Making Business Sense

The 50p tax - good intentions, bad outcomes

The impact of high rate marginal tax on Government revenues in a world with no borders

November 2011

Contents

Executive summary

Britain's 270,000 richest wealth creators - the top one percent of Income Tax payers - contribute around £40bn of Income Tax a year, 25% of the £163bn paid in Income Tax to the HMRC in total.[1] Britain's highest-earning 14,000 taxpayers who earn more than £1m a year pay an average of £823k in Income Tax a year and contribute a total of £11bn of Income Tax.

Managing this critical source of national wealth is of the utmost importance to the British Government.

This report presents Cebr's analysis of the suitability of high rates of Income Tax in an age of globalisation and increased labour and capital mobility. Drawing on statistical evidence, survey data, existing academic literature and building on a 2009 Institute for Fiscal Studies briefing note which examined the impact of a 45% top rate of Income Tax, the report reaches the following findings:

A. Once a low-tax safe haven for wealth creators, there is a danger that Britain's high-rate tax regime will turn away the modern generation of wealth creators

Britain has lost its place as an attractive, low-tax jurisdiction that welcomes job creators and celebrates financial success. Once one of the most competitive tax regimes in the world, the British tax system is now one of the most punitive.

In the same timespan, other countries have lowered their top rates of tax (and often become more stable, comfortable and prosperous). Countries are increasingly designing tailor-made tax regimes and offering one-to-one negotiations to attract increasingly mobile entrepreneurs and their businesses.

As a result, the Treasury is set to lose the global competition to keep wealth creators and the fortunes they create on British shores. There is even a danger that the 50p tax pushes Britain over an important psychological "threshold" that breaks any sense of a "social covenant" these important taxpayers feel towards their domestic tax regime.

B. Modern wealth creators are increasingly pragmatic and mobile

Younger and more global than their forebears, today's generation of wealth creators have new choices because of digital banking, EU membership, sophisticated HR and remuneration arrangements introduced by increasingly sympathetic employers, financial deregulation, migration and a creative wealth management industry that reaches beyond a small world of billionaires and now offers tax management to small companies and professionals.

[1] Survey of Personal Incomes 2007-08

Wealth creators have embraced the tax-minimising opportunities of a digital, globalised economy. Physical emigration and fraud – whilst still significant issues for the Treasury – are no longer the only sources of leakage for the HMRC. An increasing number of wealth creators can now enjoy a degree of "financial emigration" whereby they employ perfectly legal and pragmatic approaches to modern tax management to channel their wealth out of domestic high-rate Income Tax and into lower-tax categories and legal overseas arrangements, whilst never leaving home.

To the modern wealth creator, Income Tax is effectively voluntary.

C. The Treasury's assumptions about 50p tax seem somewhat dated and in need revision

Our calculation shows that the combination of higher VAT, higher National Insurance Contributions and increased labour and capital mobility mean that the 50% rate of Income Tax is likely to lead to a loss of tax revenue for the Government.

Indeed, our analysis suggests that the **revenue maximising top rate of Income Tax is likely to be less than 40%.**

Conclusion

Whilst well-intentioned, advocates of 50p tax are likely to cost the Treasury a significant amount of money in lost income over the coming years.

As popular as the 50% rate of Income Tax may be among the electorate at present, the analysis in this report suggests that the economic impact is likely to be negative – leading to a loss of tax revenue in addition to deterring entrepreneurship and hard work.

2 Introduction

When the decision on 50p tax was announced by former Chancellor Alastair Darling, the Treasury estimated that it would raise £2.52bn in 2011/12.[2] At the time of the 2010 Budget, these estimates were revised upwards to £3.05bn.[3]

Since then, question marks have risen over the 50% rate of Income Tax for those earning more than £150,000 per year. In particular, whether it raises tax revenue and whether it is having a negative impact on the growth performance of the UK economy.

The disincentive effect of high tax may also deter job creation and entrepreneurship, hindering what is already a fragile economic recovery.

If high tax rates create a disincentive to work and encourage expensive but effective tax management techniques (and possibly even evasion and emigration), they may in fact reduce government tax revenues.

Existing research by the Institute for Fiscal Studies (IFS) has suggested that even a 45% rate of Income Tax for those earning above £150,000 is unlikely to raise any additional revenue for the Government. Even before recent rises in VAT and NIC, it estimated that the revenue-maximising top rate of Income Tax was probably closer to 41%. Despite the popularity of "taxing the rich" among the British electorate at present, the economic evidence is far from clear-cut.

Critical to the IFS research paper is a metric known at the taxable income elasticity, which measures how much taxable income falls as marginal tax rates rise – a result of individuals investing more time and money on tax management, reduced incentives to work and individuals choosing to expatriate their wealth as a response to high tax.

The precise value of this elasticity is uncertain. As marginal Income Tax rates on the rich – before the introduction of the 50% rate in 2010 - had not changed in recent decades, the IFS had to estimate elasticity based on changes to Income Tax during the 1980s. This, in turn, means that their paper makes the implicit assumption that individuals behave the same way now as they did in the 1980s.[5]

A small change in taxable income elasticity – a critical component of in the Treasury's income forecast - would mean that, instead of raising £3bn for public services, the 50p tax could actually lead to a loss of revenue to the Exchequer.

In Cebr's view, times have changed. Given the onward march of globalisation and increased labour and capital mobility in recent decades, assumptions based on 1980s data are unlikely to be reliable (something the IFS paper acknowledges).

For a generation of savvy, highly-mobile wealth creators with roots in several tax jurisdictions, a 50% rate of Income Tax is even more unlikely to raise the expected tax revenue as these individuals choose to manage their tax affairs more efficiently, even relocating to more favourable tax regimes overseas, leading to an outflow of wealth and income – impacting tax revenue, job creation and business investment.

The negative impacts of excessively high Income Tax are compounded still further by the fact that they also deter high-income, high-skill entrepreneurs and employees from overseas choosing to settle in the UK.

Furthermore, compared with the 1980s, there has been an increase in the number of financial products which upper middle class individuals can utilise to minimise their tax burden – Offshore Bonds, Venture Capital Trusts and Individual Savings Accounts all provide individuals with a means of reducing how much they have to pay in Income Tax.

Essentially for many of today's generation of wealth creators, **Income Tax has largely become a voluntary tax for high earners.**

This report draws on evidence from a range of sources, examining how the revenue maximising rate of Income Tax is likely to have changed since the 1980s.

[2] HC 407 April 2009 pp153-4.
[3] Budget 2010 HC 451 March 2010 p140.
[4] IFS Briefing Note 84: Can more revenue be raised by increase Income Tax rates for the very rich?
[5] See page 5 of IFS briefing note – footnote 7

A

Once a low-tax safe haven for wealth creators, there is a danger that Britain's high-rate tax regime will turn away the modern generation of wealth creators

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3 The UK's competitive position

The UK has gone from being a relatively low tax place to do business to one which is relatively uncompetitive compared with other larger economies. The country now has the highest top (central government) rate of Income Tax among the 10 largest economies in the world, as shown in Figure 1.

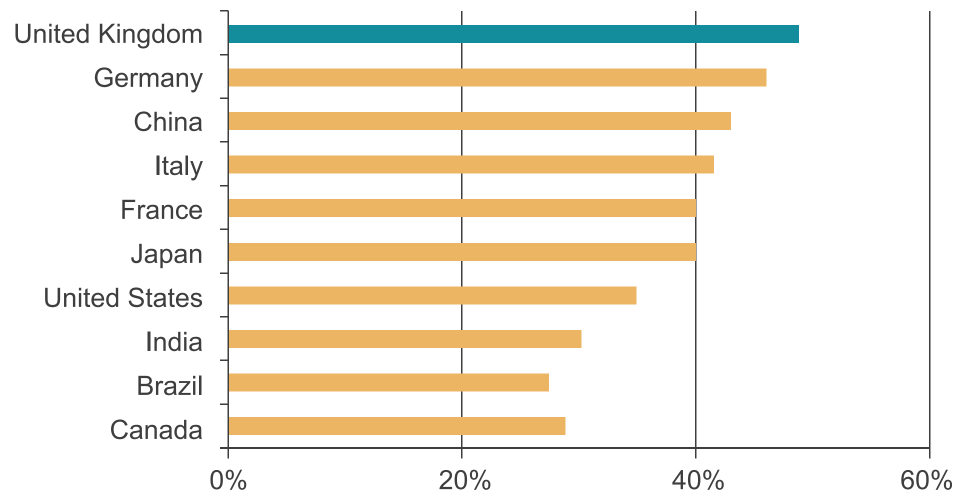

Fig. 1:
Top rate of central government income tax in the ten largest economies in the world, 2011

Since 1997, the UK has dropped from 4th position to 95th in the World Economic Forum's tax competitiveness ratings. [6]

This can be seen from figure 2 in KPMG's global tax survey which shows how, with a highest rate of tax set at 40%, Britain was once in the middle of the pack of OECD countries. But, now with a 50p tax, it appears to have crossed a threshold and joined a minority of countries like Sweden, Norway and Finland with high rates of taxation.[7]

[6] World Economic Forum, The Global Competitiveness Report: 2010-11, September 2010
[7] BKPMG Individual Income Tax and Social Security Rate Survey 2011 (page 28)

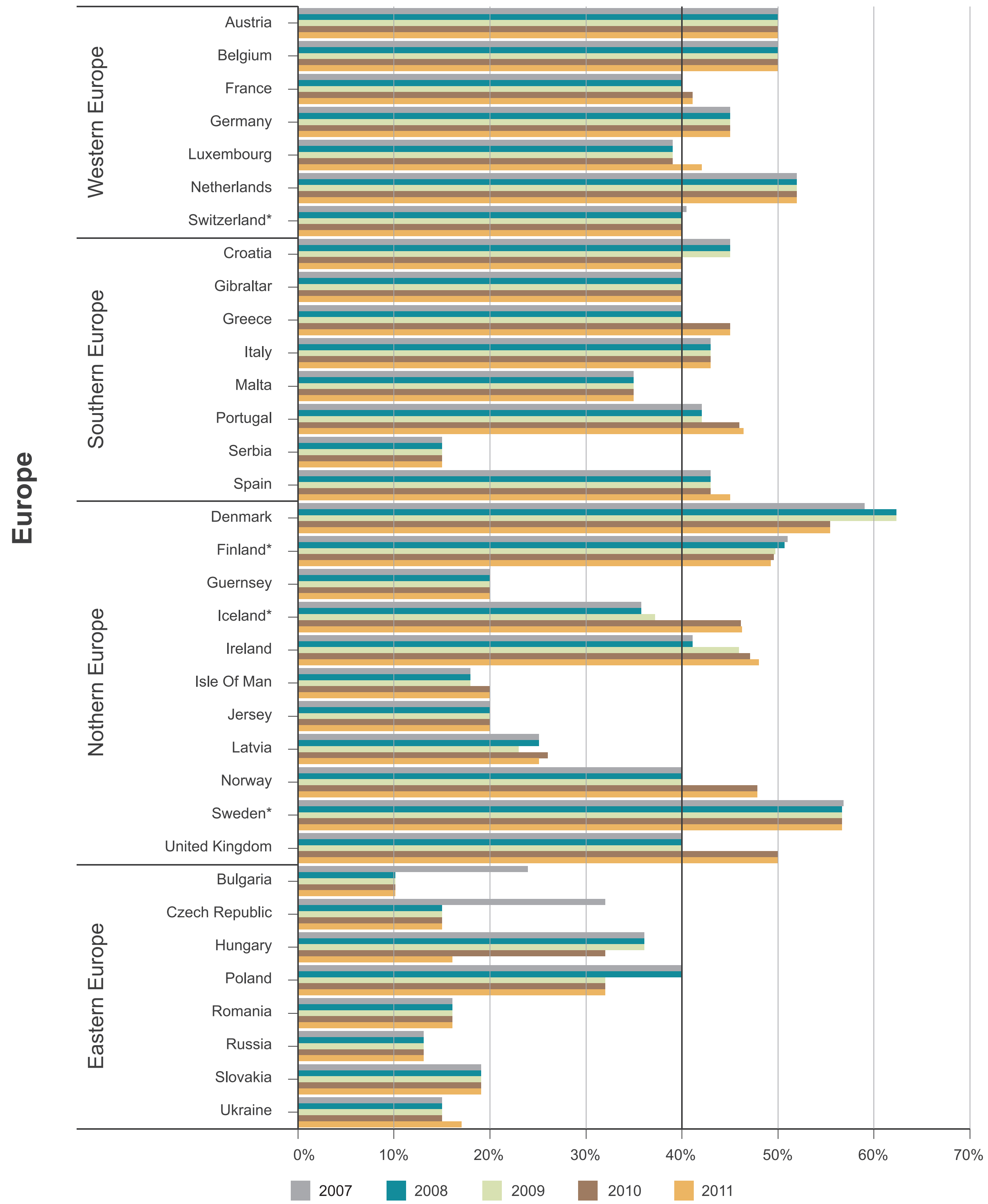

Fig. 2
KPMG Global Tax Survey

Notes*
With the exception of Switzerland where the figure quoted includes Zurich cantonal and communal rate, and Sweden, Finland and Iceland where the figures quoted include average rate across municipalities, amounts reported do not include state/provincial rates.

Source: Tax rate and social security information for each country provided by the KPMG member firm in each respective country.

With the addition of National Insurance and VAT, Britain is in danger of pricing high income beyond a threshold that is reasonably acceptable to law-abiding wealth creators.

The UK's tax competitiveness - as measured by the Heritage Foundation's Index of Fiscal Competitiveness - has slid in recent years, as shown by Figure 3. The UK is now less fiscally competitive than Germany and Canada - something which was not the case ten years ago. **Indeed, among the ten largest economies in the world, the UK is now the least fiscally competitive.**[8]

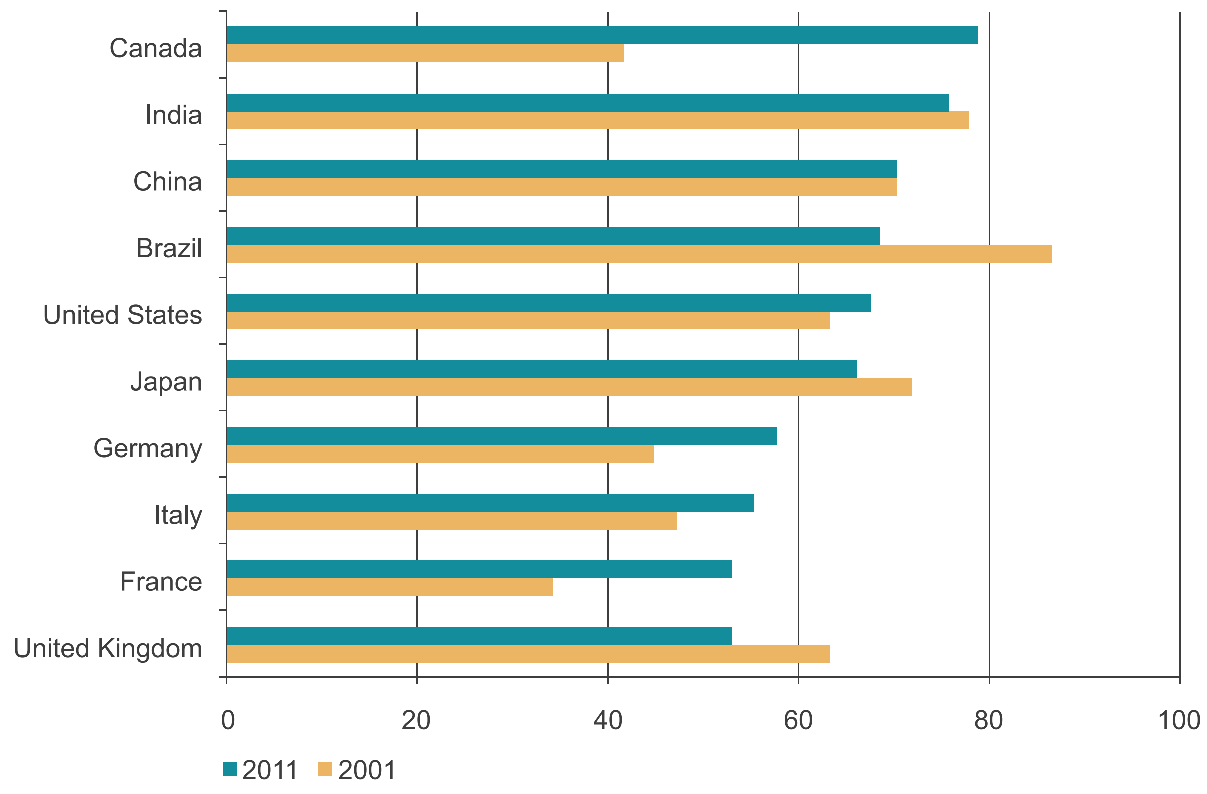

Fig. 3:
Heritage Foundation Index of Fiscal Competitiveness

[8] The Index of Fiscal Freedom is a measure of the tax burden imposed by government. It includes both the direct tax burden in terms of the top tax rates on individual and corporate incomes and the overall amount of tax revenue as a percentage of GDP.

Whilst Britain has increased taxes rates for wealth creators, other countries have developed policies to make their tax arrangements more attractive. Traditional tax havens like the Cayman Islands and Jersey are home to increasingly sophisticated wealth management industries. Entrepot economies like Dubai and Hong Kong have energetic inward investment programmes that advertise low-tax regimes. Even mature economies are competing. Ireland has set its corporation tax at a competitive rate that has successfully attracted the European headquarters of global firms like Google and, after a head-to-head competition with Britain, Twitter. Spain passed the Spanish Tax Decree, known as the "Beckham Law", in June 2005, so foreign workers living in Spain are liable only for Spanish taxes on their Spanish source income and assets.

The position of the UK vis-à-vis other nations is important; if other countries had also increased their top rates of Income Tax at the same time as the UK, the rationale for an individual moving wealth and income abroad in response to higher tax would be limited.

However, with the UK having raised taxes in relative isolation, thus becoming more tax uncompetitive, the high rate of marginal taxation feels tangibly higher than the median to many tax payers; creating a greater imperative to take steps to expatriate income or wealth, or even emigrate altogether.

Unlike mandatory taxes like stamp duty or inheritance tax that are linked to legal commitments and therefore difficult to avoid, efficient Income Tax collection relies, in part, on a sense of social commitment amongst taxpayers.

There is growing evidence that this social covenant and sense of obligation, once one of the attractive qualities of British life, is giving way to a new pragmatic attitude.

B

A generation of modern, globalised wealth creators who are increasingly pragmatic about their tax affairs treat Income Tax as "voluntary"

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4 Income management in the modern era

In an age of financial market liberalisation, more sophisticated financial products and easier access to wealth management services, high-income individuals can now tap into new means of reducing their tax burden. Income Tax has essentially become a voluntary tax, where individuals can opt-out by utilising financial products.

The British government ignores these mega-trends at their peril.

A combination of financial market liberalisation, an increased number of financial products and easier access to wealth management services means that individuals on high incomes are now able to minimise their tax liability far more effectively than in the past.

Perfectly legal, over-the-counter financial products, such as individual savings accounts (ISAs), venture capital trusts (VCTs), and offshore bonds now enable individuals to reduce their Income Tax burden. Some offer Income Tax relief. Some effectively turn income into capital. And some "house" income until either (a) there is a change in Income Tax rates or (b) the taxpayer has a chance to spend a mid-career gap year abroad for tax purposes (or a "Tax-yah") – see section 5.

Even without using these relatively new financial products, individuals can minimise their tax through effective wealth management. For example, by moving from income investments to investments which are subject to capital gains tax, or by transferring income-producing investments to a spouse, individuals can reduce tax burdens. Similarly, individuals may choose to set themselves up as a company as a way of having access to more ways of paying less tax.

Individuals may also engage in **salary sacrifice**, where they give up some of their income in exchange for enhanced benefits such as workplace car parking, childcare vouchers or workplace nurseries. There is thus a plethora of products and services which individuals can employ to reduce their tax burden. Critically, there are more options available now than there were in the 1980s – which almost certainly means that the responsiveness of taxable income to higher rates of Income Tax is higher now than it was in earlier decades.

With so many products available on the market the **Income Tax is now essentially a voluntary tax**, which individuals can easily avoid by rearranging their financial affairs – this casts doubt on the ability of the tax to effectively raise additional revenue for government.

5 Globalisation and the rise of "fiscal migration" and "virtual emigration"

Since the 1980s, the UK labour force has become increasingly globalised. Immigration and emigration have increased sharply.

Compared with the 1980s, the UK has become an increasingly globalised country. Composite measures, such as the Globalisation Index produced by the Centre for the Study of Globalisation and Regionalisation, paint the UK as a country which has become more socially, economically and politically tied to the rest of the world. In particular, capital and labour can more easily move across national borders than was the case in the early 1980s. See figure 5.[9]

Fig. 4:
CSGR Globalisation Index for the UK (a higher value suggest a more globalised economy)

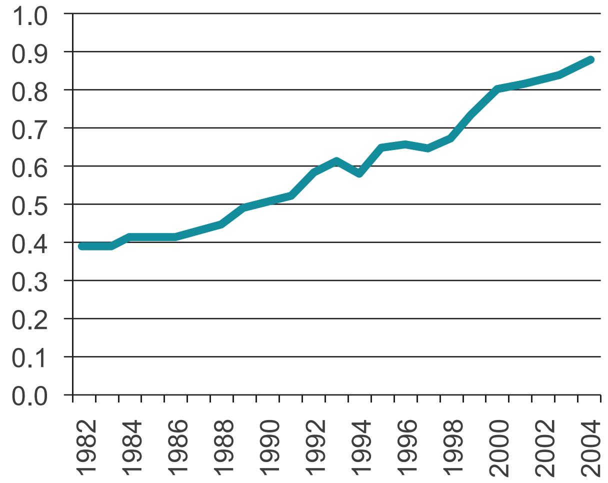
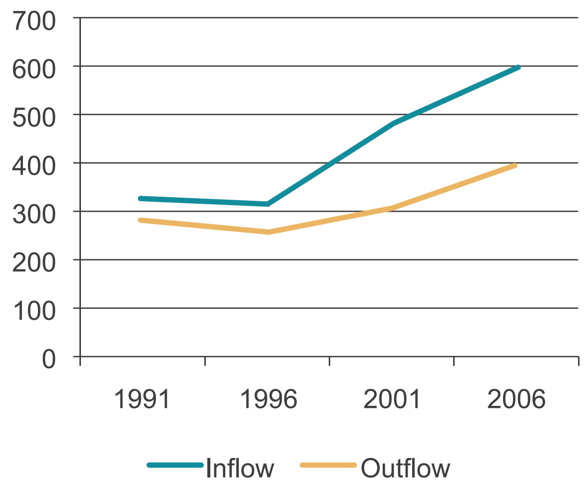


Fig. 5:
Inflows and outflows of individuals to and from the United Kingdom, thousands



[9] www2.warwick.ac.uk/fac/soc/csgr/index

There is strong evidence of increased labour mobility in recent decades. Over the 15 years between 1991 and 2006, migration into the UK rose by 74% while emigration from the UK rose by 40%, as shown in Figure 5. A third of Londoners were not born in Britain.

These mega-trends have three key effects:

- The prospect of moving tax jurisdiction, which seemed formidable even a few years ago, is more attractive as more countries offer first-world levels of comfort, education facilities and security;
- More British taxpayers have roots – businesses, houses, families – in overseas jurisdictions which can be used to optimise their tax position;
- There is now an intense competition between jurisdictions for wealth creators, particularly those from volatile regimes who are looking for a safe haven. Amongst the rich, "economic migration" has been replaced by "fiscal migration".

Tax laws drafted during the British Empire cannot keep up with the lifestyles of a new generation of business people, as demonstrated by recent cases featuring Mr. Robert Gaines-Cooper, a jet setting jukebox businessman, and Mr. Lyle Grace, an airline pilot.

6 Virtual emigration

In today's economy it is no longer necessary to emigrate to a tax shelter like Monaco for the rest of your life to escape the British taxman.

Many business owners are taking advantages of the relatively weak treatment of income by many tax treaties that were negotiated at a time when British Income Tax was relatively low and capturing capital gains tax was a greater priority. A British taxpayer can spend just one year offshore to claim non-residency and thereby escape UK Income Tax for that year. With the agreement of the local tax jurisdiction, income over a period which is housed in some sort of offshore bond can be paid in a lump sum during this period. Spending a mid-career tax year abroad (known as a "Tax-yah") is becoming an enjoyable gap year for many young wealth creators seeking to crystallise their earnings and maybe take their family on a worldwide trip before returning to Britain.

Nor is this international approach confined to the super-rich. The HMRC recently revealed that it had records of 500,000 undeclared offshore bank accounts held by British taxpayers which would indicate that the practice of off-shoring wealth had crossed over to the mainstream on a massive scale.

The HMRC revealed last month they were targeting the growing number of taxpayers with overseas second homes.

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7 The challenge facing policy-makers

With individuals more able and more inclined to move to countries which offer the best economic opportunities, policymakers in the UK can no longer set policy on the basis that individuals will not emigrate as a response to the negative aspects of a policy. Changes in tax rates can either attract or deter individuals from living in the UK (something which is backed up by survey evidence presented on the following page) – with important economic implications.

The increased mobility of labour is likely to be particularly apparent among high net wealth individuals. Supporting this view, a study by Brewer et al. (2008) showed that the fraction of individuals born outside the UK at the top of the UK income distribution has increased much more rapidly in recent years than the fraction in middle groups, suggesting that a relatively favourable tax regime in the UK over this period was successful in attracting high wealth, high income individuals from overseas – beneficial from a revenue maximisation perspective.[10]

As Lord Bilimoria, Chairman of Cobra Beer and Chairman of the UK-India Business Council put it:

> ***"Not only is excessive tax a burden on business, a disincentive to entrepreneurship and a burden on the consumer, but it is a disincentive for overseas talent. We are driving people away."*** [11]

Due to the 50p top rate of Income Tax, it now seems unlikely that the UK will continue to benefit from an inflow of high-income individuals from overseas.

[10] Brewer, Saez and Sherphard, Means Testing and Tax Rates on Earnings, 2008
[11] Theyworkforyou, 25th March 2010:
http://www.theyworkforyou.com/lords/?id=2010-03-25a.1072.0&s=50p+tax+2010-03-25..2010-05-01+section%3Auk#g1094.0

8 Changing attitudes to emigration

Indeed, the UK may soon start to suffer from an outflow of wealth from the country. Less than half of millionaires are committed to staying in the UK and high taxation is the most frequently cited reason for considering leaving the country, according to a recent survey by savings and investments company, Skandia.

Skandia's survey of 549 millionaires in June 2011 showed that only 44.1% of millionaires were certain of remaining in the UK, while 7.7% were planning to leave (Figure 4 illustrates). Just under half (48.2%) were either considering moving abroad or felt that certain circumstances might make them do so. See figure 6.

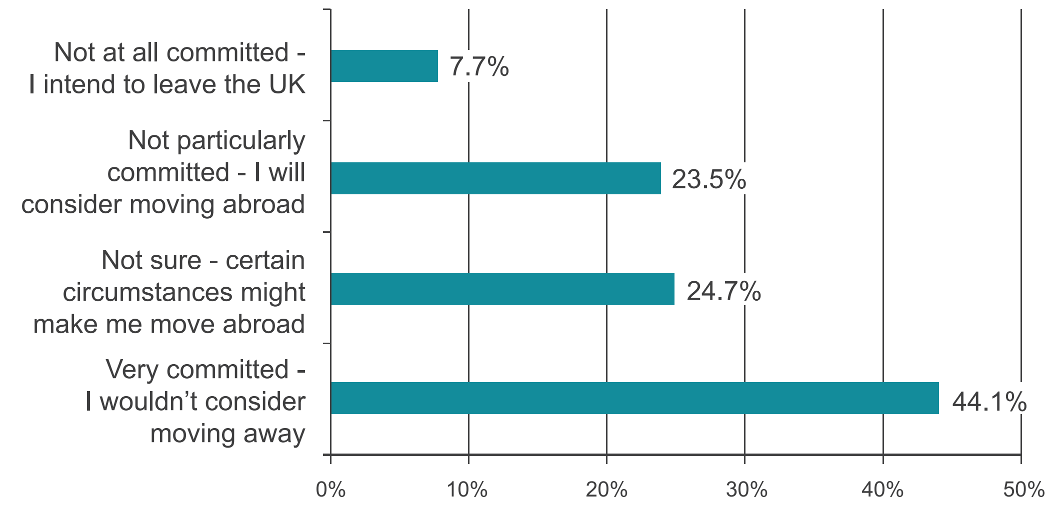


Fig. 6:
How committed are you to living in the UK?

Critically, high taxation was the most frequently cited reason for considering leaving the UK, with just under a third (31%) citing it as a reason, as shown in Figure 5. Overall, this suggests that more favourable tax regimes elsewhere have the potential to attract high income, high wealth individuals from the UK, while punitive rates of Income Tax have the potential to trigger individuals to leave the UK – resulting in a reduction in tax revenue for the government. See figure 7.

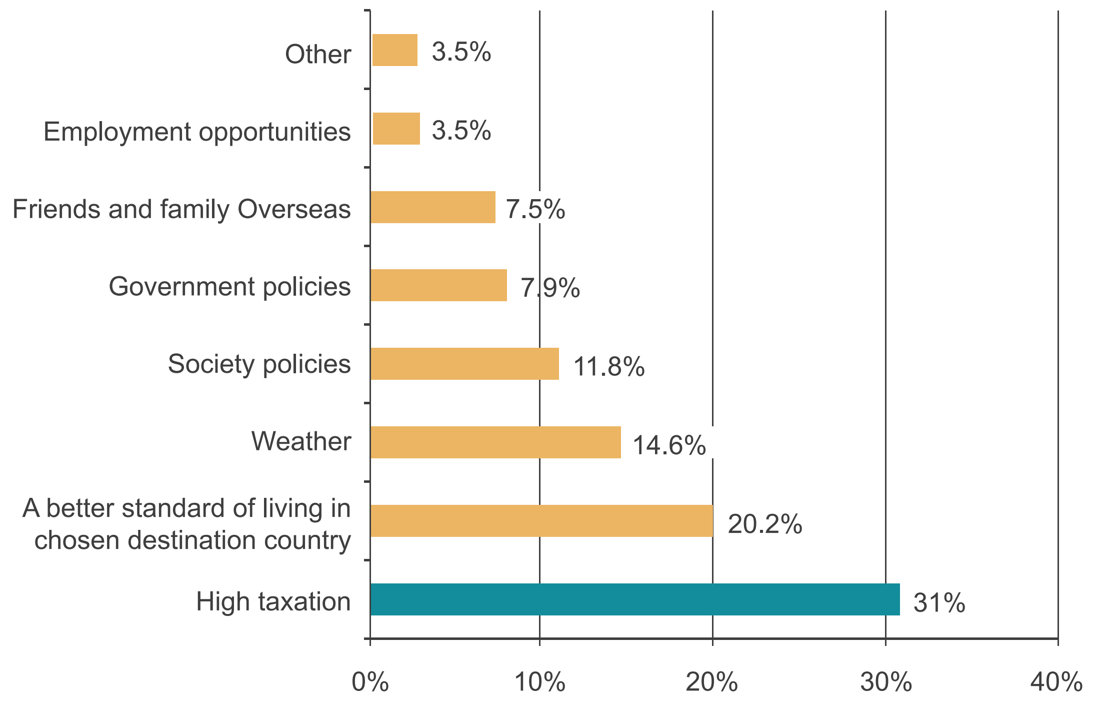


Fig. 7:
Reasons why you would consider leaving the UK

The Skandia survey shows that almost twice as many under 50s (9.9%) intend to leave the UK as over 50s (5.1%), **suggesting the difficulty of retaining high wealth, high income individuals may be particularly acute among younger generations**.

9 The disincentive effect of high taxation

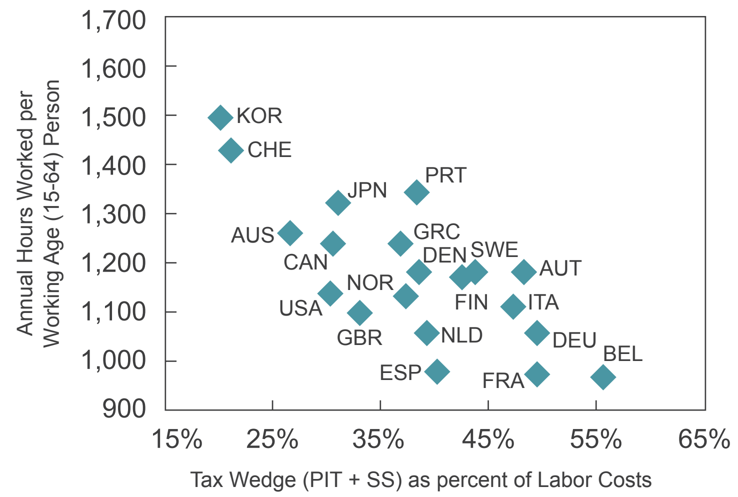
Higher tax rates have a tendency to discourage work, as shown in a recent OECD study

One way that individuals can reduce their taxable income following an increase in direct taxes is to work less hours or apply less effort in the workplace – a result of the disincentive effect created by higher marginal rates of Income Tax; if the returns from working more hours fall as a result of having to pay more tax, individuals will in general work less hard, according to economic theory.

And indeed this theory appears to be backed up empirically. Data by the Organization for Economic Cooperation and Development (OECD) has shown a strong link between high levels of personal tax and average hours worked per person – countries with high rates of Income Tax see lower average hours worked by individuals – suggesting some disincentive effect from higher taxation. Figure 8 illustrates.

Fig. 8:
Tax wedge versus average hours worked, selection of countries

Source: OECD
Notes: PIT refers to Personal Income Tax. SS refers to Social Security contributions



A 2008 OECD paper also found that high personal Income Tax "can reduce productivity growth by reducing entrepreneurial activity," while another paper suggests the 50% rate of Income Tax in the UK is likely to "adversely affect incentives and entrepreneurialism". [12][13]

[12] OECD, Tax and Economic Growth, 11th July 2008
[13] OECD, United Kingdom: Sustainable policies for growth, July 2010

10 Resistance to paying tax is leading to new collection costs

At a time when rates are rising, HMRC have been obliged to invest nearly a billion pounds in fighting an increasingly complex battle to enforce Britain's tax laws.[14]

Last autumn, as part of the UK government spending review, Danny Alexander the Chief Secretary to the Treasury committed £900m to help HMRC fight tax evasion with a plan to find £7bn of unpaid tax money before 2014/15.

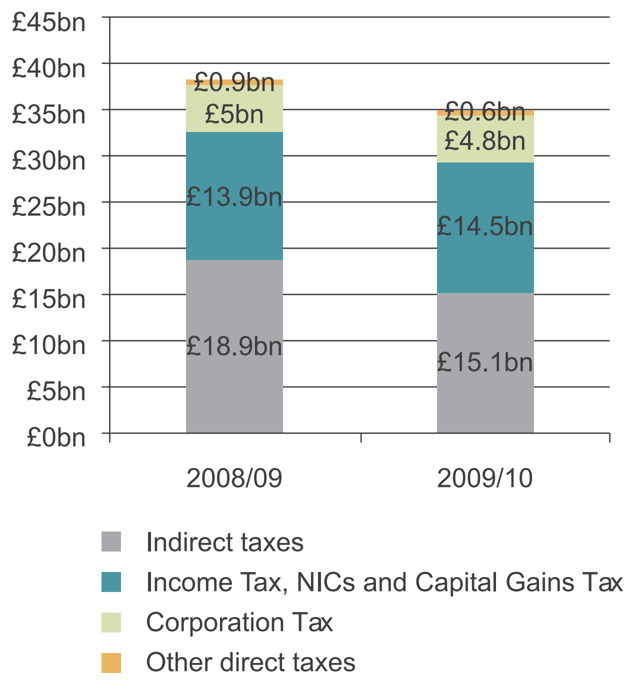
Currently, 2,250 tax inspectors are being recruited to crack down on tax avoidance among 350,000 of the UK's wealthiest people, many of whom pay 50p tax. And the 5,000 super-rich worth in excess of £25 million are being targeted by a High Net Worth Unit.

Despite these recent crackdowns, the "tax gap" in the UK is still huge, and tax evasion remains difficult to combat. The new top rate of Income Tax has increased the incentive to engage in tax evasion, tax avoidance and participate in the "hidden economy".

Between 2008/09 and 2009/10, the tax gap – a measure of the amount of tax uncollected by HM Revenue and Customs – fell from £39 billion to £35 billion.

In 2009/10, tax evasion and the hidden economy combined accounted for £13 billion (37%) of the tax gap. Furthermore, while the tax gap for most other forms of taxation fell between the 2008/09 fiscal year and the 2009/10 fiscal year, the gap for Income Tax, National Insurance contributions and Capital Gains Tax widened from £13.9 billion to £14.5 billion, as Figure 9 illustrates.

Fig. 9:
Size of the tax gap, £ billions.



[14] http://www.hm-treasury.gov.uk/press_46_10.htm

C

The Treasury's assumptions about 50p tax seem somewhat dated and in need revision

11 Globalisation and Corporation Tax

Economic studies of Corporation Tax have tended to show a fall in revenue-maximising tax rates over time – directly linked to increased capital mobility as a result of globalisation.

Studies into revenue maximising rates of Income Tax are relatively hard to come by because Income Tax systems in most countries are complicated and thus not easily comparable. Many countries have progressive tax systems with different rates for different income bands, in addition to tax free personal allowances which differ from country to country. This significantly complicates cross-country studies of Income Tax. The relative infrequency of Income Tax changes in countries such as the UK - before the introduction of the 50% rate in 2010, Income Tax rates for top earners had not changed since the 1980s - also makes it difficult to statistically estimate the revenue maximising rate of tax.

However, there have been a wide range of studies investigating the revenue maximising rate of corporation tax for a country, given the more straightforward comparability of corporation tax across countries and the higher frequency of changes to this particular form of taxation. We can thus use insights gained from Corporation Tax changes to assess how revenue maximising Income Tax rates are likely to have changed in response to globalisation.

A paper by the American Enterprise Institute suggests that the revenue maximising rate of corporation tax has fallen from 34% in the late 1980s to 26% today. The paper notes that 'a consequence of increased capital mobility may be declining corporate revenues resulting from high tax rates … the benefits of being a low tax country, and costs of being a high tax country, might be significantly higher today than they were in the 1980s.'[15]

A paper by Clausing (2007) similarly found that the revenue-maximising rate of corporation tax decreases as economies become more integrated with the world economy, suggesting that globalisation has a significant impact on the responsiveness of companies (and presumably individuals) to changing tax regimes.[16]

Another paper by Altshuler, Grubert and Newlon (2001) found that foreign direct investment has become increasingly responsive to tax rates as the elasticity of foreign capital with respect to after-tax rates of return rose from 1.5 in 1984 to 3.0 in 1992.[17]

There thus appears to be a broad range of studies suggesting a negative correlation between increased capital mobility and the revenue maximising rate of corporation tax – the more open an economy, the lower the revenue maximising rate of corporation tax will be.

A similar argument must apply with respect to labour mobility – as labour has become more mobile since the 1980s (and migration statistics suggest this is the case for the UK), the revenue maximising rate of Income Tax is likely to have diminished in recent decades – that is to say, the taxable income elasticity has almost certainly increased since the 1980s.

[15] Brill and Hasset, Revenue-Maximising Corporate Income Taxes: The Laffer Curve in OECD countries, 2007
[16] Clausing, Corporate Tax Revenued in OECD Countries, 2007
[17] Altshuler, Grubet and Newlon, Has US Investment Abroad Become More Sensitive to Tax Rates?, 2001

12 What is the revenue maximising top rate of Income Tax?

Previous estimates of the taxable income elasticity were based on the assumption that British wealth creators were strongly rooted in the British Isles and felt a moral obligation towards the British tax system. In this world, the only leakage was through extreme measures such as evasion or emigration that resulted in dramatic consequences for the taxpayer and their family.

This study shows that these assumptions are no longer relevant.

The modern British wealth creator has many more options. Whilst many high-rate taxpayers are tied to the PAYE system, many others have much more flexible arrangements. A growing number have roots in offshore jurisdictions which provide opportunities to optimise their tax affairs. A culture of currency control and the branch bank manager has given way to digital banking and "wealth management". Offshore jurisdictions have become more comfortable, safer and, sometimes, offer richer economic prospects.

There is good evidence that an increase in high-rate Income Taxes beyond 40% will lead to a loss of revenue to the Exchequer over the coming years.

Calculating the taxable income elasticity

Higher rates of Value Added Tax and National Insurance Contributions mean that the revenue maximising rate of Income Tax for the very rich has fallen over the past year. Combined with increased labour and capital mobility, this means the revenue maximising top rate of Income Tax is likely to be less than 40%.

Individuals on high incomes pay more taxes than just Income Tax – they also pay National Insurance on their incomes and they pay Value Added Tax on many of the goods and services they purchase. This means that the *effective* marginal tax rate experienced by those earning more than £150,000 is in fact much greater than 50%.

Since 2009, we have seen Value Added Tax rise to 20%, and also seen increases in employer and employee National Insurance Contributions. Consequently, high earners currently face a marginal effective tax rate of **65%** on their incomes, much higher than the 57% revenue-maximising effective tax rate under the IFS' central estimate of taxable income elasticity (0.46).

For a given taxable income elasticity, higher National Insurance Contributions and Value Added Tax mean that the revenue maximising rate of Income Tax is now lower than it was under the IFS paper. This is reflected in Figure 10 below.

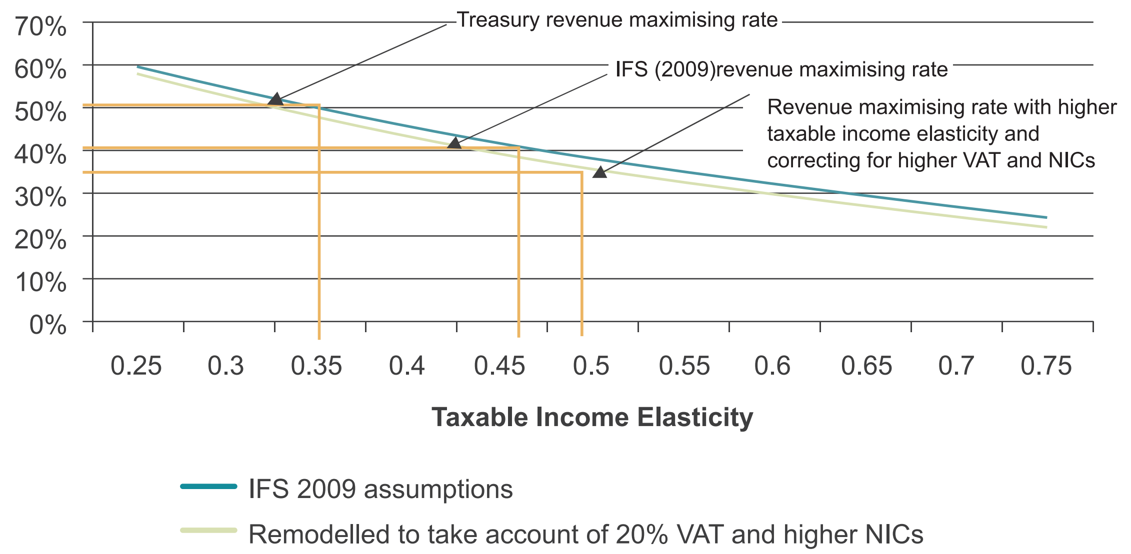


Fig. 10:
The revenue maximizing top rate of income tax for a range of taxable income elasticities

Under the IFS's central estimate of the taxable income elasticity, **the optimal top rate of Income Tax for higher earners has fallen by two percentage points from 40.9% to 38.9% as a result of higher National Insurance contributions and increased Value Added Tax.**

When the impact of higher VAT and National Insurance Contributions is compounded with a rise in the taxable income elasticity as a result of increased labour and capital mobility, and better access to tax-minimising financial products, the revenue maximising rate of Income Tax is likely to be even lower.

While the exact magnitude of the increase in the taxable income elasticity is difficult to calculate, in Cebr's view economic analysis, survey results and globalisation indices all point towards a higher taxable income elasticity than in the 1980s.

Even a conservative increase in the taxable income elasticity from 0.46 to 0.50 would reduce the revenue maximising top rate of Income Tax to just 36%, suggesting that the current 50% rate of Income Tax almost certainly does not raise any additional revenue for the government.

13 How much will the 50p tax raise?

Some 1% of the population pay 25% of the country's income tax, £39.4bn of £163.0bn, according to 2007-8 HMRC data.[18]

If there was no emigration or evasion and taxpayers' behaviours did not change, the total additional revenue from a 25% increase in high-rate marginal taxes from 40p to 50p would yield around £4.8bn of income per annum – or £5.1 billion if incomes have grown in line with average earnings; it is likely that they will have grown by more than this –prices have risen by 14.5% in this time.

However, there is clearly leakage. Emigration and tax evasion represent drastic measures. Tax management and the re-routing of wealth creation into lower tax channels or harbouring overseas are examples of legal, pragmatic tax planning. There is a debate about how much of the potential tax revenue will "leak" related to the true value of the taxable income elasticity.

When the decision on 50p tax was announced by former Chancellor Alastair Darling, The Treasury estimated that it would raise £2.52bn in 2011/12. However, at the time of the 2010 Budget, these estimates were revised upwards to £3.05bn. Hence, the Treasury assumes that out of £4.8 bn in potential additional tax income from the 50p rate, there would be leakage of some £1.8 billion based on the 2007-8 figures. However, in 2011/12 compared to 2007-8 average earnings have increased by 5% - this would imply that there is £5.1 bn in potential additional tax income – and the HMT estimate would thus imply £2.0 billion is "leaking".

The implications of income tax elasticity changes

The Treasury's assumptions, based on 1980s behaviours, suggested income tax elasticity of around "0.35". However, recent IFS work indicates that the number is more likely around "0.46", in which case the effect of the high-rate income tax rise probably loses the government revenue.

Work by Cebr suggests that the income tax elasticity could well be still higher, around "0.5", in which case, in the medium term, once the relevant taxpayers have had a chance to change their tax arrangements, the increase in high-rate income tax is even more likely to be costing the Exchequer revenue each year.

This concern was recently articulated by Paul Johnson, the director of the IFS: "It looks like the 50p rate may be too high and that it is possible it will reduce tax revenues. It could lead to more people investing in tax avoidance, illegally hiding their income or even leaving the country altogether. I wouldn't have introduced the 50p rate in the first place."[19]

[18] http://www.hmrc.gov.uk/stats/income_distribution/3-5table-jan2010.pdf
[19] http://www.telegraph.co.uk/finance/economics/8761237/50p-tax-rate-costing-Treasury-500m.html

14 Concluding remarks

There is some possibility that the 50% rate of Income Tax may raise revenue in the short term, but to use one or two years' worth of tax receipt data to support the case for maintaining the top rate would be misleading. Individuals may take several years to emigrate or rearrange their income/wealth in response to higher taxation, meaning that the negative impact of excessive Income Tax on government revenue may not be initially apparent.

In the long term, however, globalisation, financial liberalisation and mobile labour means that the scope for governments to raise revenue by taxing the rich has become increasingly limited.