Taxation

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Summary

- Net taxes and National Insurance contributions have risen from 34.8% of national income in 1996–97 to 36.3% in 2004–05. According to Treasury projections, these will rise to 38.5% of national income in 2008–09. This would be the highest level since 1984–85.
- Total government revenues have averaged 38.4% of national income under the two Labour governments, compared with 40.6% over the 18 years of Conservative government from 1979 to 1997. According to Treasury forecasts, revenues will equal 39.3% of national income in 2005–06, rising to 40.6% by 2009–10. This would be the highest level since 1988–89.
- Over Labour's two parliaments since 1997, current receipts have risen by 3.5% a year on average, in real terms, while national income rose by 2.8% on average, leaving national income minus tax to rise at 2.4% on average.
- Of the total £28.5 billion revenue increase seen since 1996–97, £19.1 billion was due to discretionary changes to the tax system, with the remainder being due to the impact of the economy on overall revenues. The largest discretionary change occurred in the first Budget after the 2001 election (the Spring 2002 Budget), which increased taxes to yield an additional £9.9 billion by 2005–06.
- Between 1997 and 2005, the UK saw one of the highest increases in revenues among OECD countries, although the UK remains a low-tax economy compared with EU countries.

1. Introduction

This Briefing Note examines the evolution of the tax burden over the last 50 years. Section 2 begins by giving an overview of revenues over time. It compares the change in the tax burden since 1997 with historical changes and analyses how it reflects changes in the relative growth rates of revenue and national income. Section 2 also considers to what extent changes in the tax burden have been due to discretionary policy changes and to what extent they have been due to other factors such as fiscal drag and economic growth. Finally, the section puts the level of changes in the UK's tax burden during Labour's two terms in office in international context.

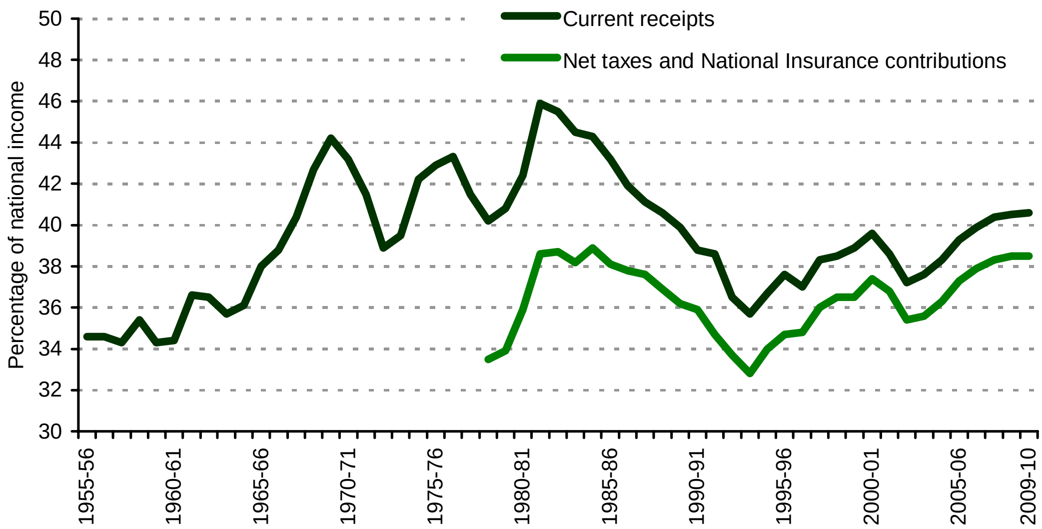
Section 3 looks more closely at the individual tax changes implemented by Labour over the last eight years and how these compare with the party's manifesto pledges prior to the 1997 and 2001 elections and with the Conservatives' tax changes immediately prior to and during their last term in office.

2. Labour's record in perspective

2.1 The tax burden over time

When we talk about the tax burden, two measures from official statistics are used most frequently.[1] The first, and most conventional, is net taxes and National Insurance contributions (NICs). As Figure 1 shows, since the late 1970s, the tax burden on this measure has fluctuated between a high of 38.9% of national income in 1984–85 and a low of 32.8% in 1993–94. Labour inherited a tax burden of 34.8% in 1996–97. It rose in Labour's early years in office, dropped as the stock market fell between 2000 and 2003, and has since risen back to 36.3%, slightly higher than Labour inherited. On Treasury figures from Budget 2005, the tax burden is expected to rise to 38.5% of national income by 2008–09, which would be its highest level for 25 years.

Figure 1. Government revenues since 1955–56



Note: Projections are from 2005 Budget.
Sources: ONS, series ANBT; HM Treasury, *Public Finances Databank*, London, March 2005 (http://www.hm-treasury.gov.uk./media/C62/B0/March05WEB.xls); HM Treasury, *Budget 2005*, London, March 2005 (http://www.hm-treasury.gov.uk/budget/budget_05/budget_report/bud_bud05_report.cfm).

An alternative broader measure of the tax burden is current government receipts. Net taxes and NICs are not the government's only source of revenues. It also generates revenues from sources such as interest payments and surpluses generated by public sector corporations. Generating revenue in this way affects people's welfare, albeit not as directly as taxation. For example, surpluses generated by public sector corporations reduce income, either of workers through lower wages or of consumers through higher prices. The gap between net taxes and NICs and current receipts shown in Figure 1 is the level of these other revenues in each year. These non-tax revenues were over 6% of national income in the late 1970s and early 1980s.

[1] The term 'tax burden' is not meant in a pejorative sense. Taxation in practice distorts people's behaviour in ways that generate economic costs, but voters may be happy to see the government take a higher share of national income in tax and other receipts if they derive greater utility from the spending it finances (despite the economic costs of the taxes used to fund it) than if taxes and spending were lower.

As a result of the privatisation of many public corporations, the operating surpluses of public corporations fell and so non-tax revenues have been declining since the early 1980s. Since 1996–97, non-tax revenues have been relatively stable, at between 1.8% and 2.4% of national income.

Current government receipts are the broadest measure of government revenues. Figure 1 shows that after a sharp rise from 34.6% of national income in 1955–56 to 44.2% in 1969–70 (in part to pay for the introduction of the welfare state), they have fluctuated between 35.7% and 45.9% of national income over the last 35 years. Since Labour came to power, current receipts have averaged 38.4% of national income, which is somewhat lower than the 40.6% average under the Conservatives between 1979 and 1997. However, the Treasury expects current receipts to rise to 39.3% of national income in the next financial year 2005–06 and to 40.6% by 2009–10. This would be their highest level since 1988–89.

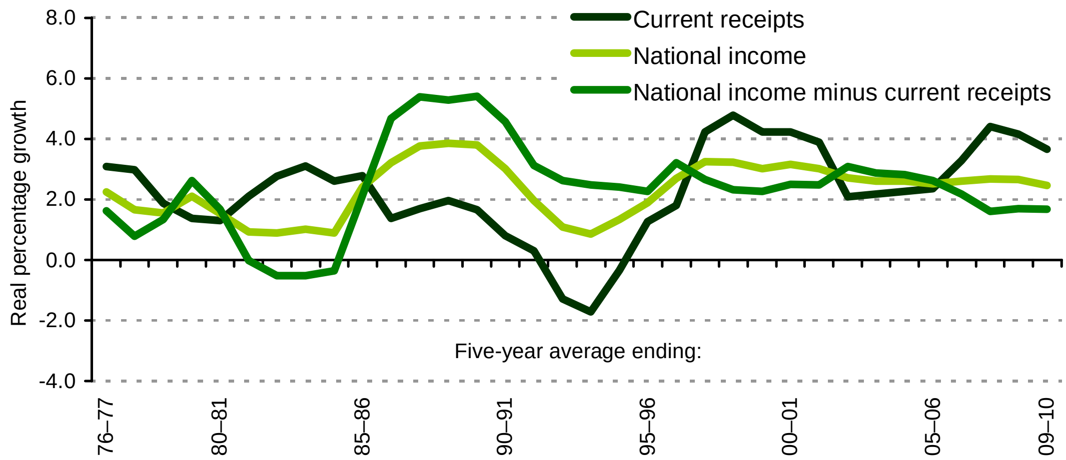
Increases in the tax burden mean that a lower proportion of national income is left in the hands of the private sector.[2] However, in the absence of policy changes, strong economic growth will lead to an increase in the tax burden so that a rising tax burden does not necessarily mean that taxpayers have less money left after tax. Therefore, it is also interesting to examine how growth in national income breaks down between growth in what the government takes in taxes (and other receipts) and growth in what the private sector has left. Since not all UK government revenue is paid by UK citizens and some UK citizens will have paid taxes to overseas governments, this is hard to do with precision. However, subtracting current receipts from national income will give a rough proxy. Figure 2 calls this measure 'national income minus current receipts'.

Average real increases in current receipts, national income and national income minus current receipts are shown in Figure 2 for every five-year period ending between 1976–77 and 2009–10, using Treasury forecasts for future years. When current receipts grow more quickly than national income, the share of national income taken in taxes increases; when current receipts grow less quickly than national income, current receipts as a share of national income fall. In general, national income after tax usually grows more quickly in real terms when the share of national income taken in tax is falling than when it is rising, but not always. The relationship between the change in national income after tax and the change in the share of national income taken in tax will depend on the reason for changes to the tax burden.

Figure 2 shows that national income has grown on a five-year average at between 0.9% and 3.9% a year between 1976–77 and 2004–05. However, growth in national income after tax has fluctuated much more – between –0.5% and 5.4% a year – over the same period. Table 1 shows how the relationship between national income and government revenue has varied across parliaments. National income and current receipts have both grown more quickly under Labour to date than they did under the previous Conservative governments. But national income after tax will have grown at exactly the same rate under Labour as it did under the Conservatives, at 2.4% a year on average.

[2] Although just under 30% of revenue collected by the government is returned to the private sector in the form of social security benefits and tax credits. See figure B.4 of HM Treasury, *Public Finances Databank*, London, March 2005 (http://www.hm-treasury.gov.uk./media/C62/B0/March05WEB.xls).

Figure 2. Growth in government revenues and national income



Note: Projections are from Budget 2005.
Sources: HM Treasury, *Public Finances Databank*, London, March 2005 (http://www.hm-treasury.gov.uk./media/C62/B0/March05WEB.xls); HM Treasury, *Budget 2005*, London, March 2005 (http://www.hm-treasury.gov.uk/budget/budget_05/budget_report/bud_bud05_report.cfm).

Table 1. Real growth in government revenues and national income by parliament

	Annualised average real increase (%) in:		
	Current receipts	**National income**	**National income minus current receipts**
Comparisons across parliaments			
Labour's two parliaments: 1996–97 to 2005–06	3.5	2.8	2.4
Of which:			
This parliament: 2000–01 to 2005–06	2.4	2.5	2.6
Last parliament: 1996–97 to 2000–01	5.0	3.2	2.2
Conservative years: 1978–79 to 1996–97	1.7	2.1	2.4
Of which:			
Major's period in office: 1990–91 to 1996–97	1.2	2.0	2.5
Thatcher's period in office: 1978–79 to 1990–91	1.9	2.2	2.4
Other periods of interest			
Current plans: 2005–06 to 2009–10	3.1	2.3	1.8
Labour's two parliaments + plans: 1996–97 to 2009–10	3.4	2.7	2.2
34-year period from 1970–71 to 2005–06	2.2	2.4	2.5

Note: Projections from Budget 2005.
Sources: HM Treasury, *Public Finances Databank*, London, March 2005 (http://www.hm-treasury.gov.uk./media/C62/B0/March05WEB.xls); HM Treasury, *Budget 2005*, London, March 2005 (http://www.hm-treasury.gov.uk/budget/budget_05/budget_report/bud_bud05_report.cfm).

On average over the Conservative period in office, current receipts grew less quickly than national income. As a result, current receipts fell from the 40.2% of national income that the Conservatives inherited in 1978–79 to 37.0% by the end of their period in office. Despite the fact that national income grew more slowly during Mr Major's term in office than during Mrs Thatcher's period in office, national income after tax grew faster under Major than under Thatcher. This is because growth in current receipts was lower in Major's premiership than in Thatcher's.

During Labour's first term in office, national income grew relatively fast, at 3.2% a year. However, because current receipts were growing even faster, at 5.0% a year, national income after tax grew more slowly in Labour's first term than it had on average under the Conservatives. However, continued strong growth in the economy at 2.5% a year in Labour's second term, coupled with slower growth of current receipts, has meant that national income after tax has grown faster in Labour's second term. The net effect of these changes has been that government receipts rose from 37.0% of national income in 1996–97 to 39.6% in 2000–01. However, assuming the Treasury's estimates are correct for 2004–05, government receipts will have fallen to 38.3% of national income by the end of 2004–05. This has been possible because rapid increases in government spending in Labour's second term have been paid for by increasing borrowing rather than increasing revenues.

In order to meet his spending plans and still meet his 'golden rule' over the next economic cycle, the Chancellor has acknowledged that the tax burden will need to increase sharply if Labour is re-elected. Treasury projections suggest that current receipts will be at a 20-year high of 40.6% of national income by 2009–10. This increase in the tax burden requires that current receipts grow by 3.1% a year, assuming Treasury forecasts for 2005–06 are correct. As the economy is expected to grow at only 2.3% a year between 2005–06 and 2009–10, this means that national income after tax will only be allowed to grow by 1.8% a year over the next four years. Figure 2 shows that national income after tax has not grown this slowly since the early 1980s, when the Conservatives increased taxes while the economy was in recession and employment was falling.

There are various reasons why the tax burden can change; it happens not necessarily as the result of discretionary policy changes. In particular, as the economy grows, more income becomes subject to higher rates of tax – in part due to income tax thresholds increasing automatically with prices while average earnings typically rise faster – a phenomenon known as fiscal drag. The composition of national income and movements in asset and commodity prices affect tax revenue, and the position of the economy in the economic cycle also plays a part. When economic activity is above its long-term sustainable level, receipts (in the absence of other changes) are high as a share of national income; when the economy is below trend, receipts are low. The Treasury estimates that, when national income rises by 1% above the level consistent with stable inflation, current receipts rise by about 0.2% of national income over two years.

In the short run, such factors are not under the government's control. However, in the medium run, the Chancellor could choose to offset changes in the tax burden due to fiscal drag or economic factors in order to keep the tax burden constant. For example, in recent times, the Chancellor has chosen to make discretionary reductions in fuel duties when higher oil prices have brought him more revenue from the North Sea. Therefore, over the medium term, all changes in revenues as a share of national income are effectively a policy choice of the government.

Table 2 explains the changes in government receipts over the two Labour governments. In Labour's first term, revenues increased by 1.6% of national income (corresponding to £19.8 billion by 2005–06). Of this, around two-thirds (£12.4 billion) was due to fiscal drag, while discretionary measures contributed £6.8 billion. Above-trend economic growth yielded £5.3 billion, while other factors reduced revenues by £4.6 billion. This decrease is partly due to the fact that the stock market had begun to fall by the end of the parliament.

Table 2. Contributions to changes in government revenue

Net increase in revenue	**Labour's 1st term**		**Labour's 2nd term**		**Labour to date**	
	% of national income	**Cash equivalent**	**% of national income**	**Cash equivalent**	**% of national income**	**Cash equivalent**
Announcements						
Conservative	0.7%	£9.1bn	0.0%	0.0	0.7%	£9.1bn
Labour 1st term	–0.2%	–£2.3bn	–0.0%	–£0.5bn	–0.2%	–£2.7bn
Labour 2nd term	n/a	n/a	1.0%	£12.8bn	1.0%	£12.7bn
All announcements	0.5%	£6.8bn	1.0%	£12.3bn	1.5%	£19.1bn
Fiscal drag	1.0%	£12.4bn	0.8%	£9.9bn	1.8%	£22.3bn
Economic cycle	0.4%	£5.3bn	–0.3%	–£3.8bn	0.1%	£1.6bn
Other factors	–0.4%	–£4.6bn	–0.8%	–£9.9bn	–1.2%	–£14.5bn
Total	**1.6%**	**£19.8bn**	**0.7%**	**£8.6bn**	**2.3%**	**£28.5bn**

Notes: Measures defined as taxation using National Accounts definitions. Hence only a proportion of the cost of the new tax credits is scored as a tax cut. The escalators on tobacco and fuel duty that were announced in the Spring 1993 Budget, and increased in the Autumn 1993 and Spring 1997 Budgets, are assumed to have been intended to run to 2001–02. The cost of abolishing these escalators is attributed to the Autumn 1999 Pre-Budget Report. For more details of classifications prior to January 2001, see table 3.1 of A. Dilnot, C. Emmerson and H. Simpson (eds), *The IFS Green Budget: January 2001*, Commentary no. 83, IFS, London, January 2001 (http://www.ifs.org.uk/budgets/gb2001/chap3.pdf).

Sources: Announcements from HM Treasury, *Financial Statement and Budget Report*, various years. Fiscal drag estimated using HM Treasury estimate of 0.2% a year from paragraph A.24 of HM Treasury, *End of Year Fiscal Report*, December 2003 (http://www.hm-treasury.gov.uk/media/324/70/end_of_year_352%5B1%5D.pdf). Impact of economic cycle estimated using figures in table A5 of HM Treasury, ibid.

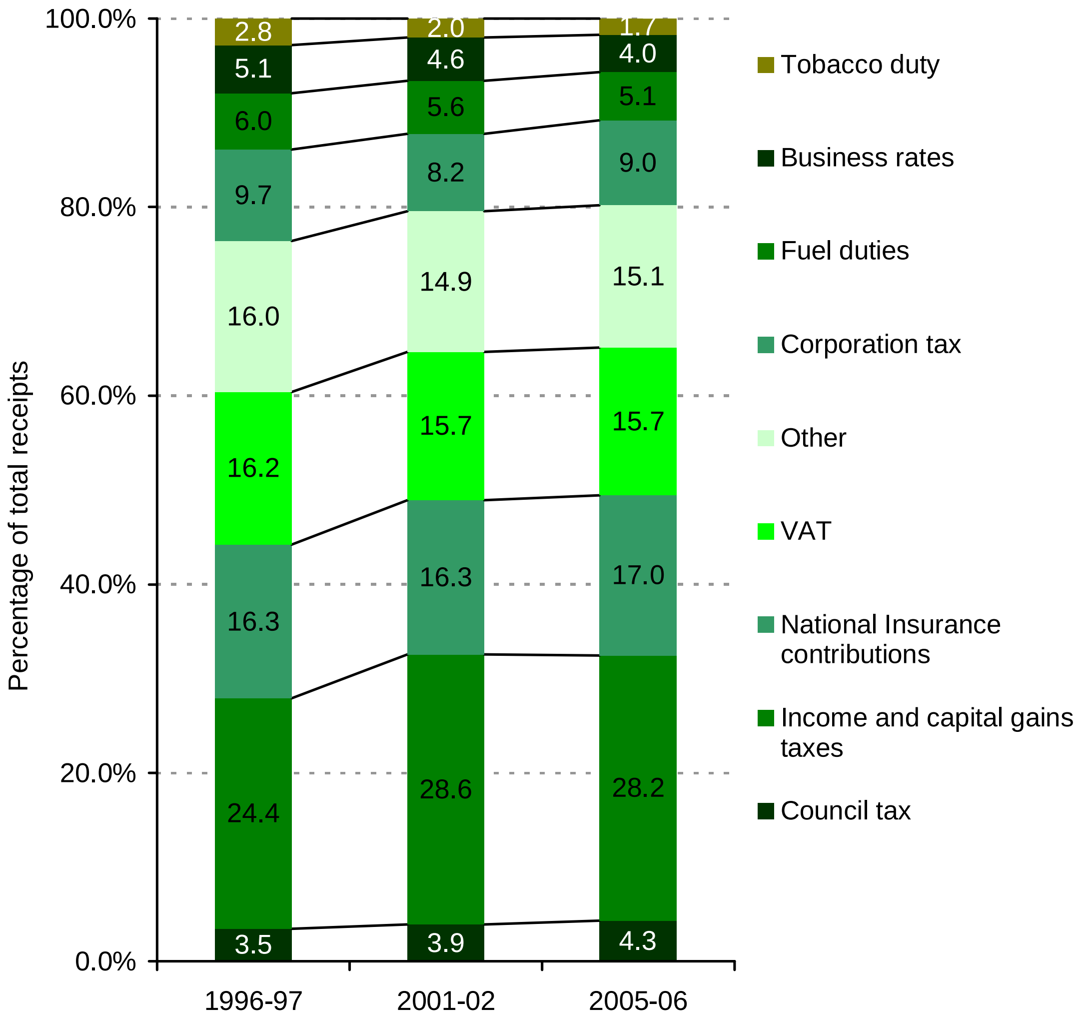
Of the discretionary measures, those announced in the previous parliament by the Conservatives but introduced by Labour increased revenues by £9.1 billion. These measures include the automatic duty escalators on tobacco and fuel. Measures announced and introduced by Labour in the first term had the effect of reducing revenues by £2.3 billion in that term and by a further £0.5 billion in the next term, resulting in a reduction in tax revenues over the two terms of £2.7 billion (this is not the same as adding the two parliaments' effects, due to rounding in the figures).

The total increase in revenues in the second term is expected to be more modest, at just £8.6 billion. The reliance on discretionary measures is stronger, with a £12.8 billion contribution from measures announced and implemented in the second term leading to an overall increase of £12.3 billion. The increase in revenues due to fiscal drag is offset by decreases due to 'other factors', while the slowdown in the economy has also led to lower revenues.

Over the two terms, Labour has had to rely on significant discretionary tax-raising measures to achieve growth in current receipts of £28.5 billion, or 2.3 percentage points of national income. As Table 1 showed, this has been at a time when the economy was growing at 2.8% a year. However, as Table 1 also showed, the government expects to achieve almost-as-high growth in current receipts over the next four years, of 3.1% a year, at a time when the economy is expected to grow less quickly, at only 2.3% a year.

Figure 3 shows how the composition of government receipts has changed, and is expected to change, in the two Labour parliaments. In the first parliament, the biggest absolute change was the proportion of government revenues coming from income and capital gains taxes, which rose from 24.4% to 28.6%. Relative to the proportion of revenue received in 1996–97, however, the largest change was the proportion of revenue from tobacco duties, which fell from 2.8% of total revenues to 2.0%. This decrease occurred despite increases in duty rates, and it continued into the next parliament. The same effect can be seen in fuel duties, where, despite increases in duties, the share of revenue attributable to them fell.

Figure 3. Composition of UK public sector receipts



Sources: ONS series from Financial Statistics Freestanding (http://www.statistics.gov.uk/statbase/tsdintro.asp); HM Treasury, *Public Finances Databank*, London, March 2005 (http://www.hm-treasury.gov.uk./media/C62/B0/March05WEB.xls); HM Treasury, *Budget 2005*, London, March 2005 (http://www.hm-treasury.gov.uk/budget/budget_05/budget_report/bud_bud05_report.cfm).

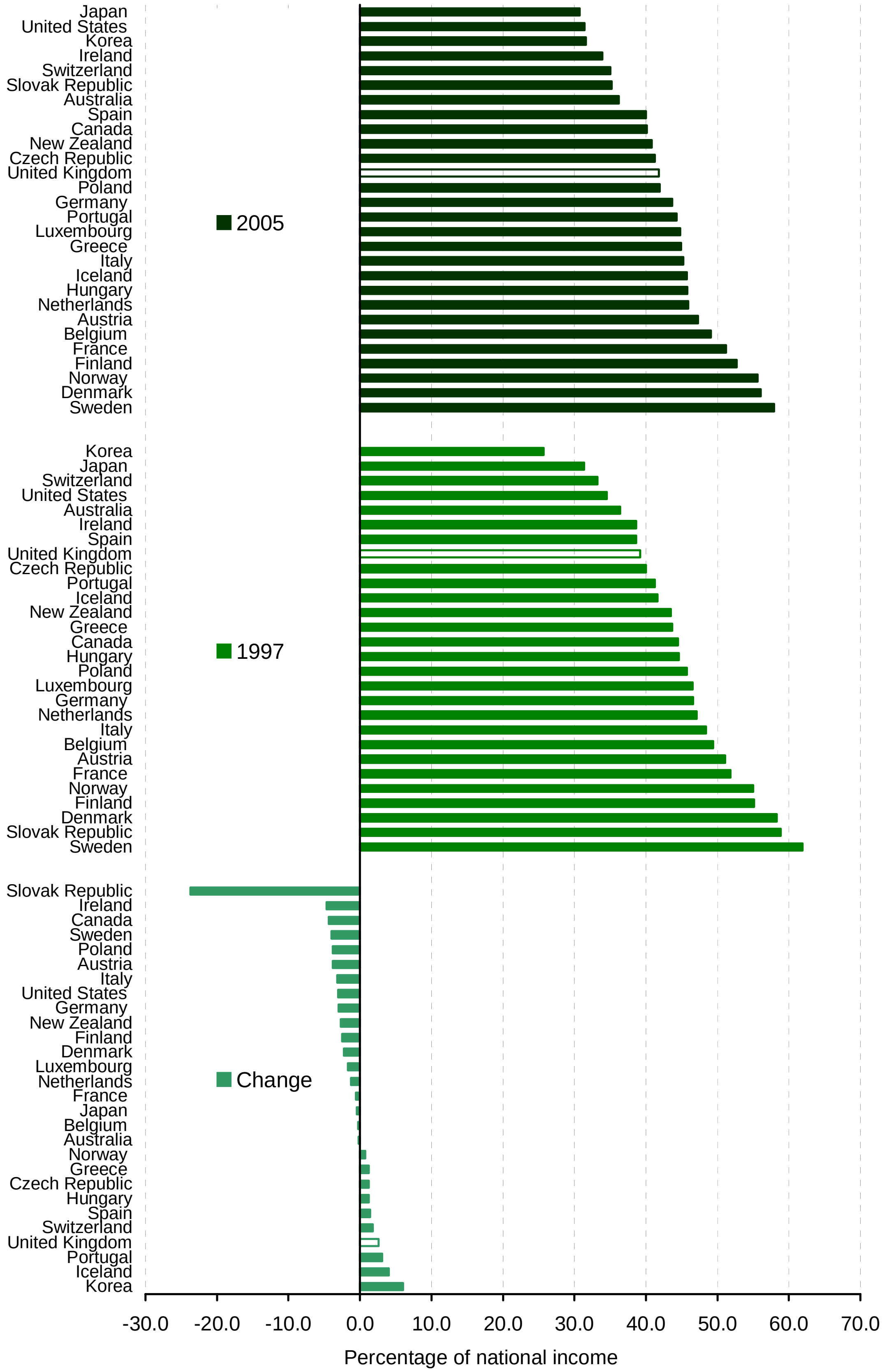
Apart from income and capital gains taxes, the only other tax in Figure 3 to increase its share in government revenues is council tax, which rose from 3.5% to 3.9% of total revenues. Although all other categories of receipts fell as a share of total revenues, this does not necessarily mean that actual receipts fell. In the case of VAT and National Insurance contributions, there was an increase in the share of national income taken in those taxes; it was not, however, large enough to make up for the overall increase in tax revenues, which was largely due to income and capital gains taxes.

The share of revenues derived from different taxes will depend, in part, on the growth of the economy and its composition. Strong growth in the first parliament followed by more modest growth in the second is in part responsible for the increase and subsequent fall in the share of revenues due to income and capital gains taxes. Over the four-year parliament ending in 2005–06, the biggest relative change in revenues is the decline in the share coming from tobacco taxes, followed by the increase in council tax. In 1996–97, 3.5% of revenues came from council tax, and this is set to rise to 4.3% next year. The share from NICs is forecast to be higher, while other taxes will see their share drop. It is worth noting the decrease in corporation tax revenues, which fell from 9.7% in 1996–97 to 8.2% in 2001–02 (and have continued to fall, reaching 7.6% in 2004–05) – in part due to the main rate of corporation tax being cut by 3p to 30p in the first parliament. The Treasury expects a large part of this decrease to be made up between 2004–05 and 2005–06, with corporation tax yielding 9.0% of government revenues in 2005–06. Overall, the picture shows a shift away from consumption taxes and company taxes, towards greater reliance on income- and earnings-based taxation and council tax – although, as mentioned earlier, part of the reason for this is the composition of national income in particular years.

2.2 How the UK compares internationally

Figure 4 shows general government current tax and non-tax receipts across a number of industrialised countries, for 1997 and 2005. (This is the closest internationally comparable version of current receipts in the UK context.) It should be borne in mind, when making international comparisons, that differences in the tax burden over the longer term will reflect differences in the range and cost of public services provided, and in the generosity of transfer payments such as pensions and social security benefits. Figure 4 shows that in 1997, the UK had the 8th lowest tax burden out of the 28 countries featured in the graph, and the 3rd lowest among the EU countries shown. The increase in government revenues that we have seen since then means that the UK is now the 12th lowest-taxing economy, and the 5th lowest among the EU countries featured. The UK's move towards the middle of the tax league table reflects the fact that it has had the 4th largest increase in tax burden among the countries we look at. In addition, the majority of industrial countries have reduced their tax burdens over this period – although the UK would still be in the same position in the league table if they had not.

Figure 4. General government current tax and non-tax receipts



Source: Annex table 26, OECD Economic Outlook 76 database, December 2004 (http://www.oecd.org/document/61/0,2340,en_2825_32066506_2483901_1_1_1_1,00.html).

3. Tax policy under Labour

This section looks in more detail at the tax-changing measures introduced under Labour. Back in 1997, the Labour Party election manifesto promised that there would be no increase in income tax rates over the parliament, that there would be a long-term objective of a starting rate of income tax of 10 pence and that VAT on fuel would be cut to 5%.

During the first term, the biggest tax-raising measures came from the abolition of dividend tax credits for pension funds, the restriction and subsequent abolition of the married couple's allowance, and increases in fuel and tobacco duties. In contrast, tax reductions were mainly from cuts to employees' National Insurance contributions, the introduction of the 10p rate and the 1p cut in the base rate of income tax. The net effect, as shown in Table 2, was to provide a tax cut, albeit heavily outweighed by the decision to maintain the Conservative fuel and tobacco duty escalators.

In its 2001 election manifesto, the Labour Party pledged to not raise the basic or higher rate of income tax and to extend the 10p band, to maintain the £7,000 Individual Savings Account (ISA) contribution limit, and not to introduce VAT on food, children's clothes, books, newspapers and public transport. In the second parliament, the main tax-raising measure has been the increase in employers' and employees' National Insurance rates by 1p each for all income above the lower earnings threshold. While there was no increase in income tax rates, the change in National Insurance rates has very similar effects to an increase in the income tax rates. The ISA contribution limit was maintained and VAT was not introduced in the areas Labour pledged to keep exempt. However, the 10p band was not extended by more than statutory indexation.

Table 3 sets out the increases in tax revenues due to discretionary measures for the last three parliaments. In the 1992–97 parliament, discretionary measures increased tax revenues by an amount equivalent to £22.1 billion in 2005–06.[3] Measures announced prior to the 1992 election (but taking effect after it) led to a cut in revenues, but the two Budgets after the election included large tax-raising measures. While some of these increases were offset by cuts in 1994 and 1995, the overall effect of announcements during the last Conservative parliament was to increase taxes by £33.3 billion.

As already shown in Table 2, the effect of measures announced in the first Labour term has been to reduce revenues by £2.3 billion in that term and by a further £0.5 billion in the second term. However, as Table 3 shows, the timing of the announcements has been such that it wasn't until the Spring 2001 Budget that tax cuts completely offset the tax-raising measures contained in the first two Labour Budgets. So for the greater part of the last parliament, the effect of Budget measures was to increase Treasury revenues.

[3] In order to allow comparability across parliaments and years, all discretionary measures' costings have been uprated with nominal GDP to 2005–06. The costings given therefore represent approximately how much the measure would yield/cost the Treasury if it were introduced in an economy of the size that it will be in 2005–06.

Table 3. Change in government revenues over various parliaments resulting from Budget announcements

£ billion, 2005–06	**Conservatives' last parliament impact in 1996–97**	**Labour's first parliament impact in 2001–02**	**Labour's second parliament impact in 2005–06**
Conservative Budgets since the 1987 election:			
Conservative Budgets from 1987–92 parliament [a]	**–2.2**	**n/a**	**n/a**
Conservative Budgets after the 1992 election:			
Spring 1993 Budget	21.0	n/a	n/a
Autumn 1993 Budget	9.8	n/a	n/a
Autumn 1994 Budget	–1.1	0.5	n/a
Autumn 1995 Budget	–5.3	–1.6	n/a
Autumn 1996 Budget	n/a	10.2	n/a
Conservative Budgets from 1992–97 parliament	**24.3**	**9.0**	**n/a**
Labour Budgets after the 1997 election:			
Summer 1997 Budget	n/a	6.6	0.0
Spring 1998 Budget	n/a	4.6	0.0
Spring 1999 Budget	n/a	–3.1	0.0
Autumn 1999 Pre-Budget Report	n/a	–4.9	–0.2
Spring 2000 Budget	n/a	–0.8	0.2
Autumn 2000 Pre-Budget Report	n/a	–0.7	–0.3
Spring 2001 Budget	n/a	–4.0	–0.2
Labour Budgets during first parliament	**n/a**	**–2.3**	**–0.5**
Labour Budgets after the 2001 election:			
Autumn 2001 Pre-Budget Report	n/a	n/a	–0.0
Spring 2002 Budget	n/a	n/a	9.9
Autumn 2002 Pre-Budget Report	n/a	n/a	0.8
Spring 2003 Budget	n/a	n/a	0.6
Autumn 2003 Pre-Budget Report	n/a	n/a	–0.0
Spring 2004 Budget	n/a	n/a	0.4
Autumn 2004 Pre-Budget Report	n/a	n/a	0.1
Spring 2005 Budget	n/a	n/a	1.2
Labour Budgets during second parliament	**n/a**	**n/a**	**12.8**
Total effect of Budget changes on revenues over parliament	**22.1**	**6.8**	**12.3**
Average change in revenues over parliament	*–38.5*	*25.8*	*–8.4*
Actual change in revenues over parliament	*–20.1*	*19.8*	*8.6*

[a] The measures having an impact after the 1992 election come from the Spring 1991 and Spring 1992 Budgets.

Notes: See Table 2.

Sources: HM Treasury, *Financial Statement and Budget Report*, various years.

In line with the announcements in the first Labour parliament, the tax increases seen in the second Labour parliament also occurred in the early days, with the first post-election Budget, in Spring 2002, raising the equivalent of £9.9 billion, mainly through increases to National Insurance rates. Since then, there has been little change due to discretionary measures, and a significant part of the small increases that have occurred have been anti-avoidance measures.

Figure 5 presents the numbers from Table 3 graphically. Starting with the small increases in the Spring 1991 Budget, it shows the cumulative effect on revenues from announcements made in each Budget, irrespective of whether the measures will be in place in the current or later parliaments. It clearly shows that there were tax-cutting measures just before the 1992 and 2001 elections, although it shows the 1997 election as following a tax-raising Budget (although all the increases were only set to be introduced after the election). It is also clear that during the first Labour parliament, just before the election of 2001 was the point at which the effect of measures was to lead to tax revenues falling below the level inherited from the Conservatives. All of the last three elections have been followed shortly by tax increases which have not been pre-announced by the winning party.

Figure 5. The impact and timing of revenue-changing policy measures