FB 2015 – the personal allowance and the national minimum wage

Personal tax

01 November 2015

LITRG comments on clauses 3, 4 and 5 of the Finance Bill

Tax credits and welfare

Clauses 3, 4 and 5 of the Finance Bill, which deal with the personal allowance and the national minimum wage, were debated and passed in Standing Committee on 17 September. Together, the effect of the three clauses is to:

- set the income tax personal allowance at £11,000 for 2016/17 and £11,200 for 2017/18, replacing the previously announced figures of £10,800 for 2016/17 and £11,000 for 2017/18 (cl 5);
- require the Chancellor of the Exchequer, before announcing a proposal to increase the personal allowance to an amount less than £12,500, to consider the 'financial effect of the proposal on a person paid the adult national minimum wage' (cl 4); and
- link the level of the personal allowance with the adult national minimum wage (NMW) in any year at the start of which the personal allowance is at least £12,500, assuming 52 weeks is worked at the NMW at 30 hours a week (cl 5).

Therefore, looking at 2016/17 and 2017/18, when the personal allowance will be less than £12,500, in both of those tax years clause 4 requires the Chancellor to consider the financial effect on a person paid the adult NMW. But what precisely is meant by 'the financial effect'? Does it involve taking account of the person's entitlement to tax credits and means-tested benefits, or is it confined to considering their pay combined with their liability to tax and national insurance?

In considering the financial position of any low-income household, we believe it is always necessary to take account not only of the tax and NIC they pay but also the benefits they receive. So we modelled the 'financial effect' of these measures as we saw them. The results did not surprise us.

Consider person P who is paid the adult NMW. Throughout 2015/16, P worked 30 hours a week earning £10,302 gross, on which they paid no income tax (for it falls below the personal allowance of £10,600) and NIC of £269.04 (primary threshold £8,060, rate 12%), giving them net pay of £10,032.96. In 2016/17 the NMW of £6.70 an hour will be supplemented by a 50p living wage premium for workers aged 25 and over, making P's gross pay £11,232. Out of this they will pay income tax of £46.40 (the personal allowance being £11,000) and NIC of £368.04 if we assume a primary threshold of £8,165 and a rate of 12%. This gives P net pay of £10,817.56, which is £784.60 more than in 2015/16.

So far, so good. But if P claims tax credits (let us assume both WTC and CTC) the effect of the reduced income threshold from £6,420 to £3,850, combined with the increase in the amount of the tapered withdrawal above that amount from 41p in the pound to 48p, will result in P's tax credit entitlement for 2016/17 being reduced by around £1,505.

The increase in P’s income due to the introduction of the national living wage will not itself have any effect on P’s tax credits award in 2016/17 because the first £2,500 of any increase in income in comparison with the previous year is disregarded. However, the disregard is effective for one year only and the increase in P’s income will be reflected in his award in 2017/18.

This illustrates that the overall tax and welfare system contains a series of complex interactions in which a gain in one aspect are counterbalanced by a loss in another.

Thus, in our view, it is the whole picture that should be examined to determine whether a person is better or worse off, not just the effect of increasing the minimum wage and raising the tax threshold.