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Income tax explained

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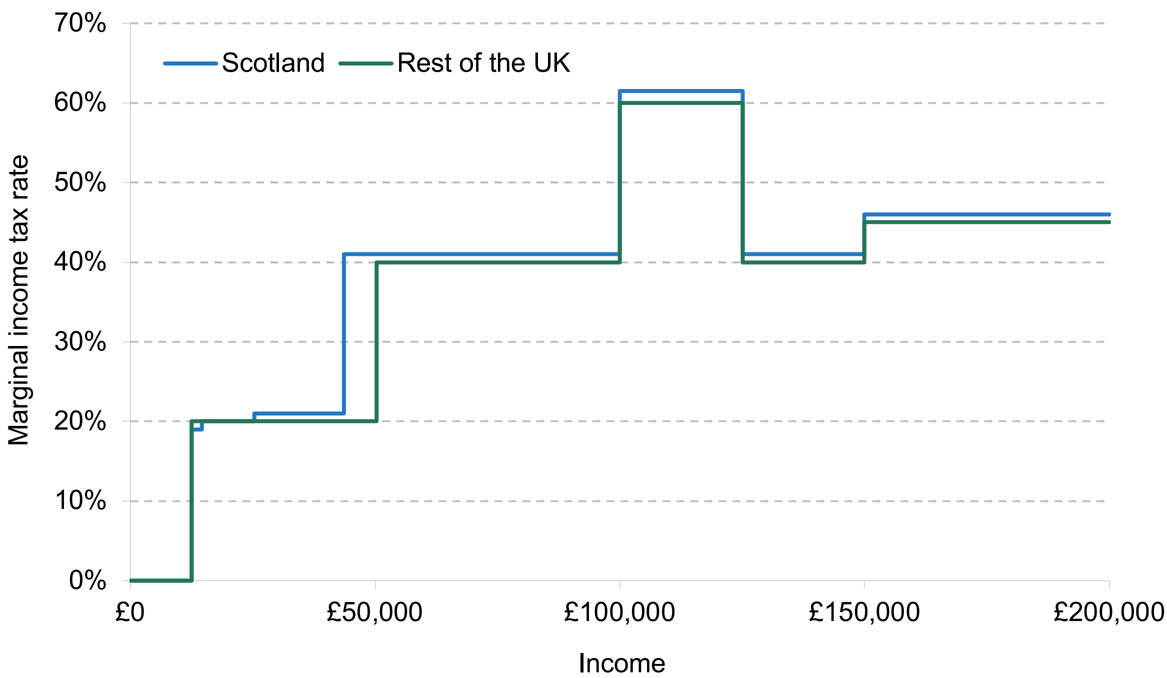
Income tax is the single most important source of revenue for the UK Treasury. It is forecast to raise around £200 billion in 2021–22 – about a quarter of all government tax receipts. It is levied on most forms of personal income, but each person has a personal allowance of income that can be received tax-free, and only around 60% of adults have income high enough to pay income tax. Above the personal allowance, income is split into bands that are taxed at different rates. The chart below shows the rate of tax paid on an additional £1 of income at different income levels. Some powers to adjust income tax are devolved to Scotland and Wales, and income tax rates in Scotland now differ slightly from the rest of the UK.

The income tax schedule, 2021–22



Source: IFS Fiscal Facts.

Savings, dividends and pensions are taxed less heavily than ordinary income. And income from employment and self-employment is subject to National Insurance contributions as well as income tax.

What incomes attract tax?

Most income is subject to income tax, including income from employment, self-employment, private and state pensions, investments and property rental. Income from certain savings products, and many state benefits, are not subject to income tax.

Money contributed to a private pension or donated to charity can be deducted from an individual's income for income tax purposes. For example, if an individual earns £30,000 but puts £5,000 of it into a pension, then she will only be taxed on £25,000 of income (though the income later received from the pension will be taxed at that stage). The tax treatment of private pensions is discussed in more detail below.

More about what incomes do and don't attract tax

The following are all subject to income tax:

- income from employment;
- profits from self-employment (as a sole trader or a member of a partnership);
- some state benefits such as the state pension, jobseeker's allowance, carer's allowance and widowed parent's allowance;
- income from a private pension;
- rental income from property;
- income from savings and investments, by default (although in practice much is exempt from tax – see below).

The following are not subject to income tax:

- many state benefits, including child benefit, universal credit, pension credit, housing benefit and personal independence payment;
- gifts received (although if the giver dies within seven years of the gift being made, it may become liable for inheritance tax);
- interest income earned on special savings products such as Individual Savings Accounts (ISAs).

Some items can be deducted from taxable income. Landlords and the self-employed can deduct their business expenses (or give up that right in exchange for an additional £1,000 tax-free allowance), although landlords can now only deduct their mortgage interest costs at the basic rate of tax. Employees can also deduct their work-related expenses, though the rules on what they can deduct are stricter than for the self-employed.

Income tax rates, bands and allowances

Each individual has a personal allowance – currently £12,570 – of income that they can receive tax-free. Only those with incomes in excess of the personal allowance pay income tax.

Above the personal allowance, different bands of income are taxed at different rates. The current bands and their associated tax rates in England, Wales and Northern Ireland are as follows (they are different in Scotland):

Income tax rates and thresholds in England, Wales and Northern Ireland, 2021–22

Income	Band	Rate	Number of adults, 2020–21	Share of revenue provided by taxpayers in band, 2020–21
£0–£12,570	Personal allowance	0%	22,100,000	0%
£12,570–£50,270	Basic rate	20%	27,600,000	33.1%
£50,270–£150,000	Higher rate	40%	4,200,000	33.1%
£150,000+	Additional rate	45%	481,000	33.6%

Note: Thresholds assume the individual receives the standard personal allowance. For people with non-standard allowances – receiving the blind person's allowance, for example, or having their personal allowance reduced by HMRC to make up for underpaying tax in the previous year – the width of the basic-rate band is unchanged, so the higher-rate threshold will be different from that shown in the table. Numbers of taxpayers include Scottish taxpayers, who are classified as higher-rate taxpayers if they have total income above the UK higher-rate threshold or if they have non-savings, non-dividend income above the Scottish higher-rate threshold, and as basic-rate taxpayers otherwise. The 22,100,000 figure for adults classified as below the personal allowance is calculated as the difference between the total number of taxpayers and the total adult (i.e. aged 16+) population; the classification is not strictly accurate as the adult population and the taxpayer population can differ for reasons other than having income below £12,570.

Source: Number of taxpayers from https://www.gov.uk/government/statistics/number-of-individual-income-taxpayers-by-marginal-rate-gender-and-age. Total adult population from ONS 2018-based principal national population projections, https://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationprojections/datasets/tablea11principalprojectionuksummary. Revenue shares from https://www.gov.uk/government/statistics/income-tax-liabilities-by-taxpayers-marginal-rate.

The table above also shows the number of taxpayers in each band (including Scottish taxpayers). 59% of the adult population have incomes high enough to pay tax: 51% at the basic rate, 8% at the higher rate and 1% at the additional rate. Despite their vastly different numbers, basic-, higher- and additional-rate taxpayers each contribute almost exactly a third of total income tax revenue – a reflection of the concentration of income in the hands of the better-off as well as the higher tax rates they face.

Technical note: the difference between allowances, bands, thresholds and limits

There is a subtle but important technical distinction between a tax allowance and a zero-rate band.

A zero-rate band is a band of income in which the tax rate happens to be 0%.

An allowance, in contrast, is an amount that can be deducted from taxable income.

In both cases, the amount in question does not get taxed.

But if a zero-rate band is made bigger, by default it ‘eats into’ the band above it, so that other thresholds are unchanged. The untaxed income would otherwise have been taxed at the rate applying to the band above.

In contrast, since an allowance is deducted from taxable income, increasing it leaves the width of all tax bands unchanged. It is equivalent to having a zero-rate band covering the first part of someone’s income but also moving other thresholds up in unison by the same amount. The untaxed income would otherwise have been taxed at the individual’s top marginal rate.

An increase in the personal allowance, leaving the width of the basic-rate band unchanged, thus automatically increases the income level at which higher-rate tax becomes payable (the higher-rate threshold).

This matters for several practical applications:

- People sometimes have non-standard allowances. They might qualify for a blind person’s allowance, for example; or if someone has underpaid tax in one year, HMRC typically recoups the underpayment by reducing their personal allowance for the following year. For people in such positions, the width of the basic-rate band is unchanged, so the higher-rate threshold will be different from that shown in the table above.
- Reflecting this, the higher-rate threshold (for example) is not in fact an official feature of the tax system. What is announced and legislated is the basic-rate limit, the level of income *after deducting allowances* up to which basic-rate tax is payable. In 2021–22, the basic-rate limit is £37,700, so for people with the standard £12,570 personal allowance, higher-rate tax becomes payable when total income exceeds £50,270, a

point commonly known as the higher-rate threshold; but someone who has a different allowance will have a different higher-rate threshold.

- An increase in the personal allowance benefits higher-rate taxpayers (who save 40% of the amount taken out of tax) more than basic-rate taxpayers (who save only 20% of it), unless the government reduces the basic-rate limit by the same amount.
- When the personal allowance is withdrawn at incomes above £100,000 (see below), the reduced personal allowance means that more income is brought into tax at the higher rate, not the basic rate.
- Despite their names, the personal savings allowance and the dividend allowance (see below) are zero-rate bands: they do not affect the point at which higher-rate tax becomes payable, for example.

The personal allowance is gradually withdrawn from individuals with incomes over £100,000 a year, creating an effective 60% tax rate on incomes between £100,000 and £125,140. In a similar fashion, families receiving child benefit have it withdrawn when the highest-income parent's income exceeds £50,000.

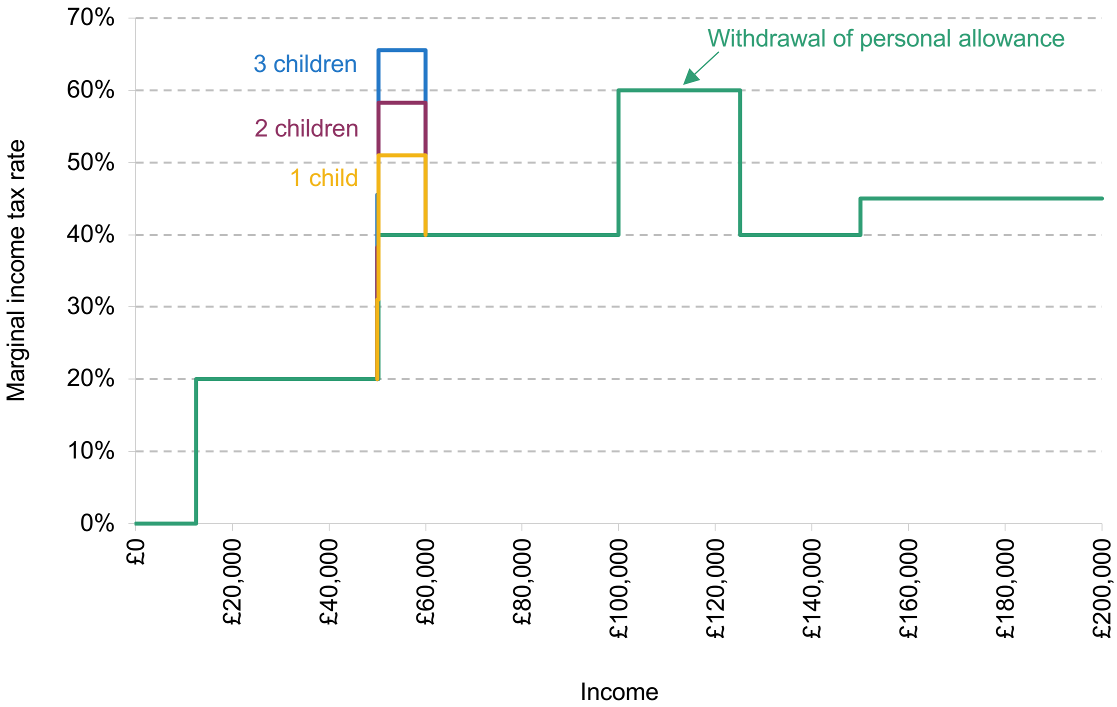
If a person's income is below the personal allowance, they can choose to transfer 10% of the full allowance to a spouse or civil partner who is a basic-rate taxpayer.

More about withdrawal of the personal allowance and child benefit

For every £1 by which an individual's income exceeds £100,000, their personal allowance is reduced by 50p. The result is that, for an individual with income of £100,000, each additional £1 of income incurs 60p of income tax. The £1 of additional income is subject to 40% higher-rate tax (meaning tax of 40p); on top of that, an extra 50p becomes taxable at 40% as a result of the withdrawal of 50p of tax-free allowance, such that an extra 20p of tax is due, making 60p in total.

The consequence of this policy is to create a 'hump' in the marginal income tax schedule: an effective 60% income tax band, twice the width of the personal allowance, above £100,000 (see the chart below).

Humps and bumps in the income tax schedule, 2021–22



Note: This is the income tax schedule in England, Wales and Northern Ireland. The children lines show the effect of withdrawing child benefit. The higher rates for those with children assume the individual does not have a higher-income partner.

In addition, families receiving child benefit have it reduced by 1% for every £100 by which the highest-income parent's income exceeds £50,000. This creates additional effective tax rates between £50,000 and £60,000 which depend on the amount of child benefit received and so the number of dependent children in the family. Families with someone on more than £60,000 have their child benefit withdrawn completely; some therefore opt out of receiving it, rather than claiming it and then having it clawed back through income tax. In effect, income tax is used as a mechanism to means-test child benefit.

More about income tax and marriage

The marriage allowance reduces the tax bill of married couples and civil partners where one is a basic-rate taxpayer and the other is a non-taxpayer. A person whose income is below the personal allowance can choose to transfer 10% of their personal allowance to a spouse or civil partner who is a basic-rate taxpayer. As a basic-rate taxpayer, the recipient sees their tax liability reduced by 20% of the amount transferred – currently saving them £251.40 in tax, since the personal allowance is £12,570.

One anomaly that arises from the marriage allowance is that eligible individuals who cross over from being basic-rate taxpayers to higher-rate taxpayers can see their tax bill jump up. For individuals able to claim the maximum marriage allowance, an increase in their income from just below to just above the higher-rate threshold results in a £251.40 increase in their tax bill because of the loss of the marriage allowance.

The dwindling number of married couples and civil partners in which one partner was born before 6 April 1935 can choose to claim the married couple's allowance (MCA) instead of the marriage allowance. The MCA reduces their combined tax bill by £912.50; however, if the husband's income (or the higher earner's income, if the couple got married/registered after 5 December 2005) is above £30,400, its value is reduced by 5p for each £1 of income above that threshold, until it reaches a minimum value of £353 for those with an income of £41,590 or more.

Most income tax bands and allowances increase automatically at the start of each tax year (in April) in line with inflation (as measured by the Consumer Prices Index, CPI), unless parliament intervenes. This mitigates a phenomenon known as fiscal drag, whereby income growth pulls ever more taxpayers into higher tax bands. However, a number of new thresholds introduced since 2010 do not increase with inflation in this way: these include the £150,000 threshold at which the additional rate becomes payable, the £100,000 threshold at which the personal allowance starts to be withdrawn and the £50,000 threshold at which child benefit starts to be withdrawn. As a result, the number of people affected by these high effective rates of tax has grown rapidly since their introduction.

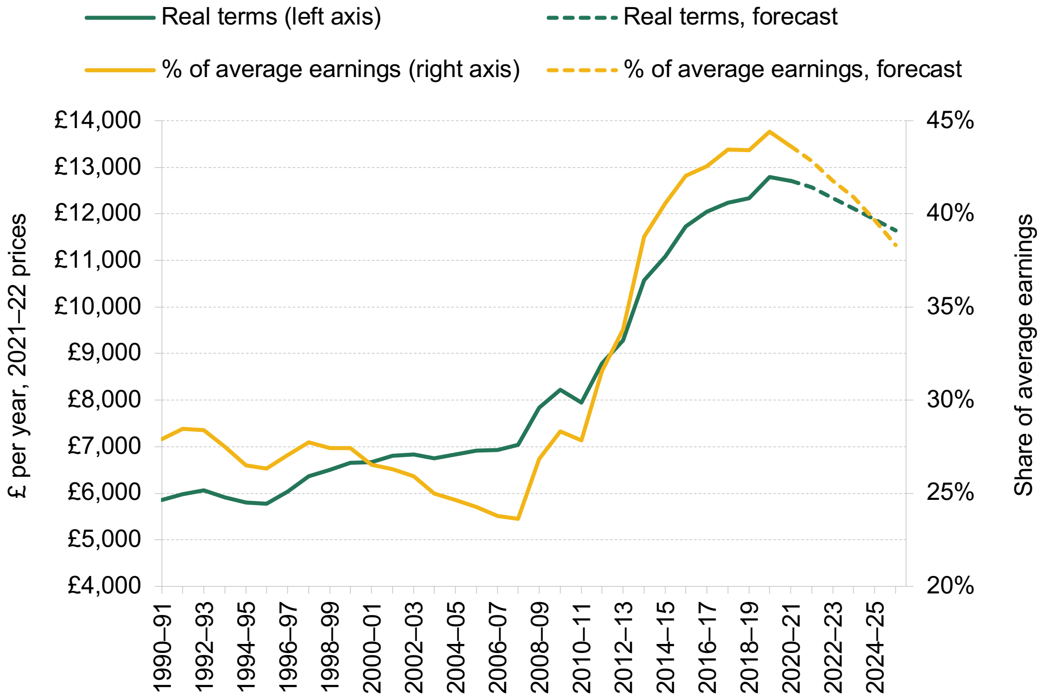
One of the biggest changes to income tax in recent years has been a large increase, over the 2010s, in the level of the personal allowance. Since the mid 2010s, there has also been a large rise in the higher-rate threshold, following a large reduction earlier in the decade. However, the government changed direction in the 2021 Spring Budget, announcing that all income tax thresholds, including the personal allowance and the higher-rate threshold, will be frozen in cash terms at their 2021–22 levels up to and including 2025–26.

Details of changes in the personal allowance and higher-rate threshold over time

The charts below show the large changes to the levels of the personal allowance and the higher-rate threshold that have been enacted in recent years. Between 1990–91 and 2007–08, the personal allowance and the higher-rate threshold both grew in real terms (that is, adjusting for inflation) by 1% a year on average – slower than growth in average earnings. After 2007–08, however, there was a sustained move to increase the personal allowance, which increased in real terms by more than 5% a year on average between 2007–08 and 2019–20 (a cumulative 82% over that 12-year period) – taking it from 24% to 44% of average earnings, which grew only slowly over that period. In the first half of the 2010s, the higher-rate threshold was reduced sharply, more than offsetting higher-rate taxpayers' gains from the increased personal allowance; however, the Conservative government changed course in the second half of the decade, increasing the higher-rate threshold to £50,000.

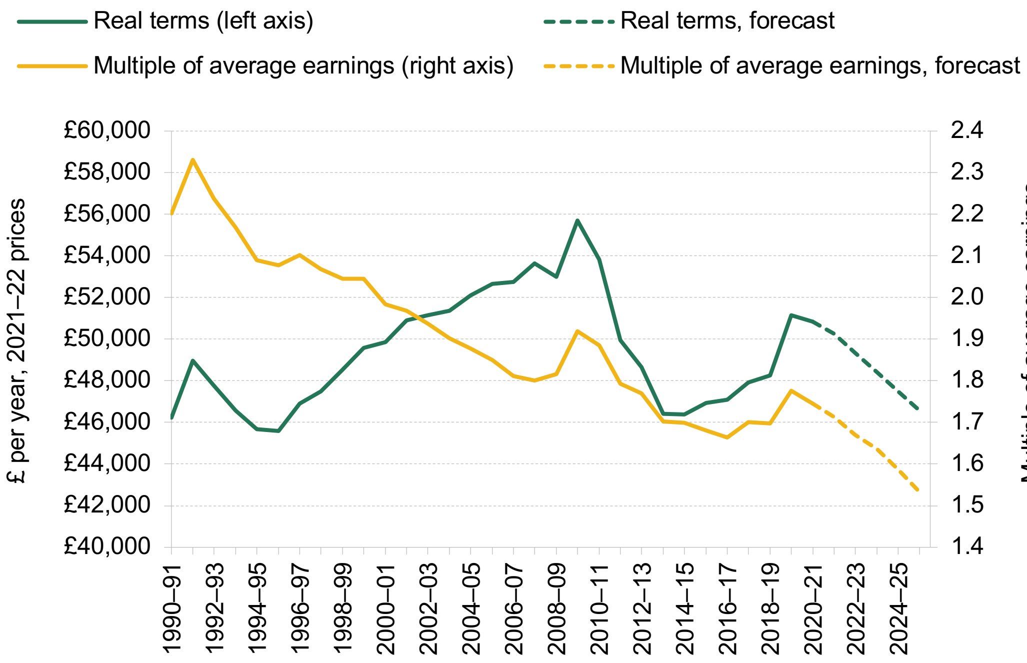
In its 2021 Spring Budget, the government changed direction again – perhaps mindful of the need to raise revenue after the COVID-19 crisis – announcing that all income tax thresholds will be frozen in cash terms at their 2021–22 levels up to and including 2025–26. On current inflation forecasts, this would amount to a 7% (2%-a-year) real-terms reduction over the period, reversing only a fraction of the rise in the personal allowance seen in the previous decade.

The personal allowance over time



Source: Allowances from IFS Fiscal Facts income tax table. Historical allowances adjusted to 2021–22 prices using the Consumer Prices Index (ONS series D7BT). Average earnings figure is 52 x average weekly earnings (AWE, ONS series KA46 and MD9M). Forecasts for CPI and average earnings from Office for Budget Responsibility, 'Economic and fiscal outlook – March 2021', https://obr.uk/efo/economic-and-fiscal-outlook-march-2021/.

The higher-rate threshold over time

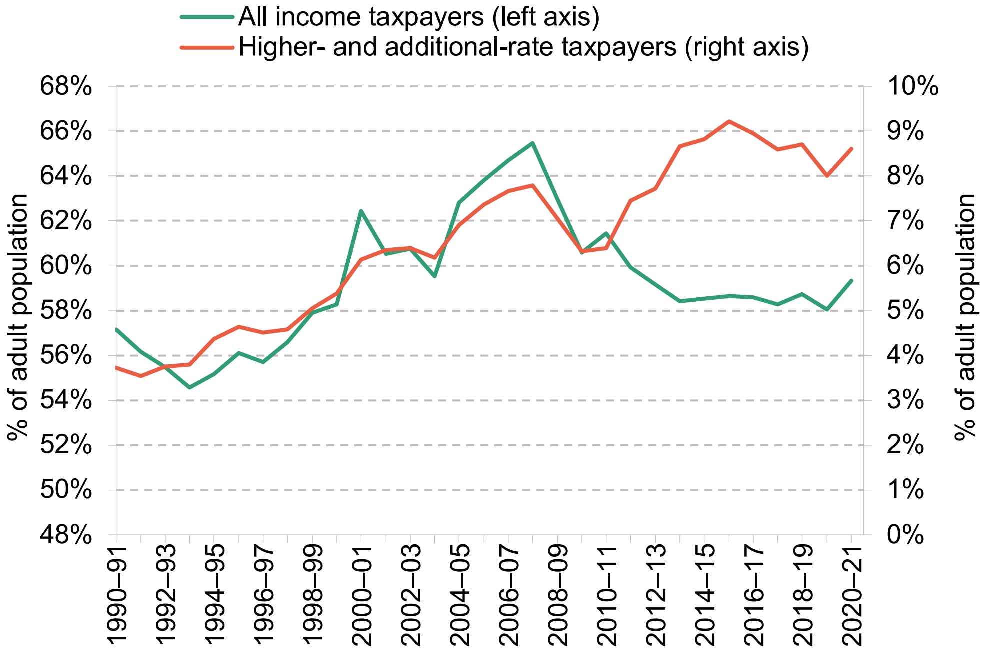


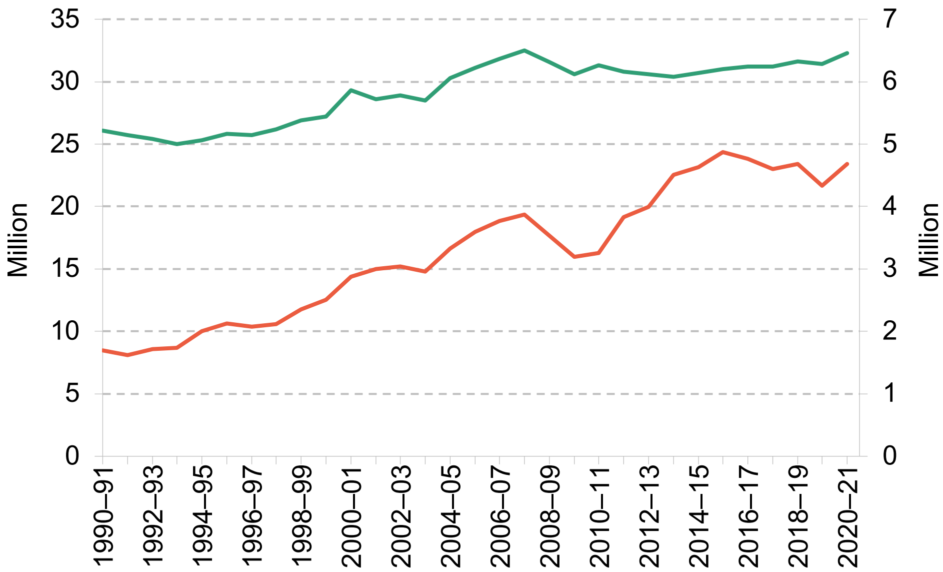
Source: Thresholds from IFS Fiscal Facts income tax table. Historical thresholds adjusted to 2021–22 prices using the Consumer Prices Index (ONS series D7BT). Average earnings figure is 52 x average weekly earnings (AWE, ONS series KA46 and MD9M). Forecasts for CPI and average earnings from Office for Budget Responsibility, 'Economic and fiscal outlook – March 2021', https://obr.uk/efo/economic-and-fiscal-outlook-march-2021/.

Changes in the personal allowance and the higher-rate threshold naturally affect the number of taxpayers and the number of higher-rate taxpayers – although these numbers also reflect other factors such as trends in demographics, employment and income inequality.

As shown in the charts below, the proportion of the population paying any income tax rose steadily through most of the 1990s and 2000s but fell from the late 2000s onwards as a result of the big increases in the personal allowance. Today, around 60% of adults pay income tax. Around 9% of adults pay higher rates of income tax, a share that has risen sharply since the early 1990s and that is likely to rise further with the coming freeze in the higher-rate threshold.

The number of taxpayers and higher-rate taxpayers over time





Note: Figures for 2008–09 are midpoints between surrounding years as data are not available. Numbers of taxpayers include Scottish taxpayers, who are classified as higher-rate taxpayers if they have total income above the UK higher-rate threshold or if they have non-savings, non-dividend income above the Scottish higher-rate threshold.

Source: Number of taxpayers from https://www.gov.uk/government/statistics/number-of-individual-income-taxpayers-by-marginal-rate-gender-and-age. Total adult population from ONS UK population estimates (https://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationestimates/datasets/populationestimatesforukenglandandwalesscotlandandnorthernireland) and ONS 2018-based principal national population projections (https://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationprojections/datasets/tablea11principalprojectionuksummary).

More about changes in the numbers of taxpayers and higher-rate taxpayers over time

The proportion of the adult population paying income tax rose steadily through most of the 1990s and 2000s. Between 2007–08 and 2019–20, however, it fell from 65.5% to 58.0%, reflecting the big increases in the personal allowance (the absolute number of taxpayers changed little, but that is in the context of substantial population growth). But it is striking that the proportion of adults paying income tax was higher in 2020–21 than it was 30 years ago, despite the personal allowance’s being much higher relative to average earnings. This partly reflects an overall rise in the employment rate over that period (albeit fluctuating with the economic cycle), particularly among women. The freeze in the personal allowance in the coming years is likely to see the number of taxpayers rise again, though much depends on the path employment takes coming out of the COVID-19 crisis.

The proportion of adults paying higher rates of income tax rose much more sharply, from 3.7% in 1990–91 to a peak of 9.2% in 2015–16: from 1.7 million to 4.9 million people. The rapidity of this increase is partly because income growth was higher towards the top of the income distribution for much of that period. Increases in the higher-rate threshold since then have stemmed the tide, but the freeze in the coming years is likely to see the number of higher-rate taxpayers reach new highs.

Savings, investments and pensions

Income from savings and investments is taxed differently from other income. Income from savings and investments held in an Individual Savings Account (ISA) is completely exempt from tax. Each individual is also allowed to receive certain amounts of interest income and dividends outside ISAs free of tax. And dividends that are still subject to tax are taxed at reduced rates. When calculating which income falls into which tax band, dividends are treated as the top slice of income, followed by interest income.

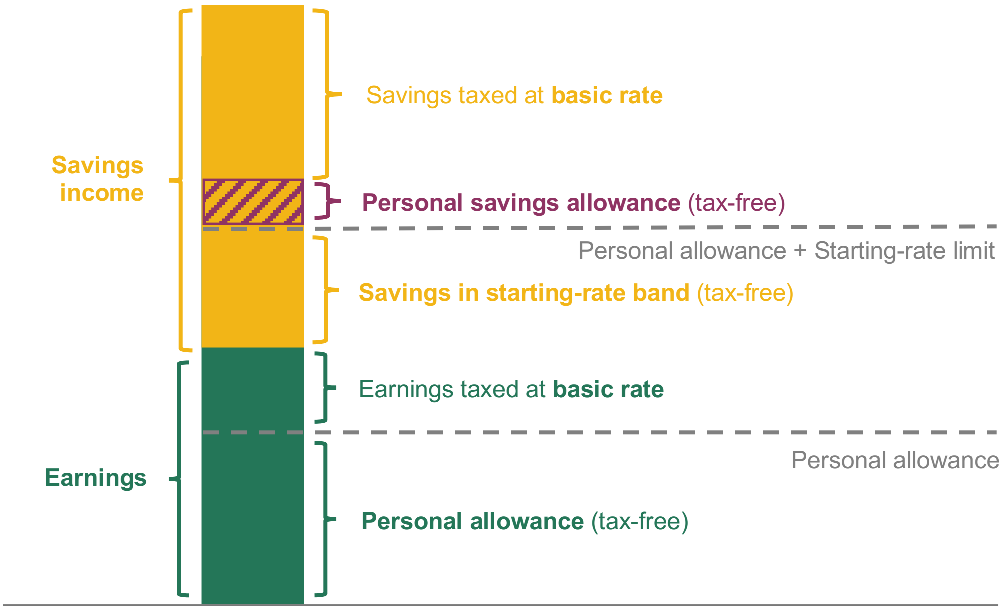
More about taxation of interest income

Savings income – interest earned on deposits with banks or building societies – is subject to standard income tax rates, except that there are two specific provisions which in practice take much of it out of tax:

- **The personal savings allowance.** This makes the first £1,000 of savings income for basic-rate taxpayers and £500 for higher-rate taxpayers tax-free. Additional-rate taxpayers do not receive a personal savings allowance. Although called a personal savings allowance, it is technically a nil-rate band rather than an allowance, in the sense that the interest income it covers is taxed at 0% but is not deducted from taxable income when calculating whether the individual is a basic-, higher- or additional-rate taxpayer and whether their personal allowance or child benefit should be withdrawn.
- **The starting rate for savings.** Savings income that falls into the first £5,000 of income above the personal allowance is free from tax. This is only of value for a specific group of people: those whose income *including* savings income is more than £1,000 above the personal allowance (since the personal savings allowance would exempt the first £1,000 anyway) but whose income *excluding* savings and dividends is less than £5,000 above the personal allowance. For example, in 2021–22, someone with £10,000 of earnings and £10,000 of savings income need only pay income tax on £1,430 of savings income: the first £2,570 of savings income (along with the £10,000 of earnings) is covered by the £12,570 personal allowance and is tax-free, the next £5,000 is covered by the 0% starting rate for savings, and the next £1,000 is covered by the personal savings allowance, leaving £1,430 to be taxed at the 20% basic rate.

The chart below (not to scale) shows another example where both the personal allowance and the starting rate for savings would be relevant. In 2021–22, someone with £15,000 of earnings and £10,000 of savings income will pay income tax on £2,430 of earnings (£15,000 minus the £12,570 personal allowance) and £6,430 of savings income. The personal allowance covers the first £12,570 of earnings, with the remaining £2,430 of earnings taxed at the basic rate. Up to the starting-rate limit of £17,570 of total income (£5,000 above the personal allowance), savings income is tax-free; with earnings of £15,000, that means the first £2,570 of savings income falls within the starting-rate band and is untaxed. Above that, the next £1,000 of savings income is covered by the personal savings allowance and is also untaxed, leaving £6,430 of savings income (£10,000 minus £2,570 minus £1,000) to be taxed at the basic rate.

The taxation of savings income: an example



More about taxation of dividend income

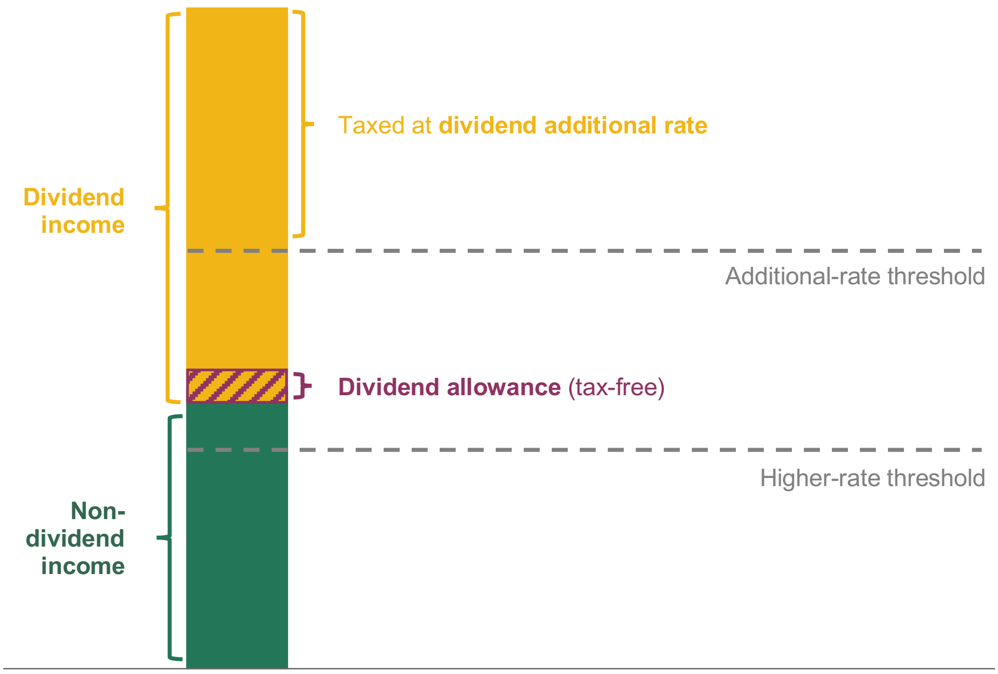
A specific dividend allowance is available to those who receive income from dividends on shares. This exempts the first £2,000 a year of dividend income from tax (and, like the personal savings allowance, it is strictly a nil-rate band rather than an allowance). Unlike the personal savings allowance, this dividend allowance does not vary with an individual's tax rate.

Dividend income in excess of the dividend allowance is taxed at lower rates than other forms of income (see the table). The chart below provides an example in which dividend income would be taxed at both the higher and additional dividend rates. Note that, as mentioned above, dividends are treated as the top slice of income when deciding which income falls into which band.

Income tax rates on dividends, 2021–22

Income	Band	Tax rate on ordinary income	Tax rate on dividend income
£0–£12,570	Personal allowance	0%	0%
£12,570–£50,270	Basic rate	20%	7.5%
£50,270–£150,000	Higher rate	40%	32.5%
£150,000+	Additional rate	45%	38.1%

The taxation of dividend income: an example



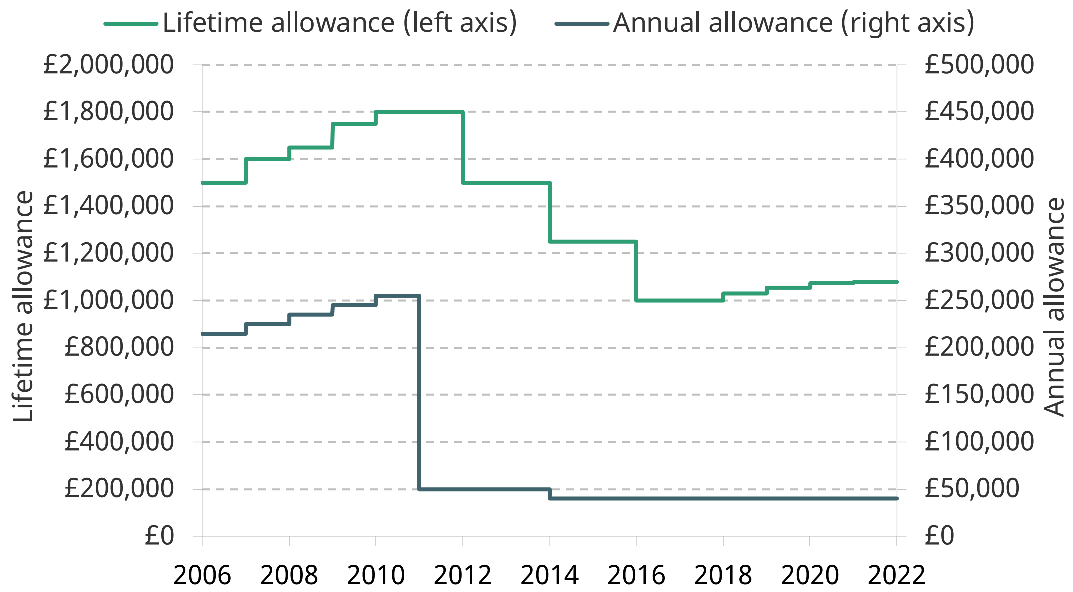
More about Individual Savings Accounts (ISAs)

Individuals can place up to £20,000 a year in an ISA. These savings can either be held in cash or invested in financial assets such as shares and bonds. Any income made on savings held in an ISA – any interest or dividends – is entirely exempt from income tax (and any capital gains are exempt from capital gains tax).

People aged under 50 can put up to £4,000 of their £20,000 ISA allowance into a Lifetime ISA (LISA), as long as they made their first contribution when aged 18–39. The government will add a 25% top-up to anything paid into a LISA, as well as any investment income being tax-free. Savings in a LISA can be freely withdrawn from the age of 60, or earlier if used alongside a mortgage to buy the saver's first home for £450,000 or less. However, money withdrawn from a LISA before age 60 for any other reason is subject to a 25% charge – more than the value of the original government top-up.

Pension income is treated as (deferred) earnings for tax purposes. Broadly speaking, income that is paid into a pension is exempt from tax, income earned within the pension fund is also exempt, but money received from the pension is taxed instead (although 25% can be taken as a lump sum free of tax). There are annual and lifetime caps on the amount that can be saved in a pension, both of which have been reduced significantly in recent years.

Pension allowances over time



Note: Years refer to financial years, so, for example, '2020' refers to 2020–21.

More about the taxation of private pensions

If an individual puts money into a pension scheme – or their employer does on their behalf – the money paid in is excluded from the individual's taxable income. This applies to pension contributions up to an annual allowance of £40,000 (or 100% of annual earnings, if lower), but the annual allowance is reduced for the highest-income individuals: specifically, if someone's income *excluding* pension contributions exceeds £200,000, the annual allowance is reduced by £1 for every £2 by which the individual's income *including* pension contributions exceeds £240,000, until it reaches a minimum level of £4,000 for those whose income including pension contributions exceeds £312,000.

In addition to this annual cap on contributions, there is also a lifetime allowance – £1,073,100 in 2021–22 – which the total value of an individual's pension pot cannot exceed without incurring penal tax rates.

The 2010s saw large reductions in the annual and, to a lesser extent, lifetime allowances (see the chart above), as well as the introduction of 'tapering' away of annual allowances for high earners described above. These steep reductions have greatly reduced the tax relief available to those with the resources to make large contributions to their pensions.

Income (and capital gains) received from investments within a pension scheme are free of personal tax while the money remains within the pension scheme. But money withdrawn from a pension – as a regular income or as an ad hoc withdrawal – is taxed like any other form of income. In effect, income tax on earnings paid into a pension is deferred until the earnings (and any investment returns earned in the meantime) are received from the pension and available to spend. The exception to this is the withdrawal of a lump sum upon retirement. An individual is entitled to withdraw 25% of their pension pot free of income tax when they retire. So long as the personal and lifetime allowances are not exceeded, this 25% escapes income tax entirely (as income tax is paid neither at the point of contribution nor at the point of withdrawal).

The way pensions are treated for income tax is very different from the way they are treated for National Insurance contributions: employer pension contributions are excluded from income for NICs purposes (as for income tax) but employee contributions are not, and no NICs are levied on pension income at all.

Devolution

The Scottish and Welsh parliaments both have the power to make certain changes to the rates of income tax within their jurisdictions. These powers do not apply to savings and dividend income, which continue to be taxed on a consistent basis across the UK.

So far, only the Scottish government has chosen to use these powers, creating a separate system of rates and bands for Scottish taxpayers.

More about income tax in Scotland

The Scotland Act 2012 and Scotland Act 2016 greatly expanded the powers devolved to the Scottish Parliament to set its own income tax rates and bands (though not the tax-free personal allowance) for residents of Scotland, except for income from savings and dividends, which continue to be taxed at UK-wide rates. Scotland has used these powers to set slightly different rates and bands from the rest of the UK. The table below shows the current income tax bands and rates in Scotland, along with the number of people in each band; the chart at the very start of this article shows how the rate schedule compares with that in the rest of the UK.

Income tax rates and thresholds in Scotland, 2021–22

Income	Band	Rate	Number of adults, 2018–19
£0–£12,570	Personal allowance	0%	1,995,000
£12,570–£14,667	Starter rate	19%	257,000
£14,667–£25,296	Scottish basic rate	20%	1,043,000
£25,296–£43,662	Intermediate rate	21%	888,000
£43,662–£150,000	Higher rate	41%	322,000
£150,000+	Top rate	46%	15,000

Note: Thresholds assume the individual receives the standard personal allowance. Taxpayers classified according to the highest band in which they have non-savings, non-dividend income: some will have savings or dividend income in a higher band. The 1,995,000 figure for adults classified as below the personal allowance is calculated as the difference between the total number of taxpayers and the total adult (i.e. aged 16+) population of Scotland; the classification is not strictly accurate as the adult population and the taxpayer population can differ for reasons other than having income below £12,570.

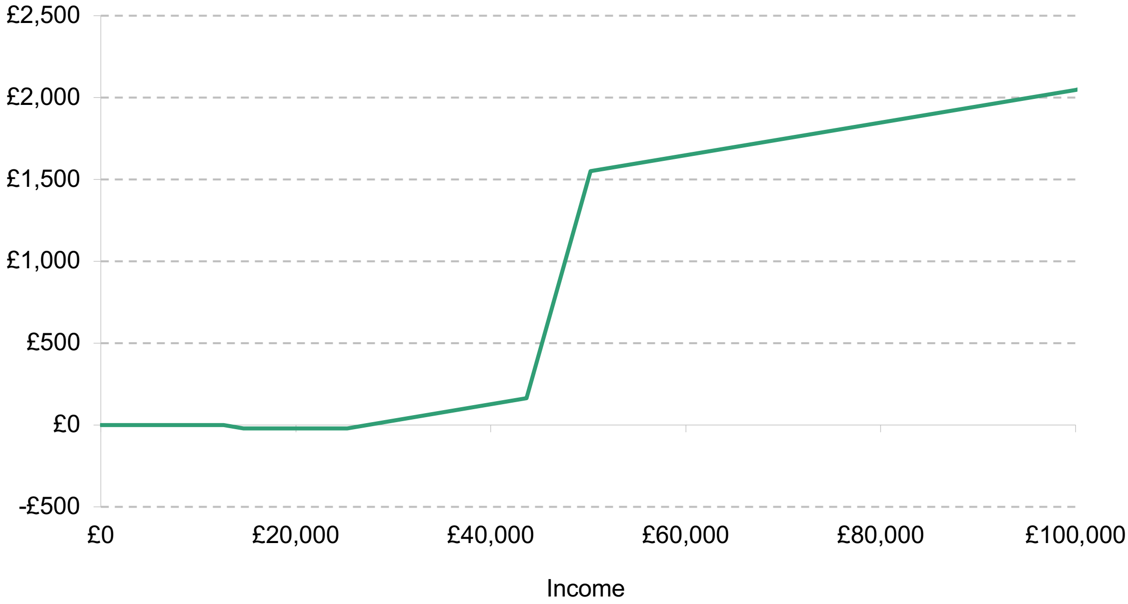
Source: Number of taxpayers from table 2 of https://www.gov.uk/government/statistics/scottish-income-tax-outturn-statistics-2018-to-2019. Total adult population from ONS 2018-based principal national population projections, https://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationprojections/datasets/z5zippedpopulationprojectionsdatafilesscotland.

The most eye-catching changes in Scotland have been to tax rates: the introduction of two new bands, taxed at 19% and 21%, either side of the 20% basic-rate band, and 1 percentage point increases in the higher and additional rates of tax. Increasing the higher rate to 41% also means that the effective tax rate between £100,000 and £125,140, caused by the withdrawal of the personal allowance, is 61.5%, compared with 60% in the rest of the UK. The biggest difference from the rest of the UK, however, is in the higher-rate threshold. It has risen by only 1.5% since being devolved, from £43,000 in 2016–17 to £43,662 in 2021–22 – not even keeping up with inflation – whereas the UK government has increased it to £50,270 in the rest of the UK.

The chart below shows the difference between income tax liabilities in Scotland and the rest of the UK at a given income level. The 19% starter rate means that taxpayers with incomes below £27,393 – just over half of Scottish income tax payers – pay less income tax in Scotland than they would in the rest of the UK. But the difference is small: the maximum gain in 2021–22 is £20.97, which applies to those in the Scottish basic-rate band, i.e. with income between £14,667 and £25,296. Those in the starter-rate band or near the bottom of the intermediate-rate band gain less than this, as do those in receipt of means-tested benefits, who see their higher after-tax income partly offset by reduced benefit entitlements.

In contrast, those with higher incomes pay significantly more tax in Scotland than they would in the rest of the UK – a result of the lower higher-rate threshold in Scotland as well as the higher rates. Someone on £50,000, for example, will pay £1,494 more income tax in Scotland than they would in the rest of the UK.

Difference in income tax liabilities between Scotland and the rest of the UK, 2021–22



Note: Assumes income is not from savings or dividends.

More about income tax in Wales

Since 2019–20, the Welsh Parliament has had the power to set the rates – though not the bands – of income tax for residents of Wales. These rates cannot be more than 10 percentage points lower than the rates that apply in England and Northern Ireland. The Welsh Parliament has so far chosen to leave the Welsh rates of income tax unchanged. Welsh taxpayers therefore face the same tax schedule as those in England and Northern Ireland.

Administration

Most income tax is deducted from income 'at source' by employers and pension providers through the Pay-As-You-Earn (PAYE) system and passed on to the government by them. Only a minority of taxpayers must fill in a tax return at the end of the year.

More about PAYE and self-assessment

The PAYE system involves employers (and pension providers) deducting income tax from earnings (and pensions) on an exact cumulative basis – i.e. when calculating tax due each week or month, the employer considers income not simply for the period in question but for the whole of the tax year to date. Tax due on total cumulative income is calculated and tax paid thus far is deducted, giving a figure for tax due this week or month. The cumulative system means that, at the end of the tax year, the correct amount of tax should have been deducted – at least for those with relatively simple affairs – whereas under a non-cumulative system (in which only income in the current week or month is considered), an end-of-year adjustment might be necessary.

Taxpayers with more complicated affairs – such as the self-employed, those with very high incomes, company directors and landlords – must fill in a self-assessment tax return after the end of the tax year, setting down their incomes from different sources and any tax-privileged spending such as pension contributions or gifts to charity; HMRC will calculate the tax owed given this information. Tax returns must be filed by 31 October if completed on paper or by 31 January if completed online. If people only paid the tax due when they submitted their tax return, they would be paying significantly in arrears, since the tax return can be filed almost 10 months after the end of the tax year in question (if done online). Most taxpayers subject to self-assessment must therefore make two 'payments on account' ahead of that – by 31 January of the tax year in question and by 31 July following the end of the tax year – each equal to half their tax bill from the previous year. For the 2021–22 tax year, for example, taxpayers make payments on account equal to half their 2020–21 liability in each of January 2022 and July 2022; when they submit their 2021–22 tax return by the end of January 2023, if it turns out their final tax liability for 2021–22 is higher (or lower) than the payments on account made so far, they pay (or get refunded) the balance of what they owe for 2021–22, in addition to making their first payment on account for 2022–23 (equal to half their final 2021–22 liability). Fixed penalties and surcharges operate for those failing to make their returns by the deadlines and for underpayment of tax.

PAYE works well for most people most of the time, sparing just over three-fifths of taxpayers from the need to fill in a tax return. The UK is unusual internationally in not requiring most people to fill in a tax return. However, in a significant minority of cases, the wrong amount is withheld – typically when people have more than one source of PAYE income during the year (for example, more than one job/pension over the course of the year), especially if their circumstances change frequently or towards the end of the year. Such cases can be troublesome to reconcile later on. Since April 2013, employers have been obliged to report salary payments to HMRC in real time, rather than just at the end of the year. This should allow HMRC to calculate tax liabilities and make any necessary adjustments more quickly based on real-time knowledge of individuals' income from all sources. In December 2015, the government also launched 'personal tax accounts', enabling people to see and manage more of their tax information online.

More change is on the way. As part of the government's 'Making Tax Digital' agenda, from April 2023 self-employed people and landlords with turnover of more than £10,000 a year will be required to keep records digitally and send an electronic summary of income and expenses to HMRC every three months during the year, with a finalisation and declaration by 31 January following the end of the year instead of a self-assessment tax return. (Those who are 'digitally excluded' and cannot do this will be exempt.) The new system is currently being piloted with volunteer businesses and landlords to test it before it becomes mandatory.

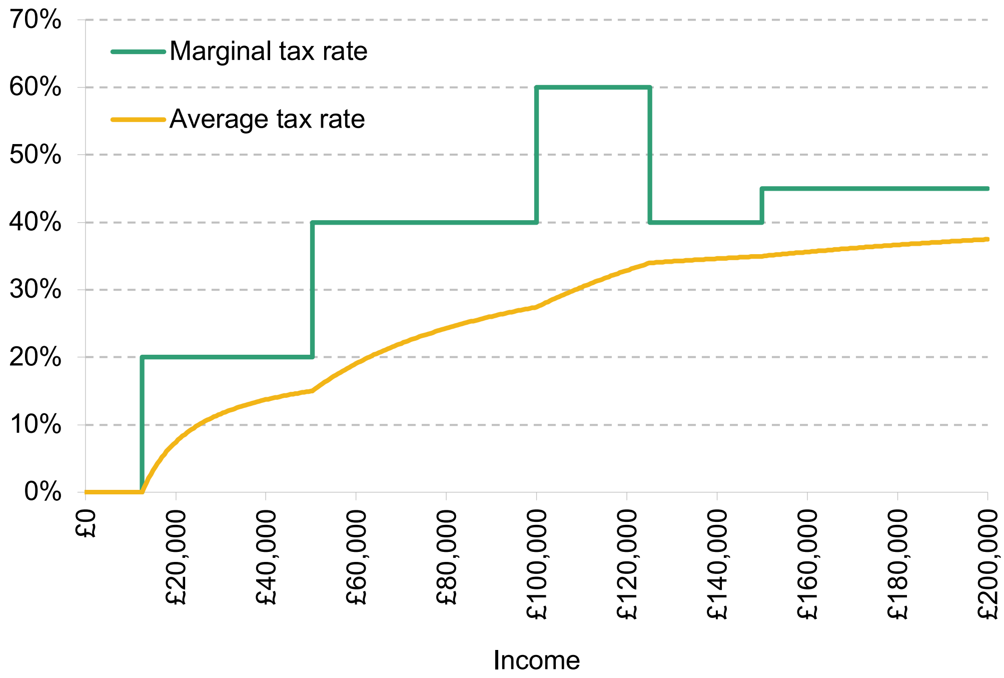
The modernisation and digitisation of tax administration are welcome. But such changes can cause major headaches if they go wrong. Implementing the new system smoothly is a major challenge for the government.

Who pays income tax?

Only 59% (about three-fifths) of adults have income high enough to pay income tax. More people than this are affected by income tax, because a higher proportion live in a family in which someone pays income tax, and a higher proportion still will pay income tax at some point in their lives. But even so, income tax reductions are poorly targeted as a way to help the poorest in society.

The schedule of rates and allowances makes income tax progressive, meaning that people with higher incomes pay a larger share of their income in income tax. This can be seen in the following chart, which shows that the average tax rate is rising at all levels of income.

Marginal and average income tax rates in England, Wales and Northern Ireland



Marginal tax rates versus average tax rates

One way to think about income tax is in terms of marginal rates. The marginal rate refers to the amount of tax paid on an additional £1 of income. For example, if an individual's income is £60,000, their tax bill will increase by 40p for every £1 by which their income increases; they therefore face a marginal income tax rate of 40%.

It is important to distinguish between marginal rates of tax and average rates of tax. The average tax rate refers to the share of a person's *total* income that is paid in tax. While an individual earning £60,000 will face a marginal tax rate of 40%, their average tax rate will be lower, because some of their income will be taxed at the basic rate of 20% and some will be exempt from tax thanks to the personal allowance.

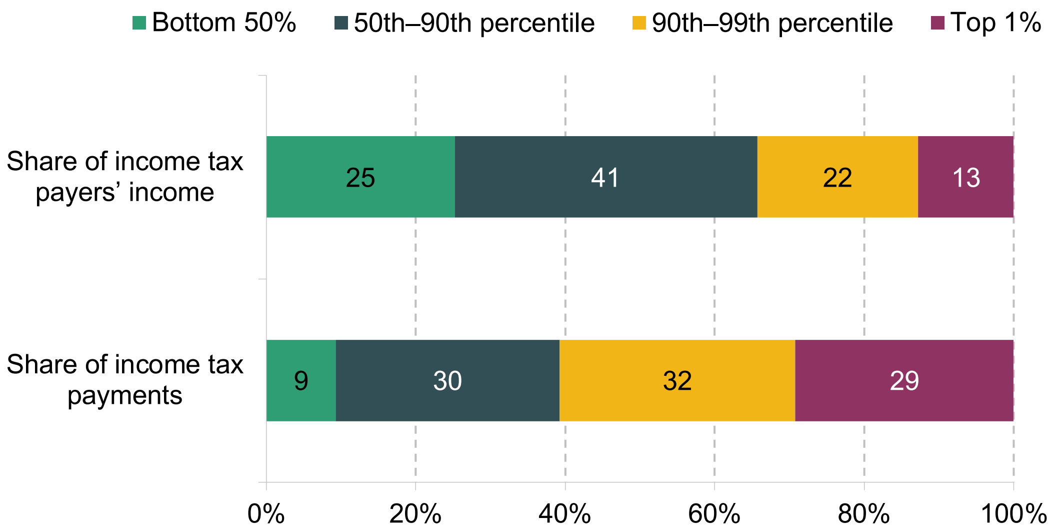
The chart above shows marginal and average tax rates at different income levels. Despite the marginal rate rising and then falling as a result of the withdrawal of the personal allowance, it is always above the average rate and so the average rate keeps rising at all levels of income. That means that people with higher incomes pay a larger share of their income in income tax: the income tax schedule is progressive.

Basic-, higher- and additional-rate taxpayers each contribute about a third of revenue (as shown in the first table in this article), reflecting the concentration of income in the hands of the better-off as well as the higher tax rates they face.

The chart below is another way to see the concentration of income tax payments among those who pay income tax. It shows that, in 2020–21:

- the higher-income half of taxpayers (the top 30% of all adults – those with incomes above £26,700) received three-quarters of the pre-tax income of income tax payers and provided over 90% of the revenue;
- the top 10% of taxpayers (the 6% of adults with incomes above £60,100) received 34% of the pre-tax income of taxpayers and provided 61% of the revenue;
- the top 1% of taxpayers (0.6% of adults, with incomes above £192,000) received 13% of taxpayers’ pre-tax income and provided 29% of all income tax revenue.

Concentration of income and income tax payments among taxpayers

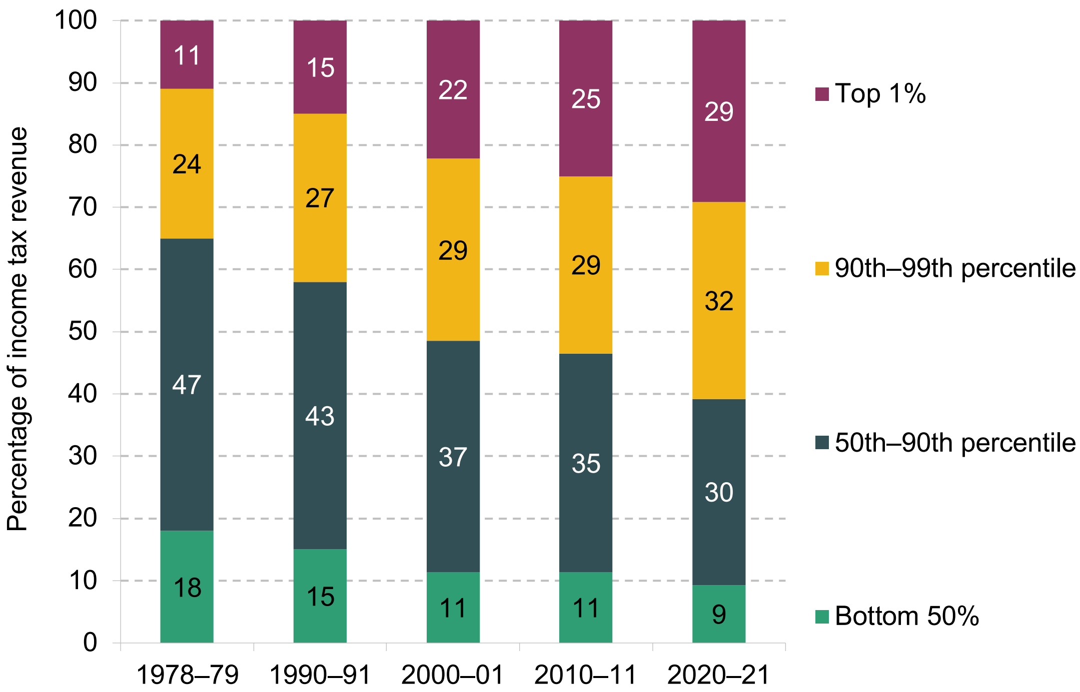


Source: HMRC Statistics table 2.4, https://www.gov.uk/government/statistics/shares-of-total-income-before-and-after-tax-and-income-tax-for-percentile-groups. Figures are projections for 2020–21.

The chart below shows that income tax payments have become increasingly reliant on a small group of taxpayers. The top 10% of taxpayers paid 61% of all income tax in 2020–21, up from 35% in 1978–79. The share of income tax revenue contributed by the top 1% of taxpayers rose from 11% in 1978–79 to 29% in 2020–21, despite big cuts in top rates of tax in the first 10 years of that period.

The reasons for the increase have changed over time: before 2007 it was driven mainly by rising income inequality, whereas since then it has been driven more by policy choices.

Contributions of different taxpayer groups (% of total income tax)



Note: 2020–21 figures are projections.

Source: HMRC Statistics table 2.4, https://www.gov.uk/government/statistics/shares-of-total-income-before-and-after-tax-and-income-tax-for-percentile-groups; various *Inland Revenue Statistics*.

Some care is needed in interpreting these figures since, as discussed above, income tax payers have been a changing proportion of the population over time. For example, during the 2010s the proportion of adults paying income tax fell as the personal allowance rose – so the top 1% of taxpayers constituted a shrinking share of the population even as they provided a rising share of the revenue.

More about the increasing reliance on high-income taxpayers

Before about 2007, the increase in the proportion of income tax paid by the highest-income taxpayers was primarily driven by rising income inequality. The top 1% paid an increasingly large share of income tax because they received an increasingly large share of aggregate income. But since 2007, increases in the share of tax being paid by the very richest have been driven more by changes to tax policy. In particular, the years after the financial crisis saw the introduction of the additional rate of tax (initially 50%, now 45%), the withdrawal of the personal allowance for those with incomes exceeding £100,000, reductions in the limits on tax-privileged pension saving, and real-terms reductions in the higher-rate threshold.

Income tax revenue has thus become increasingly dependent on a small group of people. This in turn raises challenges for the stability of UK tax revenue, as it becomes increasingly sensitive to changes in top incomes. Top incomes are more volatile and respond more to taxation than those of the population as a whole, meaning that the path of future income tax receipts is more uncertain than for more evenly spread taxes such as National Insurance contributions.

Income tax is not the whole story, of course. While it is by far the UK's biggest tax, it still only accounts for a quarter of revenue. The next two biggest taxes, National Insurance contributions and VAT, are much less progressive, while some smaller taxes such as capital gains tax and inheritance tax fall even more heavily on a small group of the very well-off.