Income Tax Personal Allowance

The impact of changes on living standards

Introduction

This paper examines income tax personal allowance and the impact of changes in the allowance on living standards. All political parties say that they want to assist low and middle income people. The last government sought to do this by in-work tax credits. This government has tried to do so by tax cuts. In May 2010 the Coalition Agreement set out the government's plan to make the first £10,000 of income free from income tax.

By way of context, we are still in a state of fiscal tightening for the medium to long term. The OBR forecast in March 2014 sets out that public sector net borrowing is set to fall by 11.1 per cent of GDP over the nine years from 2009-19 (around £180bn in today's terms) to -£4.8bn in 2017-2018. Under the Chancellor's plans around 80 per cent of this fiscal tightening will be accounted for by lower public spending[1]. The Conservative Party has also recently announced its proposal that if it wins the next election there will be a further round of significant spending cuts.

Yet despite these cuts, in May 2010 the Coalition Agreement set out the government's plan to make the first £10,000 of income free from income tax. In 2010/2011 the income tax personal allowance (the total amount of income that can be earned tax free) stood at £6,475. From 2011/2012 the personal allowance started to increase. In April 2014 the personal allowance will be further increased from the 2013/2014 level of £9,440 to £10,000. Budget 2011 set out that once it reached £10,000 it would increase in line with the Consumer Price Index from 2015/2016[2] and Budget 2014 announced a further rise to £10,500 in 2015/16. Both the Conservatives and Liberal Democrats have suggested that they would like to see the allowance rise even further. It has been reported that a further increase in the personal allowance to £12,500 may be an election pledge of both the Conservatives and the Liberal Democrats[3].

The government said in the December Autumn Statement a 'typical basic rate taxpayer will pay £705 less income tax per year in cash terms than they would have in 2010-11, leaving them over £500 per year better off than under pre-2010 plans'[4]. The Autumn Statement went on to say that 'by April 2014, 2.7 million low income individuals will have been lifted out of income tax altogether since 2010, and 25.4 million individuals will have benefited from the increases in the income tax-free threshold'[5].

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[1] Office for Budget Responsibility, Economic and Fiscal Outlook, December 2013 http://cdn.budgetresponsibility.independent.gov.uk/Economic-and-fiscal-outlook-December-2013.pdf

[2] HMRC, Income tax personal allowance for those born after 5 April 1948 and basic rate limit for 2014-15, http://www.hmrc.gov.uk/budget2013/tiin-2531.pdf

[3] Hood, Joyce and Phillips, Policies to help the low paid, IFS, 2014 http://www.ifs.org.uk/budgets/gb2014/gb2014_ch7.pdf

[4] HMT, Autumn Statement, December 2013, p. 64 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/263942/35062_Autumn_Statement_2013.pdf

[5] Ibid., p. 64

These changes have been introduced in the context of significant wider reductions in support for working families. Since 2010 there have been many tax credit cuts and 'reforms' of social security benefits[6], with the majority of reductions falling on those who are in work. The Conservatives have said that if they win the next election they will cut a further £25bn from public service spending, which will bring it to its lowest level since 1948.

The Conservatives have also announced that reductions in public spending could fund lower taxes if they win the next election, with some senior conservatives calling for the 40 per cent tax rate threshold to be raised to £44,000 in the future[7].

This paper looks at the technicalities of income tax personal allowance, before turning to who benefits from this policy change, and the impact of it, including some of the policy 'side effects'. It finishes by looking at some measures that would be more effective as a means to lift the living standards of those on low incomes.

The technicalities of the personal allowance and UK income tax

Recent increases in the personal allowance have been at a significant cost to the Chancellor. Corlett says increases up to £10,000 have cost £10.75billion per year[8]. The Treasury calculate that the Chancellor's most recent personal allowance rise (which extends to those in the 40% tax bracket) is set to cost £1.4 bn in 2015/16. Although this money has gone directly to UK taxpayers there are, as this briefing goes onto discuss, arguably more efficient ways of directing such significant sums of money at those living on low incomes.

Under the UK tax system some earned income is taxable and some is non-taxable, with income tax not paid on earnings below the personal allowance threshold.

Above the personal allowance the basic rate tax (of 20 per cent of income) is payable up to £32,010 of income in tax year 2013/14. This amount is set to fall to £31,865 in 2014/15.

The higher rate tax band, the level of income at which taxpayers pay the 40 per cent higher rate of tax, will be £31,866- £150,000 in 2014/15. However, 'the higher rate threshold' (the point at which people start paying the 40 per cent rate) is £41,865 which is the personal allowance of £10,000, plus the basic rate limit of £31,865. As the personal allowance has increased more quickly than the basic rate limit has declined, higher rate taxpayers have shared in some of the benefits from reduced starting rates of income tax.

The income limit for personal income allowance stands at £100,000 in 2014/2015, and is reduced by half of the amount - £1 for every £2 earned – that is over this limit. This means that for the very highest earners there is no personal

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[6] TUC, Keeping up with the cuts, January 2014, https://www.tuc.org.uk/sites/default/files/Keepingupwiththecuts.pdf
[7] http://www.bbc.co.uk/news/uk-politics-26427370
[8] Corlett, Making Allowance: Tax cuts for the squeezed middle, Centre: Forum, January 2014 http://www.centreforum.org/assets/pubs/making-allowances.pdf

allowance. The additional rate tax band of 45 per cent band is for income over £150,000.

The following table shows how the income tax rates have changed since 2010 and sets out some noteworthy changes. Higher rate thresholds (the point at which the 40p rate is paid) fell between 2010/11 and 2011/12 and stayed the same from 2011/12 to 2012/13. They fell again over last year (2013/14) and are then forecast to rise slightly in 2014/15. In the year prior to 2010/11 these thresholds were uprated in line with inflation, so the cut and then freeze has meant that for those earning over £42,275 the personal allowance gains over this period have been slightly offset by an increased amount of income being subject to the 40p tax rate (although this was the case to a greater extent in 2010/11 than in 2011/12) but that from 2013/14 higher earners will benefit from personal allowance gains.

Over the same period thresholds for basic rate taxpayers fell every year, meaning the upper rate of income at which low to middle income earners pay the basic rate has decreased.

These trends mean that those who were already earning above the personal allowance in 2010/11 have seen some benefit from the policy. In contrast those who were on incomes around £40,000 who saw their pay rise over this period will have gained less, as they have had to pay the 40p rate on a higher proportion of their income than would have been the case had the basic rate limit been increased.

This demonstrates the limitations of using this policy to target income improvements for those on low incomes, as inevitably all earners gain from the increased personal allowance unless there are corresponding decreases in higher rate thresholds. However, these reductions come with political challenges, as while reducing the personal allowance benefits for high earners they also reduce them for those whose earnings are close to the threshold.

Income tax allowances over time

£	**2010-11**	**2011-12**	**2012-3**	**2013-4**	**2014-15**
Personal Allowance	6,475	7,475	8,105	9,440	10,000
Basic Rate Limit	37,400	35,000	34,370	32,010	31,865
Higher Rate Threshold	43,875	42,475	42,475	41,450	41,865

The following table shows examples of people earning £99,000, £50,000, £25,000 and £8,000 and how much income tax they would pay in the years from 2010/11 to 2014/15, based on fixed total earnings.

Income tax liabilities by income level over time

	2010-11	2011-12	2012-3	2013-4	2014-15
Earnings £	**99,000**	**99,000**	**99,000**	**99,000**	**99,000**
Tax Paid £	29,530	29,610	29,484	29,422	29,227
Earnings £	**50,000**	**50,000**	**50,000**	**50,000**	**50,000**
Tax Paid £	9,930	10,010	9,884	9,822	9,627
Earnings £	**25,000**	**25,000**	**25,000**	**25,000**	**25,000**
Tax Paid £	3,705	3,505	3,379	3,112	3,000
Earnings £	**8,000**	**8,000**	**8,000**	**8,000**	**8,000**
Tax Paid £	305	105	-	-	-

These calculations show that the amount of income tax paid by the lowest earners, earning £8,000, has decreased since 2010/11 and now they no longer pay income tax. The amount paid by the £25,000 earner, the £50,000 earner and the £99,000 has also decreased. Our calculations (based on fixed incomes) show that in percentage terms, higher rate tax payers pay a greater percentage of their income than basic rate tax payers. In monetary terms our analysis shows that from 2014/15 someone earning £99,000 pay £195 less tax and basic rate payers will pay £112 less in tax. These findings are shown below.

Effective income tax rates by income level over time

	2010-11	2011-12	2012-3	2013-4	2014-15
£99,000 *earner*					
Total tax paid	**£29,530**	**£29,610**	**£29,484**	**£29,422**	**£29,227**
Effective tax rate	29.83%	29.91%	29.78%	29.72%	29.52%
£50,000 earner					
Total tax paid	**£9,930**	**£10,010**	**£9,884**	**£9,822**	**£9,627**
Effective tax rate	19.86%	20.02%	19.77%	19.64%	19.25%
£25,000 earner					
Total tax paid	**£4,010**	**£3,610**	**£3,379**	**£3,112**	**£3,000**
Effective	16.04%	14.44%	13.52%	12.45%	12.00%

tax rate					
£8,000 earner					
Total tax paid	**£305**	**£105**	**None**	**None**	**None**
Effective tax rate	3.81%	1.31%	0%	0%	0%

So, while raising the personal allowance means that those on the lowest earnings pay no tax at all, the policy also helps those all the way up the income scale by reducing the amount they pay as tax on the first part of their earnings.

Hirsch's analysis also finds that it is higher income households who benefit most, stating that:

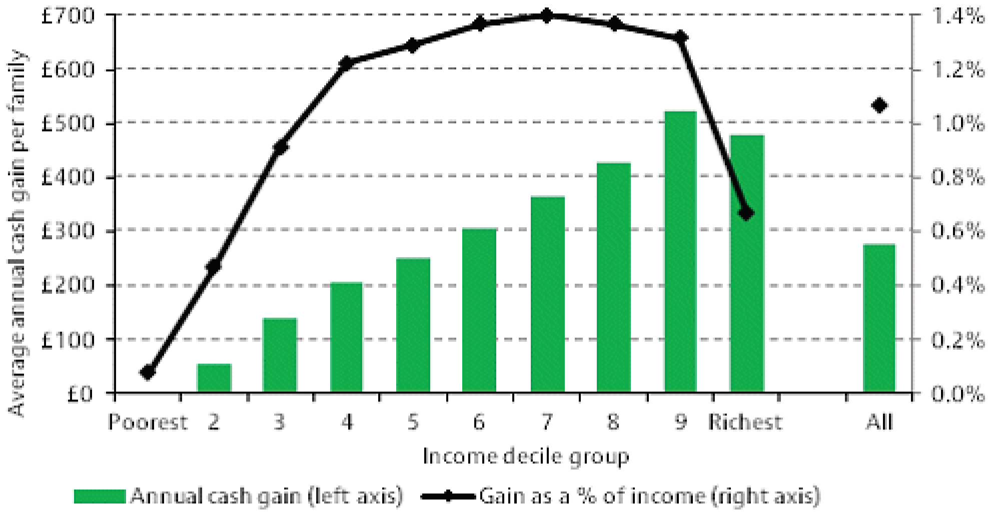
> *'even if under the most progressive approach that can be taken (limiting the gains to basic rate taxpayers by lowering the threshold for 40p tax), the greatest gains, proportionate to their income, go to households in the upper middle part of the distribution... This is partly because tax cuts do not benefit people who are not working or who are working but already earning too little to pay tax. It is also because relatively higher income households are more likely to contain two earners, therefore benefiting twice from a tax cut.'*[9]

The following graph, by the Institute for Fiscal Studies (IFS) is from 2012 and is based on the personal allowance increase to £10,000[10].. It shows that those in the middle to upper household income deciles benefit disproportionately from this policy change. This is in part because tax cuts do not benefit those who are not working and partly because they do not benefit people who work but earn too little to pay tax. IFS's analysis found that families with two taxpayers will gain most in cash terms from the increase in personal allowance, and therefore benefit twice from a tax cut, while families with one taxpayer tend to be worse off.

[9] Hirsch, Will future tax cuts reach struggling working households?, Resolution Foundation, April 2013 http://www.resolutionfoundation.org/media/media/downloads/Will_future_tax_cuts_reach_struggling_working_households.pdf p.4-5

[10] http://www.ifs.org.uk/publications/6045

Distributional impact of increasing personal allowance to £10,000 in 2012-13, by income decile group



More recent research, also by IFS, similarly found that income tax personal allowance is not progressive when you consider data at the family level. It showed a similiar pattern that families at the higher end of the income scale would gain more from an increase in the tax allowance to £12,500[11].

When you reach State Pension Age you no longer pay National Insurance contributions, but do not automatically stop paying income tax. There is currently an Age Related Allowance (ARA) (the 'granny tax' the government recently moved to reduce) before you pay income tax, which differs from the income tax personal allowance for people born after April 1948. But if taxable income, including the state pension, exceeds your tax free allowances you may still have to pay tax. In 2014/15 the ARA will be £10,500 for people born between 6 April 1938 and 5 April 1948 and £10,660 for those born before 6 April 1938.

In Budget 2012 the Chancellor announced his intention to scrap ARAs. From 6 April 2013 existing ARAs were frozen at their 2012–13 levels (£10,500 for those born between 6 April 1938 and 5 April 1948, and £10,660 for those born before 6 April 1938). This freezing will continue until the ARA aligns with the income tax personal allowance. This will mean simplification of the tax rules so that the ARA will no longer exist and everyone has the same tax break regardless of their age. In this scenario those under 65 will be affected by the allowance in the same way as for working age earners.

[11] Hood, Joyce and Phillips, Policies to help the low paid, IFS, 2014 http://www.ifs.org.uk/budgets/gb2014/gb2014_ch7.pdf

The impact of the increase in the personal allowance

The introduction of the Universal Credit (UC) from 2014/15, a new single payment which will replace six separate benefits and tax credits for both in and out of work families, will be calculated on post-tax rather than pre-tax income (which is the case for tax credits). The increase in the income tax personal allowance to £10,000, and subsequent planned increases, will mean that millions of people will benefit from greater take-home pay. However, in calculating the amount of UC a household receives, the government provides 65 pence less UC for each pound the family's income increases after tax. Therefore once UC is introduced nearly two-thirds of the financial advantage of the tax cut will be immediately recovered by a reduction in the amount received from UC[12].

For example, an increase in tax allowance of £1,000 would lead to a gain in £200 after tax income. However, there would be a £130 reduction in UC, and hence household income only rises by an additional £70. Yet, those people not receiving UC would take home the full £200 tax advantage.

This problem could be addressed so that people receiving UC gain fully from the personal allowance tax cuts without any impact in the UC entitlement. The Resolution Foundation proposes that the 'UC earnings disregard' (the amount of income that can be disregarded before deductions from UC start) be simultaneously increased every time the income tax personal allowance is raised. Hirsch similarly says that the UC disregard would need to be increased by 20 per cent of any increase in the personal allowance to provide UC claimants with the same increase in their incomes as non-UC claimants benefitting from the same tax cut. His analysis shows that there are approximately three million UC-eligible families that have at least one member working and paying the basic rate of tax who will not receive the full benefit of the personal allowance as a result of UC deductions[13.]

Furthermore, analysis by the Resolution Foundation found that raising the Universal Credit disregard would be a more cost-effective policy than increasing the tax allowance, as it would focus the benefits of the policy on people on low to middle income working households claiming UC. There are approximately four million working people (three million of whom earn enough to pay tax and one million who do not) who will receive UC, but earn too much to receive the maximum amount. They would all gain an extra 65p for every £1 of extra income the UC system was adjusted to disregard. The analysis shows that if HMT had spent as much raising UC disregards as it did raising the tax allowance in 2013/14

[12] Hirsch, Will future tax cuts reach struggling working households?, Resolution Foundation, April 2013 http://www.resolutionfoundation.org/media/media/downloads/Will_future_tax_cuts_reach_struggling_working_households.pdf

[13] Whittaker, How to ensure a rise in the personal allowance delivers on its promise, October 2013 http://www.resolutionfoundation.org/blog/2013/oct/17/how-ensure-rise-personal-allowance-delivers-its-pr/ ; Hirsch, Will future tax cuts reach struggling working households?, Resolution Foundation, April 2013 http://www.resolutionfoundation.org/media/media/downloads/Will_future_tax_cuts_reach_struggling_working_households.pdf

these households would receive around £25 per week from the tax change rather than the £1.80 a week the tax change will actually be worth to them[14].

There is also a relationship between pensions auto-enrolment, which commenced in 2012, and the income tax personal allowance. This link was proposed by 'Making automatic enrolment work: A review for the Department for Work and Pensions', conducted by Paul Johnson, David Yeandle and Adrian Boulding for the coalition government[15]. They recommended that people should be automatically enrolled when they reached the income tax threshold but that contributions should be on earnings in excess of the National Insurance threshold.

Previously, under the Turner Commission and the Pensions Act 2008 the intention was for individuals to be auto-enrolled when their earnings reached the National Insurance threshold.

But the TUC and others have shown that the current government policy has meant that millions of low-paid workers, particularly women and part-time workers, have been removed from eligibility for auto-enrolment. Previous TUC research showed that more than 1.9 million low-paid staff were not eligible to be auto-enrolled based on the 2013/2014 income tax 'earnings trigger' of £8,105 and National Insurance band of £5,564. As a result of further personal allowance rises the overall figure excluded from saving in 2014/15 will be around four million. This reduces the credibility of the current government's policy for auto-enrolment as well as reducing the amount that low earners (particularly those with multiple jobs) can save before retirement.

Finally it shouldn't be forgotten that there is also a considerable number of people who do not earn enough to benefit at all from the increase in the income tax personal allowance, a disproportionate number being women.

2013 ONS Annual Survey Hours and Earnings data allows us to learn more about this group. The bottom decile of male workers earn £11,432, above the tax threshold. Published data show that 26.2 per cent of female employees earn less than the £10,000 personal allowance. And 17.2 per cent of all employees earn less than £10,000. This means that we can use this information to determine what proportion of people in these groups earn below the personal allowance.

The 2013 data shows that a significant proportion of employees are not benefitting from the increase in income tax personal allowance, and that female employees in particular are losing out. More than four million employees overall are not currently benefiting from this tax advantage, and this will increase further in April 2014 when the personal allowance rises to £10,000.

[14] Ibid.
[15] Johnson, Yeandle, Boulding, Making automatic enrolment work: A review for the Department for Work and Pensions, 2010

Percentage of employees earning less than the tax threshold

	Men	Women	All employees
Earn less than £9,440 (2013/2014 personal allowance)	Less than 10%	24.3%	15.9%
Earn less than £10,000 (2014/2015 personal allowance)	Less than 10%	26.2%	17.2%

Derived from ASHE table 1.7a: gross annual pay

We can also make an estimate of the number of male employees affected by subtracting the total number of female employees from the total number of all employees. The table below applies the percentages from ASHE to the numbers of employees from the Labour Force Survey reported in ONS Labour Market statistics, Dec 2013 (table EMPO9).

Number of employees earning less than the tax threshold

	Men	Women	All employees
Earn less than £9,440	1,025,000	3,039,000	4,064,000
Earn less than £10,000	1,121,000	3,276,000	4,397,000

This paper has so far looked at the impact of the income tax personal allowance. It is Labour Party policy to introduce a lower income tax rate of 10p, which also seeks to improve the incomes of people on low incomes. However, it should be noted that this policy would have a not dissimilar impact to the increase in income tax personal allowance. Such a change would mean that income above the allowance and up to a specified rate is taxed at 10p in the pound rather than the current 20p in the pound starting rate. A 10p tax rate would benefit all earners, except lowest earners and the very highest (those for whom there is no personal allowance and for whom there would likely be no 10p rate). Raising the tax allowance by £1,000, or introducing a 10 per cent lower tax rate, would have a similar effect for the first £2,000 of income. This policy would also benefit higher rate 40 per cent tax payers. Looking at people on lower and moderate incomes, some gain from paying no or less income tax due to the increase in the personal allowance. Hirsch notes that this policy would also require adjustments to Universal Credit to ensure that low earners benefit[16].

[16] Hirsch, Will future tax cuts reach struggling working households?, Resolution Foundation, April 2013

A more progressive approach

As we have seen, tax cuts are ill-targeted and are not focused on lower earners; it is middle to upper earners who benefit most. And further increases in the personal allowance would perpetuate this trend. Recent IFS analysis shows that just 15 per cent of the gains from an increase in the income tax personal allowance to £12,500 would go to workers in the bottom half of the income distribution[17]. Adjusting the personal allowance so that it is more progressive, and only basic rate taxpayers benefit, would assist in it being more focused on low and middle income earners. Lowering the 40p tax threshold to offset the impact of recent and planned increases in the personal allowance would mean only basic rate payers benefit from the change, although the very lowest earners would still feel no benefit from the changes (as they have never paid enough tax to be affected by the 20p rate). A more progressive approach could also help with some of the 'side-effects' of the current government's approach to income tax referred to above.

The TUC welcomes the recent recommendation by the Low Pay Commission to increase the National Minimum Wage by 3 per cent to £6.50, although we regard this as a starting point to recover some of the ground lost since 2008. Increasing the NMW would assist in raising the living standards and incomes of lower and middle income earners. This is something all parties have recently been referring to. However, the level it is increased to is significant in making a real impact for low earners. There is also an interaction between the NMW and the level of the personal allowance, which has been recognised by the government in their latest evidence to the Low Pay Commission[18]. This means that few NMW workers stand to benefit as the personal allowance increases as most have already been taken out of income tax.

Tax credits were introduced by the last government. However they have become less generous under this government. Reversing the cuts to tax credits and increasing the UC's generosity, instead of prioritising increases in the income tax personal allowance for everyone, would facilitate a more targeted approach at people on lower incomes.

To conclude, while some people have been lifted out of paying income tax as a result of the increase in the income tax personal allowance, the benefit of doing so has not been shared progressively. There are also 'side-effects' of the increase in the personal allowance among people on lower incomes, namely the detrimental impact on entitlement to pension auto-enrolment, poorer gains for those who will be claiming universal credit and the fact that millions of lower earners are below

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http://www.resolutionfoundation.org/media/media/downloads/Will_future_tax_cuts_reach_struggling_working_households.pdf

[17] Hood, Joyce and Phillips, Policies to help the low paid, IFS, 2014 http://www.ifs.org.uk/budgets/gb2014/gb2014_ch7.pdf

[18] Department for Business, Innovation and Skills, National Minimum Wage: Government Evidence for the Low Pay Commission on the Additional Assessment, January 2014 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/273345/bis-14-534-national-minimum-wage-government-evidence-for-the-low-pay-commission-on-the-additional-assessment-2014.pdf

the income tax personal allowance threshold so do not gain. The very high cost of this policy does not appear to be justified by the limited living standards gains it brings for those on the lowest incomes.

If governments are to continue to increase the income tax personal allowance, policy adjustments are needed to secure more progressive outcomes. These could include allowing low to middle income earners to benefit from a more generous Universal Credit system, a pensions auto-enrolment system that is not linked to income tax personal allowance and further offsetting measures for higher rate taxpayers.