

Resolution Foundation

Analysing the impact:

*Increasing the personal tax allowance
to £10,500 in 2015*

A Resolution Foundation briefing paper

Alex Hurrell

March 2014
© Resolution Foundation 2014



(1) Analysing the impact of increasing the PTA to £10,500 in 2015

Who gains?

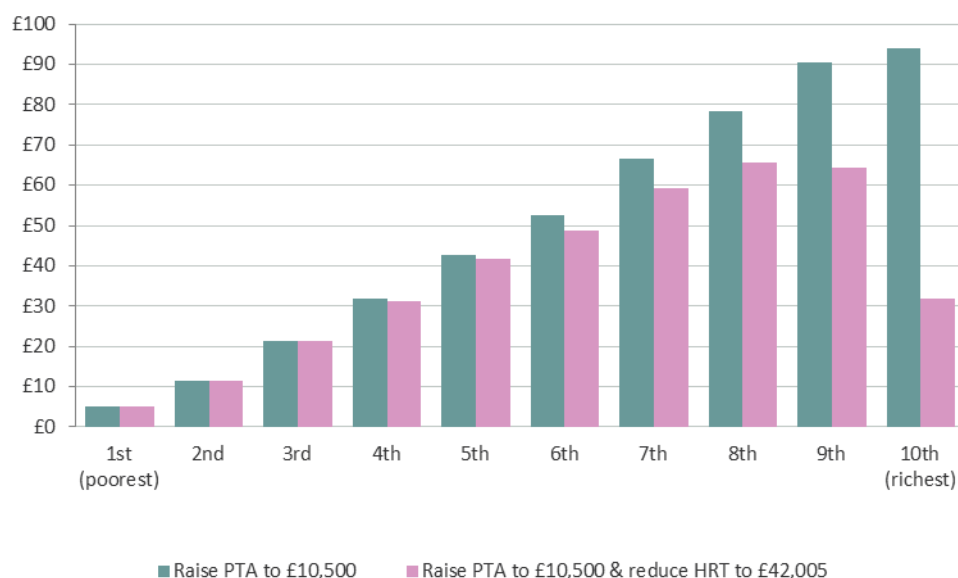
Under current plans, the PTA will reach £10,220 in April 2015. Based on our analysis using the IPPR's tax-benefit model, we estimate that increasing the PTA to £10,500 would lift roughly 200,000 people out of income tax and result in a modest reduction in income tax for 25 million workers at an annual cost of £1.4 billion. This assumes that the HRT remains fixed at £42,285 (i.e. in line with the current 1% uprating policy), ensuring higher rate taxpayers do not gain any more than those on the basic rate.

This policy would therefore mean that anyone earning between £10,220 and £10,500 a year would no longer pay income tax, though they would continue to pay national insurance contributions (NICs). In other words, this would add a further 200,000 to the just fewer than five million earners who already don't pay any income tax. The average annual benefit to those taken out of tax would be £26; whereas the average annual gain among those who continue to pay tax would be £56.

Chart 1 below shows the difference in average disposable income (in this case exactly equivalent to the change in average income tax) for each decile as a result of the policy. The deciles are defined across all households on the basis of equivalised net household income. The gains are smaller for those taken out of tax because these people are only paying very small amounts of tax to begin with, and so have less to gain from tax cuts.

Chart 1: How are the gains from raising the PTA distributed across the income distribution?

Change in average income tax and NICs by decile (annual)



Contrary to the oft-cited claim that this measure is targeted at lower income households, approximately three quarters of the cash gains from raising the PTA go to those in the top half of the income distribution, with only a tiny element of the cost of the policy actually spent on lifting people out of income tax altogether. Raising the PTA to £10,500 in 2015 is therefore a very regressive policy, although it could be made less regressive if the gains to Higher Rate taxpayers are withheld, i.e. by reducing the HRT by the same amount as the PTA increase (£280). This measure would also reduce the cost of the policy (to £1.1 billion).

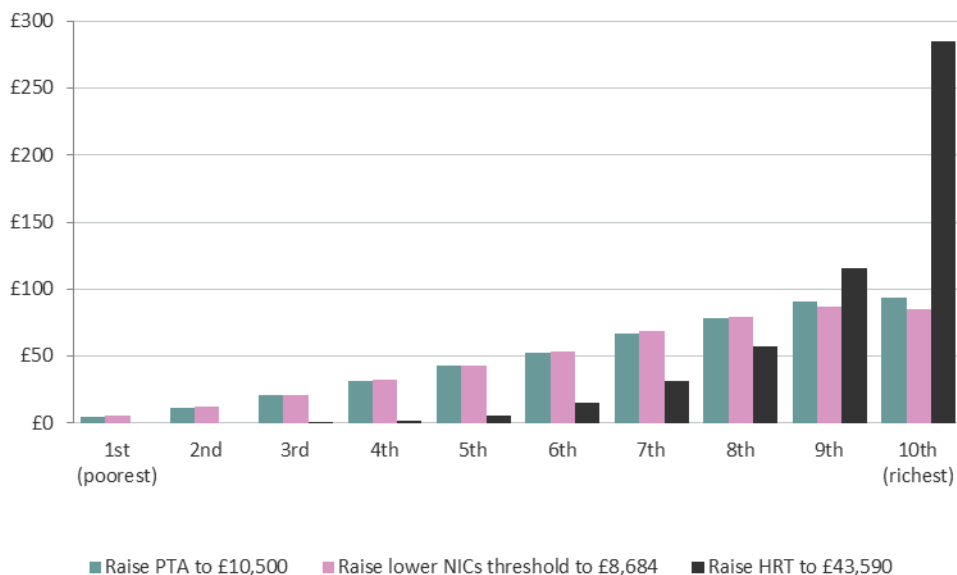
Alternative options

We compared the effects of spending the same sum of money (£1.4 billion) on two alternative tax reforms: (1) raising the threshold at which workers have to pay National Insurance Contributions (NICs); and (2) raising the higher rate tax thresholds so that fewer people get dragged into the 40 pence rate.

Chart 2 compares how the gains of each of these alternative policies are shared across the income distribution. Like the previous chart, the deciles are defined over households on the basis of equivalised net household income.

Chart 2: How do the distribution of the gains compare across the alternative policies?

Change in average income tax and NICs by decile (annual)



Under the first alternative, if the threshold at which earners pay NICs was raised from £8,112 (£156 a week) to £8,684 (£167 a week) then 250,000 workers would be removed altogether from NICs. The resulting average annual benefit for this group would be £34. There would also be about 21 million workers who continue to pay a reduced amount of NICs as a result of the change. Their average annual gain would be £69. As with raising the PTA, most of the gains still go to households in the top half of the distribution, though as Chart 2 indicates, it is a bit less regressive.

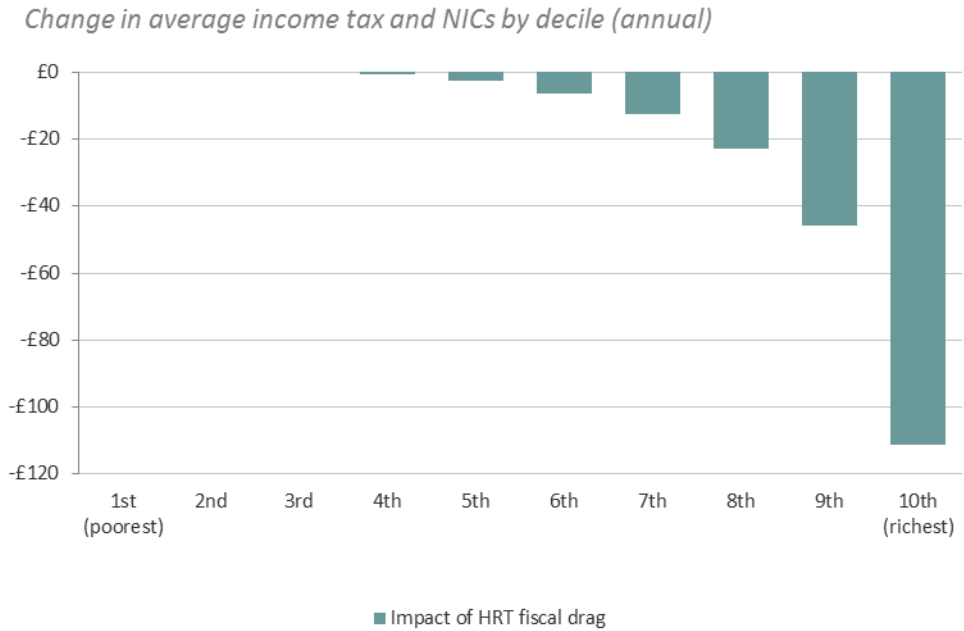
Under the second option, if the threshold at which the 40 pence rate of tax applies was raised to £43,590 this would remove roughly 350,000 taxpayers from the 40p tax bracket. Using a baseline that assumes two years of 1% uprating of the HRT (in 2014/15 and 2015/16) results in a total of over 5 million 40p rate (and additional rate) tax payers. Spending £1.4bn to increase the HRT to £43,590 reduces this number to around 5 million. The average annual gain to these 5 million tax payers would be £259.

Chart 2 shows that raising the HRT is highly regressive. In fact more than half of all the gains from this increase in the HRT would go to the richest 10% of households.

It is important to note, however, that this rise in the higher rate threshold would in part simply reverse the effects of “fiscal drag” on the HRT (the 1% uprating) which is pulling a growing number of earners into the 40p tax bracket as well as increasing the income tax-bills of those already paying 40p. It is also important to note that the cost of this fiscal drag is falling heavily on the richest 10% of households (just as the gains from a higher HRT disproportionately go to the same group).

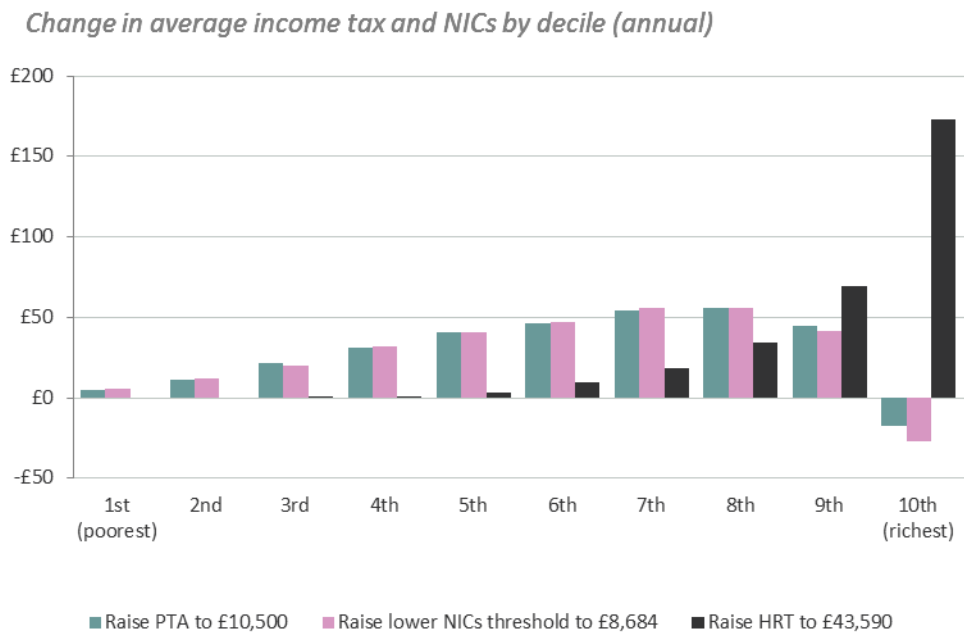
Chart 3 below illustrates exactly this point. It shows that the costs of “fiscal drag”, i.e. of uprating the HRT by 1% rather than CPI, fall disproportionately upon those at the top of the income distribution.

Chart 3: Who loses from “fiscal drag”?



The final chart (Chart 4) below shows the net effect of the fiscal drag in combination with a PTA, NICs threshold or HRT increase. It shows that spending £1.4 billion to increase the HRT to £43,590 more than offsets the impact of the second year of fiscal drag, and therefore still remains highly regressive. By contrast, while the net effect of fiscal drag when combined with raising the PTA or NICs threshold will continue to disproportionately benefit those in the top half of the distribution (receiving almost two-thirds of the gains), households in the top 10% are worse off as a result.

Chart 4: Who gains/loses from the combination of fiscal drag and a PTA, NICs threshold or HRT increase?



(2) Understanding how increases to the personal tax allowance affects taxpayers

How the system works

The amount of income tax an individual pays is principally determined by two key elements of the tax system: the personal tax allowance (PTA) and the basic rate limit (BRL). Added together, these two produce the higher rate threshold (HRT). The PTA is the point at which people start paying income tax (at the 20p rate), while the HRT is the point at which people become liable to pay the 40p rate. To allow for the effect of rising prices and nominal wages, the default uprating approach is to increase each of these parameters in line with inflation (previously RPI, now CPI, as measured in the prior September).

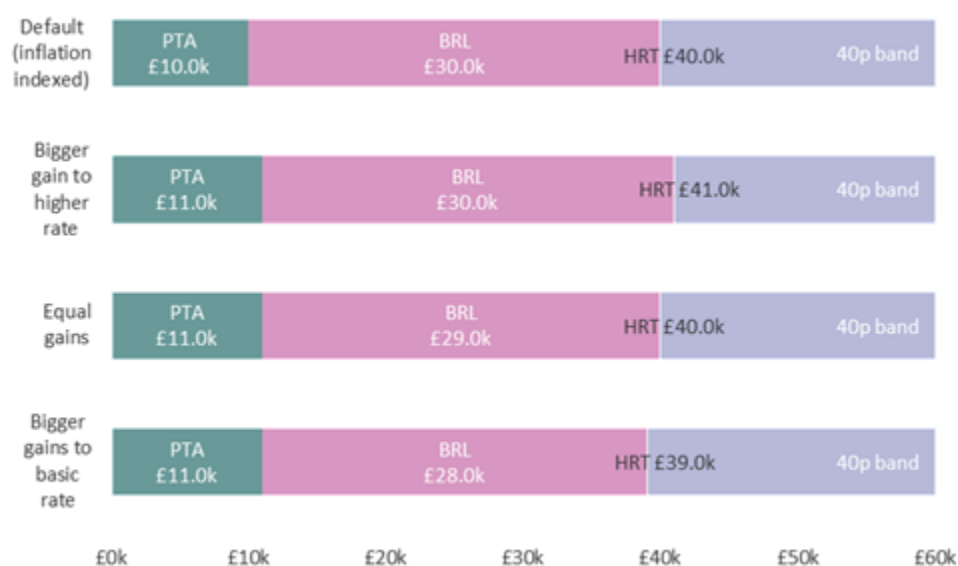
However, in recent years the Government has explicitly pursued a policy of above-inflation PTA rises in order to take the lowest earners out of income tax. What is less well understood is that each time the Government raises the PTA by more than inflation, how the gains of this policy are spread across taxpayers is determined by what it chooses to do to the BRL (and consequently the HRT). Specifically, it has three broad choices:

1. **GIVE HIGHER RATE TAXPAYERS A LARGER GAIN THAN BASIC RATE TAXPAYERS:** If the Government maintains the default (i.e. inflation indexed) size of the BRL (and therefore lets the HRT rise above its default in line with the above-default increase in the PTA) then higher rate taxpayers gain twice as much as basic rate taxpayers from the move, because their marginal tax rate is 40p rather than 20p.
2. **GIVE THE SAME CASH GAIN TO BASIC AND HIGHER RATE TAXPAYERS:** If it reduces the BRL (compared to the inflation indexed default) by the same amount as it increases the PTA (compared to default) and therefore fixes the HRT (in line with the default), then all basic rate and higher rate taxpayers (up to the point at which the PTA is tapered away for the highest earners) receive the same cash gain.
3. **GIVE BASIC RATE TAXPAYERS A LARGER GAIN THAN HIGHER RATE TAXPAYERS:** If it reduces the BRL (compared to the inflation indexed default) by twice as much as it increases the PTA (compared to default) and therefore lowers the HRT (compared to default) by the same amount as it raises the PTA (compared to default), then higher rate taxpayers gain nothing from the PTA move and all of the benefit is focused on basic rate taxpayers (above the PTA).

Worked example

Using indicative numbers, the chart below provides examples of how these three choices play out in practice. Compared to the default (top line), we increase the PTA by £1k in each instance.

1. **Bigger gains to higher rate taxpayers:** In the second line, we keep BRL at £30k and therefore increase the point at which higher rate tax is paid and benefit higher rate taxpayers by twice as much as others. A basic rate taxpayer would gain £200 (20% x £1k), whereas a higher rate taxpayer would gain £400 (40% x £1k).
2. **Equal gains:** In line three, we reduce the BRL by £1k and thereby fix the HRT and create equal gains (£200) across basic and higher rate taxpayers.
3. **No gains to higher rate taxpayers:** In line four, we reduce the BRL by £2k and therefore reduce the HRT by £1k and remove all of the gain from higher rate taxpayers.



Recent history

Since embarking on a policy of increasing the PTA above inflation, the coalition government has used a mixture of approaches ranging between equal gains and focusing the entirety of the giveaway on basic rate taxpayers. In April 2011, they lowered the HRT in line with the increase in the PTA in order to benefit basic rate taxpayers but not higher rate ones (directly increasing the number of higher rate taxpayers). In April 2012, they froze the HRT in order to create an equal cash gain for basic and higher rate taxpayers (increasing the number of higher rate taxpayers via fiscal drag only). In April 2013, they lowered the HRT in order to reduce (but not entirely remove) the gain to higher rate taxpayers (directly increasing the number of higher rate taxpayers). The original PTA announcement came in Budget 2012 and involved a lowered HRT in order to provide partial gains to higher rate taxpayers and full gains to basic rate ones.

It was then announced at the 2012 Autumn Statement there would be an additional increase in the April 2013 PTA, with the benefit of this increase being equally shared across basic and higher rate taxpayers. At this time the Government also set out a decision to increase the HRT in April 2014 and April 2015 by 1% (instead of the inflation default), raising it to £41,865 in 2014 and £42,285 in April 2015 (increasing the number of higher rate taxpayers via fiscal drag).

When announcing in Budget 2013 an above-inflation increase in the PTA to £10k in April 2014, the Government did not factor in any associated change in the BRL/HRT, but the difference between the inflation default and the 1% uprating more than offsets the gains associated with the PTA.

April 2015

From April 2014, the PTA will be £10,000. The basic rate limit (BRL) will be £31,865, producing a higher rate threshold (HRT) of £41,865. Based on the OBR's latest projection for CPI in September 2014, the PTA is expected to rise to £10,220 in April 2015. As noted above, the level of HRT has already been determined (£42,285) due to the 1% uprating policy.

If the Government were to opt for a PTA of £10,500 instead, it could – in theory – reduce the HRT by an equivalent amount (£280). But the 1% uprating policy already implies a reduction compared to inflation default of more than £280, so it might once again decide not to take any further action beyond the PTA increase.

In the next section we analyse the distributional impact of increasing the PTA to £10,500, and contrast this to alternative options that would cost the same amount.

The Resolution Foundation

The Resolution Foundation is an independent research and policy organisation. Our goal is to improve the lives of people with low to middle incomes by delivering change in areas where they are currently disadvantaged. We do this by:

- undertaking research and economic analysis to understand the challenges facing people on a low to middle income;
- developing practical and effective policy proposals; and
- engaging with policy makers and stakeholders to influence decision-making and bring about change.

For more information on this Briefing Note contact:

Alex Hurrell, Senior Analyst
alex.hurrell@resolutionfoundation.org
020 3372 2983

