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Evaluating UK Tax Policy Through the Laffer Curve: Income Threshold Freezes and Corporate Tax Reform

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Abstract: ***This research investigates the United Kingdom's recent tax policy changes, particularly the freezing of income tax thresholds and the introduction of a tiered corporation tax system. Using the Laffer Curve framework, the study explores whether these measures optimise revenue without discouraging economic activity. It also assesses the impact on investment, migration, and business confidence. Drawing on international comparisons, the paper highlights the delicate balance between tax competitiveness and public finance sustainability. The findings suggest that while current policies yield fiscal gains in the short term, they risk long-term economic drawbacks if not managed transparently and predictably.***

Keywords: UK taxation, Income tax freeze, Corporation tax, Laffer Curve, Fiscal policy

1. Introduction

Taxation is the system by which a government collects money from individuals and businesses to fund public services and infrastructure. It is a compulsory financial charge or levy imposed by the state to raise government revenue (Toma, 2019). Taxes can take various forms, such as income tax on earnings, corporation tax on business profits, value-added tax (VAT) on goods and services, and duties on fuel, alcohol, or tobacco. Beyond raising revenue, taxation also serves broader purposes. For instance, it can redistribute wealth, influence behaviour (like discouraging smoking through high tobacco taxes), and help stabilise the economy. An effective tax system aims to balance fairness, efficiency, and simplicity while ensuring enough funds to meet a country's social and economic needs.

Both high and low taxation have unique trade-offs for governments and citizens. High taxation can provide governments with the revenue needed to fund various public services like universal healthcare, education, infrastructure, and social welfare, helping reduce inequality and support vulnerable groups. However, excessively high taxes can discourage work, entrepreneurship, and investment, and may drive individuals or businesses to relocate or find ways to avoid paying tax. On the other hand, low taxation can boost disposable income, encourage spending and business investment, and attract international companies and skilled workers, stimulating economic growth. Yet if taxes are too low, governments may struggle to fund essential services adequately, leading to underinvestment in health, education, and public infrastructure, which can widen inequality and weaken long-term social and economic stability. The challenge for any government is to find a balanced tax level that funds public needs without undermining economic incentives.

In the wake of rising fiscal deficits and increasing demands on public services, the United Kingdom (UK) government faces renewed pressure to optimise tax policy. Questions about whether current tax rates maximise revenue or hinder economic activity have become especially urgent. This paper investigates whether the UK's current tax policies lie on the upward or downward-sloping side of the Laffer Curve, focusing primarily on income and corporate tax rates. The central aim is to assess whether current UK tax rates are set at levels that maximise revenue without discouraging economic activity. In doing so, it also compares the UK's tax structure and outcomes with those of other advanced economies to provide a broader perspective on what constitutes effective and competitive taxation. Beyond revenue generation, the paper examines how tax policy may influence other areas of the economy, including foreign direct investment and immigration decisions. The analysis begins with an overview of the UK tax system and its evolution, followed by a discussion of the Laffer Curve and its theoretical foundations. It then offers a discussion of how UK tax rates may relate to revenue outcomes and broader economic effects, and concludes with policy implications.

2. UK Taxation Over the Years

Over the past decade, the UK's tax system has undergone significant reforms affecting individuals and businesses. These changes were not only driven by long-term fiscal trends but also shaped by extraordinary events, most notably the COVID-19 pandemic.

2.1 Pandemic Pressures and the Fiscal Response

The COVID-19 pandemic had a dual effect: it significantly reduced tax revenue in the short term, while pushing government spending and borrowing to historic highs. The Institute for Government (2022) reported that VAT and income tax receipts dropped dramatically in 2020–21, while HMRC was forced to redeploy over 1,000 staff from compliance roles, causing an estimated £6 billion in missed revenue collection (Hansard, 2021).

To recover this fiscal gap, the UK government adopted policies such as increasing corporation tax, freezing tax thresholds, and temporarily reducing investment reliefs, all of which influence business behaviour and tax morale. Moreover, the public debt rose above 100% of GDP, prompting debates about future tax reforms and potential wealth or capital gains taxes.

2.2 Income Tax: From Indexation to Threshold Freezes

For many years, the UK's tax bands and personal allowance typically rose in line with inflation or wage growth, helping to protect taxpayers from paying proportionately more tax just because their nominal incomes increased. This meant that as wages increased, the personal allowance − the amount you can earn before paying income tax − and the higher-rate threshold, the point at which you start paying 40% tax, also went up annually to keep pace with rising living costs and only genuinely higher earners moved into the 40% tax band. Adjusting thresholds annually helped prevent 'fiscal drag' by ensuring tax burdens did not increase solely due to inflation, where inflation or modest pay rises would otherwise push people into higher tax brackets even though their real purchasing power had not improved much (House of Commons Library, 2025). For example, between 2010 and 2020, the personal allowance rose steadily from around £6,500 to over £12,500, protecting more low-to-middle earners from tax and ensuring that only genuinely higher incomes were taxed at higher rates (IFS, 2024).

The UK government has frozen income tax thresholds, including the personal allowance (£12,570) and the higher-rate threshold (£50,270), from 2021 through at least 2028 (Office for Budget Responsibility, 2023). This means these thresholds no longer increase in line with inflation or wage growth. While headline tax rates have not changed, this freeze causes "fiscal drag" as people's nominal incomes rise, more of their earnings are pushed into higher tax bands, effectively increasing the tax burden without raising rates (Deloitte, 2022).

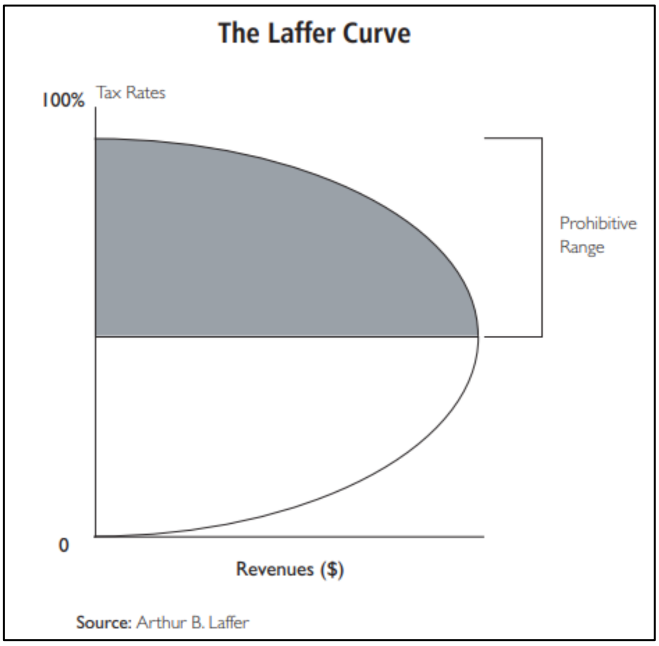
2.3 Corporation Taxes: From Flat Rates to a Tiered System

Until April 2023, the UK maintained a flat corporation tax rate of 19% on all company profits. This followed more than a decade of gradual reductions, with the rate falling from 28−30% in the late 2000s to 20% by 2015, and finally to its historic low of 19% in 2017 (House of Commons Library, 2024).

On April 1, 2023, the UK introduced a new corporation tax regime, by replacing its flat corporation tax with a tiered system. Companies with profits above £250,000 are now subject to a main rate of 25%, while those with profits of £50,000 or less continue to pay the 19% small profits rate (GOV.UK, 2025; ICAEW, 2023). Companies with profits between these thresholds face a tapered, or marginal, rate that increases gradually from 19% to 25%. To smooth this transition for medium-sized companies, the government introduced marginal relief – calculated using a fraction (3/200) – so that the effective tax rate rises progressively across the £50,000–£250,000 profit band (GOV.UK, 2025; Moore UK, 2023).

3. Laffer Curve and Optimal Taxation

The Laffer Curve is an economic concept that shows the relationship between tax rates and tax revenue. The curve is represented as a graph that starts at 0% tax with zero revenue, rises to a maximum rate of revenue at an intermediate rate of taxation, and then falls again to zero revenue at a 100% tax rate.



The Laffer curve assumes that no tax revenue is raised at the extreme tax rates of 0% and 100%, meaning that there is a tax rate between 0% and 100% that maximizes government tax revenue. It shows that there is an optimal tax rate that maximises tax revenue: if tax rates are too low, the government collects little revenue; but if rates are too high, people may work less, invest less, move to other places or find ways to avoid tax, which also reduces tax revenue. One implication of the Laffer curve is that increasing tax rates beyond a certain point, entering the prohibitive range, is counter-productive for raising further tax revenue.

The basic idea behind the relationship between tax rates and tax revenues is that changes in tax rates have two effects on revenues: the arithmetic effect and the economic effect. The arithmetic effect refers to the direct change in revenue from tax rate adjustments, while the economic effect reflects behavioural responses to these changes: if rates are lowered, tax revenues per dollar of tax base will be lowered by the amount of the decrease in the rate. And the reverse is true for an increase in tax rates. The economic effect, however, is the less obvious dynamic effect; it recognizes the positive impact that lower tax rates have on work, output, and employment and thereby the tax base by providing incentives to increase these activities. Raising tax rates has the opposite economic effect, by penalizing participation in the taxed activities. The arithmetic effect always works in the opposite direction from the economic effect. Therefore, when the economic and the arithmetic effects of tax rate changes are combined, the consequences of the change in tax rates on total tax revenues are no longer quite so obvious. (The Heritage Foundation, 2004)

The UK, like most developed economies, aims to keep its tax rates on the left side of the peak – high enough to fund public services but not so high that they significantly discourage work, investment, or business activity. For example, the recent increases in corporation tax and frozen income tax thresholds raise questions about whether the UK is moving closer to or further from the revenue-maximising point. Economists generally agree that the UK is still well below the punitive rates that would sharply reduce economic activity, but careful balance is needed to avoid crossing that tipping point. (Financial Times, 2024)

Nordic countries like Sweden and Denmark are often seen as operating towards the higher end of the curve. They have some of the highest income tax and social contribution rates in the world, with top marginal rates exceeding 50%. However, they also have strong social trust, efficient tax collection, and high-quality public services, which help maintain compliance and minimise the negative impact on work incentives. This suggests they remain just below the point where higher rates would reduce revenue. (European Central Bank, 2010; Trabandt & Uhlig, 2011)

In contrast, the United States generally sits closer to the middle of the Laffer Curve. It maintains moderate tax rates by Organization for Economic Co-operation and Development (OECD) standards, with relatively low top personal income tax rates compared to Europe but higher reliance on progressive federal and state taxes. Its tax system relies heavily on income and payroll taxes rather than high VAT or sales taxes, aiming to avoid pushing individuals or corporations to relocate or aggressively avoid taxes. Debates often emerge about whether cutting taxes further – for instance, through corporate tax cuts – will raise revenue by spurring more economic activity.

At the other end, some countries with very low tax rates, such as certain tax havens like Bermuda or the Cayman Islands, operate near the left side of the Laffer Curve. They collect little direct tax revenue because they deliberately maintain near-zero corporate and income tax rates to attract foreign companies and wealthy individuals. These economies rely instead on fees, tourism, or specific financial sectors. While they maximise attraction for mobile capital, they cannot raise much revenue directly through taxation alone, which limits public service capacity.

Dubai sits at the far-left side of the Laffer Curve for personal income tax because it has a 0% income tax rate, meaning it collects no direct revenue from taxing individuals' earnings. Instead, Dubai funds its budget through oil and gas income, business licensing fees, tourism charges, VAT (introduced at just 5% in 2018), and various government service fees. By not taxing personal income, Dubai attracts multinational companies, high-net-worth individuals, and skilled expatriates, boosting its status as a global business hub. While it could theoretically raise more revenue by introducing an income tax, Dubai deliberately maintains zero personal tax to stay highly competitive. However, it has begun shifting slightly on the Laffer Curve for business taxation, introducing a 9% federal corporate tax in 2023 to diversify revenues beyond oil.

In summary, the Laffer Curve illustrates that there are both benefits and limitations to adjusting tax rates. While lower taxes can incentivize work, investment, and economic growth, overly low rates may leave governments unable to fund essential services. Conversely, high tax rates risk discouraging productive activity and prompting tax avoidance or relocation, ultimately reducing revenue. The optimal tax rate varies across countries and contexts, depending on economic structure, public trust, tax compliance, and the effectiveness of public spending. Policymakers must carefully balance these trade-offs to achieve sustainable revenue without undermining economic performance.

4. Discussion

In recent years, the UK has implemented a series of significant tax policy changes – most notably, the freezing of income tax thresholds and the shift to a tiered corporation tax system. These reforms, largely aimed at restoring public finances following the economic shocks of COVID-19 and Brexit, have had wide-ranging effects on revenue generation, business investment, and cross-border mobility of both people and capital. This section discusses the observed and potential impacts of these changes.

4.1 Tax Revenue

One of the most substantial drivers of increased tax revenue has been the decision to freeze income tax thresholds until 2028, a policy introduced in 2021 by then-Chancellor Rishi Sunak. Known as "fiscal drag," this approach gradually moves more taxpayers into higher tax bands as nominal wages rise, even if their real incomes remain stagnant (House of Commons Library, 2025). As a result, individuals pay a larger share of their income in tax, reducing household purchasing power.

According to the Office for Budget Responsibility (OBR, 2023), this measure alone is projected to raise £40 billion annually by 2029–30, making it the single largest driver of increasing tax-to-GDP ratio. Longer-term estimates suggest the policy will raise £42.9 billion by 2027–28 and £44.6 billion by 2028–29, which is about 1.4% of GDP. The policy is expected to draw nearly 4 million additional individuals into the tax net, including 2.7 million entering the higher (40%) band and 400,000 into the additional (45%) band. Political estimates suggest this "stealth tax" could yield nearly £9 billion in additional receipts between 2025-26 and 2029-30, affecting approximately 1.9 million workers (OBR, 2023).

At the same time, the rise in the main corporation tax rate, from 19% to 25% for firms earning over £250,000 from April 2023, has aimed to restore revenue lost during the pandemic. Corporation tax receipts rose sharply, from £82.3 billion in 2022–23 to £93.3 billion in 2023–24, a £8.8 billion (10%) increase (UK Parliament Research Briefing, 2024). HM Treasury projects the higher rate could raise an additional £18 billion annually by 2025 (IFS, 2023). However, the true corporate tax burden is partially offset by generous allowances such as full expensing and marginal relief, especially for small and medium-sized enterprises.

4.2 Business Investment

The impact of these tax changes on business investment has been mixed. While higher corporation tax typically discourages capital investment, especially in an uncertain post-COVID, post-Brexit context, the government has sought to counteract this through targeted reliefs. Notably, “full expensing” for plant and machinery investments allows companies to deduct 100% of eligible costs upfront, easing the burden of the higher tax rate (Institute for Fiscal Studies, 2023; GOV.UK, 2023).

The Institute for Fiscal Studies (IFS) highlights that although the UK has among the lowest private investment rates among the G7 countries, it also historically had some generous capital allowances. This combination contributed to UK business investment remaining among the lowest in the OECD, around 10.5% of GDP, compared to an OECD average of approximately 13.6% (IFS, 2022). The higher corporate tax rate may worsen this gap, especially as international evidence from the IFS and OECD suggests a 1% rise in corporate tax reduces inward foreign direct investment by approximately 2.5%. A 6% rise in corporate tax could reduce foreign investment in the UK by up to 15%.

Temporary incentives have offered some mitigation. The 130% super-deduction (2021–2023) and the subsequent full expensing policy introduced alongside the tax rate increase were designed to boost investment. HMRC modelling estimates that such policies could raise investment by around 3.5%, especially among mid-sized firms (GOV.UK, 2023; HMRC research via RSM UK, 2025). However, persistent policy uncertainty – due to frequent changes in tax rules – continues to dampen long-term investment confidence (IFS, 2023).

4.3 Migration of People and Firms

The question of whether tax hikes outward migration of individuals and companies has gained renewed attention. While the UK’s top marginal income tax rate remains moderate at 45%, frozen thresholds have pushed more middle- and upper-middle-income earners into higher tax brackets. For some, this has altered perceptions of fairness and competitiveness in the tax system.

Research by Kleven et al. (2020) suggests that while average high earners tend to be relatively immobile, ultra-high-net-worth individuals, such as professional athletes and global entrepreneurs, are more responsive to tax changes. For example, top football players have been shown to change leagues based in part on tax treatment, with elasticities near 1.0. In the UK, reforms to non-domiciled status and tighter capital gains tax rules have already prompted some wealthy individuals to relocate to tax-favourable jurisdictions such as Switzerland or Dubai (OECD, 2023).

On the corporate side, Brexit has amplified tax and regulatory uncertainty, prompting some multinationals to move headquarters or shift investment to EU countries. The end of freedom of movement also made the UK less attractive to skilled European workers. Countries like Ireland and the Netherlands now offer more predictable corporate tax regimes and fast-track visas, increasingly drawing talent and firms away from the UK. For example, firms like HSBC and Panasonic relocated major operations to continental Europe, citing regulatory alignment and tax stability. According to the Financial Times (2023), more than 1,500 UK-based firms have registered EU subsidiaries since 2019 to retain access to the single market and avoid compliance complexities. While tax may not be the sole motivator, the cumulative effect of higher tax burdens and post-Brexit divergence plays a substantial role in shaping corporate location decisions.

5. Conclusion

The trajectory of UK’s tax policy in recent years reveals a deliberate shift towards maximising government revenue without visibly increasing headline tax rates. This has been achieved primarily through mechanisms such as frozen income tax thresholds, marginal relief in corporate taxation, and targeted changes designed to increase the tax base incrementally. While such measures have proven effective in raising revenue − especially through “fiscal drag” − they also bring subtle economic consequences that extend beyond the immediate gains.

The income tax threshold freeze, for instance, illustrates how stealth taxation can yield significant fiscal returns without politically sensitive rate hikes. As nominal wages increase in an inflationary environment, more individuals are pushed into higher tax bands, resulting in a rising effective tax burden. This phenomenon is expected to generate nearly £45 billion annually by the end of the decade. However, it simultaneously erodes the real income of middle-class earners, dampens disposable income, and contributes to a growing perception of unfairness, particularly among those who see their purchasing power decline despite stagnant real wages.

Similarly, the increase in corporation tax from 19% to 25% represents a reversal of over a decade of pro-investment tax cuts. While this move has successfully increased tax receipts − rising by nearly £9 billion in just one year − it risks disincentivising business investment and foreign direct investment in the medium to long term. Empirical studies suggest that higher corporate tax rates significantly reduce foreign investment, meaning the current policy could reduce inbound investment by as much as 15%. Though temporary reliefs such as full expensing aim to mitigate this impact, frequent policy changes and lack of predictability have undermined business confidence.

Migration patterns of both individuals and firms further complicate the picture. While ordinary high earners are largely immobile, the super-rich, highly skilled professionals, and multinational firms are more responsive to tax and regulatory environments. Evidence from post-Brexit migration and tax reforms shows that some high-net-worth individuals have relocated to more favourable jurisdictions like Dubai and Switzerland. In the corporate sphere, Brexit combined with increasing tax and compliance burdens has pushed many firms to either shift operations to the EU or establish parallel entities within the Single Market. The cumulative effect is that the UK may be sacrificing long-term competitiveness in exchange for short-term fiscal gains.

From a theoretical standpoint, the UK appears to be operating on the left side of the Laffer Curve – still in a position where raising tax rates or expanding the tax base leads to higher revenue. However, it is moving closer to the curve's peak, beyond which further increases may begin to yield diminishing returns and provoke adverse behavioural effects such as tax avoidance, emigration, or reduced work effort. Comparative analysis with other countries supports this caution. Nordic countries have managed to sustain high taxes with social cohesion and trust, while low-tax jurisdictions like Dubai attract capital and talent through fiscal incentives but lack sustainable public funding mechanisms.

In light of this, the future of UK taxation should focus not only on revenue maximisation but also on economic resilience, investment stimulation, and fairness. Policymakers must consider the long-term trade-offs: while current measures have stabilised public finances post-COVID and Brexit, they have also strained household finances, complicated investment planning, and contributed to an erosion of economic confidence. A shift towards greater tax transparency, predictability, and a more strategic use of incentives could help restore investor trust and public support, ensuring that the UK remains both fiscally sound and economically competitive.

Ultimately, taxation is not just a tool for funding the state but a reflection of a nation's values, priorities, and ambitions. Sustainable tax policy must balance fiscal stability with economic dynamism, guided by clarity, predictability, and fairness.

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