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CABINET
MINISTERIAL COMMITTEE ON ECONOMIC STRATEGY

BRINGING SHORT TERM BENEFITS INTO TAX

Memorandum 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". Taxation of short term benefits is also one of the priority items within our strategy exercise.

2. We are making useful progress. So far as sickness benefit goes, the scheme to pass the main responsibility for this to employers, foreshadowed in the Answer given by the Secretary of State for Social Services on 17 December, will effectively bring most of the amounts paid within the PAYE system. The taxing of benefits paid to the unemployed, which is what this paper is concerned with, has been examined by an Interdepartmental Working Group and also, in parallel, by an outside firm of consultants, Arthur Young. The attached note by the Inland Revenue examines the implications. The operation is feasible, and decisions on detail are now needed quickly in order that we should bring the system into operation by April 1982.

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The questions to settle

3. There are two allied questions to be settled.
 - a. Which benefits payable to the unemployed should be taxed.
 - b. How should they be taxed.

Benefits to be taxed

4. There are three benefits in question - (i) flat rate unemployment benefit (UB), (ii) supplementary benefit (Sup Ben) and (iii) earnings related supplement (ERS). There is no reason in principle why UB and ERS should not be taxed in full - indeed that is the object of the exercise. As for Sup Ben, this should also in principle be brought into tax because it is a major part of the benefits paid to the unemployed, and it may be simply a matter of chance whether an individual is entitled to UB or Sup Ben or a mix of the two. I propose, however, that child additions to UB and Sup Ben, and certain other additions to Sup Ben, set out in paragraph 3 of Annex A to the Inland Revenue note should not be taxed for the reasons given.

Method of taxation

5. There are two methods, both of which are feasible:
 - i. Bringing the benefits into tax at the time they are paid (Method A in the Inland Revenue note, but with compound tax on ERS and the "suspense" provisions in paragraphs 14-15 of the note). Under this method local offices of the paying departments (mainly the Department of Employment) would act as if they were employers and apply PAYE to UB and Sup Ben, subject to the limitation that deduction

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of tax should not reduce the payment below an actual or estimated Sup Ben level; any tax not deducted for this reason could be collected later eg at the end of the spell of unemployment or the end of the tax year. ERS would however be taxed at a low flat rate (say 15 per cent) and paid "net of tax", as described in paragraph 14 of the Inland Revenue note.

- ii. Bringing the benefits into tax in full at the end of the period of unemployment, or at the end of the tax year if that falls within the period (Method B).

6. The yield from Method A, as varied in paragraphs 14-15 of the Inland Revenue note, would be some £190m and from Method B some £200m; the total Civil Service staff required would be about 3,400 for Method A (as varied) and 2,800 for Method B. It may however be possible to reduce these figures substantially - see paragraph 10 below. Both conceptually and in practice Method A differs substantially from Method B.

7. Instinctively I prefer Method A: my preference rests on my very strong belief that the object of the exercise should be to tax unemployment benefits by bringing them into the PAYE system. The PAYE system is known and understood; it applies to the vast majority of wage and salary earners, it will apply to sickness payment when brought within the Employers' Statutory Sick Pay scheme, and it is likely to apply shortly to retirement pensions and the like. It is what the man in the street understands by "taxing" when weekly or monthly payments are in question.

8. But under Method A there is no way of guaranteeing that the operation of PAYE will not bring some people below their Sup Ben level. Estimates are hard to come by but with Method A (even as varied in paragraphs 14 and 15 of the Inland Revenue note) there might be 20,000 claimants at any one time brought

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below their Sup Ben level. (These could, as the law stands, claim Sup Ben to restore their income to this level.) Method A as varied to incorporate a "suspense" device, thus leaves the Sup Ben problem unresolved, though somewhat reduced. Moreover, I have to accept that it would be difficult for the public and staff operating it to understand; that it would add to the administrative complexity of the scheme and so to the staff costs; and that the yield would be reduced.

9. For all these reasons, I reluctantly join the Secretaries of State for Social Services and Employment in favouring Method B, particularly as it now agreed that refunds at the end of the period of unemployment should be made by DE rather than by the new Employer or the Revenue. Method B avoids the Sup Ben problems altogether; it enables ERS to be taxed properly; and it also has the effect of totally withholding tax refunds during unemployment (unless the end of the tax year intervenes) which may make it more acceptable since the withholding of refunds until return to work would widen the gap between income in and out of work,

10. But whichever method is adopted the staff cost is worrying. As the Revenue Note indicates (para 16) the figure - 2,860 for Method B - may be reduced following further discussion with the consultants; and initial discussion suggests that it might come down to around 2,000. In the longer term, as officials and claimants become more familiar with the system and PAYE is computerised (after 1987), the figure would come down further. But it would still remain in four figures. I have therefore been considering less costly alternatives.

11. Undoubtedly the fair and proper method which we promised in our Manifesto - is to treat the benefits as the claimant's income for tax purposes. The ways of doing this have been thoroughly explored by officials and the consultants, and they lead us to either Method A or Method B. The only conceivable alternative would be a system of "imputed tax" under which benefits would be reduced by a flat x per cent per week. This

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would not be tax as it would not accrue to the Exchequer, but it could be presented as at least a precursor of a proper tax system.

12. The main advantage of this would be that it could be introduced before 1982, with an offer to re-examine the possibility of bringing the benefits into tax later in the decade in the light of developments such as the computerisation of PAYE. Its main disadvantages are first that seen as a method of taxation it does not necessarily give fair results. It would reduce benefits going to all the unemployed, although a good many of them, especially the long-term unemployed, would be exempt from tax on the benefits if treated as part of their income. The unfairness could to some extent be mitigated if benefits for longer term unemployment (eg after a year) were not reduced; but this would be extremely rough and ready. Secondly, tax refunds during unemployment would continue. It would be presentationally awkward, to say the least, to reduce benefit by an amount that was seen as a possible precursor of tax, while continuing to make tax refunds, representing the personal allowances due week by week, under the normal operation of PAYE. Furthermore, it would patently not be taxation, and we should continue to be under pressure to fulfil our Manifesto commitment.

13. I see the attraction of such an alternative as avoiding the heavy staff costs; and indeed in the context of the public expenditure operation the Secretary of State for Social Services may want to use some shadow of this argument in relation to certain of our proposals. But seen as an alternative to taxation in the longer term, I consider that its attraction is much outweighed by the considerable disadvantages. I should therefore favour bringing the benefits into tax (under Method B) with effect from 1982.

Implementation

14. I had hoped that it might have been possible to start a scheme of taxation in April 1981. Our review has unfortunately revealed that it would be very difficult to do this before.

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April 1982, and our consultants agree. Regretfully I think we must accept this. Even this date cannot be regarded as firm until further planning work has been carried out, particularly on the computer side. In order to get the planning going it is essential that an announcement be made by the end of January at the latest.

Summary and recommendation

15. Methods have been found whereby our Manifesto commitment to tax unemployment benefits can be implemented from April 1982. The benefits in question are unemployment benefit, ERS and Sup Ben, though not child dependency and other allowances payable with unemployment benefit and Sup Ben. Of the two possible methods of bringing the benefits into tax - applying PAYE as far as possible (Method A as varied) and settling the tax position on return to work or at the end of the tax year (Method B) - the Secretaries of State and I come down in favour of Method B. Although it may not be what the ordinary person expects of us, it avoids the very serious problem of bringing people below their supplementary benefit level, and it has a lower staff cost and higher tax yield than Method A.

16. In view of the staff cost I have considered the possibility of an alternative under which benefits would simply be reduced by a flat percentage (which could be presented as a precursor of a tax system). But it would be fundamentally unfair, and neither I nor my colleagues could recommend it as a permanent solution.

17. I invite colleagues to agree that we should choose Method B and announce our decision before the end of this month. The staff cost will be further examined with the consultants, with a view to reducing the cost as far as possible.

hm.
(G.H.)

H.M. TREASURY
17 January 1980

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NOTE BY THE INLAND REVENUE

BRINGING SHORT TERM BENEFITS INTO TAX

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.

2. Annex A contains summaries of the main proposals in reports by a Working Group of officials from the departments concerned, and also by a firm of management consultants (Arthur Young Management Services) who have 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 the point needs to be stressed that tax will actually be deducted in relatively few cases. This is because the standard rate of the benefits is below the tax threshold. The real effect of the proposals in most cases will 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

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

5. It is proposed that certain additional payments should be excluded from the tax charge, for the reasons given in paragraph 3 of Annex A.

Method of taxation

6. There are two ways in which benefits could be brought into tax either when they are paid, as under PAYE (Method A); or later, either at the end of the period of unemployment or the end of the tax year if that falls during the period (Method B).

7. Incentive effects Both methods would affect the tax refunds at present available when taxable income drops to nil on becoming unemployed. They should both therefore reduce the present disincentive to return to work. Under Method A, the refunds would be made automatically with payments of benefits each fortnight (not dependent on a claim as now), but they would be much smaller than now. Most married men would get a refund of around £4 a fortnight as against £44 a month - in both cases in addition to his benefit. Under Method B there would be no refund until return to employment (or the end of the tax year if that was sooner). For the minority of claimants from whom tax was deductible from the benefits there would tend to be a greater incentive to return to work under Method A than under Method B. But in the majority of cases, where refunds were due, the incentive effect would tend to be greater under Method B. On the other hand, many do not now claim the refunds

due to them during unemployment but allow them to accumulate until return to work, and this suggests that the prospect of a future refund may not be so great an incentive. The difference in incentive effects is probably not enough to govern the choice between methods.

8. Administrative considerations 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 - to an extent which would depend on the benefits charged - some 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. Method B would:

- i. remove any danger of making current deductions, whatever the benefits charged;
- ii. be simpler for DE and DHSS to operate.

But it would -

- iii. involve extra work for the Revenue, and possibly add to the burden of employers who might have to pay tax were applied currently many more people would be brought below the Sup Ben level.

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a substantial proportion of the 1.8 million refunds made during unemployment. However, this would be avoided if the refunds were made by DE at the end of the benefit period.

Benefits to be brought within the tax net

11. It is proposed that those elements of benefit paid to the unemployed listed in paragraph 3 of Annex A should not be brought into tax. So far as the rest are concerned, the taxation options examined by the Working Group are summarised in paragraph 1 of the Annex. UB up to the standard rate (for single or married, excluding child additions) is common to all options and raises no particular problems. The problems arise over Sup Ben and ERS.

12. Supplementary benefit Sup Ben should clearly be taxed, because it is a major part of the benefit paid to the unemployed; in addition, if it were left untaxed, this could give rise to inequity of treatment between the person with a good contribution record (receiving UB) and one with deficient record (receiving Sup Ben), and between the involuntarily unemployed (who receive UB if otherwise qualified for it) and the voluntarily unemployed (who can receive reduced Sup Ben). However, taxing Sup Ben currently (under Method A) would mean that a significant number of claimants would be brought by tax deductions below their Sup Ben level; in that event, they would be entitled to make a further Sup Ben claim to restore themselves to the level. It would go a long way to meet this problem if the taxability of Sup Ben were confined to the standard rate of UB as in Option 3A: the number of people who could fall below the Sup Ben level as a result of tax deductions might then be about 60,000 at any one time. These would be mainly people whose PAYE code reflected other income or arrears of tax.

13. Earnings related supplement 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 were applied currently many more people would be brought below the Sup Ben level.

14. There is however a way of treating ERS which overcomes objections to its exclusion and also goes some way to meet 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 much the same way as Building Society interest but 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 - as some 15,000 might do on this basis - he would be entitled to claim Sup Ben (as 19,000 ERS recipients already do). 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, although lower, amount of tax from ERS. Some claimants would pay tax to which they would not otherwise be liable, however.

15. Reducing numbers brought below Sup Ben level under Method A.

There is no ready method of preventing the 15,000 ERS claimants mentioned in paragraph 14 above from falling below their Sup Ben level. However, it would, at least in theory, be possible to reduce the numbers - at any one time some 60,000 (as at paragraph 12 above) plus a further 38,000 claimants of ERS or flat-rate UB - liable to be brought below their Sup Ben level through PAYE tax deductions. Where the claimant was already on Sup Ben no tax would be deducted; and where he was not on Sup Ben, the standard Sup Ben level would be assumed, by reference to which the PAYE deduction would be restricted. Tax due but not deducted would be held in suspense for recovery later. To the extent that an individual's entitlement to Sup Ben proved to be higher than assumed, some claimants - perhaps some 5,000 in addition to the 15,000 mentioned in paragraph 14 - would still be brought by tax below their Sup Ben level; and these would, as the law stands, have a right to claim Sup Ben to restore them. Although such a system would be feasible, it would be difficult to comprehend (for those operating it, as well as for claimants) and would detract from the "current" principle of Method A. The total administrative costs would be higher than those for Method B (see paragraph 16 below).

Staffing and Revenue

16. 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 figure of staff required - for most options - is about 2,800. But if a scheme along the lines of that examined in paragraph 15 were adopted, then the staff cost of Option 3A - modified to bring in ERS at a compounded rate - would rise to around 3,400, with a yield of about £190m (and even this figure of 3,400 would be on the low side if the existence of a "suspense" system increased speculative claims for Sup Ben from people who in fact did not qualify for it). 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

17. Officials and consultants agree that it would be very difficult to bring in a satisfactory scheme before April 1982 (and if a scheme along the lines of paragraph 15 were adopted, even that date would be put at risk). Nor can this date 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

18. 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

Strikers

19. 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 currently 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.~~ before deciding the tax issue

Timetable for decision

20. Since the lead time is over two years, it is essential that decisions about the method and the tax base should be made before the end of January 1980 if the suggested timetable (implementation in April 1982) is to be achieved. This should be followed immediately by an announcement (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

21. It is proposed that the benefits to be taxed should be UB, including the addition for dependent wives, ERS, and Sup Ben up to the standard rate of single or married UB. If Ministers choose a current rather than a subsequent method of taxation, a scheme on the lines set out in paragraph 15 would be required if the number of claimants brought below their Sup Ben level it to be restricted to the minimum. The staff cost would then be of the order of 3,400 (for Method A, as varied), compared with 2,800 for Method B. The yield would be some £200m (Method B) or somewhat less (£190m) - depending on how ERS was taxed - for Method A. It is proposed that an announcement should be made

before the end of January 1980 with a view to implementation in April 1982. The essential decision about the method of taxing the benefits lies between Method A (as modified in paragraphs 14-15 above) and Method B. In addition, the timing of the taxation of benefits paid to the unemployed in Northern Ireland is for decision.

Option 2 US and ERS

Option 3 US and ERS up to the standard rate of US

Method of taxation

Current, as under the Bill, is to be applied to the period of unemployment in the tax year.

US and ERS

US and ERS

Method of taxation

at present, under the Bill, the standard rate of tax is applied to the period of unemployment in the tax year. This is to be applied to the period of unemployment in the tax year.

Method of taxation

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ANNEX A

SUMMARY OF MAIN RECOMMENDATIONS IN REPORT'S

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 Current, 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 (DHSS dissenting) and consultants suggest that tax deductions under Option 3 should not give rise to (further) Sup Ben.

3. Items not to be brought into charge

All agree that the following should be excluded from tax:

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

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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.