REFORMING THE TAXATION OF DIVIDENDS

REVENUE ESTIMATES FOR LABOUR, THE CONSERVATIVES AND THE LIBERAL DEMOCRATS

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INTRODUCTION

Taxation is the means by which governments raise revenue and fund the welfare and public services on which a civilised society depends. The IPPR Commission on Economic Justice identified a need to move to a higher tax, higher spend economy – with future public spending challenges likely to increase over time (IPPR CEJ 2018). We also seek a tax system that is more progressive – so that those with the greatest ability to pay contribute the most – as well as more transparent and efficient. The UK is one of the most unequal countries in the developed world, and income inequality could be set to worsen as capital and property ownership become more important sources of income generation. Redistribution is essential for economic justice.

This briefing paper focuses on the proposal that income from wealth should be taxed the same as income from work, with a focus on dividend income. It is profoundly unjust that those who work for their incomes are taxed more highly than those whose income is derived from wealth. This situation is all the worse when we consider that the wealthiest are less likely to generate their income from labour than the rest of us. Payments to shareholders primarily benefit a wealthy minority. Among the richest 1 per cent, over one-quarter of total income is generated from dividends and partnership income alone (Joyce et al 2019). UK taxpayers earning over £150,000 (barely 1 per cent of all taxpayers) captured around 22 per cent of all direct income from UK dividends (High Pay Centre and TUC 2019). Dividend income accruing via pension savings also primarily benefits those at the top – 46 per cent of pension wealth is owned by the wealthiest 10 per cent of households (ibid). Economic justice demands change.

Following this principle would mean that dividend income would be taxed at the same main rates as income from employment, and the separate tax-free dividend allowance of £2,000 per year would be abolished. Tax rates on dividend income are currently lower than tax rates on income from work. Lower tax rates for the wealthy than for ordinary earners are fundamentally unfair; they also distort economic behaviour and create opportunities for tax avoidance. Particularly in the case of owner-managers and executives, income can be shifted into dividend payments to face a lower overall tax bill than if income were received as employment income.

In a previous report, *Just Tax* (Nanda and Parkes 2019), we estimated the revenue impact of reforms to the taxation of capital gains such that gains would be taxed under the income tax schedule. Here, we estimate the revenue impact of analogous changes to the taxation of dividend income. We find that these changes could raise £33 billion over five years under the current income tax schedule, falling to £29 billion with behavioural effects. There are inevitably large uncertainties around these estimates, but even if the behavioural effects were larger, we would still expect these changes to raise significant sums.

In this paper, we also consider the impact of these changes if made alongside the new income tax schedules likely to be proposed by Labour, the Conservatives and the Liberal Democrats. We find that under Labour's new schedule, the amount of additional revenue raised would instead be up to £42 billion over five years, falling to £37 billion when accounting for potential behavioural effects. Under the Conservative's proposals, these changes could instead raise an additional £30 billion over five years, falling to £26 billion with behavioural effects. Under the Liberal Democrats' proposals, these changes could raise an additional £36 billion over five years, falling to £32 billion with behavioural effects.

OUR PROPOSAL

Our modelling here considers changes to dividend tax only. We propose the following changes, which we have incorporated into our modelling.

Taxing dividend income at the same rates as earnings

Currently, dividends are taxed at 7.5 per cent for basic rate taxpayers, 32.5 per cent for higher rate taxpayers and 38.1 per cent for additional rate taxpayers. We propose that dividends should instead be taxed under the ordinary income tax schedule. Currently, that would mean dividends would be taxed at rates of

20 per cent for basic rate taxpayers, 40 per cent for higher rate taxpayers, and 45 per cent for additional rate taxpayers.

In addition to modelling this change under the current income schedule, we also estimate revenues under the Labour, Conservative and Liberal Democrat likely proposed income tax schedules.

Proposed changes to income tax

Labour has proposed lowering the 45 per cent additional rate income tax threshold from £150,000 to £80,000 and reintroducing the 50 per cent rate for those earning above £125,000 (The Times 2019a).

During the 2019 Conservative party leadership contest, Boris Johnson announced plans to raise the higher rate income tax threshold from £50,000 to £80,000 (Johnson and Waters 2019). While recent reports have suggested this may not feature in the manifesto, we include it here as the only trailed policy which would affect the revenue estimates (The Times 2019b).

The Liberal Democrats have proposed a 1p rise in the rate of income tax, bringing rates up to 21 per cent, 41 per cent and 46 per cent (Politics Home 2019).

Removal of the personal dividend allowance

Currently, dividend taxpayers receive an additional personal allowance of £2,000, meaning that individuals with income from both employment and dividends will benefit from a larger tax-free allowance compared to people who have earnings from employment alone. We propose removing this in order to bring the taxation of dividends in line with the taxation of income from work.

There should, however, be a *de minimis* allowance, such as £500, to prevent an overly burdensome tax declaration process. This is not included in our modelling, but we would anticipate its impact to be small.

ESTIMATING THE STATIC IMPACT

In this section, we outline our modelling of the static impact of the changes, followed by our modelling of potential behavioural impacts which dampen our estimates. This implicitly assumes that the proportion of tax paid by basic rate, higher rate and additional rate taxpayers stays constant in future years.

Taxing dividend income at the same rates as earnings

The latest HMRC statistics (HMRC 2019a) break down dividend tax liabilities by income tax bracket. We simply apply the current and proposed dividend tax schedules to estimate the mechanical impact of the change in rates on revenues. We then apply these estimated increases to forecast dividend tax revenues. This implicitly assumes that the proportion of tax paid by basic rate, higher rate and additional rate taxpayers stays constant in future years.

We also model the impact of this change under the Labour, Conservative and Liberal Democrat likely proposed income tax schedules. Labour and the Conservatives have both proposed changes to income tax thresholds, meaning that their tax schedules do not map exactly to the current income tax schedule. This therefore requires us to make some assumptions about the distribution of dividend income within the current tax brackets. In the absence of more granular data, we have assumed that dividend incomes are uniformly distributed by number across each interval.

Our results are shown in Table 1.

TABLE 1

Estimated direct increase in tax revenues

Income tax schedule	Current	Labour	Conservative	Liberal Democrat
Percentage increase in revenues	45%	58%	40%	50%

Source: Author's analysis based on methodology outlined above.

We then apply these percentage increases to forecast dividend tax revenues. Disaggregated statistics on dividend tax income revenues or forecast revenues are not readily available. To forecast future revenues, we use the above statistics (HMRC 2019a) on dividend tax liabilities in 2019-20 as a proxy for revenue in 2019-20.[1] In the absence of better data, we then assume that these would rise in line with overall income tax revenue (OBR 2019).[2] This implies additional revenue of £6.8 billion in 2021/22 under the current income tax schedule, rising to £7.8 billion in 2024/25.

Removal of the personal dividend allowance

Here, we use the HMRC cost of the allowance, and then adjust it in line with expected growth in the number of income taxpayers.

HMRC estimates that the direct cost of the personal dividend allowance in 2018/19 was £0.70 billion (HMRC 2019b). Regarding the publication as a whole, they state: "These estimates are particularly tentative and subject to a wide margin of error". We have chosen to use this estimate as it remains the best estimate available.

We then adjust this figure for the expected growth in the number of dividend taxpayers. In the absence of time series data on the number of dividend taxpayers, we assume that the number will grow in line with the total number of income taxpayers. This has grown broadly linearly over the period 1990/91 to

[1] HMRC warns that liabilities may not match up with revenues in a given year. However, a comparison of statistics on overall income tax liabilities and revenues suggested that, for the period in question, liabilities in a given year were a good proxy for revenues in that year.
[2] There is currently no official forecast for 2024/25, but we assume revenue will grow in line with the historic growth rate from 1999/2000 to 2023/24.

2019/20[3]. We project this trend forward. Implicit here is the assumption that the number of individuals whose dividend income falls below the allowance will grow in line with the number of taxpayers.

Taking these adjustments together, we estimate the cost of the allowance to be £0.75 billion in 2021/22, rising to £0.82 billion in 2024/25.

ESTIMATING THE POST-BEHAVIOURAL IMPACT

The direct figure is unlikely to be the true amount raised by the policy, because behavioural changes will have a potentially large impact on revenue. The potential behavioural impacts from the proposed changes to dividend tax are as follows.

Substitution/switching to other forms of income

Changes to dividend tax rates mean that people may make different decisions about the form in which to take their income in order to minimise their total tax bill. Bringing different tax rates more in line means that this avoidance will reduce, and so this effect will have an upwards impact on overall tax revenues.

Tax-motivated incorporations are one example of such substitution. Here, sole traders or partners may find it cheaper to incorporate and receive their income as a company than receive it as an individual.

Greater use of ISAs – which are tax-exempt, and which we are not proposing to remove here – is another such example.

Moving abroad

Those currently in the UK could avoid paying these higher dividend tax rates by moving abroad. However, the evidence suggests that historically, this has been relatively uncommon – only 5 per cent of world billionaires have moved abroad since becoming successful (Guardian 2019).

Ideally, these measures would be accompanied by action against tax havens and cooperation with other countries to align tax rates and prevent a race to the bottom.

Forestalling

When increases in dividend tax are pre-announced, people may bring forward dividend income to avoid paying tax at the higher rate. Dividend income is typically easier to bring forward than other types of income, as the majority of it is received by owner-directors of companies, who can choose when to withdraw their profits (OBR 2017).

Long-run steady state effects

Increases in dividend tax rates may reduce investment in shares. However, this should be balanced against the potential for greater public spending.

[3] Figures for 2017/18 onwards are projections.

Companies may also change their behaviour. Higher tax rates on dividends increases the incentives for companies to opt for retained earnings over dividend payouts. This may lead to increased investment.

It also increases the attractiveness of debt financing over equity financing. We have previously recommended other ways to reduce the relative tax advantages of debt financing (Roberts et al 2018, Blakeley 2018).

Methodology

The July 2015 budget (HM Treasury 2015) estimated the impact of increasing all effective dividend tax rates by 7.5 percentage points and introducing a £5,000 dividend allowance. The budget gave estimates of both the direct and post-behavioural impact of these changes. These estimates are shown in Table 2.

TABLE 2

2015 budget estimates of the impact of changes to dividend tax (£bn)

	2016/17	2017/18	2018/19	2019/20	2020/21
Direct impact	0.0	3.0	2.6	2.8	3.0
Post-behavioural impact	2.7	-0.5	1.6	2.6	2.5

Source: HM Treasury (2015)

Of the above behavioural effects, the 2015 budget estimate accounted for reduced investment, reduced incorporation, and forestalling. They do not specify accounting for individuals moving abroad, which could lower revenues; or individuals switching to other forms of income, which could increase revenues. They do not attempt to estimate the long-run macroeconomic impacts of these changes.

To estimate post-behavioural impact, we have taken the ratio between the direct and post-behavioural impacts estimated by the Treasury and applied these to our own estimates of direct impact. We have excluded the impact of forestalling, on the assumption that these changes would not be pre-announced as they were in 2015. To exclude the impact of forestalling, we have used the ratios from 2019/20 and 2020/21 only. We have taken the average of these two ratios. This gives a result of 88 per cent (a 12 per cent reduction in revenues due to behavioural effects).

Caveats to our approach

This approach assumes that the size of the behavioural impact relative to the direct impact is the same for higher increases in tax rates as it is for the 2015 increases. It also assumes that the size of the behavioural impact relative to the direct impact is the same for those dividends affected by the changes in 2015 as those not affected (those that fell into the £5,000 allowance). In reality, the behavioural impact is likely to be larger for higher changes in tax rates; and we are proposing to raise tax rates not to 38.1 per cent, but to up to 45 per cent, or up to 50 per cent under the parties' income tax schedules. We are therefore at risk of overestimating the revenue raised from these changes after accounting for behavioural effects.

We are also assuming that the size of the behavioural effects relative to the direct effects will be the same for the removal of the dividend allowance as for changes in rates. The allowance means that the current tax rate for those dividends is effectively zero. By removing it, we are therefore starting from a lower tax rate and hence the behavioural effect is not likely to be as large, at least at first; and we are, therefore, in less danger here of overestimating the revenue raised. However, the allowance also covers those with small amounts of dividend income, who are not currently affected by changes to tax rates. This group may have a different behavioural response than those with higher dividend incomes. There is therefore potentially a larger amount of uncertainty associated with our estimates of the behavioural effects of removing the allowance than of increasing tax rates.

RESULTS

Despite the aforementioned limitations, we believe that the approach taken here allows us to estimate approximate figures for the potential impact of the proposed reforms.

Current system

Table 3.1 shows the impacts of our proposed changes, if implemented together, under the current income tax schedule. Interactions between the changes mean that the impacts given here are different from the impacts of each change if implemented individually. We have accounted for this by assuming that, where the changes interact, revenues from one change will rise in proportion with the revenue effects of the other. We do not anticipate changes in year one, as per previous HM Treasury policy costings (HM Treasury 2015).

TABLE 3.1

Marginal impacts of changes (£bn) under current income tax schedule, implemented together

		2020/21	2021/22	2022/23	2023/24	2024/25	Total
Direct impact	**Increase tax rates**	0	+7	+7	+7	+8	+29
	Remove personal allowance	0	+1	+1	+1	+1	+4
	Total	0	8	8	8	9	**33**
Post-behavioural impact	**Increase tax rates**	0	+6	+6	+7	+7	+26
	Remove personal allowance	0	+1	+1	+1	+1	+4
	Total	0	7	7	7	8	**29**

Source: Author's analysis based on methodology outlined above.
Note: Figures may not sum due to rounding.

Labour

Table 3.2 shows the impacts of our proposed changes, if implemented together, under Labour's likely proposed income tax schedule.

TABLE 3.2

Marginal impacts of changes (£bn) under Labour income tax schedule, implemented together

		2020/21	2021/22	2022/23	2023/24	2024/25	Total
Direct impact	**Increase tax rates**	0	+9	+9	+10	+10	+37
	Remove personal allowance	0	+1	+1	+1	+1	+5
	Total	0	10	10	11	11	**42**
Post-behavioural impact	**Increase tax rates**	0	+8	+8	+8	+9	+33
	Remove personal allowance	0	+1	+1	+1	+1	+4
	Total	0	9	9	9	10	**37**

Source: Author's analysis based on methodology outlined above.
Note: Figures may not sum due to rounding.

Conservative

Table 3.3 shows the impacts of our proposed changes, if implemented together, under the Conservative's likely proposed income tax schedule.

TABLE 3.3

Marginal impacts of changes (£bn) under Conservative income tax schedule, implemented together

		2020/21	2021/22	2022/23	2023/24	2024/25	Total
Direct impact	**Increase tax rates**	0	+6	+6	+7	+7	+26
	Remove personal allowance	0	+1	+1	+1	+1	+4
	Total	0	7	7	8	8	**30**
Post-behavioural impact	**Increase tax rates**	0	+5	+6	+6	+6	+23
	Remove personal allowance	0	+1	+1	+1	+1	+3
	Total	0	6	6	7	7	**26**

Source: Author's analysis based on methodology outlined above.
Note: Figures may not sum due to rounding.

Liberal Democrat

Table 3.4 shows the impacts of our proposed changes, if implemented together, under the Liberal Democrat's likely proposed income tax schedule.

TABLE 3.4

Marginal impacts of changes (£bn) under Liberal Democrat income tax schedule, implemented together

		2020/21	2021/22	2022/23	2023/24	2024/25	Total
Direct impact	Increase tax rates	0	+8	+8	+8	+9	+32
	Remove personal allowance	0	+1	+1	+1	+1	+4
	Total	0	9	9	9	10	**36**
Post-behavioural impact	Increase tax rates	0	+7	+7	+7	+8	+28
	Remove personal allowance	0	+1	+1	+1	+1	+4
	Total	0	8	8	8	8	**32**

Source: Author's analysis based on methodology outlined above.
Note: Figures may not sum due to rounding.

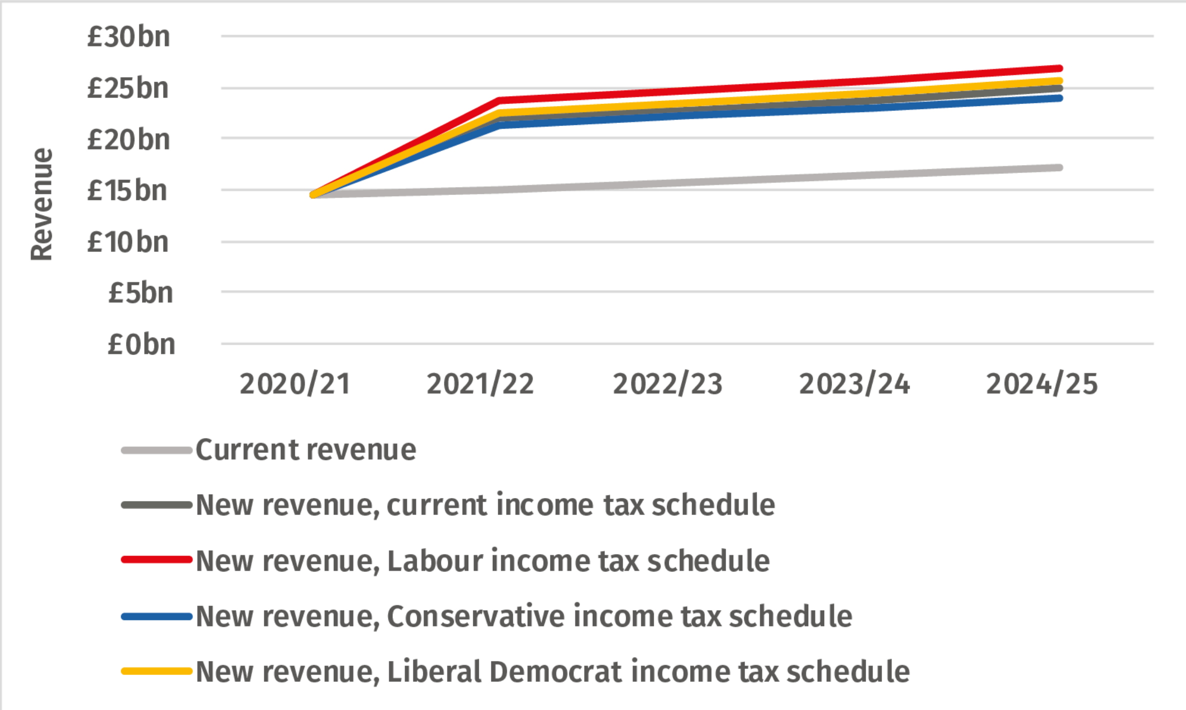
CONCLUSION

We propose that income from wealth should be taxed the same as income from work. In addition to our capital gains tax proposals (Nanda and Parkes 2019), this would entail taxing dividends under the income tax schedule and ending the separate dividend allowance. We have estimated the direct impact of these proposed reforms using HMRC data on dividend tax liabilities and HMRC estimates of the direct cost of the dividend allowance. We have estimated the behavioural impact of these reforms by deriving a 'behavioural multiplier' from Treasury estimates in the July 2015 budget. We have also considered the impact of these changes if made alongside the new income tax schedules likely to be proposed by Labour, the Conservatives and the Liberal Democrats. In total, we estimate that these changes would raise £29 billion over five years under the current income tax system, £37 billion under the Labour income tax schedule, £26 billion under the Conservatives and £32 billion under the Liberal Democrats. There are significant uncertainties around these estimates, but, even if the behavioural effects were larger, we would still expect these changes to raise significant sums, as well as making the system fairer.

FIGURE 1

Our proposals will raise significantly more tax revenue over five years in all scenarios

Projected revenue under different parties' income tax proposals: post-behavioural impacts



Source: Author's analysis based on methodology outlined above.

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