

# Fiscal drag and real tax rates

When inflation is high, fiscal drag, which involves reducing the value of freezing allowances to counteract inflation, tends to be more effective. However, it often serves as a discreet way to increase taxes without violating political promises.



The Chancellor's Autumn Statement on November 17, 2022, faced criticism for its use of fiscal drag, with headlines claiming that "millions more" people would become "40% taxpayers". Was this criticism justified?

One viewpoint is that it was acceptable to highlight that the current inflation makes the use of fiscal drag by Mr. Hunt more noticeable and less stealthy compared to previous instances (although not as openly used as keeping the definition of "higher-paid employee" as one earning over £8,500 from 1979 to 2014, which impacted the taxation of benefits in kind but was too complicated to address).

However, it's inaccurate to suggest that "40% taxpayers" means they will pay that rate on all their income (this was an issue with the slab system of stamp duty in the past, but that's not an excuse).

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## **A look at the actual income tax rates:**

It's worth examining the actual income tax rates people pay in England, Wales and Northern Ireland. Although rates in Scotland are slightly higher, they won't significantly impact this overview.

National Insurance contributions are significant but are often ignored by headline writers, so we'll do the same.

“The basic income tax rates are: 0% for earnings up to £12,570; 20% for the next £37,700; 40% for earnings up to £150,000; 45% for earnings above £150,000.

The personal allowance of £12,570 for tax-free earnings is reduced by £1 for every £2 of income above £100,000.

This results in the following tax rates for different earnings: 0% for £12,500; 9.9% for £25,000; 15% for £50,000; and 27.4% for £100,000.

## **The Impact of Fiscal Drag**

A person affected by fiscal drag and labeled as a "40% taxpayer" may earn £50,000 this year and receive a 10% pay increase. Their income over £50,270 would then be taxed at 40%, resulting in an increase in their overall tax rate from 15% to 17%.

This is the most extreme scenario, but doesn't make for a headline-grabbing story. A more attention-grabbing headline would be: "Fiscal drag leads to an infinitely high tax rate increase for someone earning £12,500 and receiving an inflation-driven pay increase."