

# RESTATE THE CASE

## Fiscal drag

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### Why is this important?

During the Conservative party leadership campaign, Boris Johnson said that the income tax thresholds should be raised to help the growing number of people captured in the higher rates by fiscal drag.<sup>1</sup> TaxPayers' Alliance polling showed that 69 per cent of those asked supported income tax rates being linked to inflation or wage growth, in order to prevent people being moved into higher tax bands.

### What is it?

Fiscal drag occurs when tax thresholds remain unchanged while incomes continue to rise. Given that many people have at least inflation-related increases in pay, it pushes them into new higher tax brackets because the thresholds have not moved up to reflect the increased level of income. Not shifting tax bands to reflect income growth has become an easy policy for governments since it increases the tax take without having to announce they are doing so.

In his proposals during the Conservative leadership contest, the prime minister committed to raise the 40 per cent higher rate threshold from £50,000 to £80,000.<sup>2</sup> The proposal would have dealt with some of the effects of fiscal drag by removing those individuals who entered the higher rate tax threshold as a result of inflation or wage growth.

Although the higher rate threshold was raised to £37,500 in 2019-2020, no significant government action has been taken so far on the proposal made by the prime minister.

### Why should tax thresholds rise with inflation or wages?

The years 2010-11 to 2015-16 saw reductions in income tax rates within the higher thresholds, falling to £31,785 in 2015-16. In recent years, though the rate has increased. This includes a number of increases above the consumer price index, with the higher rate threshold in the current tax year being anything over £37,500. Over the same period, post-2010, the personal allowance has been increased from £6,475 to £12,500 showing that successive governments understand the impact of fiscal drag on the poorest. Yet, wages have continued to increase and this growth reached an 11-year high of 3.9 per cent in the year to June 2019,<sup>3</sup> dragging more and more workers into higher rates. The scale of this tax threshold problem has been a growing issue in the UK, where those paying higher and additional rates of income tax rose from 3.26 million in 2010-11 to 4.67 million in 2018-19.<sup>4</sup>

Indexing tax rates with inflation would be an improvement on the present tax threshold system. It would prevent marginal tax rates rising due to inflation, hence taxpayers would not be pushed into higher tax brackets as a result of inflationary income increases. This tax indexing tool, proposed by the Institute of Economic Affairs, would allow the government to adjust the tax rates in line with differing levels of inflation, whether it is high or low and would require the government to make a legislative change if it chose to not implement the indexation.<sup>5</sup>

The need for this is also seen by the number of people paying the top income tax threshold. Initially there were 319,000 taxpayers with incomes above £150,000 who this would apply to. However, the rate

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<sup>1</sup> Swinford, S., Boris Johnson's radical plan to slash income tax for three million by raising 40p rate threshold to £80,000, *The Telegraph*, 9 June 2019.

<sup>2</sup> KPMG, *A look ahead to the Autumn Budget*, 2019.

<sup>3</sup> BBC, *UK wage growth picks up to 11-year high*, 13 August 2019, [www.bbc.co.uk/news/business-49328855](http://www.bbc.co.uk/news/business-49328855), (accessed 3 February 2020).

<sup>4</sup> HM Revenue & Customs, *Number of individual income taxpayers*, 2019.

<sup>5</sup> Booth, P., *Thirty years of fiscal drag*, Institute of Economic Affairs, 16 May 2012, <https://iea.org.uk/blog/thirty-years-of-fiscal-drag>, (accessed 24 February 2020).

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has not moved since it was announced in 2008 and there are now 428,000 individuals it would apply to, an increase of more than one third as a result of no indexation.<sup>6,7</sup> Similarly, the income tax personal allowance, which starts to be withdrawn when an individual earns £100,000, has seen an increase of more than 50 per cent with 647,000 people subject to it when it was announced compared to 986,000 now.<sup>8</sup> The Institute for Fiscal Studies predicts that had inflation indexation been used then the thresholds would have moved up to £180,000 and £120,000 respectively.<sup>9</sup>

Given the fact that wage growth in recent years has outstripped inflation, the option of indexing tax thresholds to either inflation or wages (depending on whichever is higher) is an improved method of protecting taxpayers from the dual threat of inflation and stagnant tax rates.

### **What should be done?**

Given that inflation is currently beneath wage growth, at the very least there needs to be annual increases in basic, higher and additional rate income tax in accordance with the consumer price index (CPI) from 2021-22. In doing so, the government would stem the flow of individuals being forced into higher tax thresholds when they receive pay increases. Alongside this, the government needs to carry out its manifesto promise to increase the class 1 national insurance contributions threshold to equalise income tax meaning £12,500 would be completely free of tax.<sup>10</sup> As proposed by the TaxPayers' Alliance, this should be done by increasing the threshold to £12,500 in one go.<sup>11</sup> This will be done by delaying the rise in the national insurance threshold to £9,500 in April 2020 and instead increase the threshold fully to £12,500 in April 2021.

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<sup>6</sup> Adam, S & Johnson, P., *High earners increasingly hit by lack of indexation and absurd pension rules*, Institute for Fiscal Studies, 5 April 2019, (accessed 3 February 2020).

<sup>7</sup> HM Revenue & Customs, *Number of individual income taxpayers*, 2019.

<sup>8</sup> Adam, S & Johnson, P., *High earners increasingly hit by lack of indexation and absurd pension rules*, Institute for Fiscal Studies, 5 April 2019, (accessed 3 February 2020).

<sup>9</sup> Ibid.

<sup>10</sup> The Conservative and Unionist Party, *Manifesto 2019*, 2019.

<sup>11</sup> Meakin, R., *One big hit: fixing national insurance for good*, TaxPayers' Alliance, February 2020, (accessed 2 March 2020).