

TAX CONSULTATIVE COMMITTEE

NOTE OF A MEETING HELD IN THE TREASURY,

14 MAY 1984 AT 3.30pm TO DISCUSS THE TAXATION OF EMPLOYMENT INCOMES

PRESENT

Mr John Moore, Financial Secretary to the Treasury: in the Chair

Mr J M Green
Mr A J G Isaac
Mr D B Rogers
Mr R A Blythe
Mr B A Mace
Mrs C B Hubbard

Mr M J Kerr
Mr G W Penrose
Mr D C Potter
Mr E E Ray
Mr I P A Stitt
Mr B W Sutherland
Mr F Cassell
Mr R Lord

1. Apologies were received from Mr Christopher, Mr Kirby, Mr Loup and Mr Marlow.
2. The Financial Secretary thanked Mr Sutherland for preparing the paper which, along with the Revenue's commentary, was to be the subject of the meeting. A list of questions* had been circulated with a view to structuring the discussion around key themes, but he invited Mr Sutherland to make some preliminary comments.
3. Mr Sutherland said that since his paper had been written, he had had the opportunity to discuss matters with the Revenue, and in consequence had produced a supplementary note to clarify some of the issues or ambiguities which had been identified. He stressed that his proposed new system aimed at revenue neutrality, with anomalies to be resolved by employers. The new system would however start from the beginning of the tax year so that some of the fiscal adjustment could be used to smooth its path. In the longer term at least he envisaged cash allowances for all, as would be the case under a universal tax credit scheme. Initially any net cost, which was inevitable, would be "within the budgetary tolerance".

QUESTION 1: DISINCENTIVE EFFECTS

4. The Financial Secretary asked the Committee how important they thought the disincentive effect of a marginal tax rate (plus NIC) of 39%. Mr Sutherland explained that it was this very factor which had provoked him to consider an alternative system. When PAYE was introduced, only about 10% of the working population were affected by it. Different motivations affected the whole of the full-time employment force who were now within the PAYE net. The marginal rate of 39% on any increase over normal income had a significant effect which encouraged beating the system via the cash economy.
5. The other outside members of the Committee agreed that the marginal rate of 39% had a disincentive effect particularly in relation to overtime. Mr Potter, however, thought the main priority was to take the lower paid out of tax altogether. Mr Cassell pointed out that overtime was still very strong in the economy, and asked what evidence there was that the marginal rate was a real disincentive. Mr Sutherland said that much of the overtime paid was really disguised increments to the pay scales, which had become part

* attached

of the recognised pay structure, rather than rewards for extra effort. The examples of net of tax pay schemes proved that attitudes were different when the employee was paid net. The Financial Secretary said that the Government had recently given a lot of publicity to net pay schemes, but they had not yet been taken up widely.

6. Mr Potter argued that one should not stop people perceiving the cost of government. This concept outweighed any possible disincentive effects. Mr Sutherland thought such an approach led to pressures on the public services since individuals sought value from what they had paid for. The Revenue pointed out that the visible price of increasing benefits (by having to increase contributions to pay for them) had a restraining influence.

7. The Revenue asked how Mr Sutherland's proposed system would change peoples perceptions; individuals tended to look at the bottom line, ie take-home pay, which would be the same. Mr Sutherland argued that the employee would regard the wages and the cash allowance from the Government separately. The rest of the Committee however did not share this view. They thought that the bottom line was the only important thing, but there might be presentational problems in explaining why salaries were reduced to 61%. The Financial Secretary noted that Mr Sutherland's dual perception idea was not shared by the rest of the Committee.

QUESTION 2: SCOPE OF TAX CREDIT SCHEME ENVISAGED

8. Mr Sutherland said that he did not have in mind the major social objectives of the kind envisaged by the 1972 Tax Credit Green Paper. He was simply suggesting the conversion of the present PAYE codings into cash allowances. Pensioners and others not in employment could be dealt with by paying all benefits under deduction of tax. But for the present he confined discussion to application of the system to the taxation of employment income.

QUESTION 6: ADVANTAGES AND DISADVANTAGES OF COMBINING TAX AND NIC SYSTEMS

9. The Financial Secretary said that apart from the cost problems of a universal tax credit scheme, he was very concerned by the philosophical aspects of combining tax (from people in work) with benefits (paid to people in need). As the scale of benefits had risen in recent years above the tax allowances, there were clearly problems of interface between the two systems. But he wondered whether there was a way of combining the systems without changing attitudes to work. He saw considerable dangers in the idea of melding the work concept and the benefits concept.

10. Mr Potter and Mr Penrose shared the Financial Secretary's concern, and felt that it was important that the individual should be able to see the link between the paying of NIC and the system from which he might ultimately benefit. Mr Sutherland maintained that the effect of that identification would be to make him maximise his demands on the system.

11. Mr Ray said that he could accept melding on the deductions side, though not on benefits, but it would be necessary to make it clear that of the 39% rate, 9% represented contributions for National Insurance purposes, so that it could be related, for example to the cost of increasing pensions. The Revenue agreed that increases in NIC were generally accepted more readily because they could be related to the cost of increased benefits.

12. Mr Stitt could see a superficial attraction of melding on the deduction side, as the man in the street was not so concerned by the philosophical distinctions between the tax and national insurance systems, but the problem would be one of selling a high rate (39%). At present this problem did not arise as the two components could be seen as separate.

13. The Financial Secretary noted that if there was any support for Mr Sutherland's scheme, it was limited to combining tax and NIC into one rate, and that even this was not unanimously supported by the outside members.

QUESTION 5: 'KINKS' IN THE SYSTEM

14. Mr Sutherland suggested that the distortions in the present system should be eliminated by abolishing the lower and upper earnings limits for national insurance contributions. The Revenue pointed out that converting the lower earnings limit into a threshold was expensive, and that abolition of the upper earnings limit would increase the marginal rate of middle managers.

QUESTION 4: COMPLIANCE BURDEN

15. Mr Sutherland said that if the Government were nowadays to try to introduce a scheme such as PAYE, there would be an outcry from employers, but because it had developed gradually employers did not recognise the burdens imposed by the system. His system, being non-cumulative, would be infinitely simpler. Mr Potter considered that the PAYE system was not too complicated, and Mr Ray added that the days when employers did not have computers which could operate the payroll were disappearing. He said that the introduction of VAT had been feared by small businesses as an intolerable burden, but had, in fact, been managed perfectly well, and it had led to improved standards of book-keeping. Most small businesses now had computers.

16. At this point the Financial Secretary had to leave the meeting, and Mr Green took the Chair.

17. The Revenue pointed out that Mr Sutherland's scheme would have the effect of bringing into the system many who were currently outside it, such as casuals, part-timers, juveniles, or six million penders who were below the tax threshold. Against this Mr Sutherland pointed to those who were currently outside the system in the black economy, who would be brought within the net.

QUESTION 7: REVENUE COSTS

18. Mr Sutherland had explained in his supplementary paper, that his scheme was intended to be neutral in terms of revenue costs. Mr Green asked whether it would not, however, have some redistributive effects. Mr Sutherland accepted that it would, and that some employers might be worse off, depending on the pay structure within their companies. The vast majority, however, would break even, the overall revenue cost might be some 1/2 to 1 billion pounds. It might be necessary to have a pay increase for certain employees to protect take home pay.

19. Mr Stitt said that it was the element of rough justice in Mr Sutherland's scheme which gave him cause for concern and this might by itself be sufficient to rule the scheme out. There would have to be a very convincing reason for such a change, if the losers were to be persuaded to buy the new scheme. Mr Sutherland pointed out that in the examples of typical companies on which he had worked, the effect of his scheme had been minimal. Clearly, with some very different payroll structures, the differences

could be greater, but if the scheme was introduced following a budget which injected some fiscal adjustment in this field, there would not be many who would suffer unduly.

20. Mr Penrose drew attention to the difficulties which would arise in drafting the necessary legislation to cover this scheme for those individuals for whom net pay of 61% was not appropriate. The marginal situations would be so peculiar to the individuals involved that it was impossible to imagine the practicalities of legislating. Mr Potter agreed. Mr Sutherland suggested that the legislation would be framed in terms of the employer being allowed to reduce pay by up to a fixed percentage. Mr Ray pointed out that seeking to implement the scheme might risk provoking industrial action. Mr Sutherland accepted that gaining acceptance for the reduction of payments was the biggest hurdle the scheme would face.

21. The Revenue asked what effect the scheme would have on low incomes, on in particular those within the poverty trap since they would all now be paying tax on every pound of income. Mr Sutherland said that the benefits withdrawal rates would have to be restructured. The Revenue pointed out that this would have the effect of pushing, for example, FIS very high up the income scale.

22. Mr Green, drawing the meeting to a close, thanked Mr Sutherland and the rest of the Committee for a very interesting discussion; he would give the Financial Secretary a full account of all the reactions expressed. Mr Sutherland added that the subject was worthwhile discussing, even if his scheme was not accepted. It had useful spin-offs, such as looking again at national insurance contributions. Mr Ray however shared Mr Potter's view that it was more important to look at the taxation of the lower paid, and taking them out of the tax net where possible.

23. Mr Loup, who was unable to attend the meeting sent his comments by letter on Mr Sutherland's scheme in the following terms:-

" that the scheme propounded by Mr. Sutherland was unacceptable.

The nub of the matter was in his explanatory document when he started saying that wage earners would receive net payments with an imputed tax credit. Tax imputation is not readily intelligible to the person who does not deal with tax matters frequently.

However, more fundamental than this was the difficulty of translating existing wage term expressions into the new terms. It conjured up for me memories of the riots in this country when the calendar was changed and everyone was convinced that the Government of the day had cheated them of part of their lives. In addition, the whole scheme would put us out of line with other countries and make comparisons which are helpful, even more difficult. "

(Extract from letter)