Don’t write off the Budget. It showed that the Treasury is taking incentives and tax coherence seriously again.

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Before George Osborne’s 2013 Budget, his biographer, Janan Ganesh, wrote a revealing column for *The Financial Times*. “The Treasury regards Labour’s call for a fiscal loosening as dangerously wrong but at least coherent,” Ganesh explained. “It is some of the Tory right’s proposals for growth – such as tax cuts financed by deeper spending cuts, so that there is no actual overall stimulus – that really mystify.”

That raised alarm bells among those of us who think lower tax rates enhance a country’s growth potential. Osborne’s Treasury saw tax cuts as mere “demand stimulus,” on par with additional borrowing for government spending. It apparently did not think or did not understand that tax rates had important incentive effects for the economy’s supply-side: that people’s marginal rates (the proportion of additional income given up in higher taxes or lost benefits) influences their willingness to work, earn more, or invest in human capital, all affecting potential GDP.

That shone through into policy too. Osborne worried little about 1.5 million more people getting dragged into the higher income tax bands, or about the incentive effects of his new child benefit withdrawal reform, or about extremely high effective marginal rates within the novel Universal Credit system. The combined tax and benefit code got shot to bits with perverse incentives right across the income spectrum.

Rishi Sunak’s Budget last week is no classical liberal document. In tone and substance, it really could have been delivered by Gordon Brown. And yet, there were signs his Treasury is taking incentives and tax coherence seriously again. Though the overall tax burden is projected to rise to its highest level since 1949, Sunak extolled principles that point to the possibility of meaningful pro-growth reform of how revenues are raised.

The first indicator was the decision to lower the Universal Credit (UC) taper rate from 63p per £ to 55p. Sunak sold it, rightly, as an effective marginal tax rate (MTR) cut for those on low incomes, improving their incentive to work or earn more.

When you add in income tax and the new higher employees' NICs rate, the effective MTR faced by UC recipients earning above £12,750 will fall from just over 75 per cent to 70 per cent in 2022. The MTR cuts the policy delivers for people moving into work or on lower income levels will be higher still.

For families with two children and no rental costs, in fact, marginal rates will fall for all earning around £6,000 per year to just over £30,000 per year (although the lower taper naturally raises the numbers of people on UC's higher MTRs further up the income scale).

As the Office for Budget Responsibility concluded, these changes "can be expected to increase the labour supply of those affected – with evidence suggesting the most significant effects are likely to be in bringing non-working mothers into the labour market." And if Sunak is convinced of the distortionary impacts of high marginal rates, there is plenty of low hanging fruit to attack in future Budgets.

There's Osborne's "high income child benefit tax charge" that, due to child benefit's withdrawal, will raise effective MTRs for individuals earning between £50,000 and £60,000 with three children to as high as 68.25 per cent in 2022.

There's the tapering of the income tax personal allowance, which will create an effective 63.25 percent marginal tax rate for those earning between £100,000 and £125,140. There's the marriage allowance penalty for those moving into the higher income tax bracket, which can result in a cliff-edge marginal rate of over 2,800 percent.

And, of course, there's more people being dragged into higher income tax bands. The number of higher rate and additional rate taxpayers has increased by around 1.2 million since 2010. From 2022, the base combined MTR (income tax plus employees' NICs) will be 43.25 percent and 48.25 percent for 40p and 45p income tax ratepayers.

Smoothing all these high rates out would have less support than the UC changes, as they are "non-progressive" reforms. But Sunak's argument makes the intellectual case for action. What's more, his Budget reform of rationalising alcohol duties, a domain usually of interest to just a few tax experts and academics, shows he is not afraid to improve the code in politically non-salient areas.

The old alcohol tax system was a complete mess, with the tax rate per unit of alcohol completely unmoored from "pricing in" the worst social costs of drinking. Under Sunak's reforms, the number of duty rates is reduced from 15 to 6, with rates progressively increasing in steps with alcohol content. Yes, there are anomalies: cider is more lightly taxed than wine, spirits, or beer.

But overall the system is more coherent, with less distortions, and the highest tax charges well-targeted at genuine high-strength “problem” drinks.

It’s the rationale behind prioritising this which is perhaps most intriguing. Nobody was spoiling for alcohol taxation reform as a Budget demand. I doubt it’ll affect how many people vote in the next election. This was good, old-fashioned policy change – making economic improvements to the world without any large direct political rewards. And if Sunak is willing to reform a whole area of taxation in this Budget, might it signify his intention to live up to the portrait he has of Nigel Lawson by reforming another at each future Budget?

Some free-market friends will regard this as a glass half-full take. Though Sunak talked about how he aims to deliver actual tax cuts in future, for now that is rhetoric against the reality of a historically high tax burden and the ever-growing demands of an aging population.

The interesting thing about both the Universal Credit and alcohol changes though are that they actually added to the deficit – the former eventually costing £3 billion per year and the latter being greased with a one year freeze in alcohol duties. As with the sensible reform of business rates to more frequent revaluations, this highlights a truth I’ve outlined here before: any tax reform worth doing usually requires at least a temporary tax cut to ensure there aren’t too many losers who kick up a stink.

Given the Chancellor is hemmed in by spending demands and needs a more efficient economy to ease the pressure, pro-growth tax reforms that broaden bases and reduce marginal rates become even more important. If Sunak really does intend to ease the tax burden in the coming years, I’d say this Budget suggested that he will prioritise targeted cuts towards greasing the wheels for meaningful, lasting reforms. That would be a welcome change given the legacy of recent Chancellors.

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