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CABINET
MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

TAXATION OF SHORT TERM BENEFITS

Note by the Chancellor of the Exchequer

In our Manifesto, we said that "restoring the will to work ... involves bringing unemployment and short term sickness benefit within the tax system". The taxation of short term benefits is also one of the priority items within our strategy exercise.

2. The feasibility of doing this has been examined by an inter-departmental working group. A note by the Inland Revenue, who chaired the group, is attached. I have also had a parallel study carried out by an outside firm of consultants, Arthur Young.

- 3. There are two main issues:
 - (i) How the benefits should be taxed
 - (ii) Which benefits should be taxed.

How the benefits should be taxed

4. There are two methods here:

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(i) Taxing the benefits at the time they are paid (Method A in the attached note). The idea would be for the local offices of the paying Departments (mainly Department of Employment) to act as if they were employers, and apply PAYE to the benefits.

(ii) Leaving the tax to be collected later (Method B), either at the end of the period of unemployment or at the end of the tax year.

5. The main advantage of Method A is that where tax was deducted from the benefit it would deal more effectively with the incentive problem, by applying PAYE at the time the individual actually receives benefit. Its main drawback is that it could in some cases reduce an individual's income below the supplementary benefit level.

6. It does not, however, seem possible to act on a scale that will deal effectively with the "why work?" problem unless one is prepared to visualize the deduction of tax from incomes which would, in some cases, bring the claimant below the "official poverty line". I do not believe this means that one is wrong in principle: more probably the "official poverty line" has been drawn more generously than is compatible with the maintenance of incentives.

7. The main advantage of Method B is that it would avoid any question of making current deductions from supplementary benefit. On the other hand its main impact would not be felt until the individual returned to work.

8. Both schemes would reduce the tax rebates at present available when an individual's employment income drops to nil as he moves onto benefit. Under Method A, the rebates could continue, but they would be much smaller. Under Method B they would disappear altogether.

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9. The administrative changes required by Method A would be mostly for the Department of Employment; Method B would involve extra burdens for the Inland Revenue. Method B could impose an additional burden on employers, whereas Method A would not.

10. My strong preference is to bring the benefits within the tax system when they are received (Method A), and to treat them exactly as ordinary pay.

Which benefits are to be taxed

11. There are a number of short term benefits. Those paid for special needs (see paragraph 3 of the annex to the attached note) ought not to be taxed. The future of sickness benefit is already under review elsewhere, with the possibility that the main responsibility may pass to employers, in which case it will be possible to tax it under PAYE in the normal way.

12. That leaves, therefore, the following main benefits:

- (i) flat rate unemployment benefit (UB)
- (ii) supplementary benefit (Sup Ben)
- (iii) earnings related supplement (ERS)

13. There should be no problems in bringing UB into tax and it is right in principle to do so.

14. Sup Ben should also, in principle, be brought into tax because it is a major part of the benefits paid to the unemployed, and it may often be simply a matter of chance whether an individual is entitled to UB or Sup Ben or a mix of the two. Assuming we decide on Method A as the means of taxing this benefit, there will be some cases in which Sup Ben recipients are brought below the basic Sup Ben level. If Sup Ben were taxable only up to a level equivalent to the standard rate of UB, the number affected would be reduced to about 60,000. This is what I think we should do.

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15. One problem with bringing ERS into tax is that this would push many people down below the Sup Ben level. It is, however, the benefit which is mainly responsible for minimising the gap between income in and out of work. I have, therefore, no doubt that it should be brought into tax. To deal with each assessment individually would be a complex and expensive business. But in my view such precision is unnecessary. The thing to do would be to pay it in a "net of tax" form, rather like building society interest - with a standard "deduction" of possibly 15 or 20 per cent.

Revenue yield

16. The revenue yield from taxing benefits on the basis I have proposed would be about £200 million.

Staffing

17. Around 2,800 staff would be required for the proposed scheme. This compares with the official estimate of 4 to 5,000 extra staff which was made shortly before the Election. It also compares with an estimate of 750 additional staff made by the consultants, Arthur Young. It is possible that the current estimate of 2,800 might be reduced in the light of further discussions with the outside consultants.

Implementation

18. I had hoped that it might-have been possible to start the scheme in April 1981. Our review has, unfortunately, revealed that it would be very difficult to do it before April 1982, and our consultants agree. Regretfully, I think we must accept this.

19. To meet even the April 1982 deadline, considerable work needs to be done, particularly on the computer side. To facilitate the planning, we ought to make an announcement early in January.

Recommendations

20. I invite colleagues to agree that:

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- (i) We proceed with a scheme to bring into tax unemployment benefit, supplementary benefit and earnings related supplement, on the basis I have described.
- (ii) The benefits should be brought into tax when they are paid (Method A).
- (iii) We aim to implement the scheme from April 1982.
- (iv) We make an announcement immediately after the turn of the year.

BRINGING UNEMPLOYMENT BENEFIT WITHIN THE TAX NET

BRINGING UNEMPLOYMENT BENEFIT WITHIN THE TAX NET

In their pre-Election Manifesto, the Government stated their determination to restore the will to work by bringing unemployment and short-term sickness benefit within the tax system. Proposals are under consideration to replace most sickness benefit by requiring employers to pay a minimum level of sick pay, and such payments could be readily brought into PAYE. This paper is concerned with the benefits paid to the unemployed.

2. Annex A contains summaries of the main recommendations in reports by a Working Group of officials from the Departments concerned, and also by a firm of management consultants (Arthur Young Management Services) (G.H.) made a parallel but independent assessment. (These reports have been seen by Ministers immediately concerned and copies can be supplied on request.)

What does "taxation" of benefits mean?

3. While it is customary to talk in terms of "taxing" benefits needs to be stressed that tax will actually be deducted

H.M. Treasury
7 December 1979

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ATTACHMENT TO E(79)79

NOTE BY THE INLAND REVENUE

BRINGING UNEMPLOYMENT BENEFIT WITHIN THE TAX NET

Introduction

In their pre-Election Manifesto, the Government stated their determination to restore the will to work by bringing unemployment and short-term sickness benefit within the tax system. Proposals are under consideration to replace most sickness benefit by requiring employers to pay a minimum level of sick pay, and such payments could be readily brought into PAYE. This paper is concerned with the benefits paid to the unemployed.

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What does "taxation" of benefits mean?

3. While it is customary to talk in terms of "taxing" benefits the point needs to be stressed that tax will actually be deducted

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in relatively few cases. This is because the standard rate of the benefits is below the tax threshold. The real effect of the proposals will simply be to reduce the PAYE refund the individual would otherwise have received (which is a principal element in producing a situation under which income in unemployment is often as high or nearly as high as income in employment).

Benefits concerned

4. The benefits which have been considered for inclusion within the tax charge are flat-rate unemployment benefit (UB), including earnings-related supplement (ERS) and supplementary benefit (Sup Ben). The following table shows the scale and the combinations of these benefits received by unemployed claimants in Great Britain in November 1978:

UB alone	213,000
UB and ERS	189,000
UB and Sup Ben	71,000
UB, ERS and Sup Ben	19,000
Sup Ben alone	516,000

5. It is recommended that certain additional payments (listed in Annex A) should be excluded from the tax charge.

Method of taxation

6. There are two ways in which benefits could be brought into tax: either when they are paid (Method A); or later, either at the end of the period of unemployment or the end of the tax year (Method B). As will appear later, the choice of basis of taxability affects the decision as to what items should be brought within the tax net.

7. The main advantage of Method A is that where tax was deductible from the benefit it would deal more satisfactorily with the incentive problem by applying PAYE at the time the individual actually receives benefit.

8. From the administrative viewpoint, current taxation (Method A)

- (i) has the virtue of familiarity (since it embodies the PAYE procedures used by the Inland Revenue and widely understood by employers and claimants);
- (ii) means that tax would be applied to benefit in just the same way as to earnings.

9. On the other hand, Method A would:
- (i) raise the problem that in a limited number of cases - depending on the benefits charged - beneficiaries might be pushed below the Sup Ben level;
 - (ii) cause more work for DHSS and for DE, who would act as "employer" for PAYE, and would therefore have to take on additional responsibility (including fortnightly statements of explanation).

10. The main problem with Method B is that tax would not be deducted currently. The benefits would be paid in full, and the impact on incentives would not be felt until tax had been collected later, after any return to work.

11. From the administrative point of view, Method B would:
- (i) remove any danger of making current deductions, whatever the benefits charged;
 - (ii) be simpler for DE and DHSS to operate;
 - (iii) involve extra work for the Revenue;
 - (iv) add to the burden of employers who would, unless tax refunds were made by DE at the end of the benefit period, have to pay a substantial proportion of the 1.8 million refunds made during unemployment.

12. It would of course be technically possible to combine either method with any choice of benefits to be brought within the tax net.

Benefits to be brought within the tax net

13. The full list of short-term benefits is set out in Annex A. Those in paragraph 3 of Annex A should not be brought into tax. So far as the rest are concerned, the taxation options are summarised in paragraph 1 of the Annex.

Supplementary Benefit

14. There is a strong case for taxing Sup Ben, because, if it were excluded:

- (i) a major part of the benefit paid to the unemployed would be left out of tax;
- (ii) a person with a good contribution record (receiving UB) would be liable for more tax than one with a deficient record (receiving Sup Ben);
- (iii) the voluntarily unemployed (who receive Sup Ben) would be favoured as against the involuntarily unemployed (who receive UB if otherwise qualified for it. At present, those disqualified from UB receive rather less than those in receipt of UB. If Sup Ben were exempt from tax, while UB was taxed, that difference could be largely eliminated.

15. On the other hand, there is the question whether it would be right to bring Sup Ben within the tax net at all. In some cases this would mean tax actually being deducted from means-tested amounts which are regarded as the minimum subsistence level. Method B would avoid this problem while still enabling Sup Ben to be taken into tax. Under Method A tax deductions would depend on the claimant's PAYE code number (determined principally by his personal tax allowances) and the level of benefit. In most cases, the effect would be to reduce the amount of tax refunded due to unemployment, rather than cause tax deductions. In some cases, depending on whether or not the charge was limited to an amount equivalent to the basic rate of UB, deductions would bring the claimant below his Sup Ben level. If he were then to be left below his Sup Ben level, this would require legislation - no doubt controversial - to amend the Sup Ben scheme. If, on the other hand, he were allowed to draw further (non-taxable) Sup Ben to bring himself up to the level, this would mean taking benefit away with one hand and returning it with another; and it would not only create a substantial unproductive work load but would lead to a high risk of the scheme being discredited in the eyes of staff, claimants, the general public and Parliament.

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16. It would go a long way to meet the problem and might avoid the need to restore beneficiaries to the Sup Ben level if the taxability of supplementary benefit were confined to the standard rate of unemployment benefit as in Option 3A. As this would normally be below the tax threshold, tax would not be deducted in most cases. The number of people who would fall below the SB level as a result of deductions would be about 60,000. These are mainly people on emergency codes, or who have other income, or whose code reflects arrears of tax.

Earnings related supplement

17. There is a good case in principle for including ERS in the tax base: it is the relatively well off worker, qualifying for ERS, who gains most from benefit being untaxed. But if both ERS and Sup Ben are within the tax net and tax is applied currently many more people are brought below the Sup Ben level.

18. There is however a way of treating ERS which overcomes objections to its exclusion and also meets the difficulties referred to in the previous paragraph. Normally ERS, or a considerable portion of it, would actually attract tax as it is likely to bring the recipient above the tax threshold. One could therefore "deduct" from all payments of ERS a "compounded" rate of tax - possibly 15 per cent or 20 per cent. ERS would then be paid "net" in just the same way as Building Society interest and there would be no question of either repaying the tax or charging any additional tax by reference to the income of the recipient. If the recipient then fell below the Sup Ben level he would be entitled to claim Sup Ben (as 19,000 ERS recipients already do) without there being any obvious implication that Sup Ben was being given to make good tax deductions. An approach on these lines would enable one to apply PAYE currently to UB and the standard rate of Sup Ben (Option 3A) while at the same time securing a reasonable measure of "tax" from ERS.

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Staffing and Revenue

19. Annex B to this paper sets out the official Group's estimates of the staff required, and annual revenue yield, and the running costs of five of the six options. The yield varies between £m150 and £m200. The figure of staff required - for most options - is about 2,800. This is a significant reduction compared with figures quoted earlier. The estimates given by the consultants after adjustments on both sides are still significantly lower again. This is partly because they recommend changes in procedures which may or may not be acceptable and partly because they are looking at the position not when the scheme is first introduced, but when it has had time to settle down. Discussions are continuing and it may be that some further reduction can be made in the estimates given above.

Implementation

20. Officials and consultants agree that it would be very difficult to bring in a satisfactory scheme before April 1982. Even this date cannot be regarded as firm until a rigorous and detailed analysis is made of the requirements, particularly in relation to programming and testing the computer system. Moreover, if the unemployment register rose above two million, additional computer capacity would be needed to allow the scheme to proceed.

Northern Ireland

21. Payment of UB in Northern Ireland will not be computerised before 1984. Taxing it manually would be disproportionately costly, which suggests that it might be preferable to defer the start of a scheme in Northern Ireland until 1984 (or when computerisation is completed). Considerations of fairness as between one individual and another, however, point the other way.

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Strikers

22. There would be the appearance of discriminatory treatment if Sup Ben were taxable in the hands of the unemployed but not in the hands of strikers. If Sup Ben is to be taxed, the options examined could probably be adapted to apply to strikers, with some administrative difficulty (since strikers, unlike the unemployed, are still "employed" and their PAYE records remain with their employers and this would probably mean that if strikers' benefit were to be taxed this could only be done by deducting tax at the basic rate). But it would be preferable to await the outcome of current consideration of "deemed strike pay" proposals before deciding on this.

Timetable for decision

23. Since the lead time is over two years, it is highly desirable that decisions about the method and the tax base should be made before the end of December 1979 if the suggested timetable (implementation in April 1982) is to be achieved. This would be followed by an announcement early in January 1980 (since the Staff Sides of the three departments concerned would need to be involved in the detailed planning of a scheme with effect from then). Main legislation, which though relatively simple could be controversial, would then be in the 1980 Finance Bill, with consequential amendments to regulations in 1981.

Summary

24. The following are the main issues for decision:
- (a) Should benefits be brought within the tax net on a current basis, i.e. as with PAYE at present (Method A), or on a subsequent basis, i.e. when unemployment ends or at the year end (Method B) (paragraphs 6-12)?
 - (b) (i) Should supplementary benefit be brought within the tax net (paragraphs 14-15)?
 - (ii) If it is, should the amount brought in be restricted to the standard rate (paragraph 16)?

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- (c) (i) Should ERS be exempted (paragraph 17)?
(ii) Or would the kind of scheme set out in paragraph 18 be acceptable?
- (d) If Ministers choose a current rather than a subsequent method of taxation, and some beneficiaries are brought below their supplementary benefit level, what steps, if any, should be taken to help them?
- (e) Do Ministers agree that the elements of benefit listed at Annex A(3) should not be taxed?
- (f) Will Ministers accept the staffing requirements even if they cannot be further reduced (below about 2,800) (paragraph 19)?
- (g) Should taxation of benefits paid to the unemployed in Northern Ireland be deferred until payment of UB is computerised there (paragraph 21)?
- (h) Do Ministers accept the proposed timetable for operating the scheme and for decision and announcement (paragraphs 20 and 23)?

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SUMMARY OF MAIN RECOMMENDATIONS IN REPORTS

1. a. Benefits to be charged

Option 1 flat rate unemployment benefit (UB), including the addition for dependent wives, earnings related supplement (ERS) and supplementary benefit (Sup. Ben) up to the standard rate of single or married UB.

Option 2 UB and ERS

Option 3 UB and Sup. Ben. up to the standard rate of UB.

- b. Method of taxation - A Currently, as under PAYE
- B Subsequently, at the end of the period of unemployment or the tax year.

DE and DHSS prefer Option 1B

IR and consultants prefer Option 3A

2. Tax deductions under Method A which reduce claimant's income below Sup. Ben. level

Officials suggest that, under Options 1 and 2, whose broader tax bases would increase the likelihood of tax deductions, claimants brought below the Sup. Ben. level should be entitled to (further) Sup. Ben. (which, to avoid an infinite regression, should not itself be taxable). Officials and consultants suggest that tax deductions under Option 3 should not give rise to (further) Sup. Ben. (DHSS dissenting).

3. Items not to be brought into charge

All agree that the following should be excluded from tax:

- i. Exceptional circumstances additions (discretionary weekly additions to Sup. Ben. in respect of exceptional and specific expenses).

iii. Child additions to UB and Sup ben It would be anomalous to tax since Child Benefit and the Child additions to (taxable) long term benefits are exempt from tax.

iv. Rent and rate additions It would be anomalous to tax while rent and rate rebates paid by local authorities continue to be tax-free.

Options	1990	1991	1992	1993	1994
1A	90	670	1050	100	2,860
2A	1160	1090	1050	300	3,600
2B	80	670	1070	130	2,550
3A	340	1090	1050	300	2,780
3B	90	670	1030	100	2,490

Options	Approx annual running cost in £ million					Average 1990-94
	DB25	DB	1A	DB25 DB1	TOTAL	
Option 1B	1.8	4.6	11.7	6.7	14.8	180
2A	9.7	7.2	6.3	2.0	25.2	250
2B	1.5	4.6	10.3	6.7	17.1	180
3A	3.3	7.1	6.1	2.0	18.5	175
3B	1.6	4.6	11.7	6.7	14.6	175

These estimates, which are currently being examined with the consultants, are subject to revision in the light of more detailed consideration of various options, procedural changes under review, and any variations in the numbers of employed, etc.

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ANNEX B

STAFF COSTS - REVISED OFFICIAL ESTIMATES

Options	Approx number of staff required in units				
	DHSS	DE	IR	DHSS (NI)	TOTAL
Option 1B	90	670	2000	100	2,860
2A	1160	1090	1050	300	3,600
2B	80	670	1770	110	2,630
3A	340	1060	1050	300	2,750
3B	90	670	2000	100	2,860

Options	Approx annual running cost in £ million					Revenue yield £m
	DHSS	DE	IR	DHSS (NI)	TOTAL	
Option 1B	1.6	4.6	11.7	0.7	18.6	200
2A	9.7	7.2	6.1	2.0	25.0	150
2B	1.5	4.6	10.3	0.7	17.1	150
3A	3.3	7.1	6.1	2.0	18.5	175
3B	1.6	4.6	11.7	0.7	18.6	175

These estimates, which are currently being examined with the consultants, are subject to revision in the light of more detailed consideration of methods of taxation, procedural changes under review, and any variations in the numbers of unemployed, etc.

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