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Income tax and National Insurance

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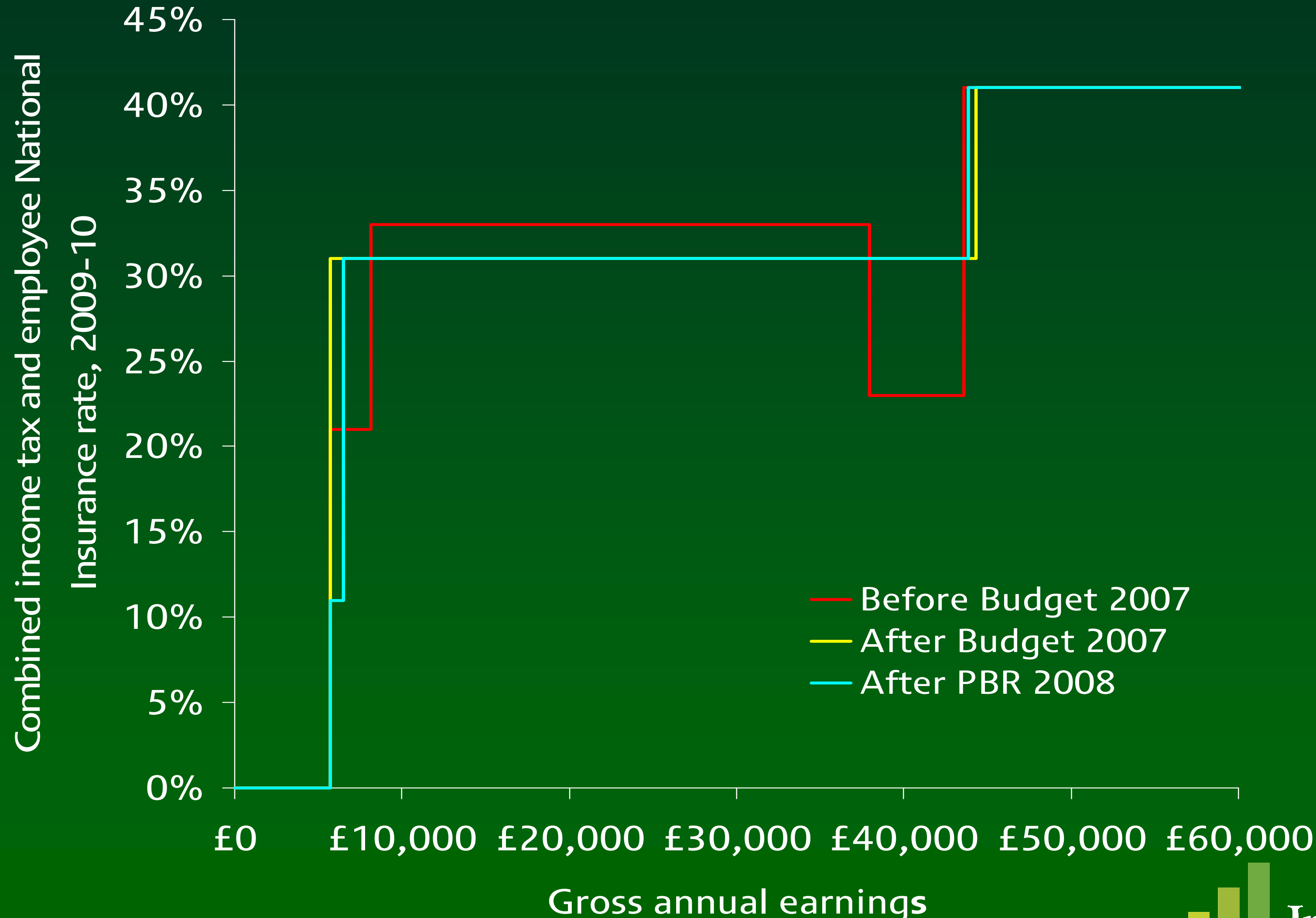
Summary

- Why marginal tax rates matter
- Reforms to income tax and National Insurance since Budget 2007
- Proposed changes affecting the very rich
- Reforms to realign income tax and NI thresholds

Motivation

- Tax system creates a wedge between amount an employer has to pay an employee when they earn more and the value of a pay rise to them
- Size depends on
  - Income tax rate
  - Employee's National Insurance rate
  - Employer's National Insurance rate
  - Withdrawal of means tested benefits and tax credits
  - Indirect tax rates
- High marginal tax rates weaken the incentive to work a little harder
- Structure of marginal tax rates should be simple

Brown simplified the marginal rate schedule but Darling has made it more complicated again



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Marginal rate schedule will become even more complicated by 2011–12

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60% income tax bands

- Two short 60% tax bands likely to distort the behaviour of those who expect their total income to fall in those ranges
  - Very simple for them to increase pension contributions so their taxable income falls to the bottom of the band
- Those with incomes between £106,475 and £140,000 pay £1,295 more but marginal tax rate does not change
  - Some might emigrate/not come to the UK/retire early
  - Others might work harder to maintain level of post-tax income
  - Amount means neither effect likely to be significant, at least in the short term

60% income tax bands

- Will affect 750,000 people in 2011–12 and raise £1.6 billion (HM Treasury)
  - We broadly agree with this costing
  - Do not expect behavioural response to affect revenue raised significantly
- Is this a good idea?
- Possible that tax rate should be lower at the very top than slightly lower down…
- …but difficult to think of any good reason for these two spikes in the tax schedule

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45% income tax rate

- Would raise £3.4 billion a year if no behavioural response
  - Expect behavioural response to be sizeable
  - Treasury expects to raise £1.6 billion
- Very difficult to estimate the size of any revenue effects
- Requires accurate information about
  - Responsiveness of high income individuals
  - Income growth among the very rich
  - The shape of the very top of the income distribution
- Estimates all subject to a high degree of uncertainty
- The Treasury has so far declined to publish the assumptions it has made when estimating the amount of revenue raised

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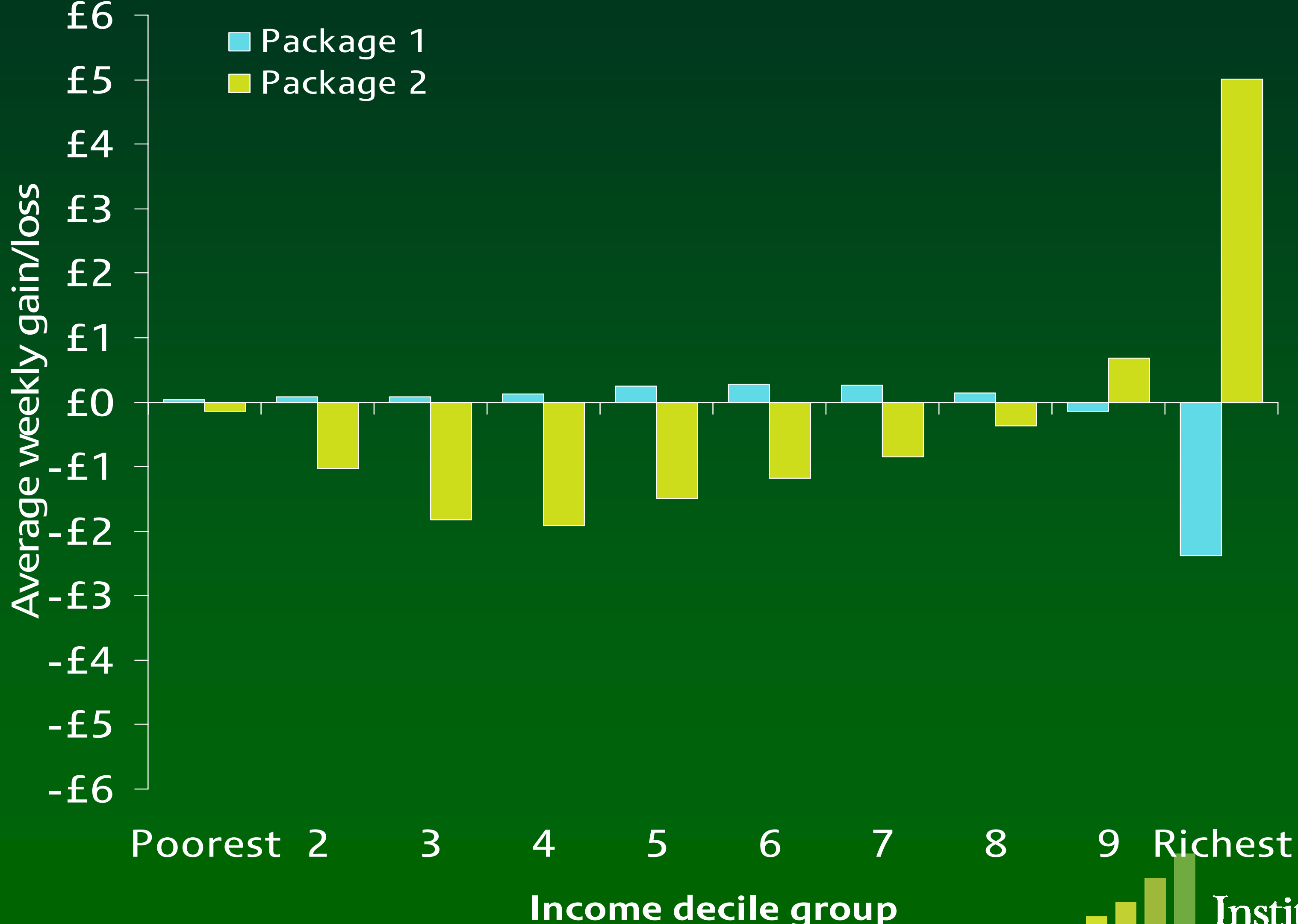
Packages to realign income tax and National Insurance thresholds

- PBR 2008 leaves the employers' NI threshold unaligned from the income tax personal allowance and the employees' NI threshold
- Two packages to realign them and the threshold at which tax credits start to be withdrawn
- **Package 1: Levelling upwards**
  - Increase employer NI threshold to level of personal allowance
  - Need to increase NI rates to pay for this
- **Package 2: Levelling downwards**
  - Reduce personal allowance and set NI thresholds and tax credit threshold equal to this
  - Can then afford to cancel the planned increases in NI rates

Distributional effect of these packages



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Conclusion

- Budget 2007 proposed a very simple marginal rate structure, but subsequent announcements have made it more complicated
- It is possible to realign income tax and NI thresholds while broadly maintaining revenue and distributional neutrality
- New 45% tax rate likely to provoke a considerable behavioural response
  - Treasury seems to be allowing for this in its costings
  - But they have so far declined to publish their assumptions
- Difficult to think of any good rationale for two 60% income tax bands

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