The living standards tax gap: how falling wages have hit the income tax take

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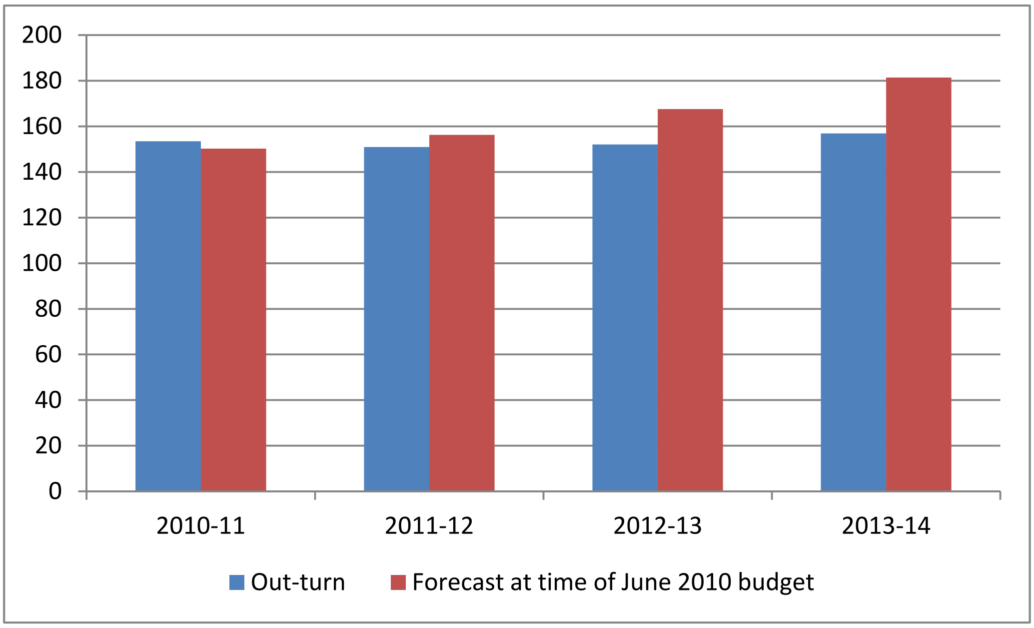
Findings

Since 2010, income tax receipts have not performed according to expectations. At the time of the June 2010 budget, the Office for Budgetary Responsiblity (OBR) predicted that gross income tax receipts (i.e. before taking into account tax credits) would rise from £153bn in the 2010–11 financial year to £181bn in 2013–14. Looking at the latest out-turn data on actual income tax receipts (Figure 1) reveals that in fact there was only a £4bn rise over that period, implying an overall shortfall of £24bn.

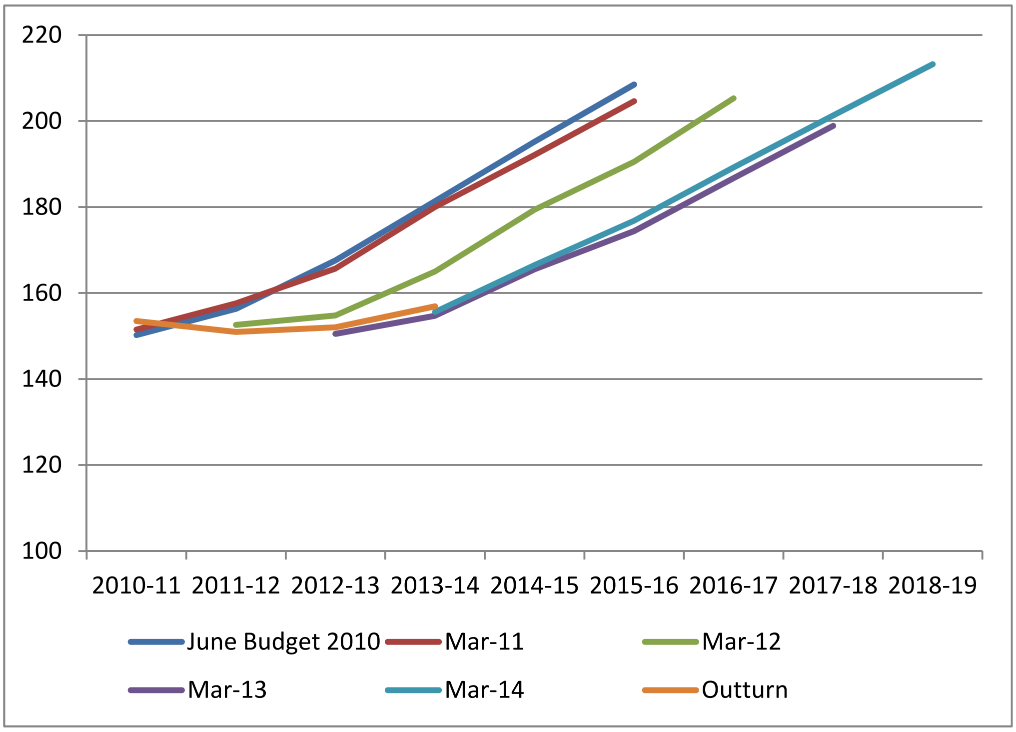
Figure 1 Forecast and actual income tax receipts 2010/11–2013/14



Source: HMRC (2014) and OBR (2010)

Indeed, forecasts of income tax receipts carried out by the OBR at the 2010–2012 budgets have each looked stronger than the subsequent performance of receipts (Figure 2). At the last two budgets, in 2013 and 2014, the OBR's expectations have been more in line with how receipts turned out, in fact under-estimating receipts slightly. Nonetheless, these forecasts expected tax receipts to be well below where they were expected to be just two years ago.

Figure 2 OBR forecasts at each budget and HMRC out-turn data of income tax receipts



Source: HMRC (2014) and OBR (2010–2014)

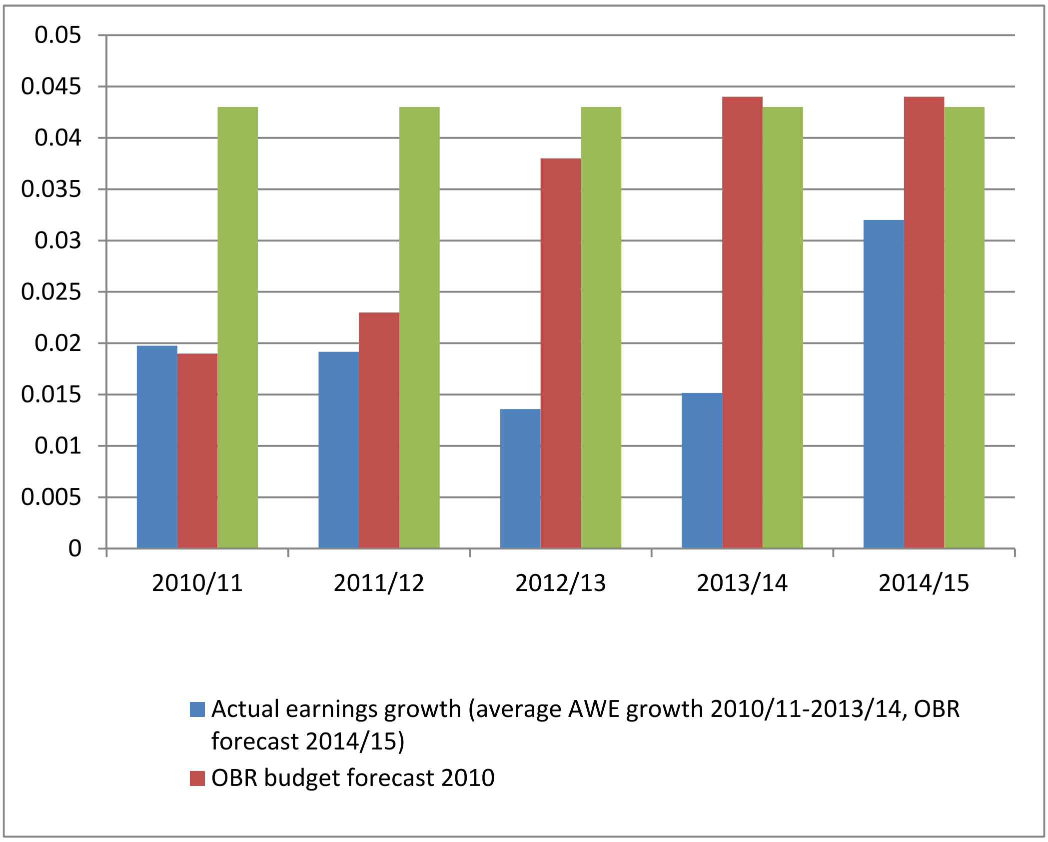
Income tax receipts are determined by a wide variety of economic and demographic forces, as well as historical and recent policy decisions setting income tax bands and rates. But the historically low rate of wage growth seen in the UK in recent years is clearly an important factor causing the recent shortfall.

In order to assess the contribution of weak earnings growth to this shortfall, we have conducted original modelling using the IPPR tax-benefit model of alternative scenarios for earnings growth since 2010. To do this we look at the impact on income tax receipts in the 2014/15 financial year of the following scenarios:

- if earnings had grown in line with the OBR's June 2010 forecast between 2010/11 and 2014/15
- if earnings had recovered to their average pre-recession (2000/01–2007/08) rate of growth between 2010/11 and 2014/15.

Figure 3 illustrates the difference in average earnings growth represented by these scenarios, versus the out-turn average weekly earnings (AWE) data. The AWE series in the figure shows the yearly average of monthly year on year AWE growth, other than in 2014/15 when we use the OBR's most recent forecast of earnings growth published at the time of the March 2014 budget. It shows how poorly earnings growth has performed relative to the OBR's expectations. Other than in 2010/11, AWE has consistently under-performed the OBR's expectations. The gap between the two widened considerably in 2012/13 and 2013/14 to over two percentage points. In the current year the OBR expects wage growth to rise from the 1.5 per cent seen in 2013/14 to 3.2 per cent. Although this is still considerably lower than the 4.4 per cent expected at the time of the June 2010 budget, it nonetheless looks optimistic given that earnings growth has averaged less than 1 per cent between April and September 2014.

Figure 3 Earnings growth (OBR 2010 forecast, average weekly earnings out-turn and pre-recession trend)



Source: HMRC (2014), OBR (2010) and ONS (2014)

As of the March 2014 budget, in 2014/15 the OBR expects income tax receipts to be £166.5bn, although there are concerns that recent monthly data points towards income tax receipts significantly under-shooting that result. In the latest tax receipts data (referring to the twelve months to October 2014), income tax receipts were £158.0bn, only £1bn more than in the 2013–14 financial year. In order to reach £166.5bn in 2014/15 HMRC will need to collect around £8.5bn more in November through March than they did last year, including in the key month of January when most self-employed workers complete their tax return.

Our estimate of how much will be raised in 2014/15 is based on total weekly earnings growth between the survey year of 2011/12 through to September 2014, the last month for which we have average weekly earnings figures. Under this baseline scenario, we expect HMRC will raise £158.5bn in the current financial year, £1.5bn more than in 2013/14 but substantially lower (£8bn) than the OBR's forecast for 2014/15. If earnings growth picks up over the coming months, our expectation for 2014/15 income tax receipts may prove to be an under-estimate.

Turning to our alternative scenarios, we find the following results:

- Had earnings growth between 2010/11 and 2014/15 been in line with the OBR's forecast at the time of the June 2010 budget, income tax receipts in 2014/15 would be £175.6bn, £17.1bn more than the figure we expect.
- Had earnings growth between 2010/11 and 2014/15 been in line with the pre-recession trend, income tax receipts in 2014/15 would be £188.5bn, £30.0bn more than the figure we expect.

Caveats

Differential earnings growth

Our model uses data from the 2011/12 Family Resources Survey, uprating earnings data to the present using the ONS average weekly earnings time series. This process assumes that all workers experience the same rate of earnings growth. In reality, it is likely that those lower down the earnings distribution will see their pay rise at a slower than average rate, and those higher up the distribution will see their pay rise more quickly. This has implications for tax receipts.

Employment rate

Our model data has an underlying working-age employment rate of 72.6 per cent, slightly less than the current rate of 73 per cent, but broadly in line with the average of the last year. This means we may be slightly under-estimating income tax receipts. It is also likely that, since earnings growth has to be traded off to some extent with employment, if earnings had risen at pre-recession rates it may have acted to dampen the rapid employment growth we have seen.

Self-employment

Much of the recent growth in the workforce has been in low-earning self-employment, which is not taken account of in the average weekly earnings figures that underlie our estimates.

Pay deals versus compositional factors

Recent research has highlighted that the weak performance of average earnings growth is linked to the changing composition of the workforce, as well as weak pay settlements. Our model, on the other hand, up-rates workers earnings from 2011/12 rates to the present, therefore combining the two effects. When analysing the overall impact on tax receipts this is less of an issue, but may be explored in any future analysis of the distributional impact of policy and earnings scenarios.

References

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