conservativehome
the home of conservatism

Ryan Bourne: Fiscal drag remains the Government's stealth tax of choice

By Ryan Bourne

Last updated: April 6, 2022 at 9:47 am

Remember when Conservatives slammed New Labour for using "stealth taxes" to raise revenue? Well, the Conservatives' own stealth tax of choice for the past twelve years has been "induced fiscal drag."

They've deliberately suppressed the real and wage-adjusted value of the 40p and 45p income tax thresholds at times, shoving more people into higher income tax brackets as nominal incomes rise.

Now this policy has combined with high inflation to become a massive tax hike from Rishi Sunak.

The facts are startling. In 1990, just one in fifteen income tax payers (1.7 million taxpayers) paid the 40p income tax rate. Between 2010 and 2022 that rose from one in ten taxpayers (3.2 million) to one in seven (4.8 million).

Now, the Office for Budget Responsibility (OBR) estimates two million more people will become higher rate payers by 2025/26. That means 6.8 million are now forecast to pay the higher rates in three years' time (oe in every 5.5 taxpayers) – a million more than projected just last year.

That forecast-busting uplift is the result of our current macroeconomic ill: high inflation. But that's the point.

All tax thresholds should be automatically indexed to aggregate prices to protect the legislated tax structure. If the 40p threshold had just been tied to inflation or wage growth since 2010/11, it would stand at around £60,000 today, rather than £50,270.

Under Sunak, the higher rate tax threshold has only risen by 0.5 percent between 2019/20 and 2021/22, a time during which nominal earnings grew 8.9 percent. Last year he announced it would be frozen with the personal allowance for another four years, resulting in an effective 16.4 percent cut in its real value by 2025 given today's inflation outlook.

The 45p threshold, remarkably, has been preserved in aspic at a fixed value of £150,000 by the Conservatives, despite being introduced in the dying days of Gordon Brown's government. Then, just 0.8 percent of income taxpayers paid it (236,000 people). Now, it's 1.4 percent

(440,000). There's been a 22 percent increase in employees subject to the 45p rate in the last two years alone.

All this is before mentioning how the threshold for tapering the personal allowance has been fixed at £100,000 since 2010, exposing growing numbers to the even higher effective marginal tax rate it creates.

Sadly, most reporters and politicians don't acknowledge that protecting the real value of all thresholds should be the baseline for judging tax policy.

True, the Chancellor was fairly upfront about his threshold freezes being a tax hike when he introduced the plans last year. But higher inflation has made this decision a much bigger tax rise than he implied, something which he did not mention or amend in last week's Spring Statement.

The crux is: given inflation is driving more people into higher tax bands, a failure to adjust this policy represents an effective doubling of the original tax hike. The Institute for Fiscal Studies now estimates that suppressing thresholds will raise a massive £17.5 billion in annual revenue by 2025/26.

So don't be fooled by the Chancellor's claim that shaving 1p off the basic rate of income tax in a few years is some great income tax cut. That and the rise in the starting thresholds for national insurance announced last week amount to around £10 billion worth of tax cuts annually — completely dwarfed by the new health and social care levy and the threshold suppression.

In fact, for all the talk of the destructive impacts of the new social insurance levy, OBR analysis shows that threshold suppression will now deliver a tax rise of roughly equivalent size (0.6 percent of GDP).

Hiking taxes through inflation and threshold restraint, while declaring yourself a tax cutter, is not a new political strategy. A 1980 report recommending indexation of brackets in the US warned:

"The existence of the inflation tax allows elected officials to enact tax cuts which may have no real lasting effect on tax burdens, but do allow legislators to campaign on a record of 'cutting taxes.'"

More importantly, unmooring thresholds from any real value risks changing people's tax burdens in inflationary periods arbitrarily, without any parliamentary oversight.

Sunak is not the first Conservative to use this approach, of course. George Osborne suppressed the higher rate threshold through the 2010-2015 Parliament, even cutting it in nominal terms at one point. The former Chancellor went further in arguing the political upsides of the policy, reportedly arguing to backbench Conservatives:

"There are advantages in more people paying tax at 40p. It means they feel they are a success and joining the aspirational classes. That means they are more likely to think like Conservatives and vote Conservative."

That seemed like motivated reasoning and was belied by the fact that Osborne's Conservatives entered the 2015 election promising that a majority Conservative government would deliver a large corrective uptick in the higher rate threshold to £50,000. Yet Osborne was right that keeping thresholds suppressed could be a relatively low salience way of raising funds.

We are seeing clear evidence of this right now, with the health and social care levy getting far more scrutiny and pushback than holding down tax thresholds, despite their equivalent burdens.

Conservatives, though, shouldn't desire a world where more and more people are forever being dragged into paying higher marginal tax rates just because they might not squeal. Nor should they accept that tax burdens should be delivered by the effects of unplanned inflation, rather than legislation.

We therefore need policy to both correct for recent real threshold erosion and to protect against the inflation tax in future. If a triple-lock is good enough for the state pension, a temporary double-lock increasing all of the higher thresholds by the larger of inflation or wage growth each year until each recoup at least their 2010 real values would be desirable.

After that, we need legislation that will explicitly protect against the vagaries of under-indexation going forwards. Let chancellors come to Parliament and tell MPs they must vote against default inflation protection by explicitly voting to suppress each threshold every year (including the thresholds for personal allowance withdrawal and the 45p rate).

But to protect against the inflation tax, let's make them specify the real value of the threshold their tax hike desires.

That way if inflation exceeds projections, corrective indexing to account for this outturn can apply the next year, to avoid tax rises beyond those which Parliament explicitly voted for.

Ryan Bourne is Chair in Public Understanding of Economics at the Cato Institute.