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How much tax do you really pay?

- The marginal effective tax rate (METR) is the incentive for those in work to increase their earnings. It represents the incentive to either move into work, or to work more.

- It is measured as the proportion of an increase in employer cost, i.e. gross earnings plus employer national insurance contributions (NICs), lost through income tax, employee NICs, employer NICs and any state benefits or credits foregone by the worker. The lower the METR, the greater the incentive to work.

- The complexity of the tax credits and benefits system makes it difficult to chart METRs faced over all levels of income. However, METRs comprising income tax, together with employee and employer NICs, can be calculated.

- Public finance theory suggests there is no long-term difference between the impact of employees' and employers' NICs. Both drive a wedge between the cost of the employee to the employer and what the employee finally receives, as outlined by Bell et al (2002).

- The METR faced by someone depends on their level of income. **Basic rate income taxpayers face an METR of 40.2%** - that is, for each extra pound it costs to employ them, 40.2p goes to the Treasury.

- **Those in the higher rate income tax band face METRs of 49.0%,** whilst for **those earning between £100,000 and £114,950 the METR is 66.6%**, due to the gradual withdrawal of the income tax-free personal allowance.

- Individuals in the **additional rate income tax band (the 50% band) have METRs of 57.8%.**

- In reality those at the lower end of the income scale face significantly higher METRs, as benefits and tax credits are withdrawn as income increases and student loans are repaid. It has been estimated that the marginal deduction rate (which also incorporates lost benefits) is sometimes as high as 96% for those moving into work from benefits.

- Reducing marginal tax rates improves incentives to work. Coalition reforms to the welfare system should remove the exceptionally high marginal deduction rates faced by those who seek to move from welfare to paid employment. **The highest marginal deduction rate, including employer NICs, under universal credit will be 79.1%.**

- But the government should aim to reduce marginal rates faced across all levels of income. Lower marginal tax rates, particularly for higher levels of income, are likely to boost government revenues through both increasing the tax base and reducing the incentive for tax avoidance techniques.

- When politicians refer to marginal tax rates of 20, 40 or 50 per cent, they are referring only to income tax. This is misleading. There should be more transparency about the real marginal tax rates people face.