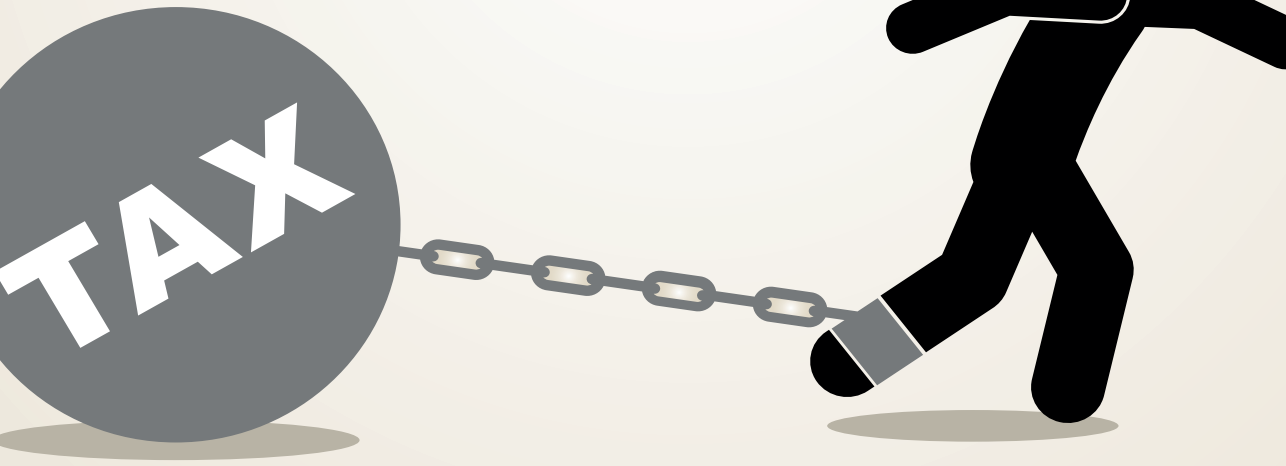


Briefing 14:09

TAXING PROBLEM

The UK's incoherent tax system

By Ryan Bourne
December 2014



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About 2020 Vision

2020 Vision focuses on the future of the UK economy and identifies the key economic issues likely to face the next UK government.

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Summary

- The UK tax system is incoherent. Even ignoring benefits styled as tax credits and the withdrawal of child benefit, taxpayers can face seven different marginal rates of personal tax.
- When allowing for the withdrawal of tax credits and child benefit, many families face very high effective marginal tax rates. For example, a single earner married couple would face an effective marginal rate of tax (including benefit withdrawal) of over 60 per cent across the income ranges: £10,000-£39,407; £50,000-£60,000; and £100,000-£120,000. This represents a severe disincentive to career progression, training and work effort and produces a complex and barely comprehensible system.
- Since 2010, the system of taxes on income has become more complex and the way in which the transferable tax allowance is being introduced will add another significant anomaly. Indeed, the withdrawal of the transferable tax allowance for higher rate tax payers will lead to an infinite marginal tax rate for some families.
- Fiscal drag has brought more people into paying higher rates of income tax over recent decades. The higher rate tax threshold has fallen by over 40 per cent relative to wages since 1979. The number of higher rate taxpayers has trebled since 1990.
- The Conservative Party's pledge to increase the higher rate tax threshold in the next parliament will not stop the number of higher rate taxpayers increasing given reasonable expectations of inflation and real wage growth.

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- The long-term objective of personal tax reform should be to move towards a simple, coherent marginal rate structure which is as flat as possible – with well-understood and automatic increases in thresholds.
 - The four main political parties have suggested a range of changes to personal taxation for after the next general election, including:
 - Raising the income tax personal allowance further
 - The creation of a 10 pence income tax band
 - The creation of a 35 pence income tax band
 - An increase in the additional rate of income tax
 - Abolition of the transferable tax allowance
 - An increase in the higher rate income tax threshold
 - Many of these proposals would further complicate the tax system and make it even less coherent. Increasing the top rate of tax may even lead to less revenue being generated.
 - Instead, there are a range of steps governments could take to making the tax system more coherent:
 - Abolition of the savings income allowance
 - Significantly raising the employees' national insurance allowance
 - Starting the process of integrating income tax and national insurance
 - Raising the higher rate income tax threshold
 - Abolishing the additional rate of income tax
 - Abolishing the withdrawal of the personal allowance at the £100,000 income level
 - In the long term, aiming for significantly lower levels of government spending could facilitate substantial marginal tax rate cuts, and the government should aim to return to a tax system with two, or preferably one, overall marginal rates of tax on income.
 - The benefits system should be reformed to replace most benefits by household tax allowances that depend on household size and composition with a 'negative income tax' being received by those households earning less than their combined allowances. This would substantially improve work incentives and end the discrimination against single-earner households and family formation in the UK tax system.

Introduction

In 2014, it is estimated the government will raise 41.2 per cent of GDP in tax revenue¹ (OECD, 2014). It is widely believed that a high overall tax burden has a negative impact on the economic fortunes of the economy by reducing its productive capacity (see Minford and Wang 2011 and Heath et al 2012). But also important for economic efficiency is how the desired revenues are raised – i.e. on what activities are taxes imposed, how high are the rates, what is the tax base and how is the tax structured (Adam and Johnson 2012).

In the past five years there have been significant policy changes to personal taxes on income, namely income tax and employee national insurance contributions (NICs). Combined, these taxes represent 32.9 per cent of all current revenues.

Policy changes in this area since 2009/10 have largely complicated the system, and the interaction with the tax credit and benefits system has created a bizarre marginal tax rate structure which adversely affects the incentive to work, accumulate human capital and seek promotion. For those on low incomes, it also creates perverse incentives with regards to family formation.

All of the four main political parties are proposing incomes tax cuts after the 2015 general election. Unfortunately, their proposals would do little to eliminate the key economic problems of the current system, namely: high

1 The figure normally quoted is just over 37 per cent. However, this is based on an inappropriate way of measuring national income which, if measured at so-called “market prices”, is inflated by indirect taxes. The correct way to measure national income for these purposes is at “factor cost”. This is the approach of the OECD whose estimate is used here.

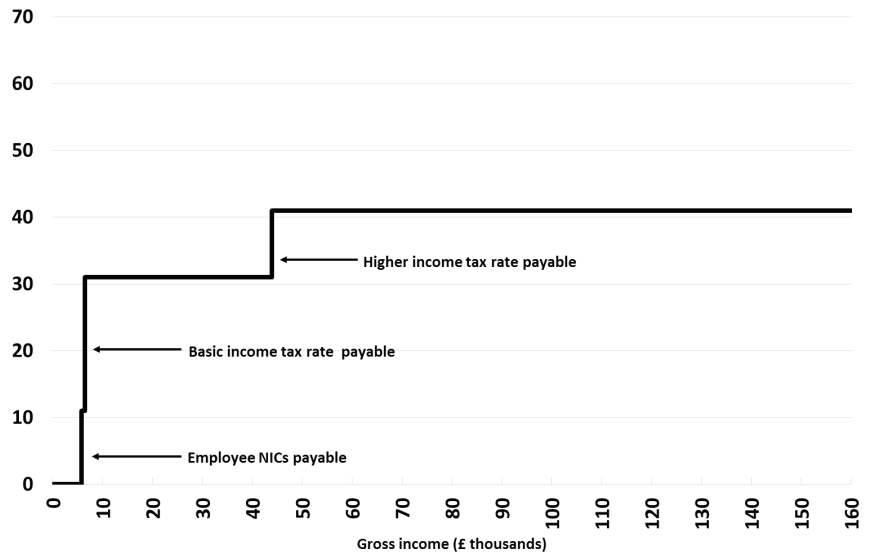
marginal rates; a dysfunctional marginal rate structure; and significant amounts of fiscal drag.

If we want lower marginal rates across the board then it is necessary to significantly cut government spending. But there are a range of steps that governments could take to develop a more coherent personal tax system, and to protect taxpayers from significant fiscal drag.

The incoherence of our marginal tax rate structure

As Figure 1 shows, until 2009/10 the combined effect of income tax and employee national insurance contributions (NICs) created a progressive tax framework on income – with four overall tax bands (0 per cent, 11 per cent, 31 per cent and 41 per cent). In other words, as income increased, the marginal tax rate faced by individuals increased in jumps – giving the marginal tax rate structure a “step”-like appearance with no overall rate higher than 41 per cent. This represents the joining of an income tax with a progressive structure (0, 20, 40) to employees’ NICs, with a (0, 11, 1) rate structure.

Figure 1: Marginal tax rate structure (income tax and employee NICs) 2009/10 (in 2009/10 prices)

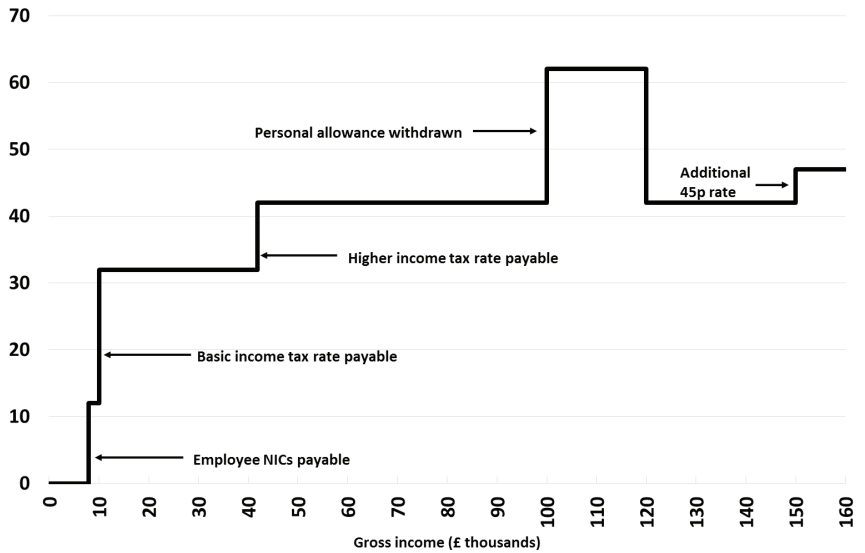


Since 2009/10, there have been significant policy changes to income tax and employees' NICs, which have made the marginal tax rate structure for an individual across the income spectrum much less coherent (Johnson, 2014) – see Figure 2 for 2014/15:

- The last Labour government instituted a new 'additional' rate of income tax for those earning over £150,000 per year (initially at a rate of 50 per cent, but subsequently cut to 45 per cent by the coalition government) creating an additional 'step' in the marginal tax rate schedule at the high income end.
- The government also instituted a policy of tapering away the personal allowance for those earning over £100,000 – reducing the allowance by 50p for every marginal £1 earned until the personal allowance is eliminated (in effect, adding 20 percentage points to the marginal tax rate on a range of income above £100,000).
- There has been an increase in the employees' NICs rate of 1 per cent across the board.

- The significant increase in the personal allowance under the Coalition has meant that the gap between when employee NICs become payable and income tax becomes payable has become much larger.

Figure 2: Marginal tax rate structure (income tax and employee NICs) 2014/15



Even more complexity in reality

Though we do not consider them here, there is also an argument that employers' national insurance contributions should be included when calculating marginal tax rates. Public finance theory suggests that there is no long-term difference between the impact of employees' and employers' NICs – both drive a wedge between the cost of employment for the employer and the wage the employee receives (Bell et al 2002). Including these and developing an 'effective marginal tax rate' (EMTR) which expresses total tax paid as a proportion of the total employer cost of labour would raise the marginal rate for basic rate taxpayers to 40.2 per cent; for higher rate taxpayers earning up to £100,000 to 49.0 per cent; for those earning between £100,000 and £120,000 to 66.6 per cent; for those earning

between £120,000 and £150,000 to 49.0 per cent; and, for those earning over £150,000 to 53.4 per cent.²

Another complication not included above is the impact of the savings income allowance. At the moment the first £2,880 of savings income above the tax-free personal allowance is taxed at a starting rate of 10 per cent. From April 2015, this will be lowered to 0 per cent and the band increased to £5,000 – in effect increasing the personal allowance for those with savings income but whose taxable earnings income (as opposed to savings income) is less than £5,500.³

Nevertheless, these are small concerns relative to some of the truly bizarre effective marginal tax rates faced by individuals with households in particular circumstances. This is because of the interaction of the tax and tax credit system; the recent policy decision to taper away child benefit payments for those with someone in a household earning more than £50,000; the system of student loan repayments (whereby graduates earning above £21,000 will now, in effect, face a marginal tax rate increase of 9 per cent until their debts are repaid); and, from next year, the effect of the new transferable married tax allowance only applying to basic rate taxpayers.

To take a simple example, imagine a married couple with three children where one individual works more than 30 hours a week but does not claim housing benefit, council tax benefit or assistance with childcare costs. The earner does not have any student loan repayments. Table 1 shows the marginal rates faced by this household at different levels of income.

2 These are calculated as the marginal effective tax rate on total employer cost. Given that the employers' NICs rate is 13.8 per cent for those above the starting threshold, the effective marginal rates can therefore be calculated according to $(\text{Sum of marginal rate of income tax and employees' NICs} + 13.8)/113.8$.

3 For more details, see HMRC online: "How the 10% tax rate is calculated – worked examples". In effect, anyone with overall income of less than £15,500 per annum will no longer pay tax on their savings income.

Table 1: Marginal tax rates faced by single-earner married couple with three children

Gross income	Marginal income tax rate	Marginal NICs rate	Tax credit withdrawal	Child benefit or tax allowance withdrawals	Overall MTR
1) £0 -£6,420	0%	0%	0%	0%	0%
2) £6,420 - £7,596	0%	0%	41%	0%	41%
3) £7,596 - £10,000	0%	12%	41%	0%	53%
4) £10,000 - £39,407	20%	12%	41%	0%	73%
5) £39,407 - £41,865	20%	12%	0%	0%	32%
6) £41,865 (one point from 2015/16)	40%	2%	0%	infinite	infinite
7) £41,865 - £50,000	40%	2%	0%	0%	42%
8) £50,000 - £60,000	40%	2%	0%	24.75%	66.75%
9) £60,000 - £100,000	40%	2%	0%	0%	42%
10) £100,000 - £120,000	40%	2%	0%	20%	62%
11) £120,000 - £150,000	40%	2%	0%	0%	42%
12) £150,000 +	45%	2%	0%	0%	47%

(1) Income range before tax credits withdrawal, NIC payments or income tax payments kick in. (2) Tax credits begin to be withdrawn. (3) Employees' NICs become payable. (4) Basic rate of income tax becomes payable. (5) All tax credit payments have been withdrawn. (6) Point at which, from next year, the transferable marriage tax allowance will be withdrawn completely since where higher rate of income tax kicks in and lower marginal rate of employee NICs. (7) Higher rate of income tax payable and lower rate of employee NICs. (8) Child benefit begins to be withdrawn at rate of 10.66% for first child, 7.05% for each extra child. (9) All child benefit has been withdrawn. (10) Personal allowance begins to be withdrawn by £1 for every £2 of income. (11)

Source: HMT (2013), HMRC (2012a), HMRC (2014)

The following features of this family's circumstances are worth noting:

- The family is eligible for up to £13,525 in tax credits if they work more than 30 hours per week – these are then tapered away at a rate of 41 per cent at income levels above £6,420 until their income reaches £39,407.
- Child benefit is tapered away such that someone earning £50,000 receives the full award, but someone earning £60,000 ceases to receive any child benefit. Since the full child benefit award for someone with three children would be £2,475 per year – this would mean child benefit being withdrawn at 24.75 per cent for each extra £1 earned.
- From next year, the introduction of the transferable married tax allowance will lift the personal allowance above which tax is paid for this family (not shown in this table), but it will also create an infinite marginal tax rate at the point at which the earner moves to become a higher rate taxpayer – this is because the family will lose all the allowance in one go (rather than it being tapered away).
- Other benefit withdrawals (such as housing benefit and council tax benefit) make effective marginal tax rates even higher at low incomes, though are not included here.

The sheer complexity and high nature of marginal tax rates across much of the income spectrum is likely to have significant economic consequences. Marginal tax rates affect the incentive to earn extra income. As can be seen from Table 1, effective marginal tax rates are so high across significant chunks of the income spectrum that the incentive to engage in human capital accumulation, upskilling, working hard for a promotion etc does not have a particularly high pay off. This can have negative implications for the productivity of the economy.

To a certain extent, high effective marginal tax rates on those receiving means-tested benefits are inevitable without an integrated tax and benefits system (Dillow, 2006). The slower benefits are withdrawn, the higher up the income scale benefits reach. But it is fair to say that the UK's marginal tax rate structure has little economic coherence, creates significant disincentives to work and is full of anomalies.

There is a significant body of academic research which shows that marginal tax rates really do elicit significant behavioural responses. Mertens (2013), for example, concluded from evidence in the US that there are 'large income responses to marginal tax rates that extend across the income distribution' – i.e. when marginal tax rates are cut, they lead to relatively big behavioural responses and are associated with increases in real GDP. Furthermore, though the media often focus on the marginal tax rate change responses for high earners in relation to top rates of tax, Mertens found that similar responses were much more broad-based. This backs up the findings of other academic research relating to income from work (Gokhale et al 2002; Prescott 2004), and incentives for human capital accumulation (Trostel 1993).

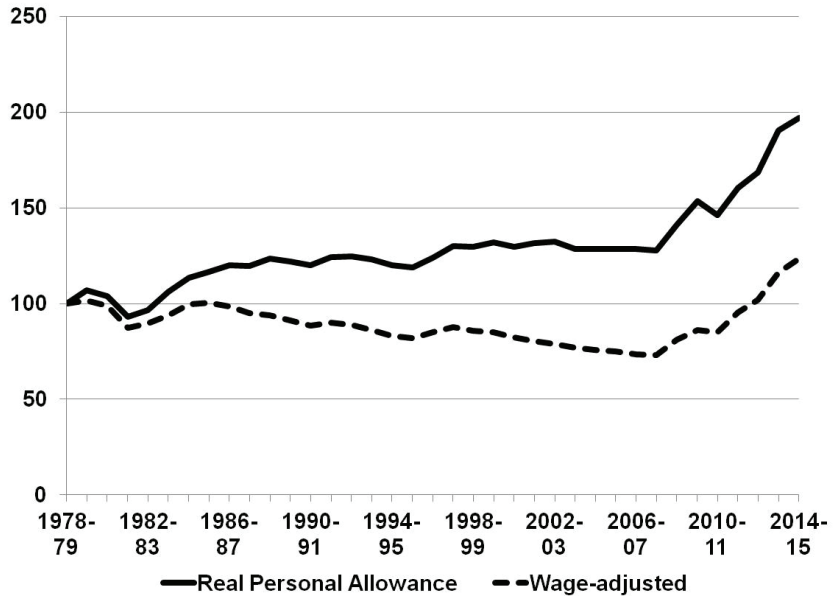
Despite this evidence, policy decisions in recent years have increased marginal tax rates across many parts of the income distribution. The increase in the personal allowance has reduced marginal tax rates for those earning between £6,475 (the personal allowance in 2009/10) and £10,000. But the child benefit taper, the withdrawal of the personal allowance above £100,000, the one percentage point increase in employees' NICs and the introduction of the new additional income tax rate have all acted to increase the marginal tax rates faced by many groups. Furthermore, more people have been sucked into the higher rate bands as a result of 'fiscal drag'.

Fiscal drag

Fiscal drag refers to a situation where inflation or earnings growth pushes more individuals into higher tax brackets which do not rise as rapidly.

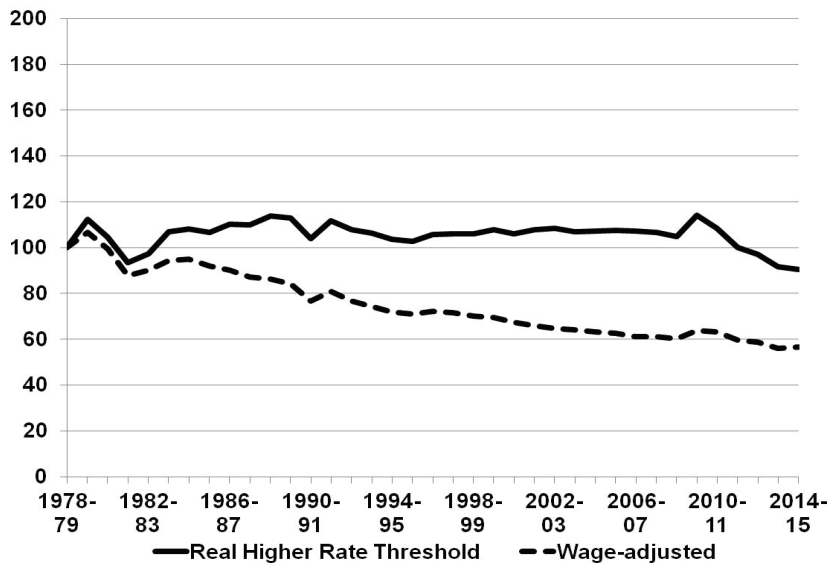
Figures 3 and 4 highlight the evolution of the personal allowance and higher rate threshold for income tax in real and wage-adjusted terms since 1979. Figure 3 shows that the value of the personal allowance has doubled in real terms since 1978/79. However, the vast majority of this increase has come since 2007/08 after which time there was a specific policy objective of raising the personal allowance. Relative to average weekly earnings growth, the personal allowance had actually fallen by 27 per cent by 2007/08. It is only because of large recent increases in the allowance that its value has now increased overall relative to wages since 1978/79.

Figure 3: Real and wage-adjusted income tax personal allowance 1978/79–2014/15



Source: author's calculations from IFS (2013), ONS (2014a; 2014b)

Figure 4 shows that both the real and wage-adjusted value of the threshold to mark the start of the higher rate band has fallen since 1979 (almost 10 per cent relative to prices and 43 per cent relative to wages).

Figure 4: Real and wage-adjusted value of higher rate threshold

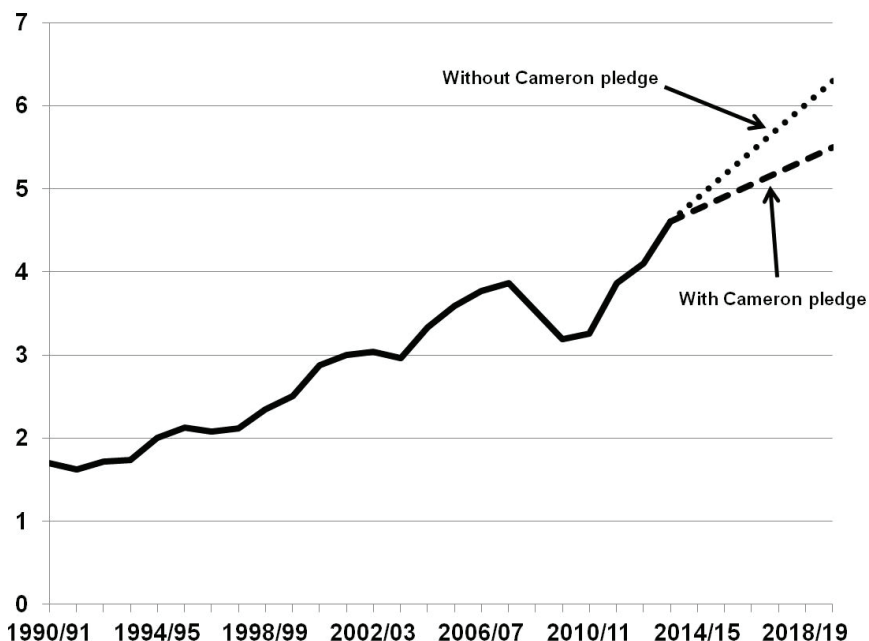
Source: author's calculations from IFS (2013), ONS (2014a; 2014b)

This has seen a huge increase in the number of people paying higher tax rates over the last 25 years. In 1990 around one in fifteen income taxpayers paid the higher rate (1.7 million people). This had increased to about one in ten by 2010 (3.3 million) but has since increased significantly to one in six income taxpayers (4.6 million) by 2013/14, as the coalition government has allowed the higher rate threshold to fall from £43,875 in 2010 to £41,865 (in nominal terms). Next year this threshold will only be increased by 1 per cent, meaning that more income taxpayers are likely to be dragged into paying the higher rates of tax. It is also worth noting that both the £100,000 threshold above which the personal allowance begins to be withdrawn and the £150,000 additional rate threshold have been held constant in nominal terms since 2010/11.

In reaction to increasing concern about this trend, the Prime Minister has pledged that a future Conservative majority government would increase the higher rate starting threshold to £50,000 by the end of the next Parliament. This was widely reported as a 'tax cut' given that, relative to the government's baseline, it will have a fiscal cost to the exchequer. However, given their expectations of inflation and real wage growth, the Treasury still expects the number of income taxpayers paying higher tax

rates to increase to 5.5 million people by the end of the next Parliament (see Figure 5). Of course, this is lower than the 6.3 million taxpayers who, it is estimated, would have been in that band without the policy pledge. Overall though, the Prime Minister's pledge is best thought as tempering a planned tax rise.

Figure 5: Number of income taxpayers paying higher rate or above (millions)



Source: HMRC Tax Statistics.

The long-term policy objective for taxes on income

Our current tax system has marginal tax rates that are too high across large bands of the income distribution; an incoherent marginal rate structure; and taxpayers have been subject to significant ‘fiscal drag’ over at least three decades. Policy changes to the personal income tax system should seek to address these problems head on. Although there would be fiscal costs of moving to an ideal tax system quickly, politicians should have a clear idea of the sort of tax system towards which they are working. In recent years, there has been significant research work undertaken to attempt to map out what an optimal personal tax regime for the UK might look like.

In *Sharper Axes, Lower Taxes*, Booth et al (2011) outlined significant government spending restraint which would require raising revenues of about 29 per cent of GDP. Within a broader tax framework, that would allow the adoption of an almost flat income tax system with a single marginal rate of 15 per cent and a personal allowance of £12,000 – with reliefs only for charitable giving and certain types of saving. There would also be a generous transferable allowance within households and child tax allowances, such that a four-person household on median earnings would pay little income tax. In addition, a flat employee national insurance rate of 10 per cent would be applied above a threshold set lower than the income tax personal allowance.

The retention of national insurance was argued for on the basis that it is important to retain the contributory principle for national insurance benefits. However, this argument is increasingly difficult to justify given the erosion of the contributory principle in the national insurance system (Heath et al 2012; Martin 2010). For this reason, there have been calls for a full merging

of income tax and national insurance. The IFS's Mirrlees Review, for example, concluded:

‘National Insurance is not a true social insurance scheme; it is just another tax on earnings, and the current system invites politicians to play games with NICs without acknowledging that these are essentially part of the taxation of labour income. The two systems need to be merged.’ (IFS 2010)

This would reduce the administrative cost of running what are, in effect, two income tax systems whilst improving transparency and reducing complexity – though there would be practical problems given those above state pension age do not currently pay employee national insurance and the self-employed and those with several jobs pay lower effective rates.

Martin (2010) has suggested merging income tax and employee national insurance into a single income tax but maintaining a new payroll tax to replace employers' NICs. This would be administratively simple, and would account for the fact that employees have some benefits not available to the self-employed (redundancy pay, sick pay, maternity pay etc). But both The Taxpayers' Alliance 'Single Income Tax' and IFS Mirrlees Review suggested going further, advocating the complete abolition of both employee and employer national insurance and their replacement with a single tax on labour income. This would facilitate full transparency of where the cost of taxation is borne.

The 'Single Income Tax' has probably been the most complete and substantial proposal for reform of the UK tax system. Under the assumption of a need to raise around 33 per cent of GDP in tax revenues, the proposal of Heath et al (2012) would entail a generous, index-linked personal allowance, above which all labour income and capital income would be taxed at a single rate of 30 per cent with no exemptions or loopholes. This same rate would be applied to distributed income from capital by businesses.

The advantages of such a tax system would be manifold:

- Incentives to avoid taxes would be minimised due to low rates widely applied. The ability to avoid taxes would also be reduced.
- The costs of compliance would be reduced.

- The tax would be transparent and households would clearly understand the incentives they face.
- Economic efficiency and economic growth would be enhanced as lower tax rates improve incentives to work, save and invest - this has long been heralded as the key advantage of all 'Flat Taxes' (see Hall and Rabushka 1995).

The long-term objective should therefore be to move towards a broad-based, low marginal rate tax structure with a single rate of tax on income. There are various ways in which it could be achieved. But something like the 'Single Income Tax' should be the long-term ambition against which all tax policy changes are judged.

Proposed changes from political parties

All political parties have proposed changes to the income tax system ahead of the next general election. These tend to all fall into three categories: increasing the personal allowance significantly; introducing new income tax rates; and increasing the additional rate of tax from 45p to 50p.

- **Personal allowance:** three political parties (the Conservatives, the Liberal Democrats and UKIP) have argued for further significant rises in the income tax personal allowance (PA): the Conservatives and Liberal Democrats want it to increase to £12,500 by the end of the next Parliament, whilst UKIP want to raise it to an amount equivalent to the gross income of someone working full time on the national minimum wage (Cameron 2014; Clegg 2014; O'Flynn 2014). Any of these policies will of course lower the marginal tax rate faced by those earning between £10,500 (the PA at the time of the next election) and the new PA. Given that these policies will entail increases in the PA above inflation, they will also come with a significant fiscal cost relative to baseline.

From a tax coherence perspective, raising the personal allowance further without also increasing the employee NICs starting threshold substantially would create a bigger gap between when employee national insurance becomes payable and when income tax becomes payable – making it more difficult to ever merge income tax and national insurance. Increasing the personal allowance also currently extends the band of income over £100,000 above which the personal allowance is withdrawn and where taxpayers face a marginal rate of 62 per cent.

As far as the direct impact is concerned, raising the personal allowance is at best ambiguous in terms of the long-term objective of producing a coherent and flat tax system. However, given fiscal constraints, raising the personal allowance also prevents other changes being made which could improve the shape of the tax system.

- **New rates:** both Labour and UKIP have pledged to introduce further bands into the income tax system. Labour wants to re-introduce a new 10p income tax band above the personal allowance – financed at least in part by the abolition of the transferable tax allowance. It is unclear how large a band of income this 10p rate would apply across, but if it was funded only by the £700 million transferable allowance, this band of income could be as small as £200 leading to a maximum tax reduction of £20 a year. Given the loss of the transferable allowance, the main net benefit would be to single people, two-earner families where both of the couple are in full-time work and those paying higher-rate tax.

A new 10p band would complicate the tax system further – and does not achieve any of its stated objectives (usually, a tax cut for those on low incomes) any better than further increases in the personal allowance (see Bourne 2013 and Corlett 2014). The current head of the Office for Budget Responsibility, Robert Chote, once said of Gordon Brown’s decision to abolish the old 10p tax rate: “The 10p band should never have been introduced in the first place. It complicated the income tax system and was poorly targeted on those it was claimed to help” (Chote, 2008).

The only logical reason to decide on a new rate rather than simply adjusting thresholds is therefore a political one – that voters are more likely to notice that they are paying a new rate and therefore to reward a political party for their tax cut. From an economic perspective though, there is no rationale for a policy such as this – and exactly the same logic applies to UKIP’s proposed new 35 per cent tax between £42,000 and £55,000 too (O’Flynn, 2014). It would be far simpler to propose a significant increase in the higher rate starting threshold, which would achieve the same stated objective of correcting for the significant fiscal drag seen in this Parliament⁴.

4 Of course, raising a threshold can never replicate the creation of a new rate of tax for every family. However, the same broad objective of lightening the burden of higher-rates of tax on those whose incomes have increased can be achieved either way.

- **Increasing the additional rate:** the Labour party has pledged to increase the additional rate of income tax back to 50 per cent from its current level of 45 per cent. According to existing research from HMRC – signed off by the Office for Budget Responsibility – this would take the additional tax rate above a revenue maximising rate of 48 per cent (HMRC 2012). Cutting the 50p rate to 45p, as implemented by George Osborne, therefore was only estimated to reduce the exchequer revenues by around £100 million after behavioural effects, including steps to avoid the tax, had been considered. Early indications after the tax was implemented suggested that the behavioural effects might be more significant still. In pure revenue terms, HMRC figures show that in 2011/12 and 2012/13 the amount collected from top income taxpayers was £41.3 billion and £41.6 billion respectively under the 50p rate before jumping to £49.4 billion in 2013/14, when the top rate was cut to 45p. Some of this effect was no doubt due to the impact of forestalling, but at the very least the ease with which individuals were able to change their tax affairs suggests that high income individuals are highly responsive to tax rates.

From an economic perspective, the key assumption in assessing the revenue effects of tax changes is the ‘taxable income elasticity’ – that is how much taxable income changes as the tax rate changes. The economic literature in this area suggests a figure of between 0.4 and 0.7. HMRC’s central estimate uses a figure of 0.45. There is considerable uncertainty around the true figure here, but with an increasingly mobile high-income class it is well within the realms of possibility that the true responsiveness is higher than the estimate used in the HMRC work, meaning that reinstating the 50p rate could even reduce the tax yield. At best we can have no real idea how much re-establishing a 50p tax rate would raise – and the central view currently held by economists is ‘little to nothing’. The Labour party’s working assumption is that it will raise £3 billion.

Recommendations

None of the proposals of the political parties deal with the key problems in the personal tax system – indeed, they may well make the system more complex and less coherent.

As outlined above, the long-term aim of policy should be to move towards a simple, coherent personal tax system which is as flat as possible. The way this interacts with the tax credit and benefit systems should also be carefully assessed. Below is a series of steps that could be taken to get us closer to a coherent personal tax system. Some of these measures would need radical policy changes on other fronts but others involve changes that would have a relatively small fiscal costs.

- 1) Significant reductions in government spending:** tax reform without tax cuts is extremely difficult and this ultimately requires significant spending cuts. A reduction in government spending to between 30-33 per cent of GDP would allow marginal rate cuts across all levels of income as well as the possibility of moving somewhere closer to a flat tax. Booth et al (2011) set out how spending cuts of this magnitude could be achieved.
- 2) Abolish the savings income allowance:** the savings income allowance is little known about, creating significant confusion and with low reported levels of claims.⁵ The government has proposed to reduce the current 10 per cent rate to 0 per cent next year. But with recent significant rises in the personal allowance, the savings income allowance should just be abolished altogether as a simplification measure.

⁵ See, for example, ThisIsMoney.co.uk (2013) 'Battle to keep the 10p savings tax: Pensioners must claim back overpayments to stop preferred rate being scrapped'.

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- 3) Equalise income tax and national insurance thresholds as a first step to abolition of national insurance contributions:** as has been documented, the contributory principle of the national insurance system has largely ceased to exist. In the long-term, complete abolition of national insurance and the rolling up of these taxes into one single tax on labour income is sensible – though as Heath et al (2012) made clear, this will require a careful phased transitioning and steps to deal with anomalies surrounding pensioners and the self-employed.

A good first step would be equalisation of the employee NICs and income tax thresholds. There would need to be a significant rise in the allowance above which earners are required to pay employee NICs to equalise it with the income tax personal allowance. When merging the NICs and income tax systems, it will be necessary to adjust NICs to be levied on an annualised basis and to be levied on a per-person basis (rather than a separate allowance per job, as currently).

- 4) A negative income tax for the low paid with family-based allowances:** to improve incentives currently faced by those near the bottom of the earnings scale, a fundamental reform of the welfare system (including tax credits) is necessary. The government's universal credit reforms will eliminate the very extreme effective marginal tax rates faced by some households at the moment. However, marginal tax rates for households with children will still be as high as 76 per cent as tax credits are withdrawn. In order to achieve much lower marginal tax rates, the government should overhaul the welfare system and introduce a form of negative income tax. This would eliminate 'fiscal churning' whereby millions of households currently receive income-related transfer payments whilst also simultaneously paying income tax. If a household earned below their tax allowance they would receive a payment from the government (a 'negative tax') and, if they earned above their allowance, they would pay tax. The household tax-free allowance would vary by household type with allowances for adults and children within the household. For example, if the allowance for a childless couple is £18,500, it could be £28,000 for a couple with two children, and £12,100 for a single adult. This would simplify the system, remove 'fiscal churn', end the discrimination against single-earner couples and against family formation and remove the very high marginal rates households with children often face today. Because child benefit and the transferable tax allowance would be rolled into this system, this would also mean that other anomalies in our current marginal tax rate structure, such

as the child benefit taper and (from next year) the withdrawal of the transferable tax allowance would not occur. For more details of how this might work, see Niemietz (2010).

- 5) **An end to fiscal drag:** to protect taxpayers from fiscal drag, there should be a statutory 'lock' on tax thresholds – such that they are increased by average wage levels each year. Given the significant fall relative to earnings, there is a strong case for a significant increase in the higher rate threshold now. Alternatively, a 'double lock' of increasing tax thresholds by the higher of price and wage increases could operate for a decade or more.

- 6) **Abolish the personal allowance withdrawal:** the withdrawal of the personal allowance above £100,000 creates an extremely high 62 per cent marginal tax rate as well as additional complexity. This withdrawal policy should be abolished entirely in time, at an annual revenue loss of between £1.5 billion and £2 billion.

- 7) **Abolish the 45p rate:** it is likely that the abolition of the highest rate of tax would come at only a modest fiscal cost. Indeed, some bodies such as the CEBR have estimated that the 45p rate is already above a revenue maximising rate, which they estimate is likely to be less than 40p (CEBR, 2011). There is significant disagreement about the assumptions which generate this result. However, the aim of tax policy should not be to maximise government revenues. The abolition of the 45p tax rate would, in the long-term, help achieve the other objectives set out in this briefing.

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