Paying for the Pandemic:
the scope for tax rises in the UK

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The increase in UK government spending provoked by the coronavirus pandemic has been unprecedented in peacetime. This year, the general government deficit is projected to rise to up to £400 billion, close to 20% of GDP. In July, UK government debt, as a ratio to GDP, rose to above 100%, the highest since the early 1960's. At some stage, this largesse will need to be paid for. The Institute for Fiscal Studies ("IFS") has estimated that tax rises of some £40 billion might be required by 2025. How might such sums be raised, and how realistic is such a scenario?

The coronavirus pandemic has transformed the outlook for the UK public finances. In March, the Spring Budget forecast a 2020-21 budget deficit of £54.8 billion, or 2.4% of GDP. By October, the IFS had increased its projection to £351 billion, some 18% of GDP. Since that estimate, the country has entered a second lockdown and the Chancellor has announced a further extension to the furlough scheme for employees and additional support for the self-employed to the end of March 2021. As a result, the deficit for 2020/21 is now likely to be closer to £400 billion. This dramatic increase in borrowing stems from the sharp increase in discretionary spending designed to support employment and business through the pandemic, now estimated at around £240 billion, alongside the economic impact of the recession on tax receipts and welfare spending, likely to be around £100 billion.

Clearly, the sharp increase in spending has been necessary to support the economy through the pandemic and prevent a dramatic rise in unemployment and business failure from doing long term damage to the economy. The continued weakness of the economy through at least next year suggests tightening fiscal policy too quickly would be a mistake, even if the degree of direct support to employees and businesses is gradually reduced. However, at some stage, as the Chancellor has stated, the government will need to stabilise the public finances and "balance the books". After a decade of public spending constraint, it is unlikely this can be achieved through further austerity. Even if still some way off, tax rises of some description are in prospect. The IFS has estimated that, if the government were to attempt to stabilise the level of national debt at close to 100% of GDP by 2025, while still running an annual budget deficit of £80 billion, a tax increase of some £40 billion a year would be necessary.

Raising a sum close to £40 billion a year from tax rises is no easy task. It would represent an increase in total tax revenues of some 6-7%, compared with 2019/20. If it were to be achieved through raising the headline rates of existing taxes, a revenue increase of £40 billion would be likely to require significant increases in the rates of each of the three major tax categories (see table 1). As a rule of thumb, a 1% rise in all rates of income tax yields about £5.5 billion, increasing NICs by 1 percentage point yields around £5 billion, and raising VAT by 1% yields about £5.2 billion. These are the big three revenue earners for the government; raising other taxes can produce sizeable sums, but are not widespread enough to make sufficient inroads into the £40 billion cited.

Table 1: Total HMRC Tax Receipts (UK 2019/20) **£634 billion**

	%
Income taxes	31
National Insurance Contributions	22
VAT	21
Corporate (inc oil taxes etc)	10
Other indirect taxes (alcohol, tobacco, APD, insurance et al)	6
Capital taxes (CGT, IHT, stamp duty)	5
Fuel taxes	4
Other	1

Source: National Statistics HMRC tax receipts and NICs for the UK (21/10/20)

An alternative stealthier tactic, which might prove more politically expedient, would be to reduce or abolish specific tax reliefs. Such reliefs currently incur significant "cost" to HMRC (see table 2). While many have strong economic justification, reducing them may prove more attractive to a Chancellor seeking significant revenue increases without breaking manifesto promises on tax rates.

Table 2: Tax Reliefs (UK 2019/20)

Selected reliefs with HMRC cost >£1.5 billion		HMRC annual cost (£ billon)
Income Tax	Pensions	21.2
	ISAs	3.3
NICs	Employer pension contributions	18.7
VAT (zero or reduced rates)	Food	18.9
	Construction/sale new dwellings	15.3
	Domestic passenger transport	5.6
	Domestic fuel and power	4.8
	Prescription drugs	3.2
	Children's clothing	2.0
CGT	Main residence relief	26.5
	Entrepreneurs' relief	2.1
IHT	Transfers to spouse	1.8
Corporation tax	SME Scheme	2.5
	R&D relief	2.3

Source: HMRC Estimated Cost of Tax Reliefs (10/10/19)

A third option would be to introduce new taxes, such as a wealth tax. This has been supported by Lord O'Donnell, former Head of the Civil Service, as a measure to tackle inequality, and has been adopted in other European countries. However, the political and practical difficulties in designing a wealth tax remain considerable, particularly as 70% of total net wealth in the UK is held in the form of pensions, property or business assets. While some form of wealth tax cannot be ruled out, changes to CGT and IHT, as a proxy, might be more likely.

If fiscal policy is to be returned to a more sustainable footing, the timing of any tax rises will be critical. A premature tightening of fiscal policy would likely be counterproductive, as it would slow the economic recovery. The IFS scenario assumes that the Chancellor would want to stabilise the national debt at 100% of GDP as early as 2025. Neither of these targets is sacrosanct: a debt level of 100% of GDP is not an absolute ceiling (other G7 economies will have debt ratios above that of the UK in coming years); and the debt level does not need to be stabilised as early as 2025 – with interest rates at historic lows, the government can continue to borrow very cheaply, and The Office for Budget Responsibility projects debt service costs for 2025 to be significantly lower than expected before the pandemic hit, even with a higher level of debt. In the event, the Chancellor may choose to move somewhat more cautiously, raising taxes more slowly and letting the level of national debt remain elevated for rather longer.

However, the reckoning can only be postponed, not avoided. Such elevated debt levels can only be sustained while interest rates remain low, and longer-term pressures on the UK's finances as the population ages require that fiscal stabilisation is not over-delayed. As a result, some relatively stiff tax rises appear inevitable in coming years, compounding the economic cost of the pandemic.

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