11. Income tax and National Insurance

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Summary

- Budget 2007 proposed a very simple set of combined income tax and National Insurance rates. Since then, however, changes have been announced, to come into effect by 2011–12, that would create a system where key elements of the two systems are misaligned and which involves a complicated structure for marginal tax rates on incomes above £100,000 a year.
- The government has proposed two 60% income tax bands, between £100,000 and £106,475 and between £140,000 and £146,475, to come into effect from 2010–11. These are likely to distort quite considerably the behaviour of people who expect to fall into these bands. If individuals at the top of the income distribution are more responsive to changes in their marginal tax rate than individuals lower down the distribution, there may be a case for having a lower marginal tax rate at the very top of the income distribution than slightly lower down. But it seems very unlikely that the optimal tax schedule has these two large spikes in it.
- It would appear that the Treasury has assumed that there will be a considerable behavioural response to the new 45% tax rate on incomes over £150,000. However, it is very difficult to estimate how much revenue reforms such as these would raise, as it requires accurate information about income growth at the top of the income distribution, the shape of the income distribution and the responsiveness of the very rich to changes in their marginal tax rates. All of these are subject to a high degree of uncertainty, and the Treasury has so far declined to publish the assumptions it made when estimating how much these measures will raise.
- We present two alternative reforms that aim to realign the income tax and National Insurance thresholds in revenue-neutral and broadly distributionally-neutral ways.

11.1 Introduction

In his final Budget in March 2007, Gordon Brown bequeathed his successor a commendably simple structure of income tax and National Insurance (NI) rates on earned income. But in responding to the furore over the abolition of the 10p income tax rate, and in the way he has attempted to raise revenue in the November 2008 Pre-Budget Report (PBR), Alistair Darling has undone this good work. His announcements will create a schedule of income tax and NI rates that is even more complicated than that which preceded the 2007 Budget.

By way of preamble, it is worth recalling why the shape of the tax schedule matters. The effective marginal tax rate is a measure of the financial incentive for individuals to work slightly more paid hours or to seek a slightly higher-paying job. What we are ultimately interested in from an economic perspective is the impact of a £1 increase in what an employer pays to employ someone on the amount of goods and services that the employee can buy. This depends on:

- the amount that the employer has to pay in NI contributions;
- the amount that the employee pays in income tax and NI contributions; and
- the proportion of what the employee spends that is taken in consumption taxes (e.g. VAT and excise duties). The impact of VAT on incentives to work is discussed in Chapter 10.

It is important to remember that the long-term economic impact of employers' and employees' NI contributions is the same – both drive a wedge between what the employer pays and what the employee receives, and therefore, at least in the medium term, both will have the same impact on the after-tax earnings of employees.

For simplicity, we focus below on income tax and employees' NI contributions when discussing the 2007 Budget and the 13 May 2008 response to the abolition of the 10p income tax rate, as they involved no significant changes to employers' NI or consumption taxes. We extend the scope of the discussion to employers' NI contributions and consumption taxes when considering the changes announced in the November 2008 PBR.

Section 11.2 describes the income tax and NI changes since Budget 2007 in more detail. Section 11.3 examines the income tax changes affecting the very rich more closely and discusses the behavioural changes we might expect to see resulting from them. Section 11.4 discusses some alternative reform packages and Section 11.5 concludes.

11.2 Reforms announced since Budget 2007

The 2007 Budget proposed a very simple tax schedule for earned income from April 2009, with three combined marginal rates of income tax and employees' NI contributions – zero, 31% (20% income tax plus 11% employees' NI) and 41% (40% income tax plus 1% employees' NI). This reduced the number of income tax bands applying to earned income from three to two and the number of combined income tax and employees' NI rates from four to two, as shown by Figure 11.1.[1] The rates of employers' NI were unchanged and the thresholds remained aligned with those of employees' NI.

One effect of these changes was that around 5.3 million families who had previously benefited from the 10p starting rate of income tax were paying more tax as a result of its abolition and were not fully compensated by other tax and benefit changes announced at the same time.[2] The government announced in April 2008 that it was looking at ways of compensating these families and in May 2008 announced a 'one-off' increase of £600 in the income tax personal allowance – the point above which income tax is paid – for the 2008–09 tax year. This moved the threshold at which an individual starts paying income tax out of line with the threshold at which they start paying NI contributions (NICs), thereby creating an additional 11% band in the combined income tax and employees' NICs schedule. The 2008 PBR announced that this one-off change would be made permanent, and that the personal allowance would be increased by a further £140 in 2009–10 and 2010–11 (but not in future years). Therefore, the actual combined income tax and employees' NI schedule in 2009–10 will be as shown in Figure 11.2.

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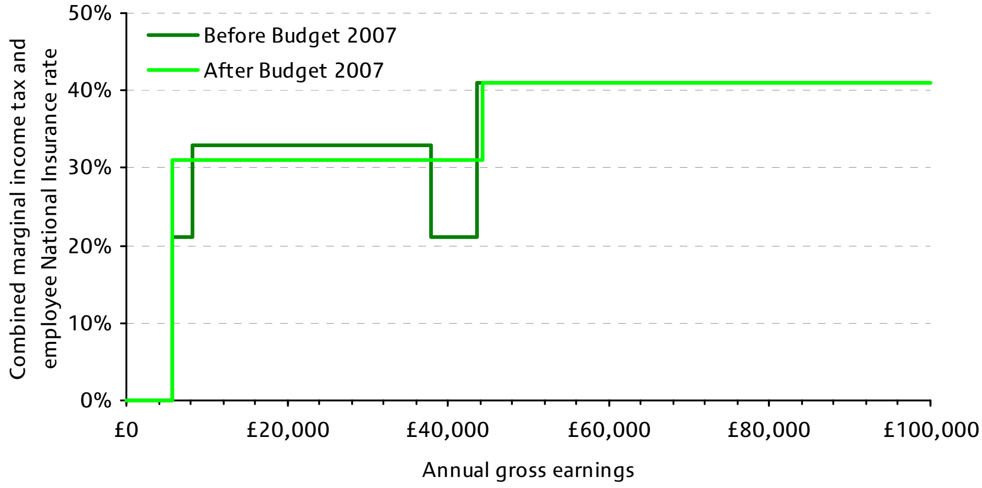
[1] Note that there are still three income tax rates for savings income: the 10% rate still exists for savings income falling in the starting-rate band. This remains an unwelcome over-complication of the income tax system.

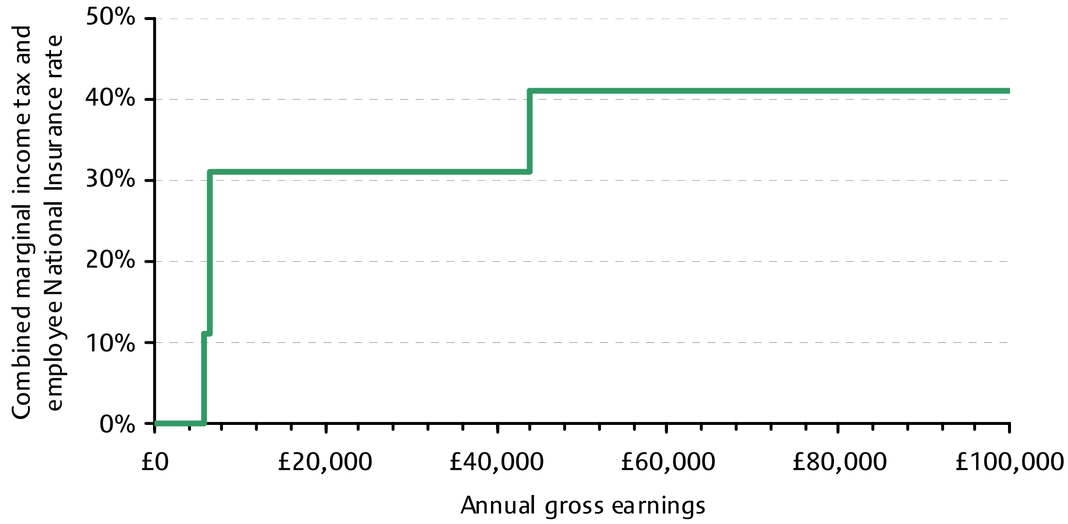
[2] For more on this, see S. Adam, M. Brewer and R. Chote, *The 10% Tax Rate: Where Next?*, IFS Briefing Note 77, 2008 (http://www.ifs.org.uk/bns/bn77.pdf).

Figure 11.1. Effects of changes announced in Budget 2007 on the combined income tax and employees' NI schedule in 2009–10



Notes: Employers' NI and indirect taxes not shown as rates of both were unchanged in Budget 2007 and employers' NI thresholds remain aligned with those for employees' NI. Assumes individual is contracted in to the State Second Pension, has only one job and has constant earnings throughout the year.
Source: Author's calculations.

Figure 11.2. 2009–10 combined income tax and employees' NI schedule



Notes: As Figure 11.1.
Source: Author's calculations.

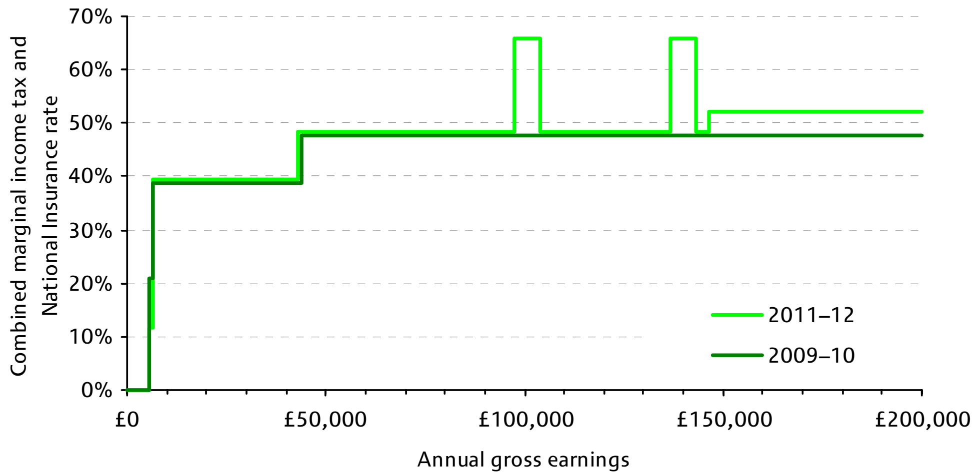
The November 2008 PBR also proposed various income tax and NI changes to come into force in 2010–11 and 2011–12:

- In 2011–12, the threshold for paying employees' (but not employers') NI contributions will be increased to the level of the income tax personal allowance.
- All NI rates (employees', employers' and self-employed) will be increased by half a percentage point in 2011–12.

- The income tax basic-rate limit (the amount of income that is taxed at the basic rate) will be frozen in nominal terms in 2011–12, effectively reducing it in real terms by an expected 2½%.[3]
- From 2010–11, the income tax personal allowance will be withdrawn in two stages from those with incomes greater than £100,000. This will effectively create two bands of income where the marginal rate of income tax is 60%. This is because someone earning £100,000 will pay 40p of each additional pound earned in income tax and also lose 50p of their personal allowance, incurring an additional 20p tax liability (40% of 50p), meaning that they lose 60p in total through additional income tax payments.
- In 2011–12, a new 45% rate of income tax will be introduced on incomes above £150,000. The combined income tax and employees' NI rate will be 46.5% on earnings over this level, and including employers' NICs as well would take this to 52.8% as a percentage of employer cost.[4]

Figure 11.3 illustrates the impact of the changes on the combined schedules for income tax, employees' NICs *and* employers' NICs, expressed in 2009–10 prices. We show the effective marginal rates as a proportion of employer cost – that is to say, gross earnings plus employers' NI contributions. This is the proportion of an extra pound that an employer spends employing someone that is taken in the three taxes, and which therefore reduces the employee's take-home pay.

Figure 11.3. Income tax, employees' NI and employers' NI reforms between 2009–10 and 2011–12



Notes: Percentages expressed as a proportion of gross employer cost (i.e. gross earnings plus employers' NI). Includes income tax and employers' and employees' NI. Assumes individual is contracted in to the State Second Pension, has only one job and has constant earnings throughout the year. Source: Author's calculations.

We can see from Figure 11.3 that:

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[3] This is intended to reverse the real rise in the basic-rate limit that will occur in 2010–11 when RPI inflation is forecast to be negative but the Treasury has said that the basic-rate limit will not fall.

[4] This is calculated by adding together the income tax rate, employees' NI rate and employers' NI rate and dividing by 1 plus the employers' NI rate, in this case (0.45 + 0.015 + 0.133)/1.133. This is because increasing gross earnings by £1 leads to additional income tax liability of 45p, additional employees' NICs of 1.5p and additional employers' NICs of 13.3p and the total cost to the employer has increased by £1.133. This therefore gives the proportion of an extra pound that an employer spends employing someone that is taken in income tax and employees' and employers' NICs.

- The reforms will not fully align the thresholds at which payment of income tax and NI commences – the threshold for employees' NI will be realigned with the level of the income tax personal allowance, but in the process de-aligned from the threshold for employers' NI.
- The reforms introduce a strange marginal rate structure at the top of the income distribution, for which it is hard to see any obvious economic rationale. It will introduce a combined income tax and employees' and employers' NI rate of 66% of employer cost for those caught in the two narrow bands where the personal allowance is withdrawn.

The next section discusses the income tax changes affecting those with incomes greater than £100,000 in more detail.

11.3 Income tax changes affecting the very rich

Withdrawal of the personal allowance above £100,000

The government announced that it intends to withdraw the income tax personal allowance from individuals with incomes greater than £100,000 in two stages from 2010–11. This would effectively create two income tax bands, between £100,000 and £106,475 and between £140,000 and £146,475 in 2010–11, where individuals will face an income tax rate of 60% and a combined income tax and employees' and employers' NI rate of 66% (as a share of gross employer cost). It seems likely that anyone expecting their total income to fall within these ranges will seek to reduce their taxable income slightly – for example, by making additional private pension contributions[5] – to the point where the phase-out begins. In this case, the main distortion created by this tax increase for these individuals would seem to be the additional effort expended by these individuals when managing their affairs in a tax-efficient way. The change may also distort the decisions of slightly lower-income people deciding whether it is worthwhile seeking increases in pay that would take them into, or above, these bands.

Individuals with incomes between £106,475 and £140,000 would be paying £1,295 more in tax each year than before, but would find their marginal tax rate unaffected by this reform. As a result, these individuals might be less likely to respond in the same way as those facing a marginal income tax rate of 60% since they would have to make some pension contributions that received tax relief at only 40% before receiving 60% tax relief. However, they may decide to work less hard and reduce their incomes below £100,000, emigrate from the UK, not migrate to the UK or retire earlier, if they considered the income tax burden to be too high. On the other hand, they might work harder in order to maintain their level of post-tax income. Given the sums involved, though, it seems unlikely that either effect will be significant, at least in the short term.

The Treasury estimates that 750,000 individuals[6] will be affected by this reform in 2011–12 and that it will raise £1.6 billion in a full year once behavioural responses are taken into account. This is a small amount relative to the £156.7 billion expected to be raised from income tax overall in 2008–09, of which 23.1% or £36.2 billion is expected to be

[5] Such individuals would receive income tax relief at 60% when making an individual contribution to their pension (and greater relief if it were made via their employer, e.g. through salary sacrifice), but would be likely to only face a tax rate of 40% on their pension income in retirement.

[6] Source: Private correspondence.

raised from the top 1% of taxpayers.[7] Using data from the 2005–06 Survey of Personal Incomes uprated so that we match the Treasury's estimate of the number of individuals with incomes over £100,000,[8] we broadly agree with the Treasury's estimate of the amount of revenue raised, but only under the assumption of no behavioural response. It would therefore appear that the Treasury has assumed that there will be relatively little behavioural response to this reform. Even if we assume that everyone whose income falls in the range where income is subject to a 60% marginal income tax rate reduces their taxable income to the bottom of that range in response to this reform, this behavioural response would reduce the amount of revenue raised by less than £100 million. It would appear therefore that this change would have a large distortionary impact on a relatively small number of people.

It is possible that the optimal tax schedule does involve a lower marginal rate at the very top of the income distribution than slightly lower down, as this package does. This might be the case if those at the very top of the income distribution were more responsive to changes in their effective marginal tax rate than those slightly lower down. However, it seems very unlikely that the optimal tax schedule would involve two big spikes as there are here.

45% income tax rate above £150,000

As discussed previously, the 45% income tax rate on incomes over £150,000 will take the combined income tax and NI rate on earnings to 46.5% excluding employer NI or 52.8% including employer NI. Including indirect taxes as well would take the full tax wedge to 59.6% (we include the average consumption tax rate of 17% here).[9] The Treasury estimates that this measure will affect around 350,000 people and raise £1.6 billion in a full year once behavioural response is taken into account. If we uprate incomes in the way described in Box 11.1, assuming uniform income growth at the top of the income distribution, we estimate that, if there were no behavioural response, this reform would raise £3.4 billion. This suggests that one or more of the following is true:

- The Treasury is assuming a fairly large behavioural response to this reform.
- The Treasury is assuming lower income growth among those with incomes greater than £150,000 than among those slightly lower down.
- The Treasury is being deliberately conservative in light of the uncertainties surrounding estimates of the revenue raised by this reform.

Going through each of these points in turn, we would expect the behavioural response to this change to be substantial. The very highest income earners will have the option of paying more money into pension funds to attract tax relief at 45% or might emigrate from the UK, not migrate to the UK, work less hard or even retire earlier in response to this change. Box 11.2 discusses the difficulties in estimating the size of this behavioural response.

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[7] Sources: HM Treasury, *Pre Budget Report 2008*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm) and table 2.4 of HMRC Statistics (http://www.hmrc.gov.uk/stats/income_tax/table2-4.pdf).

[8] See Box 11.1 for more details.

[9] The 59.6% is equal to (52.8% + 17%) / 1.17.

Box 11.1. Using the Survey of Personal Incomes to estimate the effects of these income tax reforms

The Survey of Personal Incomes (SPI) is an annual sample of individuals who HMRC believes could be liable to income tax. Stratified samples are drawn from three HMRC databases (people subject to PAYE, self-assessment taxpayers and neither of these). Variables that were used to stratify the sample include sex, pay, tax liability, main source of income and occupational pensions in previous years. Individuals with high incomes or rare allowances tend to be oversampled. This is therefore a much better source of information on those with very high incomes than traditional household surveys such as the Family Resources Survey that we generally use to analyse tax and benefit reforms.

Certain steps are taken to ensure anonymity. All sources of income, allowances and reliefs are rounded to three significant figures, with tax amounts imputed based on these rounded figures. Unusual combinations of allowances are examined to ensure no one can be identified. HMRC ensures that no group has a sampling weight of less than 1 in 60 or represents a population of fewer than 10,000. Finally, incomes of more than £600,000 are combined to create composite records in order to ensure anonymity. This is done by combining cases with similar characteristics (e.g. same stratum and sex) and taking averages for each variable on the file.

To create a 2011–12 population using 2005–06 data, we simply increase everyone's incomes by a certain proportion. We choose the uprating factor to ensure we match the Treasury's estimate of the number of people with incomes greater than £100,000 in 2011–12, namely 750,000. In other words, we ensure that the 750,000th richest person in the income distribution has an income of £100,000 and that relative income differentials are unchanged. This also ensures that around 350,000 people have incomes greater than £150,000, in line with the Treasury's estimate. This requires that we increase nominal earnings by 27%, which means we are effectively assuming average annual income growth of 4.1% between 2005–06 and 2011–12 or average annual real income growth of 1.3% using actual inflation between 2005 and 2008 and Treasury forecasts of inflation to 2011.

Box 11.2. Estimating the behavioural response to the new 45% income tax rate

It is highly likely that changes in the income tax and NI rates that apply to the richest individuals will lead these individuals to change their behaviour in a manner that reduces the revenue raised. However, accurately estimating what these behavioural changes mean in practice for tax revenues is extremely hard.

Estimates of how much revenue is lost by behavioural changes to changes in the top rate of tax rely on accurate estimates of the extent to which the very rich will change their behaviour and on accurate estimates of the underlying distribution of income of the very rich. These are discussed in turn below.

A recent study by IFS researchers together with Professor Emmanuel Saez of the University of California, Berkeley (henceforth BSS)[a] estimated a parameter known as the *taxable income elasticity* amongst the richest 1% of adults in the UK. This elasticity tells us to what extent taxable income falls when the richest 1% are faced with a rise in the marginal tax rate. Using information on how the share of total income held by the top 1% changed during the 1980s, when marginal tax rates for the very rich were cut considerably, BSS estimate that the taxable income elasticity is 0.46. However, BSS stress the considerable uncertainty around this estimate.

Box 11.1 described how the Survey of Personal Incomes can be used to estimate the underlying distribution of income of the very rich, which then allows one to assess the impact of income tax changes on the very rich. But despite the survey oversampling very rich individuals, the number of observations with very high incomes is still very small, and this means that any estimates of the revenue lost by behavioural change from a tax change applying to the richest individuals can be very sensitive to the sample. An alternative approach to using the SPI is to assume that the underlying distribution of income of the very rich follows a distribution with a known shape, and a common approach is to use Pareto distribution.

Ongoing work by IFS researchers is exploring both of these methods in more detail, and is examining how sensitive are the resulting estimates of the amount of revenue lost by behavioural change to increases in the tax rates affecting the very rich, and therefore estimates of the revenue-maximising top rate of tax. This work has not yet been completed, but IFS hopes to publish a Briefing Note on it in the spring of 2009.

PBR 2008 contained no detail of how the government estimated the revenue that would be raised from the two proposed tax changes affecting the very rich, and the Treasury and HMRC have so far declined to release any details.

a. M. Brewer, E. Saez and A. Shephard, *Means-Testing and Tax Rates on Earnings*, submission to the IFS Mirrlees Review, Institute for Fiscal Studies, 2008 (http://www.ifs.org.uk/mirrleesreview/press_docs/rates.pdf).

Turning to the second explanation, previous work by researchers at IFS has shown that income growth at the very top of the income distribution has been highly correlated with the performance of the stock market.[10] Given the recent falls in stock market indices around the world, this would lead us to expect that income growth at the very top of the income distribution would be lower than income growth slightly lower down between 2005 and 2011. This would lead to less income falling into the 45% bracket than we find by increasing all incomes by the same proportion, as we do above. However, the amount of money raised by this reform under the assumption of no behavioural response is relatively insensitive to differential earnings growth within the top 1% – if the incomes of the top 0.5% grew 1% per year faster than those lower down the income distribution, this reform would raise £3.7 billion a year, while if they grew 1% slower per year, it would raise £3.1 billion. The effect of changing the income growth of the top 0.5% does have a considerable impact on the total amount of revenue raised from income tax and NI, though.

As for the final point, to estimate the amount of revenue raised from this reform, one has to make assumptions about income growth among the very richest individuals to 2011–12, the shape of the income distribution and the responsiveness of those with very high incomes to changes in their marginal tax rate. We have argued in this section how difficult it is to know any of these things with any degree of precision. It is therefore right for the Treasury to be cautious when forecasting how much revenue this reform will raise.

Conclusion

The Treasury estimates that the introduction of the two new 60% income tax bands and the new 45% rate will together raise £3.2 billion, significantly less than the £5 billion that the Treasury estimates would be raised if the basic rate were increased from 20% to 21% in 2011–12.[11]

The Treasury expects that the 45% band will raise £1.6 billion. In the absence of any behavioural response and given various assumptions about income growth to 2011–12, we estimate that it would raise £3.4 billion. This would suggest that the Treasury is expecting a considerable behavioural response to this reform.

Under the same assumptions about income growth among the very rich, we broadly agree with the Treasury's estimate that the two 60% income tax bands will raise £1.6 billion a year. This is because we might expect relatively little behavioural response to this change, given that, at least initially, not many people are likely to have their marginal tax rate changed by this reform. While it may be the case that the optimal tax schedule would involve a lower marginal tax rate at the very top of the income distribution than slightly lower down, it seems highly unlikely that it would have the two large spikes that the government is proposing.

Assessing the revenue implications of tax changes that affect this thinly-populated section of the income distribution is very hard at the best of times. Unfortunately, the Treasury has not published the assumptions that it has made regarding growth in incomes at this level or the behavioural responses that it expects. We have asked for this information in a

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[10] See M. Brewer, L. Sibieta and L. Wren-Lewis, *Racing Away? Income Inequality and the Evolution of High Incomes*, IFS Briefing Note 76, January 2008 (http://www.ifs.org.uk//bns/bn76.pdf).

[11] Source: Table 4 of HM Treasury, Tax Ready Reckoner and Tax Reliefs, November 2008 (http://www.hm-treasury.gov.uk/d/pbr08_taxreadyreckoner_287.pdf).

Freedom of Information request, so as to undertake a more informed analysis. Regrettably, the Treasury and HMRC have asked for more time to consider this request on the grounds that releasing this information may harm the formation and development of government policy and may damage the economic interests of the United Kingdom. Therefore this information was unavailable as we went to press.

11.4 Alternative reform packages

As we have seen, the reforms announced by Alistair Darling last year will leave us with a very complicated structure of income tax and NI rates. In this section, we ask whether it would have been possible to achieve broadly the same revenue and distributional effects that the reforms are likely to produce in a simpler and less distorting way.

To that end, we look at two alternative packages, the main goals of which are:

- to align the points at which payments of income tax and employees' and employers' NI contributions begin;
- to be revenue neutral; and
- to minimise the distributional effects of the reforms.

We do not attempt to come up with a different income tax structure above £100,000, because – as discussed in Box 11.2 – there is considerable uncertainty about how much reforms affecting those with very high incomes would raise. We would like to know what single income tax rate on incomes over £100,000 would raise as much as the government's reforms in order to create a more rational tax rate structure while maintaining revenue and distributional neutrality. As Box 11.2 explains, researchers at IFS are exploring different ways of answering this question and we hope to publish conclusions in the spring of 2009.

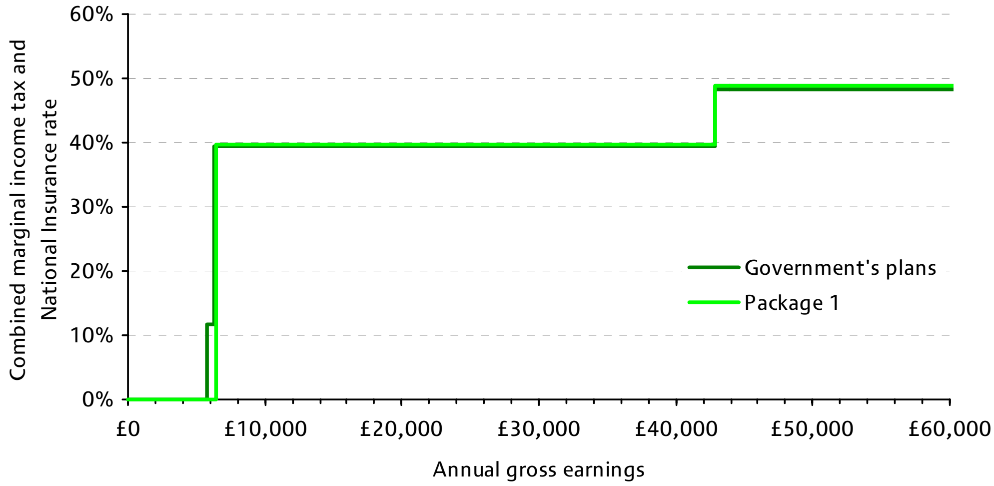
We have come up with two packages that would meet the above requirements. One of these ensures there are no low-income losers by increasing both the threshold for paying employers' NI and the NI threshold for the self-employed to the income tax personal allowance as well as increasing tax rates. The other package removes the need for the increased NI rates planned for 2011–12 and involves a lower top rate of income tax, but does this at the expense of reducing the income tax personal allowance and the threshold for paying employees' NI.

Starting from the government's plans for 2010–11, Package 1 makes the following changes:

- increasing the threshold for paying employers' NI to that for paying employees' NI and income tax, namely £122 per week;
- increasing the threshold for NI for the self-employed to £6,345 per year, the level of the income tax personal allowance;
- reducing the threshold for the withdrawal of the child and working tax credits to £6,345 per year (this is currently £6,420 and the default is for it to be frozen; there is a strong case for aligning it permanently with the income tax and NI thresholds, which are linked to the RPI);
- increasing the employers' NI rate by a further 0.3 percentage points to 13.6% both above and below the UEL;

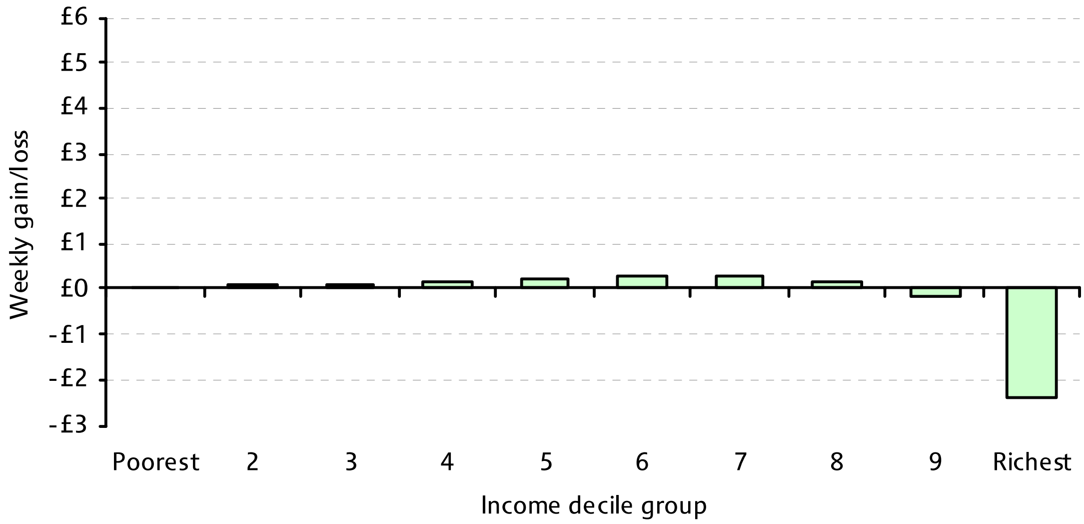
- increasing all NI rates for the self-employed by a further 0.3 percentage points below and above the upper profits limit to 8.8% and 1.8% respectively; and
- increasing the employees' NI rate above the UEL by a further 0.3 percentage points to 1.8%.

Figure 11.4. Effect of Package 1 on the combined income tax and National Insurance schedule



Notes: As Figure 11.3.
Source: Author's calculations.

Figure 11.5. Distributional impact of Package 1



Notes: Income decile groups are derived by dividing all families into 10 equal-sized groups according to income adjusted for household size using the McClements equivalence scale. Decile group 1 contains the poorest tenth of the population, decile group 2 the second poorest, and so on up to decile group 10, which contains the richest tenth. Assumes employers' NI contributions are incident on employees so that employer cost remains the same after the change to employers' NI.
Source: Author's calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on the 2006–07 Family Resources Survey.

Box 11.3. Assigning employers' National Insurance contributions

In our distributional analysis of the packages, we change individuals' gross earnings in each job they hold so that the cost to their employer of employing them remains the same before and after the reform. This means that employers' and employees' NI are treated in the same way, which is appropriate as both contribute to a wedge between the cost of an employee being employed and the employee's take-home pay, and therefore their ultimate impact on take-home pay will be the same. However, a 1 percentage point cut in employers' NI would not be worth as much to an individual as a 1 percentage point cut in employees' NI, as although it leads to higher gross earnings, some of these additional earnings are taxed away. Similarly, an increase in employers' NI does not reduce net income by as much as a similar increase in employees' NI because an increase in employers' NI leads to a reduction in gross earnings, which then reduces income tax and employees' NI payments.

To compare an individual's net income under two tax and benefit systems, we first run them through our tax and benefit microsimulation model under the original system. We then make the employers' NI adjustment to their gross earnings and run them through again under the new tax and benefit system to get their new net income level. The gain or loss from the reform is the difference between these two net income levels.

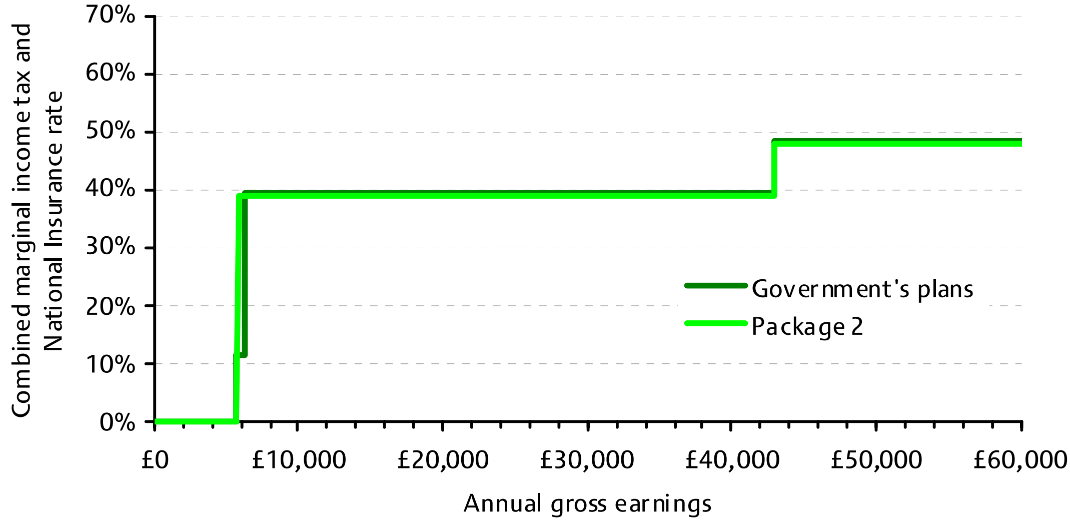
Figure 11.4 shows the effects of these changes on the combined income tax and NI schedule, again including employers' NI contributions. We see that these reforms create a simpler marginal rate structure, with only two rates on earnings below £100,000: 39.7% and 48.8% as a percentage of employer cost. (These include employers' NI, without which the marginal rates are 31.5% and 41.8% as a percentage of gross earnings.)

Figure 11.5 presents the distributional effects of the Package 1 changes. It shows that these reforms are essentially distributionally neutral relative to the government's planned reforms for 2011–12, as well as being revenue neutral. Indeed, more than three-quarters of families would be affected by less than a pound a week by these changes. The gains from the higher thresholds for paying NI for employers (from which we would expect employees to benefit, as explained in Box 11.3) and the self-employed slightly more than offset the losses from the higher NI rates for the bottom eight deciles on average, but do not quite offset the losses for the richest two deciles.

Package 2 consists of the following changes relative to the government's plans for 2011–12:

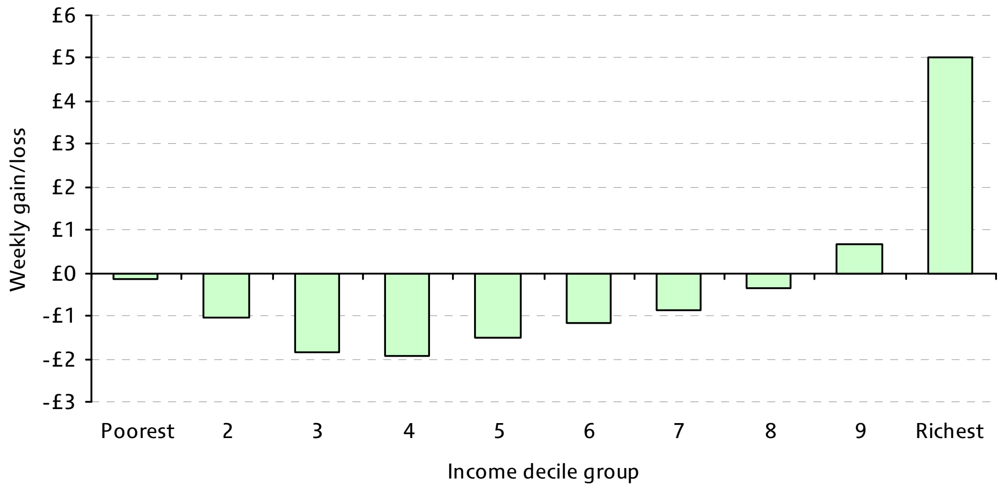
- the planned increase in all NI rates of 0.5 percentage points in 2011–12 does not go ahead;
- the income tax personal allowance is reduced to £5,815 in 2011–12;
- the threshold for paying employees' NI is increased to this lower personal allowance in 2011–12, an increase from £110 to £112 per week rather than to £122 per week as is currently intended;
- the threshold for paying employers' NI contributions is increased to £112 per week;
- the threshold for paying NI for the self-employed is increased to £5,815 per year; and
- the threshold at which the child and working tax credits start to be withdrawn is reduced to £5,815 per year.

Figure 11.6. Effect of Package 2 on the combined income tax and National Insurance schedule



Notes: As Figure 11.3.
Source: Author's calculations.

Figure 11.7. Distributional impact of Package 2



Notes: As Figure 11.5.
Source: Author's calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on the 2006–07 Family Resources Survey.

Figure 11.6 shows the effects of these changes on the combined income tax and NI schedule, including employers' NI. Again, the package creates a simpler marginal rate schedule, with only two tax rates below £100,000: 38.8% and 47.7% (as a percentage of employer cost). Excluding employer NI reduces these to 31% and 41% as a percentage of gross earnings.

Figure 11.7 shows the distributional impacts of the Package 2 changes. This package is less distributionally neutral than package 1, mainly because those towards the bottom of the income distribution are paying more income tax and NI because the thresholds have been lowered while those at the top benefit from lower NI rates. Even so, more than half of families are affected by less than a pound a week by these changes. Low-income families with children also receive up to £235 a year less in tax credits because of the drop in the threshold at which they start to be withdrawn.

11.5 Conclusions

We have seen that the government's proposed reforms to income tax and National Insurance create a combined income tax and NI schedule that is overly complicated, with additional marginal rates created by the misalignment of key parameters and the phasing-away of the personal allowance from those with incomes over £100,000. This chapter has demonstrated that it is possible to realign income tax and NI thresholds while broadly maintaining revenue and distributional neutrality.

This chapter has also discussed the likely behavioural responses to the government's proposed income tax changes affecting the very rich. The phasing-out of the personal allowance from those with incomes greater than £100,000 is likely to distort the behaviour of a small number of individuals considerably. While it is possible that an optimal tax schedule would have higher marginal rates slightly below the top of the income distribution than at the very top, it seems very unlikely that it would feature the two large spikes in the marginal rate schedule that the government is proposing.

It would appear that the government is anticipating a substantial behavioural response to the proposed new 45% tax rate on incomes over £150,000. It is very difficult, however, to estimate how much particular reforms will raise, as this requires accurate information about income growth among the very rich, the shape of the income distribution and the responsiveness of the very rich to changes in their marginal tax rate, all of which are subject to a high degree of uncertainty. The Treasury has so far declined to publish the assumptions it has made when estimating how much these reforms would raise.