# Tax after coronavirus Inquiry – Submission

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## Executive Summary

1. There is substantial scope for increasing tax revenues within the current tax system by re-considering the significant tax discounts afforded to capital gains over income, and by removing tax reliefs which do not achieve their economic purpose.
2. We are currently leading a large project to investigate whether a new 'wealth tax' is desirable and deliverable. We will explore options for a one-off tax or recurring annual tax on wealth to help rebuild public finances after coronavirus.
3. Any changes to the tax system need to be accompanied by appropriate resourcing for HMRC. Appropriate operational resourcing is critical for facilitating efficient collection of tax revenues, while analytical resourcing, especially if focused on the HMRC's Datalab facility, can greatly enhance the government's capacity for analysis of tax reforms.

## About us

Arun Advani is Assistant Professor of Economics and Impact Director of the CAGE Research Centre at the University of Warwick. He is also a Research Fellow at the Institute for Fiscal Studies, and a Visiting Fellow at the LSE International Inequalities Institute. He studies issues of tax compliance and tax design, with a particular focus on those with high incomes or wealth.

Andy Summers is an Associate Professor of Law at the London School of Economics and an Associate of the International Inequalities Institute at LSE. His teaching and research focuses on tax law and policy, particularly the taxation of wealth. His work also investigates the measurement of inequality using tax data.

Helen Hughson is a Research Officer at the London School of Economics, currently working on tax policy, inequality and migration issues. Prior to joining LSE, she worked as an economist at the Reserve Bank of Australia. She has an MSc in Economics from University College London.

## Our research

We are collaborating on a series of academic research projects relevant to this review. Most of our work has taken place in HMRC's Datalab facility, giving us access to anonymised data from the personal tax records of every UK resident in recent years. Having done a significant amount of exploration of these data, we are in a unique position to submit evidence on these issues.

A key focus of our work has been capital gains, including the characteristics of those who earn the highest taxable gains, the tax rates they typically pay, and the impact of this on inequality. Our work documenting empirical evidence on the sources and distribution of taxable capital gains has been made public in a series of papers and briefings, to which our submission below refers.

We are also currently leading a major project on the feasibility of a wealth tax, studying whether a UK wealth tax is desirable and deliverable with input from a network of world-leading experts from many disciplines.

## Taxing returns on wealth

1. There are three ways to tax wealth: taxes on returns on wealth; taxes on gifts or bequests of wealth; and taxes on holdings of wealth (Summers, 2019).[1] Returns on wealth include income from savings and investments ('capital income'), as well as the increase in the value of the assets held since their acquisition ('capital gain'): in the UK the former is taxed as income while the latter is treated separately. Below, we summarise the work we have done on taxation of capital gains and its impact on taxpayer behaviour as well as on tax revenues.
2. Returns from wealth are much more unequally distributed in the UK than income, but the tax system does not redistribute returns from wealth nearly as effectively as it does income. In fact, the very low tax rates available on certain types of taxable gains incentivise superficial changes in behaviour, encouraging those who can to 'repackage' income as gains and pay lower tax rates than others earning a regular income.
3. Many current tax reliefs do not promote growth and efficiency; some (in particular those related to taxable gains such as uplift at death, Business Asset Disposal Relief (previously Entrepreneurs' Relief), and Investors' Relief) actively distort behaviour. A critical element of tax reform should be policy analysis and evaluation; we show later in this submission that better resourcing for HMRC can radically improve its ability to support this.

### Capital Gains

4. Capital gains are growing rapidly and are highly concentrated, and thus contribute to increasing inequality. Our policy brief *Capital Gains and UK Inequality: New evidence from tax microdata*[2] (Advani and Summers, 2020b) showed that:

    a. Aggregate taxable gains measured nearly £55bn in 2018, having grown by an average of 20% each year over the previous 5 years.

    b. Over half (54%) of all gains go to just 5,000 people.[3]

    c. For some, capital gains are regular part of their remuneration, rather than a rare or once-in-a-lifetime event: a third of those with gains over £20,000 in 2017 also averaged gains over £20,000 in the previous four years.

[1] While the UK does not currently directly tax wealth holdings, we also discuss the possibility of doing so later in this submission. We do not discuss Inheritance Tax in this submission, but a good summary of the issues with the current system can be found in the All-Party Parliamentary Group for Inheritance & Intergenerational Fairness report from January this year (APPG, 2020).

[2] https://warwick.ac.uk/fac/soc/economics/research/centres/cage/manage/publications/bn19.2020.pdf

[3] For comparison, the top 5,000 income-earners receive just 2% of all income.

   d. Gains are concentrated amongst people in certain types of work: the majority of taxable gains go to business managers rather than arms-length investors.

   e. Including capital gains in measures of income inequality paints a very different picture of the level and trend of inequality: rather than remaining fairly steady over the 20 years to 2018, the top 1% share of total remuneration (income and gains) has increased from 14% to 17%.

5. Substantial tax discounts are afforded to gains over income on the basis that gains are returns on rising asset values rather than returns to labour. Empirically, though, it is difficult to distinguish capital gains which are genuine returns on asset values from income which is 'repackaged' as capital gains. Many of the highest-earning individuals are able to structure their earnings so that they pay very low tax rates, an opportunity not available to people with regular employee income.

6. An example is the creation of personal services companies: individuals can often choose to supply their services through their own company, instead of as an employee or self-employed trader. This enables them to take their pay as dividends (thereby avoiding national insurance contributions and gaining additional personal allowance amounts), or eventually as a capital gain (by rolling up profits inside the company) (Summers, 2019).

7. Discount tax rates on taxable gains and reliefs such the Business Asset Disposal Relief (previously Entrepreneurs' Relief) also create economic inefficiencies by incentivising certain behaviours – often not the behaviour they are intended to incentivise. Miller, Pope and Smith (2019) showed that company owner-managers respond to differential tax rates on income and capital gains by adjusting how and whether they take money out of their company, rather than by increasing investment.

8. We observe these distortions in the substantial horizontal and vertical inequities in tax rates paid amongst taxpayers. Our policy brief *How much tax do the rich really pay? New evidence from tax microdata in the UK*[4] (Advani and Summers, 2020c) showed that, in the 2015-16 tax year:[5]

   a. High-earners who were able to do so overwhelmingly took their total remuneration (income and gains) in a form taxed at a lower rate than earned income: investors and owner-managers in the top 1% earned 40-50% of their total remuneration from capital gains (and half of that in the form of gains taxed at only 10%), while only 10% came from employee or self-employment income.[6]

[4] https://warwick.ac.uk/fac/soc/economics/research/centres/cage/manage/publications/bn27.2020.pdf

[5] The subsequent rise in dividend rates from 2016, and decrease in the lifetime cap on Entrepreneurs' Relief in 2020, will have improved equity outcomes. However, there is still substantial scope for some individuals to pay tax rates which are low compared to both headline tax rates and to rates a middle-income earner would expect to pay. Tax discounts on capital gains play a major role in this.

[6] By contrast, top-earning employees and self-employed workers earn around 80% of their total remuneration in earned income, taxed at an effective rate of 47%.

b. The average person with £10 million in total taxable income and gains paid an effective average tax rate (EATR) of just 21%.[7]

c. There was substantial horizontal inequity across individuals with the same earnings: around a quarter of taxpayers with total remuneration above £100,000 paid the headline average rate for earnings (47%), while around one in ten paid an EATR of 10%.[8]

*An Alternative Minimum Tax*

9. Our estimates show that an Alternative Minimum Tax (AMT) requiring everyone earning more than £100,000 to pay at least a 35% tax rate on their taxable income and gains could raise around £11 billion (Advani and Summers, 2020c).

10. This is equivalent to the static effect of increasing the basic rate of Income Tax by 2p, or both the higher and additional rates by 5p. But the advantage of an AMT over such a response is twofold: the money would be raised from those among the rich who are currently paying the lowest shares, while at the same time limiting the scope for tax avoidance.

11. We believe there is a very strong case for moving towards the equalization of tax rates on income and taxable gains. However, if it were thought necessary to retain the differential between those headline rates, an AMT would at least provide a useful backstop, limiting the extent to which deductions, reliefs and low-tax sources of remuneration could be used to reduce overall tax bills.

## **Taxing holdings of wealth**

12. Even before the current crisis there were widespread calls to tax wealth more. Now, after the crisis has simultaneously exposed cracks in the social fabric and ramped up pressure on public services, the idea has been pushed higher up political agendas around the world. These issues require us to consider whether the UK has the right approach to taxing wealth, especially as the inevitable pressure on public finances necessities new thinking in tax policy.

13. One set of options concerns reforms to existing taxes on the wealthy, such as Inheritance Tax, Capital Gains Tax, and Income Tax on investment income. There is a strong case to be made for reforms in these areas (see the earlier section of this submission), but the arguments are mostly well-rehearsed.

14. By contrast, there is a distinctive gap in our understanding of the role that a wealth tax might play in a post-COVID-19 UK. The UK government last considered a wealth tax in the mid-1970s, and this was also the last time that academics and policymakers in the UK thought seriously about how such a tax could be implemented.

15. Critics point to a number of legitimate issues that would need to be addressed. Would it be fair, and would the public support it? Who would pay it, and on what wealth? How can you

[7] This is far less than the statutory average tax rate on taxable income of 47%; in fact it is less than the rate that would be paid by someone on median earnings of £30,000.

[8] This is a lower rate than someone earning just £15,000.

even value some assets? How would it affect incentives, for example to save and invest? How would you stop the wealthiest from hiding their assets? Will they all simply leave? What happens to people who own lots of wealth, but have little income with which to pay a wealth tax? And if wealth taxes are such a good idea, why have many countries abandoned them?

16. We have embarked on a project[9] to address these questions, to come to an assessment of whether a UK wealth tax is desirable and deliverable, and to develop a comprehensive evidence-base for the theoretical and practical issues in implementing such a policy. The project contributors span multiple academic disciplines: economics, law, social policy, and public administration.

17. The project has four key aims:

    a. First and foremost, the project aims to generate a new evidence base on the desirability and feasibility of a wealth tax for the UK. Eleven 'core' evidence papers will address key issues in the design of a wealth tax, drawing on international experience and developing novel insights from adjacent fields.

    b. The project will also model the revenue and distributional impacts of a wealth tax for the UK, based on several reform options according to different design specifications and choices of rates and thresholds, including estimates that take account of how people might respond to the tax.

    c. Drawing on the new evidence base, the project will conclude with a final report providing policy recommendations to the UK government. If a wealth tax is recommended, the report will include a detailed design specification aiming to achieve a 'ready to legislate' proposal.

    d. A key dimension of the project is to communicate our findings to UK policymakers and the general public, where our work is primarily focused, and to international partners.

18. Launched in July, our Initial Report[10] set out initial evidence on what has been happening to wealth and wealth taxation in the UK (Avani, Chamberlain, and Summers, 2020):

    a. UK private wealth has grown substantially over the last 70 years. Over the decade since the financial crisis, most measures suggest aggregate wealth has grown by an average of 2-4% annually.

    b. Rising wealth has been driven by growth in the value of assets which are typically held passively: the value of private pensions and the price of property.

    c. The concentration of wealth amongst older age groups has become increasingly stark since the turn of the century.

19. Core Evidence Papers studying key issues such as valuation, public attitudes to wealth taxes, behavioural responses of the wealthy, and international experience of wealth taxes in depth, will be made public in October. These will inform a final report to be published in December

[9] More information is available at: https://www.ukwealth.tax/

[10] https://static1.squarespace.com/static/5ef4d1da53822a571493ebd0/t/5efd1390a451b40fbf12b7ba/1593643938709/Is-It-Time-For-A-UK-Wealth-Tax.pdf

2020, alongside which we will launch a new online tax simulator where visitors can see what effect different rates and thresholds would have on who pays the tax, and how much it could raise.

20. While efficiency of the tax system is an important consideration, fairness is also important, both in terms of the outcome (the distribution of wealth) and the process (how the distribution came about) (Summers, 2019). The current distribution of wealth is a cause for serious concern: the young today have less wealth (in real terms) than older generations had at the same age (Cribb, Hood and Joyce, 2016; Crawford, Innes and O'Dea, 2016; Crawford and Sturrock, 2019), and are also finding it more difficult to get onto the housing 'ladder'. This is the sort of (generational) 'luck' that tax systems should be designed to offset.

## Resourcing HMRC

21. It is essential that HMRC is properly resourced to administer implementation of tax reform and evaluate policy changes, regardless of what those reforms are. Past research has shown that better resourcing is cost-effective way to increase collection of tax revenues (see paragraph 2423).
22. In particular, the HMRC Datalab[11] provides a crucial channel for transparent tax policy analysis. This facility enables academic researchers to conduct cutting-edge research using UK tax data, all undertaken in the public interest with virtually no cost to the government. The Datalab is perfectly positioned to advance the government's 'big data' agenda, but it is currently critically under-resourced, constraining the scope for productive collaboration between HMRC and academic researchers. Additional resourcing for the Datalab is a highly cost-effective means of enhancing the government's capabilities in data analysis, by leveraging input from the UK's world-leading academic research institutions.

## Operational

23. Tax system reform is not the only way to achieve substantial increases in tax revenues; well-considered implementation and better enforcement can also contribute to the rebuilding of public finances.
24. As an example, recent research has shown that, with appropriate operational resourcing, HMRC can itself be a source of increased tax revenue:
    a. Advani (2017): Who does and doesn't pay taxes? identified key characteristics of individuals who are most likely to underpay taxes, and showed how their behaviour changes after a tax audit.

[11] The HMRC Datalab was established in 2012 to enable accredited academic researchers to access de-identified tax data for projects approved by HMRC in the public interest. It facilitates independent analysis of tax policy by providing access to information that is not available in the public domain, via a secure setting that maintains strict protection of taxpayer confidentiality. Datalab projects must be shown to assist HMRC's functions of tax design, collection and administration before approval: a full list of approved projects is available via the HMRC Datalab webpage. Academic researchers work closely with HMRC at each stage of the research process, but the results are published independently and are subject to academic peer-review. The facility is physically housed within HMRC's Canary Wharf offices and is staffed by a small team from HMRC's Knowledge, Analysis and Intelligence division ('KAI').

b. Advani, Elming and Shaw (2019): The Dynamic Effects of Tax Audits showed that tax audits are highly cost-effective: HMRC not only receives repayment of the taxes owed in the audited year, but also 1.5-1.8 times as much additional revenue over subsequent years as audited individuals continue to declare more income.

*This package of work recommended an increase HMRC's budget to facilitate more audits. This important change was implemented in the March 2020 Budget.*

**Analysis**

25. The government's evaluative agenda and other key bodies have pointed to the critical importance of policy evaluation. In a separate submission (authored by Advani & Summers), we describe how HMRC's Datalab facility can supplement and enhance HMRC's internal analytic capacity, at very little cost to the government.
26. A modest increase in Datalab resources would radically transform the capacity of academic researchers to deliver impactful and policy-relevant projects in the public interest, and could be achieved with very minimal additional spend in the context of HMRC's total budget for data analysis. Better resourcing of the Datalab would also make this facility more attractive to academic researchers in future, thereby enhancing the capacity of government to leverage external expertise to advance its agenda to improve policy evaluation using big data.

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