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

Average weekly gain/loss

£6 £5 £4 £3 £2 £1 £0 £1 £2 £3 £4 £5 £6

Poorest 2 3 4 5 6 7 8 9 Richest

Income decile group

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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