

TAX AND RECOVERY: BEYOND THE BINARY

WHY RAISING SOME TAXES THIS YEAR, ALONGSIDE A BOLD STIMULUS, IS IN LINE WITH A STRONG RECOVERY

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KEY POINTS

Even before the pandemic struck, the UK tax system was in serious need of reform. It is inefficient, unfairly taxes labour more than capital, exacerbates inequality, and fails to shape the economy in a sustainable way. The current crisis has made this even more problematic. It is sharply widening inequalities, with richer households increasing savings and wealth valuations up; while lower income households are losing earnings and falling into debt (Berry et al 2020). Moreover, the policy decisions made today will influence the shape of the economy for years to come. The tax system is crucial for shaping what types of activities are encouraged – including for instance green vs polluting ones. Next to addressing inequalities and shaping the economy, tax increases will be key to balance out likely permanently increased public spending resulting from the pandemic.

It is therefore good news that, ahead of the March budget, the Treasury has floated a range of possible tax increases. For example, one proposal has been raising corporation taxes from their historic low back closer to the international average (The Times 2020). Another one is the widely hailed suggestion of equalising the taxes on income from capital and income from labour (OTS 2020). Public opinion too is in favour of substantive reform; for instance, a majority of Conservative voters support capital gains tax reform (Demos 2020; Tax Justice UK 2020).

However, while agreeing with the need to fix the tax system, some have argued that 'now is not the time' to raise taxes in order to not stifle the recovery (FT 2020). **In this briefing we argue that we must move away from this**

binary framing of 'raise taxes now - YES or NO'. The fact is: some taxes, like corporation tax and capital taxes, can be raised without stifling the recovery - if they are accompanied by a big stimulus. And raising certain taxes now could ensure the recovery is more balanced, more sustainable and prevents inequality from escalating further. Indeed, such a package would have a large positive effect on the recovery. This does not preclude a discussion of further tax reform in the future. But some initial changes should start now.

THE UK TAX SYSTEM IS LOPSIDED AND UNFAIR – AND THE PANDEMIC IS FURTHER INCREASING INEQUALITIES

Tax increases should begin this year, starting at the March 2021 budget, in order to avoid a further deepening of inequalities and in order to help shape a balanced and sustainable recovery.

The UK tax system is lopsided, unfair, and not aligned with social objectives. For example, it taxes the similar activities at different rates. Income from labour is in some cases taxed at only half the rate if it is declared as a dividend, and at less than quarter the rate if taxed as capital gains (Advani & Summers 2020). Overall, the bias in favour of income from capital over income from labour exacerbates inequality: while the role of private wealth in the economy has more than doubled since the 1980s (WID 2019), taxes on it have not kept pace (Nanda & Parkes 2019). And there are a range of tax advantages for the better off – many related to wealth tax exemptions¹ – which fail to counter inequality.

The pandemic is deepening existing inequalities. The world's billionaires saw their wealth go up in value by more than a quarter last year (UBS 2020). Many businesses and the housing market were supported by large-scale interventions, while benefitting from a low tax regime. Meanwhile, low-income households are bearing the brunt of the crisis, with incomes down, unemployment set to spike, wages expected to fall, and eviction bans ending all while labour taxes are higher than those on wealth (Brewer et al 2021).

Whilst being bad for inequality now, these systemic flaws are also bad for the economy in the long-term. Starting to fix the system now would be good for long-term growth (Ostry et al 2014). Indeed, recent cross-country evidence shows that tax systems skewed to benefit the well-off have demonstrably hindered long-term growth (Hope & Limberg 2020). Moreover, increasing inequality, facilitated by a skewed tax system, has been shown to be a possible

¹ This includes several exemptions from capital gains taxation, inheritance taxation as well as the treatment of trusts, all of which significantly narrow the tax base (Roberts et al 2018).

driver behind asset bubbles, creating macro-financial imbalances and depressing growth enduringly (Mian et al 2021).

The tax system also provides preferential tax treatment for several polluting activities, which is at odds with the government's emission reduction targets (Evans 2020). Conversely, tax revenues raised should in turn be used to promote socially useful activities, including funding public investment for the transition to net zero emissions and supporting the care economy. Tax reform can thus address economic imbalances and support growth in welfare-enhancing, future-proof sectors (Jung & Murphy 2020).

Finally, in the aftermath of the pandemic, tax increases will be required in order to put public finances on a sustainable footing in the medium term. This will likely include addressing increased funding needs for public services such as health and social care. The exact size of this will partly depend on how quickly the economy bounces back (which in turn depends on the size of the stimulus this year). Addressing shortcomings of the tax system now could be a first step in this direction.

A SIZEABLE OVERALL STIMULUS IS WHAT MATTERS MOST FOR THE RECOVERY

Making a start now to fix the tax system can be done in a way which would not impede the recovery. What matters first and foremost for the recovery is the overall net fiscal stimulus provided.

We have argued that a spending stimulus to the tune of 8.6 per cent of GDP is needed to help the economy bounce back – a similar ambition to the plan of US President Biden (Jung et al 2021). With negative real interest rates on 30-year government borrowing (i.e. the state is *paid* by markets to take their money), it makes financial sense for most of the stimulus to be debt-financed. And with overall fiscal support of this order of magnitude we propose, some tax increases will not unduly weigh on the recovery.

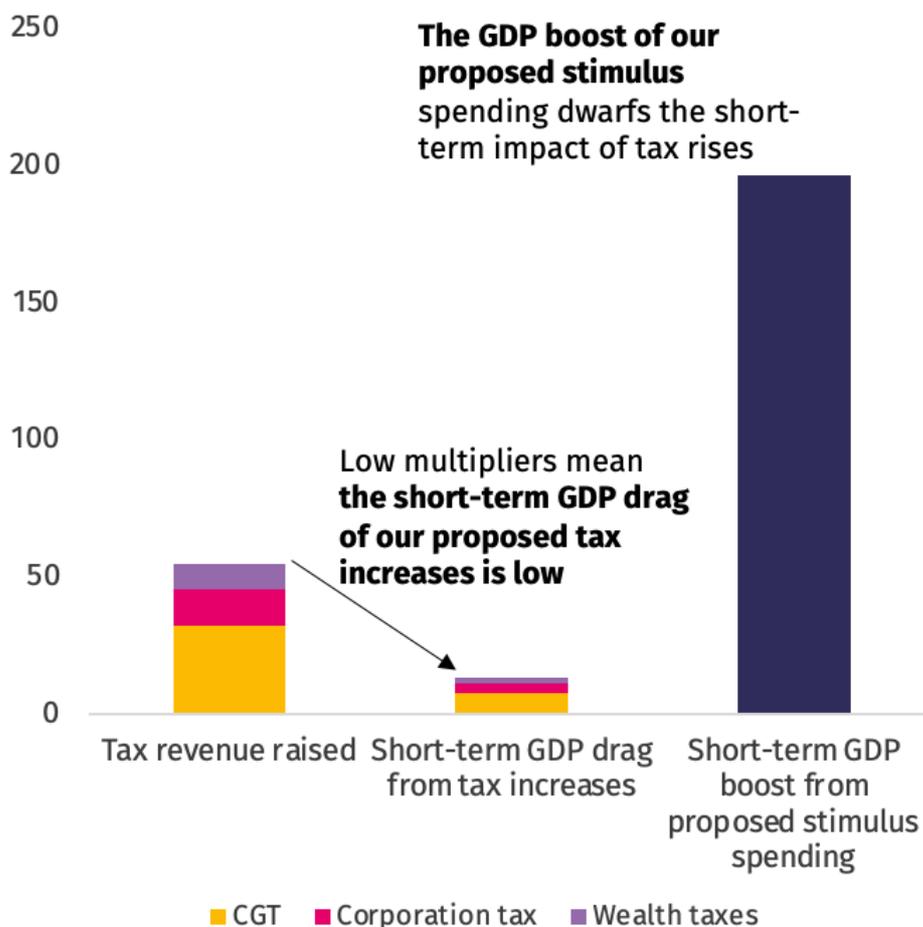
Below we propose a host of reforms that could take place even before the recovery has been achieved, including raising capital gains and dividend tax, corporation tax, wealth tax and a land value tax. These could make the system significantly more balanced, raise up to £55 billion, and have only a small impact on growth during the recovery.

Figure 1 shows that while they would raise up to £55 billion in taxes per year, their impact on GDP would only be about a quarter of that (as explained in the next section). This GDP drag would be only a small fraction (about 7 per cent) of our proposed overall stimulus. In other words, Rishi Sunak could make an overdue first step towards fixing our tax system, while still guaranteeing a strong recovery.

FIGURE 1

The short-term GDP drag of tax increases is dwarfed by the growth impact of stimulus spending

£ billion



Source: IPPR analysis of Nanda & Parkes (2019), Nanda (2019), Blakeley (2018), Roberts & Jung (2020), Jung, Dibb & Patel (2021).

Note: For tax multipliers, we used estimates from the literature shown in the next section. The average multiplier of stimulus spending is 1.03, as explained in Roberts & Jung (2020).

SOME TAXES WOULD BE BETTER TO INCREASE NOW THAN OTHERS

When it comes to raising taxes this year, it will still be best to pick taxes that have a limited *short-term* impact on growth, such as to not unduly weigh on the recovery. Moreover, any tax changes should be accompanied by a sufficiently large overall stimulus to the economy is able to bounce back quickly, as argued in the previous section (see also Jung et al 2021).

Taxes that are preferable to raise even before the economy has recovered should **meet four criteria**. They should be:

1. **Efficient**. They reduce distortions in the system (such as unfair advantages, biases, and loopholes).
2. **Fair**. They do not further reduce the income of those already negatively affected by the crisis (who have tended to be those on low incomes (Berry et al 2020)). And they start addressing inequalities in the system.
3. **Future proof**. They shape the economy in a beneficial way, in line with social objectives, and adapt the tax system to key economic trends.
4. **Recovery friendly**. Raising them has a low impact on the types of investment and spending that would benefit the recovery, as reflected in low multipliers.

The literature gives indicative insights into which taxes fulfil the fourth of these criteria (recovery-friendly), by estimating what short-term fiscal 'multipliers' different taxes have. This is a starting point for determining which taxes to look at now. In broad terms, macroeconomic analysis distinguishes between four types of taxes (table 1): labour income taxes, capital taxes, company taxes and consumption taxes.

The 'tax multiplier' describes how a change in tax impacts overall activity in the economy. For instance, if it is equal to 1, a tax rise that collects £10 billion would temporarily reduce economic activity by the same amount – £10 billion. This is why many are worried that increasing taxes by a large amount would take steam out of the recovery. However, if the multiplier is 0, a tax rise would not impact economic activity at all. In that case it would not weigh on the recovery. The closer multipliers are to zero, the less concern there should be about raising them now.

In general, **capital taxes are found to have significantly lower multipliers than labour taxes**, meaning they have less negative short-term impact on growth if they are raised. Such taxes can be increased now without unduly weighing on the recovery, as long as this takes place in the context of sufficient stimulus spending.

Table 1 provides a high-level summary of tax multipliers, which is based on a review of the literature (see full account in technical annex). Figure 2 shows their values. It suggests short term multipliers for capital taxes are around 0.2. This means that for every £1 of capital tax collected, the economy contracts by only 20p. This is less than a third of the contractionary effect of labour income taxes (0.8). An effect of this limited size for capital taxes means raising taxes on capital would not weigh on the recovery much. It also means that a labour tax cut could easily offset a capital tax hike – even if it just were just one third of its size. Corporation tax multipliers are found to be similarly low, at 0.3

This underscores our argument that some taxes could be raised much more easily now than others.

TABLE 1

Different types of taxes have different impacts on short-term growth

	Capital taxes	Company taxes	Consumption taxes	Labour income taxes
Principle	Taxes related to assets that people own ²	Taxes related to production	Taxes that arise when things are bought for consumption	Taxes on people's income that comes from work
Examples	<ul style="list-style-type: none"> • Capital gains tax • Wealth tax • Property tax 	<ul style="list-style-type: none"> • Corporation tax • Excess profits tax • Business levy • Production-related carbon taxes 	<ul style="list-style-type: none"> • VAT • Fuel duty 	<ul style="list-style-type: none"> • Income tax • National insurance contribution
Short-term multipliers in the literature	Low impact on short-term growth	Low impact on short-term growth	Medium impact on short-term growth	Medium to high impact on short-term growth
Need for reform	UK capital taxes are too low, distortive, bad for inequality and riddled with exemptions benefitting mostly the well off.	UK corporation taxes are among the lowest in rich economies.	Consumption taxes in many areas currently make it cheaper to choose more polluting activities over greener ones (Zero Carbon Commission 2020).	The UK tax base is narrow by international standards. And there is a live debate on the needed to make taxation for the self-employed fairer.

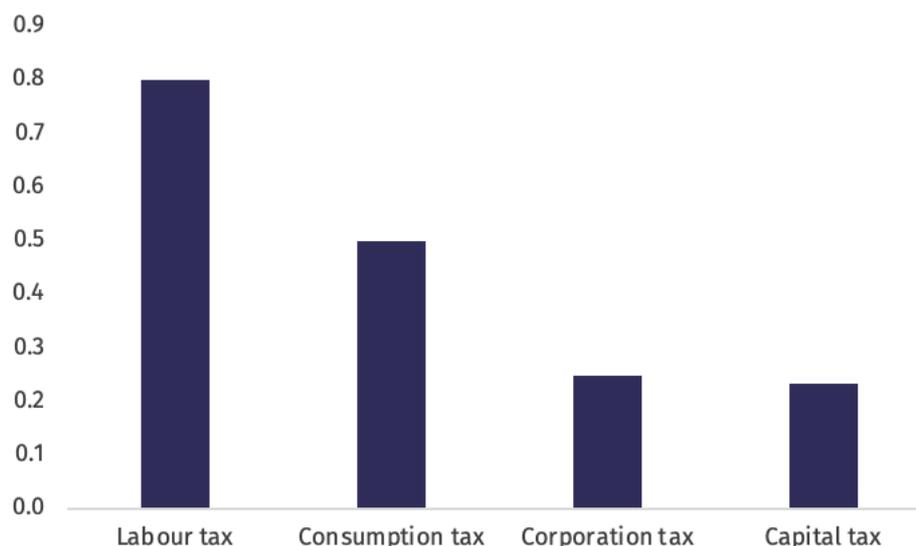
Note: This list of categories is not exhaustive and slightly different categorisations are possible. They are chosen to fit those categories used in the macroeconomic literature on fiscal policy. For instance, 'indirect taxes' is a category of taxes that fall on producers and retailers but are passed on to consumers. The short-term multipliers are taken from the literature review below.

² Some classify their income as returns from capital to take advantage of lower taxes. In this case it's a *de facto* return on income tax but *de jure* a return on capital tax. This situation is a key reason for equalising the two tax rates.

FIGURE 2

Capital and corporation taxes have significantly lower fiscal multipliers than labour taxes

Short-term percentage point change in GDP in response to a percentage point over GDP change in tax revenues from a given type of tax



Source: IPPR analysis of IMF (2020), Coenen et al (2012), Zubairy (2014), Kilponen et al (2015), Mertens & Ravn (2013). Note: The multipliers shown are the averages for the studies described in sources. Tax multipliers are usually denoted with a negative sign, but these are here shown as positive values for ease of illustration. 'Short-term' refers to up to a 2-year time horizon within the change being enacted.

SO WHICH TAXES SHOULD BE RAISED IN THIS MARCH BUDGET?

It should be stressed that the multipliers shown in the previous section should be seen as indicative, as they are based on a number of modelling assumptions and come with margins of error. To decide which taxes should be raised this year, it is therefore instructive to now also consider our first three criteria highlighted above: tax increases should be efficient, fair and future-proof.

As we explain below, taken together, **our four criteria suggest at least four tax increases could take place now: capital gains and dividend tax reform, wealth tax reform, corporate tax reform, and beginning the reform of land and property taxes.**

First, equalise taxation of income from wealth and income from labour.

Income from wealth - in the form of capital gains and dividends - should be taxed at the same rate as income from work (Nanda & Parkes 2019). Separate reliefs applied to both should also be abolished.

- This would be **fair**. In the UK, most capital gains benefit only a small number of people. For instance, the majority of the UK's taxable capital gains in 2018-19 (£41 billion) were made by just 10,000 individuals (0.015 per cent of the population), who each made gains of £1 million or more (HMRC 2020). And half of taxable gains went to only 5,000 individuals (Advani & Summers 2010).
- It would be **efficient**. The wealthiest individuals are much more likely to save, which leads to lower aggregate demand compared to a situation where gains are more widely shared. Mian et al (2020) have shown that this imbalance can have large negative effects on growth.
- It would be **future proof**, as it would address the long-standing lop-sidedness of the tax system: over-charging labour and under-charging capital. According to our pre-pandemic estimate this reform could raise up to £32.5 billion (Nanda, 2019).
- It would be **recovery friendly**. And as described in the previous section, raising capital taxes have a low multiplier meaning they should have a low impact on short term growth.

Second, **reform wealth taxes**. Despite the hugely increased importance of wealth as a source of income and rising inequality, wealth taxes are at a post-war low (WID 2018). There have been widespread calls to address this. One crucial proposal is around wealth transfers. A recent study showed that, in the UK, 60% of wealth is inherited rather than accumulated through work (Alvaredo et al 2017). The current system of inheritance tax is easy to avoid and favours the 'wealthy, healthy and well-advised', not ordinary citizens. **To make the system more just and efficient**, IPPR has previously advocated that inheritance taxes should be abolished and replaced with a lifetime gifts tax (Roberts et al 2018). The APPG on Inheritance and Intergenerational Fairness (2020) came to the same conclusion.

- This would be **fair** as it would address tax advantages that mostly benefit the well off.
- It would be **efficient**, as it would streamline the tax system and reduce loopholes that currently mainly benefit those with the best tax advisors.
- It would be **future proof**, as it would contribute to addressing the current lop-sidedness of the system against income from work in favour of capital.
- It would be **recovery friendly** as it has a low multiplier, like other capital taxes.

Third, **corporation tax**. Corporation tax cuts of the past decades should be reversed, raising the rate to 24 per cent.

- This would be **fair**. The UK has been among the leaders of a global race to the bottom on corporation taxation, undercutting most other rich economies. The UK currently has one of the lowest corporation tax rates in the OECD at 19 per cent, compared to 38 per cent in France and 31 per

cent in Germany. Reversing this could raise about £13 billion per year (Blakeley 2018).³

- It would be **efficient**. Corporation tax is only levied on profits, so struggling firms will not be negatively impacted. In that sense they, pro-cyclical as they only affect businesses in 'good times' when profits are up; not in bad times when they are down. UK business investment has declined in recent years despite cuts to corporation tax (ibid). And there is increasing evidence that corporation tax rates at levels comparable with the international average do not hamper business investment (ibid).
- It would be **recovery friendly**. As shown above, short-term fiscal multipliers are similarly low, in the order of 0.3.
- It would be **future proof**. It would ensure businesses who can shoulder it pay their fair share in return for the unprecedented amount of support they received throughout this crisis. It would form the foundation for a new social contract between business and society following the pandemic.

Fourth, begin reform of land and property taxes. As part of this, **business rates should be replaced with a land value tax for commercial property.** This is a tax on the rental value of land in its optimal use, excluding the value of any buildings or structures, as already implemented in European countries and parts of the US. At the same time, **current property taxation (council tax and stamp duty), for residential property, should be replaced with a proportional property tax.** This tax would be proportional to the present-day-value of homes, as has been called for by the Fairer Share campaign (Fairer Share 2020). Both reforms would require some institutional changes and preparation before they can be implemented (Roberts et al 2018) – these could start immediately.

- Both reforms would be **efficient**. A land value tax for businesses incentivises the most productive use of land and disincentivises leaving it undeveloped. It would also stop penalising businesses that improve their use of the land they are on. It would encourage, rather than deter, productive investment, and increase the cost of using land inefficiently (ibid). Proportional property taxation, in turn, would make the way we tax housing more related to the economic value of homes.
- Both reforms would be **fair**. The land value tax would be progressive as it would shift the burden from regions with relatively lower land values to those that can more easily shoulder it. A proportional property tax similarly would be progressive, replacing the regressive nature of the current council tax system. It would benefit the vast majority of

³ 2018 estimate relating to 2020/21.

households and, in particular, those in the bottom half of the income distribution (ibid).

- It would be **future proof** in that it would keep pace with the changing economic geography of the UK as well as the changing use of land. It would benefit areas with lower land values across the country and thus be in line with the government's 'levelling up' agenda. The proportional property tax would ensure that homes are taxed based on their shifting economic value as opposed to outdated valuations from 1991 as is currently the case with council tax.
- It would be **recovery friendly**. The literature suggests that land value taxes, in common with other taxes on economic rent, can have a positive impact on growth (Stiglitz 2015; Allan & Hovsepyan 2019; Tideman 1995). We calculate the change would have no impact on the net receipts (Roberts et al 2018); while the distributional and efficiency impacts could be growth-enhancing. The proportional property tax equally would benefit the housing market as a whole. By aligning taxation with actual present-day values, rather than past ones, it will ensure that taxation promptly and efficiently reacts to changes in the housing market.

These four reforms meet the four criteria we have set out above, including being in line with a strong recovery from the pandemic. The chancellor should thus wait no longer and begin to fix our tax system – and he should start at this March's budget.

TECHNICAL ANNEX

Fiscal multipliers of different types of tax changes

The IMF (2020) finds short-term multipliers for capital tax increases of around 0.4. Zuibary (2014) finds multipliers of around 0.2 and Kilponen et al (2015) finds capital multipliers of as little as 0.12. (Note tax multipliers are usually denoted with negative sign. We show their absolute value for ease of illustration.) In these studies, capital tax multipliers are mostly significantly lower for consumption taxes and lower than those government current spending and investment. This implies that spending and investment can cost-effectively 'offset' the contractionary effects of some capital taxes – ie less of it is needed to retain a net neutral fiscal stance.

Coenen et al (2012) find multipliers between 0 and 0.15 for corporation tax changes. Mertens and Ravn's (2013) empirical estimates show that corporate tax multipliers are 0.6 - about a third of the size of those of personal income taxes.

For consumption taxes, Coenen et al (2012) find consumption tax multipliers of 0.2 to 0.4. Kilponen et al (2015) find them on average at 0.81 (over a two year horizon at the zero lower bound). The IMF (2020) finds it to be just over 1.

For overall tax multipliers, estimates vary widely – possibly because they pick up the underlying heterogeneity of multipliers of different taxes, or possibly because of methodological differences. The OBR (2020) uses short-term tax multipliers (for all type of taxes) of 0.33. Alesina et al (2018) find that taxes – in general – have a higher multiplier than spending, which would mean that spending would have to increase by more than the amount of the tax increase. Romer and Romer (2010) and other papers using narrative too find high overall multipliers. But again, these are studies for tax increases in general. As we have highlighted in this briefing, the aggregate picture conceals significant heterogeneity of underlying multipliers.

Finally, several studies show that tax increases have different impacts in different economic contexts. Artin et al (2015) estimate that the impact of tax increases is lower during times of economic slump, implying (counterintuitively) that it is better to increase them during a recession. Battini et al (2012) and Baum et al (2012) too find tax multipliers to be smaller in recessions.

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