Dan Neidle

Britain's tax system is a mess

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THE SPECTATOR

The last time a Conservative Chancellor was in the business of cutting taxes, he pointed out that they reduce the incentive to work, invest, and start a business. This was why Kwasi Kwarteng proposed to abolish the 45 per cent additional rate of income tax last year.

He was right about the impact taxes have on incentives, but he was wrong to focus on 45 per cent as the highest rate of tax people pay in the UK. In fact, there are millions of

We really, really, shouldn't have a tax system that can have a 68 people paying a marginal tax rate (the percentage of tax you'll pay on the next pound you earn) of more than 60 per cent. And hundreds of thousands pay much more. Some are even on a 100 per cent marginal tax rate, so that they don't keep any extra money they earn.

per cent marginal rate, let alone a 20,000 per cent one

For those earning £125,000 or more, the marginal rate in theory caps out at 47 per cent. That's 45 per cent on income tax plus 2 per cent on national insurance (and a bit more in Scotland, where all the marginal rates are slightly higher).

I'm not terribly convinced this rate prevents anyone taking on additional work. After all, you still get to keep more than half of any additional earnings.

But people earning much less than £125,000 can end up with a considerably higher rate, thanks to four effects:

- Child benefit starts to be phased out once your salary hits £50,000, and you get no child benefit at all once it hits £60,000.
- The personal allowance – the amount we earn before income tax kicks in – starts to be phased out if your salary hits £100,000, and is gone completely by £125,000.
- Student loan repayments.
- And the various government childcare schemes, which disappear completely once your income reaches £100,000.

For a family with three children, the marginal tax rate for a given salary looks like this:

UK marginal tax rate for single earner, family of 3 kids

Includes simple student loan modelling

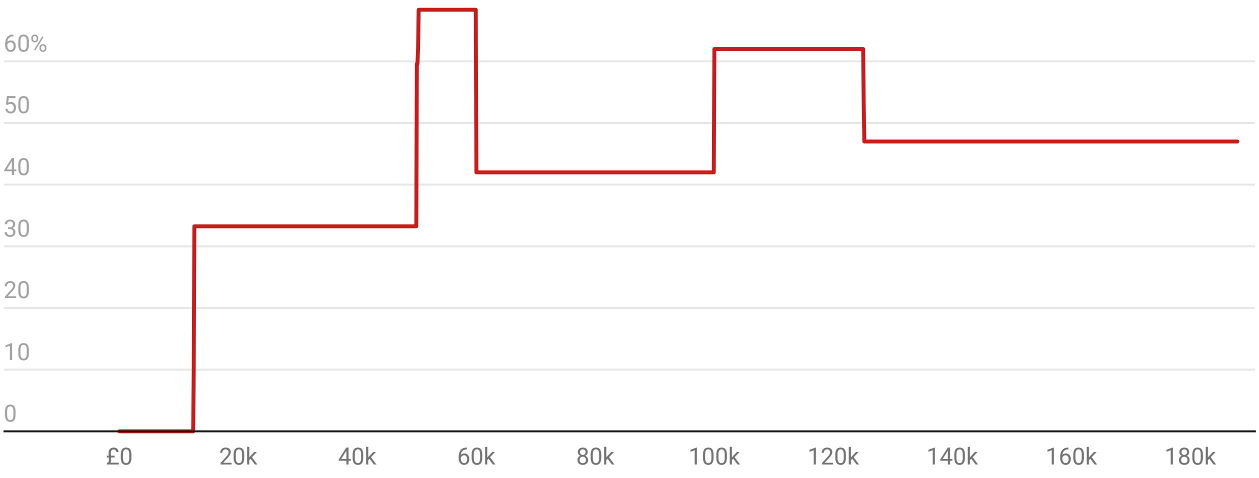

Chart: The Spectator (QG4KL) • Source: Tax Policy Associates • Get the data • Created with Datawrapper

That bump between £50,000 and £60,000 is a 68 per cent marginal tax rate, meaning that for every additional £1,000 you earn gross, you take home £320.

Now let's look at it in a different way. Imagine you work 1,500 hours a year and earn £50,000. That translates to about £38,000 after tax. Which means you earn £33 an hour before tax, and £25 an hour after tax. Perhaps you'd like to work another 200 hours a year for the same hourly rate. But if you did this, because of the high marginal tax rate, you would end up earning £10 an hour instead. You may well not think that's worth your while. And, given that £10 an hour is less than minimum wage, if you need childcare cover then you could end up out of pocket.

The bump in the graph above between £100,000 and £125,000 is what happens when the personal tax allowance is phased out. Though this is less dramatic, it still results in people ending up with a 62 per cent rate.

We are, however, just getting started.

We need to add on student loans – in reality just a complicated hidden graduate tax. For someone starting university before 2012, you pay 9 per cent of your salary on anything over £20,184 until the loan is repaid. The precise effect will vary depending on an individual's educational and salary history – but, as a rule of thumb, many people in their early 30s will end up with the same marginal rates as in the chart above, but with an extra 9 per cent. That 68 per cent top marginal rate becomes 77 per cent.

That problem, however, is dwarfed by the dramatic 'cliff edge' created by the government's increasingly generous childcare schemes. These can be worth over

£20,000 a year to a family with two small children living in London. But the moment your salary hits £100,000, you become ineligible.

That sends the marginal rate when you hit £100,000 off the chart (literally: the marginal rate becomes 20,000 per cent). The whole concept of marginal rates breaks down when earning a penny more than £99,999.99 costs you £20,000.

This is clearer if we plot gross income versus take-home income:

Uk gross wages vs take-home pay

for single earner, family of two kids inc new childcare scheme

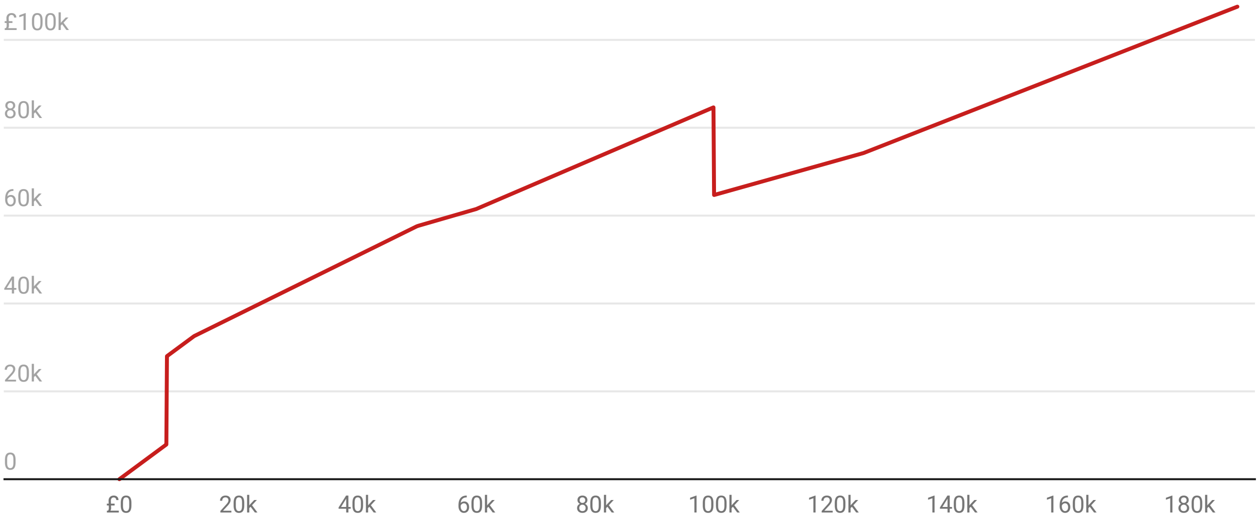

Chart: The Spectator (c891f) • Source: Tax Policy Associates • Get the data • Created with Datawrapper

As you can see here, someone's after-tax income drops calamitously at £100,000, and doesn't recover to where it was until their gross salary hits £145,000.

If a political party went into an election promising a tax system like this, there would be uproar. But instead, we've drifted into this disaster over many years, and the topic is absent from almost all political debate. The Conservative party mostly doesn't talk about these high marginal rates – perhaps because they're too embarrassed to admit it's a system they created. Labour doesn't talk about it either – perhaps because they're too embarrassed to appear to care about anyone earning more than £50,000.

The people affected are well aware of the mess they've been landed in. They react rationally. The employed use salary-sacrifice schemes or even refuse promotions to make sure they aren't impacted. The self-employed turn away work or top up their pensions instead (although that's not straightforward when your hours and earnings are unpredictable).

And it's entirely plausible that these effects are more than an inconvenience for those affected and, across the economy as a whole, act as a brake on growth.

It would cost about £6.6 billion to scrap the personal allowance and child benefit tapers. This is about the same as abolishing inheritance tax, but with a much clearer – and wider – benefit. As for the lunacy of the £100,000 childcare cliff-edge, surely it's better to let the well-off qualify, and then recoup the cost by adjusting income tax thresholds (for example reducing the point at which the additional rate kicks in).

There are certainly other alternatives. But the important thing is that we really, really, shouldn't have a tax system that can have a 68 per cent marginal rate, let alone a 20,000 per cent one.

The question is whether there are any politicians honest enough to admit we have a problem here, and brave enough to actually do something about it.

WRITTEN BY

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