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 JOHN VEIT-WILSON'S PAPERS
 ON CONCEPTS, DEFINITIONS AND MEASURES OF POVERTY,
 ON INCOME ADEQUACY AND ON MINIMUM INCOME STANDARDS.

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Publication data: *Routledge International Encyclopaedia of Social Policy* (2006) [www.routledge.com/]

MARGINAL TAX RATE.

A person's marginal tax rate is the proportion paid in tax of each additional income unit received at their highest level of income. It must be distinguished from their average tax rate, which is the proportion of their total income (including tax-free allowances and bands of income liable to tax at varying rates) paid in tax. Both of these must also be distinguished from their tax burden, the proportion of total income which goes on paying taxes, which can include indirect as well as direct taxes.

Governments can use marginal tax rates to affect the distribution of disposable personal incomes. A government wanting to redistribute unequal gross incomes may set marginal tax rates at progressive levels (increasing with each higher band of income). By contrast, as Adam Smith recognised (1776: *The Wealth of Nations*, book 5, chapter 2, part 2), a marginal tax rate of the same percentage across all income levels would effectively be regressive in its effects, since the utility of the same marginal income unit net of tax is far greater for a person on a low income than for one on a high income. He therefore called for the rich to pay 'not only in proportion to the[ir] revenues but something more than in proportion'. Using marginal tax rates to affect net income distribution is a different issue from the question of the total amount government aims to raise from income and other taxes on each section of the population.

The importance of the marginal tax rate to social policy also depends on the incidence of fiscal welfare as a whole. The levels of the tax threshold and of tax deductible allowances and tax credits affect individual tax burdens just as the tax rate does. Governments can use other fiscal tools besides income tax (for instance taxes on consumption or on corporate profits) for revenue purposes. The choice of balance between these factors is usually seen as a matter of the political salience of public concerns, which often focus on income tax marginal rates.

Implicit marginal tax rates are also found in some countries in the way cash or service benefits for low income recipients, or the remission of certain property taxes or charges for services, are linked to their income levels in such a way that as income rises, so their benefits taper downwards until they are lost. The *poverty trap or poverty plateau were the terms devised by David Piachaud and Jonathan Bradshaw in the UK in the early 1970s to describe the cumulative effect of income taxes and the tapered withdrawal of the value of *means-tested benefits as income rose. Low income earners trying to raise their incomes incurred effective marginal tax rates around or over one hundred per cent at certain points on the income continuum (the trap), and over significant ranges of gross income increases their net incomes remained relatively constant because of a commensurate loss of benefits (the plateau). This problem did not exist until governments had allowed the tax threshold to

fall to levels where even low incomes were liable to tax, and it was exacerbated by increases in the additional burden of separate hypothecated social security taxes (National Insurance Contributions in the UK) and in the variety of benefits and remissions of charges subject to means tests. Complex mixed systems of this kind are liable to impose very high implicit marginal tax rates on low earners, often far higher than political rhetoric asserts is tolerable for high earners.

It is widely believed that individuals' knowledge of their marginal tax rates affects their earning behaviour. High marginal rates are commonly believed to act as a disincentive for increased output by high earners, but as an incentive to work harder for low earners, and economists and rational choice theoreticians have speculated widely on the effects of such knowledge. Empirical survey evidence for such asserted behavioural effects, even amongst professionals with the best information and over many years in several countries, has not yet confirmed the belief, and psychological studies of work motivation have tended to refute it. However, some of the failure of many low income earners in the UK to claim means tested benefits has been ascribed to awareness of the potential poverty trap.

Further reading

Deacon, A. and Bradshaw, J. (1983), Reserved for the Poor, Oxford: Blackwell and Robertson.

Kay, J. and King, M. (1990), The British Tax System, Oxford: Oxford University Press.
