Dragging people into higher rates of tax

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Dragging people in

This Saturday (6 April 2019) marks the start of a new tax year. Unlike many other countries, the UK routinely – and sensibly – uprates the cash values of most tax thresholds and benefit rates each year in line with inflation, in order to maintain their real value.

In a number of cases, however, this routine uprating has now been cancelled for extended periods:

- The inheritance tax threshold has been fixed at £325,000 since 2009–10.
- Fuel duties have not increased in cash terms since April 2010.
- Most working-age benefits have been frozen in cash terms since 2015–16.
- The VAT registration threshold has been frozen at £85,000 since April 2017, and the last Budget announced that it would remain frozen until April 2022.

Some of these policies raise revenue; others give money away. But in neither case is it sensible policymaking.

When George Osborne announced a four-year freeze to benefit rates in his 2015 post-election Budget, he presumably did not intend that this would lead to an average loss among benefit recipients of zero in year 1 and £70 in year 2 before jumping to £270 in year 3 and £420 in year 4 as inflation rose. The government might believe that benefits should be more or less generous, but the extent of any change in generosity should be thought through and justified, not the arbitrary and accidental result of what the rate of inflation turns out to be.

Yet at least these cases are ostensibly temporary. The official public finance forecasts continue to be predicated on the assumption that inflation uprating will resume, and if the government wants to continue freezing these rates and thresholds, it must announce that decision and adjust its stated plans accordingly.

Perhaps more insidious is the gradual retreat from the assumption that inflation adjustments are the norm. When governments introduce new thresholds into the tax system, they are increasingly tending to build in the assumption that these thresholds will not routinely keep pace with inflation.

There have always been some thresholds that have not kept pace with inflation. Thresholds for stamp duty land tax, for example, are not increased routinely in line with inflation (let alone property price growth); instead, the rather unsatisfactory approach seems to be that the thresholds are kept frozen in cash terms until the number of purchases being dragged into tax reaches levels deemed unacceptable, and the threshold is then suddenly doubled (as happened in both 1993 and 2005, in both cases after more than a decade of being essentially frozen).

But over the past decade or so, this has moved from being a rare exception to being commonplace. New features of the tax landscape – from the apprenticeship levy allowance to the employment allowance in National Insurance, from the lifetime allowance for entrepreneur's relief to the personal savings allowance and the dividend allowance – are frozen by default. In all of these cases, this builds in an assumption of rising taxes over time – tax rises which are both opaque (some would say stealthy) and depend arbitrarily on the rate of inflation.

The most prominent examples of this phenomenon relate to new income thresholds affecting those with the highest incomes. They include:

- the £100,000 threshold at which the income tax personal allowance starts to be withdrawn;
- the £150,000 threshold at which the 45% additional rate of income tax starts to be payable;
- the £50,000 threshold at which child benefit starts to be withdrawn (via an income tax charge, unless the recipient opts to stop claiming child benefit);
- the £100,000 threshold at which eligibility for 'tax-free childcare' is removed;
- the £110,000 and £150,000 thresholds at which the annual limit on tax-privileged pension saving starts to be reduced.

The failure to uprate these thresholds with inflation can cumulate to generate big effects over time, as more people see their income exceed the threshold and those above the threshold see more of their income above it. As Table 1 shows, the number of people above these thresholds has risen rapidly over time. Over 300,000 (30%) more families with children now have some of their child benefit withdrawn than when the policy was first introduced in 2013. IFS researchers have estimated that, by 2022–23, one in five families with children will lose at least some of their child benefit, up from one in eight when the policy was introduced.[1]

Similarly, there are now 428,000 taxpayers with incomes above £150,000, a third more than there were in 2007–08, the year before the introduction of the additional rate was announced; and there are 986,000 with incomes above £100,000, an increase of more than half since 2007–08, before the withdrawal of the personal allowance was announced.[2]

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[1] C. Emmerson, R. Joyce and T. Waters, 'Stealthy changes mean that soon one in five families with children will be losing some child benefit', IFS Observation, 2019, https://www.ifs.org.uk/publications/13791.

[2] Comparing the numbers now with the numbers when these thresholds were actually introduced in 2010–11 would be misleading, as there is strong evidence that people brought forward income from 2010–11 (and beyond) to 2009–10 in order to avoid or minimise payments of additional-rate tax. This artificially inflates the number of people above £150,000 in 2009–10 and depresses the numbers in 2010–11 and 2011–12. See J. Browne and D. Phillips, 'Estimating the responsiveness of top incomes to tax: a summary of three new papers', IFS Briefing Note BN214, 2017, https://www.ifs.org.uk/publications/9675. The most recent figures available that are not affected by this forestalling relate to 2007–08.

Note also that the number of additional-rate taxpayers is slightly lower than the number of taxpayers with incomes above £150,000, as for various reasons about 30,000 people each year have incomes above £150,000 but are not liable for additional-rate tax. Since there were, of course, no additional-rate taxpayers before the reform was introduced, the only available like-for-like comparison is of the number of taxpayers with incomes above £150,000.

Table 1. Number of people affected by various thresholds over time

Feature of system	Threshold	Number of families with children / individual taxpayers above threshold	
		Historical	2018–19
Child benefit withdrawal	£50,000	1,033,000 in 2013–14	1,349,000
Personal allowance withdrawal	£100,000	647,000 in 2007–08	986,000
Additional rate of income tax	£150,000	319,000 in 2007–08	428,000

Source: Child benefit – IFS calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on data from the Family Resources Survey 2013–14 and 2016–17. Income tax – HMRC Statistics, table 2.5, https://www.gov.uk/government/statistics/income-tax-liabilities-by-income-range.

Not all of the change in numbers is attributable to the freezing of the thresholds: incomes may have grown more quickly (or more slowly) than these thresholds even if they had been uprated in line with inflation. But accounting for inflation makes a significant difference. For example:

- If the £100,000 threshold for withdrawal of the personal allowance and the £150,000 additional-rate threshold had kept pace with inflation (as measured by the Consumer Prices Index) since they were introduced in 2010–11, they would now stand at around £120,000 and £180,000 respectively – and would be increasing again on Saturday. Almost a million affected individuals would be paying over £1 billion a year less in tax (except to the extent that facing lower tax rates prompted them to increase their incomes, with the tax on this extra income dampening the effect on revenue).

- If the child benefit threshold had been uprated since it was introduced in 2013, it would now stand at around £54,000 rather than £50,000, and would affect 220,000 fewer families.

Reducing these thresholds in real terms also means that more people are exposed to some of the more damaging work incentive effects of our tax system.

Both the withdrawal of the personal allowance and the withdrawal of child benefit create income bands with very high effective marginal rates of income tax: an effective 60% income tax rate on incomes between £100,000 and £123,700 in the case of the personal allowance, and in the case of child benefit an effective marginal income tax rate between £50,000 and £60,000 that is higher for those who have more children (it is currently 51% for those with one child and 65% for those with three children). In the case of child benefit withdrawal, the top and bottom of the band are both frozen, increasing the number of people who move out of the band (beyond the £60,000 threshold) as well as the number who move into it; but the freeze means that the high marginal rates are affecting more densely populated parts of the income distribution. As for the withdrawal of the personal allowance, the number of people affected is growing much more rapidly as the bottom of the 60% band is frozen while the width of the band rises twice as quickly as the personal allowance, which the government has not merely been uprating with inflation but increasing rapidly in real terms.

There are cliff-edges as well as high-marginal-rate bands: since ‘tax-free childcare’ was introduced in April 2017, parents can lose up to £2,000 a year of childcare support at a stroke once their income exceeds the £100,000 eligibility cap, a strong incentive to keep income below that level.

Arguably the most perverse case of all, though, is the reduction in the pension annual allowance for high-income individuals.

For most people, pension contributions of up to £40,000 a year receive relief from income tax (the money mostly being taxed when paid out of the pension scheme instead).

But since 2016–17, for people whose income *excluding* pension contributions exceeds £110,000, this annual allowance is reduced by £1 for each £2 by which their income *including* the value of pension contributions exceeds £150,000, until it reaches a minimum of £10,000 for those with income (including pension contributions) above £210,000. These thresholds are frozen from year to year, so are gradually affecting more people.

Contributions in excess of the annual allowance are subject to income tax when they are made, as well as being taxed again when the person receives their pension. This is designed to make contributing more than the annual allowance so unattractive that nobody would want to do it.

It is hard to see much logic to the tapering of the annual allowance. It is not clear why someone getting total remuneration of £150,000 (including pension contributions) should be able to save £40,000 of it in a pension without incurring penal tax rates, while someone earning £210,000 should only be able to save £10,000.

But aside from incoherence, the taper has damaging effects on work incentives.

For those with incomes (including pension contributions) between £150,000 and £210,000, earning an extra £100 means not only paying income tax and National Insurance contributions on it, but also losing £50 of pensions annual allowance. The value of this lost annual allowance depends on their income and their pension contributions. For someone contributing less than their annual allowance anyway, it is irrelevant; for someone who reduces their pension contribution to stay below the limit, the loss is the reduced opportunity to save in a pension, with all the tax and other advantages that brings; for someone already at or above their annual allowance who keeps their pension contribution unchanged, there is an additional income tax charge at their marginal rate, which depends on their income *excluding* pension contributions (for example, if their income excluding pension contributions is above £150,000, the pension tax charge will be £22.50 on top of the £45 additional-rate income tax, bringing their marginal income tax rate up to 67.5%; other examples can generate higher or lower marginal rates).

In some cases, people with pension contributions in excess of £40,000 can face a marginal tax rate of more than 100%: they would actually be worse off if they increased their earnings.

This can arise because of the £110,000 threshold for income *excluding* pension contributions, below which the pensions annual allowance is never reduced.

Consider, for example, someone with £50,000 of pension contributions and £110,000 of other income as well, £160,000 in total.

Since the standard annual allowance is £40,000, they will already have to pay £4,000 in higher-rate (40%) tax on the £10,000 'excess' pension contribution anyway. But as soon as their income excluding pension contributions crosses the £110,000 threshold, their annual allowance will be reduced from £40,000 to £35,000 (their total income of £160,000 is £10,000 above the £150,000 threshold, so they lose £5,000 of annual allowance) and so their £50,000 pension contribution now exceeds their annual allowance by £15,000, not £10,000, incurring an additional tax charge of £2,000 from an extra £1 of earnings. They would be paying to do the extra work.

Moreover, each additional £1 they earn will further reduce their annual allowance and increase the pension tax charge by 20p – in addition to 40p higher-rate income tax, 2p employee National Insurance contributions, and an additional 20p of income tax because they are in the range where their personal allowance is withdrawn as their income rises. With a pension tax charge of £2,000 for crossing the £110,000 threshold and an 82% marginal tax rate on additional earnings (20 + 40 + 2 + 20), even a pay rise of £10,000 would leave them with less after-tax income than when they started.

Unused annual allowances can be carried forward for up to three years, so if a person's high pension contributions are a one-off and they were below the annual allowance in previous years, they might not face these penal taxes.

More broadly, these most extreme examples could be avoided by keeping pension contributions below the annual allowance, as the system encourages.

Many private sector employers now offer employees higher salaries rather than additional pension contributions that would take them above the annual allowance.

But some public sector workers in particular, such as senior doctors and civil servants, are in defined-benefit pension schemes that are both generous and inflexible. The way that their employers' pension contributions are determined and measured means that they can easily exceed the £10,000 annual allowance that applies to the highest earners, and sometimes exceed even the £40,000 standard annual allowance. Members cannot ask for additional salary in exchange for a smaller pension; typically their only way to avoid exceeding the annual allowance would be to opt out of the pension scheme entirely, losing the whole of their employer's contribution (including other features such as payments to their family if they die).

On Tuesday (2 April 2019), Parliament debated the effect of the tapered annual allowance on NHS pension scheme members.[3] Either the pension scheme or the tax system could usefully be reformed. Ideally both would be.

[3] See https://hansard.parliament.uk/Commons/2019-04-02/debates/71E9792B-AD44-4938-9A2A-4A4E253D17BE/NHSPensionSchemeTaperedAnnualAllowance. While the issue applies more widely across the public sector, the taxation of doctors' pensions in particular has been attracting concern recently: see, for

The cases we have looked at here concern unusually high-income individuals, and many people might struggle to shed a tear for their plight. But nobody's interests are served by encouraging these high earners to work less in order to keep their income below an arbitrary threshold. And as these thresholds are frozen while incomes rise, these pernicious incentives become relevant to an ever-wider group of people.

example, https://www.bma.org.uk/news/2018/august/call-to-rethink-pension-tax-rules and https://www.ft.com/content/225fb300-4c8e-11e9-bbc9-6917dce3dc62.