



# BRIEFING

## Why Alistair Darling should raise the personal allowance

- Tax cuts are not a silver bullet, but they do boost the economy. They are a vital part of the fight against recession.
- The government should immediately raise the personal allowance to £12,000. Such a measure would take 7 million people out of income tax altogether, and make the average household £100 per month better off.
- For an average worker this would be equivalent to a gross pay rise of £1,730.
- It would cost the Exchequer just under £19bn.
- The government should not fund this or any other tax cut through increased borrowing. The UK already spends more than £30bn a year servicing government debt, and there is plenty of public sector waste to eliminate first.

### Introduction

Alistair Darling, the Chancellor of the Exchequer, is widely expected to announce a package of tax cuts in his pre-budget report, which is due to be delivered to the House of Commons at 3.30pm on Monday 27 November 2008. In this briefing we argue that the government is right to want to cut taxes, and strongly urge them to start by raising the personal income tax allowance to £12,000 for all UK taxpayers. However, we also argue that the Treasury should not 'fund' this tax reduction through increased government borrowing, but rather by cutting public sector waste and reducing public spending on non-essential programmes.

### Why Cut Taxes?

The UK economy is currently in recession. According to the Bank of England's most recent quarterly inflation report, the UK entered a recession in the middle of 2008 and is likely to continue contracting well into 2009. The Bank now believes that the UK economy could shrink by as much as 2 percent over the next 12 months. The OECD has predicted that Britain's economy will perform worse than any other member of the G7 group of rich countries.<sup>1</sup> Meanwhile unemployment has reached an eleven-year high, with the Confederation of British Industry saying it may rise to as much as 2.9 million by 2010.<sup>2</sup>

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There is of course only so much that politicians can do to ameliorate this downturn. Although increased government spending can sometimes result in an immediate



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boost to the economy, as the public sector fills the gap left by falling private demand, such benefits are always short-lived. In the long run, governments alone cannot pull a country out of recession – they can really only make it easier for individuals and businesses to do so.

There are two ways governments can do this. Firstly, they can make it easier for private borrowing to sustain business activity and keep people in jobs. That is what the Bank of England was hoping to achieve when it cut interest rates by 1.5 percent in November 2008. Secondly, they can reduce taxes in order to (a) remove barriers to wealth-creating activity and strengthen incentives, and (b) put more money back in people's pockets, so they can spend or invest it and get the economy going again. This is what the government has said it will do in the pre-budget report.

To summarize, tax cuts are not a silver bullet that will solve all our problems, but they are a key element of the fight against recession, and one of the most potent pro-growth policy tools that government has available to them.

### What we are proposing

There are many different tax cuts that would have substantially beneficial effects. For example, reducing taxes on capital would encourage investment and attract wealth from overseas to the UK. Slashing corporation tax rates to Irish levels would boost business activity and encourage more corporations to base themselves here. Abolishing employers' national insurance contributions – a perverse 'tax on jobs' at the best of times – would help keep people in work and off benefits. There are plenty of other options.

However, the most important thing that the government can do is to simply put more money back into people's pockets, both so that they can get by more easily day-to-day, and – crucially – so they can go out into the market and spend or invest it, jumpstarting the economy in the process.

Therefore, we are proposing that the personal income tax allowance be raised to £12,000 for all UK taxpayers. This would mean that no one would pay any income tax at all on earnings

below that £12,000 threshold. Such a measure would take 7 million people out of the income tax net altogether, and would leave the average household £100 per month better off.<sup>3</sup>

The extra take-home pay from this reform would be equivalent to a pay rise of £1,730 per person<sup>4</sup> — a 7 percent pay rise for an average worker, and up to 14 percent for a low-income worker.

Assuming the £12,000 allowance is the same for all taxpayers, and the higher rate income tax threshold is kept at its current level, rather than being raised in line with the personal allowance, this reform would cost the Exchequer just £18.9bn.

In theory, such a reform could not come into force until the start of the new tax year. In practice, however, the Chancellor could give this change immediate effect by making tax rebates temporarily available on income earned between now and the end of current tax year.

### What would be the benefits?

Raising the personal allowance would have numerous benefits. The main ones are outlined below:

- **It would give people more disposable income.** This is a major issue. According to a 2007 report by consumer group uSwitch, disposable income was then at its lowest level for a decade. Ernst & Young, the accountants, estimated that the average household's monthly disposable income had fallen from £899 to £838 over the preceding four years.<sup>5</sup> More recently, Asda's monthly income tracker found in September 2008 that disposable incomes were 9.6 percent lower than they had been one year earlier.<sup>6</sup>
- **It would increase spending and investment in the productive, private sector of the economy.** By putting almost £19bn per year back in people's pockets, the government would allow substantial additional spending and investment in the productive private sector economy, where it can create lasting wealth, rather than in the unproductive public sector, where it won't. Getting people spending and investing again is key to overcoming recession and restoring growth.

- **It would help eliminate the 'benefits trap'.** The tax system currently creates substantial disincentives to work, which encourage people to remain on benefits rather than find employment. Often people find that as they start working, they both pay tax and lose benefits, leaving them little better off than they were before. Indeed, the effective marginal tax rates for people moving from benefits to low-paid jobs can be close to 100 percent. Our proposals would change that: 7 million low-paid workers would no longer pay income tax at all.
- **It would reduce the size of the 'tax wedge'.** The cost of employing a worker (the money a company needs to earn in order to pay the worker's gross salary plus national insurance) can easily be twice what the worker actually receives. This 'tax wedge' makes many jobs uneconomic because the gross cost for the employer of providing a reasonable after-tax wage becomes more than the work is worth. This particularly damages the unemployed and low skilled, as it reduces job opportunities. Raising the personal allowance would reduce the number of potential jobs destroyed by the tax wedge.
- **It would strengthen incentives to work and produce wealth.** Tax reductions have dynamic effects. It is well known that cutting taxes can stimulate economic activity and boost growth by strengthening incentives. It is also well established that the growth a tax cut generates (or, indeed, the contraction it averts) can sometimes more than make up for any immediate reduction in tax revenues.

### How can it be financed?

The government will be tempted to finance this tax reduction, or any similar measure, simply by borrowing more money. This would be a mistake. According to the Office of National Statistics (ONS), UK's public debt already stands at 43.4 percent of Gross Domestic Product – well above the government's long-cherished (but now abandoned) 40 percent debt ceiling.<sup>7</sup> As a result, the taxpayer currently shells out more than £30bn a year servicing government debt. Adding to this debt hardly seems sensible.

It is also worth noting that the ONS figures exclude liabilities incurred under the Private Finance Initiative (which had reached £180bn by October 2007) and unfunded public sector pensions liabilities (which now exceed £1trillion). As a result the true scale of public sector debt may not become clear for some time. The point is, however, that this debt has to be paid at some point. Government borrowing ultimately amounts to little more than deferring higher taxes into the future.

Fortunately, the government can afford to cut taxes without borrowing, since there is plenty of potential for cutting waste in the public sector. In the face of a recession, every business and household in the country is looking to find economies and savings, and there is no reason why the government, with an annual budget in excess of £600bn, should be any different. Were government departments simply to stick to their budgets, they could save more than £14bn a year. Abolishing the Department of Business, Enterprise and Regulatory Reform (as the Liberal Democrats have suggested) would save nearly £7bn. Cutting quango budgets by 10 per cent would save £6 billion a year.<sup>8</sup> There is no shortage of other options.<sup>9</sup>

### Variations on our proposal

As noted above, our figures are based on the government raising the personal allowance to £12,000 but keeping the upper rate threshold at its present level. If the government were able to find significant cost savings, however, it would be well advised to raise the higher rate threshold (currently set at £40,835) in line with the personal allowance. This would cost an additional £6bn, taking the total cost of the reform to approximately £25bn. There is certainly a good case for such a measure: according to Treasury Figures, the number of higher-rate taxpayers in the UK has almost doubled since 1997, because the government has failed to lift the threshold in line with wage inflation.<sup>10</sup> It would also have all of the benefits outlined above in relation to raising the basic personal allowance.

Alternatively, if the government were to baulk at even £19bn, the cost of raising the personal allowance to £12,000 could be reduced by



a further £5.2bn (to £13.7bn) by reducing certain tax credits and taxing a number of non-means tested benefits. Although this would not leave people any worse off than they were before, it would blunt both the political and economic appeal of raising the personal allowance, and is therefore not recommended.

## Conclusion

The government is right to want to cut taxes: they are one of the most potent policy options available to them to alleviate the impact of a recession. Although there are many worthy tax cuts to consider, we have advocated starting by raising the personal allowance to £12,000. At a cost of £18.9bn to the Exchequer, this would make the average household £100 per month better off and take 7 million people out of income tax altogether. It would stimulate the economy by giving people more disposable income to spend and invest, and by strengthening incentives to work. It would also encourage employment by alleviating the 'benefits trap' and reducing the size of the 'tax wedge'. However, this tax cut should not be financed by increased borrowing: the government must focus on trimming the fat from the public sector first.

## End Notes

<sup>1</sup> Sean O'Grady, "OECD says UK is worst placed in G7 to withstand global downturn", *The Independent*, 3 September 2008, <http://www.independent.co.uk/news/business/news/oecd-says-uk-is-worst-placed-in-g7-to-withstand-global-downturn-917276.html>

<sup>2</sup> "'Close to 3m unemployed' by 2010", *BBC News*, 17 November 2008, <http://news.bbc.co.uk/1/hi/business/7732223.stm>

<sup>3</sup> This figure assumes single-earner households; dual earner households would in fact show much greater savings from the reform, due to the availability of two increased personal allowances.

<sup>4</sup> A pay rise would be subject to tax and national insurance. For the worker to see an extra £1,200, they would have to receive an additional £1,730 in gross pay.

<sup>5</sup> Harry Wallop, "Disposable income at lowest level in 10 years", *The Daily Telegraph*, 8 October 2008, <http://www.telegraph.co.uk/news/uknews/1565499/Disposable-income-at-lowest-level-in-10-years.html>

<sup>6</sup> <http://www.about-asda.co.uk/income-tracker>

<sup>7</sup> Public Sector, October: £1.0bn current budget surplus, *Office of National Statistics*, <http://www.statistics.gov.uk/cci/nugget.asp?id=206>

<sup>8</sup> See D.Craig, *Squandered*, (Constable: London), 2008 for more information.

<sup>9</sup> In their *Bumper Book of Government Waste 2008*, Matthew Elliot & Lee Rotherham calculate savings totalling £101bn.

<sup>10</sup> Robert Winnett, "Britons paying higher-rate income tax double under Labour", *Daily Telegraph*, 1 July 2008, <http://www.telegraph.co.uk/news/2229720/Number-of-British-paying-higher-rate-income-tax-doubles-under-Labour.html>

<sup>11</sup> All calculations undertaken by Richard Teather, Taxation Fellow, Adam Smith Institute.

