

## 5. Risks to the rules: tax revenues

Rowena Crawford, Carl Emmerson, Thomas Pope and Gemma Tetlow (IFS)

### Summary

- The government's plan to reach a fiscal surplus is predicated on tax receipts increasing by 1.1% of national income (£21 billion per year in today's terms) between 2015–16 and 2019–20.
- Lower- (higher-)than-expected growth would hit (boost) cash tax receipts and, since cash spending is unlikely to be affected to the same degree, this would feed through into higher (lower) borrowing. Changes in average earnings levels of just 1% can change income tax and National Insurance revenues by around £5 billion.
- Capital taxes are dependent on the prices of, or transactions in, particular assets, which can be very volatile even if the economy grows as forecast. For example, the Office for Budget Responsibility (OBR) downgraded its underlying forecast for receipts from stamp duty on residential properties in 2020–21 by one-sixth between July and November 2015.
- Between the November 2015 Autumn Statement and the end of January 2016, equity prices fell by 7½%. If they were to remain 7½% below the OBR's latest forecast, this could reduce capital tax receipts in 2020–21 by around £2 billion.
- Revenues from North Sea oil and gas production are currently £12 billion below their 2008–09 level, largely as a result of lower oil prices. The overall impact of a decline in oil prices, though, is to strengthen the public finances slightly, as a fall in the price of oil boosts economic activity and hence other tax receipts.
- One particular risk to tax receipts is future policy change. The government has commitments to increase the income tax personal allowance and the higher-rate threshold by the end of the parliament, at an estimated cost of £8 billion per year. All else equal, government will presumably need to find tax increases, or additional spending cuts, of a similar scale elsewhere to fund these tax cuts.
- With no increase in the £150,000 threshold at which the additional rate of income tax kicks in, numbers affected have already risen by 40% since it was introduced in 2010. Current policy also fixes the £50,000 point at which child benefit starts to be taxed away in nominal terms. The number losing child benefit might rise by 50% within five years. This may prove sustainable but is not a good way of making policy.
- History suggests the government might not increase fuel duties in line with RPI inflation as is assumed in the OBR's forecasts – since 2011, all increases that had been pencilled in have been cancelled. Freezing fuel duties for a further five years would cost around £3 billion per year by 2020–21.
- The government might raise revenue through changes to the pensions tax regime. However, it will need to be careful to distinguish between what is genuinely a permanent increase in revenues and what is only a temporary windfall. Relying on temporary revenues to achieve a budget surplus in 2019–20 would not be in keeping with the rationale underpinning the Chancellor's stated fiscal objectives.

## 5.1 Introduction

George Osborne has an ambitious target to eliminate the budget deficit by 2019–20 and then to continue to run budget surpluses thereafter. As Chapter 3 discussed, this forms one of the three fiscal rules he has set himself. The latest official forecasts from the Office for Budget Responsibility suggest that he is on course to achieve this. However, there are many risks facing the public finances, which could knock the current plans off course.

How the UK economy grows over the next few years will be crucial for determining how tax revenues, spending and borrowing evolve. The Office for Budget Responsibility (OBR) estimates that the economy will grow by 2.4% in 2016, 2.5% in 2017 and 2.4% in 2018, before returning to 2.3% in 2019 and 2020. It is on the basis of this forecast for economic growth that the OBR forecasts that borrowing will fall from 3.9% of national income this year to a surplus of 0.5% of national income in 2019–20. However, if growth were to turn out significantly stronger (weaker) than this, borrowing is likely to be lower (higher) than currently forecast.

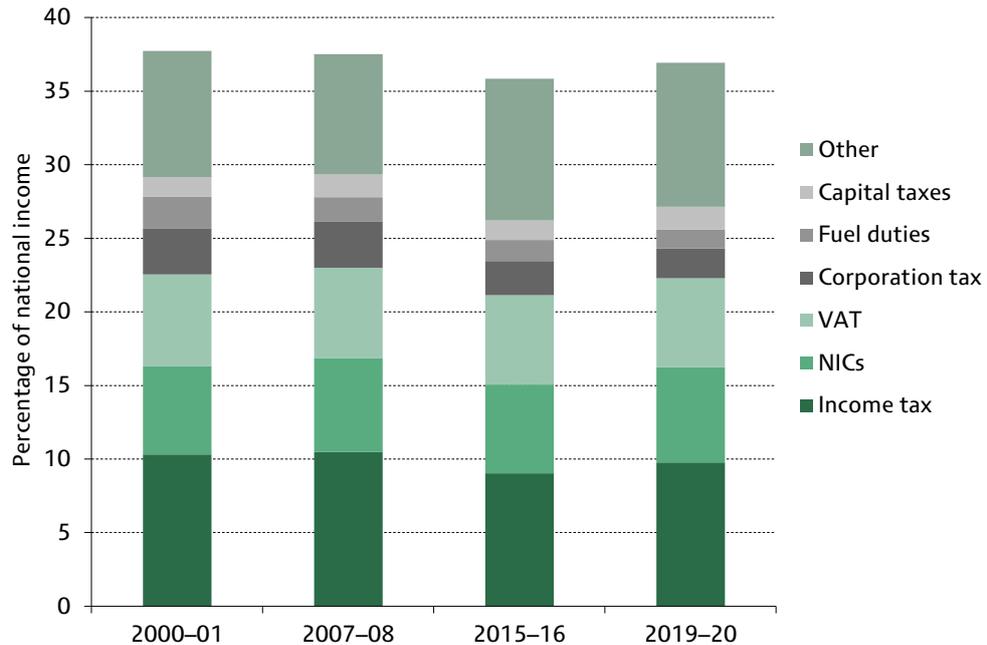
One risk on the downside for the UK would be the sort of scenario described by Oxford Economics in Chapter 2, in which the Federal Reserve increases interest rates more quickly than the market currently expects, dampening economic growth in the UK in 2016 and 2017 but with growth rebounding thereafter. If this were to happen, by 2019–20 the UK economy might be 0.7% smaller than it is currently expected to be by the OBR. A simple rule-of-thumb estimate suggests that a loss of output of this magnitude would result in borrowing being 0.5% of national income higher in 2019–20 than the latest OBR forecast suggests – i.e. a budget balance rather than a surplus of 0.5% of national income. This increased deficit would result from tax revenues being lower and spending higher than forecast as a share of national income. As a share of national income, tax revenues would be slightly reduced (as the progressive nature of the tax system means that, in cash terms, taxes tend to grow slightly more quickly than the economy does), while public spending would rise, as (largely) fixed cash plans for spending on public services would amount to a larger share of the smaller-than-expected national income.

Of course, there are also potential upside risks. If, instead, growth were to be higher than the OBR currently expects, the budget surplus could be larger in 2019–20. This improvement would in part be due to revenues being slightly increased as a share of national income but would mainly be due to public spending being pushed down as a share of the (larger-than-expected) national income.

Between 2015–16 and 2019–20, revenues are forecast to increase by 1.1% of national income (£21 billion in today's terms) from 35.8% to 36.9% of national income (as shown in Figure 5.1). This would still leave them below the level seen just prior to the financial crisis (in 2007–08 they were at 37.5% of national income) and below the level seen in 2000–01 when the UK last ran an overall budget surplus (when receipts were 37.7% of national income). In other words, the government is aiming to achieve an overall budget surplus in 2019–20 with a level of tax receipts that is not particularly high by recent UK standards.

Of the taxes decomposed in Figure 5.1, the largest growth in receipts as a share of national income between 2015–16 and 2019–20 is expected to be in income tax receipts – an increase of 0.7% of national income – though these are still forecast to remain below the level they were at in 2007–08 and 2000–01. Receipts of National Insurance contributions (NICs) are forecast to grow by 0.5% of national income, which would be

Figure 5.1. Revenues as a share of national income, selected years



Source: Figures for 2015–16 and 2019–20 are from table 4.6 of OBR, *Economic and Fiscal Outlook*, November 2015. Figures for 2000–01 and 2007–08 are from table PSA6D of ONS, *Public Sector Finances*, November 2015. GDP from the OBR databank, <http://budgetresponsibility.org.uk/data/>.

sufficient to push them above the level seen in 2007–08 and 2000–01. Receipts of capital taxes, which are currently running about the same level as in 2000–01, are forecast to increase by 0.2% of national income, returning them to the level seen on the eve of the financial crisis in 2007–08. In contrast, receipts of VAT, corporation tax and fuel duties are forecast to fall as a share of national income, and to be below the level seen in both 2007–08 and 2000–01.

In addition to general uncertainty about how the economy as a whole (and thus overall revenues, spending and borrowing) will grow over the next few years, there are specific risks facing some components of revenues. In this chapter, we set out some of the key risks and uncertainties to revenues that the government faces (and in some cases has created) that could affect whether or not the Chancellor does succeed in running budget surpluses from 2019–20 onwards. Chapter 6 does the same for risks facing public spending.

Section 5.2 focuses on risks to underlying tax revenues. Specifically, this looks at the risk that some parts of the economy might not evolve as is currently expected. In particular, we look at employment and earnings, VAT receipts, corporate profits, stamp duty land tax on purchases of residential properties, equity prices, and North Sea oil and gas prices. Section 5.3 looks at risks from future policy changes, specifically highlighting areas where politicians may not (and, in some cases, are likely not to) adhere to currently legislated policy plans. Section 5.4 draws some conclusions.

## 5.2 Uncertainty in revenue forecasts

### Outlook for employment and earnings

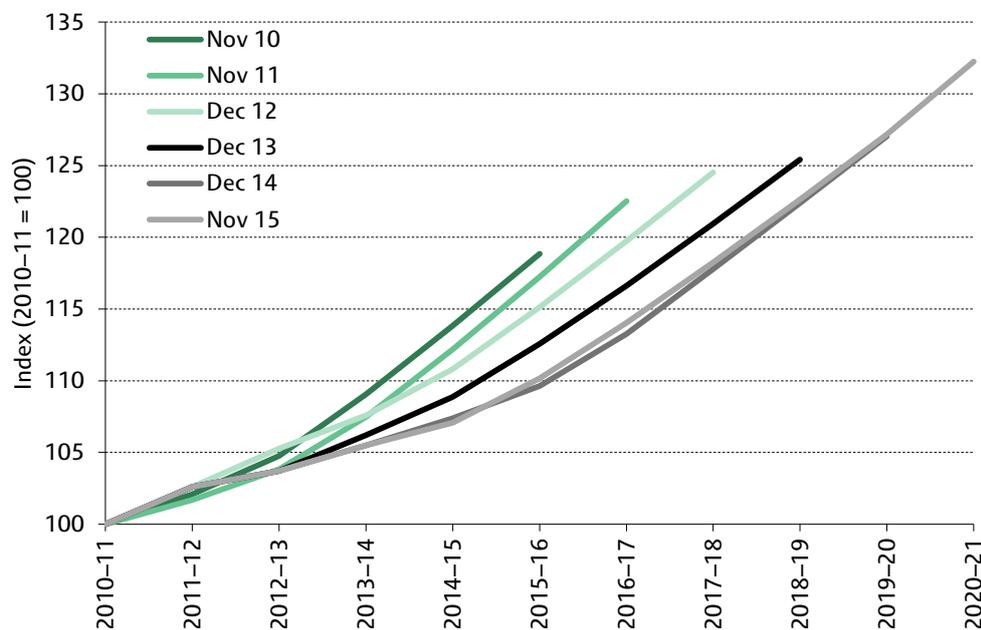
As we discussed in last year's Green Budget, one factor that drove large revisions to forecasts for revenues published between 2012 and 2014 was changes to expectations of future earnings and employment growth.<sup>1</sup> These economic factors significantly determine receipts from the two largest taxes – income tax and National Insurance contributions. Income tax receipts are forecast to be £171.8 billion in 2015–16, of which £147.2 billion is expected to come through pay-as-you-earn, while NICs receipts are expected to total £114.6 billion.

Figure 5.2 compares successive forecasts for growth in average earnings, while Figure 5.3 compares forecasts for growth in employment. Between November 2010 and December 2014, forecasts for average earnings growth were repeatedly downgraded, while forecasts for employment growth were repeatedly revised up.

While the November 2015 forecast saw a break in this pattern, with forecasts for growth in average earnings and employment being very similar to what had been forecast a year earlier, recent experience should teach us that forecasts can surprise on the upside or the downside, with consequent significant effects for receipts of income tax and NICs.

The OBR's ready reckoner for the effect of average earnings on income tax and NICs revenues suggests that a 1% increase in average earnings would boost annual receipts from these taxes by around £4¼ billion to £5¼ billion (or 1½% of the tax base<sup>2</sup>). If the

Figure 5.2. Changing forecasts for growth in average earnings

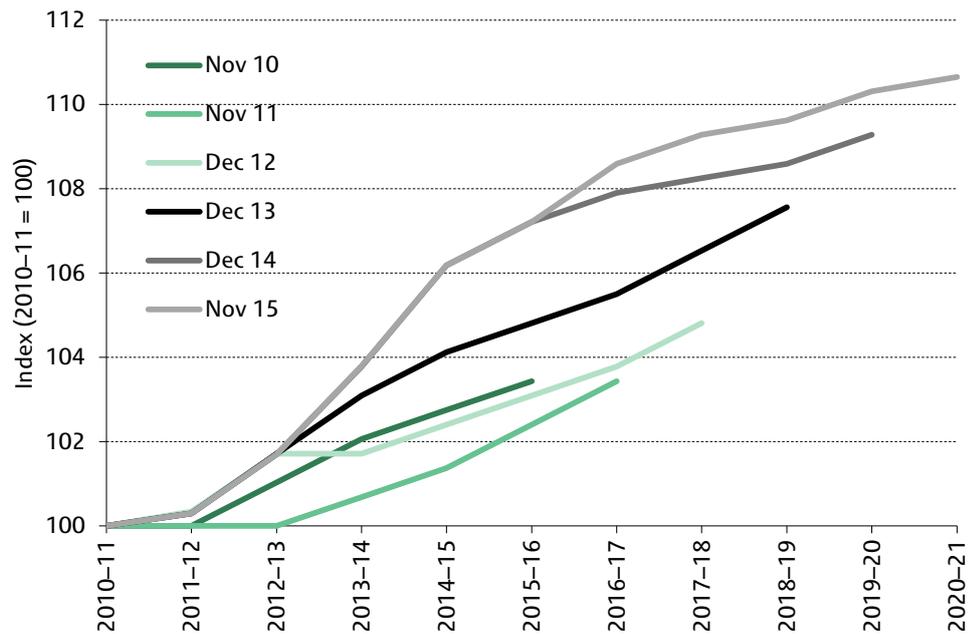


Source: Authors' calculations using OBR, *Economic and Fiscal Outlook*, various editions.

<sup>1</sup> See R. Crawford, C. Emmerson and G. Tetlow, 'Public finances: a dicey decade ahead?', in C. Emmerson, P. Johnson and R. Joyce (eds), *The IFS Green Budget: February 2015*, <http://www.ifs.org.uk/publications/7530>.

<sup>2</sup> See Office for Budget Responsibility, 'How we present uncertainty', Briefing Paper No. 4, June 2012, <http://budgetresponsibility.org.uk/wordpress/docs/Briefing-paper-No4-How-we-present-uncertainty.pdf>.

Figure 5.3. Changing forecasts for growth in employment



Source: Authors' calculations using OBR, *Economic and Fiscal Outlook*, various editions.

latest OBR forecast for earnings growth in 2015–16 proves correct, earnings this year will be 7% lower than they were forecast to be in the November 2010 forecast. If the latest OBR forecast for 2020–21 contains an error of the same magnitude, tax revenues in that year could turn out to be as much as £40 billion lower or higher (in nominal terms) than they are currently forecast to be.

The OBR's ready reckoner for the effect of employment growth on income tax and NICs revenues suggests that a 1% increase in employment would boost receipts from these taxes by around £2½ billion to £3½ billion (or 1% of the tax base). If the latest OBR forecast for employment growth in 2015–16 proves correct, employment this year will be 10% higher than forecast in the November 2010 forecast. If the latest OBR forecast for 2020–21 contains an error of the same magnitude, tax revenues in that year could turn out to be around £35 billion lower or higher than they are currently forecast to be.

## Forecasting VAT

Currently, the second-largest revenue stream is VAT: revenues from VAT in 2015–16 are forecast by the OBR to total £115.6 billion, very slightly more than forecast receipts of NICs, meaning that (for now) it is the second-largest UK tax. Revenues from VAT are sensitive to growth in consumer spending.

The November 2015 *Economic and Fiscal Outlook* (EFO) introduced a significant change to the way that the OBR forecasts VAT revenues, which had the effect of boosting forecast VAT revenues by £3.3 billion a year by the end of the forecast horizon. This is equal to 2.3% of forecast VAT revenues in 2020–21. Though this modelling change had been flagged by the OBR in its October 2015 Forecast Evaluation Report,<sup>3</sup> the publication of the

<sup>3</sup> See paragraph 3.21 of OBR, *Forecast Evaluation Report: October 2015*, <http://budgetresponsibility.org.uk/forecast-evaluation-report-october-2015/>.

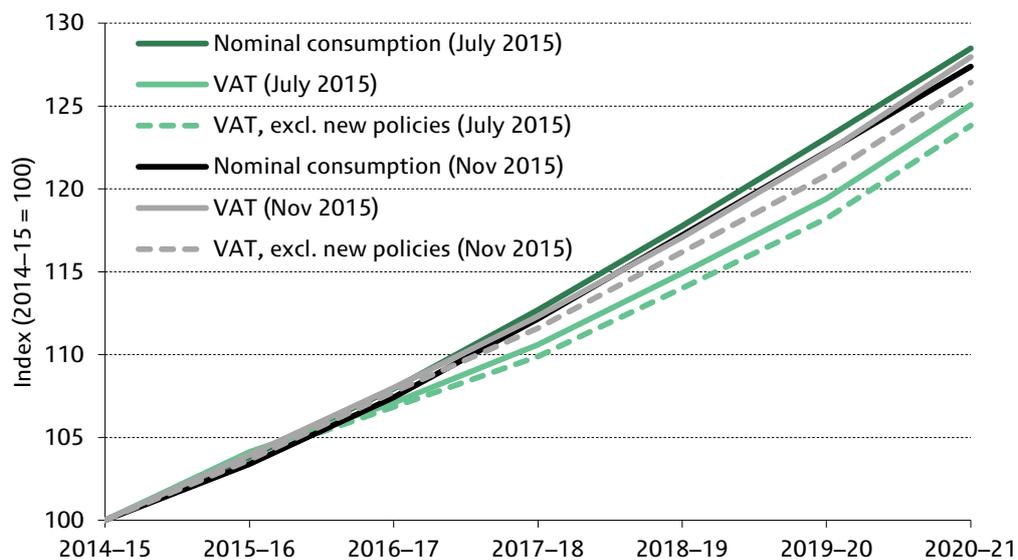
new figures in the EFO caused a lot of debate and drew ridicule from some quarters for being such a large (and, apparently, politically convenient) change.<sup>4</sup>

The reason that the OBR gave for the change was that its model had previously been overestimating future VAT deductions on spending by government (and thus underestimating net VAT revenues). Specifically, the OBR model had previously projected VAT deductions on the basis of a continuation of past trends. However, because of cuts to spending on public services, deductions claimed by government have not been growing nearly so quickly. The OBR's new model therefore assumes that these deductions will grow at the same rate as government spending, rather than in line with past trends.

This change is significant and begs the question of whether the new forecasts are reasonable. Since businesses and the public sector are able to reclaim VAT on any intermediate inputs to production, the main driver of growth in net VAT revenues is growth in consumer spending (and what fraction of that spending is on goods that are subject to VAT).<sup>5</sup> Therefore, one way to assess the forecasts for VAT revenues is to compare forecast growth in VAT revenues with forecast growth in consumer spending. This is done in Figure 5.4.

The most recent forecasts from the OBR suggest that VAT revenues (solid grey line in Figure 5.4) will grow at almost exactly the same pace as consumer spending (black line) between 2014–15 and 2019–20 but then grow somewhat more strongly in 2020–21. However, if we strip out the effect of new policies that are to be implemented over the

Figure 5.4. Comparing forecasted growth in consumer spending and VAT receipts



Source: Authors' calculations based on data from OBR, *Economic and Fiscal Outlook*, July 2015 and November 2015.

<sup>4</sup> See, for example, C. Giles, 'Autumn Statement: how do Osborne's sums add up?', *Financial Times*, 25 November 2015, <http://www.ft.com/cms/s/0/e65dd262-9384-11e5-b190-291e94b77c8f.html?siteedition=uk#axzz3wYVW3jWpA>.

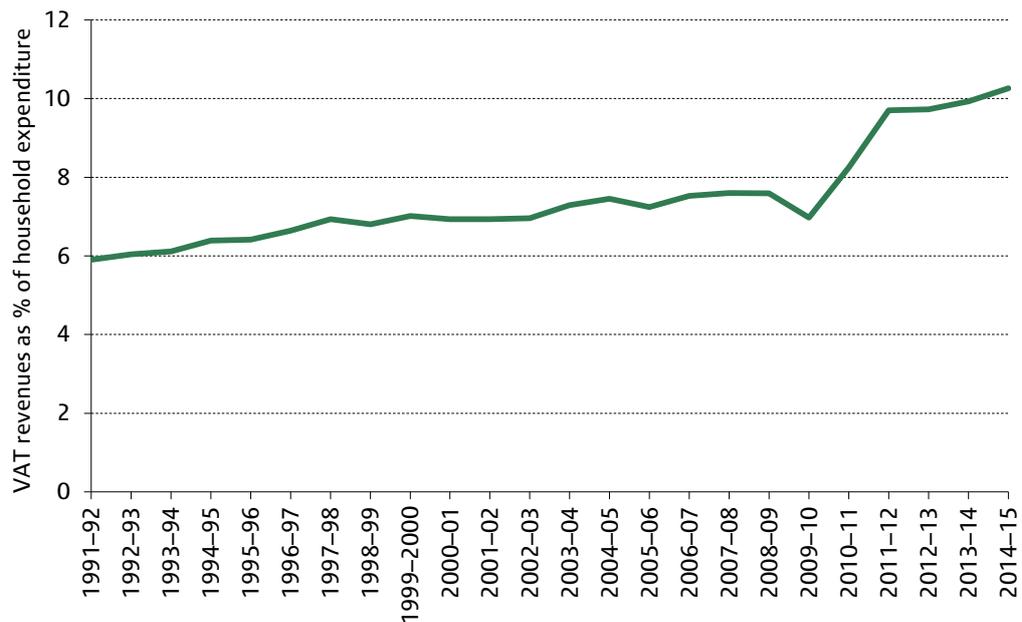
<sup>5</sup> IFS's public finance forecasting model, which was used to produce forecasts in each Green Budget up to 2013, was based on the assumption that VAT revenues grew in line with nominal consumer spending. For a more detailed explanation of the IFS forecasting model, see C. Giles and J. Hall, 'Forecasting the PSBR outside government: the IFS perspective', *Fiscal Studies*, 1998, 19, 83–100.

next few years, underlying growth in VAT revenues (dotted grey line) is projected to be a little lower than growth in consumer spending.<sup>6</sup>

In contrast, the earlier forecasts produced by the OBR (as shown, for example, by the comparison of figures from the July 2015 Budget in Figure 5.4) suggested that net VAT revenues would grow substantially less quickly than consumer spending over the next five years. This comparison suggests that the OBR's latest forecasts do not look unduly optimistic. If anything, the earlier forecast looks rather pessimistic – in a way that is consistent with the OBR's narrative.

The above line of argument relies on the assumption that VAT receipts are likely to grow at least in line with consumer spending. Figure 5.5 suggests that this has been the case over the last two decades, as VAT revenues as a share of household expenditure have grown.<sup>7</sup> In fact, VAT revenues have grown more quickly than household spending on average. The drop between 2008–09 and 2009–10 is due to the temporary reduction in the main rate of VAT from 17.5% to 15% that lasted for 13 months from the start of December 2008. The increase between 2009–10 and 2010–11 is the result of this cut being reversed (as planned) and then the permanent rise in the main rate of VAT from 17.5% to 20% that took place in January 2011. The more general drift upwards over time will be driven at least in part by a greater share of expenditure being devoted to goods that are subject to VAT over time as incomes have risen.

Figure 5.5. VAT receipts as a share of household expenditure over time



Source: Authors' calculations based on data from HM Revenue & Customs and the Office for National Statistics (series ABJR).

<sup>6</sup> The main changes that are to be made to VAT policy over the next few years are anti-avoidance measures announced in the July 2015 Budget (including measures to improve compliance and tackle the hidden economy). Together, the new measures coming in over the next few years are expected to raise £1.5 billion a year by 2020–21.

<sup>7</sup> Prior to this, during the early 1990s, there was concern that VAT receipts were underperforming relative to consumer spending, as discussed in HM Treasury (1997). However, this divergence appears to have ceased around 1995–96, as described in HM Customs & Excise (2002). (HM Treasury, *The VAT Shortfall: Report of the Working Group on VAT Receipts and Forecasts*, Treasury Occasional Paper 9, 1997; HM Customs & Excise, 'Measuring indirect tax losses', 2002.)

This analysis suggests that, rather than the pressure being on the OBR to justify the validity of its new forecasts, the onus perhaps ought to be on those thinking that the latest forecast is unduly optimistic to explain whether this is because they expect consumer spending to grow less quickly than the OBR, or whether they think VAT revenues will grow substantially less quickly than nominal consumer spending (and, in either case, to explain why).

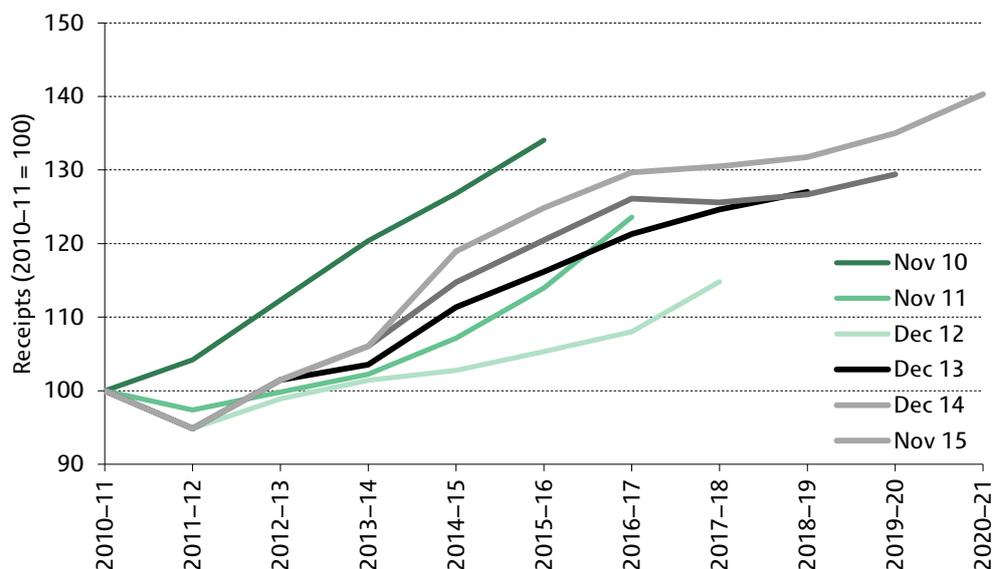
The OBR may now have a better model for producing central forecasts of future VAT receipts than it previously had (as opposed to one that appears to have been biased downwards). However, there is still uncertainty about how much revenue will be raised from this tax because consumer spending could grow faster or slower than the latest OBR forecast suggests. The latest OBR forecast suggests that between 2015–16 and 2020–21 nominal consumer spending will grow by 23%. The OBR’s ready reckoner suggests that a 1% increase (fall) in nominal consumer spending will increase (reduce) VAT revenues by around £¾ billion (or around 0.1% of total revenues).

### Risks to corporate profits and corporation tax revenues

Onshore corporation tax receipts are the fourth-largest source of tax revenues (bringing in an expected £43.4 billion in 2015–16) but they are volatile and extremely responsive to economic conditions. Onshore receipts fell from a peak of £41.3 billion in 2007–08 to a low of £31.6 billion in 2009–10, caused by a large decrease in corporate profits as a result of the financial crisis and associated recession.

Figure 5.6 shows the last six Autumn Statement forecasts for onshore corporation tax revenues after stripping out the direct impact of policy changes. The large spread reflects the uncertainty and sensitivity of this revenue stream. In November 2010, revenues were expected to be £48 billion in 2015–16. In November 2011, just a year later, after stripping

Figure 5.6. Changing forecasts for growth in onshore corporation tax, accounting for policy change



Note: Calculated as forecast from the OBR’s *Economic and Fiscal Outlook* minus the aggregate effect of policy changes announced from Budget 2011 to the date of forecast, based on initial costing.

Source: OBR, *Economic and Fiscal Outlook*, November 2010 to November 2015; OBR policy measures database, [http://budgetresponsibility.org.uk/pubs/Measures\\_database\\_BUD15-FINAL.xlsx](http://budgetresponsibility.org.uk/pubs/Measures_database_BUD15-FINAL.xlsx).

out the effects of policy change in the intervening period, 2015–16 revenues were expected to be over £7 billion lower. Although the last five years have been especially uncertain, and so we might expect more modest forecasting adjustments going forwards, the sensitivity of these receipts to even minor changes in the economic situation means that significant uncertainty remains, particularly in the face of recent global uncertainty – as highlighted by the recent falls in equity prices (see below).

## **Uncertainty about property prices, transactions and revenues from stamp duty on residential property transactions**

Stamp duty land tax on residential property purchases raises a relatively small amount of money compared with the taxes just discussed (an expected £7.8 billion in 2015–16) but there is considerable uncertainty around the forecast for these revenues because of the difficulty of forecasting residential property prices and, in particular, the volume of transactions.

Purchases of residential property in England, Wales and Northern Ireland are subject to stamp duty land tax (SDLT).<sup>8</sup> Since 4 December 2014, this has been charged at a rate of:

- 0% on the value up to £125,000;
- plus 2% on the value between £125,001 and £250,000;
- plus 5% on the value between £250,001 and £925,000;
- plus 10% on the value between £925,001 and £1.5 million;
- plus 12% on the value above £1.5 million.

In addition, the Chancellor announced in the November 2015 Autumn Statement that from 1 April 2016 some purchases of second or subsequent residential properties will face an additional bill of 3% of the property value.<sup>9</sup>

The latest forecasts from the OBR are for receipts from SDLT on residential property purchases (in England, Wales and Northern Ireland) to rise from £7.6 billion in 2014–15 to £13.4 billion in 2020–21. Policy changes are forecast to boost revenues by around £1.1 billion over the next few years (the majority of which is from the new levy on purchases of additional residential properties mentioned above). Stripping this out leaves underlying revenues forecast to rise by just over 60% over the six-year period from 2014–15 to 2020–21.

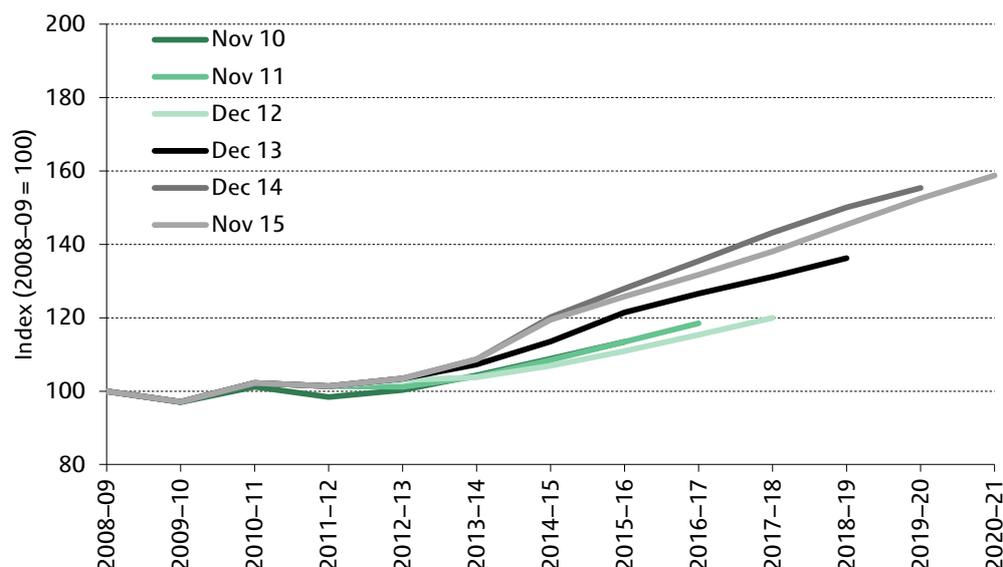
But there is a considerable amount of uncertainty around this forecast. Like all transaction taxes, receipts of SDLT are very sensitive to the number of transactions made in a year and the price of properties transacted. If the distribution of prices of properties sold were unchanged, a doubling of transactions would double receipts. The progressive nature of the tax with respect to property values means that an across-the-board 10% increase in prices would boost receipts by more than 10%, since it would increase the average tax rate that applied to the properties.

---

<sup>8</sup> Since 1 April 2015, Scotland has had its own land and buildings transaction tax.

<sup>9</sup> Purchases of properties worth less than £40,000, and those made by corporate landlords with more than a certain number of properties, will be exempt. The precise details of this new policy to charge an additional levy on purchases of additional residential properties are still being consulted on: <https://www.gov.uk/government/consultations/consultation-on-higher-rates-of-stamp-duty-land-tax-sdlt-on-purchases-of-additional-residential-properties/higher-rates-of-stamp-duty-land-tax-sdlt-on-purchases-of-additional-residential-properties>.

Figure 5.7. Changing forecasts for residential property prices



Source: Authors' calculation using OBR, *Economic and Fiscal Outlook*, various years.

Forecasting housing prices and, in particular, housing transactions with any degree of accuracy is extremely difficult to do. In addition, historic data on the relationship between property prices and SDLT receipts will not be a good guide to revenues going forward due to the major reform that took place in December 2014.<sup>10</sup>

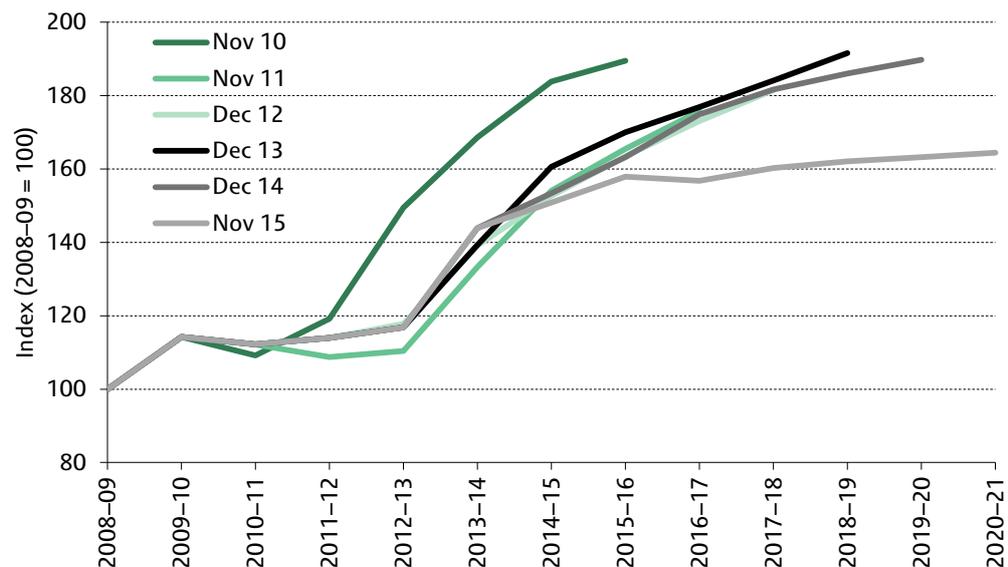
The OBR's forecasts have, on average, tended to understate growth in residential property prices. The forecasts from each autumn are shown in Figure 5.7. The November 2010 forecast implied that residential property prices would grow by 13% between 2008-09 and 2015-16, whereas the latest figures suggest they will have grown twice as fast over this same period.

In sharp contrast, the OBR has tended to overestimate the number of residential property purchases – in some cases quite considerably. Large errors in these forecasts are not surprising as forecasting the number of transactions that will take place in a year is difficult to do in any period, but especially so during a period when the economy is recovering from a financial crisis, when mortgage regulations are changing, when new housing market policies (such as the various Help to Buy initiatives) have been introduced<sup>11</sup> and when SDLT itself is being reformed. Figure 5.8 shows successive OBR forecasts from each autumn for the growth in residential property transactions. The November 2010 forecast was for these to grow by 90% between 2008-09 and 2015-16 as, in particular, credit conditions eased. But the latest estimate is that these will only have grown by 58% over the same period and that even by 2020-21 they will only be 64% up on their 2008-09 level.

<sup>10</sup> Prior to this date, the rates of SDLT (which were lower than the current rates) applied to the whole value of the property and not just the marginal value within each band. Revenues from this system of SDLT will have been much more sensitive to the level and distribution of house price growth than those under the new system.

<sup>11</sup> See <https://www.gov.uk/government/policies/homebuying>.

Figure 5.8. Changing forecasts for residential property transactions



Source: Authors' calculation using OBR, *Economic and Fiscal Outlook*, various years.

The combined effect of these forecasting revisions is that forecast receipts of SDLT in 2020–21 will be much lower than they would have been had the earlier vintages of OBR forecasts for residential property prices and transactions been correct. While the latest estimates of higher residential property prices will have pushed up forecast receipts, this will have been more than offset by the much lower level of residential property transactions that has been seen in recent years and is expected in future.

The November 2015 OBR forecast was for £1.4 billion lower receipts from SDLT on residential property transactions in 2020–21 (£13.4 billion) than had been forecast in July 2015 (£14.8 billion). This is despite the £1.1 billion increase in SDLT revenues from measures implemented in the November 2015 Autumn Statement. The underlying downgrade to forecast receipts in 2020–21 is therefore £2.5 billion: this is equivalent to a one-sixth decline in receipts in the space of OBR forecasts produced just four months apart.

Much – but by no means all – of this downgrade can be simply explained by the overall change to forecast residential property prices and transactions. A simple calculation suggests that this explains £1.5 billion of the £2.5 billion downgrade. The remaining £1 billion is due to the fact that the OBR now expects growth in the value of residential property transactions to generate a smaller increase in SDLT revenues than it previously did.<sup>12</sup> This is because it is now expecting fewer residential property transactions at higher prices (which contribute disproportionately to revenues) than it was in July 2015. The OBR has made this change to its modelling on the basis of evidence from the current year, in which there has been a 10% drop in purchases of residential properties worth more than £2 million (perhaps because the December 2014 change to the structure of SDLT, which raised tax rates on purchases of the highest-value residential properties, is

<sup>12</sup> This is based on a simple model of 2020–21 revenues being equal to revenues in 2014–15  $\times (1+T) \times (1+p) \times E$  plus the estimated revenue effect of any policy changes, where  $T$  is the forecast growth in transactions,  $p$  is the forecast growth in prices and  $E$  is an elasticity. The estimated elasticity from the OBR's July 2015 forecast is 1.22 (i.e. 1% growth in the value of transactions would, all else equal, boost revenues by 1.22%), whereas in the OBR's November 2015 forecast this had declined to 1.12.

depressing transactions by more than the OBR originally assumed). But how the number and price of properties transacted will evolve over the next few years is particularly uncertain. It certainly would not be a surprise were the OBR’s forecasts for these receipts to be revised significantly – either upwards or downwards – again.

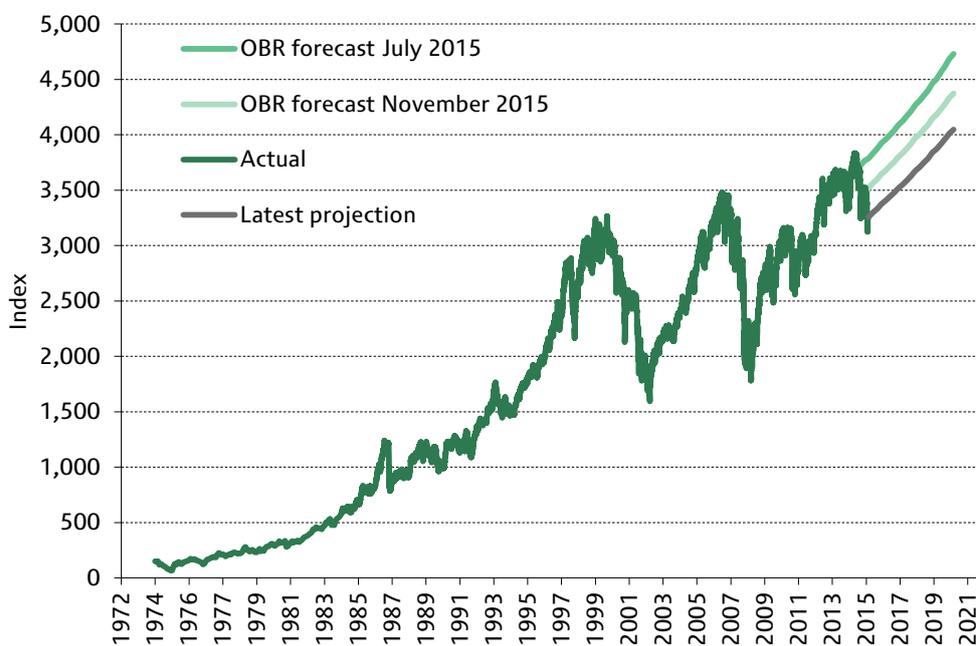
## Outlook for equity prices

The risks discussed above look relatively balanced – the outlook for receipts is uncertain but, as yet, there is no strong evidence to suggest that things will necessarily move in one direction or the other between the OBR’s last and its next forecast. In contrast, developments since November 2015 suggest that the outlook for equity prices (and thus revenues from capital taxes that depend on equity prices) seems biased to the downside. Equity prices significantly affect the public finances. If the falls in equity prices seen since the OBR published its last forecast in November are not reversed before March, this will depress the outlook for receipts.

Equity prices in particular feed directly through into receipts from capital taxes, namely capital gains tax (forecast receipts of £6.4 billion in 2015–16), inheritance tax (£4.4 billion) and stamp duty on share transactions (£2.9 billion). They also affect corporate tax receipts as they influence the taxable profits of the life assurance sector. Equity prices also indirectly affect receipts of personal and corporation taxes from the financial sector.

The OBR’s forecasting model makes a fairly simple assumption about how equity prices will evolve in future. Essentially, the model assumes that equity prices will grow in line with nominal GDP from the level that they are at when the forecast is made. Between July

Figure 5.9. FTSE All-Share index



Note: Projections are calculated assuming that equity prices grow in line with the OBR’s quarterly GDP forecast from July 2015 (for the ‘OBR forecast July 2015’ line) or November 2015 (for the ‘OBR forecast November 2015’ and ‘Latest projection’ lines).

Source: FTSE All-Share data from <https://uk.finance.yahoo.com/q/hp?s=%5EFTAS> and <https://www.google.co.uk/finance/historical?q=INDEXFTSE:ASX>.

and November 2015, equity prices fell, rather than growing at the rate that had been assumed in the OBR's July 2015 forecast. Predominantly as a result of this, in November 2015 the OBR revised down its forecast for equity prices in 2020–21 by 7.4%. This translated into a reduction in forecast revenues from capital taxes in that year of £2.1 billion. Of this downwards revision, £1.5 billion was from a reduced forecast for receipts of capital gains tax.

This weaker-than-assumed performance of the FTSE All-Share index between the OBR's July and November forecasts is shown in Figure 5.9. Also shown is how the index has evolved since the November forecast was made. Rather than growing as the OBR had expected, it has fallen further. If the index were to grow from its level at the end of January 2016 in line with the OBR's forecast for nominal growth in national income through to 2020–21, this would suggest that there would be a further 7.4% downgrade.

If equity prices remain 7.4% below the OBR's November forecast at the time that the forecast is made for the March 2016 Budget, a further downgrade in capital tax receipts is likely to occur. Scaling the decline seen between the last two forecasts would suggest this could be around £2 billion. In addition to this, there might also be a reduction in corporation tax receipts from declining taxable profits of life assurance companies and indirect impacts of weaker equity prices on receipts of personal and corporate taxes related to the performance of the wider financial sector.

## North Sea oil and gas prices

Revenues from North Sea oil and gas have, for the last four decades, made up a small but not insignificant share of the UK government's revenues. However, they are volatile and, related to this, very difficult to forecast. Receipts can, and have, varied due to changes in the sterling oil price, changes in production, changes in capital and operating expenditure (both of which are fully tax-deductible) and changes to the tax regime. As recently as 2008–09, total North Sea revenues were £12.4 billion, whereas the latest OBR forecast is that in 2015–16 these receipts will amount to just £0.2 billion.

Furthermore, the revenue from these receipts could become negative, so the downside risk is not bounded at zero: the low level of receipts forecast this year arises from £0.9 billion of corporation tax on offshore activities being offset by £0.7 billion of negative receipts from petroleum revenue tax, PRT (in other words, the payable tax write-offs that companies operating in the North Sea can claim are expected to exceed their PRT liabilities). The OBR's latest long-run forecast is for negative receipts to occur frequently from the mid 2020s onwards.<sup>13</sup>

A large part of the volatility in North Sea revenues is due to fluctuations in the dollar price of Brent Crude, which has translated into large fluctuations in the sterling price. As shown in Figure 5.10, the Brent Crude oil price was generally above \$100 per barrel between Spring 2011 and Summer 2014 but has since fallen to below \$30 per barrel. This has translated into a drop in the price in pounds from over £60 per barrel to £30 per barrel.

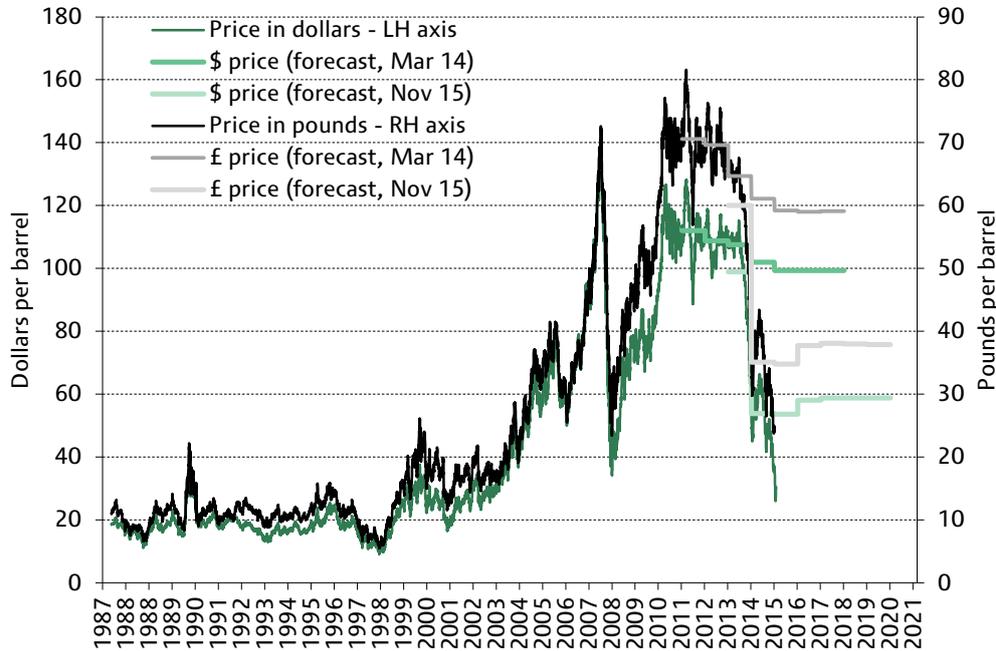
The sharp decline in the oil price after Summer 2014 was not forecast by the OBR (or most other commentators). The March 2014 Budget assumed that the oil price in 2015 would be \$102.0 per barrel, and that this would translate to a sterling oil price of £61.1 per barrel. It was then assumed to decline slightly to \$99.3 per barrel (or £59.1 per

---

<sup>13</sup> See chart 4.5 of Office for Budget Responsibility, *Fiscal Sustainability Report: June 2015*, [http://cdn.budgetresponsibility.independent.gov.uk/49753\\_OBR-Fiscal-Report-Web-Accessible.pdf](http://cdn.budgetresponsibility.independent.gov.uk/49753_OBR-Fiscal-Report-Web-Accessible.pdf).

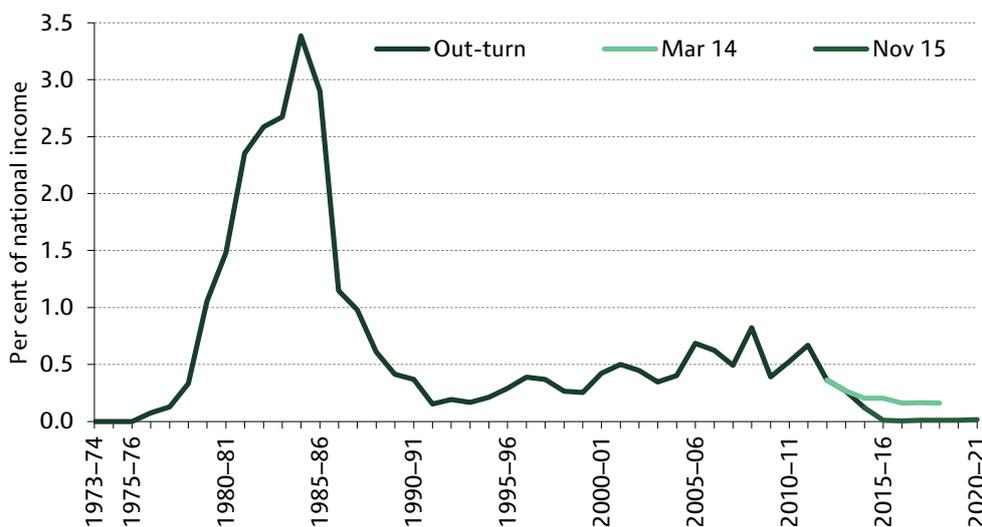
barrel) in 2018. The latest OBR forecast implied that the oil price in 2015 would instead be \$53.8 (or £35.1) per barrel and that this will only increase slightly over the next few years, reaching \$58.8 (£38.1) per barrel in 2018 and remaining roughly constant in nominal terms thereafter.

Figure 5.10. Brent oil prices over time (\$ and £ per barrel)



Source: Figure shows the spot price of Europe Brent Oil downloaded from the US Energy Information Administration ([https://www.eia.gov/dnav/pet/pet\\_pri\\_spt\\_s1\\_d.htm](https://www.eia.gov/dnav/pet/pet_pri_spt_s1_d.htm)). Price of oil in pounds calculated using the dollar/pound exchange rate from the Bank of England (<http://www.bankofengland.co.uk/boeapps/iadb/Rates.asp?Travel=NixIRx&into=GBP>).

Figure 5.11. UK oil and gas revenues



Note: Figure takes cash receipts from petroleum revenue tax and offshore corporation tax and divides through by the latest estimates of GDP.

Source: Authors' calculation using chart A on page 122 of OBR, *Economic and Fiscal Outlook*, December 2014, table 4.5 of OBR, *Economic and Fiscal Outlook*, March 2014, and table 4.6 of OBR, *Economic and Fiscal Outlook*, November 2015.

This unexpected decline in the oil price has led to forecasts for revenue from North Sea oil and gas production being reduced significantly. The March 2014 Budget forecast that revenues would fall from £3.9 billion in 2015–16 to £3.5 billion in 2018–19, whereas the most recent OBR forecast is for these receipts to be just £0.2 billion in 2015–16 and for them to remain around this level over the period to 2019–20. This would be the lowest level of receipts in cash terms, let alone as a share of national income, since 1977–78 (shown in Figure 5.11).

A key source of uncertainty for receipts from these revenues remains the sterling oil price. The OBR estimates that the direct impact of a £10 rise (fall) in the price of a barrel of oil would be to increase (reduce) North Sea oil and gas revenues by approximately £2 billion a year.<sup>14</sup> For large changes, the relationship is likely to be different: for example, the £26 per barrel downgrade in the assumed oil price in 2015 that was seen between March 2014 and November 2015 (as described above) was associated with a £3.7 billion downgrade in forecast receipts in 2015–16 (rather than the £5.2 billion that would have been expected from scaling the ready reckoner).

In any case, these figures significantly overstate the impact of oil price changes on the overall public finances. Most obviously, a change in oil prices will also affect petrol purchases and thereby receipts of fuel duties: a £10 rise (fall) in the oil price is estimated to reduce (increase) fuel duty revenues by £¼ billion a year.<sup>15</sup> However, as the UK is a net oil importer, a higher (lower) oil price would – in isolation – also tend to depress (boost) output in the economy, which would feed through into a significant reduction (increase) in other revenues.<sup>16</sup> While there is much uncertainty about the net effect of oil prices on the UK's public finances, earlier analysis from the OBR suggested that the overall impact of a (moderate) rise (fall) in oil prices would be to weaken (strengthen) the public finances very slightly. In other words, the OBR's central estimate is that the indirect impact on tax receipts (in particular, from affecting economic activity and revenue from fuel duties) would be more than sufficient to offset the direct change in receipts from North Sea oil and gas revenues.

In practice, changes in oil prices happen for a reason, and the nature of the trigger associated with any future change in oil prices may be crucial. For example, a lower oil price that was caused by an increase in the global supply of oil – such as from the lifting of sanctions on Iran – might be of clear benefit to the UK's onshore economy. In contrast, the impact of a lower oil price that was predominately caused by a drop in global demand would have clearer adverse consequences: the direct impact of lower oil prices would still be to boost the onshore economy, but the drop in global demand could contribute to a macroeconomic slowdown that has larger effects on the public finances.

---

<sup>14</sup> See table 3.2 of Office for Budget Responsibility, 'How we present uncertainty', Briefing Paper No. 4, June 2012, <http://budgetresponsibility.org.uk/wordpress/docs/Briefing-paper-No4-How-we-present-uncertainty.pdf>.

<sup>15</sup> See table 3.2 of Office for Budget Responsibility, 'How we present uncertainty', Briefing Paper No. 4, June 2012, <http://budgetresponsibility.org.uk/wordpress/docs/Briefing-paper-No4-How-we-present-uncertainty.pdf>.

<sup>16</sup> A rise in the oil price is also estimated slightly to increase VAT revenues, to increase spending on benefits, public service pensions and debt interest, and to reduce spending on the state pension. See Office for Budget Responsibility, *Assessment of the Effect of Oil Price Fluctuations on the Public Finances*, Occasional Paper, 14 September 2010, [http://budgetresponsibility.org.uk/wordpress/docs/assessment\\_oilprice\\_publicfinances.pdf](http://budgetresponsibility.org.uk/wordpress/docs/assessment_oilprice_publicfinances.pdf).

## Summary

Table 5.1 summarises the sources of uncertainty around future receipts from the specific taxes that were discussed in this section.

Table 5.1. Uncertainty in revenue forecasts: summary table

Taxes	2015–16 revenue forecast (£bn)	Source of uncertainty	New central estimate
Income tax / NICs	286.4	Growth of earnings and employment	Unchanged
VAT	115.6	Growth of consumer spending	Unchanged
Corporation tax (onshore)	43.4	Growth of corporate profits	Unchanged
Stamp duty (residential property)	7.8	Residential property prices and transaction volume	Unchanged
Capital taxes	13.7	Equity prices, which have slumped since forecast	£2 billion p.a. lower
North Sea revenues	0.2	Oil price, though offsetting changes to public finances elsewhere	Unchanged

Note: Forecast from OBR, *Economic and Fiscal Outlook*, November 2015. ‘Capital taxes’ comprises capital gains tax, inheritance tax and stamp duty on share transactions. ‘North Sea revenues’ refers to petroleum revenue tax and offshore corporation tax.

## 5.3 Policy risk

The OBR’s forecasts are predicated on currently legislated policy continuing and on legislated policy changes having the anticipated impact on revenues. However, there are some parts of the tax system where policy stability looks far less assured than in others and some planned policy changes that have particularly uncertain revenue implications.

### Policy commitments that are not included in the forecast

The Conservative Party manifesto in 2015 committed to increasing the income tax personal allowance to £12,500 by 2020 and the higher-rate threshold to £50,000. However, given current CPI inflation forecasts, current legislated policy suggests that these thresholds will only have increased to £11,900 and £46,100, respectively, by April 2020.<sup>17</sup> Increasing the personal allowance by a further £600 and raising the higher-rate threshold to £50,000 would cost around £8 billion.<sup>18</sup>

This is a significant additional cost (amounting to around 3½% of income tax revenues forecast for 2020–21) that has not yet been factored into the official forecasts. As the

<sup>17</sup> Current policy is for the personal allowance to be increased to £11,200 by April 2017 and for the higher-rate threshold to be increased to £43,600 by that point. Thereafter, both are set to be increased in line with the CPI. The latest OBR forecasts are for CPI inflation of 6% between September 2016 and September 2019 (see table 4.1 of Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2015*, <http://budgetresponsibility.org.uk/economic-fiscal-outlook-november-2015/>).

<sup>18</sup> The HMRC ready reckoner suggests that each £100 increase in the personal allowance reduces revenues by £800 million a year, while a 10% increase in the basic rate limit reduces revenues by £3.3 billion a year (see <https://www.gov.uk/government/statistics/direct-effects-of-illustrative-tax-changes>).

commitments for a £12,500 personal allowance and £50,000 higher-rate threshold are set in nominal terms, any further downgrade to the outlook for inflation would increase the cost of meeting this pledge, while any increase in expected inflation would make it less expensive to meet.

These costs would come on top of the cost of increases in income tax allowances that were seen over the last parliament and those that were announced in the July 2015 Budget. Together, the total cost of changes to the personal allowance and the higher-rate threshold between 2010–11 and 2017–18 will be about £11 billion per year.<sup>19</sup>

However, even if the higher-rate threshold is increased to £50,000 by 2020–21, it is still forecast to fall relative to average earnings, meaning that a greater fraction of individuals will be paying the higher rate of income tax. Estimates produced by IFS researchers in the run-up to the last election suggest that if the higher-rate threshold is increased to £50,000 by 2020–21, the numbers paying higher rates of income tax would still increase by around 300,000.<sup>20</sup>

## Policies to tackle tax avoidance

Since coming to power, the Conservative government has announced a package of anti-avoidance and anti-evasion measures that the OBR expects to result in £3.6 billion additional revenues in 2020–21.<sup>21</sup> These come on top of similar types of measures introduced by the previous coalition government that were forecast to raise revenues by £6.1 billion in 2015–16.<sup>22</sup> These costings are already included in the OBR's forecasts. However, the costings for most of these policies have been designated 'highly uncertain' by the OBR. In November 2015, the OBR assessed a subset of anti-avoidance policies and found that, while some exceeded their original expected yield, on average the original costings had overestimated the true revenue yield. There is a clear risk that the measures implemented over this parliament fail to raise the anticipated revenues.

On the other hand, it is likely that further anti-avoidance measures will be introduced in response to recent policy recommendations from the OECD. As described in more detail in Chapter 8, the OECD has recently made a series of policy recommendations for countries to tackle tax avoidance. The expected result is substantial international policy change. When the UK government implements its response, the OBR will have to incorporate a costing into its official forecasts. Section 8.4 considers the revenue implications for the UK, concluding that they are highly uncertain. While several expected changes should increase UK revenues, the actual revenue yield from these measures is

<sup>19</sup> Source: slide 2 of S. Adam, 'Tax measures', July 2015, [http://www.ifs.org.uk/uploads/publications/budgets/Budgets%202015/Summer/Adam\\_tax\\_.pdf](http://www.ifs.org.uk/uploads/publications/budgets/Budgets%202015/Summer/Adam_tax_.pdf).

<sup>20</sup> Source: page 16 of See S. Adam, J. Browne, C. Emmerson, A. Hood, P. Johnson, R. Joyce, D. Phillips, H. Miller, T. Pope and B. Roantree, 'Taxes and benefits: the parties' plans', IFS Briefing Note BN172, 2015, <http://www.ifs.org.uk/uploads/publications/bns/BN172.pdf>.

<sup>21</sup> Figure for total revenue raised from anti-avoidance and anti-evasion measures was calculated by summing the estimated effect of policies classified under the headings 'avoidance and tax planning' and 'avoidance, evasion and tax planning' in table A.1 of Office for Budget Responsibility, *Economic and Fiscal Outlook: July 2015*, <http://budgetresponsibility.org.uk/efo/economic-fiscal-outlook-july-2015/> and table A.1 of Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2015*, <http://budgetresponsibility.org.uk/economic-fiscal-outlook-november-2015/>.

<sup>22</sup> Figures for total revenue raised from anti-avoidance and anti-evasion measures were calculated by summing the estimated effect of policies classified under the headings relating to 'avoidance', 'evasion' or 'tax planning' in Budgets and Autumn Statements since the last coalition government came to power, but excluding the introduction of the bank levy, and policies that are expected to have predominantly temporary effects on revenues such as accelerated payment schemes and restrictions on loss write-offs.

very difficult to predict. Meanwhile, policies undertaken by other countries could negatively impact the UK's tax take. Overall, the likely effect is perhaps for a slight revenue increase, but there is substantial uncertainty surrounding this.

### **Planned increases in rates of fuel duties may not occur**

The OBR's forecasts assume that fuel duties will be increased in line with inflation – as measured by the discredited Retail Prices Index (RPI) – each year from April 2016. However, recent years – as described in Chapter 9 – have seen a number of previously-planned inflation increases being deferred and, eventually, abandoned. Fuel duty rates have remained frozen in nominal terms since April 2011. Similar behaviour – of cancelling planned increases in line with inflation – also often happened during the last period of Labour government.

This might lead one to suspect that the indexation planned for the next few years will not take place either. Given current inflation forecasts, freezing fuel duties for the next five years, rather than increasing them in line with RPI inflation as is currently planned, would reduce forecast revenues by an estimated £3 billion a year by 2020–21. Moving instead to indexation in line with the Consumer Prices Index – which would be more justifiable than indexation in line with the RPI and which would bring the indexation of indirect taxes into line with the indexation of direct tax and benefit parameters – would reduce forecast revenues from fuel duties by £1¾ billion by 2020–21.<sup>23</sup>

Current low oil prices perhaps provide scope for the government to increase duty rates, which has been more difficult politically when oil prices have been high. However, oil prices have been declining steadily since mid 2014 (as Figure 5.10 shows) and yet the previous and current governments have made no attempt to increase duty rates. Most recently, in March 2015, the previous government chose to cancel a planned increase in line with inflation that was due to take effect in September 2015. It remains to be seen whether the government will go ahead with the inflationary increase planned for April 2016, which is due to amount to an increase of 1.16p per litre.

### **Implications of freezing certain income tax thresholds**

There are now several parameters of the income tax system that are not indexed at all. Because the underlying tax base is expected to grow in nominal (and real) terms over time, while the thresholds are frozen, the forecasts imply that the average tax rate and the number of individuals to whom the tax applies will increase over time.

The threshold at which the personal allowance starts to be withdrawn (£100,000) – which creates an effective marginal income tax rate of 60% over a range of income (£22,000 from April 2016) above the threshold – and the point at which the 45p additional rate starts to be paid (£150,000) are, by default, not indexed at all. This means that the thresholds are already 15% lower in real terms than when they were introduced and are due to be 30% lower by 2020–21. Combined with the fact that earnings levels tend to grow in real terms over time, this means that the numbers affected are likely to grow substantially. Already the number of people paying the additional rate of income tax

---

<sup>23</sup> The OBR forecasts that the RPI will increase by 12.8%, and the CPI by 6.8%, over the period from September 2014 to September 2019 inclusive (see table 4.1 of Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2015*, <http://budgetresponsibility.org.uk/economic-fiscal-outlook-november-2015/>). The HMRC ready reckoner suggests that each 1% off fuel duty rates reduces revenues by £265 million a year (see <https://www.gov.uk/government/statistics/direct-effects-of-illustrative-tax-changes>).

has grown by more than 40%, from 236,000 to 332,000, since its introduction in April 2010.<sup>24</sup>

It may well be politically feasible for the current government to continue freezing these thresholds. However, if the desire is for these tax rates to apply to a greater fraction of individuals than is currently the case, it would be better for politicians to state this clearly, rather than achieving the outcome through stealth using fiscal drag, which is unlikely to be the most desirable way of achieving the preferred distributional objective. Current policy here lacks any coherent principle: it embodies no view at all on either the real level of income at which higher rates of tax should kick in or the appropriate fraction of people who should be affected by them (since these can both change every year indefinitely).

Another threshold related to the income tax system that is frozen in cash terms is the point at which child benefit starts to be withdrawn. Since January 2013, child benefit has been tapered away from families containing an individual with a taxable income exceeding £50,000 a year, such that families containing an individual with a taxable income of £60,000 a year or more receive no child benefit at all. These thresholds are, by default, not indexed at all. Not indexing the £50,000 threshold means that more and more families will have part or all of their child benefit withdrawn in future as incomes rise in cash terms. In 2016–17, we estimate that 1.1 million families will lose some or all of their child benefit. If taxable incomes rise in line with the OBR's forecast, while the thresholds remain fixed, we estimate that in five years' time the number of families affected would increase by 50% and in ten years' time it would have more than doubled as a result of fiscal drag.<sup>25</sup> In addition, because neither the £50,000 nor the £60,000 threshold is indexed, the range of income over which child benefit is withdrawn is fixed at £10,000. This means that over time, if child benefit rises in cash terms (which it is scheduled to do from April 2020), the effective income tax rate faced by those who have their child benefit withdrawn would increase.<sup>26</sup>

It remains to be seen whether this is sustainable. On the one hand, it may be particularly hard to sustain beyond 2020–21 when (if the Conservatives deliver on their manifesto pledge) the higher-rate threshold will reach and then (presumably) rise above £50,000. If the threshold for child benefit withdrawal remained frozen at £50,000, basic-rate taxpayers would start losing child benefit.

On the other hand, it could be that, as fewer families are able to receive child benefit, public support for the benefit is eroded. If continued indefinitely, child benefit would be received by fewer and fewer families over time. But if this is the government's intention, it would again be better to state this clearly rather than achieving it by stealth.

---

<sup>24</sup> Source: table 2.5 of HM Revenue & Customs, 'Income tax statistics and distributions', <https://www.gov.uk/government/collections/income-tax-statistics-and-distributions>.

<sup>25</sup> Andrew Hood provided these estimates using TAXBEN run on updated 2013–14 Family Resources Survey data.

<sup>26</sup> The marginal income tax rate faced by someone with three children was around 65% (40% plus 25%) in 2015–16. Child benefit is set to be frozen in cash terms over the four years from April 2016, which would leave this unchanged until at least the end of 2019–20. For more details, see A. Hood and D. Phillips, 'Benefit spending and reforms: the coalition government's record', IFS Briefing Note BN160, <http://www.ifs.org.uk/publications/7535>.

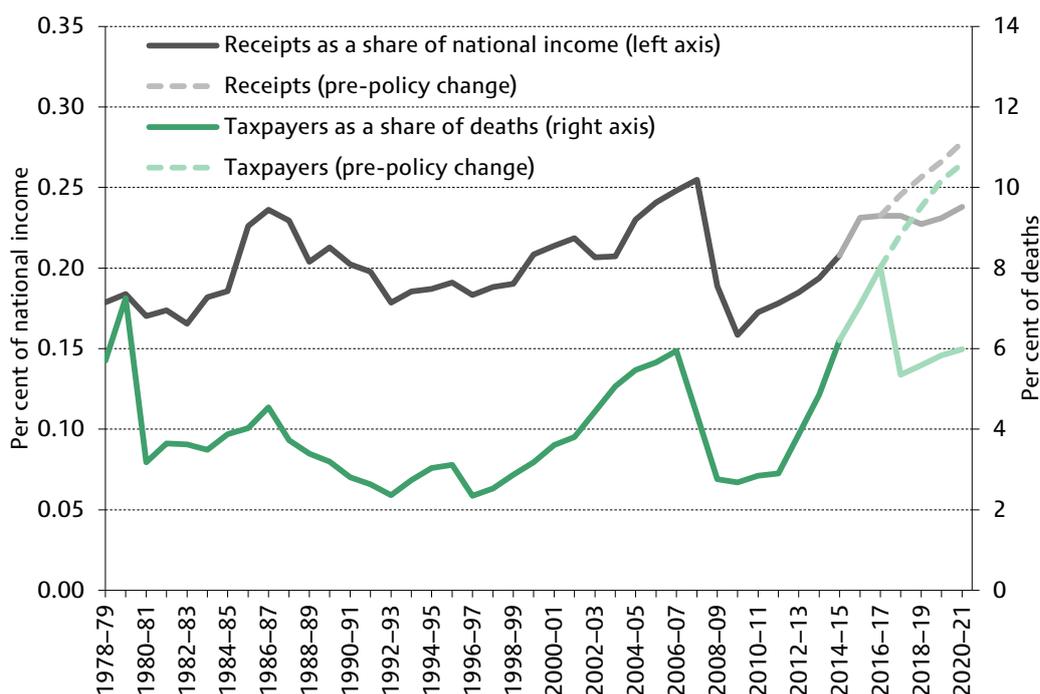
## Is it plausible to freeze inheritance tax thresholds in cash terms?

In aggregate, inheritance tax is a relatively small tax, currently raising around £4 billion a year (less than 1% of total government revenues). It is paid by only a small minority of estates – currently around 6%, and that figure has been even lower for much of the last 40 years. Despite this, it has proved an unpopular tax. Current policy is for the inheritance tax threshold (£325,000) to be frozen in nominal terms through to March 2021. This alone would tend to push up the number of estates liable for inheritance tax over time. Putting to one side the economic arguments for and against such an outcome, is it plausible that politicians will allow it to happen?

In last year’s Green Budget, we highlighted that, as a result of freezing the threshold and the rising value of asset holdings, the fraction of estates liable for inheritance tax was due to increase steadily and by 2018–19 to reach its highest level since at least 1978–79.<sup>27</sup> In fact, the trend will now be (at least temporarily) reversed as a result of a new policy announced in the July 2015 Budget.

From April 2017, there will be a new transferable main residence allowance for couples who are married or in a civil partnership. It will initially be set at £100,000 and then rise by £25,000 per year until it reaches £175,000 in 2020–21. Figure 5.12 shows that this policy change has reduced both forecast inheritance tax receipts and, especially, the

Figure 5.12. Receipts from and fraction of estates liable for inheritance tax



Note: Figure shows total receipts and number of estates liable for inheritance tax and (for years before 1986–87) capital transfer tax at death. Forecasts are shown including and excluding the effect of measures announced in the July 2015 Budget, which introduced a new transferable main residence allowance and extended the freeze in the threshold for an additional two years.

Source: Authors’ calculations based on data from HM Revenue & Customs, the OBR and the Office for National Statistics.

<sup>27</sup> R. Crawford, C. Emmerson and G. Tetlow, ‘Public finances: a dicey decade ahead?’, in C. Emmerson, P. Johnson and R. Joyce (eds), *The IFS Green Budget: February 2015*, <http://www.ifs.org.uk/publications/7530>.

number of estates likely to be liable for the tax. The latter is estimated to be reduced by 40% in 2020–21 – from 60,500 to 34,200.

It is notable that there was also a significant policy change the last time the fraction of estates liable for inheritance tax approached 6% (in 2008–09). At that time, in the October 2007 Pre-Budget Report, the Labour government introduced for the first time the ability for married couples and civil partners to transfer any unused inheritance tax allowance to their surviving partner. This had the effect of sharply reducing the fraction of estates that would be liable for the tax.

Recent history suggests, therefore, that politicians have a habit of cutting inheritance tax when the fraction of estates liable for it rises above its current level. Despite the latest significant tax cut, both receipts of inheritance tax and the percentage of estates liable are forecast to rise to a relatively high level over the next few years compared with the last 40 years. In 2020–21, it is forecast that 6.0% of deaths will be liable for inheritance tax. While this is lower than the 6.2% seen in 2014–15, it would be higher than any year between 1980–81 and 2013–14 (inclusive), and it remains to be seen whether this can be maintained.

## Potential reforms to the taxation of pensions

One factor that could significantly affect the future level and profile of tax revenues is the possible reforms to the tax treatment of private pension contributions that are currently being considered by the government. At the moment, broadly speaking the income tax treatment of pensions is that contributions to private pensions are made from pre-tax income, returns on investments held by pension funds are tax-free, and then pension income is taxed on receipt. This is often referred to as EET (exempt–exempt–taxed) treatment.<sup>28</sup>

Over the summer, the Treasury consulted on potential reform of the current personal tax treatment of pension saving, with an apparent focus on three broad types of potential future system:<sup>29</sup>

- Retaining the current system, though potentially with reductions to the annual and lifetime contribution limits.
- Offering tax relief on pension contributions at a flat rate, rather than at each individual's marginal tax rate. This rate would be set to be greater than the current basic rate of income tax (20%), but lower than the current higher rate of income tax (40%).
- Moving to a system of TEE (taxed–exempt–exempt) treatment of pension contributions – that is, contributions to private pensions would be made out of taxed income, while investment returns and any income ultimately received would be tax-

<sup>28</sup> For a discussion of the ways in which the current personal tax treatment of private pension contributions deviates from the EET ideal, see C. Emmerson, 'Taxation of private pensions', in C. Emmerson, P. Johnson and H. Miller (eds), *The IFS Green Budget: February 2014*, <http://www.ifs.org.uk/publications/7072>. In addition to the factors discussed there, announcements made in the July 2015 Budget mean that – from April 2016 onwards – those whose income including pension contributions is above £150,000 and whose income excluding pension contributions is above £110,000 will have a reduced annual allowance.

<sup>29</sup> HM Treasury, *Strengthening the Incentive to Save: A Consultation on Pensions Tax Relief*, 2015, <https://www.gov.uk/government/consultations/strengthening-the-incentive-to-save-a-consultation-on-pensions-tax-relief>. These three reform options are the ones reported by J. Cumbo and C. Barrett, 'Pensions – which way now?', *Financial Times*, 21 August 2015, <http://www.ft.com/cms/s/0/3ec9a72a-44fa-11e5-af2f-4d6e0e5eda22.html#axzz3we4NOVfq>.

free. Under this reform, there would also be an additional government top-up on at least some pension contributions.

The implications of and the economic rationale (or lack thereof) for these alternative tax treatments for private pension saving were discussed in detail in the 2014 IFS Green Budget.<sup>30</sup> We do not revisit these arguments here but instead focus on the potential implications for the level and profile of tax revenues and the resultant risks for the public finances.

### ***Retaining the current system***

Retaining the current tax treatment but with reduced annual and lifetime allowances would have two main effects, though it is difficult to quantify how large these would be. By reducing the amount that individuals can contribute tax-free to a pension, the reforms would tend to increase the amount of income that would immediately be liable for income tax (and National Insurance contributions). This would boost tax revenues in the near term. However, this would come at the expense of some future tax revenues, since future pension payments would be expected to be lower and thus less tax would be payable.

The overall effect on the public finances is likely still to be positive, since pension savings are much more tax favoured than most other forms of saving. If the funds not placed in a pension were spent rather than saved in some other form, this would also boost indirect tax receipts now and depress them in future. To give a sense of scale, the government estimated that the reduction of the annual limit from £50,000 to £40,000 and the reduction in the lifetime limit from £1.5 million to £1.25 million that was announced in the Autumn Statement of 2012 would together raise £1.1 billion in 2017–18, while the March 2015 Budget announcement to cut the lifetime limit from £1.25 million to £1 million was scored as a £600 million tax rise in 2019–20.<sup>31</sup> Further reductions of the same size would raise significantly more than that because far more people would be affected. As far as we are aware, no estimates have been produced of the extent to which this would represent a permanent strengthening in the public finances as opposed to just bringing revenue forwards in time.

### ***Flat-rate tax relief***

The proposals that have been discussed for offering a single flat rate of ‘tax relief’ on pension contributions entail offering relief at a rate higher than the basic rate of income tax (20%) but lower than the higher rate (40%). This would tend to increase the total amount of tax relief offered up front to those on middle or lower incomes but reduce the amount offered to those on higher incomes. In the latter case, the lower amount of tax relief claimed would be both because the tax relief per pound of saving would be reduced and because the incentive to save in a private pension at all would be reduced.

This policy – like the option of reducing the annual and lifetime limits – has the potential to increase tax revenues somewhat in the short term but potentially at the cost of slightly lower revenues in the longer term. The magnitude of these effects would depend on the

---

<sup>30</sup> See C. Emmerson, ‘Taxation of private pensions’, in C. Emmerson, P. Johnson and H. Miller (eds), *The IFS Green Budget: February 2014*, <http://www.ifs.org.uk/publications/7072>.

<sup>31</sup> Source: table 2.1 of HM Treasury, *Autumn Statement 2012*, [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/221550/autumn\\_statement\\_2012\\_complete.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/221550/autumn_statement_2012_complete.pdf) and table 2.1 of HM Treasury, *Budget 2015*, [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/416330/47881\\_Budget\\_2015\\_Web\\_Accessible.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/416330/47881_Budget_2015_Web_Accessible.pdf).

precise policy design. It would be possible to design the flat-rate relief in such a way that it reduced revenues in both the short and long runs – for example, if the flat rate of relief were set at a fairly high level. However, the Treasury’s consultation suggests that it is looking to make net exchequer savings, suggesting that this is an unlikely outcome.

In 2013, the Pensions Policy Institute published an estimate suggesting that a flat rate of tax relief of around 30% might, in the short term, be roughly revenue neutral.<sup>32</sup> However, there is uncertainty around this estimate for a number of reasons. First, it is based on estimates of the distribution of up-front tax relief on contributions made directly by individuals in recent years, whereas the majority of pension contributions have been made on individuals’ behalf by their employers. Second, the cost and distribution of this up-front relief will have been changed by the recent reductions to the annual limit and lifetime allowance. Third, any changes in pension saving behaviour in response to the reforms would also affect the impact on revenues.

The crucial issue of the impact on revenues in the longer term is even more uncertain. If lower- and middle-income individuals end up having larger pension pots (for example, because they choose to save more or just because of the higher amount of up-front tax relief), then tax revenue on the resulting pension would increase. But if higher-income individuals end up having smaller pension pots (due to them saving less or just because they received less up-front tax relief), then this would result in less tax revenue on the resulting pension. Any impact on household saving and spending decisions would also impact upon future indirect tax revenues.

### **TEE tax treatment**

The third option – moving to TEE tax treatment – has much more dramatic consequences for the profile of tax revenues and poses significant political risks. Moving to a system in which contributions are taxed up front rather than on receipt would dramatically boost tax revenues in the near term. But levying this income tax up front would come at the expense of a reduction in revenues in the future, as the government will no longer collect income tax on these pensions in payment.

The extent to which the net increase in tax is permanent rather than temporary would depend on a number of factors, including the extent to which people face lower marginal tax rates in retirement than when they make their pension contributions and future investment returns. If the tax rates some individuals face in retirement are lower than those they faced when their pension contributions were made and if there were no excess returns, then at least part of the higher revenues raised in the short term from a move to TEE would be a permanent gain. If there were excess returns (but no tax-rate smoothing), then a move to TEE would lose the government revenue over the longer run.

The longer-run cost would also depend on the size of any new tax incentives offered to all those saving in pensions compared with what is currently available. Under the current EET income tax system, the incentive offered takes the form of the tax-free lump sum. Under a TEE income tax system, the incentive could take the form of an up-front government top-up. If the new incentive is less generous than the old one, then part of the additional revenues raised in the short run would be permanent.

The government estimates that up-front income tax relief on pension contributions totalled £27.0 billion (£6.8 billion on individual contributions and £20.2 billion on

---

<sup>32</sup> Pensions Policy Institute, *Tax Relief for Pension Saving in the UK*, London, 2013, <http://www.pensionspolicyinstitute.org.uk/publications/reports/tax-relief-for-pension-saving-in-the-uk>.

employer contributions) in 2013–14.<sup>33</sup> However, much of this will be recouped in future from income tax received when private pension incomes are drawn. In 2013–14, £13.1 billion of income tax was paid on income received from private pensions. This figure gives some feel for how much of the up-front tax relief might be only temporary, though in practice future growth in the pensioner population is likely to push this number up. If the government also wanted to introduce a significant up-front top-up, then it would be quite possible that the vast majority of any additional income tax revenues raised in the short term would be temporary rather than permanent.

This raises a concern that, with a tendency to focus on short-term indicators of the health of the public finances, the Chancellor – or one of his successors – might inappropriately spend rather than bank this temporary windfall. To the extent that the policy change only brings revenue forwards in time, the right response is to bank this money rather than use it to cut taxes or boost spending in the short term. But is it credible that the Chancellor or one of his successors – faced with a large surge in income tax revenues – would resist the temptation to give at least some of it away? In the longer term, when higher-income older people are enjoying their tax-free pension income, is it credible that a future, potentially cash-strapped, Chancellor will avoid the temptation to levy tax again on this income (i.e. TET tax treatment)? The first question suggests that future generations of taxpayers may not thank us if we allowed a Chancellor to take the tax revenue up front and spend it. The second question suggests that we might ourselves be wary of putting much into our pension funds in case a future Chancellor decides to tax us again.

### *Summary*

The Treasury confirmed in the 2015 Autumn Statement that a decision about the future tax treatment of pension contributions would be made in the 2016 Budget. Depending on which of the options is chosen, the effect on the headline public finances over the next five years could be substantial, but the true effect on the underlying and longer-term fiscal position may not be so easy to glean from the numbers that will be presented on Budget Day. Any revenues lost in the longer term will not show up in the five-year forecast. In addition, the behavioural response to the policy will be difficult to predict. The assumptions made about this could have important effects on the policy costing, but the evidence base that could be used to inform them is patchy and any assumptions will not be verifiable for years to come. This means it would be very important for the OBR to publish estimates of the impact on revenues in future years and full details of the underpinning assumptions used to produce those estimates.

Finally, it is worth noting that if the government does announce a major change to tax relief on pension contributions – either a shift to a single rate of up-front relief or a move to a TEE system – there would likely be complicated responses in the very short term before the policy is implemented. Both of the major reforms being considered would lead to higher-income individuals expecting to receive less generous tax treatment of pension contributions in future. Therefore, they might plausibly respond by bringing forwards their future pension contributions in order to qualify for more generous tax treatment while they still can. This would have the effect of depressing income tax receipts prior to the reform coming into effect and then increasing them significantly for a while thereafter.

---

<sup>33</sup> Source: table PEN6 at <http://www.hmrc.gov.uk/statistics/pension-stats.htm>.

## Summary

Overall, the balance of policy risks to receipts is biased to the downside. Manifesto commitments on the personal allowance and higher-rate threshold are expected to reduce revenues by £8 billion per year by 2020–21. Meanwhile, there are further policy decisions assumed by the OBR in its forecast that may prove infeasible. In particular, there is good reason to doubt whether fuel duties will be increased as much as standard indexation would dictate over the course of the parliament: continuing the recent pattern of freezing the rates of these duties for five more years would cost around £3 billion. There are counterbalancing risks to the upside, although these come with caveats. Reform to the taxation of pensions could lead to a large increase in revenue in the short term, though a somewhat smaller gain in the long term. Further anti-avoidance policies are likely to raise more revenue, but these costings are highly uncertain and previous anti-avoidance costings have slightly overestimated their impact on revenues on average.

## 5.4 Conclusion

There are clear upside and downside risks to the OBR's latest forecast for tax revenues in the UK. However, on balance, it seems likely that its next (March 2016) forecast will be for lower total revenues over the next few years than it expected in November.

If the pessimistic scenario set out by Oxford Economics – in which the Federal Reserve raises interest rates more sharply than markets currently expect – were to materialise, then absent further policy action, the public budget might be only in balance by 2019–20, rather than reaching a surplus of 0.5% of national income as the latest OBR forecast suggests.

The key economic determinants that, if downgraded, would feed through into a significantly weaker outlook for tax receipts are average earnings, employment and consumer spending, since these affect revenues from the three largest taxes – income tax, National Insurance contributions and VAT. There is no strong evidence that the outlook for these determinants has moved in a particular direction since the OBR's forecasts in November.

Equity prices, however, have fallen particularly sharply since the start of the year. Unless the lost ground is made up before March, this alone could result in a reduction of around £2 billion a year in forecast receipts from capital taxes by the end of the forecast horizon. This is equal to around 0.3% of total revenues or 0.1% of national income.

Another downside risk to future revenues is that, at some point in the next few years, the Conservative government makes good on its manifesto commitment to increase the income tax personal allowance and higher-rate threshold to £12,500 and £50,000, respectively. This would cost around £8 billion per year, which is not yet factored into the official forecasts.

Official policy is for rates of fuel duties to be increased each year from April 2016 in line with inflation as measured by the (discredited) RPI. Given that rates have been fixed since 2011, it is arguably more likely that they continue not to be indexed at all. But doing this for a further five years would result in £3 billion of lost revenue from 2020–21.

There is also uncertainty about how much will be raised from recently-introduced and potential new anti-tax avoidance measures. The Conservative government has introduced a raft of anti-avoidance and anti-evasion measures that are predicted to raise £3.6 billion

a year by 2020–21. However, the costings for these policies are highly uncertain and they could disappoint. While proposed new international action to tackle tax avoidance might boost expected future revenues (which is not yet factored into the official forecast), again there is a significant risk that revenue from these measures will disappoint.

The March 2016 Budget may contain significant new announcements on the income tax treatment of private pension contributions. Some of the options being considered would have a more significant effect on the timing of tax payments in future years than they do on the overall amount that is being raised. It will be very important for the OBR to publish estimates of the effect on revenues in all future years and full details of the underpinning assumptions. The government should not rely on temporary revenues to achieve a budget surplus in 2019–20, since this would not be in keeping with the rationale underpinning the Chancellor’s stated fiscal objectives (described in Chapter 3).