

TAX BRIEFING NOTE

INCOME TAX

JANUARY 2023

What is it?

Income tax is levied on most personal income and provides the largest receipts of any tax, over a quarter of the total. It was first introduced in Great Britain (but not Ireland) at 10 per cent on annual incomes above £60 in 1799 to fund the Napoleonic wars. It was withdrawn in 1802 then reintroduced in 1803 and lasted until 1816, one year after the battle of Waterloo. In 1842, income tax was once again reintroduced on incomes over £150. Rates soared during the world wars. The standard rate rose from 6 per cent to 30 per cent between 1914 and 1918. By 1939 the standard rate was still 29 per cent but by 1945 it had risen to 50 per cent while the top rate rose from 70 per cent payable on incomes over £50,000 to 98 per cent on incomes over a much lower £20,000. A 98 per cent rate on 'unearned' income returned between 1973-74 and 1978-79.

The current basic rate is 20 per cent, the higher rate is 40 per cent and the additional rate is 45 per cent, having been introduced at 50 per cent in 2010 and cut to its current level in 2013. A further effective rate of 60 per cent exists on incomes above £100,000 by double the level of the personal allowance. Technically, the personal allowance is reduced by £1 for every £2 of income earned in excess of £100,000. This was also introduced in 2010, and its convoluted structure was (almost certainly) chosen to disguise the existence of such a high rate.

What's the problem with it?

Income tax weakens incentives to engage in productive economic activity. In some cases and for some people, it makes the difference between an activity or investment being worthwhile or not. This means that some jobs and promotions are not sought by workers, and some are not created by employers because some investments are not made in the first place. This leads to lower employment, lower incomes and lower productivity. The difference between taxes on consumption and taxes on income is that the income taxes also hit investment, which makes them disproportionately damaging to the economy. More directly, it reduces the amount of money workers and investors have to spend on what they value for themselves and their families.

The progressive and differential rate structure creates complexity, not just because of the rates and thresholds themselves, but also because of the anti-avoidance measures which are required to tackle unwelcome attempts to take advantage of different rates.

What should be done?

1. All taxes on income (including national insurance, capital gains tax and corporation tax) should be replaced over time with a single tax on all income at a single rate of 30 per cent. See our report *How to abolish national insurance* for detailed plans which ensure that all taxpayers, including pensioners, could be better off with a well-designed reform.
2. In the meantime
 - a. The higher rate of 40 per cent should be cut in steps.
 - b. The 45 per cent additional rate should be abolished immediately.
 - c. The 60 per cent effective rate above £100,000 should be abolished immediately.
 - d. The personal allowance should be increased and then formally tied to earnings growth.
 - e. The higher rate threshold should be increased and then formally tied to earnings growth.