

However, NICs also have downsides. In particular, the current structure of NICs raises horizontal equity concerns – in other words, it leads to differences in the tax treatment of otherwise similar 'workers'. This can be seen when considering the overall effective marginal tax rate from Income Tax and NICs on employment and self-employment, shown below in Chart 2.4.

28. IFS, "National insurance contributions explained" (2021).

Chart 2.4. Total marginal tax rates from Income Tax and NICs on different forms of economic activity, 2021-22



Source: IFS, "Fiscal facts: Recent headline tax rates" (2021).

When NICs are taken into account, there is a clear penalty on employment relative to self-employment. In large part, this is because there is no equivalent to employer NICs for the self-employed. Although the legal incidence of employer NICs falls on employers, economic theory suggests that in the long run employer NICs are ultimately borne by employees through lower pay, as will be explained later in Chapter Three.

This is reflected in the chart above, which assumes that the incidence of employer NICs is fully passed onto employees. Admittedly, though, empirical evidence on the full impact of employer NICs on net pay is not conclusive.[29] Nevertheless, the structure of NICs leads to a clear tax

29. Stuart Adam, David Phillips and Barra Roantree, "35 years of reforms: A panel analysis of the incidence of, and employee and employer responses to, social security contributions in the UK", *Journal of Public Economics* (2019), 29-50.

differential between different forms of employment.

A second discrepancy is between those working above and below the State Pension Age (SPA). Those above the SPA do no pay Class 1, 2 or 4 NICs even if they are working, though employer NICs do still apply. In effect, this means that someone aged 67 attracts a considerably lower effective tax rate on their work than someone aged 65 simply by virtue of being on the other side of the SPA cut-off point.

Understanding the Health and Social Care (HSC) Levy

The HSC Levy was announced in September 2021 as a means of raising revenue to, in the short term, pay for the NHS backlog caused by COVID-19 and, in the long term, support the social care system.

The design of the tax is based on the NICs system. Indeed, in the 2022-23 tax year the HSC Levy will function as a 1.25 percentage point surcharge on existing NICs rates – applying to annualised income above the NIC thresholds detailed above in Tables 2.2 and 2.3 – for working age employees, self-employed and employers. From the 2023-24 tax year the HSC Levy will be formally separated out from NICs. At this point, the Levy will also apply to individuals working above the State Pension Age (SPA), unlike standard NICs.

Although it will in legislative terms be a separate tax, the HSC Levy can be thought of as an additional class of NICs. Apart from its application to those working above the SPA, the HSC Levy otherwise operates in much the same way as other forms of NICs.

The Government paired the core HSC Levy with a rise in dividend tax rates of 1.25 percentage points effective from April 2022.[30] This effectively extends the scope of the HSC Levy, or this form of NICs, beyond earnings from work.

The combination of the HSC Levy and increase to dividend tax is estimated to raise approximately £12 billion a year on average.[31] As a

30. GOV.UK, "Build back better: our plan for health and social care" (2021).
31. Ibid.

revenue-raising measure, it performs strongly.

However, the measure has been criticised on several grounds. First, it is not as broad-based as it could be; non-working pensioners will not pay the tax. Indeed, pensions income and rental income are not in the scope of the tax. Consequently, the HSC Levy disproportionately affects working age adults. Indeed, the IFS have estimated that households in which the oldest person is above the SPA would have provided almost 14% of the revenue if the HSC Levy was applied as an increase in Income Tax, whereas they only provide 1.4% of the revenue from a NICs rise.[32]

Indeed, a typical 25-year-old worker can expect to pay an additional £12,600 in tax over their working life; a pensioner will pay no additional tax as a result of the Levy.[33] Though people working above the SPA will pay the tax, this is not the case for the 65% of pensioner families who receive private pension income.[34] As a result, the effective tax rates on earnings and pension income at average income now stand at 20% and 11% respectively, whereas in 1978-79 they were 33% and 27%.

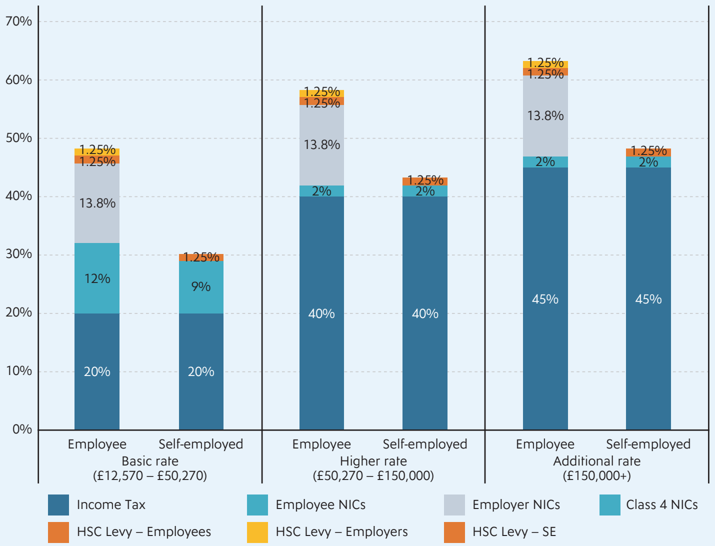
Second, the introduction of the HSC Levy introduces additional complexity to the current NICs system. It brings a new group – namely, workers above the SPA – into the NICs system, thereby introducing a new distinction between working and non-working pensioners.

An additional criticism of the HSC Levy is that it further worsens the gap in effective tax rates between different forms of work. This is because of the flat increase of 1.25 percentage points across employee, employer and self-employed NICs, which means that employees will see a rise in their effective marginal tax rate of 2.5 percentage points, while the self-employed will face a 1.25 percentage point rise. This is

32. Stuart Adam, "Pensioner families would provide ten times more of the revenue from an income tax rise than from a NICs rise", https://ifs.org.uk/publications/15594 (2021).
33. Torsten Bell, Mike Brewer, Nye Cominetti, Lindsay Judge, Krishan Shah, Daniel Tomlinson and Lalitha Try, "Nationally insured? New taxes and new spending to address key Department for Health and Social Care priorities", https://www.resolutionfoundation.org/app/uploads/2021/09/Nationally-insured.pdf (2021).
34. Ibid.

shown graphically in Chart 2.5, below, which effectively updates Chart 1.4 from earlier with the new HSC Levy when it comes into effect from the next tax year.

Chart 2.5. Total marginal tax rates after introduction of HSC Levy on different forms of economic activity, from 2022-23



Source: IFS, "Fiscal facts: Recent headline tax rates" (2021) plus author's own calculations based on HSC Levy announcements.

Chapter 3: Reforming taxes on an individual's work

While Income Tax, NICs and the HSC Levy, explained in detail in Chapter Two, are no doubt important revenue raisers for the UK, there are numerous flaws in their current structure and design. Recent events, as well as longstanding economic trends, necessitate reforms to these major taxes on work.

A reduction to taxes on work could have several advantages to economic activity at this still fragile time for the economy: improving work incentives, increasing take-home pay, or reducing costs for businesses, all of which help increase consumer spending and company investment.

Improving work incentives

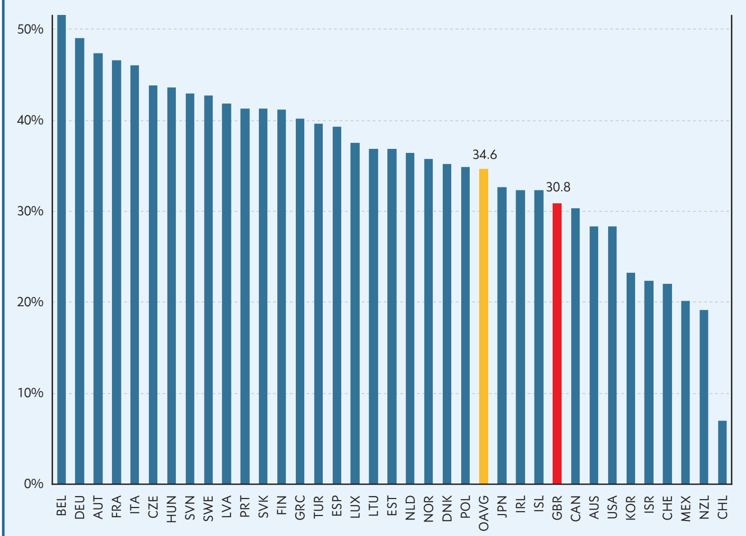
Although they are progressive and effective as revenue-raisers, direct taxes on work such as Income Tax and NICs also significantly affect work incentives. While it is not the sole determinant of decisions to enter work or progress further in work, the tax and benefit system plays a pivotal role in affecting these choices. Indeed, one analysis of work incentives between 1979 and 2005 concluded that "real tax and benefit changes are the single most important determinant of changes in the average incentive to progress".[35]

35. Stuart Adam, Mike Brewer and Andrew Shephard, "Financial work incentives in Britain: comparisons over time and between family types", https://ifs.org.uk/wps/wp0620.pdf (2006).

In particular, taxes on work increase the cost of labour to employers, thus increasing the 'tax wedge'. The tax wedge is the difference between the total cost to employers of hiring labour and the take-home pay of employees.

Admittedly, by international standards, the UK's tax wedge is low. OECD analysis illustrates that the UK had a tax wedge of 30.8% in 2020.[36] This is below the OECD average, which stood at 34.6% in 2020. It is also below several European countries, such as Germany (49.4%), Italy (48%) and France (46.7%). However, other countries such as the United States (29.8%), Australia (27.9%) and New Zealand (18.8%) have considerably lower tax wedges than the UK. The country with the lowest tax wedge, of just 7%, is Chile.[37] This is shown in Chart 3.1 below.

Chart 3.1. Tax wedges across OECD countries for a single worker on average wage, 2020



Source: OECD Data, "Tax wedge" (2020). UK tax wedge is displayed in red, and OECD average is displayed in yellow.

36. OECD Data, "Tax wedge", https://data.oecd.org/tax/tax-wedge.htm (2021).
37. Ibid.

While the UK's tax wedge is not unusually high, in the current economic context there is a strong case for lowering the tax wedge as a policy tool to stimulate employment and reduce the cost to businesses of hiring and retaining staff.

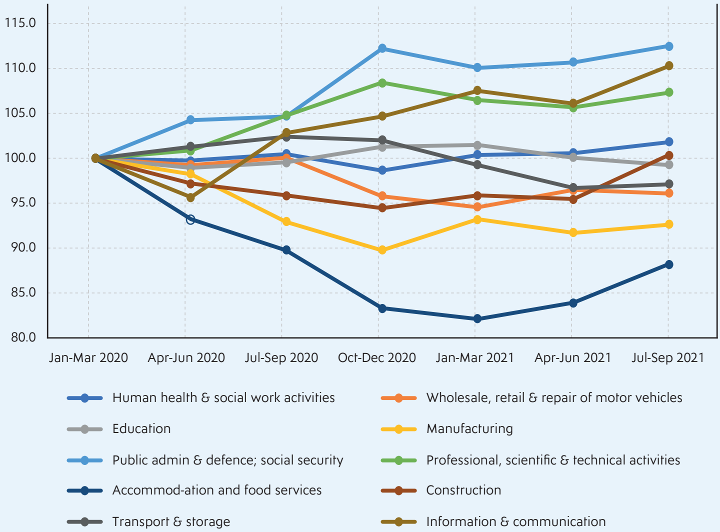
The number of people in employment fell considerably over the course of the pandemic. In February 2020 the number of people in payrolled employment hit a high of 29,057,834. As the pandemic wore on there was a sharp decrease in employment: by November 2020 numbers in employment had hit a low of 28,086,253. The overall number of payrolled employees only recovered to pre-pandemic levels in September 2021[38], though in some sectors employee numbers are still yet to recover fully.

The emergence of the Omicron variant has renewed pressure on the labour market. Already, business confidence has weakened substantially in recent weeks, with companies increasingly pessimistic about investment and hiring.[39] Potentially, lower demand from consumers could feed through into job losses.

Importantly, the impact of the COVID-19 pandemic on employment has been highly uneven. Young people aged 18-24 accounted for more than 60% of job losses between February 2020 and March 2021.[40] In addition, the impact has also not been evenly felt across sectors. Chart 3.2 below illustrates the proportional change in employee numbers, broken down by Standard Industry Classification (SIC). Some sectors, such as accommodation, have seen falls in employee numbers of over 10%. Meanwhile, other sectors – notably financial and insurance activities and real estate activities – have remained largely unaffected or even seen increases in employee numbers during this period.

38. ONS, "Earnings and employment from Pay As You Earn Real Time Information, UK: October 2021", https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/bulletins/earningsandemploymentfrompayasyouearnrealtimeinformationuk/october2021 (2021).
39. Romei, "UK business confidence takes a sharp hit from Omicron".
40. ONS, "Labour market overview, UK", https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/bulletins/uklabourmarket/march2021 (2021).

Chart 3.2. Changes in employee numbers in the largest ten sectors between Q1 2020 and Q3 2021, indexed to Q1 2020 levels



Source: ONS, "EMP14: Employees and self-employed by industry" (2021), author's calculations.

The sectors that have borne the brunt of the economic fallout from the COVID-19 pandemic have, for the most part, been consumer-facing. In particular, accommodation and food services, as well as retail are yet to fully recover from the impact of the pandemic in terms of employee numbers.

Vacancies also saw a sharp drop during the pandemic: there were around 785,000 reported vacancies in January to March 2020, but this level had more than halved – to around 340,000 – by April to June 2020. Since then, the number of vacancies has recovered more strongly than numbers in employment: vacancies have now surpassed their pre-pandemic peak, reaching an all-time high of 1.2 million in September to November 2021.[41] The uptick in vacancies

41. ONS, "Vacancies and jobs in the UK: December 2021", https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/bulletins/jobsandvacanciesintheuk/december2021 (2021).

has occurred across all sectors, reflecting a broad-based demand for workers. As recent data on online job adverts and business confidence show, however, this demand may now be weakening as a result of the Omicron variant.[42]

Box 3.1. How does cutting employer-side SSCs improve economic activity?

Reforms to employer-side SSCs (or NICs) have been used across Europe to incentivise businesses to hire more workers. In France, from 1993 to 1996 employer SSCs were gradually reduced for those earning up to 1.33 times the minimum wage. Estimates suggest that as a result of reductions to SSCs between 1994 and 1997, the average employment growth rate attributable to the policy was 2.24% in the manufacturing sector and 3.15% in non-manufacturing.[43]

Previous cuts to employer SSCs have often been targeted at specific groups, such as young people. In the UK, employer NICs were effectively zero-rated for young people under 21, and earning up to the Upper Earnings Limit, from April 2015. In 2016, employer NICs for apprentices under the age of 25 were abolished. Government research found that around a third of claimant businesses found the savings from the reliefs to be very or fairly significant.[44] Smaller businesses were more likely to view the savings as significant, because they were more likely than larger businesses to claim the reliefs for a larger proportion of their workforce. The majority of employers reported absorbing the savings made through these NICs reliefs into the general revenues of their business.[45]

42. ONS, "Economic activity and social change in the UK, real-time indicators: 6 January 2022".
43. Raul Ramos et al., "Employment effects of reduced non-wage labour costs", https://www.eurofound.europa.eu/publications/report/2017/employment-effects-of-reduced-non-wage-labour-costs#tab-02 (2017).
44. HMRC, "Employer National Insurance contributions (NICs) reliefs for apprentices under 25 and employees under 21", https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/760285/Employer_NICs_Reliefs_U21_Apprentices_U25_-_HMRC_Research_Report_514.pdf (2018).
45. Ibid.

Reforms in Sweden offer an indication of wider positive effects resulting from similar measures. Between 2007 and 2009, the amount of SSCs on young workers aged 26 and under was effectively halved. As a result, youth unemployment rates were reduced by two to three percentage points between the pre-reform years (2002-2006) and the post-reform years (2009-2013).[46] A further finding from the Swedish reform policy was that businesses with a high share of young workers (those targeted by reductions to employer SSCs) grew more quickly in terms of total assets, sales, and profits than those firms with a medium share of young workers, which suggests that the reform had positive effects on business performance as well as employment.[47]

Admittedly, empirical studies have produced mixed findings on whether changes to employer SSCs primarily impact employment, wages, or business profitability. In the examples of France and Sweden above, there were clear and positive employment effects. However, one study of administrative tax data from Canada between 2001 and 2011 concluded that variation in employee and employer SSCs had no impact on employment, productivity, or profits, but did have a significant impact on increasing wages.[48] In other studies, employers use the tax savings to increase wages or profitability, but there is no wider benefit on employment levels.

Supporting businesses

The COVID-19 pandemic has led to a steep rise in businesses applying for external finance. External finance includes a range of financial products such as overdrafts, credit cards, bank loans, commercial mortgages, leasing or hire purchase, loans or equity from family and

46. Emmanuel Saez, Benjamin Schoefer and David Seim, "The effects of employer payroll tax cuts on employment, business activity and wages", https://voxeu.org/article/effects-employer-payroll-tax-cuts (2017).
47. Emmanuel Saez, Benjamin Schoefer and David Seim, "Payroll Taxes, Firm Behavior, and Rent Sharing: Evidence from a Young Workers' Tax Cut in Sweden", *American Economic Review* (2019), 1717-1763.
48. Jonathan Deslauriers, Benoit Dostie, Robert Gagné and Jonathan Paré, "Estimating the impacts of payroll taxes: evidence from Canadian employer-employee tax data", http://ftp.iza.org/dp11598.pdf (2018).

friends or directors, invoice finance, grants, loans from other third parties, export or import finance, crowd funding, asset-based lending, or any other loan or overdraft facility and government or local authority finance.[49]

Forty-four percent of SMEs were using external finance in Q4 2020, which was a considerable increase from the 31% that were using external finance in the first half of 2020.[50] Eighty nine percent of businesses seeking finance in 2020 did so because of the impact of the pandemic, with 75% of these SMEs seeking external finance to help with cashflow.[51]

Despite unprecedented levels of government support, large numbers of businesses will struggle even after support measures are lifted. Research by the insolvency company Begbies Traynor, for example, found that there were around 723,000 businesses in financial distress at the start of 2021. This represents a 42% year-on-year increase between Q1 2020 and Q1 2021.[52]

As support schemes are now withdrawn, even with the Omicron surge, tax policy has an important role to play in helping businesses adjust to the eventual post-pandemic economy. Specifically, reductions to employer NICs in particular can serve as a way of reducing one of the main costs to businesses.

Targeted support for employers

Although the short-run effects of changes to SSCs or NICs are ambiguous, as Box 3.1 above detailed, the economic literature does suggest that cuts to employer NICs in the UK would likely result in

49. British Business Bank, "Small business finance market 2020/21", https://www.british-business-bank.co.uk/wp-content/uploads/2021/03/BBB-SBFM-Report-2021-Widescreen-AW-tagged-002.pdf (2021).
50. Ibid.
51. British Business Bank, "Record levels of smaller businesses sought external financial support in 2020, with further significant demand expected in 2021, finds British Business Bank research", https://www.british-business-bank.co.uk/record-levels-of-smaller-businesses-sought-external-financial-support-in-2020-with-further-significant-demand-expected-in-2021-finds-british-business-bank-research/ (2021).
52. Ric Traynor, "Highest quarterly leap recorded by Red Flag Alert as almost 100,000 additional businesses drop into significant financial distress in Q1 2021" https://www.begbies-traynorgroup.com/news/business-health-statistics/highest-quarterly-leap-recorded-by-red-flag-alert-as-almost-100000-additional-businesses-drop-into-significant-financial-distress-in-q1-2021 (2021).

economically beneficial outcomes in the long term, either through increased employment, higher wages among employees, reduced overhead costs for businesses, or a combination of these effects.

Economic theory predicts that the ultimate burden of employer SSCs or NICs falls upon employees in the form of lower wages. Thus, theoretically, cutting employers NICs would actually mainly benefit employees.[53] Moreover, especially considering the growing rate of inflation in the UK at the moment, there is upward pressure on wages. Cutting employer NICs would thus help businesses cost-effectively meet increased wage demands.

In addition, there is significant discrepancy between the tax on work from employees and the self-employed, which will worsen as a result of the HSC Levy, as Chart 2.5 earlier starkly illustrated. Relative to self-employment, employment is penalised by the UK tax system, and even more so after the introduction of the HSC Levy. The discrepancy in effective tax rates between employees and the self-employed has been a significant concern. The Institute for Fiscal Studies and Bright Blue, among many others, have argued that this presents a significant inequity in the tax system that is not justified by the difference in state benefits that employees and self-employed people accrue.[54] Indeed, the Chancellor admitted this at the start of the pandemic when upon announcing the SEISS he said "I must be honest and point out that in devising this scheme [the SEISS] … it is now much harder to justify the inconsistent contributions between people of different employment statuses."[55]

Employer NICs are the biggest contributor to the tax differential across different legal forms of work.[56] This is largely because the

53. OECD, "Employer versus employee taxation: the impact on employment", https://www.oecd.org/employment/emp/4343154.pdf.
54. Stuart Adam and Helen Miller, "Principles and practice of taxing small business", https://www.ifs.org.uk/uploads/WP201931-Principles-and-practice-of-taxing-small-business-1.pdf (2019).
55. Rishi Sunak, *Statement on coronavirus*, 26 March 2020, https://www.gov.uk/government/speeches/chancellor-outlines-new-coronavirus-support-measures-for-the-self-employed.
56. Stuart Adam and Helen Miller, "Taxing work and investment across legal forms: pathways to well-designed taxes", https://ifs.org.uk/uploads/R184-Taxing-work-and-investment-across-legal-forms.pdf (2021).

rate structures for employee NICs and Class 4 NICs paid by the self-employed are in fact very similar: while there is a three percentage point difference between them at the basic rate, both attract a marginal rate of 2% for higher and additional rate taxpayers. The substantive difference is that self-employment has no equivalent of employer NICs.

For this reason, cuts to employer NICs should not be accompanied by cuts to self-employed NICs, including in the HSC Levy. Self-employed workers already face a lower overall tax rate than employees, and so cutting self-employed NICs at a similar rate to employer NICs would simply maintain the present gap in tax rates at a time when they have recently been increased through the HSC Levy.

Focussing on cutting employers NICs first, rather than self-employed and consequently employee NICs, will thus help to narrow this concerning discrepancy in total tax take between the two employment statuses, whilst also supporting – as the evidence suggests – the take-home pay of employees.

For these reasons, we consider cutting employer NICs, initially in the new HSC Levy, should be the first priority for any cuts to taxes on an individual's work.

If the reduction on work taxes was done through Income Tax, as the Chancellor was recently reported to be considering,[57] this would represent a less targeted way of reducing the relative tax burden on work specifically: due to the broader base of Income Tax, it would reduce tax rates on pensions and dividends, whereas reforms to NICs, including the new HSC Levy, would reduce the tax rate on earnings specifically. And reducing Income Tax would maintain the present gaps in tax rates between people in employment and self-employment. If the goal is to rebalance the tax burden and tax work less, then reforming employer NICs, especially the HSC Levy, is a more targeted way of doing so than reforming Income Tax.

A further advantage to targeting employer NICs specifically is that

57. Steven Swinford, "Rishi Sunak's plan to slash taxes", *The Times*, 3 December, 2021.

it could also be an effective way of supporting struggling sectors coming out of the pandemic. Research from CEBR, admittedly from 2014, found that for the average small business (comprising seven employees including the owner-manager) employer NICs accounted for 12.7% of all employment costs, making them the most significant cost after wages.[58]

Recommendation one: The Government should prioritise significantly lowering the rate of the employer element of the HSC Levy from 1.25% on income above the existing employer NICs threshold as soon as possible. Then, if the public finances allow, the rate of employers NICs should then also be cut.

This measure represents a cost to the Treasury in the short term; a one percentage point decrease in employer NICs would cost £6.5 billion in 2022-23 according to 'ready reckoner' figures from HMRC.[59] However, falling employer NICs, initially with the HSC Levy, can be expected to result in greater employment, higher wage levels and/or more profitable businesses. In the long run, then, some of this revenue would be effectively 'clawed back' by the beneficial economic effects of the policy leading to more tax receipts in other areas such as Income Tax. In any case, it would be a welcome boost to some of the hardest-hit sectors during the pandemic including retail and hospitality, which have a higher share of labour costs to total costs.

The extent to which HM Treasury cuts the current rate of employer NICs in the short-term will most likely depend on other revenue-raising measures to compensate for it. This paper will propose such measures throughout this paper.

58. CBER, "Cost of small business employment", https://cebr.com/reports/cost-of-small-business-employment/ (2014).
59. HMRC, "Direct effect of illustrative tax changes bulletin (June 2021)", https://www.gov.uk/government/statistics/direct-effects-of-illustrative-tax-changes/direct-effects-of-illustrative-tax-changes-bulletin-june-2021#direct-effects-of-illustrative-changes (2021).

Broadening the base of the HSC Levy

As well as reforms to NICs, there is a clear case for reforming the HSC Levy. Though it is likely to achieve its primary objective of raising revenue to support the health system, it has increased the tax burden on work at a time when we should be doing more to ensure post-COVID economic growth, as well as encourage job creation and move to the high-wage, high-productivity economic model that the Conservatives espoused at their 2021 Party Conference.[60]

As well as increasing the relative tax burden on work, the HSC Levy has widened several other dividing lines within the tax system. First, it has increased the gap in effective tax rates between the employed and the self-employed. Since both employees and employers pay the Levy at 1.25%, the effective increase in the marginal tax rate for employees (accounting for the likely economic incidence of the employer HSC Levy) has increased by 2.5% compared to 1.25% for the self-employed. This further distorts decisions taken by businesses and individuals around how to structure work arrangements.

Second, by exempting pensions income, the measure has also increased the gap in tax rates between different age groups. In other words, over time there has been a relative shift of the tax burden onto earnings rather than pension income, which the new HSC Levy has accelerated further.[61]

Third, while the HSC Levy captures income from dividends, other forms of income – for instance, rental income – remain outside the scope of the tax, which further exacerbates the difference in tax rates that different forms of income attract. These forms of income are concentrated in higher-income households; as an example, two thirds of those who own buy-to-let properties are in the top fifth of the income distribution.[62] Even those who receive dividend income are unlikely to

60. Boris Johnson, *Speech at Conservative Party Conference 2021*, 6 October 2021, https://www.spectator.co.uk/article/full-text-boris-johnson-s-conservative-conference-speech.
61. Paul Johnson, Carl Emmerson, Helen Miller, David Phillips, George Stoye, Isaac Delestre, Isabel Stockton, Kate Ogden, Robert Joyce, Stuart Adam, Tom Waters, Max Warner and Ben Zaranko, "An initial response to the Prime Minister's announcement on health, social care and National Insurance", https://ifs.org.uk/publications/15597 (2021).
62. Bell et al., "Nationally insured?"

be affected by the new tax, due to the £2,000 dividend allowance and the exemption for dividends held in ISAs.

Admittedly, the impact of the HSC Levy is progressive according to Treasury analysis.[63] But in a number of ways, it pushes the tax system in the wrong direction – towards more, not less, discrepancy in the treatment of different forms of income; towards more, not less, of the tax burden falling on earnings from work. A more equitable approach would apply to a broader range of income, with this broader tax base allowing for a lower rate to be applied. Indeed, Income Tax provides a model for this approach: it taxes pensions and rental income and applies equally to different forms of employment. Basing the design of the HSC Levy on Income Tax, rather than a slightly modified form of NICs, would enable revenue for health and social care to be raised in a way that limits distortions to the tax system and spreads the burden of the new tax more equally across society.

Recommendation two: The HSC Levy should be broadened to apply to pensions and rental income.

This is one of several reforms that could offset the short-term cost of reducing the employer rate of the HSC Levy.

A tax on the young?

A further area ripe for reform is the age restriction placed on NIC payments. Currently, after the SPA is reached individuals are no longer liable for Class 1 employee contributions or Class 2 and Class 4 self-employed contributions. Admittedly, those working above the SPA are not entirely exempt from NIC: employer NICs still apply,[64] as does the HSC Levy. But the effective tax rate on labour is still drastically reduced

63. HM Treasury, "Illustrative analysis of the impact of "Building back better: our plan for health and social care" on households, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1015735/Impact_of_Building_Back_Better_Our_Plan_for_Health_and_Social_Care_on_households.pdf (2021).
64. IFS, "National Insurance contributions explained", https://ifs.org.uk/taxlab/taxes-explained/national-insurance-contributions-explained (2021); GOV.UK, "National Insurance and tax after State Pension age", https://www.gov.uk/tax-national-insurance-after-state-pension-age (2021).

for those above the SPA relative to those of working age.

The exemption from NICs for those above the SPA has traditionally been justified on the grounds that, as NICs fund specific state benefits, people above the SPA should not have to pay NICs; they have already funded their state pension.

This argument does not stand up to scrutiny for two reasons. First, as established earlier in this report, the link between NICs revenues and state benefits is extraordinarily weak. Contributions often do not entail higher benefits; some groups who pay no NICs still receive benefits; and, most importantly, separation between the NIF and other government spending is illusory. In particular, when it comes to pensions NICs operate as a pay-as-you-go system: revenues paid by today's workers are used immediately to pay for existing pensions liabilities. There is no earmarked link between individual contributions and individual receipts.

Without the contributory principle, the case for exempting people above the SPA from NICs weakens substantially. If NICs effectively operate as just another tax, then this raises the question of why certain workers should attract a lower effective tax rate on their labour simply by virtue of being past the SPA cut-off point. Indeed, people receiving income from work or pensions pay Income Tax.

Second, continuing to exempt those above the SPA ignores a long-term increase in people working past retirement age. Over the past three decades, the proportion of people aged 65+[65] in employment has increased from around 5.5% in the early 1990s to 10.5% today. Indeed, there are now almost 1.3 million people aged above 65 in employment.[66] Additionally, average pensioner incomes have increased in the last few decades: in 2020, 48% of pensioners were in the top half of the overall income distribution,

65. The SPA was raised to 66 as of October 2020, however statistical releases typically use 65+ as the default age group.
66. ONS, "Employment, unemployment and economic inactivity by age group (seasonally adjusted)", https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/datasets/employmentunemploymentandeconomicinactivitybyagegroupseasonallyadjusteda05sa (2021).

compared to 38% in 1995.[67] Median weekly earnings (at 2019-20 prices) for pensioners have increased from £272 in 1994-95 to £336 in 2019-20.[68]

As the number of those working past the SPA has continued to increase, so too has the amount of foregone revenue lost to the Exchequer as a result of the age-based limit on NICs payments. Previous estimates from the Resolution Foundation on the impact of extending Class 1 and 4 NICs to those above the SPA indicate that it could raise around £1 billion a year, and do so progressively: over 80% of the revenue raised would come from the most affluent fifth of pensioners.[69]

Admittedly, this measure could impact incentives to work above the SPA. A majority (around two thirds) of those working above the SPA are doing so by choice, for reasons such as keeping active or because they enjoy working. Around a third do so out of financial necessity.[70] This would suggest that people in this age group could be responsive to changes in tax rates. On the other hand, the fact that older people who choose to work above SPA largely do not need a financial incentive to do so indicates that tax policy is unlikely to play a significant role in decisions to continue working.

Recommendation three: End the exemption from Class 1, 2 and 4 NICs for those working above the SPA

Not only will this contribute to raising revenue to offset the reduction in the employer aspect of the HSC Levy, but it will also address a structural anomaly in the tax system. The HSC Levy will already apply to those working above the SPA.

67. DWP, "Pensioners' income series: financial year 2019 to 2020", https://www.gov.uk/government/statistics/pensioners-incomes-series-financial-year-2019-to-2020/pensioners-incomes-series-financial-year-2019-to-2020 (2021).
68. Ibid.
69. Laura Gardiner, "A budget for intergenerational fairness?", https://www.resolutionfoundation.org/app/uploads/2017/11/IC-pre-Budget.pdf (2017).
70. Giorgio Di Gessa, Laurie Corna, Debora Price and Karen Glaser, "The decision to work after state pension age and how it affects quality of life: evidence from a 6-year English panel study", *Age and Ageing* (2018), 450-457.

Box 3.2. Summary of policy recommendations for taxes on work

Tax cutting

The Government should prioritise significantly lowering the rate of the employer element of the HSC Levy from 1.25% on income above the existing employer NICs threshold as soon as possible. Then, if the public finances allow, the rate of employers NICs should then also be cut.

Revenue raising

End the exemption from Class 1, 2 and 4 NICs for those working above the SPA.

The HSC Levy should be broadened to apply to pensions and rental income.

Chapter 4:
Taxes on an individual's wealth

While reforming taxes on work is of paramount importance, changes to the HSC Levy should not be looked at in isolation. First, the interplay between earnings from work and other sources of income, such as rental income and financial assets, is a major driver of inequities in the tax system.

Second, although taxes on wealth in the UK do not currently provide large amounts of revenue, and admittedly are limited in the potential amount they could provide in future, revenues from reforms to such taxes could nevertheless play a role in further reducing the tax burden on work, which should be seen as both an economic and moral imperative. Indeed, the extra revenue from reformed taxes on wealth could be used to finance our proposed reductions to the HSC Levy, alongside our other revenue-raising ideas from the last chapter such as broadening the base of the HSC Levy and applying NICs to those above the SPA.

However, the key point of reforming wealth taxes is not as a large-scale revenue-raising exercise. Rather, it reflects key economic and moral arguments for rebalancing the tax system by reducing taxes on earned income which is associated with effort, while addressing the relatively lower tax burden on other sources of unearned income associated with luck.

BOX 4.1. What is wealth and how is it taxed?

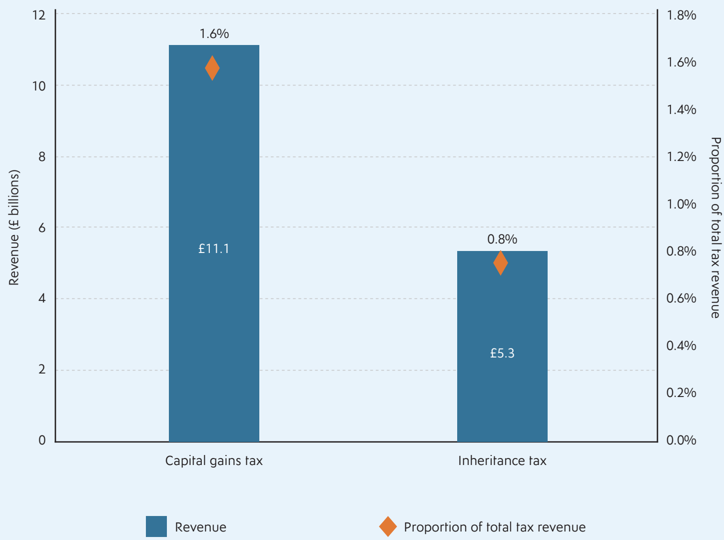
Wealth can be understood as the stock of all financial and physical assets a person owns. The Office for National Statistics (ONS) identifies four components of wealth in its Wealth and Assets Survey: property wealth; financial wealth; physical wealth (possessions such as antiques, artworks, and vehicles); and, private pension wealth.[71]

Taxes on wealth fall into three major categories. First, taxes can target the holdings of wealth. This approach is typified by net wealth taxes, which apply a recurrent tax to an individual's total stock of wealth. Second, another target for tax is returns on wealth. Assets such as rent from a property or interest on savings can provide a recurrent stream of income, while uplifts in the value of assets such as shares provide income upon disposal. Third, some taxes apply to transfers of wealth, such as sales of property or inheritances.

Though the UK lacks a unified net wealth tax, there are several taxes that target wealth directly and indirectly. Chief among these are Capital Gains Tax (CGT) and Inheritance Tax (IHT). Admittedly, they are not big revenue-raisers, especially relative to Income Tax and NICs: they raised 1.6% and 0.8% of total tax receipts in 2021-21 respectively, as Chart 4.1 below illustrates.[72]

71. ONS, "Total wealth in Great Britain: April 2016 to March 2018", https://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/incomeandwealth/bulletins/totalwealthingreatbritain/april2016tomarch2018 (2019).
72. OBR, "Public finances databank – November 2021", https://obr.uk/data/ (2021).

Chart 4.1. Receipts from CGT and IHT, 2020-21



Source: OBR, "Public finances databank: November 2021" (2021).

There are a number of other taxes that could also be considered 'wealth taxes' insofar as they affect holders of wealth in some way. Council Tax has an impact on housing wealth, given that it is linked to property value (albeit regressively, given that Council Tax liabilities tend to decrease as a proportion of property values the higher the value of the property, as highlighted in a recent Bright Blue paper).[73] Stamp Duty Land Tax (SDLT), which applies to purchases of property, effectively targets transfers of assets. Corporation Tax, though levied on businesses, reduces the effective return on the value of shares to individual shareholders. Even VAT has been described as a tax on accumulated wealth at the

73. Paul Cheshire and Christian Hilber, "Home truths: options for reforming residential property taxes in England", https://www.brightblue.org.uk/portfolio/home-truths-options-for-reforming/ (2021).

point of consumption. Tax on pension drawdowns can similarly be regarded as a levy on accumulated income, and therefore a tax on a form of wealth, but as Chapter Two showed it is liable to Income Tax.

However, it is difficult to make the case to categorise the above as taxes that are specifically targeted at wealth. Although Council Tax raises considerably more revenue than either CHT or IHT[74] it falls on occupants of housing, rather than owners. It also taxes the consumption of housing and is often justified on this basis. In this sense, it is not strictly a tax on wealth. Similarly, while there is a case for including Stamp Duty in this analysis as a wealth tax, Stamp Duty is better thought of as specifically a tax on the purchase of property – in this sense it is more of a consumption tax. Recommendations to reform the property tax system were put forward in a recent Bright Blue paper.[75]

VAT is a tax on consumption first and foremost. Indeed, people with no or minimal wealth will pay it. It is true that some of the economic incidence of Corporation Tax falls upon shareholders. But the literature suggests that this incidence is shared between workers and consumers as well as shareholders; it is therefore not accurate to describe it specifically as a wealth tax on shareholders alone.[76]

Given the above considerations, this paper focuses on CGT and IHT when discussing taxes on wealth and how to reform them.

Understanding Capital Gains Tax (CGT)

CGT applies to gains from disposals of 'chargeable assets' above an annual tax-free allowance (the 'annual exemption limit'), which in the 2021-22 tax year stands at £12,300. The chargeable assets liable to CGT include:

- Personal possessions worth £6,000 or more, apart from cars

74. Matthew Keep, "Tax statistics: an overview" (2021).
75. Cheshire and Hilber, "Home truths".
76. Clemens Feust, Andreas Peichl and Sebastian Siegloch, "Do Higher Corporate Taxes Reduce Wages? Micro Evidence from Germany", *American Economic Review* (2018), 393-418.

- Shares not in an Individual Savings Account (ISA) or Personal Equity Plan (PEP)
- Business assets
- Property not being used as a main home
- Main home if it has been let out, used for business, or covers over 5,000 square metres in total
- Cryptoassets (such as Bitcoin).

CGT is currently taxed at a lower rate than income from work, with rates ranging between 10% and 28%, as Table 4.1 below illustrates. This reflects a policy quandary: on one hand, a high CGT rate has the potential to dampen investment incentives. On the other, a low CGT rate creates opportunities for tax arbitrage, owing to the difference in rates between income from labour and income from wealth. This creates distortions to economic activity – in other words, an incentive to rearrange the legal form of one's income to reduce the effective tax rate on that income.

Table 4.1 CGT rates, compared with Income Tax rates

Income Tax status	Standard Income Tax rate	Standard Capital Gains Tax rate	Residential property & carried interest CGT	Business Asset Disposal Relief & Investors' Relief
Basic rate	20%	10%	18%	10%
Higher rates	40/45%	20%	28%	10%

A number of reliefs apply to CGT. The key reliefs include:

- **Private Residence Relief.** Under most circumstances, a person's home is exempt from CGT when sold. The person must have one home and have lived in it for all the time they've owned it; not let part of it out or used part of it exclusively for business purposes; and, the grounds must be less than 5,000 square metres in total.

- **Business Asset Disposal Relief (formerly Entrepreneur's Relief).** Those selling all or part of their business can pay CGT at a reduced rate of 10% on the first £1 million of eligible gains. This means that for higher or additional rate CGT taxpayers, they will be charged at half of the usual effective rate.
- **Investors' Relief.** Investors' Relief applies to the disposal of shares in a company that is not listed on any stock exchanges. Shares must be ordinary shares acquired by subscription and have been owned for at least three years. Qualifying gains are charged at a reduced CGT rate of 10% for lifetime gains up to £10 million.
- **Gifts between spouses.** There is usually no CGT payable on assets gifted to a spouse or civil partner, with some exceptions. If the spouse/civil partner later sells the asset, the base cost is calculated as the value the asset was first acquired at by the donor, rather than the value when it was gifted.
- **Relief on investments.** Certain types of investments are exempt from CGT, subject to qualifying conditions. ISAs are always free from CGT. A number of investment schemes, such as the Enterprise Investment Scheme (EIS), Seed Investment Scheme (SEIS), Social Investment Tax Relief (SITR) and Venture Capital Trust (VCT) shares also enjoy CGT exemptions.
- **Rollover reliefs.** When a business reinvests existing assets into a completely new business asset, this relief allows for a deferment of CGT. To do this, HMRC deducts that CGT amount from the expenditure on the new business asset.
- **Replacement of business assets.**
  - **Incorporation.** When an individual's business is transferred to another company in return for shares, this tax relief means that the same individual will not pay tax until those shares are sold. The seller must be a sole trader/in a business partnership.

- **Disincorporation.** Is similar, but instead this usually concerns the transfer of assets to the shareholders from the company their shares originate from This relief allows certain assets to be transferred slightly below market value.

Box 4.2. The evolution of CGT

Since its introduction in 1965, CGT has had a turbulent history in terms of reform, often vacillating between the two distinct policy objectives of minimising distortions and encouraging investment.

When introduced at a flat rate of 30%, it was justified on the basis that, in the then Labour Chancellor James Callaghan's words, "gains confer much the same kind of benefit on the recipient as taxed earnings... [and]... the present immunity from tax of capital gains has given a powerful incentive to the skilful manipulator".[77]

Similarly, in 1988, the then Conservative Chancellor Nigel Lawson equalised CGT and Income Tax rates on the basis that there is "little economic difference between income and capital gains".[78] The system of taxing capital gains at the same headline rate as Income Tax continued until 2008.

Later reforms to CGT aimed to incentivise investment by lowering the effective rate on capital gains. In 1998, the then Labour Government introduced a taper relief on assets held for three or more years. The taper decreased the chargeable gain by 5% for each additional year the asset

77. James Callaghan, *Budget 1965*, 6 April 1965, https://api.parliament.uk/historic-hansard/commons/1965/apr/06/i-capital-gains-tax.
78. Office for Tax Simplification, "Capital Gains Tax review –first report", https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/935073/Capital_Gains_Tax_stage_1_report_-_Nov_2020_-_web_copy.pdf (2020).

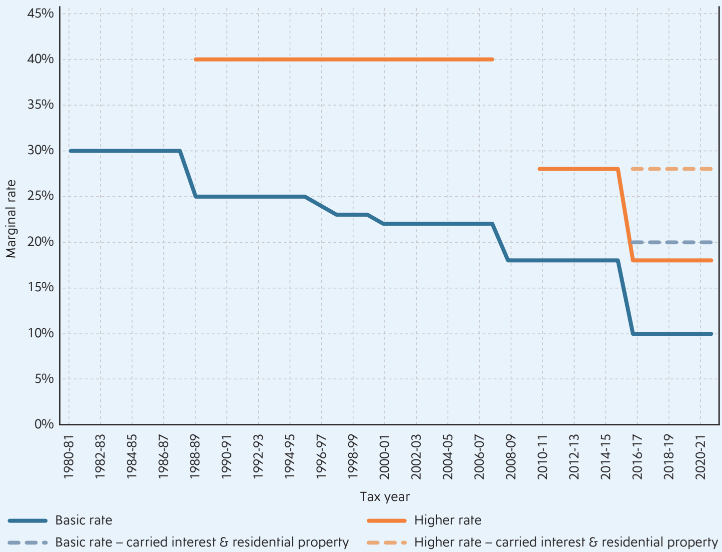
had been held, up to a maximum 40% relief for assets held for at least 10 years. Between 2000 and 2004, the value of the relief was increased for business assets, at the same time that the definition of business assets was widened. At its full value, the taper relief reduced the effective tax rate for higher rate taxpayers from 40% to 10%.

Towards the end of the last Labour Government, taper relief was abolished and replaced by a flat rate of CGT set at 18%, apart from Entrepreneur's Relief.[79] Entrepreneur's Relief was, in large part, a compensating measure for the abolition of taper relief. The relief (now called Business Asset Disposal Relief, as explained earlier) provides a special CGT rate of 10% on gains from the disposal of a business.

The Coalition Government last decade made further changes to the rate structure of CGT. In the 2010 Budget, a new higher rate of 28% was introduced. In 2016, CGT was reformed to apply particularly to certain types of economic expenditure or activity. Headline rates were cut to 10% and 20% for the basic and higher rates respectively, though the rates for certain assets – such as carried interest and residential property – remained at 18% and 28% at the basic and higher thresholds, as Table 4.1 above shows. Besides reforms to the rates, Governments since 2010 have also made extensive and often contradictory changes to Entrepreneur's Relief: the threshold for the relief was increased from £2 million to £5 million in 2010, to £10 million in 2011, and decreased to £1 million in 2020.[80]

79. Antony Seely, "Capital gains tax: recent developments", https://researchbriefings.files.parliament.uk/documents/SN05572/SN05572.pdf (2020).
80. Ibid.

Chart 4.2. Standard CGT rates for individuals, 1980-81 to 2020-21



Source: IFS, "Fiscal facts: Capital gains tax" (2021).

BOX 4.3. Capital gains in other developed countries

Capital gains tax regimes vary considerably between different countries. As an illustration, across Europe top marginal CGT rates vary between 0% – in other words, being tax-exempt under certain circumstances in some countries – to 42% in Denmark.[81] The average capital gains tax rate across European countries for the sale of listed shares is 19.3%.[82]

Besides the differences in rates, there is significant variation in the approach taken to capital gains. Some countries, such as Canada, operate a similar system to that in the UK insofar as capital gains are taxed at reduced, but not zero, effective rates; in Canada, half of a capital gain is

81. Elke Asen, "Capital gains tax rates in Europe", https://taxfoundation.org/capital-gains-tax-rates-in-europe-2021/ (2021).
82. Ibid.

taxable, and taxed at Income Tax rates.[83]

Several other countries differentiate between short-term and long-term holdings. While the UK does not currently make this distinction, the previous taper relief introduced under the last Labour Government reduced the effective CGT rates on assets according to how long they had been held. The US applies CGT of up to 20% for assets held longer than 12 months, otherwise gains are taxed at the higher Income Tax rate, to encourage long-term investing.[84] Similarly, Australia applies Income Tax rates (between 19% and 45%) to capital gains, but if the asset has been held for over a year then the value of the gain can be reduced by 50% or, if the asset was acquired before 1999, taxpayers can choose to apply inflation indexation to the gain or use the 50% discount method.[85]

In other countries, such as Denmark and Estonia, no distinction is made between capital gains and income: capital gains are taxed at Income Tax rates.[86] In fact, Norway taxes capital gains more highly than income: the value of gains on shares and dividends are adjusted by a coefficient of 1.44 before being taxed at the 22% income tax rate, making the effective tax rate on capital gains 31.68%.[87]

A key advantage of CGT is that it acts as a 'backstop' to Income Tax: by taxing capital gains, the incentive to convert income into capital gains, so as to avoid tax, is reduced. Indeed, as Box 4.2 above described, this was one of the primary motivations behind the introduction of the tax.

As well as this, the tax is designed to target the returns to wealth in the form of gains in the value of an asset upon disposal. This is a more appropriate target for tax than holdings of wealth: a recurring tax on holdings of wealth would be imposed regardless of a taxpayer's actual returns. Targeting returns on wealth, as CGT does, is a fairer and less

83. PwC, "Canada: individual – income determination", https://taxsummaries.pwc.com/canada/individual/income-determination (2020).
84. PwC, "United States: individual – other taxes", https://taxsummaries.pwc.com/united-states/individual/other-taxes (2021).
85. PwC, "Australia: individual – income determination", https://taxsummaries.pwc.com/australia/individual/income-determination (2020).
86. Asen, "Capital gains tax rates in Europe".
87. PwC, "Norway: individual – income determination", https://taxsummaries.pwc.com/norway/individual/income-determination (2021).

arbitrary way of taxing wealth.

However, CGT does have a number of weaknesses, particularly when it comes to revenue raising. First, as it is only collected upon the disposal of assets, it is a voluntary tax; you only pay CGT if you choose to dispose of assets in a way that takes your total gains above the Annual Exempt Amount in a given year. Indeed, for this reason, there is a significant amount of 'bunching' of reported gains near the limit of the Annual Exempt Amount.[88] This also makes behavioural responses to changes in the tax more likely: unlike recurrent taxes on property or employment income, which are difficult to avoid, when it comes to CGT an investor can simply choose not to dispose of the asset in hopes of reducing their tax liability for that year, or in the expectation that a future government may lower CGT rates.

Second, when the voluntary nature of the tax is combined with the CGT base cost uplift on death, which 're-indexes' an asset that is inherited to its current market value rather than the price at which it was originally bought, this leads to an incentive to hold onto an asset until death. This is because the gains will be lower if the underlying value of the asset is determined to be higher upon death, meaning the CGT liabilities will be low. This is known as the 'lock-in' effect.

A separate problem is around the fairness to those who sell their investments. Since it does not allow for inflation, CGT does not precisely target returns to investment: it also taxes 'paper gains' that arise purely due to inflation. Since capital income is generally affected by inflation to a much greater extent than normal income, owing to the timeframes involved in most investments, this is a significant flaw in the design of CGT, as will be argued in greater detail in Chapter Four.

Understanding Inheritance Tax (IHT)

IHT taxes the value of an estate upon its transfer, including property, possessions and financial wealth. The tax is charged at a headline rate of 40% on the value of the estate above a £325,000 threshold (the 'nil-

88. Office for Tax Simplification, "Capital Gains Tax review –first report".

rate band' or 'NRB'). Beneath this simple rate structure, there are a host of allowances, reliefs and exemptions which can reduce the effective rate of IHT an estate pays. These include:

- **Annual exemption.** A person can give £3,000 worth of gifts each tax year without incurring IHT.
- **Small gift allowance.** A person is allowed to give any number of gifts of up to £250 per person each tax year, as long as they have not used another allowance on the same person.
- **Gifts for weddings and civil partnerships.** There is an allowance each tax year for gifts to someone who is getting married or starting a civil partnership. This allows for gifts up to £5,000 for a child; £2,500 to a grandchild or great-grandchild; and, £1,000 for anyone else.
- **Gifting exemptions.** Any gifts that are made more than seven years from death are exempt from IHT, while the rate of tax applied to gifts made between three and seven years before death is tapered. This is known as the 'seven year rule'. Additionally, certain gifts qualify for exemption from IHT regardless of when they were made:
  - Any gifts between spouses and civil partners are free from IHT, provided that the recipient is UK domiciled.
  - Gifts to charities or political parties are also exempt.
- **Business Property Relief.** IHT relief at 100% is available for a business or interest in a business, as well as shares in an unlisted company. Additionally, 50% relief is available for shares controlling over 50% of voting rights in a listed company, as well as land, buildings or machinery used in a business the deceased was a partner in or controlled, or held in a trust that it has the right to benefit from. A number of restrictions apply. In particular, relief is only available if the deceased owned the business for at least two years before death, and the company is not eligible for relief if it is a not-for-profit organisation; mainly deals with securities, stocks or shares, land or buildings, or in making or holding investments; is being sold; or, is being wound up.

- **Agricultural Property Relief.** Gifts of land occupied for the purposes of agriculture, including relevant buildings and farmhouses, may attract Agricultural Property Relief. Similar to Business Property Relief, Agricultural Property Relief is given at two rates: 100% and 50%. Broadly, a relief of 100% applies if the land is in-hand, let on a Farm Business Tenancy (FBT) or the owner has the right to vacant possession within 24 months. In most other cases, relief applies at 50%. The relief applies specifically to the agricultural value, rather than the market value, of land.

BOX 4.4. The evolution of IHT

Historically, taxes on estates have been more extensive than at present. Inheritance tax was first introduced in a recognisable form in 1894 with the introduction of the Estate Duty, which brought together numerous pre-existing taxes on estates. This had a highly progressive rate structure. In 1969, there was a top tax rate of 85% on estates valued above £750,000.[89] Reliefs were relatively limited compared to modern-day IHT: bequests to spouses only became tax-free in 1972, and until World War Two more people were liable to Estate Duty than to Income Tax.[90] From 1910 Estate Duty was applicable on lifetime gifts three years from death, and in 1969 this was extended to seven years, giving rise to the now-familiar 'seven year rule'.

Estate Duty was succeeded by the Capital Transfer Tax (CTT) in 1975. Notably, CTT comprised taxes on lifetime transfers as well as on death, with marginal rates for both reaching 75% at the top level.

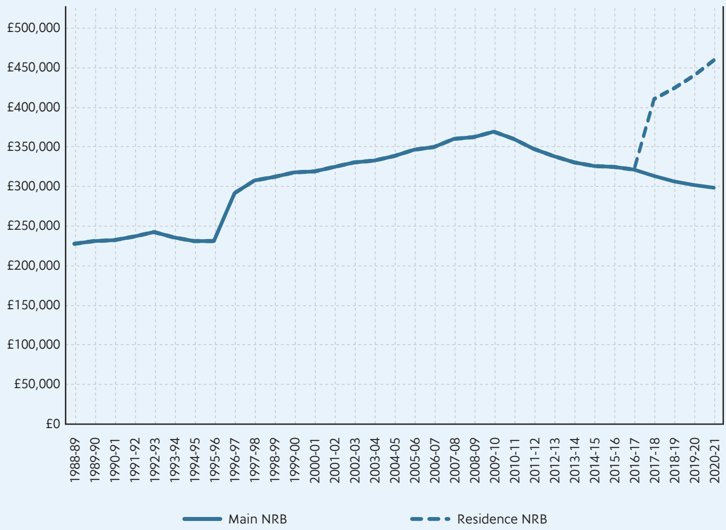
89. HMRC, "Scale of estate duty rates applying to deaths in Great Britain and Ireland", https://uk.practicallaw.thomsonreuters.com/Link/Document/Blob/Ib621db502c5d11e498db8b09b4f043e0.pdf?targetType=PLC-multimedia&originationContext=document&transitionType=DocumentImage&uniqueId=a81f5cb2-86eb-4b80-9502-6f5ee9b188cc&ppcid=73b6f6db0b094ad194b72ee4f9ac24c5&contextData=(sc.DocLink)
90. Adam Corlett, "Passing on: options for reforming inheritance taxation", https://www.resolutionfoundation.org/app/uploads/2018/05/IC-inheritance-tax.pdf (2018).

CTT was short-lived, and was replaced by today's IHT in 1986. This reform abolished taxes on lifetime transfers (unless they fell within the seven-year rule). Initially, IHT rates varied between 30% and 60%, though since 1988-89 the rate structure has remained flat at 40% above the nil-rate band.

Since 1988, substantive changes to the IHT regime have mainly been focused on the nil-rate band threshold. Until 2010, the real value of the NRB gradually became more generous in real terms. However, since 2010, the value of the main NRB has decreased as the value of the threshold has been maintained at £325,000 since 2009-10.

Though the value of the NRB has been eroded by inflation, the last Coalition Government introduced a number of other reforms to make the IHT system more generous. In April 2017, a new 'residence nil-rate band' came into force. This additional NRB applies on transfers on death of a main residence to a direct descendant. It also applies where the donor downsizes or ceases to own a home, in which case the downsizing addition allows a person to claim the amount of residence NRB that they would have been entitled to had they not downsized. The residence NRB was initially set at £100,000, and has since been raised to £175,000. The residence NRB is, however, withdrawn for estates worth more than £2 million by £1 for every £2 over the threshold. Chart 2.3 below shows the trajectory of the nil-rate band in real terms since shortly after the establishment of IHT.

Chart 4.3. Real value of the main and residence NRB thresholds 1988-89 to 2020-21, adjusted to 2015 prices (CPI)



Source: IFS, "Fiscal facts: Inheritance and capital transfer taxes" (2021)and ONS, "CPIH index 00: all items 2015=100" (2021), author's calculations.

For all its faults, IHT has a clear rationale. When looked at from the point of view of the recipient, IHT is a tax on an unearned windfall rather than labour or investment. From a fairness perspective, this is clearly a legitimate target for tax policy; it makes sense both to ensure that tax rates on different taxpayers do not vary too much depending on the form of income they receive, and to use tax policy to promote equality of opportunity by mitigating concentration of wealth – in other words, to 'level the playing field'. Indeed, the liberal philosopher John Stuart Mill spoke of the need to fix "a limit to what any one may acquire by the mere favour of others, without any exercise of his faculties".[91]

Relative to other countries, IHT also captures a large amount of revenue: only five other OECD countries collect more from inheritance,

91. John Stuart Mill, *Principles of political economy*.

estate and gift taxes than the UK as a share of total tax revenues.[92]

In practice, however, IHT in its current form is beset with difficulties. Due to the reliefs and exemptions that apply to it, the tax is relatively easy to avoid and indeed only around 5% of estates pay the charge.[93]

Moreover, recent changes to the IHT system have made the tax complex to administer. In particular, the residence NRB has been criticised as adding a new layer of complexity to calculating IHT liabilities – since its scope is narrower than that of the main NRB – and also for disadvantaging those who do not have children or own their own home. Some have suggested that increasing the main NRB would have been a simpler way of achieving the then Government's objective of taking estates out of IHT.[94] In addition, the various rules around gifting, such as the annual exemption and small gifts allowance, create uncertainty and can make it difficult to establish whether or not IHT is payable on a gift.

Crucially, the tax is also deeply unpopular: in a 2015 YouGov poll, a majority (59%) of respondents described IHT as an unfair tax, making it the least popular out of 11 major taxes. Across all demographic groups, more people described IHT as unfair than fair.[95] This presents a significant political challenge for reform.

92. OECD, "Inheritance, estate and gift taxes could play a stronger role in addressing inequality and improving public finances", https://www.oecd.org/newsroom/inheritance-estate-and-gift-taxes-could-play-a-stronger-role-in-addressing-inequality-and-improving-public-finances.htm (2021).
93. Antony Seely, "Inheritance tax", https://researchbriefings.files.parliament.uk/documents/SN00093/SN00093.pdf (2021).
94. Ibid.
95. YouGov, "Voters in all parties think inheritance tax unfair", https://yougov.co.uk/topics/politics/articles-reports/2015/03/19/inheritance-tax-most-unfair (2015).

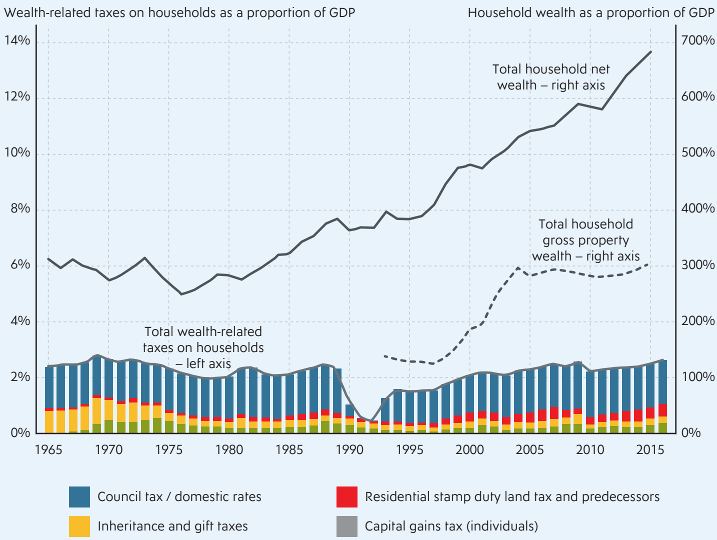
Chapter 5:
Reforming taxes on an individual's wealth

The most immediate observation about the two primary wealth taxes in the UK we identified in Chapter 4, CGT and IHT, is that they have failed to keep pace with growing levels of wealth.

Household wealth has risen as a proportion of GDP from 300% during the 1960s to almost 700% today, with increases seen across its component parts – financial wealth, property wealth, physical wealth and pensions wealth.[96] Yet wealth–related taxes have not risen in line with this economic development, remaining steady at around 2% of GDP.[97] When excluding the aforementioned ambiguous taxes such as Council Tax and SDLT, this figure is even lower. This is shown in Chart 5.1 below.

96. George Bangham and Jack Leslie, "Rainy days: an audit of household wealth and the initial effects of the coronavirus crisis on saving and spending in Great Britain", https://www.resolutionfoundation.org/app/uploads/2020/06/Rainy-Days.pdf (2020).
97. Adam Corlett and Laura Gardiner, "Home affairs: options for reforming property taxation", https://www.resolutionfoundation.org/app/uploads/2018/03/Council-tax-IC.pdf (2018).

Chart 5.1. Wealth-related taxes versus wealth levels, 1965 – 2017



Source: Adam Corlett and Laura Gardiner, "Home affairs: options for reforming property taxation" (2018), p.15.

In short, the UK's tax system has not yet adjusted to one of the most important economic developments of the last 30 years – namely, a substantial and sustained increase in levels of wealth.

Examining the drivers of this uptick in wealth further strengthens the case for reform. Typically, wealth accumulation is thought to result from households increasing their savings rates and reinvesting returns on investments. But the rise in household wealth over the last three decades has, in large part, been down to good fortune rather than shrewd financial activity.

The main driver of increased wealth has been rising asset prices, which explains over 80% of the increase in gross financial wealth.[98] In a similar vein, the bulk of increases in household wealth are due to

98. Bangham and Leslie, "Rainy days".

rising house prices.[99] Especially in the case of financial wealth, rising asset prices have been underpinned by a global and long-term fall in interest rates. As the economist Ian Mulheirn puts it: "The growth in total household wealth has been overwhelmingly down to luck, rather than saving behaviour on the part of the (newly) wealthy. The benefits have accrued as a windfall to people who just happened to hold interest rate-sensitive assets over a period of sharply falling interest rates."[100]

A further concern for policymakers is that rising wealth levels have been accompanied by an increase in wealth inequality. Since 2006-08, the Gini coefficient[101] for wealth has increased from 0.61 to 0.63.[102] The wealthiest families – those in the ninth and top wealth deciles – hold a higher share of total net household wealth today than they did in 2006-08, by roughly 1.4 and 0.9 percentage points respectively.[103] While wealth shares in the bottom three deciles have remained stable, and even seen moderate increases, the wealth share of the middle deciles has notably decreased in this period.

These trends present more than simply a missed revenue opportunity for the Exchequer. There are important social and moral reasons to address the growth in wealth levels and reform wealth taxes. Two key challenges emerge from the growing importance of wealth. First, the differential between taxes on wealth and earnings raises questions of fairness in the tax system. Second, wealth inequality also has effects on wider society, with significant impacts on social mobility and economic performance. Indeed, both the OECD and the IMF have identified

99. Ian Mulheirn, "Sources of wealth and their implications for taxation", https://www.wealthandpolicy.com/wp/BP122_Sources.pdf (2020); see also Bangham and Leslie, "Rainy days".
100. Mulheirn, "Sources of wealth".
101. The Gini coefficient is a summary measure that describes levels of inequality. The measure ranges from 0 to 1, with 0 representing perfect equality (everyone in society has the same resources) while 1 represents perfect inequality (a single individual holds all resources and everyone else has nothing).
102. Arun Advani, George Bangham & Jack Leslie, "The UK's wealth distribution and characteristics of high-wealth households", https://www.resolutionfoundation.org/app/uploads/2020/12/The-UKs-wealth-distribution.pdf (2020).
103. Ibid.

the need to tax wealth more to address economic inequalities.[104] The following sections will outline how these challenges can be addressed by tax policy.

Changing capital gains

First, we explore why we should reform CGT and how to do so.

As discussed above, wealth is taxed more lightly than earnings. Even at a purely philosophical level, there is a case for this gap to be narrowed: two people receiving the same amount of income might pay markedly different effective rates of tax depending on where their income came from.

Analysis of HMRC administrative datasets based on anonymised tax returns of those receiving over £100,000 and below £2 million in total remuneration (including taxable gains as well as earnings) illustrates this point. One quarter of individuals with remuneration above £100,000 had effective average tax rates (EATRs) at close to the headline Income Tax rate of 45%, but another quarter attracted EATRs under 30%, which would be equivalent to someone paying Income Tax on £60,000.[105] In fact, around a tenth of people with remuneration exceeding £1 million paid a lower EATR than an employee earning £15,000. This was largely driven by the 10% rate on gains qualifying for Entrepreneur's Relief (now Business Asset Disposal Relief).[106]

Such wide disparities in effective tax rates for different types of income raises the question of why some economic activities should be favoured over others; put bluntly, one might ask why someone who earns their money from a job should pay proportionately more in tax than another person whose income arises from the proceeds of selling assets.

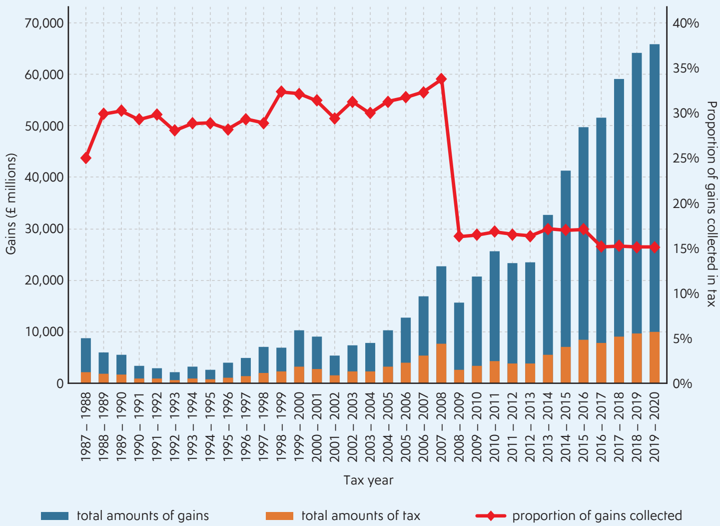
104. OECD, "Inheritance, estate and gift taxes could play a stronger role in addressing inequality and improving public finances", https://www.oecd.org/newsroom/inheritance-estate-and-gift-taxes-could-play-a-stronger-role-in-addressing-inequality-and-improving-public-finances.htm (2021); Philip Inman, "IMF calls for tax hikes on wealthy to reduce income gap", *The Guardian*, 1 April, 2021.
105. Arun Advani and Andy Summers, "How much tax do the rich really pay? New evidence from tax microdata in the UK", https://warwick.ac.uk/fac/soc/economics/research/centres/cage/manage/publications/bn27.2020.pdf (2020).
106. Ibid.

High returns on investments could occur for many reasons which, in themselves, do not seem to conceptually justify a lower tax rate. They could arise from hard work and entrepreneurial activity; a predictably worthwhile investment; or, they might arise simply from good fortune. If the gain arises from hard work, then it is not obvious why the hard work of an employer or asset manager should be rewarded more than the hard work of an employee. If the investment is strong and there is a high chance of high returns, then it is worthwhile regardless of some of the return being taxed away. Finally, if the gain arises from luck – for example, buying stocks in online shopping just before the pandemic, or enjoying favourable macroeconomic conditions – then it is difficult to see why this fortune should be uniquely rewarded.[107]

Besides the moral arguments for taxing capital gains more, there are also more practical considerations for reforming CGT. Mirroring the trends in wealth and wealth taxes detailed in Chart 5.1 above, CGT has also lagged behind increases in the amount of capital gains. In fact, the proportion of CGT receipts to total gains has halved: whereas around 30% of gains were collected in tax before 2008, more recently this has hovered at around 15%.

107. Stuart Adam, "Where next for capital gains tax?", https://ifs.org.uk/uploads/Presentations/What-next-for-CGT.pdf (2020).

Chart 5.2 Total capital gains and CGT receipts, 1987-2020



Source: HMRC, "Estimated number of taxpayers, amounts of gains and tax liabilities by year of disposal" (2021), author's calculations.

A further problem with taxing capital gains at lower rates is that the distinction between what is income from labour and income from capital is not always easy to define, which necessitates enforcement of the boundary between different forms of income. The most well-known example of this ambiguity is 'carried interest'. Investment fund managers are compensated through a 'management fee' (a proportion of the initial value of the fund) and 'carried interest' (which is set at a percentage of the fund's returns, above a threshold). Given that carried interest reflects the fund manager's work and skill, many have made the case that it is better described as income from labour rather than a capital gain.

Similarly, employee share schemes are another area where the line between labour and capital gains is blurred. Such schemes grant employees of a company share options in lieu of salary, in effect converting labour income into capital gains for tax purposes. There are several ways in which employees can claim their remuneration. Some schemes are 'approved' by HMRC, whereas other schemes do not fall in a specific HMRC category. Some, such as 'growth share' schemes, involve the creation of a new class of shares distributed to employees at a low base cost (subject to income tax and NI) with gains from these shares then treated as capital gains. Others operate by using joint ownership of shares between employees and an Employee Benefit Trust, where the employee is only entitled to the increase in the value of a share.[108] Again, the central point made in objection to such schemes is that they are not driven by substantive economic activity but rather by a desire to convert what would otherwise be labour income into capital gains, which attracts a lower rate of tax.

Incentivising investment and encouraging equity

A common response to these observations is that lower taxes on wealth incentivise productive economic activity such as creating, and investing in, businesses. This reflects the central policy trade-off at the heart of taxing capital gains: on the one hand, lower rates lead to significant inequities in the tax system between different taxpayers, as well as complications arising from policing the boundaries between earned income and capital income. On the other, higher rates have the potential to dampen incentives to save and invest.

Business creation and investment are, of course, activities that should be encouraged. But policymakers should consider more targeted ways of encouraging this than applying significantly lower tax rates on capital gains.

There is little evidence that initiatives based on lowering CGT rates, such as Business Asset Disposal (BAD) Relief, have substantially increased business activity. Government research from 2017 indicates that only

108. Adam Corlett, Arun Advani and Andy Summers, "Who gains?", https://www.resolutionfoundation.org/app/uploads/2020/05/Who-gains.pdf (2020).

16% of people who had claimed BAD relief (then Entrepreneurs' Relief) were aware of it at the point that they invested in their business. Of that group, only 50% reported that the relief actually had some or a lot of influence on their behaviour. At the point of disposal, while 73% were aware of the relief, only 16% reported being influenced by it.[109]

The same government-commissioned report also found that a minority of people reported being influenced by the difference in CGT rates compared with other taxes. Twenty-six percent of those who had claimed Entrepreneurs' Relief in the last five years stated that the difference in tax rates had influenced their business decisions. This figure was 15% for those who had paid the full rate of CGT in the last five years and 5% for those who had neither paid CGT nor claimed ER in the past five years but held assets that mean they might be eligible to claim ER in the future.[110]

Rather than focusing solely on low rates, an alternative way of encouraging investment through CGT would be to make changes to the tax base. A well-designed wealth tax should target earnings above normal returns; anything that fails to do so risks unduly penalising investment and risk-taking. In its current state, though, CGT taxes nominal gains. This means that an investor could make an investment which performed equal to inflation, and then get taxed on the nominal gains, making them worse-off in real terms than before the investment. Protecting the normal returns to CGT should therefore be a key part of an ambitious reform package. If CGT only targets above-normal returns, this will minimise distortions to investment decisions and provide a fairer basis for the tax.

Additionally, while CGT taxes the upside of investments, the downside is not fully protected because there are restrictions on how capital losses can be offset. Currently, capital losses can be offset against capital gains

109. HMRC, "Capital Gains Tax Entrepreneurs' Relief: behaviours and motivations", https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/663877/HMRC_Report_456_CGT_ER.pdf (2017)
110. Ibid.

realised in the same year, but cannot be carried back and set against earlier years. In addition, capital losses cannot be set against income. An exception to this is losses on unlisted shares, which can be offset against income in the same or previous tax year.[111]

As many organisations including the IFS have argued, the key point is that while the trade-off between fairness and investment incentives cannot be completely escaped, it can be mitigated through intelligent reform. To do this, a balanced package of CGT reform should pursue two objectives: first, address the discrepancy between effective tax rates on earnings from work and gains arising from wealth. Second, to maintain investment incentives, the CGT base should be reformed. Such reforms will better achieve the policy goals of reducing distortions and encouraging investment, as well as providing additional revenue for the reforms to taxes on work detailed earlier in this report.

Recommendation four: To reduce the discrepancy between tax on capital gains and tax on earnings, the Government should narrow the gap in headline rates between CGT and Income Tax, by creating two main rates for all capital gains of 18% at the basic rate and 28% at the higher rate, with modifications only for assets that have already paid Corporation Tax.

There are numerous approaches that could be taken to narrow the gap in Income and CGT rates, depending on how far the Government chooses to pursue the logic of alignment. As an initial reform, one option would be to end the distinction between standard CGT rates and rates applied on residential property or carried income, as well as end BAD Relief and Investors' Relief. This would collapse the rate structure of CGT from four distinct rates, shown in Table 4.1 earlier, to two main rates: an 18% basic and a 28% higher rate.

111. Adam and Miller, "Taxing work and investment across legal forms".

This rates could be lowered only for assets that have already been paid Corporation Tax. While this approach would narrow, and not eliminate, the discrepancy in tax rates between CGT and Income Tax, it would represent a simplification compared to the current system.

If the Government wanted to raise even more revenue from CGT, while also addressing the 'lock-in effect' (the incentive to hold onto an asset until death, at which point it is re-indexed) it could end the re-indexing of CGT upon death. This means that a person inheriting assets would acquire them at the original base cost when the asset was first bought, rather than the price at the time of inheritance as is currently the case. For example, if someone received an asset that was originally bought by the deceased at £100 but was now worth £300, under the current system they would be treated as having acquired the asset at its current market value of £300, thus making their tax liabilities lower. If the base cost uplift on death was abolished, then the person inheriting the asset would instead be treated as having acquired it at its original cost of £100. Therefore, if they were to sell it, they would be liable to higher CGT because of the higher uplift in value.

Recommendation five: The Government should end the CGT base cost uplift on death, meaning CGT liability will be assessed on the uplift in the value of assets from when they were acquired rather than their present value.

Given the behavioural impacts that a rise in CGT rates could have on investment and on tax revenues, rate rises – which dampen investment incentives – must be paired with offsetting measures that improve the design of the tax base to protect the real value of investments. Indeed, a focus on targeting the real value of investments is especially relevant given recent spikes in inflation. Box 5.1 below outlines the two main measures that could achieve this.

Box 5.1 Inflation indexation and rate-of-return allowances

There are two main ways of precisely targeting real investment returns.

First, inflation indexation provides a deduction to CGT liabilities to compensate for inflation over time. This ensures that the part of an investment return that is simply compensating the investor for the effects of inflation is taken out of the tax base altogether. The UK took this approach before 1998.

Second, a 'rate of return allowance' (RRA) functions slightly differently. The aim of a RRA is to protect the risk-free part of an investment from tax. The risk-free rate is, in theory, the minimum return an investor expects in order to make an investment with zero risk. Of course, no real-life investment is without risk. However, the risk-free rate can be approximated by the interest rate on medium-term government bonds since, theoretically, governments are able print more money to honour debt obligations.[112]

This makes it distinct from inflation indexation: although recently the inflation rate and gilt yields have been very similar, this has not always been the case, particularly from the mid-1980s to the late 1990s when gilt yields were notably higher than inflation.[113]

In practice, the risk-free rate would be used to calculate the portion of a return on capital that could have been achieved with a risk-free asset such as government bonds. Any returns above that threshold would be taxed at CGT rates, with returns below the risk-free rate treated as capital losses. Such an approach has been used in Norway, where the RRA is set as the average interest rate on three-month Treasury bills in the year for which the allowance is to be calculated.[114]

112. James Mirrlees, Stuart Adam, Timothy Besley, Richard Blundell, Stephen Bond, Robert Chote, Malcolm Gammie, Paul Johnson, Gareth Myles, and James Poterba, "Tax by design: chapter 20 – conclusions and recommendations for reform", https://economics.mit.edu/files/19873 (2011).
113. Andy Summers, "Ways of taxing wealth: alternatives and interactions", https://www.wealthandpolicy.com/wp/EP4_Alternatives.pdf (2020).
114. Norwegian Ministry of Finance, "Report no.11 to the Storting: evaluation of the 2006 tax reform", https://www.regjeringen.no/contentassets/4402291a902b4d129854f4fe447b56ce/en-gb/pdfs/stm201020110011000en_pdfs.pdf.

Either of the options presented in Box 5.1 to limit CGT to real gains come with administrative costs. Indeed, the then Chancellor Gordon Brown cited how "difficult to understand and complicated to administer" indexation allowance was, when replacing it with taper relief.[115] But they are effective ways of ensuring that what CGT is targeting is genuine capital gains.

The RRA is arguably more comprehensive than inflation indexation in stopping higher rates of CGT from discouraging investments, as the IFS have argued.[116] However, on balance, it is likely that inflation indexation would be cheaper to administer,[117] and is perhaps more intuitive to taxpayers.

Recommendation six: To ensure that CGT targets only the real returns to investments, and does not punitively target paper gains, narrowing the gap between CGT and Income Tax rates should be paired with the reintroduction of inflation indexation on CGT liabilities.

Admittedly, reintroducing inflation indexation would be costly. The Institute for Public Policy Research (IPPR) estimated the post-behavioural revenue impact of inflation indexation at £14 billion over the five tax years to 2024-25.[118] To put this cost into perspective, the IPPR estimated the revenue gain from fully equalising the main CGT rates with Income Tax rates at £36 billion to 2024-25, adjusting for potential behavioural effects; a reform that narrowed rates rather than equalising them, as we suggest, could be expected to raise significantly less revenue. That said, removing BAD relief, as we propose, would raise additional revenue.

The basic logic of accompanying rate alignment with measures to

115. Budget 1998, https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/26 5717/budget98.pdf, paragraph 4.26 (1998).
116. Adam and Miller, "Taxing work and investment across legal forms".
117. Shreya Nanda and Henry Parkes, "Just tax: Reforming the taxation of income from wealth and work", https://www.ippr.org/research/publications/just-tax (2019).
118. Ibid.

protect real gains can be further extended by treating the downside risk of investment – capital losses – more leniently. Investors are currently restricted in how they can offset capital losses. Capital losses can be set against capital gains in the current tax year, or carried forward to future tax years. Capital losses cannot normally be set against income, unless the loss was on shares in unlisted companies.

In principle, there is no reason why capital loss offsets could not be extended to cover a wider range of assets and a wider period. A number of other countries, including Germany and Canada, allow capital losses to be carried back to previous tax years after they have been offset against the current tax year.[119]

Indeed, in the UK, trading losses can currently be carried back for the purposes of Corporation Tax. Typically, this can be done for one year, but due to COVID-19, the Government amended this so that for accounting periods ending between 1 April 2020 and 31 March 2022, this has been extended to three years.[120] Additionally, Terminal Loss Relief enables companies that stop trading to carry back losses for Corporation Tax for three years.

Another way of making capital loss offsets more flexible would be to allow capital losses to be set against income in a wider range of situations. For example, loss offsets against income could apply not just to unlisted shares, but also to listed shares as well as other asset types including investment funds or valuables such as works of art and antiques.

Admittedly, most countries only allow capital losses to be offset against capital gains.[121] Part of the reason for this is that, if capital losses were set against income then the value of the relief would be higher than CGT. For example, if an additional rate taxpayer offset a capital loss against their Income Tax liabilities, the relief would be given at 45%.

This issue could be alleviated by restricting the amount of relief given, either by capping the amount of tax relief that can be claimed by setting

119. Office for Tax Simplification, "Capital gains tax review".
120. GOV.UK, "Work out and claim relief from Corporation Tax trading losses", https://www.gov.uk/guidance/corporation-tax-calculating-and-claiming-a-loss#carry-a-trading-loss-back (2021).
121. Office for Tax Simplification, "Capital gains tax review".

capital losses against income, or, more simply, by applying relief strictly at CGT rates. For example, someone claiming relief for a capital loss on income above the additional rate would then receive relief at 28%, not 45%.

Recommendation seven: Capital losses should be able to be carried back for up to three years and set against taxable income with relief restricted to CGT rates.

Taken together, these four measures ensure that wealth overall is taxed relatively more heavily, which can help offset to some extent the reduction in taxes on work taxes described in Chapter Three, but also more fairly. With inflation indexation, the part of returns on investments that are solely due to inflation are excluded from the tax base. This ensures that investments on the margin – those that just break even – are not discouraged by tax, as CGT would only target those investments that are truly profitable. And greater flexibility in loss offsetting is one way of cushioning the downside risk of investments in return for taxing the upside more heavily.

It must be emphasised, however, that without adequate reforms to the base – in other words, making sure that 'paper gains' reflecting only inflation are not taxable by CGT, as we propose – a substantial rise in CGT could be more detrimental than beneficial.

Inheritance and social mobility

Now we turn to the other main wealth tax, IHT, and the case for reforming this and how to do so.

A growing body of evidence suggests that excessive wealth inequality has detrimental impacts on social mobility and social cohesion. The idea of wealth inequality hampering intergenerational social mobility is intuitive: higher-wealth households can pass down resources[122] to enable

122. Sarah Voitchovsky, "Inequality and economic growth", https://www.researchgate.net/profile/Sarah_Voitchovsky/publication/263162092_Inequality_and_Economic_Growth/links/0c96053a1332dbb588000000.pdf (2009).

the recipients to engage in riskier, higher-return financial activity.

Indeed, coming from a high-wealth household has a number of impacts on life outcomes. Recent analysis by the International Monetary Fund (IMF) studied Norwegian administrative data, focusing on changes to the wealth tax rate in the late 1990s and early 2000s. It found that those who grew up in families with more wealth tended to have higher labour income, even after controlling for the education and incomes of their parents. A net wealth of one million Norwegian krone (NOK) was found to increase the wages of children by NOK 14,000.[123]

Inheritance in particular plays a key role in driving wealth inequality. One study of Swedish households, for example, suggests that at least half of parent-child wealth correlations can be explained by bequests and gifts – more than earnings and education, which accounted for a quarter of parent-child wealth correlations.[124] Another study of four OECD countries found that the contribution of inheritances to wealth inequality is 26.2% in Great Britain, with the contribution of family background accounting for an additional 10.1%.[125]

The Institute for Fiscal Studies (IFS) has argued[126] that, in the UK, the role of inheritance in social mobility, or at least how rich young people eventually become, is increasing: 75% of those born in the 1970s have either received or expect to receive an inheritance, compared with 68% of those born in the 1960s, 61% of those born in the 1950s, 55% of those born in the 1940s and less than 40% of those born in the 1930s.[127] In other words, a greater proportion of people in younger generations are expecting to receive an inheritance. Inheritances are

123. Kristoffer Berg and Shafik Hebous, "Does a Wealth Tax Improve Equality of Opportunity? Evidence from Norway", https://www.imf.org/en/Publications/WP/Issues/2021/03/19/Does-a-Wealth-Tax-Improve-Equality-of-Opportunity-Evidence-from-Norway-50258 (2021).
124. Adrian Adermon, Mikael Lindahl and Daniel Waldenström, "Intergenerational Wealth Mobility and the Role of Inheritance: Evidence from Multiple Generations", *The Economic Journal* (2018), p.F482-F513.
125. Juan C. Palomino, Juan G. Rodríguez, Brian Nolan and Gustavo A. Marrero, "Wealth inequality, intergenerational transfers and family background", https://www.inet.ox.ac.uk/publications/no-2020-15-wealth-inequality-intergenerational-transfers-and-socioeconomic-background/ (2021).
126. Rob Merrick, "Inherited wealth will decide how rich young people will become, a study warns", *The Independent*, 5 January, 2017.
127. Andrew Hood and Robert Joyce, "Inheritances and inequality across and within generations", https://www.ifs.org.uk/publications/8831 (2017).

also increasing as a share of lifetime income: for those born in the 1980s, average inheritances will be worth 16%, compared to 9% for those born in the 1960s.[128]

These trends have implications for social mobility. The IFS found that inheritances are set to increase intragenerational inequalities: among those born in the 1980s, inheritances are predicted to increase lifetime incomes by 5% on average for the bottom fifth of the wealth distribution, and by 29% for those whose parents are in the top fifth.[129]

As well as the broader issues around wealth inequality and social mobility, there are specific issues with the design of IHT that are in need of reform. Mirroring the uptick in levels of wealth more broadly, as documented earlier in the paper, IHT has also failed to keep pace with the rising value of estates passing on death. While IHT receipts are forecast to have increased by almost 150% between 1995 and 2022-23, the total value of estates is set to increase by 300% over the same time period.[130]

Moreover, the current design of IHT allows extensive opportunities for avoidance. One reason for this is that gifts made more than seven years before death do not fall under IHT, meaning that those in a position to make gifts more than seven years before death "avoid [IHT] altogether by the simple expedient of passing on wealth well before they die".[131] This creates an arbitrary distinction in the tax system between those who receive gifts before the donor dies and those who receive gifts after.

Exemptions offer further opportunities to reduce effective IHT rates. A prime example is the exemption from IHT for transfers made upon death to a spouse or civil partner, which applied to an estimated £11.4 billion of assets in 2016. This exemption further interacts with the CGT base cost uplift on death: a partner might receive assets that are exempt

128. Pascale Bourquin, Robert Joyce and David Sturrock, "Inheritances and inequality over the life cycle: what will they mean for younger generations?", https://www.ifs.org.uk/publications/15407 (2021).
129. Ibid.
130. Corlett, "Passing on".
131. Mirrlees et al, "Tax by design".

from IHT, and because of the CGT base cost uplift could then sell the asset for a substantial profit without incurring any CGT.

Additionally, agricultural and business property benefits from up to 100% relief from IHT, with these two reliefs between them reducing the value of taxable estates by £2.6 billion in 2016.[132]

The case for the reliefs is clear: they are there to ensure that businesses and farms remain viable after being passed on. But the extent to which the current design of these reliefs is justified is highly questionable.

Business property relief applies not just to shares in a family business but can also apply to the value of shares in companies with no family connection.[133] In particular, shares on the AIM market can be free of IHT, with no requirements for minimum shares in a company and no need to prove a personal relationship to the company.[134] Indeed, various companies offer AIM Inheritance Tax ISAs – ISAs comprising shares of companies that are expected to quality for Business Property Relief, as well as being exempt from CGT due to being in an ISA wrapper.[135] The relief is also unconditional: a person could sell the business the day after inheriting it without this changing the tax position.

Agricultural Property Relief exhibits similar flaws. Investors and trusts can buy agricultural land to take advantage of the relief. Indeed, in 2017, 40% of agricultural land was purchased by farmers, down from 60% in 2011.[136] More broadly, the two reliefs overwhelmingly benefit the richest estates: in 2015-16, estimates suggest that around 71% of Business and Agricultural Property Relief went to estates valued above £1 million.[137] While Business Property Relief and Agricultural Property Relief have a clear theoretical justification, it is

132. Jonathan Bradshaw (ed), Let's talk about tax (London: Child Poverty Action Group, 2019).
133. GOV.UK, "Office of Tax Simplification: Inheritance tax review", https://www.gov.uk/government/publications/office-of-tax-simplification-inheritance-tax-review (2018).
134. Corlett, "Passing on".
135. For example, see Octopus Investments, "Octopus AIM inheritance tax ISA", https://octopusinvestments.com/our-products/business-property-relief/octopus-aim-inheritance-tax-isa/.
136. Paul Hebden, Robert Palmer and Tom Tyldesley, "In stark relief: how inheritance tax breaks favour the well off", https://www.taxjustice.uk/uploads/1/0/0/3/100363766/in_stark_relief_final_lr.pdf (2019).
137. Ibid.

clear that both reliefs could be far better targeted to benefit genuine business owners.

Taken together, the various ways around IHT lead to a situation whereby the wealthiest estates pay proportionately less tax. The Office of Tax Simplification examined the effective IHT rate paid by estates across the wealth distribution, finding that while the average effective tax rate on most estates is around 20%, this falls to 10% for the very richest estates, defined by the OTS as those with an estate value of £10 million or more. It is worth noting that the proportion of an estate covered by IHT reliefs tends to increase with estate value: while around 20% of the value of the smallest estates (up to £1 million) are covered by a relief, this rises to over 70% of the largest estates (those above £10 million).[138] This is largely driven by the asset composition of estates: lower-value estates mostly comprise cash and residential property, which do not attract IHT reliefs.[139]

In other words, IHT is not as broadly based as it could be, while extensive exemptions and opportunities to avoid the tax mean that IHT is not as progressive or fair as it could be either. This is set against a backdrop of inheritances playing an increasingly prominent role in influencing social mobility and life chances.

An effective way of addressing both of these issues – an overly narrow tax base as well as the implications this has for fairness, wealth inequality and social mobility – would be to tax lifetime transfers as well as inheritances. This is already done in countries such as Ireland.[140] Indeed, this would represent a move back to the system that existed in the UK prior to 1986.

Recommendation eight: Replace Inheritance Tax with a Lifetime Receipts Tax (LRT). The LRT should have a starting

138. GOV.UK, "Office of Tax Simplification: Inheritance tax review".
139. Ibid.
140. Irish Government, "Gift and inheritance tax (capital acquisitions tax – CAT), https://www.revenue.ie/en/gains-gifts-and-inheritance/gift-and-inheritance-tax-cat/index.aspx (2021).

lifetime allowance of £125,700. The headline rates should mirror Income Tax rates from now, with the threshold set at ten times the Income Tax salary thresholds.

A well-designed LRT would have several advantages compared to the current system. A tax that applies to lifetime gifts, and not just gifts bequeathed after (or near) death, would end the arbitrary distinction between the timing of gifts. By reducing exemptions and reliefs, it would minimise the distortions currently present in IHT. This would also reduce the abilities of wealthier estates to minimise effective tax liabilities, thereby ensuring that inheritances are taxed more progressively.

From the standpoint of economic theory, there is a case for effectively merging IHT with Income Tax by treating any inheritances or gifts as income; when viewed from the perspective of the recipient rather than the donor, any inheritances represent unearned income. Taxing this income would not substantially alter the recipient's behaviour, either. Notably, the IPPR have proposed a LRT modelled on the Income Tax schedule on this basis.[141] Resolution Foundation estimates suggest that such a move would raise £15 billion, or £9 billion a year more than the current IHT system.[142]

However, such a move would be incredibly punitive relative to the current system; the bulk of any large inheritances would be subject to the top 45% Income Tax rate. Moreover, while an IHT-Income Tax merger may make economic sense, the political hurdles to IHT reform cannot be ignored: in particular, its unpopularity[143] and the perception of the tax as an illegitimate and regressive charge on life earnings.[144]

While there is a clear rationale for treating inheritances as

141. Carys Roberts, Grace Blakely and Luke Murphy, "A wealth of difference: reforming the taxation of wealth", https://www.ippr.org/files/2018-10/cej-a-wealth-of-difference-sept18.pdf.
142. Corlett, "Passing on".
143. YouGov, "Voters in all parties think inheritance tax unfair"
144. Daisy-Rose Srblin, "The tax detox", https://fabians.org.uk/wp-content/uploads/2015/12/The-Tax-Detox-2.pdf (2015).

income and ensure a broad-based LRT, reform must be mindful of the opposition to the idea of taxing estates. A pragmatic approach would be a generous tax-free allowance. In 2014-16, only 10% of those receiving an inheritance reported receiving an inheritance over £100,000, while only 2% received a gift worth over £50,000.[145] A lifetime allowance of around £125,000 would be sufficient to ensure that only a small minority would be liable to the tax, as is currently the case with IHT. Though this narrows the tax base, it could make the move to a LRT an easier political sell. If a future government chose to broaden the base, it could do so by freezing the tax-free threshold.

Wide tax bands can avoid the situation of most large inheritances being subject to a 45% rate. The Resolution Foundation explored the implications of setting the tax bands for a new LRT at ten times 2018-19 Income Tax thresholds, finding that it would yield £13.5 billion, or £7.7 billion of additional revenue, compared with IHT.[146]

Using the 2020-21 Income Tax thresholds as a reference point, this would imply a lifetime allowance of £125,700; 20% up to £502,700; 40% up to £1.5 million; and, 45% above that. Income Tax thresholds are set to be frozen for some years. This goes slightly further than the Resolution Foundation's original recommendation for a LRT, which had a personal allowance of £125,000, a 20% rate up to £500,000, and a 30% rate on any amount above that.

The general ten times Income Tax proposal has advantages. It raises more revenue than current IHT. And using the Income Tax schedule as a reference point would make the new LRT easy to understand and emphasise the underlying rationale of treating inheritances as income.

Admittedly, a shift to a receipts-based tax would bring its own challenges. The most significant problem is that lifetime gifts would need to be reported. A system that operates on self-assessment would

145. Ibid.
146. Ibid.

increase the administrative burden on HMRC, and ensuring compliance could be a challenge.

Another consideration is what to do with Business Property Relief and Agricultural Property Relief. There is a case for keeping such reliefs in place, however eligibility should be significantly restricted.

Recommendation nine: Business Property Relief and Agricultural Property Relief in IHT, or the new LRT, should only apply where the donor had a demonstrable working relationship to the business or farm and for at least two years after acquisition.

Under this system the donor would need to demonstrate that they owned, worked for, or had significant control in the company or farm to quality for tax relief on the assets in scope. This would aim to ensure that what is being passed on is genuinely a family business.

However, this does not address what happens after inheritance occurs; even with these conditions in place, there would still be an incentive to use businesses or agricultural land as a vehicle which the beneficiary could then sell on to avoid the Lifetime Receipts Tax (LRT). To safeguard against this, government could stipulate that the beneficiary must continue the business to qualify for relief. This could be for a period of at least two tax years. In practice, relief would be given upfront, however if the beneficiary then sold the business or agricultural land within two years of acquisition, then the relief would be clawed back. Taken together, these adjustments ensure that reliefs for business and farming benefit the people they are supposed to and cannot simply be used as a vehicle to reduce tax liabilities.

Box 5.1. Summary of policy recommendations to reform wealth taxes

Revenue raising

To reduce the discrepancy between tax on capital gains and tax on earnings, the Government should narrow the gap in headline rates between CGT and Income Tax, by creating two main rates for all capital gains of 18% at the basic rate and 28% at the higher rate, with modifications only for assets that have already paid Corporation Tax.

The Government should end the CGT base cost uplift on death, meaning CGT liability will be assessed on the uplift in the value of assets from when they were acquired rather than their present value.

Replace Inheritance Tax with a Lifetime Receipts Tax (LRT). The LRT should have a starting lifetime allowance of 125,700. The headline rates should mirror Income Tax rates from now, with the threshold set at ten times the Income Tax salary thresholds.

Business Property Relief and Agricultural Property Relief in IHT, or the new LRT, should only apply where the donor had a demonstrable working relationship to the business or farm and for at least two years after acquisition.

To ensure that CGT targets only the real returns to investments, and does not punitively target paper gains, narrowing the gap between CGT and Income Tax rates should be paired with the reintroduction of inflation indexation on CGT liabilities.

Capital losses should be able to be carried back for up to three years and set against taxable income with relief restricted to CGT rates.

Tax cutting

Taken together, we forecast that the changes we propose to CGT and IHT in this chapter would increase revenue to HM Treasury, helping to offset the reductions in taxes on work we propose in Chapter Three.

Chapter 6:
Conclusion

The pandemic has, in many ways, upended assumptions about economic policymaking that have been prevalent over the past decade or so. The need to repair the public finances, and reform taxes in order to do so, has been noted by the Conservative Government, which has adopted a number of revenue-raising measures from both personal and corporation taxes.

Fiscal policy, however, should aim to lower taxes on work in order to support economic activity in this fragile time and reward effort and enterprise. The HSC Levy was a significant and surprising tax rise for a Conservative Government to implement. It cannot be abolished, but it can be made much fairer. Any detrimental impact on workers and employers can be mitigated.

Taxes on wealth should be increased, to some extent, in order to offset in part the losses in revenue from lowering taxes on work, as well as respond to rising wealth levels and the increasing role of luck and inheritance in life outcomes.

Admittedly, the revenue implications of the policies we are proposing are uncertain; they depend on the rates and rules set by policymakers and the behavioural responses of those affected. But, overall, we are suggesting that reforms should aim for revenue neutrality in the short-term.

This paper makes nine main proposals to work and wealth taxation to achieve these aims, outlined in Box 6.1 below.

Box 6.1. Summary of recommendations

Revenue raising

End the exemption from Class 1, 2, and 4 NICs for those working above the SPA.

The HSC Levy should be broadened to apply to pensions and rental income.

To reduce the discrepancy between tax on capital gains and tax on earnings, the Government should narrow the gap in headline rates between CGT and Income Tax, by creating two main rates for all capital gains of 18% at the basic rate and 28% at the higher rate, with modifications only for assets that have already paid Corporation Tax.

The Government should end the CGT base cost uplift on death, meaning CGT liability will be assessed on the uplift in the value of assets from when they were acquired rather than the present value.

Replace Inheritance Tax with a Lifetime Receipts Tax (LRT). The LRT should have a starting allowance of 125,700. The headline rates should mirror Income Tax from now, with the threshold set at ten times the Income Tax salary thresholds.

Business Property Relief and Agricultural Property Relief in IHT, or the new LRT, should only apply where the donor had a demonstrable working relationship to the business or farm and and for at least two years after acquisition.

Taxes on work

Taxes on wealth

The Government should prioritise significantly lowering the rate of the employer element of the HSC Levy from 1.25% on income above the existing employer NICs threshold as soon as possible. Then, if the public finances allow, the rate of employers NICs should then also be cut.

To ensure that CGT targets only the real returns to investments, and does not punitively target paper gains, narrowing the gap between CGT and Income Tax rates should be paired with the reintroduction of inflation indexation on CGT liabilities.

Capital losses should be able to be carried back for up to three years and set against taxable income with relief restricted to CGT rates.

Tax cutting

Tax is an incredibly politically sensitive policy area. The Treasury is inherently conservative in changing taxation policy. To do what we propose around work and wealth taxation, there will be difficult and potentially unpopular decisions along the way. But the long-term reward would be a tax system that makes the UK more efficient and equitable.

A centre-right Government that is committed to 'levelling up' the UK should rebalance the tax system from income associated with work and effort and onto income associated with privilege and luck.

The report proposes that the UK should lower taxes on an individual's work to aid the post-COVID economic recovery and reward effort and enterprise. At the same time, the UK should increase taxes on an individual's wealth to some extent to offset in part the losses in revenue from lowering taxes on work, as well as respond to rising wealth levels and the increasing role of luck and inheritance in life outcomes.

Tax is an incredibly politically sensitive policy area. To do what we propose around work and wealth taxation, there will be difficult and potentially unpopular decisions along the way. But the long-term reward would be a tax system that makes the UK more efficient and equitable.

A centre-right Government that is committed to 'levelling up' the UK should rebalance the tax system from income associated with work and effort and onto income associated with privilege and luck.

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