Cribstone
Strategic Macro

Labour needs an Education on VAT

The Labour party's flagship proposal to apply VAT on private schools looks a case of ideology trumping impact. While it looks like a progressive tax on the wealthy, it fails on two fronts.

- First, it is not truly progressive. For the families hit, it is effectively a flat tax irrespective of the income status of private school parents – meaning a huge marginal tax for some.
- Second, unless Labour has a crystal ball of the impact on demand, it could prove a very flawed revenue raising measure.

Will VAT on private schools cut private school attendance? Of course. Most parents do everything for their children, so expect the stickiness of existing independent students will remain high. But it is unquestionable that the future intake in a post-VAT world will shrink. A family with two kids in private day schools is currently paying circa £32,000 a year in fees. Based on ONS data, that's about half after-tax median income of the top 20% of households. VAT alone will be a £6,400 annual hit to post tax income. That is equivalent to rise in the marginal tax rate from 40% to 46% on all earnings over 50k for a family making £150k a year vs just 41% for a family making £500k.

How Elastic is Demand for Private Schooling?

How much will demand fall? The Institute for Fiscal Studies expects a 3-7% decline, while a survey of parents by the Independent Schools Council puts the figure at 20%. Neither address the most important audience, future students who will find it easier to go public, having never attended independent schools. As lower demand from these new entrants hits, the revenues meant to fund improved education outcomes will almost inevitably decline for 13 straight years. As funding sources to improve education go, this policy does not get high marks.

Will VAT really impact demand?

Those that think enrollment will remain resilient argue private student numbers have remained flat despite a 55% real increase in the cost of independent schools since 2010. This masks the fact that market share for independent schools has declined from 7.1% in 2010 to 6.4% in 2022. Notably private schools fees were flat in real terms from 2019-2023. In this past school year, inflation drove an 8% rise in average fees, and admissions fell 2.7%. Independent schools are tightening belts. Class sizes are no longer falling and your author knows of one well healed primary schools where students now pack their own lunches for trips and the staff Christmas lunch went potluck this year. Why? Demand is sensitive to pricing even when prices rise at a fraction of the level they would if VAT were introduced. No one can confidently predict the outcome on demand from a further 20% VAT driven price rise.

Loopholes are likely to benefit richer schools

VAT importantly is not a sales tax. The richest, best funded schools will have significant potential to offset VAT obligations with VAT paid over the previous decade on capital upgrades. The Institute for Fiscal studies assumes the net VAT payable by private schools after deductions will equate to a rate of 15%. There are reports of significant efforts to institutionalize pre-payment to avoid future VAT. Boarding schools will likely find it possible to avoid VAT on lodging, motivating them to shift fee towards lodging vs taxable tuition. Expect Independent School bursars will become “VAT mitigation specialists”

Potential Risk: Increased geographic inequality

There may be counter-productive economic and social implications. Parents may decide that the cumulative £80,000 in VAT for two children, is better spent moving near a great state school rather than as a gift to the government. A well intentioned effort to lift the state sector may ended up leading to less affluent homeowners being gradually pushed out of catchment areas for higher performing schools. The risk is a policy aimed at reducing social inequality could, over the long term, raise ghettoization of catchment areas for average and underperforming state schools.

Independent Schools are a Source of the UK’s competitive advantage

The UK’s private education sector is one of the UK economy’s competitive advantages. It’s not just about the pull of foreign students and Harry Potteresque soft cultural power. One of the arguments in favor of introducing VAT is to mitigate the advantage privately educated pupils get in lifetime earnings. But part of that advantage must be due to the high-quality talent pool attracting high paying employers. If you handicap a strong driver of academic performance, will it ultimately reduce the UK’s share of higher paid jobs? Anything that risks hurting a competitive sector should be highly scrutinized. If there is a better way (there is), it should be explored.

Low income bursaries for 17% better than VAT at 20%

Imposing VAT to improve education outcomes feels more ideological than pragmatic. If you want to guarantee improve education outcomes, simply allow schools to choose between imposing VAT, or <u>full</u> scholarships to lower income students for a minimum of <u>one-sixth</u> of their student body. Not only will the most talented lower income students see their outcomes elevated, it will also dramatically diversify the student body of private schools. For those schools that insist on just picking from the elite and economically aspirational, fine…they can charge VAT. But for those that want to do what is best for their growth, their communities and society at large, they can use some combination of tuition hikes, savings and fund raising to opt for bursaries over VAT.

There are better revenue sources than VAT on Independent Schools

If Labour is simply ideologically opposed to private schools whatever their outcomes, then their policy makes sense. But if it is about taxing the wealthy and entitled, they can do better. Why not impose duty on private members and sporting clubs where consumption is totally discretionary and reductions in membership won’t lead to higher state expenditures? If Labour really wants a progressive tax on wealth to fund improved education, a property tax would be a much better place to start. Ah, but that sounds like class warfare, while VAT on independent schools can be sold as closing a loophole. Just because it’s an easier sell doesn’t make it better policy.

Elementary Math, Uncertain Variables

Oxford Economics estimates that the UK taxpayer saves just over £8,000 for each of the 532,000 students that choose the private sector over state education (saving £4.25bn for taxpayers annually). If the introduction of VAT leads the number of private school students to fall by a not implausible 10%, then this means net VAT of 15% will be imposed on 479,000 students who pay an average of £16,000 in tuition. While £1.15bn will be raised, the state will have to spend £424mn on 53,000 students moving to the state sector, cutting the net tax take to £726mn (less than 0.8% of state spending on secondary & primary education). While unlikely, if private enrollment eventually falls 23%, the net impact on government revenues would fall to zero.

Why VAT avoided on private schools might not be spent elsewhere

Unconvincingly, the Institute of Fiscal Studies argues that VAT saved by parents who switch their kids to state schools will be unchanged as they will spend the money on consumption goods that are also be subject to a 20% VAT rate. That's heroic as it assumes the investment in schooling will be replaced with discretionary consumption. A modicum perhaps, but those who balk at the higher schools fees are unlikely to have the cashflow to fund that choice – arguing more pressing needs are paying for more costly mortgages, investing to secure their children's university education, or future housing down payments. And to the extent this "windfall" is spent on holidays, a holiday home abroad, foreign governments rather than the UK Treasury will benefit. The base case for assumptions should be that VAT gains will be limited to those who pay private school tuition.