Labour's proposed income tax rises for high-income individuals

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Key findings

1. **The Labour Party plans to increase income tax for 1.6 million people** with taxable incomes over £80,000 a year from April 2020. This is currently the highest-income 5% of income tax payers, or the highest-income 3% of all adults.

2. **Losses would be greater, in cash terms, for those with higher incomes.** Someone with an annual taxable income of £100,000 would lose £1,000 a year, whereas someone with an income of £150,000 would lose £5,375 a year.

3. **The proposals would affect ever more people over time,** since the £80,000 threshold would be fixed in cash terms. In 2023–24 approximately 1.9 million people will have incomes exceeding £80,000 (24% more than in 2020–21): the top 6% of income tax payers or the top 4% of adults.

4. **The top 5% of income tax payers contribute half of all income tax revenues today, up from 43% just before the financial crisis.** Labour's proposal would be the latest in a series of income tax increases for high-income individuals implemented in the last decade, including the introduction of the additional rate (now 45p), the withdrawal of the personal allowance, cuts in income tax relief for private pension contributions and real-terms reductions in the higher-rate threshold.

5. **The tax revenue that Labour's proposals would raise is highly uncertain,** and depends on the extent to which people reduce their taxable incomes in response to the rise in income tax. If no one changed their behaviour, the tax rises would raise around £10 billion per year on average between 2020–21 and 2023–24. Given existing evidence on how the affected group responds, a reasonable central estimate for the revenue raised is around £3 billion per year, but it is also plausible that it could raise £6 billion or that it could reduce revenue by £1 billion. All else equal, people would respond less to the tax rise if avoidance opportunities were fewer, so introducing other measures as well might affect the amount it would raise.

Labour proposes increases in income tax rates for the 'top 5%'

The Labour Party plans to increase income tax for individuals with annual taxable incomes over £80,000. Under the current system, income tax is payable on incomes above the personal allowance of £12,500 a year. The 40% higher rate becomes payable at £50,000, and the 45% additional rate kicks in at £150,000.

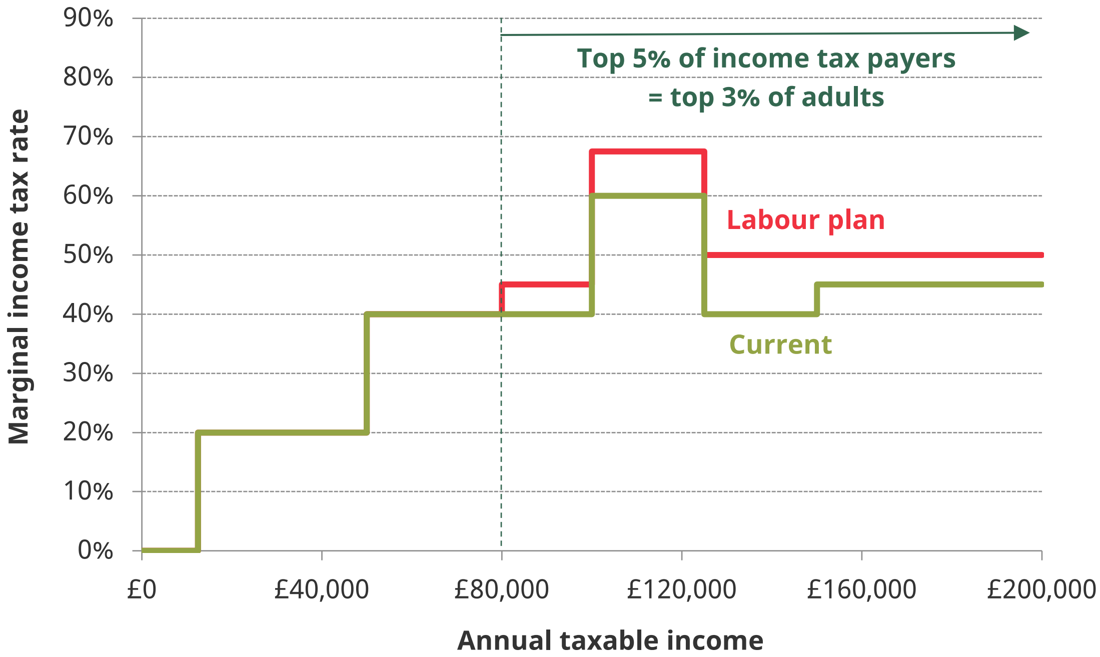
Labour would introduce a new 45% income tax rate starting at £80,000 a year, and a new 50% rate starting at £125,000, from 2020–21 (Figure 1).

Labour would continue the current practice of withdrawing the personal allowance from those on high incomes, reducing it by £1 for every additional £2 of income at incomes above £100,000. Under the current system, this creates an effective 60% marginal income tax rate on incomes between £100,000 and £125,000 (the point at which the personal allowance has been fully withdrawn). Labour's proposals would see this bizarre rate rise to an even higher 67.5%.

Income tax is devolved to Scotland, so Labour's proposal would not apply there. Throughout this briefing note we focus on effects on individuals in England, Wales and Northern Ireland. Our revenue estimates are for the UK as a whole, taking into account the automatic reduction in grant funding to Scotland that this proposal would entail under the Barnett formula (so that Scotland would not benefit from the higher public spending that this tax rise could pay for unless the Scottish Government decided to implement equivalent tax rises).[1]

Labour has said that this policy would only increase tax for the top 5%.[2] In 2020–21, the 1.6 million individuals with taxable incomes above £80,000 are the top 5% of income tax payers, or the top 3% of all adults. That said, around 6% of adults live in a household where someone is affected by Labour's plans, and since people's incomes change over time, many more would be affected at some point in their lives if the policy were to remain in place.

Figure 1. Income tax schedule with and without proposed Labour reforms in 2020–21



Note: Excludes Scotland. Adults defined as those aged 16 and over. See Appendix for details.

Source: Authors' calculations using HMRC income tax statistics and ONS population statistics.

Labour plans to freeze the £80,000 threshold in cash terms, continuing the worrying trend in recent years of nominally freezing tax and benefit rates.[3] Indeed it seems to have

[1] See D. Phillips, *Would Boris's tax plans represent an unfair grab of Scotland's money*, 2019. (https://www.ifs.org.uk/publications/14169)

[2] The Guardian, *Labour's NHS 'rescue package' to be paid for by higher taxpayers, says McDonnell*, 13 November 2019. (https://www.theguardian.com/politics/2019/nov/13/labour-nhs-rescue-package-to-be-paid-for-by-higher-taxpayers-says-mcdonnell)

[3] See for example S. Adam and P. Johnson, *Dragging people into higher rates of tax*, 2019 (https://www.ifs.org.uk/publications/14048) and A. Hood and T. Waters, *Higher inflation means more pain for households from benefit freeze, less gain from £12,500 personal allowance*, 2017 (https://www.ifs.org.uk/publications/9993)

become commonplace now among parties across the political spectrum to introduce new tax thresholds into the system with no sensible rule for how they will evolve over time. This lack of indexation means that the numbers affected by Labour's 45% income tax rate would rise over time at an arbitrary and unknown rate that depends on future nominal income growth. Based on current forecasts, approximately 1.9 million people will have incomes exceeding £80,000 in 2023–24: the top 6% of income tax payers, or the top 4% of adults.

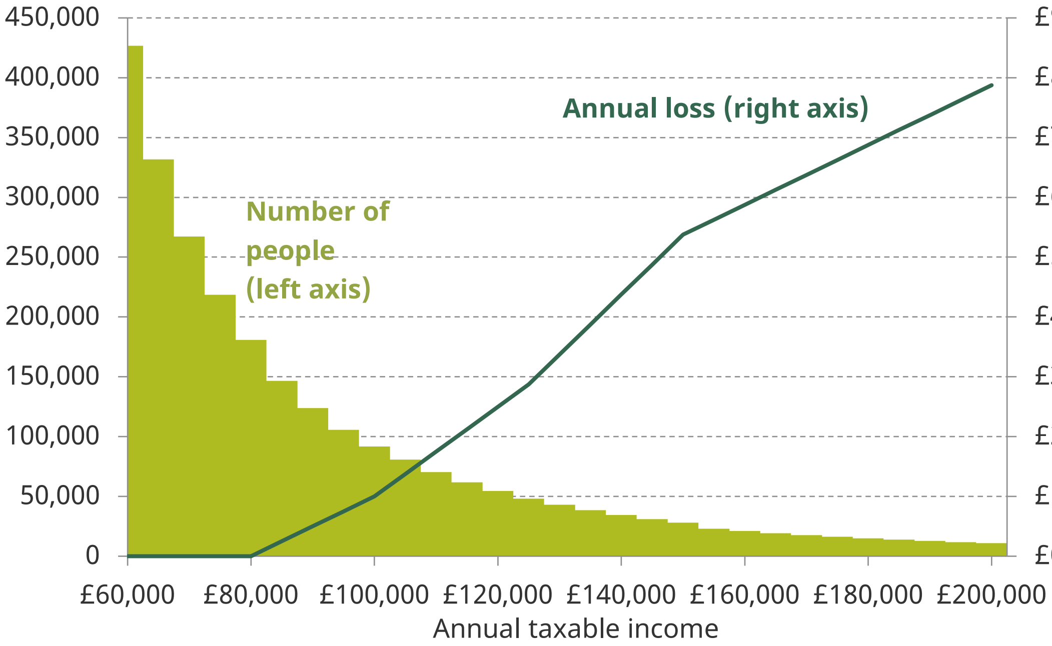
In contrast, the threshold for paying the 50% rate would be aligned with the point at which the personal allowance is fully withdrawn. The threshold for tapering the personal allowance is fixed at £100,000 in cash terms, and the income range over which the personal allowance is withdrawn grows at twice the rate of inflation. As a result, under current inflation forecasts, the threshold for paying the 50% rate would be £125,480 in cash terms in 2021–22, £125,980 in 2022–23 and £126,500 in 2023–24.

Losses would increase with taxable income

Labour's proposal would increase tax for everyone with incomes above £80,000. The loss is bigger, in cash terms, the higher above £80,000 incomes are. For example, someone with an annual taxable income of £100,000 would lose £1,000 a year relative to the current system, whereas someone with an income of £150,000 would lose £5,375 a year.

The income distribution thins out very quickly at the top, so most of those who would be affected by Labour's policy have incomes not far above £80,000 a year. Figure 2 shows the losses from Labour's proposals by taxable income, overlaid on the estimated number of people at each income level in 2020–21, when the policy would first take effect. There are set to be around 0.6 million people with taxable incomes between £80,000 and £100,000 a year, 0.6 million people between £100,000 and £150,000 a year, and 0.5 million with incomes exceeding £150,000 a year. Many people are set to have incomes a little below £80,000 in 2020–21 and, as discussed above, would be caught by the new 45% rate in future years as their incomes grow and the tax threshold remains frozen. Note that these numbers could change somewhat as result of Labour's proposed reforms, if people respond by reducing their taxable incomes (see below).

Figure 2. Loss from Labour's proposal in 2020–21, by taxable income



Note: Excludes Scotland. Approximately 0.3 million individuals have incomes above £200,000 a year. See Appendix for details.

Source: Authors' calculations using HMRC Income tax statistics and distributions.

Those affected already pay half of all income tax

The top 5% of income tax payers already contribute a large share of income tax revenue. HMRC estimates that 50% of all income tax payments in 2019–20 will come from the top 5% (Figure 3).

This share has risen from 43% in 2007–08, just before the financial crisis, largely due to a rise in tax take from the top 1%. The rise in concentration in recent years has not been driven by rising income inequality at the top. As Figure 3 shows, the top 1%'s share of all taxpayers' income is the same in 2019–20 as it was in 2007–08, and the next 4%'s share actually fell slightly over that period.[4]

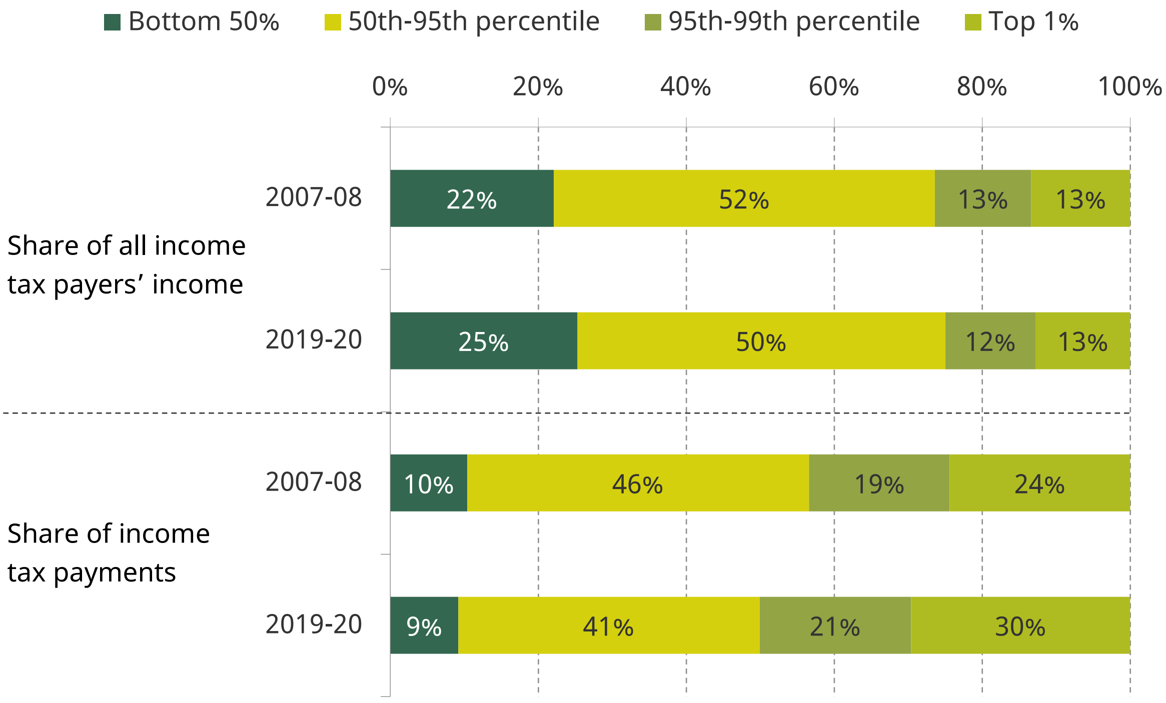
Rather, it reflects a number of income tax rises for the very highest-income individuals since 2010. These include the introduction of the additional (currently 45%) rate of income tax, the withdrawal of the personal allowance, substantial cuts in income tax relief for private pension contributions and a real-terms reduction in the higher-rate threshold.

Labour's proposal would further skew the distribution of income tax payments towards the very top. However, it is worth noting that the two next biggest taxes, National Insurance contributions and VAT, are much less targeted at those with high incomes

[4] The comparison over time is not exact, because increases in the personal allowance since 2007–08 have taken many people out of income tax. But since that reduces both the share of income received by taxpayers and the size of the top 5% group, it is not clear that it biases the comparison one way or the other.

(though some smaller taxes, such as inheritance tax and capital gains tax, are more top-heavy than income tax).

Figure 3. Concentration of incomes and income tax payments among income tax payers



Note: Both bars show shares of the population of income tax payers. Incomes defined as pre-tax income before private pension contributions. Percentiles based on income before tax.

Source: Table 2.4 of HMRC Income tax statistics and distributions.

Revenue yield depends on size of behavioural response

When it proposed this income tax rise during the 2017 election, Labour expected it to raise around £4.5 billion a year in 2018–19 prices, or £4.7 billion in 2020–21 prices.[5] This time round, Labour has said that the reform would pay for its NHS 'rescue package'.[6] Based on IFS analysis of Labour's NHS spending plans, this would require at least an additional £3.6 billion a year on average between 2020–21 and 2023–24, in 2020–21 prices.[7]

[5] S. Adam, A. Hood, R. Joyce and T. Waters, *Labour's proposed income tax rises for high-income individuals*, 2017. (https://www.ifs.org.uk/publications/9229)

[6] The Guardian, *Labour's NHS 'rescue package' to be paid for by higher taxpayers, says McDonnell*, 2019 (https://www.theguardian.com/politics/2019/nov/13/labour-nhs-rescue-package-to-be-paid-for-by-higher-taxpayers-says-mcdonnell)

[7] This corresponds to Table 2 in G. Stoye and B. Zaranko, *Labour's NHS spending plans*, 2019 (https://www.ifs.org.uk/election/2019/article/labour-s-nhs-spending-plans) in 2020–21 prices, less additional capital spending which can be covered by borrowing under Labour's proposed fiscal rules.

Whether the tax rises would raise that amount, or more or less than that, depends crucially on how people respond to the increases in income tax – an area of considerable uncertainty.

If there were no change in people's taxable incomes as result of this reform, it would raise around £9.2 billion in 2020–21. However, evidence suggests that the taxable incomes of individuals at the very top of the income distribution are relatively responsive to income tax changes.[8] The evidence tells us less about the mechanisms by which these people adjust their taxable incomes in response to higher taxes. Possibilities include working less (for example, retiring earlier), increasing the extent to which they legally avoid taxes (for example, shifting income into forms that are taxed at lower rates such as capital gains), or increasing the extent of illegal tax evasion (for example, failing to declare overseas income). People might also emigrate or choose not to move to the UK in the first place.

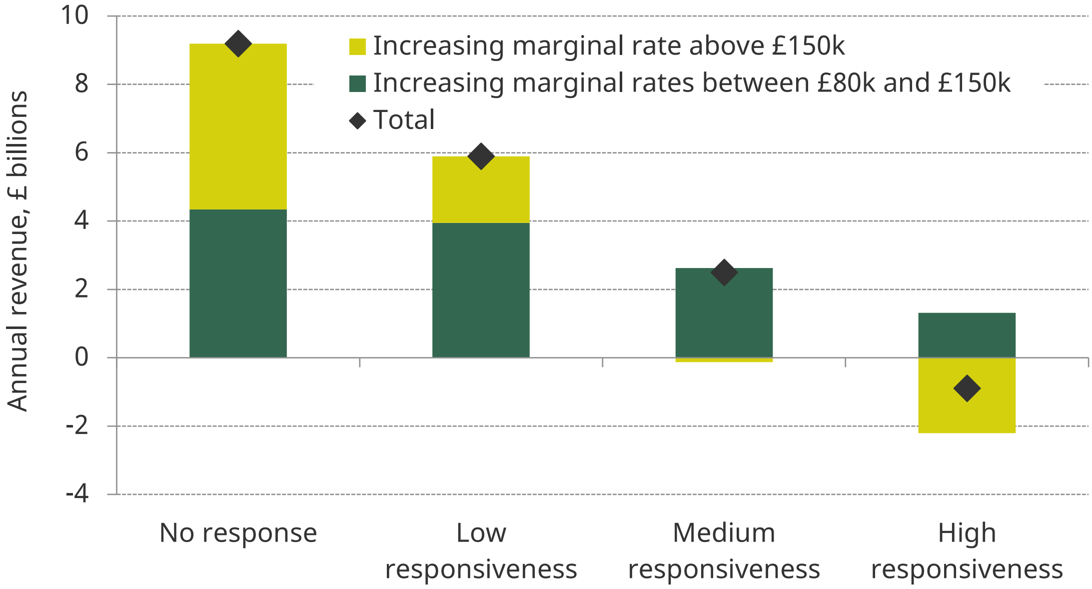
The size of such behavioural responses is highly uncertain. Figure 4 shows revenue estimates for Labour's proposals in 2020–21 in three illustrative scenarios based on the existing evidence – low, medium and high responsiveness (see Appendix for details). It is important to note that these scenarios are based on estimated responses to previous changes in income tax. To the extent that Labour also introduces other policies that affect how people can respond to income tax changes (e.g. anti-avoidance measures), the proposals may raise a different amount of revenue (see below).

In our medium responsiveness scenario, Labour's current proposal would raise an estimated £2.5 billion. In other words, in this scenario, of the £9.2 billion 'mechanical' increase in tax revenue that would accrue if nobody changed their behaviour in any way, about £6.7 billion would be lost due to people reducing their taxable incomes in response to the tax rise.

However, the bounds of plausibility are very wide indeed. It is entirely possible that the policy would raise up to £5.9 billion a year, but on the other hand, it is also possible that it would raise nothing at all. It could even reduce income tax revenues, if the fall in pre-tax incomes more than offsets the higher tax paid on those incomes. Those on the very highest incomes have a disproportionate amount of taxable income and pay relatively high taxes already. This means that if they reduced their taxable income in response to tax rises, the government would not only fail to collect the additional tax it intended, it would also lose the tax that it already collects on that income.

[8] J. Browne and D. Phillips, *Estimating the responsiveness of top incomes to tax: a summary of three new papers,* 2017. (https://www.ifs.org.uk/publications/9675)

Figure 4. Estimates of revenues from Labour's proposal under different assumptions of responsiveness, 2020–21



Note: Figures in 2020–21 prices. See Appendix for details.

Source: Authors' calculations using HMRC Income tax statistics and distributions.

Because the £80,000 threshold will be frozen in cash terms, Labour's proposal is likely to raise more revenue in future years, as more people see more of their incomes lie above the threshold. In our medium responsiveness scenario, the policy would raise £3.1 billion in 2023–24 (in 2020–21 prices), up from £2.5 billion in 2020–21. Revenue estimates for 2020–21 and 2023–24 based on the three scenarios are given in Table 1 below.

Table 1. Estimates of revenues from Labour's proposal under different assumptions of responsiveness, 2020–21 and 2023–24, £ billions (2020–21 prices)

Scenario	2020–21	2023–24	Average 2020–21 to 2023–24
No response	9.2	10.5	9.8
Low responsiveness	5.9	6.9	6.4
Medium responsiveness	2.5	3.1	2.8
High responsiveness	−0.9	−0.7	−0.8

Note: Average revenues assume revenues grow linearly between 2020–21 and 2023–24. See Appendix for details.

Source: Authors' calculations using HMRC Income tax statistics and distributions.

In the 2017 election, Labour estimated that the proposed income tax increases would raise around £4.5 billion a year in 2018–19 prices. This acknowledged that there would be substantial behavioural responses to the tax rise, but assumed a degree of responsiveness that, while possible, was towards the lower end of the range of plausible estimates (based on the existing literature). Our central estimate in 2017 put the revenue gain at £2.5 billion a year in 2018–19 prices.[9] Labour's estimate of £4.5 billion roughly corresponded to our 'low responsiveness' scenario that year.

Labour has not yet said how much it expects the proposals to raise this time round, other than to say that the revenue would be enough to fund its NHS spending package. Our medium responsiveness scenario suggests that the proposals would raise £2.8 billion a year on average between 2020–21 and 2023–24, a little less than the £3.6 billion required to cover the additional spending on the NHS (in 2020–21 prices). But there is a great deal of uncertainty: the proposals could plausibly raise up to £6.4 billion a year, or reduce income tax revenues, depending on how much people reduce their pre-tax incomes in response to the tax increase.

It is important to note that the extent to which people respond to income tax changes is not immutable, but rather depends on the policy environment (among other factors). The less scope the tax system provides to shift income into more lightly taxed forms, the more revenue tax rises will bring in.[10] In its 2017 manifesto, Labour proposed a number of measures to combat what it saw as tax avoidance and evasion.[11] More recently, Shadow Chancellor John McDonnell has said that he would 'look carefully' at proposals to align capital gains tax rates with income tax rates, which would reduce the scope to shift incomes into capital gains to avoid paying higher rates of income tax.[12] We do not comment here on the other pros and cons of such proposals; but the more Labour ensures that all income is taxed at the standard rates, the more revenue its income tax proposal would be likely to raise.

Appendix

Estimation of the distribution of taxable income

The number of people with incomes above £80,000 in the UK is estimated using Tables 2.4 and 2.5 of HMRC's income tax statistics and distributions,[13] which provide projections of points in the total income distribution among taxpayers in 2019–20.

We uprate these to 2020–21 using the OBR's March 2019 forecast for average earnings growth,[14] and scale down the proportion of individuals above each threshold to adjust for private pension contributions (that is, to go from the distribution of total incomes to something nearer the distribution of taxable incomes). We then fit a Pareto distribution to interpolate between these adjusted percentiles and assume that the number of income tax payers rises in line with projected population growth. Finally, we strip out Scottish

[9] S. Adam, A. Hood, R. Joyce and D. Phillips, Labour's proposed income tax rises for high-income individuals, 2017. (https://www.ifs.org.uk/publications/9229.)

[10] See for example H. Miller, T. Pope and K. Smith, *Intertemporal income shifting and the taxation of owner-managed businesses*, 2019. (https://www.ifs.org.uk/publications/14475.)

[11] https://labour.org.uk/wp-content/uploads/2017/10/Tax-transparency-programme.pdf

[12] John McDonnell comments on IPPR's Just Tax report, 2019. (https://labour.org.uk/press/john-mcdonnell-comments-ipprs-just-tax-report/.)

[13] https://www.gov.uk/government/collections/income-tax-statistics-and-distributions

[14] https://obr.uk/efo/economic-fiscal-outlook-march-2019/

taxpayers using a linear approximation of the share of Scottish taxpayers by £5,000 income band, based on the Family Resources Survey 2017–18.

Scenarios for revenue estimates

The extent to which people's taxable incomes respond to income tax rates can be summarised by the 'taxable income elasticity' (TIE). This tells us by what percentage reported taxable incomes change following a 1% change in the marginal net-of-tax rate (that is, in the percentage of additional income that is not taxed away: 100% minus the marginal tax rate). The higher the TIE, the more responsive taxpayers are to changes in tax rates and the less revenue would be raised by increases in tax rates.

HMRC's central estimate of the TIE for taxpayers with incomes above £150,000 (affected by the introduction of the 50% additional rate in 2010) is 0.48.[15] However, the statistical uncertainty surrounding this central estimate is very large. In addition, relatively modest changes to HMRC's methodology can lead to big changes in the 'central' estimate. One particular difficulty is distinguishing temporary shifts in the timing of income around the moment that tax rates change (in particular, bringing income forward so that it is taxed at the lower, pre-reform rate) from permanent effects on behaviour.

The evidence suggests that people on lower incomes are less responsive to changes in tax rates, so TIEs for those with incomes between £80,000 and £150,000 are likely to be lower than for those with incomes above £150,000. In Budget 2012, following a review of the evidence, HMT assumed a TIE of just 0.03 for individuals affected by cuts to the higher rate threshold (with incomes over £48,000 in today's prices). IFS analysis of responses to the introduction of the 50% additional rate suggests that the TIE for those close to the £150,000 threshold was 0.1 to 0.2 – the much higher 0.48 figure being driven by a high degree of responsiveness among those with the very highest incomes.[16]

We estimate revenues in three plausible scenarios of the degree of responsiveness:

1. **Low responsiveness.** We assume a TIE of 0.03 for those between £80,000 and £150,000, and 0.28 for those above £150,000. These elasticities are below the central estimates in each case, but well within the bounds of possibility.

2. **Medium responsiveness.** We assume the TIEs are 0.13 and 0.48 respectively – approximately central estimates.

3. **High responsiveness.** We assume the TIEs are 0.23 and 0.68 respectively – above the main central estimate in each case, but again well within the bounds of possibility.

[15] https://webarchive.nationalarchives.gov.uk/20130127161217/http:/www.hmrc.gov.uk/budget2012/excheq-income-tax-2042.pdf

[16] J. Browne and D. Phillips, *Estimating the size and nature of responses to changes in income tax rates on top incomes in the UK: a panel analysis*, 2017. (https://www.ifs.org.uk/publications/9676.)