tax justice network

*** EMBARGOED for 00:01 GMT, Tuesday, April 21, 2015 ***

UK political parties rely on unsafe top tax rate estimates

Tax is one of the key battlegrounds in the UK's general election due on May 7th. No tax is more important than the income tax, and debates about the wisdom of cutting or hiking the top rate of income tax will heat up as polling nears.

A new report written for TJN by John Thompson, an independent analyst[1], shows that the debates on the top rate of income tax hinge on official estimates from HM Revenue and Customs (HMRC) which are so uncertain as to be of little or no value in determining tax policy. Perhaps more damningly, the survey of evidence into the longer term wider effects of a change in the top tax rate are, as Thompson puts it:

> "so selective as to be unreliable and, if relied upon, worthless or worse[2]."

The influential economist Thomas Piketty, whom we contacted, declared himself 'surprised' by the way HMRC used his research to support its analysis.

Where the Parties Stand

The Labour government increased the top income tax rate for anyone earning above £150,000 per year from 40 to 50 percent from April 2010, the first increase since 1974. The coalition government cut the rate to 45 percent in April 2013.

Current manifesto pledges are:

- **Conservative:** haven't ruled out a cut in the top rate to below 45p in the £
- **Labour:** will restore the top rate to 50p
- **Liberal Democrats:** no specific pledges on top rate.
- **Green Party**: a top rate of 60p in the £
- **SNP:** has said it supports a top rate of 50p.
- **UKIP:** a 40p top rate.
- **Plaid Cymru**: a 50p top rate

The HMRC report

The key report that estimated revenue yields for top income tax changes was published by HMRC in 2012. Entitled The exchequer effect of the 50 percent additional rate of income tax, it is the main reference point in this area, and Financial Secretary to the Treasury David Gauke has said that further reports

> "are entirely unnecessary. The impact of reducing the additional rate of income tax has been examined in great detail. The 50p rate was ineffective."

Among other things, the HMRC report estimated that cutting the top rate of tax for high earners from 50 to 45 percent would only cost £100m per year in lost revenues, a surprisingly small figure that has been used repeatedly by politicians and in the media to justify income tax cuts for the wealthiest. The HMRC report also claims that higher top income tax rates would make the UK tax system "less competitive" and would reduce economic growth.

Problems with the official estimates

Our new report makes two core points.

First, official estimates of how much revenue would be gained or lost, and the impact on economic growth, from cuts or hikes to the top tax rate are subject to such huge, irreducible uncertainties that they are essentially meaningless.

The biggest problem in making estimates is that short term tax cuts or hikes change taxpayers' short term behaviour in ways that cannot be predicted with enough accuracy to be able to estimate longer term tax yields.

In support of their tax yield estimates HMRC cite other studies but these not only all have their own problems and uncertainties, but are based on tax changes at different times, with different rates, in most cases for different countries with different tax systems and different societies and taxpaying cultures.[3]

Even if one were to take the underlying HMRC numbers from its own report as correct, a more informative conclusion would have been to say that yields from having raised the top rate from 40 to 50 percent were somewhere between more than a £4 billion revenue gain and more than a £2 billion loss. But the underlying HMRC numbers are also subject to further uncertainties.

Second, HMRC research seems to have been highly selective, in ways that appear to fit prevailing orthodoxy that higher taxes reduce growth.

For instance, HMRC reviews the literature about how higher top tax rates might affect growth, productivity, entrepreneurship, investment, and so on. One of its conclusions is, the report said, backed by the work of the influential French economist Thomas Piketty. We sent HMRC's conclusion to Piketty, and he said:

> "it is indeed quite surprising to learn that our paper with Saez and Stantcheva was used in this manner, given that we basically find the opposite."[4]

Piketty's is arguably one of the most relevant studies in this area, so this mistake by HMRC is striking. Thompson remarks, based on extensive analysis of the evidence, and other examples of apparently selective use of data, that:

> "It seems that the prevailing orthodoxy that higher taxes reduce growth is so ingrained that contrary evidence cannot be recognised."

The report contains a wealth of detail and analysis that will be of great relevance for political parties, analysts and the general public and should serve as a long-term cautionary tale about complex studies in this area – and not just in Britain.

Going beyond Thompson's report, TJN would also point out that HMRC's assertion that cuts to the top rate of income tax necessarily make the UK's tax system "less competitive" reveal a fundamental economic illiteracy.

"Tax competitiveness' sounds wonderful but is in fact a Trojan horse for wealthy people and corporate interests to extract unjustified tax concessions paid for by mostly less wealthy taxpayers and consumers of public services. In short, 'tax competitiveness' is fools' gold. Read more about this here.

Recommendations

We make five recommendations.

1. Raise top income tax rates, if voters want that, knowing that the balance of evidence suggests no harm to the economy or revenues will result, and that benefits – in the form of higher revenues, higher growth and lower inequality – are also possible.

2. Create an Office of Tax Responsibility, as Richard Murphy has proposed. We recognise that such a body can also be credulous or 'captured' by the tax-cuts-for-every-ailment brigade, but it potentially creates useful new lines of accountability.

3. Create a robust new independent civil society tax watchdog, funded by fully independent donors, specifically to expose and debunk studies that otherwise have a track record of being received and regurgitated by credulous media and politicians without question. This would include a tax training facility for media and civil society actors.

4. If there is fear that higher tax rates will lead to increased avoidance or evasion, introduce measures cracking down in these particular areas. Cuts to HMRC staffing should be reversed.

5. As always, we need more and better research. Better still would be an outbreak of honesty and a recognition that even half-decent estimates may be impossible with short term pre-announced tax changes. The independence of civil servants to make objective evaluations must be protected, especially in the political minefield of tax policy. Policy makers must de-emphasise the importance of such studies, and muster the courage to say 'we really don't know' – then make honest political judgements based on factors like fairness and voters' declared wishes.

John Christensen, Director of the Tax Justice Network, said:

> "We hear again and again that tax cuts all but pay for themselves, that they make the economy grow, and all sorts of other good things. This new report is a weighty reminder of what many of us have known for a long time: there isn't any good evidence for these claims.
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> The public needs honesty from politicians and the tax authorities if it is to regain trust in the tax system."

Alex Cobham, TJN's director of research, said:

> "At present the balance of evidence suggests that higher top income tax rates are likely to be associated with both higher revenue and higher economic growth – and indeed with lower inequality.
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> But these remain open research questions – so it is frustrating that the policy debate pretends to a level of certainty that simply doesn't exist, and doubly so that the most common political claims are those which are most clearly contradicted by the current weight of evidence."

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[1] Thompson is a former Head of Analysis for Policy at the Higher Education Funding Council for England. He has written widely on higher education policy and, in particular on the sustainability of student loans. His report published today was written for TJN.

[2] This quote, and Thompson's subsequent quote in this press release, are not drawn from the report but provided additionally by Thompson.

[3] A question is: how ought this research to be used?. Even if one *could* get certainty about revenue yields, one must consider why they may be like this. Revenues don't rise or fall in direct proportion to changes in top income tax rates, because of behavioural responses. But these responses come in two kinds: 'supply' responses (such as emigration, or reduced working) which the government can't really do anything about, and those (such as tax avoidance and evasion) which the government can tackle. The HMRC report estimates that 'supply' responses account for a third to a half of the expected behavioural change, but provide no source for that estimate.

[4] On p11 the HMRC paper says: "A regression result in a recent study implies that higher taxes may reduce real GDP per capita levels, although the results are not conclusive." It cites Piketty, T, Saez, E and Stantcheva, S (2011) *Optimal taxation of top labor incomes,* NBER working paper no. 17616. But that report states: The regressions consistently display negative coefficients across the full period, suggesting that low top tax rates are detrimental to growth. The estimates however are not fully robust to the choice of time period . . . we can conservatively conclude that low top tax rates do not have any detectable positive impact on GDP per capita."