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THE LIBERAL DEMOCRATS' PROPOSALS

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The Liberal Democrat proposals

As can be seen in Election Briefing Note 10, the Liberal Democrats wish to increase both tax and public spending by around £8bn annually relative to government plans. The average financial effect on households would be negative, as higher taxes would largely be used to direct revenue from households towards public services, such as health and education. But even in financial terms, some households would gain, because part of the proposed public spending increase would be on benefits, such as the retirement pension.

This Election Briefing Note asks which families would gain and which would lose from Liberal plans for the tax–benefit system, but first it outlines and analyses the specific measures.

1. Tax-raising measures

Table 1 lists the Liberal Democrats' proposed tax increases and shows how much each raises. More than £6bn of the total of almost £8bn comes from higher income tax. This derives from two measures which yield similar amounts – a one penny increase in the basic rate, to 23p in the pound, and a new 50% higher rate of tax to be charged on gross income above £100,000. The rest of the revenue is raised through capital gains tax reforms.

Table 1. Revenue effects of proposed tax changes

Measure	Annual exchequer yield
Income tax	
Increase basic rate from 22% to 23%	£2,800m[a]
50% rate on income over £100,000	£3,400m[b]
Capital gains tax	
Reversal of Labour 'taper' reforms	£400m[c]
Exemption at death removed	£1,100m[a]
Total	£7,700m

Notes: Estimates are in 2001 prices and are on an accruals basis, i.e. full-year effect is shown. Estimates for yield from basic-rate increase are based on 1999–2000 income tax system. The IFS tax and benefit model, TAXBEN, run on 1997–98 Family Expenditure Survey data, suggests yield would be around 3% lower under 2001–02 system. Exchequer yield from reversing Labour's capital gains tax reforms is net of revenue forgone in reintroducing indexation and retirement relief.

Sources:

a. HM Treasury, *Tax Ready Reckoner and Tax Reliefs*, London, November 2000.

b. Parliamentary Question no. 148940, answered on 14 February 2001.

c. Parliamentary Question no. 153714, answered on 14 March 2001.

Income tax proposals

The extra penny paid on each pound taxed at the basic rate would only affect people with gross income above £6,415. Those with gross income above

£33,935 face the maximum tax rise of £275 each year, or £5.30 extra each week. For people with income between £6,415 and £33,935, gains depend positively on income.[1]

The new 50% band represents a 10 percentage point increase on the current 40% top income tax rate. It would only affect individuals with a gross income above £100,000 and would only apply to the top tranche of income. Such individuals would forgo an extra 10% of income possessed in excess of £100,000. The policy would affect only 300,000 people, or, roughly, the richest 1% of taxpayers.[2] Very high-income individuals would see a quite substantial increase in tax liability. Someone with an annual income of £300,000, for example, would pay £385 extra in tax each week.

Together, these reforms represent a modest reversal of the trend for cutting income tax rates that has been a prominent feature of fiscal policy for the past 25 years.

Capital gains tax proposals

Capital gains tax (CGT) is a levy on the benefit individuals receive when they buy an asset at one price and sell it on at a higher price. Gains made from selling one's principal home are exempt, leaving stocks and shares as the main type of asset affected. There is also a substantial tax-free allowance on capital gains, worth £7,500 each year. At present, CGT is a small tax, yielding around £2bn each year for the Treasury.[3] The Liberal Democrats propose to increase its take by £1.5bn through two reforms.

The first set of proposed changes is reversal of the CGT reforms undertaken by the current government, which are briefly outlined in Election Briefing Note 5. The reduced rates that now apply to assets held for long periods would be abolished, and indexation, which exempted gains that merely compensated for inflation, would be reintroduced. Further, Labour's preferential treatment of 'business assets' would also be ended, although business owners would be partially compensated for this by the reintroduction of 'retirement relief', which ensured individuals over 50 could receive the first £250,000 of capital gains from selling the family business tax-free, with the next £750,000 being taxed at half the standard rate. Taken together, these reforms would raise £400m annually.

Reversal of Labour's reform would have the merit of simplifying the tax system: the large number of rates at which CGT was charged would be reduced. It would also be a step towards aligning the tax treatment of income and capital gains, as the latter would typically be taxed at one's marginal income tax rate. This would reduce the likelihood that the CGT system would

[1] Illustrative figures are for a single childless person who is under 65 years of age.

[2] Source: *Inland Revenue Statistics*, 2000. Latest updated edition available from http://www.inlandrevenue.gov.uk. The figure is based on projections of the 2001–02 income distribution.

[3] Source: *Inland Revenue Statistics*, 2000. Figure is for 1998–99, the most recent year for which an estimate of yield is available.

distort people's behaviour by encouraging them to convert income into capital gains in order to reduce their total tax liability.

The second element of the Liberals' proposal to increase CGT is to abolish the exemption for capital gains unrealised at death, which has existed since 1971. This could raise £1.1bn per year, although the yield might be reduced if individuals altered their behaviour to avoid their estate paying CGT after their death. As well as raising money, the reform could be advanced on the grounds that it would ameliorate the distortion that the current system imposes against disposing of one's assets before death for people planning their bequest.

Removing the exemption might be objected to on the grounds that the total tax rate on some estates would be left very high, as both inheritance tax and CGT could be charged simultaneously. Inheritance tax is paid at 40% on the top tranche of estates worth £242,000 or more; CGT would apply in addition to this on any part of the estate that represented capital gain in excess of £7,500. This 'double taxation' would mean that tax could consume very large proportions of some parts of the estate, although it should be stressed that the generous thresholds in both CGT and inheritance tax, together with the fact that estates will only ever partially consist of capital gains, would help contain the total effective tax rate applied to estates.

Data limitations mean we cannot model the precise incidence of this tax increase, but we argue in Election Briefing Note 5 that there are strong reasons to think that Labour's CGT reforms could be characterised as a substantial tax cut for a small group of people who are, for the most part, relatively well off. Reversing these measures is a substantial tax increase for this same group. Ending the CGT exemption on gains that remain unsold at death would tend to hit the estates of the wealthiest individuals hardest. Both elements of the Liberals' CGT proposal can thus be characterised as broadly progressive tax increases.

2. Benefit increases

Pensions

The Liberal Democrats would increase the basic state pension by £5 per week for pensioners entitled in their own right, and increase the couple rate by £8. This is over and above the increases that Labour is planning. In addition, they would introduce new age-related additions, which would be received in full regardless of any incompleteness in National Insurance contributions records. Every pensioner aged 75 to 79, regardless of whether they claim in their own right or in respect of their partner's National Insurance contributions, would

Table 2. Weekly basic state pension increases under Lib Dem plans

Age	Single	Couple
Retirement age to 74	£5	£8
75 to 79	£10	£18
80+	£15	£28

Note: Figures for couples assume that one partner receives the dependant's addition in respect of their spouse's National Insurance contribution record and that both partners fall within the same age bracket.

receive an extra £5, and every pensioner aged 80 or over would receive an extra £10. Table 2 shows the total effect on the basic pension received by singles and couples of different ages.

The cost of the proposed increases would be substantial, at around £2.8bn per year.[4] The policy would represent a very decisive shift from the approach of the current government, which has targeted much of the extra support made available for pensioners through increased means-tested benefits rather than by increasing the state pension, which is received by rich and poor alike. Indeed, the Liberal Democrats are advancing the policy as an explicit alternative to Labour's reliance on means testing. The more generous treatment of older pensioners, who tend to be poorer, is supposed to be a way of targeting help without relying on an explicit income test.

But the intention to move away from a means-tested system has led the Liberal Democrats to avoid coupling the pension increase to any proposed increase in the means-tested minimum income guarantee (MIG). Consequently, MIG recipients would see their increased state pension cancelled out by lower MIG entitlement. As a result, the Lib Dems could be criticised for failing to provide any increase in benefit entitlement for the poorest pensioners. But against this charge must be weighed the consideration that the very poorest pensioners of all are those who do have MIG entitlement but do not claim it, and these people would be helped by the Liberal policy.

The differing attitudes of the parties to means-testing more generally are considered in Election Briefing Note 11.

Families with children in long-term poverty

The Liberal Democrats propose to award £3.85 per week to families with children who have been in receipt of income support for more than one year. The extra help is designed to alleviate the specific problems associated with long-term poverty. Around a million families could gain, at an annual cost of around £200m.

Measures for the young

The Liberal Democrats plan to extend entitlement to income support and housing benefit to people aged 16 or 17 who have already left full-time education. This policy would cost about £100m each year.[5] Currently, people under 18 can only claim support in special circumstances (e.g. after leaving young offenders' institution). Another proposal in the area of means-tested support would be the relaxation of the single-room rent restriction applicable to housing benefit claimants under 25. This would allow young people who do not share accommodation to receive full housing benefit support, at an annual cost of £30m.[6]

[4] Parliamentary Question no. 140950, answered on 30 November 2000.

[5] Parliamentary Question no. 110061, answered on 17 February 2000.

[6] Estimate from Shelter's Policy Unit Briefing Note, May 2000.

Young people on low earnings would also benefit from the Liberal Democrat policy of increasing the 'youth' rate of the minimum wage to the adult level for all aged 16 or over. At present, the minimum wage for people aged 18 to 21 inclusive is £3.20, as against £3.70 for workers of 22 or above. There is currently no minimum wage for workers of 16 or 17. The distributional effects of the proposed change to the minimum wage are excluded from the rest of the analysis in this Election Briefing Note.

Winter fuel payments for disabled people

The Labour government has introduced and increased winter fuel payments for the over-60s, which on current plans will pay out £150 each year.[7] The Liberal Democrats argue that these should be extended to people under 60 with severe disability, defined as those who qualify for the health-contingent disability living allowance at higher rates.[8] The policy should benefit around 1.5 million households at an annual cost of a little over £200m.

While redistributing money to the severely disabled may be a worthy aim, it is not obvious that this policy is the best way to deliver it: increases in the rates of disability living allowance itself would achieve the same without the administrative complication.

Cold weather payments

The Liberal Democrats also propose to include the wind-chill factor in assessment of the cold weather payments made through the means-tested benefit system. This measure would cost just £8m a year and would not effect a significant redistribution of income.

3. Distributional effect

We model the Liberal tax and benefit changes as decreasing household incomes by around £2bn per year, about £1.60 per week for every household. Two factors mean that the negative effect of Lib Dem reforms on household incomes will be underestimated. First of all, as already mentioned, we cannot model the capital gains tax reforms which would reduce household incomes by about £1.5bn. Second, the Family Resources Survey (FRS), on which the simulations have been run, undersamples the very richest households, which would see large increases in their tax bills following the introduction of the 50% band. Thus, even though we can model the reform, our results are likely to underestimate its effect. Sections 1 and 2 showed that, while the Liberal Democrats would increase taxes by £7.7bn, increases in direct benefits would amount to about £3.3bn. The £4.4bn difference between these suggests an average loss of around £3.60 per week per household, which is a more accurate estimate of the average change.

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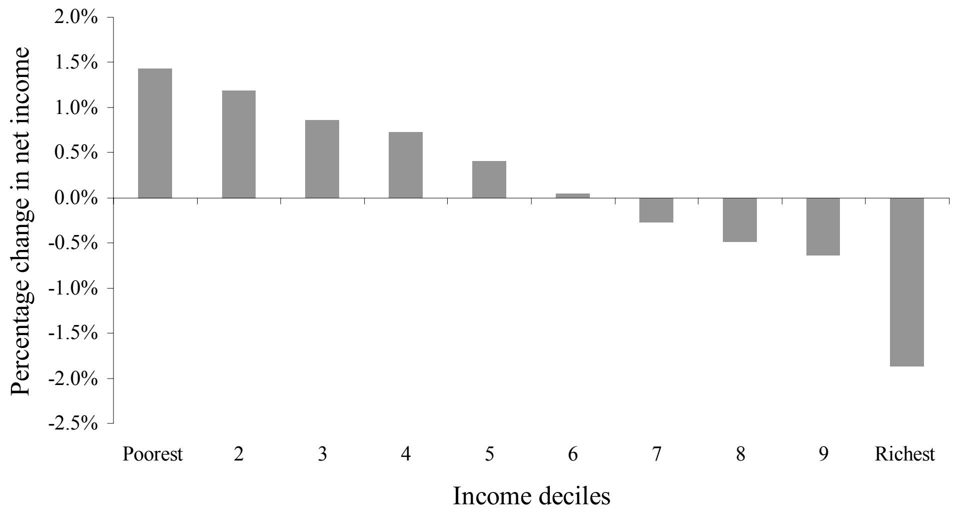
[7] The 2000 Pre-Budget Report increased the payment to £200, but only for the single year 2000–01.

[8] Including the medium rate of the care component.

Figure 1 illustrates the effect of the Liberals' proposed changes in direct taxes and benefits on average post-tax incomes in each income decile. Modelled reforms exclude the capital gains tax proposals and abolition of rent restrictions for under-18s. The impact of the two income tax reforms explains a large part of the progressiveness of the package. The 50% tax rate is clearly a tax rise exclusively for the rich. Losses from the increase in the basic rate of tax are restricted to those with income sufficient to pay basic-rate tax: for childless individuals under 65, this is gross annual income above £6,415. Losses vary positively with income until the higher-rate threshold of £33,935 per year, above which a flat-rate loss is incurred.

Figure 1. Distributional effect of Lib Dem tax and benefit reforms



Notes: The FRS has been used here as it offers the best available data on incomes. By contrast, analysis of the other parties' proposals has been based on Family Expenditure Survey data because, unlike the Liberal Democrats', they affect the levels of indirect taxes, which means data on family expenditure are required, something the FRS does not contain. Income deciles are derived by dividing the population into 10 equally sized groups according to household income adjusted for family size. Decile 1 contains the poorest tenth of the population, decile 2 the second poorest and so on, up to decile 10, which contains the richest tenth.
Source: The IFS tax and benefit model, TAXBEN, run on 1998–99 Family Resources Survey.

Households in the bottom decile gain most, both in absolute and in proportional terms. This largely reflects the extension of means-tested support to under-18s. The average gain to a household in the bottom 10% of the income distribution is about £2.20 per week. This figure is likely to be an underestimate since it is based on the assumption that the poorest pensioners take up their means-tested benefit entitlement, which would prevent them gaining from the proposed basic pension increases. In practice, the very poorest pensioners are likely to be those who fail to take up this means-tested support, and individuals in these circumstances would gain from the higher state pension. Increases in the retirement pension are the most important reason why, on average, households in all other income deciles below the seventh gain from Liberal proposals. By contrast, the top 40% of the income distribution see their incomes fall as a result of the reforms, as income tax increases outweigh benefit increases.

The richest 10% are modelled to lose £17.60 per week. The figure is likely to underestimate the effect of the income tax reform, because of the undersampling of rich households. The simulated yield from the proposed 50% tax band is about £1.5bn, which underestimates the true yield by about £1.9bn. This £1.9bn in extra tax would certainly fall entirely on the richest 10% of the population, making their total average cash loss £32.90 per week. Overall, therefore, the top 10% would see their disposable incomes fall, on average, by 3.5%. But even within the top 10%, the effect is highly uneven. Among households in the top decile, the great majority would see their disposable incomes rise slightly or fall by less than £10 per week; for the remainder – chiefly households containing the highest-income individuals – the cash loss would be substantial.

Table 3 shows average weekly gains and losses by family type following the introduction of the Lib Dem package. Income tax rises mean that most family types lose on average. Pensioners stand out as the exception. A single pensioner would gain just less than £3 per week on average, while pensioner couples would benefit by about twice as much. Despite the fact that reforms would increase universal benefits, the average gains are lower than the proposed increases. This is because neither taxpaying pensioners nor those on means-tested benefits would see their disposable incomes rise by the full amount of the pension increase.

Table 3. Average weekly gains from Lib Dem proposals by family type

Family type	Average weekly gain
Families with children	
Single-parent family	£0
No-earner couple with children	£1.77
Single-earner couple with children	–£7.98
Two-earner couple with children	–£4.83
Pensioners	
Single pensioner	£2.96
Pensioner couple	£5.89
Others	
Single, not employed	£0.71
Single, employed	–£4.18
No-earner couple without children	£0.34
Single-earner couple without children	–£3.80
Two-earner couple without children	–£5.77

4. Longer-term aspirations

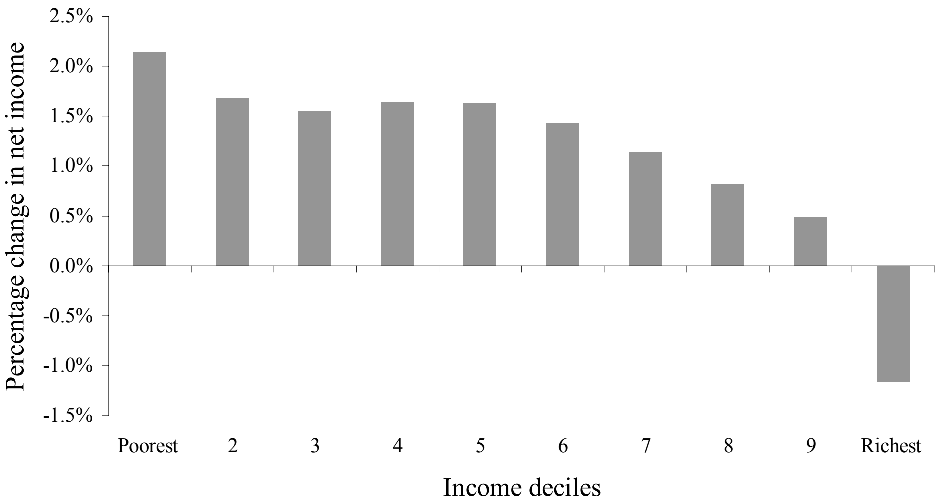
In addition to the definite commitments that we have analysed in the paragraphs above, the Liberal Democrats have announced an aspiration to abolish the 10% starting rate of income tax when this is affordable. This is equivalent to extending the personal allowances by £1,880 per year. It would be a significant break with the policy of the present government, which replaced the 20% lower rate with a new 10% starting rate. The abolition of the

10% band would benefit anyone with gross income in excess of £4,535.[9] The largest amount that any individual could gain from the reform is £188 per year (just over £3.60 per week). This gain would go to anyone with income above the level at which basic-rate tax begins, which is £6,415.

This reform would make the income tax system administratively simpler, reducing the number of tax bands by one and removing around 2.69 million individuals (almost 10% of taxpayers) from the tax net. This would see the exchequer forgoing £4.5 billion per annum in income tax revenue.[10] The extent of this simplification would be somewhat reduced if the National Insurance (NI) system were not reformed at the same time. Reforms to NI during the last Parliament saw the lower earnings limit (LEL) aligned with the income level at which individuals begin to pay income tax. Abolition of the 10% rate without a corresponding change in the LEL would reintroduce the discrepancy that has recently been eliminated. But if the LEL were raised commensurately, the cost of the reform would rise very substantially.[11]

In the long run, the Liberal Democrats also propose to increase income support and housing benefit levels for those under 25 to the levels applicable to people aged 25 and over. The reform would raise the level of these benefits to £53.05 for single people and £83.25 for couples from the current levels of £42.00 for single people under 25 and £63.35 for couples under 18.

Figure 2. Distributional effect of Lib Dem tax and benefit reforms, including 'aspirations'



Note: See notes to Figure 1.
Source: The IFS tax and benefit model, TAXBEN, run on 1998–99 Family Resources Survey.

[9] This is the level of the personal tax allowance on earned income for single adults under 65 in the 2001–02 tax system. There are higher allowances for older people.

[10] Source: TAXBEN run on 1998–99 FRS data.

[11] Abolition of the 10% rate with corresponding increases in the LEL would cost £11.5bn a year. This figure includes the costs of raising the LEL in employee, self-employed and employer NI contributions to £123.40 per week.

Both of these measures would benefit households at the lower end of the income distribution. This is clearly shown in Figure 2, which demonstrates the distributional effect of the Lib Dem package including longer-term measures. Given that the highest gains from abolition of the 10% tax rate would go to households with multiple basic- or higher-rate taxpayers, adding this measure reduces the progressiveness of the Liberal Democrat package.

Families in the bottom decile now see their disposable incomes rise by £3.30 per week on average. All other deciles see their incomes rise primarily because of the abolition of the 10% tax rate. This policy benefits all those earning more than £4,535 per annum and, combined with state pension increases (on average), is enough to outweigh the effect of the income tax increases described above in all but the top income decile.

5. Conclusions

The Liberal Democrats propose to increase personal taxes in order to increase expenditure on what they see to be priority issues. Some of the increases in spending represent a handing-back of disposable income through the benefit system. The overall effect of the changes in direct taxes and benefits would be progressive, with gains near the bottom of the income distribution and losses at the top. A proposal to abolish the 10% tax rate would make the package somewhat less progressive. This policy and some of the other proposals analysed here – notably those for the pension system – would represent a significant change in direction compared with the policy of the incumbent government.