THE TOP RATE OF INCOME TAX
New ElectionEconomics policy briefing from the Centre for Economic Performance

If a new government were to raise the top rate of income tax, it is unlikely that the UK's highest earners will work less hard but it is likely they will try harder to avoid paying tax. That means tougher enforcement will be needed if taxes rise.

These are among the conclusions of a new report from the Centre for Economic Performance (CEP) – the latest in a series of background briefings on key policy issues in the May 2015 UK general election. The CEP reports that:

- In 2010, Labour raised the top rate of income tax (the 'additional rate') from 40% to 50% for those with taxable income over £150,000. The personal allowance was phased out for those with income above £100,000, leading to a marginal tax rate of 60% for the affected workers.

- The coalition government reduced the additional rate to 45% in 2013 but retained the phase-out of the personal allowance.

- In the current election, the Labour manifesto proposes to restore the 50% rate for those with taxable income over £150,000 while the Green Party propose raising it to 60%. The UKIP manifesto mentions the ambition to lower the rate to 40%. The Liberal Democrat and Conservative manifestos do not mention the top rate of tax though it was widely reported that the Conservatives wanted a rate of 40% when the rate was reduced in 2013.

- In 2012-13, only 0.9% of taxpayers (273,000 people) had taxable income above £150,000. They received 11% of total taxable income and paid 25% of income tax.

- Compared with the average taxpayer, top taxpayers are male, aged 35-54, living in London and the South East, working in finance, and company directors.

- Reported taxable income falls as tax rates increase. So rises in the top tax rates bring in less government revenue than one would predict assuming taxable income does not respond. Indeed, tax revenue might even fall.

- The magnitude of this change is very unclear. For example, a change from the current rate of 45% to 50% would bring in an extra £1-1.8 billion in income tax in 2014-15 using HMRC estimates. But there are likely to be changes in national insurance receipts, VAT receipts and other taxes if income is shifted to other sources. A pessimistic evaluation of all the effects might suggest a fall of £0.4 billion but an optimistic evaluation might suggest a rise of £2.8 billion.

- Taxable income falls after tax rates rise because (i) people work less so earn lower incomes and/or (ii) people spend more resources on avoidance and even evasion, which can take many forms.

- Theory and evidence both show that the level of work of high paid employees hardly responds to changes in tax rates (there is no reliable evidence for the self-employed).
• There is clear evidence that avoidance responds to changes in tax rates, for example, shifting income between tax years and income types in response to changes in tax rates. Avoidance is probably the main problem when raising the top rate of income tax.

• Evidence from other countries suggests that making avoidance harder and high rates of tax are complements to each other.

Alan Manning, author of the report, concludes:

‘If politicians want to raise the top rate of tax, they need a more aggressive approach to dealing with tax avoidance and tax evasion.

‘It’s a continuing battle between tax accountants trying to come up with new ways to reduce their clients’ tax bills and HMRC trying to close those loopholes.’

ENDS

Notes for editors:

‘The Top Rate of Income Tax’ by Alan Manning is the latest in CEP’s #ElectionEconomics series.

Objective, brief and non-technical, CEP Election Analysis is a series of background briefings on the policy issues in the May 2015 UK General Election

This series discusses the research evidence on some of the UK’s key policy battlegrounds, including immigration, austerity, real wages and living standards, productivity and business, Europe, the NHS, schools, tuition fees, gender gaps, urban and regional policy, top tax rates, inequality, housing and planning, crime, climate change and energy, and mental health.

These analyses are provided by some of our expert researchers and draw on some of our past and current research.

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