CHASM | Centre on Household Assets and Savings Management

Briefing Paper

Income tax personal allowances matter for household portfolio choice

There are various policy measures which can help people on low incomes. Many are based on direct action such as social security benefits and housing subsidies. But long-term policy to help those on low incomes become better off is likely to require a more financially sustainable approach. One way of achieving this is to provide incentives for people on low incomes to save, and to save in a balanced portfolio of low and high risk assets[1]. Providing tax incentives is one potential policy tool in this area. Current policy initiatives such as ISAs are designed to increase incentives to save[2]. We are interested in the structure of savings.

Tax incentives can be provided in different ways. For example, the government could reduce the marginal income tax rates and/or increase the income tax allowances[3] If the marginal income tax rate is reduced and the Capital Gains Tax rates remain the same, then on the one hand, the increased after tax return on investments would encourage individuals to invest more in risky assets. On the other hand, the increased wealth could lead the investor to hold a relatively conservative portfolio. Both substitution effects and wealth effects will work together to determine the

[1] Low risk assets deliver lower returns than high risk assets but are more certain to deliver such returns.

[2] For example, there are approximately 24 million ISAs holders as at end 2008-2009 (HMRC), among whom 11% are having annual income below £5,000 and 16% are having income between £5,000 and £9,999. However, there are still many low income-households having no savings at all. Based on Family Resources Survey, 40% of families with an annual income below £20,000 had no savings in 2008–09.

[3] Note that government policy proposals are consistent with an increase in tax thresholds.

overall impact of taxation on individual’s portfolio allocation. Similar effects would be found by increasing the income tax allowances. However, the latter will have a relatively large quantitative impact on low-income households since they have low wealth. Compared with facing a reduced marginal income tax, increasing tax allowances will take low-income households out of paying tax or, equivalently, a zero-tax regime.

According to our research[4], tax allowances affect an individual’s asset allocation more than the marginal tax rates. We find that increasing income tax allowances will encourage those on low incomes to save in a more balanced portfolio (ie: they increase their risky asset proportion). All financial markets will provide a long-term basis for the low-income households to build wealth and develop long-term financial security. We find that taxation can encourage a more balanced saving approach.

Of course, such a change would need to be funded, for example, through a relatively small tax on the more wealthy in the short term. The key aspect is that by encouraging such behaviour the long term consequences for the economy will be that low-income households will substantially benefit from having more assets and greater income and that they will pay more tax in the future as a consequence.

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[4] We used individual level data from the British Household Panel Survey (BHPS) to examine the impact of tax allowances and marginal tax rates on portfolio shares in risky assets by using the Difference-in-Difference method. After controlling for demographic factors, we found paying income tax has negative impact on individual’s risky asset shares, which is significantly different from zero at 1 percent level. In contrast, we found the effect of marginal tax rate on risky asset shares is statistically insignificant.