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Chapter 1: Introduction

1.1 The Government regard it as of major importance to reduce the burden of income tax. Obviously, there are certain services that the State has to provide for the community as a whole - for example defence, policing, justice - and, as a matter of policy, governments provide other services, such as education and health care and support for the elderly and others in need. These have to be paid for, wholly or mainly, by general taxation. Beyond that provision the Government believes that people should be left to spend their own money as they wish. This maximises their freedom of choice. It gives incentives to effort and enterprise. And it produces an economy that is responsive to changing tastes and circumstances. For all these reasons taxes must be kept as low as possible, and their incidence made as fair and efficient as it can be.

1.2 The Government have already done much to ease the burden of income tax. The basic threshold at which income becomes liable to tax has been raised by 20 per cent in real terms since 1979, taking 1½ million people out of tax altogether. The basic rate of tax has been reduced from 33 to 30 per cent; and the top rate from 98 to 60 per cent.

1.3 But further progress is needed. Tax thresholds are still too low in relation to earnings. Before the last war a married man on average earnings paid no income tax. In 1950 the tax threshold for a married man was 60 per cent of average earnings; now it is 39 per cent. The married man on average earnings now pays nearly a quarter of his income in tax.

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1.4 If the tax burden is to be further reduced the first need is to contain public expenditure. Over the 20 years from 1964 to 1984 public expenditure rose from about 35 per cent of gross domestic product (GDP) to about 45 per cent. That upward trend has now been reversed. The second need is to ensure that tax reductions are concentrated where they can do most good. This means combining tax reductions with changes in the structure of our personal tax system.

1.5 A major structural reform of income tax is bound to shift the relative burden of tax between individuals. But if that is considered unacceptable, then no tax reform would ever be possible. Indeed, it is one reason why so little reform of income tax has been undertaken. But there has also been another reason. The pay-as-you-earn (PAYE) system, which is such an efficient and simple method of collecting tax, could not, while operated manually, cope with radical change. The computerisation of PAYE now under way, and due to be complete by the end of 1987, offers an opportunity to change the structure of the tax system in radical and imaginative ways that were not possible before. As the Chancellor said in his Budget speech, when announcing this Green Paper, "The computerisation of PAYE makes this the right time to review the system of personal taxation."⁽¹⁾

1.6 The first part of this Green paper deals with the reform of personal allowances and the tax treatment of husband and wife. Chapter 2 describes the present system and sets out the case for change. It explains how the present system prevents tax reductions being concentrated where they are most needed, denies married women the opportunity for independence and privacy in their tax affairs and imposes penalties on marriage. Chapter 3 proposes a new system of transferable personal allowances, designed to meet these short-comings, which would be the centre-piece of the programme of tax reduction.

(1)

1.7 The second part of the paper, chapters 4 and 5, looks at how, if the new system were to be introduced, it might deal with particular groups, such as the elderly and single parents, and at its implications for other areas of the tax system.

1.8 The third part of the paper considers how the tax system might develop in the longer term, and in particular the relationship between the tax and social security systems. It also examines possible developments in the way the tax system is administered. Unlike the earlier parts, it does not set out proposals for change, but examines the arguments that have been advanced for moving to a different system.

1.9 Computerisation gives us the opportunity to change the structure of personal taxation. To be able to take maximum advantage of it, and introduce a tax system more fitted to the times, we need to examine precisely what is wrong with the present system, and discover the best way to put it right. That is the purpose of this Green Paper.

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PART I - TRANSFERABLE ALLOWANCES

Chapter 2: The Case for Reform

The Present System

2.1 The amount of income tax people have to pay depends on the rate of tax and on the personal allowances to which they are entitled. The personal allowance is essentially a slice of tax-free income.

2.2 The structure of the basic personal allowances has remained virtually unchanged since 1942.

- Single people have an allowance, currently £2,205.
- Married men have approximately 1½ times the single person's allowance, currently £3,455.
- The wife's earned income allowance is equal to the single person's allowance but, as its name implies, can only be set against the wife's own earned income.

2.3 The income of a married couple is added together ("aggregated") for tax purposes and treated as if all the income belonged to the husband. All personal allowances (including, in law, the wife's earned income allowance,) are given against the husband's income (which is taken to include his wife's income). This means that:

- A married couple where both are in paid work (a "two-earner couple") have approximately 2½ times the single allowance, (married man's allowance of 1½, plus wife's earned income allowance of 1).

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- A married couple where only the husband is in paid work (most "one-earner" couples) have approximately $1\frac{1}{2}$ times the single allowance, through the married man's allowance.

- But, where only the wife is in paid work the couple have approximately $2\frac{1}{2}$ times the single allowance. This is because all the income is treated as the husband's for tax purposes, so he can set against it both his married man's allowance and the wife's earned income allowance.

Annex 1 gives further details of the present system.

2.4 The Government have looked at the case for reforming the structure of personal allowances, with three main objectives in mind:

- To be able to raise tax thresholds cost effectively in terms of reducing the tax burden on families with low incomes. The present low tax thresholds for many such families contribute in no small measure to the poverty and unemployment traps.

- To give married women the same opportunity for privacy and independence in tax matters as their husbands.

- To remove discrimination against marriage and the family.

RAISING THRESHOLDS

Thresholds for Different Couples

2.5 Tax thresholds are too low. Chart 2.1 shows how the married man's tax threshold has fallen as a proportion of average manual earnings since the late 1940s.

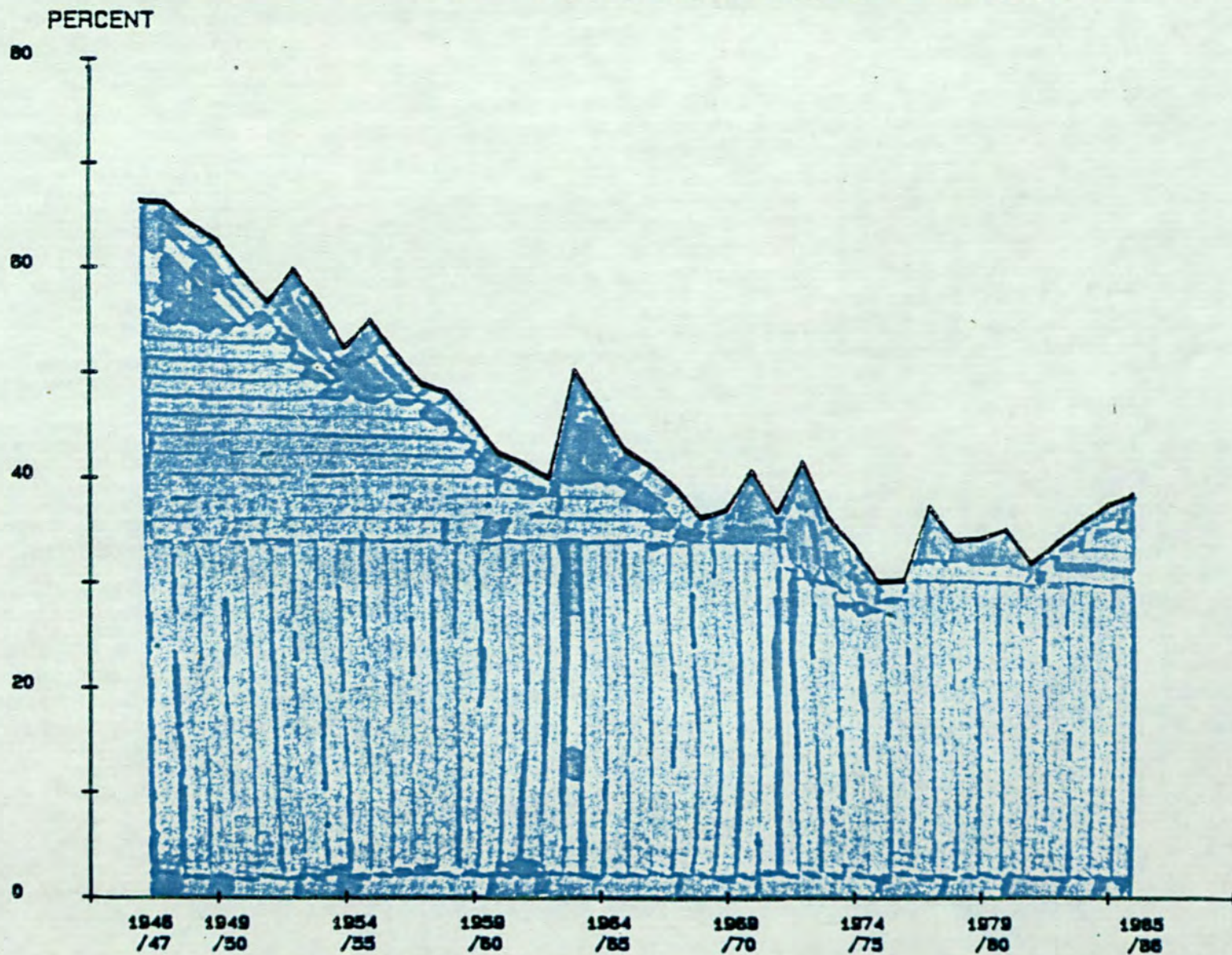
2.6 In spite of the 20 per cent real increase in thresholds since 1979, too many people still come into tax at too low a level of income. Further progress must be made. But raising tax thresholds is expensive - it costs around £1 billion in revenue to increase personal allowances by 5 per cent. So it is vital that thresholds are increased in the most cost-effective way.

2.7 Low tax thresholds weaken incentives. The group worst affected are married men on low earnings with families to support. Not only is their tax threshold (at £3,455, or £66 a week) a good deal lower than for families where both husband and wife are in paid work (where it is £5,660 or £108 a week), but they are often at a stage in life where their family commitments are high. Thus it is mostly one-earner families that are caught in the unemployment and poverty traps that arise where the tax and social security systems overlap.

The Unemployment Trap

2.8 People find themselves in the unemployment trap when their income out of work is almost as high as their disposable income when they are in work. Indeed, it may actually be higher on occasion. An important reason for this is that people entering work start paying tax at levels of income well below half average earnings.

CHART 2.1 : MARRIED MANS TAX THRESHOLD AS A PERCENTAGE OF MANUAL WORKERS AVERAGE EARNINGS 1946-47 TO 1985-86



2.9 It is reckoned that one in every 16 working families - 900,000 - would have at least 80 per cent of their present income if they did not work at all.

The Poverty Trap

2.10 People who are in work find themselves in the poverty trap when, because of the combination of income tax, national insurance contributions, and the withdrawal of income-related benefits, they are little or no better off if their earnings increase. Indeed they may sometimes be worse off.

2.11 The amount that people in the poverty trap lose out of each extra pound of earnings is known as their marginal rate. At present, in the extreme case, it is possible for the marginal rate to be as high as 108 per cent.

2.12 It is estimated that some [210,000] low income families with children have marginal rates of 75 per cent or more; [165,000] of these are people receiving family income supplement who also pay tax. A further [90,000] families have marginal rates between 50 and 75 per cent.

Changes in Social Security

2.13 The Government's proposals for the reform of social security⁽¹⁾ would help to alleviate these traps.

2.14 They would align the structure of the benefits paid to people who are out of work with those for people in work, with the aim of ensuring that people in work are better off than they would be if they were not

(1) "Reform of Social Security", June 1985, Cmnd 9517-9519. This is referred to from now on as "the Social Security Green Paper".

working. Family income supplement would be replaced by a new income-related benefit for low income families in work, called family credit.

2.15 The amount of family credit a person receives would depend on his net income, after tax and national insurance contributions, rather than on his gross income. Similarly, the entitlement to housing benefit would depend on net income, after tax, national insurance contributions and family credit.

2.16 The social security reforms will reduce the level of marginal rates that people can face: marginal rates of 100 per cent or more will be eliminated. However, further changes are needed to reduce the number of people who find that their incomes are low enough to make them eligible for income-related benefits but high enough for them to have to pay income tax.

2.17 This can be offset by raising tax thresholds. But with the present system of personal allowances it is very expensive to increase thresholds for married couples where the wife is not in paid employment, who are much the largest group affected by the traps. The table below and chart 2.2 show how a rise of 5 per cent in personal allowances, costing about £1 billion in revenue, would be distributed among different groups of the population. Because the married man supporting his family gets $1\frac{1}{2}$ times the allowance for a single person, whereas the couple who are both in paid employment get up to $2\frac{1}{2}$ times, some 45 per cent of the increase in tax relief for those of working age goes to two earner couples, though these form only 30 per cent of taxpaying families.

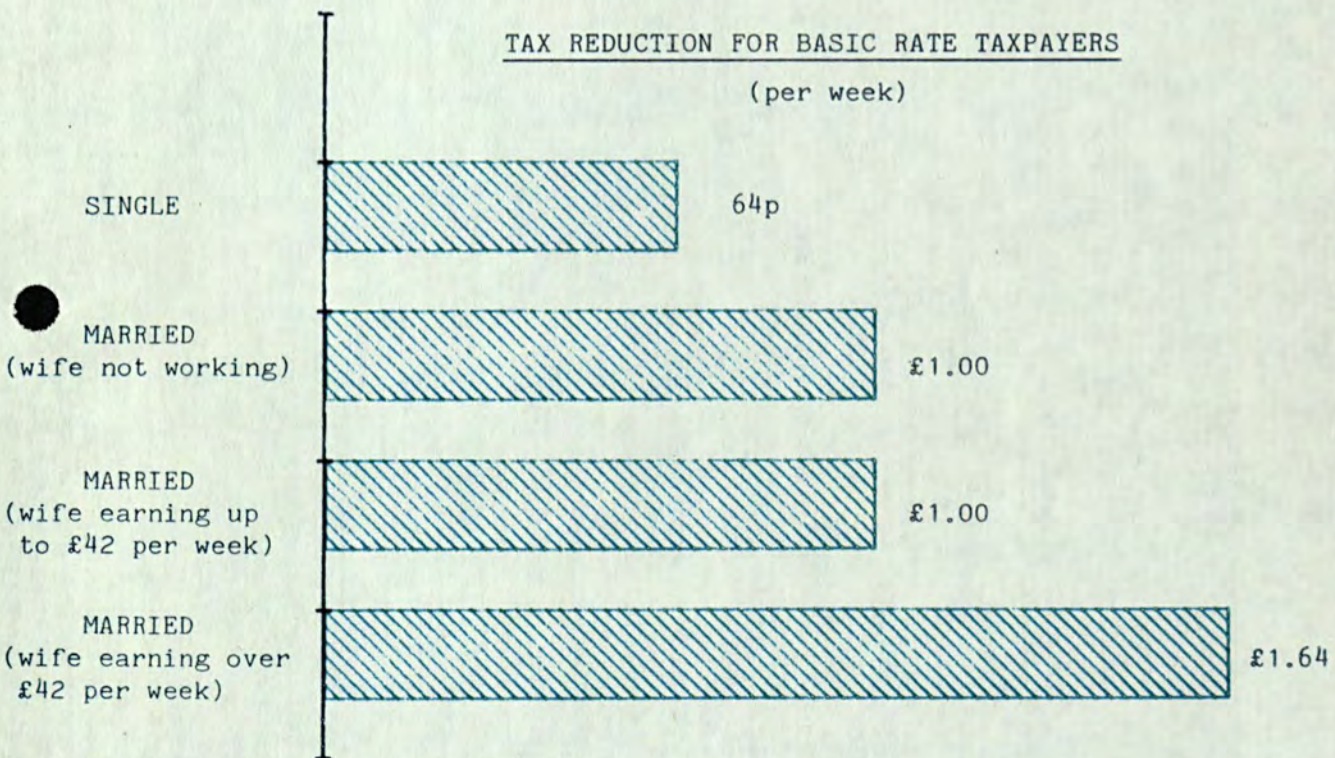
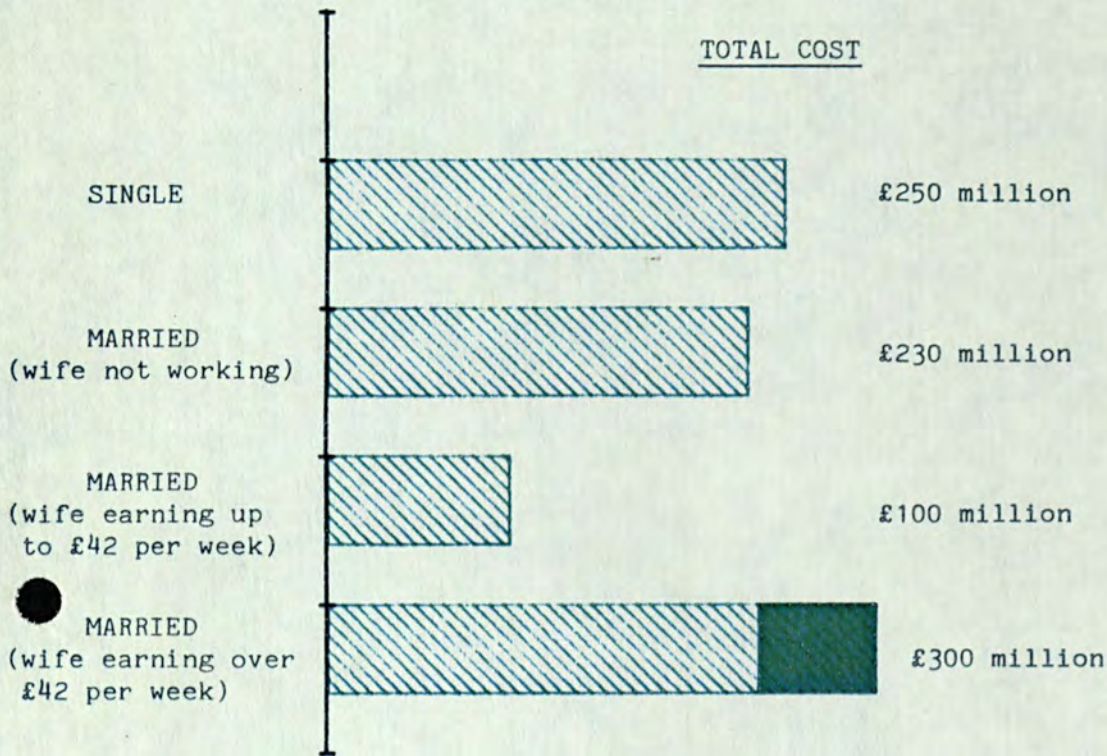
2.18 So when tax thresholds are increased in the Budget, two-earner couples benefit much more than one-earner couples. If allowances are increased by 5 per cent, families with one earner will be £1.00 a week better


Table : Effect of 5 per cent increase in personal allowances for taxpayers of working age.

Taxpayer group:	Single	Married Couples (wife not working)	Married Couples (wife earning under £42 per week)	Married Couples (wife earning over £42 per week)	Total
Total cost of allowance increases (£ million)	250	230	100	300*	880
Number of taxpayers affected (million)	7.8	4.4	1.8	3.6	17.6
Tax reduction for a basic rate taxpayer (per week)	64p	£1.00	£1.00	£1.64	-

Of which £65 million represents the additional cost of increasing the allowances for two earner married couples by more than twice the increase available to a single person.

CHART 2.2 : EFFECT OF 5 PERCENT INCREASE IN PERSONAL ALLOWANCES
(Taxpayers of working age)



 Extra cost (£65 million) due to these couples having about 2½ times, rather than twice, the single persons allowance

off, whereas families with similar incomes but with two earners will gain by £1.64 a week.

2.19 The present system therefore does not target effectively the benefit of threshold increases where it is most needed and where it can do most to ease the poverty and unemployment traps. A new structure is needed to raise the tax threshold for one-earner couples.

TREATING HUSBAND AND WIFE EQUALLY

2.20 The present system rests ultimately on tax law dating back to the start of the last century, which treats a married woman's income as her husband's for tax purposes. In the words of the legislation:

"A woman's income chargeable to income tax shall ... (for any year) during which she is a married woman living with her husband be deemed for income tax purposes to be his income and not to be her income".⁽¹⁾

A number of features of the system flow from this, and have attracted widespread criticism.

2.21 A married woman does not have an allowance of her own to set against income other than earnings. Partly because of this, and partly because a wife's investment income is added to her husband's for tax purposes, some 350,000 married couples pay more tax than two single people with the same incomes.

2.22 The husband is legally responsible for a couple's tax affairs. This means that the husband has to include his wife's income on any tax return he gets, and hence that a married woman cannot have privacy in her financial affairs.

⁽¹⁾ Section 37 Income and Corporation Taxes Act 1970, though the wording has been in substance the same since 1806.

2.23 These matters were considered in the earlier Green Paper "The Taxation of Husband and Wife"⁽¹⁾ and the proposals in chapter 3 below have taken into account the responses to it. The proposals reflect the Government's belief that a married woman should have the same right to deal with her own tax affairs as any other taxpayer.

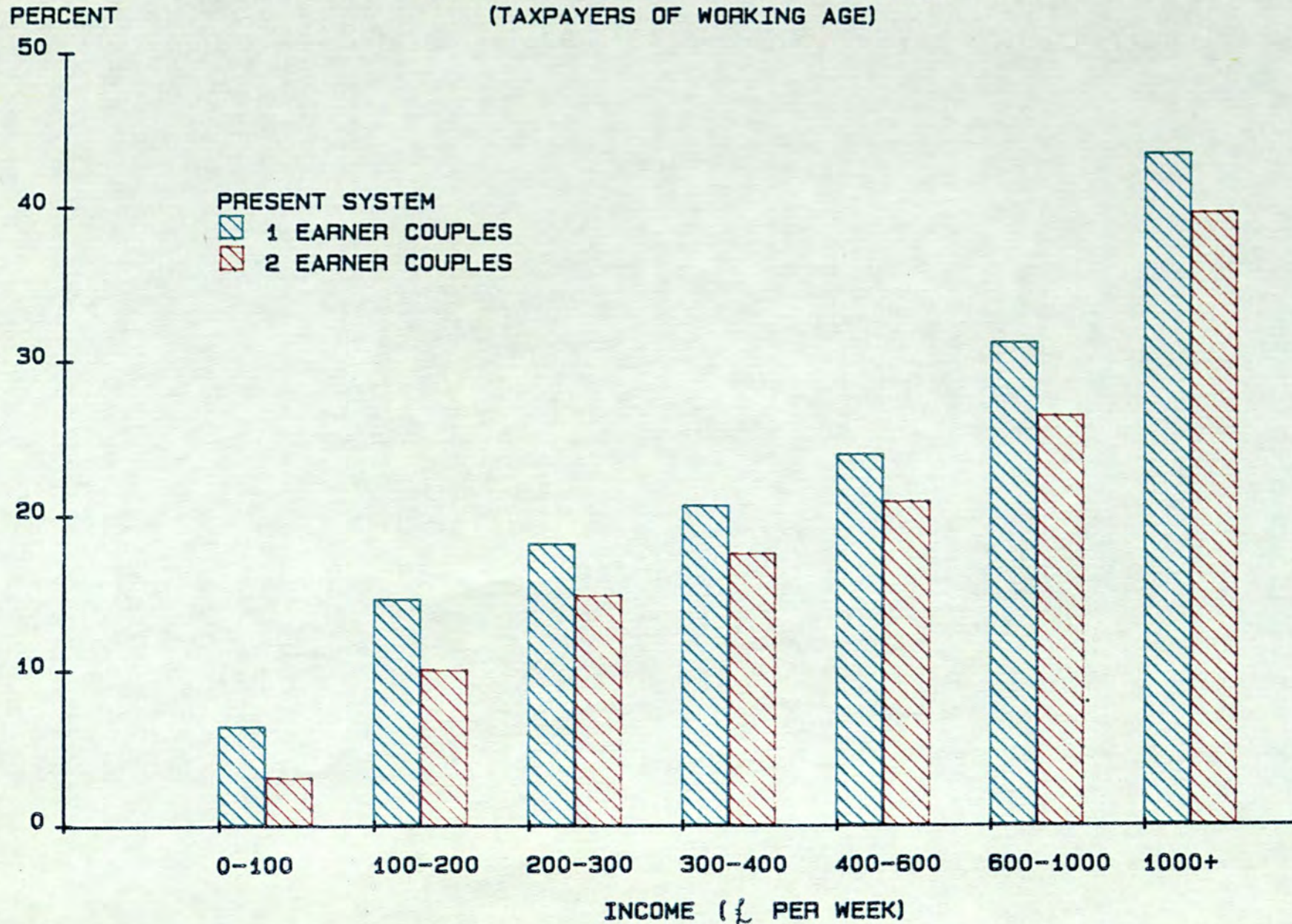
A BETTER DEAL FOR THE FAMILY

2.24 Although, in a number of ways, the tax system takes account of the shared responsibilities of married people, in other ways it bears more harshly on married than on unmarried couples. This applies to the taxation of investment income and capital gains, to the additional personal allowance for single parents and to the relief allowed on mortgage interest. In all these areas the present system operates in a way that can mean that a couple would pay less tax if they were unmarried. Many of these effects stem from the basic rule that for tax purposes a married woman's income is treated as her husband's. All this is rightly seen as an indefensible tax penalty on marriage.

2.25 The present tax system also bears hardest on many married couples at times when they have the responsibilities of a young family. Under the present system, if a one-earner married couple and a two-earner couple have the same income, the two-earner couple will pay substantially less tax (see Chart 2.3). In most other countries, as can be seen from Annex 7, there is no such discrimination.

2.26 Most couples nowadays find that at times both partners are earning and at other times only one is earning, depending on where they are in their life cycle. The vast majority of married men below retirement age are in the job market, as are over 60 per cent of married women of working age. Almost all women will be in paid

CHART 2.3: AVERAGE RATES OF TAX FOR MARRIED COUPLES
AT VARIOUS LEVELS OF GROSS INCOME
(TAXPAYERS OF WORKING AGE)



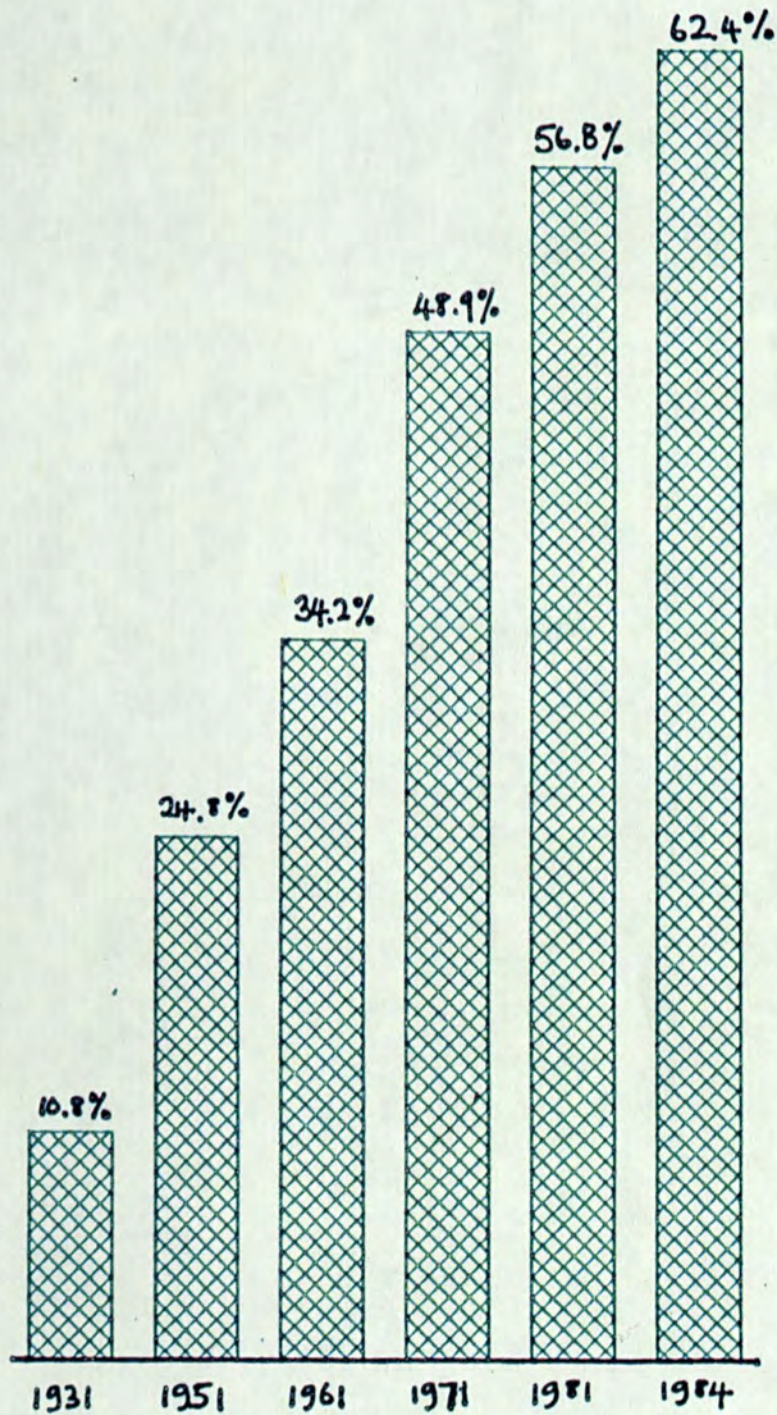
married lives. Chart 2.4 shows how the proportion of married women in paid employment has grown since the 1930s. Most of the married women who do not have a paid job have specific reasons for not going out to work: many are looking after children or other relatives; others suffer from ill-health, or find it difficult to enter the labour market after an absence caused by domestic responsibilities. Chart 2.5 illustrates this, drawing on the results of a survey (taken in 1980) of the reasons given by married women for not being in paid employment. Annex 6 gives more details of married women's employment patterns.

2.27 Thus in many marriages both partners will typically have paid jobs until the wife leaves work to have children. She may then go out to work again as the children grow older.

2.28 The present tax system takes no account of this life cycle. Couples have high tax allowances ($2\frac{1}{2}$ times the single allowance) when both are in paid work, but see a sharp reduction (to $1\frac{1}{2}$ times the single allowance) if the wife leaves paid work. This is likely to be the time when the couple are under greatest financial pressure - they lose the wife's earnings, and may be taking on new family responsibilities, usually with the birth of the first child.

2.29 The present structure of allowances, giving two-earner couples $2\frac{1}{2}$ times the single allowance, originated in the circumstances of war in 1942, when there was a need to give special encouragement to married women to go out to work. Today, for most married women, it is the rule rather than the exception to be in employment, and the system needs to be changed to remove discrimination against couples where only the husband is in paid employment. The present tax system bears hardest on couples at precisely the point when most of them can least afford it.

CHART 2.4: THE PROPORTION OF MARRIED WOMEN WORKING OR LOOKING FOR WORK HAS BEEN GROWING SINCE THE 1930'S.



SOURCE: CENSUSES OF POPULATION AND LABOUR FORCE SURVEY 1984

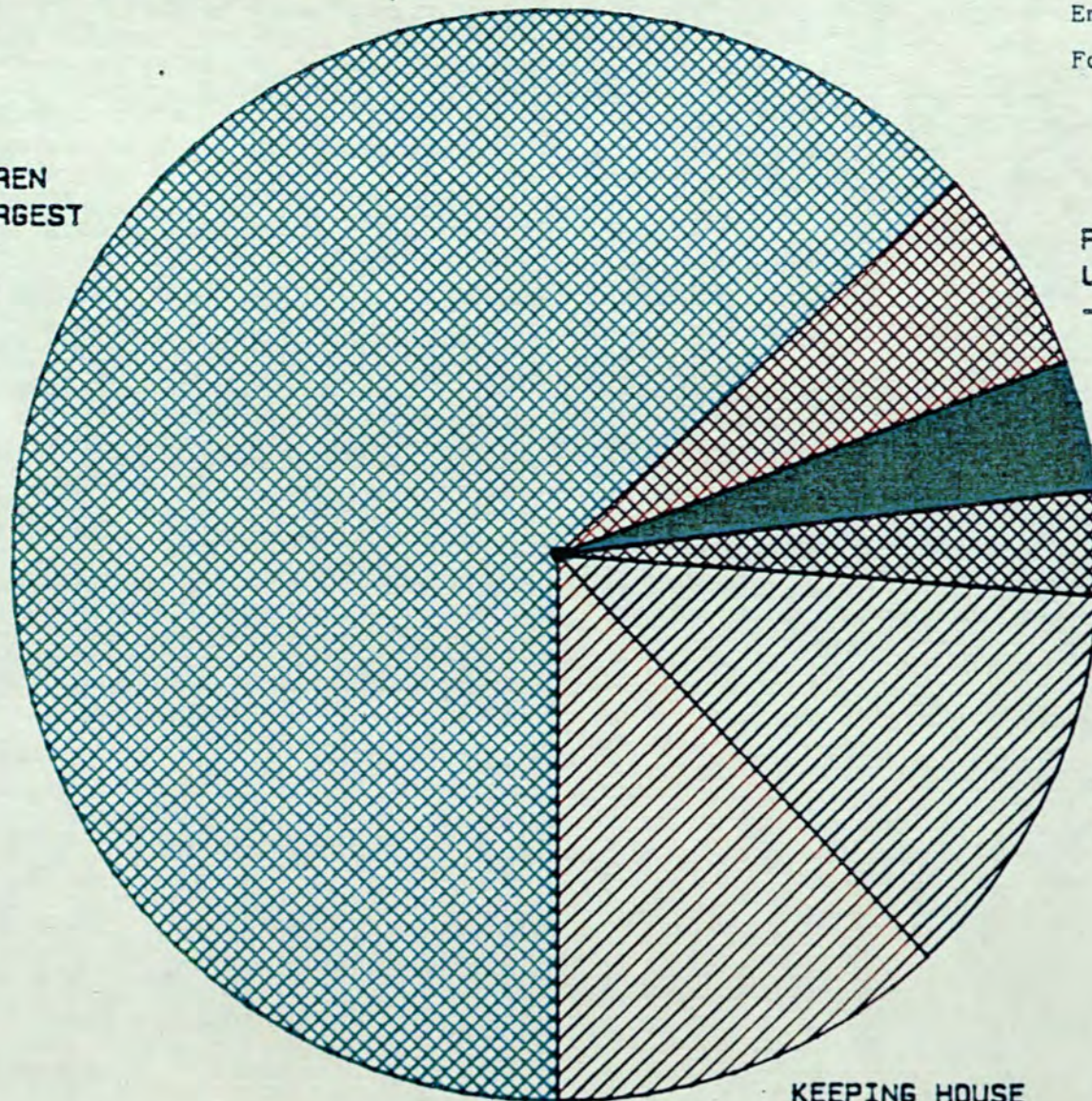
FOR DETAILED FIGURES SEE ANNEX 6 TABLE 1.

CHART 2.5 : REASONS GIVEN BY MARRIED WOMEN FOR BEING ECONOMICALLY INACTIVE

Source: DE/OPCS 1980 Women and Employment Survey

For detailed figures see Annexe 6, Table

LOOKING AFTER CHILDREN
ACCOUNTS FOR THE LARGEST
NUMBER OF WOMEN
NOT WORKING - - 63%



PERMANENTLY
UNABLE TO WORK
- - 5%

OTHER REASONS
- - 4%

LOOKING AFTER
RELATIVES - - 3%

KEEPING HOUSE
AGED UNDER 50 - - 12%

KEEPING HOUSE
AGED OVER 50 - - 12%

2.30 It is also far from straightforward. Married men are treated differently from married women, "breadwinner wives" differently from "breadwinner husbands", a wife's investment income differently from her earned income, and, for pensioners a wife's pension based on her own contributions is taxed differently from a pension based on her husband's contributions. There are then two options for married couples to be taxed separately, which have different purposes and different effects.

2.31 The system needs to be changed so that taxpayers can understand how much tax they have to pay, and why.

THE CASE FOR REFORM

2.32 In short, we need to move to a new system that will be better for incentives, that taxes married women on the same basis as their husbands, and that does not discriminate against marriage and the family.

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Chapter 3: Proposals for Reform

3.1 To meet these objectives, the Government propose a new system of independent taxation with transferable allowances.

3.2 Everyone - man or woman, married or single - would have the same tax allowance in their own right, whether or not they were in paid employment. However, it would be wrong to stop there, and disregard the shared responsibilities within marriage. So married people who did not have enough income to use up all their own tax allowance would, if they wished, be able to transfer the balance to their partner. A husband and wife's income would no longer be added together for tax purposes, and all taxpayers would be able to have independence and privacy in their tax affairs.

3.3 The Government intend that no couple should suffer a reduction in cash terms in their total tax allowances during the change to transferable allowances. At the completion of the transition the level of the new single allowance would be set so that two new single allowances came to the same amount as the total allowances available to a two-earner couple before the start of the change. For illustration, if the change were made now, the new single allowance would be £2,830, half the total allowances of £5,660 (= £3,455+£2,205) that a two-earner couple get at present.

3.4 Once the change to the new system was complete the effect would be as follows (again using 1985-86 allowance levels for illustration):

- Single people would have their allowance raised from £2,205 to £2,830.

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- The married man who is the only earner in the family would have his tax threshold raised from £3,455 to £5,660.

- Two-earner married couples and married couples where the wife is the sole earner would keep the same total allowances in cash terms, £5,660.

3.5 The loss of revenue from reducing the tax burden in this way would depend on developments during the period before the change is made. It would, for example, be affected by movements in prices and wages and by changes in tax rates and allowances in the years leading up to the change. To implement the proposals in this Green Paper in a single step now would reduce revenue by about £5.3 billion at 1985-86 levels of income tax rates and allowances. Unless other taxes were significantly increased at the same time, this would prove too great to be borne in one year, so the change to transferable allowances would need to be phased in over a period of at least two years. Annex 2 illustrates how phasing arrangements might work.

3.6 A change in the structure of personal taxation on these lines would achieve all the objectives for reform set out in chapter 2.

RAISING THRESHOLDS

3.7 The introduction of transferable allowances in the way described above would carry forward the Government's programme of reducing the tax burden. There would be a substantial increase in tax allowances for married couples where only the husband was in paid employment. Single people and couples where the wife had a paid job but earned less than the wife's earned income allowance (currently £2,205) would also have increased allowances. Some married couples where both

partners were earning above their current tax allowance would pay less tax (see paragraph 3.12); almost all the rest would pay the same amount of tax as before.

3.8 The change to transferable allowances would help achieve the objective of raising tax thresholds in two ways:

- The change itself would direct extra tax relief to one-earner couples.
- Once the new structure was in place, thresholds could be raised more cost-effectively than under the present system.

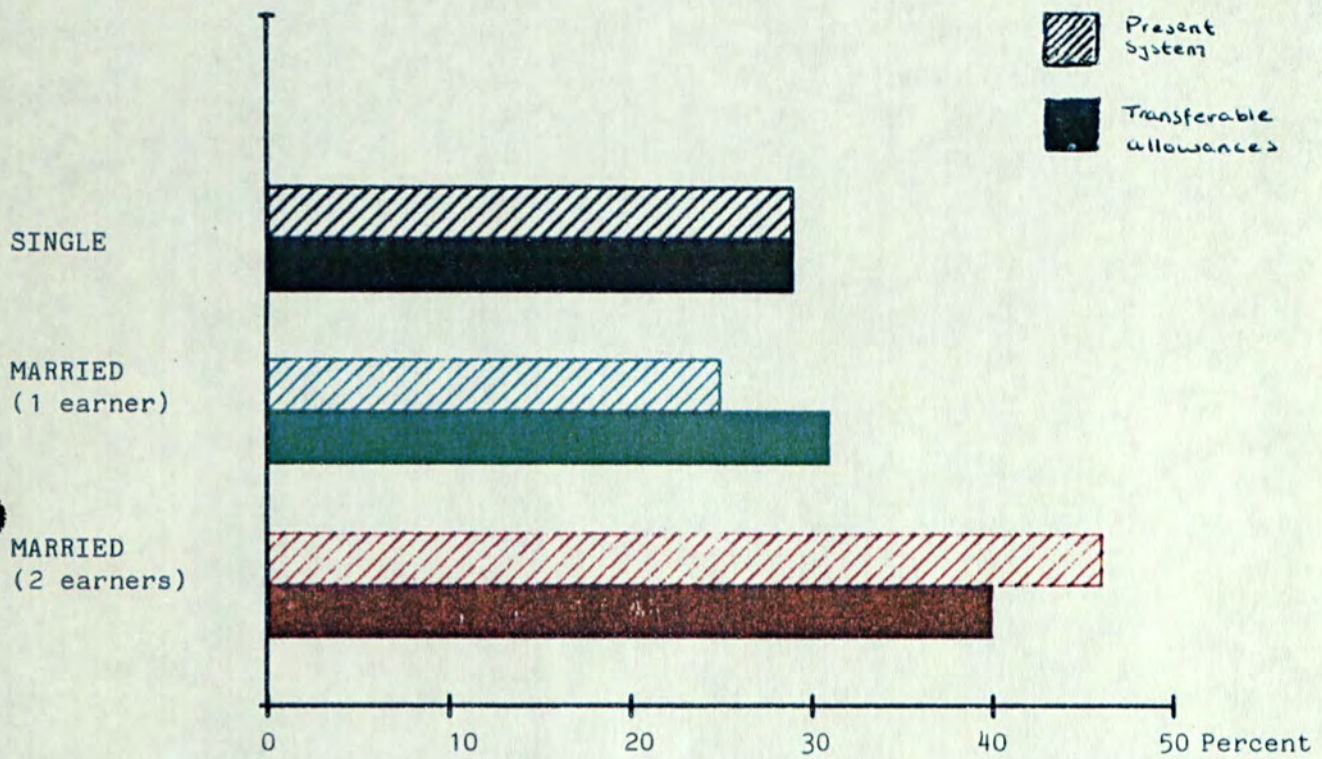
As can be seen from chart 3.1, the extra allowances for one-earner couples would mean that a higher proportion of the total amount of tax relief would go to these couples.

3.9 Chapter 2 explained why the Government's priority is to reduce the tax burden on one-earner couples. Their present tax allowances are much lower than those for two-earner couples. Couples generally have only one earner precisely at the stage in life when their family commitments are high - but under the present tax system that is when their allowances are low. Later, as their family commitments become less and both partners go back to work their allowances are higher under the present system. Thus the present tax system takes no account of the changing needs of couples over their life cycle. Moreover, a particularly high proportion of the couples caught in the poverty and unemployment traps have only one earner.

3.10 The effect of the change on people's tax payments would depend both on the structure of the new system and on what happened to the total tax burden when it was introduced. Annex 4 contains a detailed analysis

CHART 3.1 : PERCENTAGE OF TAX RELIEF GOING TO
DIFFERENT FAMILIES

(Taxpayers of working age)



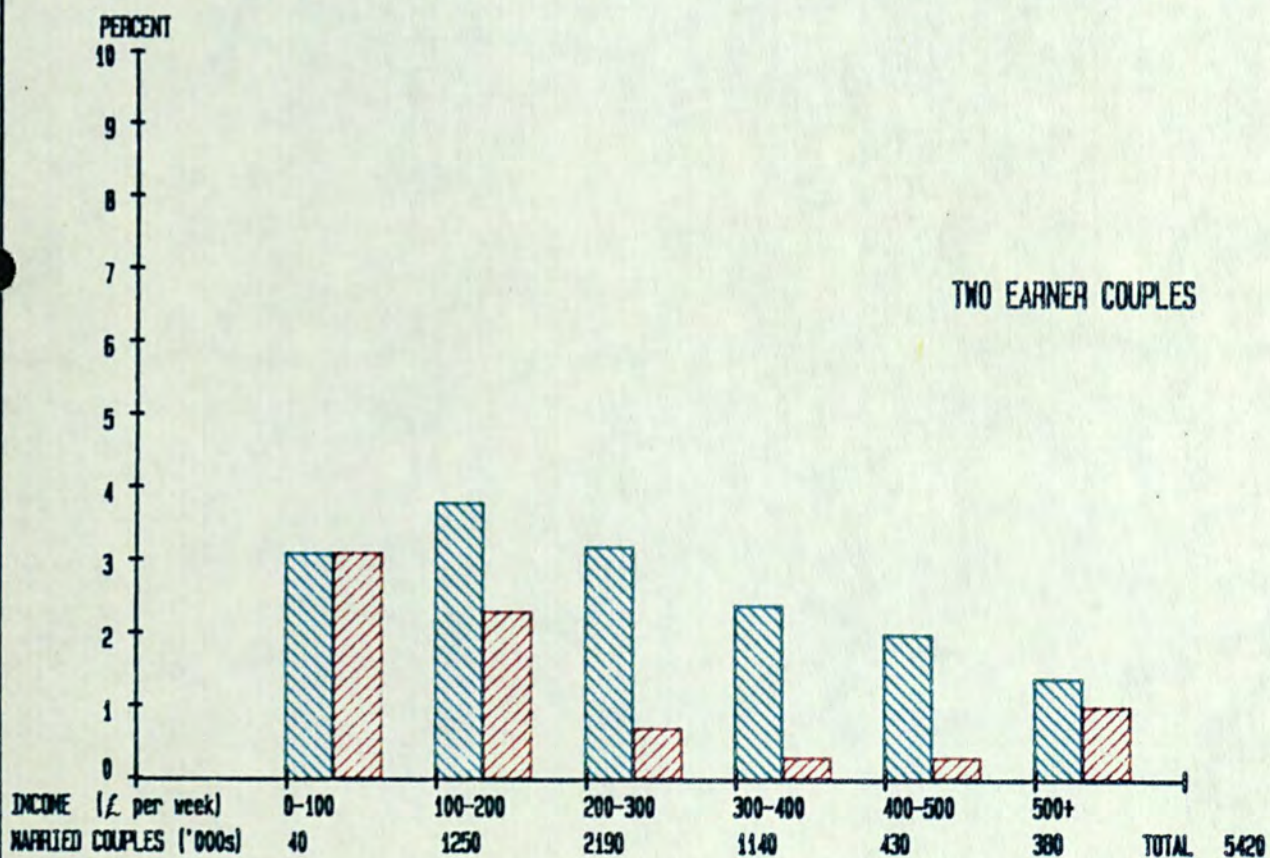
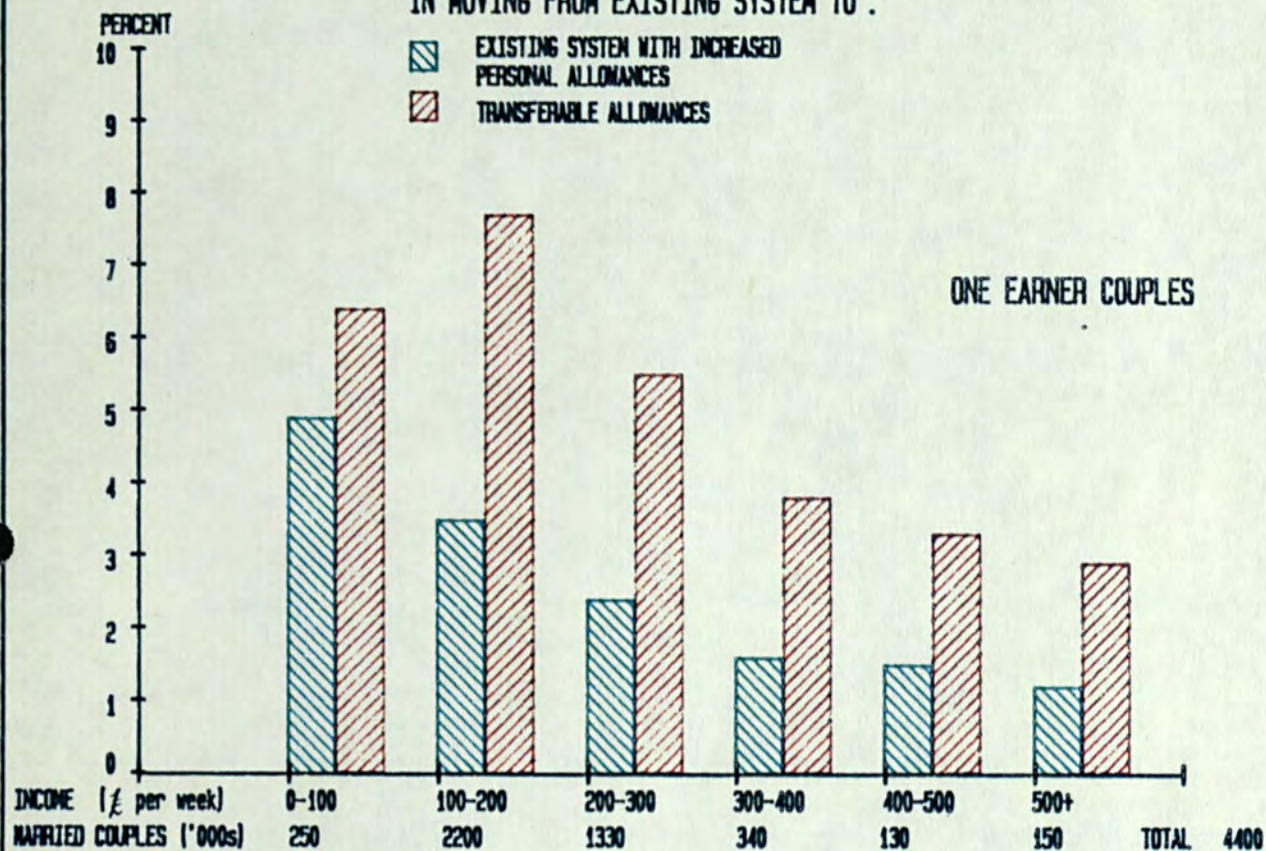
of the effects of the change if the transition were to be made in the way described in paragraphs 3.3 and 3.4.

3.11 On the same assumption, chart 3.2 illustrates the effect on the proportion of income that would be paid in tax - the average rate of tax - by one-earner and two-earner couples at different income levels and compares this with what would happen if the same amount of revenue were spent on raising the present structure of allowances.

3.12 The red-shaded bars show the reduction in the average rate of tax if transferable allowances were introduced in the way discussed here. One-earner couples at all income levels would see their tax burden fall substantially. The fall would be most marked at lower incomes. Most two-earner couples would see no change in their average tax rate. However, as the chart shows, there would be some fall in the burden for two-earner couples as a whole. This would arise partly from the disaggregation of their incomes. More importantly it would reflect the fact that two groups among the two-earner couples would have their total allowances raised by the change. The first would be those couples where the wife was earning less than the wife's earned income allowance and the husband, with her agreement, would be able to set the unused portion of her personal allowance against his own income. The second group would be those couples who under the present system had already made a "wife's earnings election" (See Annex 1): these couples do not receive the married man's allowance, and so for them the increase in the basic single allowance would not be offset by the withdrawal of the married man's allowance.

3.13 The blue-shaded bars in chart 3.2 show what the effect on average tax rates would be if, at the same loss of revenue, personal allowances were increased

CHART 3.2: REDUCTION IN AVERAGE RATE OF TAX (PERCENTAGE POINTS)
IN MOVING FROM EXISTING SYSTEM TO :



under the present structure. This would imply an across-the-board rise of 27 per cent in basic personal allowances. As will be seen, one-earner couples, at all income levels, would benefit more from transferable allowances than they would from this alternative way of reducing the tax burden. The improvement is particularly important for the lowest two income brackets, which include the couples caught in the poverty and unemployment traps. Transferable allowances would take one-earner couples with incomes below £109 a week out of tax; but the alternative measure would only take those with incomes below £84 a week out of tax.

3.14 In addition, the proportion of income paid in tax by those one-earner couples earning between £100 and £200 per week would drop substantially with transferable allowances.

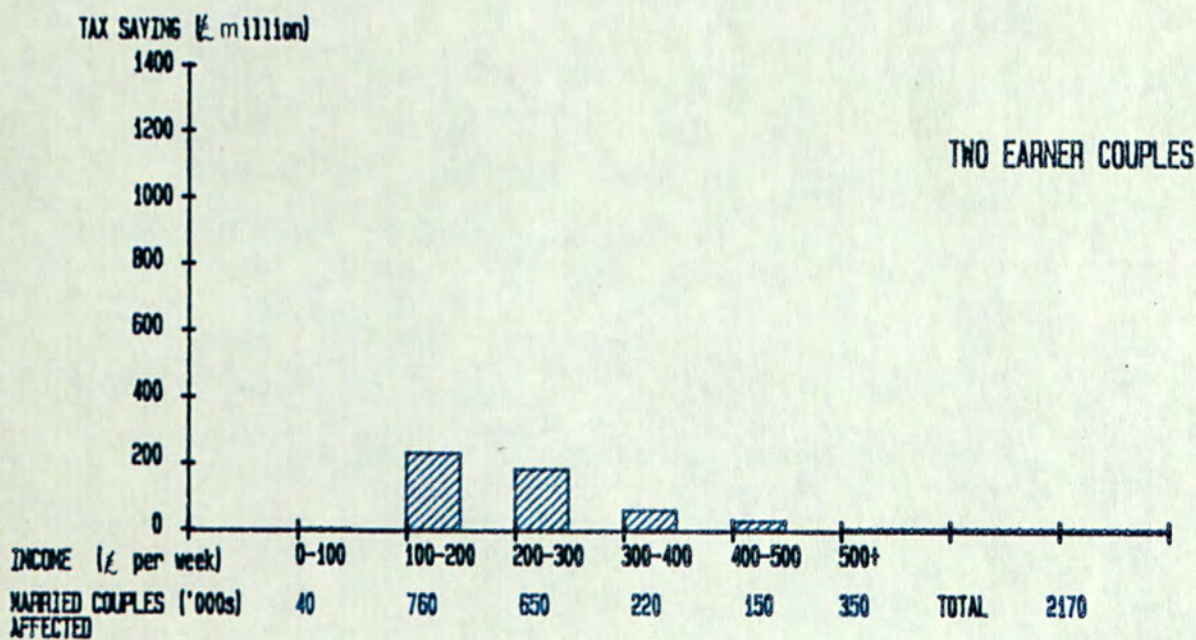
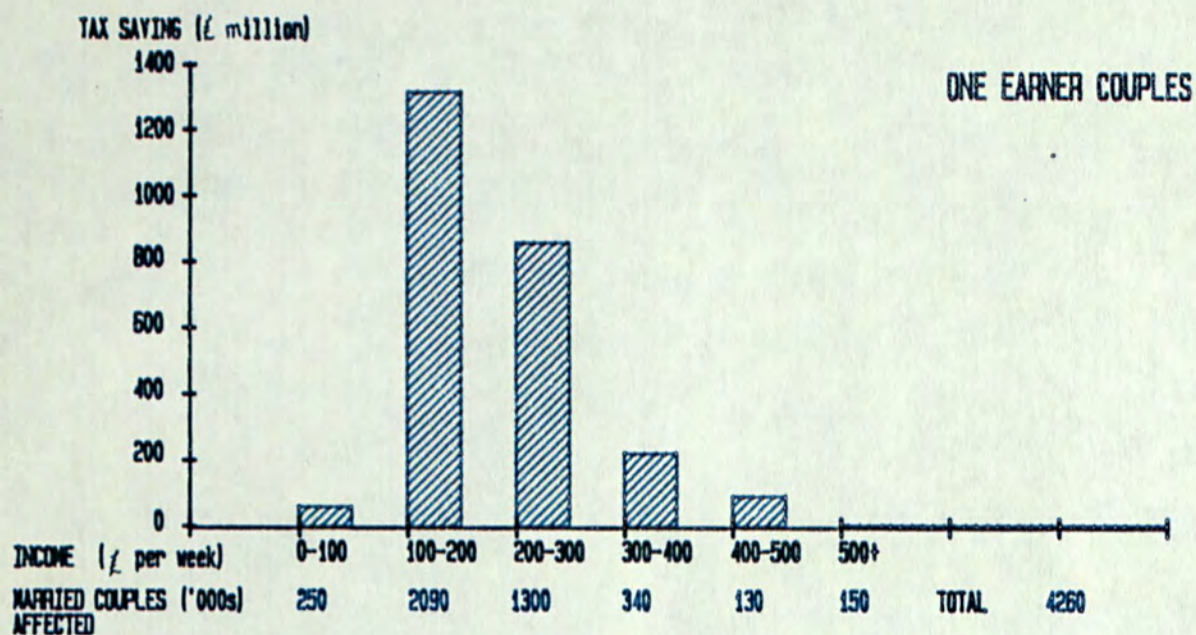
3.15 How the overall tax savings would be distributed among couples is shown in chart 3.3. The largest share would go to one-earner couples with incomes between £100 and £200 per week. There would also be significant tax savings for couples below average earnings where the wife earns less than £2,205 whether she is working full-time or part-time.

3.16 The greater concentration of tax reductions on one-earner couples means that transferable allowances are more effective than an equal revenue-loss increase in existing allowances in helping couples in the poverty and unemployment traps. Some two-thirds of married couples of working age with incomes below half average earnings are couples where the wife is not in paid employment.

3.17 Married men on low incomes with families to support are the group most likely to be in the unemployment trap. A rise in their tax allowances would increase their net income when they are in work, so the incentive

CHART 3.3 :

DISTRIBUTION OF TAX SAVINGS TO MARRIED COUPLES
(NON AGED) UNDER TRANSFERABLE ALLOWANCES



to take a job would be improved for all married men supporting families (though for some, under the proposed new structure for Social Security benefits, the increase in income would be offset in part by a fall in the income-related benefits they would receive). A move to transferable allowances would therefore ease the unemployment trap more than would a change involving equal revenue loss under the present system.

3.18 Very much the same factors make transferable allowances more effective in taking people out of the poverty trap, where again most of those in the trap are one-earner families.

3.19 Single people, who are particularly heavily represented among the 16-24 age group, where unemployment is highest, would also gain from the increase in the single allowance when transferable allowances were introduced on this basis. The increase would be roughly the same as would occur with an equal revenue-loss increase in allowances under the present system. Thus under transferable allowances, they would pay the same share of the total tax burden as they do now.

Threshold Increases under the New Structure

3.20 Once the new system was in place, one-earner and two-earner couples would subsequently gain equally from any threshold increases. More of the benefit of increases in tax allowances would go where they could be most effective. To take a simple example, cutting the burden of income tax by £1 billion by raising allowances under the present system would increase the threshold for a one-earner couple by £165; under a system of transferable allowances it would increase it by £210.

3.21 The new structure would thus provide a more sensible - as well as a more straightforward - basis on which the Government could carry forward its policy of raising tax thresholds generally.

HUSBAND AND WIFE

3.22 Under the proposed system, married women would be treated as independent taxpayers: they would be responsible for their own tax affairs, be able to fill in their own tax returns, and pay their own tax. The legislation which deems a married woman's income to be her husband's for tax purposes would be abolished.

3.23 Married women would thus have an opportunity for complete privacy in tax matters. Couples where the husband and wife both had income above the tax threshold would be treated, in effect, wholly independently. For other couples, any transfer of allowances would be wholly voluntary: people would not have to make any transfer, or they could transfer an amount less than the whole of their unused allowances if they so chose (accepting that their partner would be entitled to less tax relief in consequence of their choice).

3.24 Annex 3 explains in more detail how transferable allowances would work in practice.

THE FAMILY

3.25 Transferable allowances provide a means for recognising through the tax system that, at different times and for different reasons, one partner in a marriage may be financially dependent on the other. As chapter 5 explains, they also recognise the way in which many families share assets in common: for example, they may have joint bank or building society accounts, share the income from those accounts, and share responsibility for mortgage payments on the family home. Though husband and wife must be treated equally, the Government reject the view that the tax system should pay no regard to the special relationship and responsibilities that exist

within marriage. The aim is to recognise these in a way that is straightforward, flexible, and does not seek to make invidious distinctions between couples in different circumstances.

3.26 There would no longer be discrimination against couples where, for whatever reason, the wife was not in paid employment. And since transferability would operate both ways between a husband and wife, the system would give equal recognition to circumstances where the husband did not have income but his wife did.

3.27 All married couples with the same combined income would pay the same amount of tax, regardless of the division of income between them (unless one or both had sufficient income to pay higher rate tax). Nor would it matter whether the income came from earnings or savings.

3.28 Transferable allowances would ensure that a couple's total allowances remain the same, and do not fall, when one partner leaves paid work, which is often a time when the couple may be under financial pressure. They would, in particular, direct more tax relief to families with young children.

3.29 It may be suggested that transferable allowances could introduce a disincentive for married women to go out to work. It is of course an intrinsic feature of the proposed reform that the tax system would no longer include the present special incentive for two-earner couples, introduced in the wartime conditions of 1942. When a wife takes up employment this would, under the new system, mean that her husband would lose the benefit of allowances that she had previously transferred to him. Annex 7 gives brief details of the arrangements in Canada, Sweden and Denmark, where similar rules apply. It is important to emphasise that the married woman herself could continue - precisely

as she does now - to earn up to the same amount as a single person without attracting any liability to tax. The new system would treat married men and married women alike.

3.30 By taxing a husband and wife separately and giving a married woman her own allowance and tax rate bands in the same way as any other taxpayer, the proposed system would remove the tax penalty which arises for married couples where the wife has more than a moderate amount of savings income.

CONCLUSION

3.31 The Government believe that the system which best meets the objectives they have set for personal tax is one of independent taxation with transferable allowances.

3.32 This would increase tax allowances for one-earner couples, where the need is greatest, and would do so in a way that does most to alleviate the poverty and unemployment traps. It would be based on treating husband and wife as equal partners in marriage. But it would recognise that, within the family, there is normally a sharing of assets, income, and responsibilities.

3.33 Subject to the response to this Green Paper, legislation could be introduced on transferable allowances in 1987, and the new system could be in place soon after the completion of the Inland Revenue's computerisation programme, which is expected to be in 1989. Annex 5 gives details of the possible timetable for change.

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PART II - IMPLICATIONS FOR OTHER ALLOWANCES AND TAXES

Chapter 4: Treatment of Particular Groups

4.1 If the proposals in chapter 3 were to be implemented they would obviously affect particular groups of people who are currently entitled to personal tax allowances other than the basic allowances. This chapter explains how the Government would propose to adapt the tax treatment of these groups to the new system.

ELDERLY PEOPLE

4.2 The change to transferable allowances would be of particular benefit to many elderly taxpayers.

4.3 Most taxpayers over 65 are entitled to the age allowance. For a single person over 65 this is £2,690 for 1985-86 (compared with £2,205 for the basic single allowance). Where one partner in a marriage is over 65 the husband may claim an allowance of £4,255. The full benefit of the age allowance is obtained by those with taxable income (before deducting the allowance) of up to £8,800. For those with higher incomes the extra amount of the age allowance over the corresponding basic allowance is gradually withdrawn by reducing the allowance by £2 for every £3 of additional income. The benefit of the age allowance therefore runs out at an income of £9,528 for a single person and £10,000 for a married man. If a married woman aged 65 or over has earned income (either from a job or in the form of her own pension) the wife's earned income allowance (£2,205) is available against it.

4.4 The Age Allowance was introduced in its present form in 1975. It replaced the previous "age exemption" which elderly taxpayers had been entitled to claim since 1957-58. Like age allowance, age exemption effectively

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gave elderly taxpayers a higher tax threshold than younger people but the benefit of the higher threshold began to be withdrawn immediately the taxpayer's income was sufficient to bring him or her into tax.

4.5 On the proposals set out in Chapter 3 the basic single allowance would rise to £2,830 at 1985-86 levels - some £140 above the present single age allowance. For a married couple where only one partner has income, the total allowances available to set against that income would be £5,660. This compares with the present married age allowance of £4,255.

4.6 Table 3 of Annex 4 gives details of the numbers of elderly taxpayers. Just over 1.9 million elderly people benefit in full or in part from the age allowance. Of these just over 1 million are single and about 875,000 are married. In over 70 per cent of these married couples the wife has no earned income of her own, (compared to 45 per cent of wives in younger couples). This high proportion reflects two characteristics of elderly taxpayers:

- at present relatively few elderly married women have an occupational or State retirement pension in their own right.
- where both partners do have earned income in their own right their combined incomes will often be too high to be eligible for age allowance.

Thus the figures in Table 3 show that in nearly 60 per cent of all cases where an elderly couple is not eligible for the age allowance, the wife has some earned income of her own; and about half of all couples where the wife has some earned income are excluded from age allowance.

4.7 Elderly people as a group also tend to have a relatively high proportion of savings income. The new arrangements for transferable allowances, and for giving the married woman a full tax allowance against her own savings income, will be of particular help to them.

The future of age allowance

4.8 Against this background the Government have considered the future of age allowance.

4.9 When it was introduced, the age allowance (and age exemption before it) had two linked objectives - to recognise in a broad way, the additional expenses which the elderly might incur and to ensure that a high proportion of elderly people were kept out of income tax altogether. Accordingly, entitlement to age allowance was linked to reaching a particular age - 65. Qualification for the allowance is not tied either to payment of the national insurance retirement pension or to retirement itself. About 60 per cent of the total of 6½ million elderly households are not liable to income tax.

4.10 The Select Committee on the Social Services in 1982⁽¹⁾, expressed doubts about the justification for the age allowance in its present form. The Committee questioned the rationale for an allowance based on attainment of a particular age and recommended that the Government should review the justification for continuing with the age allowance.

4.11 The Government see considerable force in these doubts. In some respects, taxpayers find that their living costs and expenses rise with the onset of old age. But there is no evidence to suggest that this is true for taxpayers generally at age 65. And in

(1) Report on the Age of Retirement Session 1981-82 HC 26-1 Paragraphs 131-132.

other respects, there is evidence that people who pay tax find that their living costs fall at around this time. Those over 65 who are still at work no longer have to pay National Insurance Contributions; those who are owner-occupiers will usually have paid off the mortgage on their home; and those who retire no longer have to bear the cost of travelling to work.

4.12 Most elderly people do, of course, face a reduction in their income when they retire. But this of itself cannot be held to justify a higher tax threshold: there is no reason why two people with the same family circumstances and income should pay different amounts of tax on age grounds alone. The need is for tax thresholds generally to be sufficiently high, so as to reduce the burden of tax on all those with low incomes and to take more of those with the smallest incomes out of tax altogether.

The Government's Proposals

4.13 If tax allowances for the elderly were fixed at the level of the new basic single allowance of £2,830 in 1985-86 terms, this would mean increased allowances for well over 90 per cent of elderly taxpayers. A further 400,000 would cease to pay tax altogether and the proportion of elderly people not liable to tax would rise from about 60 per cent to about 65 per cent. The new structure of transferable allowances and the disaggregation of investment income would ensure that there was no increase in the share of the total tax burden paid by elderly people as a group.

4.14 The Government have therefore concluded that under the new system there would be no need to maintain a separate tax threshold for the elderly. The age allowance would be phased out on the change to transferable allowances. This phasing out would be achieved in such a way that no elderly single person

or married couple would suffer a reduction in total allowances in cash terms.⁽¹⁾

4.15 This would simplify the tax system for elderly people. Under the proposed new arrangements taxpayers would be subject to the same tax rules throughout their lives.

SINGLE PARENTS

4.16 Under the present system, single parents with dependent children receive the Additional Personal Allowance (APA), of £1,250 in 1985-86, in addition to the single person's allowance. This means that single parents get allowances equal in total to the married man's allowance.

4.17 The proposed change in the structure of personal allowances would entail changing the tax allowance for single parents. The Government have taken the opportunity to review the present provisions for single parents and the scope for rationalising the assistance that is currently available through the tax and benefits systems.

Support for single parents

4.18 Some 450,000 single parents, including 70-100,000 widows, will claim APA in 1985-86. An estimated 590,000 single parents claim One Parent Benefit (OPB) through the Social Security System. This is a flat-rate benefit

(1) A small number of elderly couples - about 150,000 out of the total of 6½ million - where the wife has earnings or pension in her own right of more than £1,405 are at present entitled to allowances which in total exceed the allowances of £5,660 (at 1985-86 levels) that would be available to a married couple once the change to transferable allowances is complete. For those couples a further special measure of transitional protection would be provided so that they did not suffer a reduction in their total allowances in cash terms.

of £4.25 per week paid for the first child of a one parent family in addition to child benefit. Widows with children receive widowed mother's allowance of £35.80 per week, plus a child dependency addition of £7.65 per week for each child, rather than OPB.

4.19 The case for rationalising provision for single parents by converting the APA into increased rates of benefit was discussed in the Green Paper "The Taxation of Husband and Wife"⁽¹⁾ published in 1980. The vast majority of organisations and individual members of the public who responded to the Green Paper were in favour of this approach. The Government propose to make the change at the same time as transferable allowances are introduced.

4.20 Converting the Additional Personal Allowance into social security provision would have four advantages:

- Rationalisation. Financial support from the state for single parent families would be provided entirely through the social security system.
- Simplification. By removing the one remaining tax allowance for children it would simplify the tax system without leading to any significant additional complication to the benefits system.
- Help for non-taxpayers. Like the conversion of child tax allowances to child benefit, it would give proportionately more help to non-taxpayers. The Government's intention is that single parents paying tax at the basic rate would at least

(1) Cmnd 8093

break even taking the changeover to transferable allowances and the conversion of APA together, so that people who received OPB but did not pay tax would gain.

- Reducing the tax penalty on marriage.
At present, couples who are not legally married but who live together as man and wife can each claim APA (on top of their basic single allowances) if they have two or more children. Thus, between them, the couple get the equivalent of two married allowances. This is a widely-resented element of the so-called tax penalty on marriage and a misuse of resources: the APA was intended to help people who have single-handed responsibility for children. Converting it into a benefit would deal with this problem, since OPB and widows' benefits are, by law, not available to people living together as man and wife.

4.21 The Government's intention is to ensure, through changes in OPB or other benefits, that single parents would be no worse off in cash terms as a result of the abolition of the Additional Personal Allowance. The scope for improving the interactions between the benefits which single parents receive would also be kept under review.

APA FOR MARRIED MAN WHOSE WIFE IS WHOLLY INCAPACITATED

4.22 The APA is also available to a married man with a dependent child, if his wife is wholly incapacitated.

Between 5,000 and 10,000 men currently qualify. Their total allowances in 1985-86 are £4,705 (married man's allowance of £3,455 plus APA of £1250). One Parent Benefit is not available in these circumstances though other benefits, such as Invalid Care Allowance or Attendance Allowance may be payable.

4.23 One of the aims of transferable allowances is to recognise the situation where one partner in the marriage is - for whatever reason - dependent on the other and has insufficient income to make use of their own allowance. The planned transition to transferable allowances would give the married man or woman whose partner had no income £5660 of allowances. So under the new system even without the APA, the married man with an incapacitated wife would see his tax threshold rise by £955. The Government have therefore decided that the APA for a wholly incapacitated wife should be abolished on the changeover to transferable allowances.

WIDOW'S BEREAVEMENT ALLOWANCE

4.24 The widow's bereavement allowance (which is set at £1250 for 1985-86) is available to a widow in the tax year in which her husband dies and for the following year.

Tax treatment in year of bereavement.

4.25 At present the tax year in which a married man dies is split into two parts for the purposes of calculating liability to tax. The married man's allowance is available against the couple's joint income in the period up to the husband's death and the wife's earned income allowance is also available against any earned income of the wife up to the same date. For the period after the date of death the widow is entitled to the basic single allowance and the widow's bereavement allowance against her income for this period.

4.26 This treatment is a direct result of the aggregation rule. Because a married woman's income is deemed to be her husband's for tax purposes she has no independent status for tax during the first part of the tax year in which her husband dies. After the date of death, however, the widow becomes a separate taxpayer in her own right. Since the husband and the widow are in law two different taxpayers during the year of death, they receive two separate sets of tax allowances.

4.27 Under transferable allowances both partners would be treated independently for tax purposes; there would be no need to separate the periods before and after the date of a husband's death. The year of death would be treated in the same way as any other tax year. Thus, if a partner in a marriage died before he or she had received sufficient income to use up his or her allowances the unused balance would be available to set against the income of the surviving spouse. Where one partner had transferred allowances during the tax year to another who subsequently died there would normally be an increased repayment due to the estate of the deceased partner.

Social Security Benefits for widows

4.28 Under the proposals in the Social Security Green Paper the present widow's allowance (payable to all widows under 60, and some over 60, for the first 26 weeks of widowhood) would be replaced by a non-taxable lump sum of £1,000 payable immediately on bereavement. In addition widowed mother's allowance (for widows who have dependent children) and widows pension will be payable from the time of bereavement rather than after 6 months as at present.

Future of widow's bereavement allowance

4.29 The Government have re-examined the case for the present widow's bereavement tax allowance in the

light of the proposed changes. The purpose of the new lump sum payment to widows is similar to that of the widows bereavement allowance; both aim to help widows cope with the difficult period immediately following bereavement. But the new lump sum will be available only to those widowed under 60, and those over 60 whose husbands have not qualified for retirement pension. The widows bereavement allowance on the other hand is available to all widows.

4.30 The Government therefore propose that the widow's bereavement allowance should continue to be available to help all widows with the difficult period of adjustment following a husband's death. The allowance would be increased and be made equal in size to the basic single allowance and would continue to be available both in the year of bereavement and in the following year. The increase in the allowance would ensure that in the year of bereavement any entitlement to widow's pension or widowed mother's allowance would not of itself give rise to a liability to tax, even if the whole of her own allowance had already been used against her own or her husband's income. The allowance would be available to be set against the widow's income for the whole of the year of bereavement, but it would not be available to set against the income of her husband up to the date of his death.

4.31 In sum, these changes would increase the help that widows derive from tax allowances.

MINOR PERSONAL ALLOWANCES

4.32 The minor personal allowances are:

Dependent relative allowance (£145 for a single woman; £100 for others);

Houskeeper allowance (£100);

Son's or daughter's services allowance
(£55);

Blind person's allowance (£360).

4.33 The first three of these allowances originated at a time when arrangements for the care of elderly or infirm people were very different from today.

4.34 Dependent relative allowance is given to people who support a widowed mother or another relative who is unable to work because of old age or ill health. It was introduced in 1920 when many widows and elderly people had little or no income of their own, and hence relied largely on a relative for their maintenance and support. In the past 65 years there has been a significant trend away from this, as pensions have improved and elderly people have become more independent. Similarly housekeeper allowance, and son's or daughter's services allowance, were important at a time when many taxpayers employed a housekeeper, or had one of their children living with them to look after them. Such arrangements are now much less common. The development of the social security system has led to resources being concentrated on helping elderly people themselves rather than those who support them, and specific needs and disabilities have been recognised, for example by paying a cash benefit, attendance allowance, to people who are in need of frequent attention.

4.35 Successive Governments have taken the view, explicitly or implicitly, that these allowances have outlived their usefulness. Their cash values have not been increased for many years. The Government believe that the change to transferable allowances provides an appropriate opportunity to end these allowances. This would further simplify the personal tax system.

4.36 Rather different considerations apply to the Blind Person's Allowance, which is currently £360. The Government regard this as an important measure of help to working blind people. They believe it should be retained.

CONCLUSION

4.37 The proposals in this chapter themselves amount to a major simplification of the present personal allowance structures. Taken together with the Government's main proposals for the reform of personal taxation outlined in Chapter 3 the result would be one of the simplest tax allowance structure of any major Western country, in which everyone, single or married, young or old, male or female, would qualify for the same basic allowance fully transferable between the partners in a marriage.

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Chapter 5: Other implications for the tax system

5.1 This Chapter considers the implications of the Government's proposals on personal allowances for other aspects of income tax and for the capital taxes. Paragraphs 5.2 to 5.16 look at the effect on the treatment of investment income; paragraphs 5.17 to 5.20 the consequences for the treatment of mortgage interest; and paragraphs 5.21 to 5.32 the implications for capital transfer tax and capital gains tax.

Treatment of investment income

5.2 Many married couples - and elderly couples in particular - have some income from investments. The single most common type is building society interest. It represents about 40 per cent of investment income and two-thirds of couples with investment income receive it. The available information⁽¹⁾ suggests that perhaps 20 per cent or more of investment income belongs to wives (treating income jointly owned as split 50/50 between husband and wife) and so might therefore be affected by a change to independent taxation. Over half of all wives receive some investment income either in their own right or jointly with their husbands.

(1) See "Investment income of Husbands and Wives" issued by the Inland Revenue in January 1981 as a Background Paper for the Green Paper "The Taxation of Husband and Wife", (Cmnd 8093). The Paper sets out the results of a special survey of the distribution of investment income between husband and wife. As the Paper explains, data about the investment income received by couples is subject to a number of limitations.

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5.3 Under the present system a wife's investment income is added to her husband's for tax purposes and the combined amount is taxed as if it all belonged to the husband at his marginal rate. A wife has no allowance of her own to set against her investment income. As a result, some married couples find that between them they pay more tax than two single people in the same circumstances.

5.4 The Government's proposals would end this further tax penalty on marriage. A married woman would have a full personal allowance in her own right to set against her income, whether it is earned or from investments. And husband and wife would each have their own set of income tax rate bands available against their individual incomes.

5.5 Transferability of allowances would in itself go far to remove the present tax penalty on a wife's investment income. Where a wife has investment income but no earned income, the couple would in future be entitled to two single allowances in total against their joint income compared with the equivalent of only $1\frac{1}{2}$ times the single allowance at present. The proposed ending of the aggregation rule that adds a wife's investment income to her husband's for tax purposes would not result in any additional reduction in many couples' tax bills. There are two reasons for this.

First, under the new system a married couple will always get the same total of allowances between them, irrespective of the division of their joint income. When a married woman has investment income, it will be taxed as her income, not her husband's, and she will be able to set her own personal allowance against it. She will then be able to transfer any remaining balance of allowances to her

husband. But in total the couple's allowances will be unchanged.

Second, where each partner has income sufficient to use up his or her own personal allowance, the ending of aggregation will mean that the married woman - not her husband - will become liable for paying the tax on her investment income. But over 90 per cent of married couples are currently liable only at the basic rate of 30 per cent on their income. In these cases, the actual amount of tax due on a wife's investment income will be unaltered.

5.6 Disaggregation may, however, change the total amount of tax due from the couple where they are at present liable to higher rate tax. In these circumstances, if both husband and wife have sufficient income to use up their personal allowance, the ending of aggregation will mean that the wife's investment income will cease to be taxed at the husband's marginal rate and will become liable at the wife's marginal rate. In all but a few cases this will result in a reduction in the tax borne on the wife's investment income.

5.7 Independent taxation will also give both husband and wife the opportunity for privacy in all of their tax affairs. In the present system there is no privacy for most married women, only for husbands. The proposals outlined in this paper would remove this discrimination. A wife could make a return of her own income and would no longer have to disclose details of the amount and source of her investment income to her husband.

5.8 Overall the additional cost of allowing independent taxation of a wife's investment income compared with a transferable allowance system which retained aggregation

of investment income would be about [£100 million]. This is the measure of the tax penalty the present aggregation rule imposes on marriage. Whatever her income, a married woman should be treated as a taxpayer in her own right. The case for ending the present discrimination in the tax system against a married woman's investment income applies to incomes at all levels. The Government reject the argument, advanced in some quarters, that disaggregation of husband's and wife's income should be the rule throughout the tax system, except in respect of liability to higher rates of tax.

Rearrangement of investment income between husband and wife

5.9 With a married woman's income taxed separately from her husband's, there would in some cases be an incentive for couples to rearrange the ownership of their income-producing assets between them. For example, if a husband with investment income was liable to tax at 60 per cent, whereas his wife was liable only at the basic rate of 30 per cent, the couple's combined tax bill would be reduced if the husband transferred some of his investments to his wife. This process of rearrangement is sometimes known as income splitting.

5.10 The Government see no case for special measures to prevent rearrangement of investment income between husbands and wives where this results from an outright gift or other complete and irrevocable transfer of the right to the underlying capital. Under a system of independent taxation, there is no reason in principle why couples where, say, the wife derives all or part of her capital from her husband should pay more income tax than a couple - in otherwise similar circumstances - where she derives her capital, say, from an inheritance. If one partner in a marriage makes a genuine transfer of assets to the other, there is no reason to impose a tax penalty on the income from those assets.

5.11 Moreover, there would be great difficulty in enforcing any special provisions to counter this. Most wives in the position described above will have had money from a variety of sources - including probably from their own earnings. There can be no straightforward way of identifying for income tax purposes which part of her capital is derived from which of the various sources.

5.12 It is very unlikely that all couples would seek to rearrange the ownership of their income-bearing assets in order to take maximum advantage of their separate tax rate bands. Many would not be able, or would not want, to make the necessary transfers of assets. But if, for example, those affected were to transfer assets yielding half the relevant investment income there could be a revenue cost of around £100 million.

5.13 Different considerations would arise, however, where, for example, a husband might seek to transfer income to his wife (or vice versa), in order to enjoy a reduction in their joint income tax liability, without genuinely transferring the right to the underlying capital.

5.14 For example, the more wealthy partner in a marriage could seek to shift income into the name of the less wealthy, without transferring the right to the underlying capital, through the use of trust arrangements. On the change to independent taxation and transferable allowances it would be necessary to ensure that the legislation denied any tax advantage from this.

Treatment of composite rate interest

5.15 Certain interest - mainly on building society shares and bank deposits - is subject to arrangements whereby the building society or bank deducts tax at

a special rate - the composite rate - on the interest it pays. The depositor receives credit for income tax at the full basic rate. The composite rate is fixed at a level to reflect the distribution of interest payments between taxpayers and non-taxpayers. No repayment can be claimed by depositors not liable to income tax.

5.16 Where interest subject to the composite rate is received by a partner in a marriage who is a non-taxpayer, the Government propose that this should not restrict the amount of the personal allowance which that partner would be able to transfer. This would give the couple credit for the composite rate tax borne on the interest. Where the partner to whom the allowance was transferred was a higher rate taxpayer however, the benefit of that part of the transferred allowance corresponding to the composite rate interest received would only be available to reduce the partner's liability to tax at the basic rate. This would ensure that, taking account of the credit for the basic rate tax on the interest, the couple would between them pay no more and no less tax than they would have done if the interest had been paid gross.

Mortgage Interest Relief

5.17 One of the aims of independent taxation with transferable allowances is to remove the tax penalties that can arise on marriage.

5.18 Under the present system, a married couple are entitled to mortgage interest relief on up to £30,000 of the loan to buy their main home. Single people are entitled to relief on up to £30,000 each. But where two or more single people borrow in order to buy the same home to live in, each can get relief on borrowing of up to £30,000, so that relief on £60,000 - and more - may be available for the same home. The fact that

this opportunity is open to unmarried couples sharing the same home is widely seen as yet another tax penalty on marriage.

5.19 The case for removing this anomaly arises independently of the move to transferable allowances. But the inequity of the present rules would be accentuated with the proposed new structure of personal allowances.

5.20 The Government therefore propose to apply mortgage interest relief to the residence rather than to the individual taxpayer. Thus two or more people borrowing to buy a house as their main residence would share the £30,000 ration between them, whether they were married or unmarried. This would end the present advantage to unmarried couples.

THE CAPITAL TAXES

5.21 The Government's approach to personal income tax is founded on two principles: that the tax system should recognise the fact of marriage and the responsibilities that go with it; and that the system should recognise the independence and equal standing of the husband and the wife within marriage. These same principles should apply to the capital taxes.

5.22 It will already be clear that the Government do not accept the view that the income tax system should, as a matter of principle, disregard the fact of marriage and, for income taxation purposes, treat husband and wife in precisely the same way as two quite separate people. By the same token, they reject the view that capital transfers between husband and wife should be taxed in the same way as other capital transfers.

5.23 The ownership of capital assets within a marriage is likely to be shared rather differently from the receipt of income. Some income, for example interest on joint

bank accounts, is often the joint property of husband and wife. However the great bulk of income (earned income in particular) clearly belongs to one or the other spouse and comes from outside the marriage. By contrast, a substantial proportion of the capital assets of married couples is held jointly; and a high proportion of the transfers of capital (potentially chargeable to tax) made by married people is to one another - while they are both alive or on the death of one of them.

5.24 In practice there is no very widespread tradition in this country of formal arrangements to determine the division of the family's property within a continuing marriage. For example, in the case of the matrimonial home - for many couples the major capital asset - it is not unusual for the property to be held in the sole name of the husband or the wife. But it would clearly be unrealistic - and unfair - to ignore the fact that both partners in the marriage will have contributed to the purchase and upkeep of the house, irrespective of whether or not they have actually helped to pay for it. Indeed, in most circumstances both partners are likely to have a beneficial interest in the property. If the home were transferred into the joint names of husband and wife, as again happens commonly enough, that may as a matter of general law count as a transfer of a capital asset from one to the other; but it would be difficult to justify treating such a transaction (and others analogous to it) on all fours for tax purposes with a gift to someone outside the family. Similar issues arise very clearly - and unavoidably - in the event of a breakdown of the marriage, when the Courts commonly enforce a division of the family's assets that varies widely from the nominal legal ownership. These practical considerations reinforce the Government's conclusion on the issue of principle.

Capital Transfer Tax (CTT)

5.25 Capital Transfer Tax is in general charged independently on each taxpayer, without differentiation by sex or marital status (with the important exception of transfers between spouses) marital status. Each spouse has his or her own threshold and set of ratebands. Each has a set of exemptions, such as the annual exemption for lifetime gifts. Chargeable transfers made by one spouse are not cumulated with those made by the other. Each spouse is responsible for delivery of accounts in respect of his or her lifetime transfers and is liable for the tax on them. Only in special circumstances may one spouse become liable to CTT on a transfer to a third party by the other spouse. Transfers between spouses domiciled in the UK - whether in lifetime or on death - are fully exempt from CTT.

5.26 The Government see these provisions as wholly consistent with the objectives of the reform of personal taxation. They therefore propose no change in the present CTT provisions.

5.27 The special issues that arise when a transfer of capital assets causes re-distribution of investment income between husband and wife is discussed in paragraphs 5.9 to 5.14 above.

Capital Gains Tax (CGT)

5.28 Under present arrangements, the gains of a wife living with her husband are generally assessed on the husband:

- the gains and losses of each spouse are aggregated⁽¹⁾ and the couple are entitled only to one annual exempt amount (currently £5,900);

(1) Spouses can however elect instead to carry forward their own losses against their own future gains.

- the husband is responsible for making a return of chargeable gains and assets acquired by both spouses, and the assessment is issued to him;
- transfers of assets between the spouses do not give rise to any liability at the time, but the partner to whom the assets are transferred takes over the acquisition costs of the transferor.

5.29 These arrangements are open to the same criticisms - on grounds of lack of independence and privacy - as the present arrangements for income tax. Here too there is a case for reform.

5.30 The Government propose that:

- capital gains should be separately chargeable on each of husband and wife;
- each should be entitled to an annual exempt amount (currently £5,900), any unused part of which would be transferable to the other spouse.
- the present relief from capital gains tax for transfers of assets between husband and wife would be retained but the provisions which allow the losses of one spouse to be set against the gains of the other would be withdrawn.

This is wholly in line with the principles of the proposed reform of personal income tax allowances.

5.32 The Government see no reason to change the present capital gains tax relief that is available on the disposal of a private residence. Where a married couple living together have only one house, whether it is owned by the husband or wife or jointly, the relief will continue to apply. Where such a couple have more than one residence, they can at present designate one as their main residence for the purpose of relief. These arrangements will continue to apply.

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PART III - THE TAX SYSTEM IN THE LONGER TERM

The remaining section of this paper discusses some longer term options which are the subject of current debate. These include ways of streamlining the relationship between the personal tax and social security systems and changes to the administration of income tax which will be made possible by computerisation. A move to transferable allowances would not be inconsistent with the ideas discussed in these chapters. While the Government have no immediate proposals to put forward, they would welcome comments on the views expressed in chapters 6-8 below.

Chapter 6: Taxes and Benefits

6.1 There is a wide overlap between the tax and social security systems. Originally income tax was paid by only the richest in the land and the social security system was concerned with the very poorest. Now, some 20 million families or single people pay income tax, and there are also [20] million receiving social security benefits. Often the same people are both paying income tax and drawing benefits. Chart 6.1 shows the extent of the overlap for each benefit.

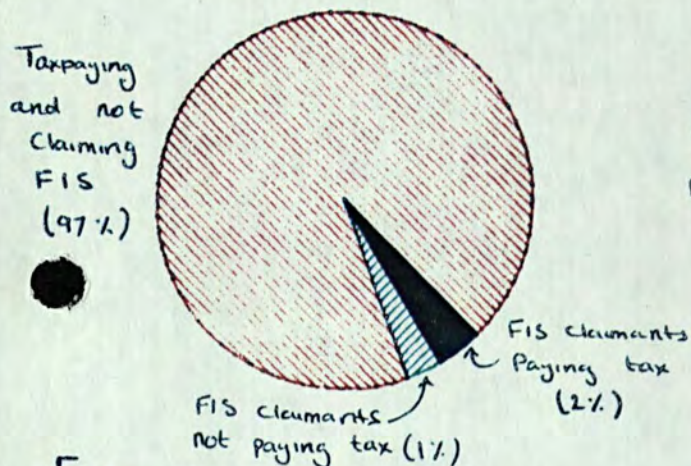
6.2 This overlap has led many people to argue that the relationship between tax and benefits should be rationalised. They claim that this would produce a more coherent and logical pattern of payments, simplify the system for both the citizen and the Government by reducing the present degree of "churning" and also help to deal with the poverty and unemployment traps. This Chapter considers these possibilities. It looks first at the proposals made in the early 1970s for a closer link between tax and benefits, then at the case today

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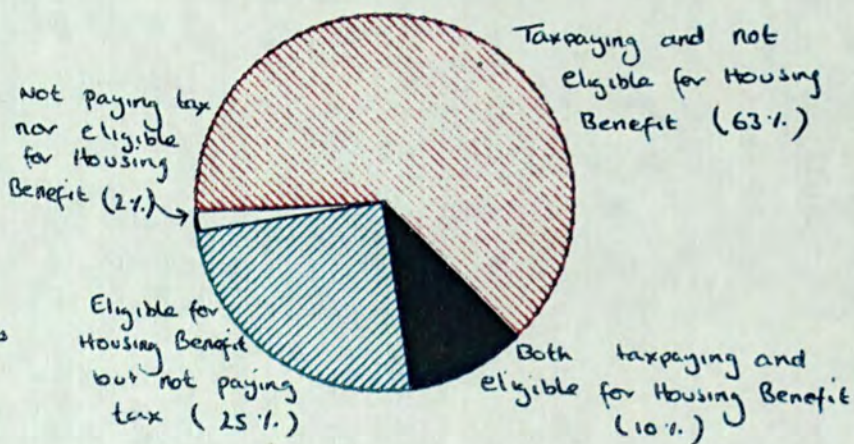
CHART 6.1 : EXAMPLES OF OVERLAP BETWEEN TAX & BENEFITS

INCOME RELATED BENEFITS

FAMILY INCOME SUPPLEMENT



HOUSING BENEFIT



Base for percentages:
Employed families
with children

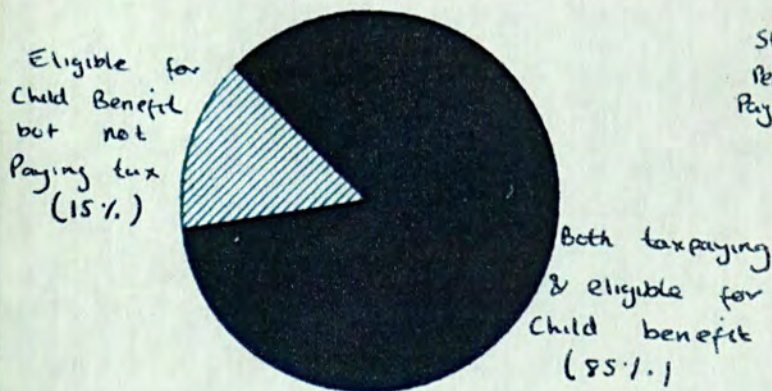
Source:
Survey of Personal
Incomes & DSS
administrative data

Base for percentages:
all households

Source:
1983 Family
Expenditure Survey

NON-INCOME RELATED BENEFITS

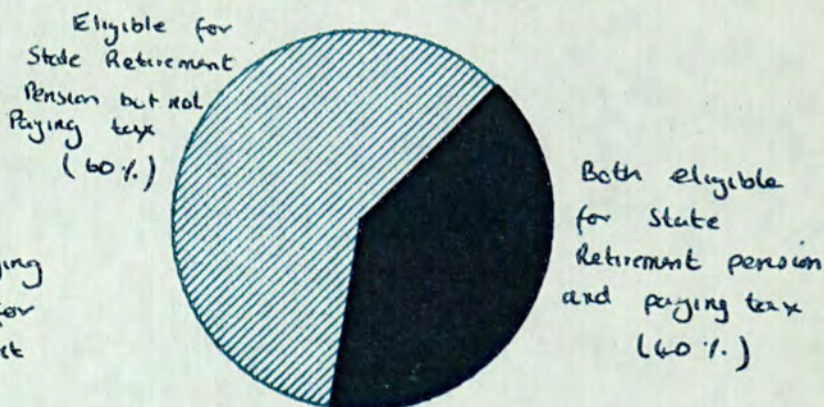
CHILD BENEFIT



Base for percentages:
Families with children

Source:
1983 Family
Expenditure Survey

STATE RETIREMENT PENSION



Base for percentages:
Families entitled to
State Retirement Pension

Source:
Survey of Personal
Incomes and
Population estimates

for a single integrated system, and finally at the case for partial integration.

The Tax Credit System

6.3 An improvement in the interface between tax and social security was the main object of the proposals put forward in a Green Paper in 1972 for a tax credit scheme.⁽¹⁾ The scheme would have introduced a new tax credit that for most people would have taken the place of the main income tax personal allowances and family allowances. When paying wages the employer would deduct tax at the basic rate (30 per cent) from the whole of those wages etc. Against this tax, the employer would set the amount of credit to which the taxpayer was entitled. If credit exceeded tax, the difference would be paid to the taxpayer; if tax exceeded credit, the difference would stand as a tax deduction.

6.4 The tax credit scheme would have applied to people in regular employment earning above a certain amount, to retirement pensioners and people receiving other national insurance benefits, and to certain others. The self-employed were not within it nor were married women, though the coverage was to be kept under review.

6.5 The scheme was never intended to replace the generality of social security benefits. Indeed, it was estimated that tax credits would remove the need for only one out of the (then) 44 income-related benefits. The intention was to supplement low employment incomes and national insurance benefits.

6.6 The scheme, in the form originally proposed, was expected to produce possible net staff savings of 10,000 to 15,000. These savings would have resulted mainly

(1) "Proposals for a Tax Credit System" Cmnd 5116; October 1972

from computerisation, the simplification of tax reliefs and allowances, and the deduction of tax at source from bank interest. However, changes to the scheme recommended by a Parliamentary Select Committee in 1973 would have considerably reduced these savings.

6.7 Work on the tax credit scheme stopped in 1974 with the change in Government. But since then there have been many other changes in both the tax and benefit systems. Many ideas originally part of the tax credit scheme have since been implemented independently; including the replacement of child tax allowances and family allowances by child benefit, and the taxation of unemployment benefit, and the introduction of statutory sick pay which means that most payments for short-term sickness are taxable. Also since 1974 there have been successive improvements in family income supplement.

6.8 Many of the administrative cost savings that would have flowed from the tax credit scheme have since been realised, in particular from changes in the treatment of mortgage interest relief and life assurance premium relief, the abolition of child tax allowances, and the introduction of a composite rate of tax on bank deposit interest. Others are in prospect, as a result of the computerisation of PAYE. Improvements in administration, some of which had been identified during the tax credit studies, have produced further substantial staff savings. Altogether, these changes will have produced savings of 13,000 staff by 1988.

6.9 Of the main elements of the original tax credit scheme which would have had additional staff costs, only taxation of unemployment benefit has been implemented. The majority of short-term sickness payments have now been brought into tax by the introduction of statutory sick pay. This made it possible to achieve that particular objective and produce staff savings in DHSS at the same time.

6.10 Thus almost all the elements of the 1972 tax credit proposals expected to achieve large staff savings - but only two of those that would have had substantial staff costs - have now either been implemented or are in the process of being implemented.

6.11 The illustrative rates of tax credit used in the 1972 Green Paper were those necessary to finance the abolition of the FIS for employees, at a net Exchequer cost of £1.3 billion. The cost would be much larger now, largely because since 1972 FIS income limits have risen faster than earnings, while tax thresholds have fallen as a percentage of earnings. Whereas in 1974-75 80 per cent of FIS recipients were below the tax threshold, now around 80 per cent of recipients are above it. The cost of a tax credit scheme now, at a rate sufficient to enable FIS to be abolished would be some £[8] billion. A scheme large enough to achieve the objectives of the new family credit scheme would involve a further large cost.

Looking to the Future: A Single Integrated Scheme

6.12 Since 1972, many other suggestions have been put forward for replacing the present tax and social security systems by a single integrated system. Such schemes involve replacing social security benefits by payments made and assessed through the tax system.

6.13 Generally such schemes are based on a system of tax-free credits. Tax would be payable from the first £ on all other incomes. Particular schemes differ in their proposed methods of determining the credits - and whether the credits would be effectively withdrawn as income increases - and in the way in which payments would be made. These differences, which reflect the objectives of the particular scheme, determine its cost and distributional effects.

6.14 An integrated system is designed to have a simpler structure than the tax and social security systems we have now, or that is proposed in the Social Security Green Paper. In the simplest schemes income-related benefits would go. Everyone would get a credit, the level of which would depend on a few very simple tests - for example, marital status or number of children - but not on income.

6.15 The Government believe that it is an over-simplification to regard an integrated scheme as the solution to the problems facing the tax and benefit systems. As was made clear in the Green Paper on Reform of Social Security, they have rejected a bigger role within the social security system for universal benefits paid to all regardless of needs. They have also rejected wholly means-tested approach. A system which provided no benefits as of right to pensioners, for example, would be unacceptable.

6.16 Perhaps the biggest problem facing proponents of an integrated system is striking the balance between the cost of the system and the extent to which it matches benefit to need. The credits would have to be high enough to support families when there was no other income. A wide variety of needs would also have to be covered. But a credit high enough to support families with the highest housing costs, for example, would be over-generous to everyone else, including those well up the income scale. To finance it would mean much higher taxes - for most people, not just the better off. On the other hand, if the credits were lower to save costs, then many poorer families might lose.

6.17 Cost would be less of a problem in schemes where the eligibility for credits was more tightly defined and related more closely to specific need. Then credits fixed to meet the needs of particular groups - such

as those with very high housing costs - would not have to apply across the board. And cost would be further reduced in those schemes where benefits would be subject to a test of income. But this means a more complicated system and one of the major advantages of integration would be lost.

6.18 Another way of resolving this dilemma might be to restrict the scope of the scheme. Exceptional needs could simply be left out of the integrated scheme and provided for separately. For example, some schemes would retain an income-related housing benefit. But this would involve taking some of the provision for meeting needs out of the system, again reducing its simplicity and also its comprehensiveness.

6.19 An integrated scheme thus faces a number of trade-offs. The simplest schemes are likely to pose the most difficult choice between cost and rough justice. This dilemma can be avoided, at least in part, but only by introducing more complexity and means testing, and making the new system more like the present one.

6.20 There are also some important practical differences between tax and benefits. Income tax is an annual charge on income over the year as a whole. If tax paid during that year is not right, it can be adjusted afterwards. In marked contrast, the social security system needs to be able to respond swiftly and precisely to changes in individual circumstances. This is particularly true of supplementary benefit which, for many recipients, is their sole or major source of income. The simplifications introduced by the new income support scheme will not change the fact that the DHSS, unlike the Revenue, often need to be closely, directly, and immediately concerned with changes in the circumstances of its clients.

6.21 But beyond these questions of cost, complexity and practical administration is the fundamental point that taxation and benefits - what an individual pays to the State out of his own income and what he receives from the State to supplement his income - are not just two sides of the same coin. Certainly taxes and benefits have to be considered together when they affect the same individuals. But this does not alter the fact that they have different functions. These can lead to big differences in the way in which the two systems work. The Government believe it is important not to blur this distinction - between reward for effort, and support for need. It is also important to retain the principle that eligibility for National Insurance benefits should be based on contributions.

6.22 For all these reasons the Government believe that a comprehensive integrated system is unlikely to provide the right answer. But this is not to say that the present relationship between tax and social security cannot be improved. The Social Security Green Paper has said that closer links between the systems could bring many advantages. This chapter now examines the possibility of partial integration.

Partial Integration

6.23 The proposals in Part I of this paper and others already announced would produce a more coherent relationship between the tax and social security systems:

- Transferable allowances would reduce the numbers of people who are both paying tax and receiving income-related benefits. They would greatly reduce the present overlap between the two systems.

- Paying the new family credit and housing benefit on the basis of net income will remove the possibility of marginal rates of 100 per cent.

- Paying family credit through the pay packet would improve administration.

- Moving the uprating date for social security benefits to April would enable changes in benefits to be synchronised with changes in tax.

Together, they mark a major step in streamlining the systems.

6.24 The case for further integration depends on a number of factors: the extent of the overlap between the two systems; the approaches to measuring the beneficiary's resources and needs; the approach to the measure of need; whether the unit of measurement should be the individual or the family; and the timescale for the measurement of income. These are considered in turn below:

a. Overlap with taxation. The scope for integration is greater where there is a large number of people both receiving benefit and paying tax at the same time. This overlap varies widely from one benefit to another. At one extreme, the overlap with supplementary benefit and the proposed new income support is minimal. The conditions for eligibility for those benefits ensures that. Two-thirds of those receiving Family Income Supplement (FIS) are taxpayers and the same is likely to be true of the new family credit, though only a small proportion of taxpayers receive these benefits. Half or more of housing benefit recipients are taxpayers. There is also considerable overlap with the national insurance benefits: some two-fifths of retirement pensioners pay tax, though the issues here are rather different.

b. Measurement of beneficiaries' resources.

For the benefits that are paid subject to a means test, some measure has to be taken of the claimant's resources. For supplementary benefit his or her capital resources are taken into account as well as income, and the Social Security Green Paper proposes that they should be treated in the same way for income support, housing benefit, and the new family credit.

c. The measure of beneficiaries' needs. Whether a person's needs can be measured in the same way for tax and social security is essentially a practical question. There would be no difficulty in principle. But it has been recognised from the time of Beveridge that it would be prohibitively expensive to raise a flat rate benefit to a level that could include adequate provision for the individual with the greatest need. Even with the simplifications introduced by the Social Security Review, income support still requires a more complex structure than that of the present tax system in which for nearly everybody of working age there are just two rates of personal allowances. It needs to be able to meet needs which vary between individuals, and for the same individual over time. The same is broadly true of Housing Benefit. Payments of FIS and the new family credit also reflect family composition.

d. The Unit: the individual or the family. Most income-related benefits have regard to the income and needs, not only of the individual making a claim but of the family as a whole. Household income is "aggregated" for married couples and unmarried couples, and income support and housing benefit assume a contribution towards housing costs from other adults living in the home. These

benefits also have regard not only to the needs of the couple, but also to the additional needs of any dependent children. By contrast, the tax system in this country has been moving away from the aggregation of husbands' and wives' incomes, and towards treating husbands and wives independently, and child tax allowances were abolished in 1979.

e. The timetable for measurement of income.

Supplementary benefit looks at the income or other means available in the current week, or over a fixed period as recent as possible - as will the new income support. In the last resort, the social security system has to ensure that the family is able to manage from day to day. Family income supplement, the proposed family credit, and housing benefit are also assessed on the basis of - broadly speaking - current income, but rates of payment change much less frequently. There are thus differences between benefits in the timescale over which income is measured in assessing eligibility. Liability for tax by contrast is measured over a period of not less than 12 months. If the tax system moved to a non-cumulative basis (as discussed in chapter 8), this difference would be reduced but by no means eliminated.

This analysis shows that the scope for a closer link between tax and benefits varies from benefit to benefit. The case is weakest for Supplementary Benefit and income support, for which there is little overlap with tax and which has to be responsive to varied and perhaps rapidly changing circumstances. It is stronger for those means-tested benefits, FIS and family credit, which are not designed to meet rapidly changing needs. It is also strong for those national insurance benefits where there is substantial overlap with tax and which again are not designed to meet changing needs.

6.25 Closer integration between tax and benefits can take one of three forms. First, it can simply ensure that there is a coherent relationship between tax payments and benefit payments. Secondly, eligibility for benefits can be assessed through the tax system. Thirdly, whether or not this is the method of assessment, payment of tax and benefits can be integrated, so that only one net payment is made.

6.26 The changes proposed in the Green Paper on reform of social security would go far to achieving the first objective. Payment of family credit through the wage packet will make much clearer the net family income in work for those families receiving support, and the structure of family credit will ensure that low-income families will generally find themselves better off working than not. And relating family credit and housing benefit to net incomes will ensure that, as earnings increase, households do not find themselves with a lower net income because of the combined effect of taxes and benefits.

6.27 The second form of integration is not an immediate possibility. Until the Inland Revenue and DHSS have computerised their main operations, it would not be practical, even were it to be desirable, to assess the title to benefits through the tax system. But the two Departments will ensure that their computer developments are compatible. As they progress it will be possible for information to be exchanged, subject to the need to protect privacy. New possibilities would then open up. It is not possible to say so far ahead exactly what changes should be made. It is never likely to make sense to integrate assessment of income support with the tax system. But developments in information technology should make it possible to improve arrangements for family support. It may, for example, prove possible to use information available to one department in order to establish title to benefit or relief available from

the other. This could improve both administration and take-up.

6.28 The third form of integration - of the payment of tax and benefits - raises issues similar but not identical to those raised by integration of assessment. The Green Paper on Social Security has already proposed it for family credit. It is never likely to make sense for benefits which, like Supplementary Benefit, are aimed at meeting needs which may vary frequently. Again, too, it is important not to increase burdens on employers, through whom payments to those at work would have to be made if they were integrated with the PAYE system. One obvious area for further study is the method of taxing National Insurance benefits. At present it is not always possible to take advantage of the Government's dual role in paying and taxing these benefits. In particular, the Government will explore further the scope for applying PAYE to the National Insurance retirement pension, so that so far as possible a pensioner receives just one single payment from the Government, after any tax deduction. This would not be cost-effective at the moment, but the balance of argument may change when computerisation is complete.

6.29 Some partial integration of the tax and benefit systems may therefore become practical and desirable in the foreseeable future, although full integration is never likely to be desirable. There remains the question whether the two revenue-raising systems - income tax and national insurance contributions - might usefully be brought together. This is the subject of the next chapter.

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Chapter 7: Integration of National Insurance Contributions
And Income Tax

7.1 Earnings are subject to two charges: income tax and employees' National Insurance Contributions (NICs). Other forms of income, such as pensions, investment income and some social security benefits, are subject to income tax, but not NICs.

7.2 It has frequently been suggested that it would be more efficient if the existing two charges on earnings - income tax and employees' NICs - with their different but overlapping bases were replaced with one combined charge to replace income tax and employee NICs. The main argument for a single charge is that it would simplify the overall structure of the administrative system, and reduce the compliance burdens which employers currently face in dealing with two separate systems. (Employers' NICs could remain as a separate charge; the Green Paper on Social Security reaffirmed the continuing need for some form of employers' contribution to the National Insurance fund.)

7.3 It has already been possible for the collection arrangements to be substantially integrated. Employers deduct both income tax and NICs from their employees' earnings, record those deductions on the same document and pay both over to the Inland Revenue in a single payment. The Inland Revenue divide the payment into an income tax component, which is paid into the Consolidated Fund, and a NIC component, which is paid mainly to the National Insurance Fund.⁽¹⁾ The Inland Revenue also collects Class 4 contributions from the self-employed at the same time as it collects Schedule D income tax.

7.4 In order to consider the arguments for and against a combined charge, it is necessary to look at the present differences between the two charges:

(1) A small amount of the income from contributions goes to the Maternity Pay Fund, the Redundancy Pay Fund and the National Health Service.

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Differences between Income Tax and National Insurance Contributions

a. Base for charge. NICs are charged on earnings, and only earnings, of all employees and the self-employed with the exception of those over pensionable age. They are not charged on pensions, investment income and social security benefits. Income tax is charged on all income, including investment income, pensions, certain lump sums, and certain income replacement benefits such as unemployment benefit. NICs paid by employees and the self-employed raise about £12 billion per year, while income tax raises about £35 billion.

b. Structure of charge. Everyone earning at or above the Lower Earnings Limit (LEL) (currently £35.50 per week) pays employee national insurance contributions on all their earnings up to the Upper Earnings Limit (UEL) (currently £265 per week). The employee rates build up in a graduated structure from 5 per cent to a flat 9 per cent. The self-employed pay a flat rate (Class 2) contribution plus a percentage of their profits between certain limits (Class 4). In the case of income tax, there are personal allowances which exempt the first slice of income from tax; tax is charged at graduated rates on the amount by which income exceeds the tax-free allowance, but there is no ceiling on the amount of income charged.

c. Reliefs and Rebates. There are no reliefs that can be set against NICs. Once the LEL is reached contributions are charged without regard to individual circumstances, though married women, and certain special categories of people, such as those in the Forces, pay lower

contribution rates, reflecting differing benefit entitlements. For income tax, as well as the personal allowances, there is a wide range of reliefs reflecting individual circumstances, eg for mortgage interest and superannuation contributions, which reduce the amount of income on which tax is chargeable.

d. Period of Assessment. NICs are due in each pay period (a week or a month for most employees) on earnings in the pay period. Each pay period is assessed individually and without regard to the previous earnings record of the employee. So an employee is liable to NICs in any period when earnings reach the LEL. Liability to income tax is measured by reference to income over the year from 6 April to 5 April. A person is not liable to income tax unless his total income for the year exceeds his allowances.

e. Basis of Deduction from Pay. For employees NICs are deducted on a non-cumulative basis. Each pay period is treated separately. Income tax is deducted on a cumulative basis so that deductions in each pay period take account of earnings and allowances that have accrued from the start of the year.

Implications of Full Integration

7.5 Levying a new combined charge on the same basis as income tax would in effect mean that tax allowances would be deducted from earnings before calculating NICs, but that all income above the tax allowance would become liable to NICs. In addition, tax reliefs would be available against the combined charge; they are not, of course, available against NICs. Since the revenue loss from these changes would exceed the revenue

gain from the extension to all income, at present rates of allowances, the combined charge would have to be set at 40 per cent to remain revenue neutral. Those with low earnings would tend to gain overall because the tax allowance would reduce their liability. But this would be at the expense of taxpayers with income not currently subject to employee NICs, such as State and occupational pensions, investment income and earnings above the UEL.

7.6 Applying the new combined charge to all income would result in significant shifts in the tax burden between different sections of the community. Elderly taxpayers and other pensioners would probably be the largest group to suffer disadvantage, since they do not currently pay NICs. Other groups who would be adversely affected would be many basic rate taxpayers with earnings above the UEL (currently £265 per week), and all higher rate taxpayers.

7.7 As noted earlier in this Green Paper, distributional effects are not in themselves a conclusive argument against tax changes; otherwise nothing would ever be changed. But wide-ranging shifts on the lines described above would be hard to justify on either economic or social grounds.

7.8 Moreover, there is an important principle enshrined in the present arrangements, namely that eligibility for National Insurance benefits should be related to the contributions paid. This would be seriously weakened by a combined charge applied to all income.

7.9 Entitlement to National Insurance benefits depends upon payment of the appropriate amount of NICs. Those who have made sufficient qualifying payments are entitled to such benefits, without means-testing, if they experience one of the contingencies that the benefits

cover. People who do not have an adequate payments record are in some cases not entitled to benefit; or in others, merely entitled to part-benefit. They may of course then be eligible for other state benefits subject to a means test, but this would normally be at a lower rate. If employee and self-employed NICs were abolished as a separate charge the form of the contributory principle would have to be reconsidered; it could not continue on its existing basis.

7.10 The Government's commitment to the contributory principle was made clear in the Green Paper, "Reform of Social Security":

"The principle that entitlement to benefits should be related to contributions paid is an important one to which the Government is firmly committed. The Government believe that it is right to retain a link between contributions paid in and benefits received".⁽¹⁾

7.11 There are several reasons for retaining a direct link between payments and entitlement to benefit. People value the unqualified right to benefit which their payments confer upon them. Contributors in effect insure themselves both against temporary loss of earnings and to provide themselves with income support when their working lives are over. Such arrangements bring home the cost of NI benefits. If benefits were paid to everyone, regardless of their contribution record, there would be substantial extra costs which would have to be borne by the general body of taxpayers. At the extreme, the absence of a qualifying test would open contributory benefits, such as the full state pension, to people who had just arrived in the country. Other safety net arrangements exist to deal with such cases where there is hardship. It would destroy the rationale of contributory benefits to make them available

(1) Reform of Social Security. Volume 1 (Cmnd 9517)
Chapter 11.1

without regard to contributions. The Government does not consider that this would be acceptable.

7.12 It would be very difficult to sustain the contributory principle with a combined charge applied to all income. In the case of people solely or mainly dependent on investment income, they would be paying for benefits, such as unemployment benefit, to which they were not entitled. Tax-paying pensioners would in a sense be asked to pay twice: after a lifetime of paying NICs, they would then have to pay contributions towards benefits which they thought they had earned as of right on the basis of their earlier contributions record. This kind of anomaly would tend to weaken the link between contributions and entitlement and thus undermine the contributory principle.

7.13 Problems would also arise as a result of setting a tax-free allowance against liability to the combined charge. Some people who currently pay NICs would find themselves taken out of charge altogether. Should they be entitled to National Insurance benefits to which they would not have contributed? The problem could become significant as tax allowances increase, for example, as a result of transferable allowances. A further question would arise in the case of an individual whose earnings just exceeded the tax allowance. Should he be entitled to National Insurance benefits on the basis of minimal contributions? These examples illustrate the problems of reconciling a combined charge with the contributory principle.

A Combined Charge with Limited Coverage

7.14 Because the distributional consequences of applying the new combined charge to all income are recognised, it is sometimes suggested that exceptions should be made to the coverage of any combined charge. The elderly, for example, could be exempted from it,

while investment income could be treated differently from earnings and taxed at a separate rate. The groups who currently pay their own lower employee NICs could have a special rate of combined charge. All these arrangements would mean that those who paid the combined charge were in essence those who pay income tax and employees NICs now. But to pay for these exemptions the tax rate of the combined charge would have to be increased to compensate for the lost revenue. This would increase the extra tax paid by those above the UEL and also mean that some of those earning below the UEL would pay more tax. The loss would be proportionately greatest for those towards the top end of the current basic rate band, but the higher marginal tax rates would have adverse consequences for incentives throughout the income range on which they were levied.

7.15 A combined charge limited more or less to those who now pay employee NICs would probably do less damage to the contributory principle than one applied to all income (though the difficulties mentioned in paragraph 7.13 above would remain). To reduce administrative costs, a simpler eligibility test might be devised, based on a qualifying period of earnings at or above a minimum level.

7.16 An exception, however, would have to be made for those who continue to be covered by the State Earnings Related Pension Scheme, SERPS. But the present scheme will continue for those within 15 years of retirement. It will be necessary to maintain a detailed record of contributions paid on earnings for this group of people until they are all retired. In effect this means the maintenance of the present arrangements for this group.

7.17 Perhaps the strongest objection to trying to restrict the base of a new combined charge in the way

suggested above would be that simplicity, the main aim of the new combined charge, would be lost. There would no longer be a single tax on all income. Earners would be subjected to the new combined charge, tax-paying pensioners would pay some different rate, which might or might not be the same as that paid on unearned income. Even the combined charge itself would have to have more than one rate if the special groups were not to find themselves worse off. At this point the whole rationale for introducing a combined charge becomes very questionable.

Conclusions

7.18 A combined charge replacing both income tax and employees' NICs could lead to reductions in administrative costs. The size of these would depend on the precise scope and nature of the new charge, and on the form taken by any new qualifying entitlements test. To the extent that the new charge was not extended to all income and/or differentiation was introduced into it the benefits of administrative simplification would be reduced.

7.19 A combined charge would have benefits for employers, especially small employers. It would simplify the calculations which have to be made separately at present. The increasing use of computers and hand calculators for payroll work, however, and their declining cost may well mean that the complexity of the present arrangements will increasingly impose less and less of a burden even on small employers.

7.20 Against those benefits must be weighed the major distributional effects of such a change and the need to find a satisfactory way of upholding the contributory principle. The Government's view is that the benefits of a combined charge would be unlikely to justify the ensuing upheaval.

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Chapter 8: Administration of Personal Tax In The Longer Term

8.1 The administration of income tax rests largely on PAYE, which has remained broadly the same since it was introduced over 40 years ago. With the PAYE system being computerised, and the prospect of transferable allowances, it is clearly time to ask whether the mechanics of PAYE are likely to be the best ones for the 1990s. In particular, it is important to recognise the compliance costs which PAYE places on employers - especially small businesses. As the recent White Paper, "Lifting the Burden", makes clear, the Government attaches a high priority to reducing the burdens on employers. This chapter looks at the PAYE system and at possible changes to it.

PAYE as it stands at present

8.2 Under PAYE, each employee is given a code, which reflects the personal tax allowances and reliefs to which he is entitled. In the normal case, the Inland Revenue send the employee his notice of coding, and also inform his employer what the code is.

8.3 The employer uses the employee's code - in conjunction with tax tables that the Revenue provide - to deduct the appropriate amount of tax from his weekly or monthly earnings. The deduction system works cumulatively. In other words, the deductions which an employer makes from his employee's earnings under PAYE in any given week (or month) normally take account of the employee's cumulative pay and tax payments for each previous week (or month) of the current tax year. The aim is that - at any point in the tax year - the amount of tax the employee has paid should be the appropriate proportion of the likely tax liability for the year as a whole.

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8.4 If an employee's circumstances change during the tax year - for example if he gets married - his tax code is normally changed to reflect this. If he changes jobs, in order to maintain cumulation his new employer needs to know the total of his pay and tax during the current tax year. To achieve this, his previous employer fills in a form (the P45) including these details, which the employee gives to his new employer. The procedures associated with the P45 also allow the employee's tax record to be moved to the correct tax office when he changes jobs. This is necessary because the Revenue keeps an employee's records at the office which deals with his employer (all the employees of one employer are therefore dealt with in the same tax office).

8.5 At the end of the tax year, the employer sends the Revenue the information about his employees' pay and the tax deducted; the Revenue then make any adjustments or assessments (and repay or collect tax) where this is necessary. Under-payments of tax are normally collected over the succeeding year or two through adjustment of the employee's code number.

Main Effects of the Present System

8.6 Coding by the Revenue and cumulative deduction operate so far as possible to avoid the need to make adjustments after the end of the year to the employee's tax payment. For more than five out of six employees paying tax under PAYE no adjustment is required to the amount of tax they have paid.

8.7 Changes of policy which would require extra end-of-year adjustments impose an additional cost. In this respect, the present system is less flexible than a system under which it is the norm to adjust and finalise the employee's liability after the end of the tax year.

8.8 The ordinary taxpayer is very little involved with the running of the system. From time to time he may have to provide information about his personal circumstances; but otherwise he is not really directly concerned in the PAYE process itself. In fact, many people could now go through the whole of their working life without being sent a tax return - or a tax demand.

8.9 A corollary of this is that the work of running the PAYE system falls largely on the employer and the Government.

An Alternative System

8.10 Apart from the United Kingdom and the Republic of Ireland, no other country operates its tax deduction system cumulatively. An alternative system for this country would be based on non-cumulation.

8.11 An inevitable feature of a non-cumulative system is that for many employees it will not result in the right amount of tax being deducted from earnings during the year. An adjustment - either a repayment of tax or a demand for it - frequently has to be made after the end of the year. In the United States and Canada, for example, this is at present done through the self-assessment system; all employees send in a tax return, with details of their complete tax position for the year, and either a cheque or a claim for repayment of tax. In most other countries the assessment is made by the Revenue authorities.

8.12 In a system where adjustments after the end of the year are the norm, it is neither necessary nor cost-effective⁽¹⁾ for the Revenue authorities to try to ensure

(1)As a rough rule of thumb, to spend an additional 10 minutes on each taxpayer's affairs would cost a total of over 2,500 Inland Revenue staff or perhaps 2800 if a standard loading for administrative overheads such as typing, handling post etc is added.

that an employee's code reflects precisely the personal reliefs to which he is entitled. Most countries with non-cumulative systems therefore use some form of "self-coding" - that is to say, the employee (and not the tax authority) determines his code.⁽¹⁾

8.13 It may be helpful to describe in outline how a system of this sort might work.

8.14 The employee starting a new job would collect a self-coding form from his employer, fill it in, calculate his code and hand the code back to his employer. If the employee's circumstances changed during the course of the year, he would be responsible for setting, and giving his employer, his new code. Depending on how the self-coding system was designed, it might be feasible for employers to give effect to Budget increases in personal allowances without altering codes. (In the United States, such increases are given effect by a new issue of tax deduction tables to employers.) In that case, a person's code would simply run on unchanged from one year to the next unless altered by a change in his circumstances. The Inland Revenue's part in a coding system of this sort would be restricted to providing any advice and guidance to employers and employees that was needed, subject, possibly, to some form of random check. On the United States pattern, the Inland Revenue might also have to give prior clearance if the taxpayer wished to claim more than a given total of deductions in his coding.

(1) A possible compromise was floated in the Tax Credit Green Paper under which a form of official coding card would be issued by the Inland Revenue to the employee; the employee would hand it to his employer when taking up a job, and collect it back when leaving (Cmd 5116, paragraph 36). However it was argued in evidence to the Select Committee that this would impose an unacceptable burden on employers (evidence from the Confederation of British Industry, the Association of British Chambers of Commerce and the British Computer Society, HC 341-II, pages 280-1 and 430-438, and HC 341-II, Appendix 24). The Select Committee recommended against the proposal and it was abandoned (HC 341, page 5 and paragraphs 242-3).

8.15 During the course of the year, the employer would deduct tax non-cumulatively from the employee's earnings. This weekly or monthly calculation of tax would depend simply on the employee's tax code and his earnings in that particular week or month; there would be no need to involve in the calculation the employee's previous earnings and tax for that year. For this reason, there would be no necessity for the employee changing jobs to take with him details of his previous earnings and tax. Under a self-coding, non-cumulative system it might turn out to be more efficient to abandon the system of keeping an employee's tax record in the tax office dealing with his employer. If that proved to be the case, employers could be relieved of all of the present information procedures associated with employees' job changes.

8.16 If the system were based on self-assessment all employees would be required to send in a tax return within a specified period after the end of the tax year. The tax returns, with the accompanying cheques or repayment claims, would normally be accepted by the Inland Revenue without detailed enquiries to the taxpayer; but there might be a check to ensure that the calculations were arithmetically correct; and United States experience suggests that with improvements in technology it is becoming feasible and cost effective to check taxpayers' returns against returns made in machine readable form by employers and other payers of income. Under a system based on self-coding and non-cumulation it might be necessary for the Inland Revenue to have more effective powers to enforce compliance (and to ensure that returns were sent in promptly). In the United States, for example, the tax authorities are able to make random audits of taxpayers' affairs.

Effects of an Alternative System

8.17 A change from our present system to a non-cumulative, and possibly a self-assessment, system would obviously have major implications for employers, employees and the Government. It is important to be as clear as possible what these would be.

8.18 For employers, the main implications would be as follows.

8.19 First, coding. As suggested above, coding alterations arising from Budget changes might become unnecessary. On the other hand, more work would be involved for many employers in receiving coding notices separately from individual employees rather than (as at present) in a batch or list from the Revenue.⁽¹⁾ (This applies less to smaller employers and more to larger ones: in particular, it is possible that some of the larger employers whose payroll records are on computers may be able to receive batches of coding information highly efficiently from the Revenue once the computerisation of PAYE is complete.)

8.20 Second, non-cumulation. The effects of non-cumulation for employers are likely to be either helpful (to smaller employers) or broadly neutral (to larger ones). They will depend on whether the employer operates PAYE manually or as part of a computer-assisted payrolling system. At present almost all larger employers, but probably only a minority of other employers, have computer-assisted payrolls or use a computer bureau (though the proportion of employers with access to computer assistance is likely to rise each year.) For this category of employer, the costs of operating PAYE cumulatively or doing so non-cumulatively would probably not on the whole be very different (though the transition from one type of system to the other would itself involve a substantial once-for-all cost).

(1) This was one of the points made in discussion of the 1972 Tax Credit proposals.

8.21 For those employers who operate PAYE manually - mainly smaller employers - a non-cumulative system should mean less work in making the weekly PAYE calculations, because these no longer have to take account of the previous weeks' pay and tax, but rather more work (in totalling figures up) after the end of the year.

8.22 If the Government were to merge income tax and NIC, the resulting system could be run either cumulatively or non-cumulatively. However, if the present separate and distinct PAYE and NIC deduction systems are maintained, non-cumulation could make it possible to put the appropriate PAYE and NIC deduction figures, for any given amount of earnings, side by side on the same line in one deduction table. The employer would still have to read off the table, and enter on his record sheet, three separate figures for the employer's NIC, the employee's NIC and the employee's tax for the week or month in question. But if the Inland Revenue and DHSS were able to combine their existing deduction tables, this would be helpful to employers who operate PAYE manually.

8.23 Third, a self-coding and non-cumulative system would save employers some work over employees' job changes. This would be particularly so if the Inland Revenue's present system of keeping the records of employees was changed, though employers would then lose the convenience of being able to deal with only one tax office for all their employees.

8.24 For employees, a new system for the type described would have three main consequences.

8.25 First, self-coding would obviously mean for most people more active involvement in, and responsibility for, determining their tax liabilities. How much extra

work this involved would depend on their particular circumstances. In many cases, it might be relatively little. A lot has been done to simplify PAYE coding in recent years, and the latest figures suggest that (apart from pensioners) somewhere between 60 and 70 per cent of taxpayers have codes reflecting the basic (single or married) personal allowance only.

8.26 In the context of transferable allowances, too, some form of self-coding system would not be inappropriate: deciding the allocation (or transfer) of allowances between husband and wife will depend in many cases on the couple's own knowledge and prediction of their particular circumstances.

8.27 One particular group - pensioners - might find self-coding more difficult than the generality of taxpayers. The large majority of pensioners who pay tax have more than one source of income - typically, an occupational pension and the National Insurance retirement pension. This - combined with the present complex rules for age allowance - tends to make their tax affairs more complicated. The Government's proposal to phase out the age allowance on the change to transferable allowances (see Chapter 4) would mitigate this difficulty, but it would still remain to some extent.

8.28 Second, running the system non-cumulatively would have a cash-flow effect for some employees. Provided that a person's earnings in each week or month stay within the wide band covered by the basic rate of tax (or indeed within any one tax band), and provided that his code is correct and does not change, a non-cumulative system produces the same result as a cumulative system. If earnings fluctuate from week to week (or month to month) above and below the tax threshold or between different tax bands, it does not: other things being equal, the employee pays more tax during the year than his strict liability because he does not get the full

benefit of his personal allowances or of the basic rate band.

8.29 This effect is likely to be relevant mainly for three groups of people:

a. Many people move during the year between employment and unemployment or between employment and self-employment. Others have irregular or occasional earnings - or have earnings which are regular but relatively low, and fluctuate around the level of the tax threshold. (In practice around 4½ million people move in and out of employment during an average year; and well over ½ million have earnings exceeding the tax threshold by less than 10 per cent). People whose incomes were just below the tax threshold for the year, but who had tax deducted in certain weeks, would be within this group. And:

b. There are a significant number of people who leave employment in the course of a year and effectively leave the labour market either temporarily or permanently. These include those retiring from work, women leaving work to raise children and people giving up work because of ill-health.

c. There is a smaller, but still significant, number of people whose earnings fluctuate between the levels of the basic and higher rates of tax, or between different higher rates - as can commonly happen with (say) payment of a bonus in one particular month of the year.

8.30 Third, self-assessment, if that was considered desirable, would require every taxpayer to submit a return of his income every year and calculate the tax due on it. Many taxpayers have income from both

employment and self-employment (as well as investment income) and may also move from one to the other during the year. Self-assessment would therefore extend also to self-employment income chargeable under Schedule D and all other sources of income.

8.31 For the Government, the change to an alternative system has two main consequences.

8.32 First, the Inland Revenue's work before and during the tax year would decrease (in relation to coding, job changes etc); and its work in processing tax returns after the tax year would increase. Taking the balance of these two effects, a system of self-coding, non-cumulation and self-assessment should be significantly cheaper for the Government to run than the present system (though the work of running it would be spread less evenly over the course of the year). In particular, the extra costs of running transferable allowances should be smaller under an alternative system of the sort described than under the present system. All this depends, of course, on the Inland Revenue being able to handle the increase in end-of-year work economically. This implies that a large part of the job of processing tax returns would be done by computer and that there would be appropriate provisions to encourage compliance.

8.33 Second, if the system required all taxpayers to send in tax returns as a matter of course, this should make it less costly - by comparison with the present PAYE system - to introduce policy changes which imply more end-year adjustments to people's tax payments.

A Possible Development

8.34 The preceding paragraphs in this Chapter have been written on the assumption that a change of system might involve self-assessment. In fact, a non-cumulative system does not necessarily imply that all taxpayers

But the proposal is to extend the approach, after a pilot programme and further study, to some further categories of taxpayers.

8.38 It is an important element in these developments that the US administration is at the same time proposing to simplify the personal tax system: to limit the number and range of tax deductions; and in particular to extend the Zero Bracket Amount.⁽¹⁾ The President's tax proposals to the Congress envisage that the number of taxpayers needing to itemise claims for tax relief, in returns made to the Internal Revenue Service, will be reduced to a little over a quarter.

Conclusions

8.39 This Chapter does not seek to do more than outline some of the main issues for discussion. Nevertheless, there are some general points worth drawing out.

8.40 First, a new system of the sort described above would mean major changes for the ordinary taxpayer: more active responsibility for his tax affairs, including perhaps the need to seek advice and guidance; a more widespread incidence of overpayments and subsequent repayments of tax; and a less elastic set of rules for meeting underpayments of tax.

8.41 Second, non-cumulation could provide advantages for many smaller employers (though the numbers benefiting will fall as more employers make use of computer-assisted payrolling arrangements). However, self-coding could be more expensive for larger employers than the present system.

8.42 Third, a system where the emphasis falls more on end-of-year action should be able to accommodate

(1) A flat rate relief that can be claimed as an alternative to itemising specific deductions and allowances.

should send in tax returns or assess themselves. Indeed, as computer technology develops, it may be more efficient to run a system in which only some taxpayers - those with relatively complicated circumstances - send in returns, and in which for many, or most, people the tax continues to be Revenue-assessed rather than self-assessed.

8.35 The essential choice for the tax authority is either to rely on the recipient of income to provide information about it or to rely on the payer of the income.

8.36 Under the emerging new technology, it is likely to be relatively expensive - even with the benefit of more advanced facilities for optical character recognition - to process tens of millions of paper forms completed in manuscript. At the same time, it is likely to become increasingly feasible, and relatively cheap, to process information provided in machine readable form by the payers of wages and other income. Thus, for example, the United States has announced its intention of moving away from its present system (under which all taxpayers are required to submit a tax return) to one in which, by the early 1990s, more than 50 per cent of all taxpayers would be absolved from the need to submit a return. The United States Internal Revenue Service could receive most of the necessary information about their annual income (with the appropriate social security reference number) in machine readable form from the payers of income; and would make any necessary refund of tax or demand for tax accordingly.⁽¹⁾

8.37 As one would expect, the taxpayers whom the American proposals would exempt from the need to submit a tax return would in the first place be single wage earners who have no complicated financial transactions.

(1) The President's tax proposals to the Congress for fairness, growth and simplicity, May 1985, Chapter 5.01. The proposals are currently under consideration in Congress and may of course be subject to modification.

at less cost policy changes which require more end-of-year adjustments. However this would in practice depend on the nature of the change; and there could still be substantial marginal costs in a policy option that required individual taxpayers (for example) to claim a new relief and for that purpose to make a return of total income which would not otherwise be needed.

8.43 Fourth, - and depending very much on the development of new technology - basing a non-cumulative system on universal self-assessment may in future not necessarily be the most efficient way to run it.

8.44 Finally, a general move to a new system involving self-coding, non-cumulation and increased reliance on assessing or self-assessing would disengage the Inland Revenue from some substantial parts of its current involvement with the deduction system. Provided that the resulting additional end-of-year work could be handled economically, a new system should be capable of being run with fewer staff - and therefore at less cost.

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Chapter 9: Conclusion

9.1 This Green Paper discusses the future of the personal tax system. The Government would welcome comments from organisations, representative bodies, and members of the public.

9.2 Its main proposals are for a new structure for income tax, based on independent taxation. Everybody would have the same tax allowance, but married people who could not use up all their allowance would be able to transfer the balance to their partner. This system would be fairer and more straightforward. It would do much to ease the present unemployment and poverty traps. It would give married women the opportunity for privacy and independence in their tax affairs. It would put an end to the present tax penalties on marriage. It would remove the present discrimination against families where only the husband is in paid employment.

9.3 Changing the structure of the personal taxation in this way would complement the Government's proposals for a reform of the social security system.

9.4 Subject to the response to this Green Paper, the Government propose to legislate for these changes in 1987, and to press ahead with the preparations to run the new system. They would therefore be grateful for comments by 30 September 1986, to be sent to Inland Revenue Policy Division, Room F11, West Wing, Somerset House, Strand, London WC2R 1LB.

9.5 The Green Paper also opens up discussion on some important longer term issues concerning the relationship between the tax and social security systems. Finally, it reviews the administration of personal taxes and examines the implications of moving to a non-cumulative

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basis for PAYE, and - a separate question - to some form of self-assessment.

9.6 As the Green Paper explains, any changes here are for the longer term. The Government does not therefore propose to set a formal closing date for comments on these wider issues, but it would be helpful if these could be sent by 31 December 1986, to the address above.

ANNEX 1 : THE PRESENT STRUCTURE OF PERSONAL INCOME TAX

1. The basis of the present system of taxing married couples is that the incomes of a husband and wife are added together and taxed as if all the income belonged to the husband. He is formally responsible for handling the couple's tax affairs, claiming the allowances, and paying the tax.

2. The main personal allowances are as follows:

- the Married Man's Allowance (£3,455 in 1985-86) can be set against any income of the couple;
- the Wife's Earned Income Allowance (£2,205 in 1985-86) is technically an allowance available to the husband to set against his wife's earnings only; in practice, it is usually given directly against the wife's earnings under PAYE.

Because the Married Man's Allowance can be set against any income of the couple, it is available against the wife's earnings if the husband has no income of his own. But the reverse does not apply: if the wife has no earnings, the husband cannot claim the benefit of the Wife's Earned Income Allowance.

3. Thus the total allowances available to couples in different circumstances are:

Both working	(£3,455 + £2,205)	£5,660
Husband only working		£3,455
Wife only working	(£2,205 + £3,455)	£5,660

4. The Single Person's Allowance is £2,205 in 1985-86.

5. Income above the personal allowances is charged to tax at the following rates - the rates are the same for the joint income of a married couple as for a single person.

£

Basic rate	30%	0 - 16,200
Higher rates	40%	16,201 - 19,200
	45%	19,201 - 24,400
	50%	24,401 - 32,300
	55%	32,301 - 40,200
	60%	40,201 and over

Alternative methods of taxing married couples

6. There are two alternatives to the basic system of taxing married couples, which have different purposes.

a. Separate Assessment was introduced in 1914. It enables each partner to be responsible for handling his or her own tax affairs independently of the other. Either partner may apply for this - the other does not have to agree. This option does not affect the total amount of tax the couple have to pay - the partners' incomes are still added together in order to work out their tax bill - but the couple can fill in separate tax returns. The Inland Revenue put the information together, work out the joint tax bill, and divide it up between the couple broadly in proportion to their incomes. Each partner is then responsible for paying his or her own share of the bill.

b. By contrast, the Wife's Earnings Election, introduced in 1971, is designed to reduce a couple's tax bill. A couple have to elect jointly for this option. The effect is that the wife's earnings are taxed as though she were a single woman, with her own set of tax rate bands while the husband loses the

Married Man's Allowance and becomes entitled to the Single Person's Allowance instead. The election is only worthwhile where their incomes are such that the savings of higher rate tax from having the wife's earnings taxed separately outweigh the loss of the Married Man's Allowance. In 1985-86, the joint income needs to be over £25,360 and the lower earner's share at least £6,596 for the election to be beneficial. This election does not affect the investment income of the wife which remains aggregated with her husband's income.

The Elderly

7. People over 65 have higher tax allowances, currently of £2,690 for a single person and £4,255 for a married man, provided their income is below a certain limit. This Age Allowance is given in full up to income of £8,800 - the limit applies to single people and to the joint income of a married couple. The allowance is then withdrawn by £2 for every £3 of income over that limit, until it is reduced to the same level as the corresponding main personal allowance.

8. The Wife's Earned Income Allowance for married women over 65 is the same as for younger people, £2,205.

Single parents

9. Single parents can get the Additional Personal Allowance (APA) in addition to the Single Person's Allowance. This allowance equals the difference between the Single Person's Allowance and the Married Man's Allowance, £1,250 in 1985-86. So a single parent gets total allowances of £3,455 in 1985-86, the same as the Married Man's Allowance.

10. The APA is also available to a married man with a dependent child, if his wife is wholly incapacitated.

Other Allowances

11. Widows get the Widow's Bereavement Allowance in the tax year in which their husband dies and in the following year. The allowance is at the same level as the Additional Personal Allowance, £1,250 in 1985-86.

12. Blind People get the Blind Person's Allowance, which is £360 in 1985-86.

13. People looking after their widowed mother, or after relatives who are too old or too ill to maintain themselves, can claim the Dependent Relative Allowance, which is £145 for single women and £100 for all other claimants.

14. Widows or widowers who have a resident housekeeper can claim the Housekeeper Allowance of £100.

15. Certain people can claim the Son's or Daughter's Services Allowance of £55 if they support a son or daughter and are dependent on that person to look after them.

How PAYE works

16. Of the 24 million people paying income tax, some 22 million pay tax under Pay-As-You-Earn (PAYE).

17. Chapter 10 gives more details about the way PAYE works. This Annex draws out some of the key features, which underlie some of the arguments in the Green Paper.

18. The fundamental principle of PAYE - and one which distinguishes it from deduction-at-source systems in most other countries - is that in normal circumstances tax deductions are made on a cumulative basis throughout the year. The aim is to ensure that, so far as possible, the amount of tax deducted from the employee's earnings, however they may vary within the tax year, is correct by the end of

the year. This is achieved for five taxpayers out of six. By contrast, the work of Revenue departments in other countries is concentrated in establishing the correct tax liabilities after the end of the tax year, and making any necessary adjustments to the tax which has been deducted at source.

19. PAYE can also be used to deduct tax from income other than earnings. Where a taxpayer has some income from which tax is not deducted at source, part of his personal allowances (equal to the estimated amount of the income) can be allocated against this source of income, leaving only what is left of the allowances (represented by his PAYE "code") to be set against his earnings. The most common example now concerns pensioners: tax is not deducted at source from the National Insurance pensions, but adjustments can be made in their PAYE code to deduct all their tax liability from their occupational pensions. It is not then generally necessary to make a formal assessment for tax on the other income; the PAYE system will deduct the right amount of tax to cover both sources of income. It is not, however, possible to deal with large amounts of other income in this way or with income received at irregular intervals.

20. Outside PAYE, tax is also deducted at source from other sorts of income. The basic rate tax due on building society interest and, from April 1985, on bank interest is collected at source through the so called "composite rate" arrangements. And recipients of company dividends are entitled to a tax credit which covers their liability to tax at the basic rate.

21. The operation of the tax system has been simplified in recent years. The most important changes have been the replacement of Child Tax Allowances by Child Benefit, and the introduction of arrangements for giving tax relief on life assurance premiums and mortgage interest payments by deduction at source.

22. Thus for most employees, the tax system is very simple: the only allowance or relief making up the PAYE code is the personal allowance; and the long basic rate band (up to £16,200 of taxable income in 1985-86) means that 95% of taxpayers pay all their tax at the single rate of 30%.

23. These features have three consequences for administration.

a. The system works without the need for most employees to complete a tax return each year - indeed a person whose affairs are straightforward may never be sent one until he or she retires.

b. In many instances there is no need for the Revenue to bring together information about the total income of a single person or the incomes of husbands and wives in most cases. The combination of deduction at source arrangements and the long basic rate band ensure that the right tax is collected from each source of income separately.

c. The Revenue does not need - and therefore does not hold - information about, for example, whether or not a taxpayer has children or what his or her housing costs are.

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ANNEX 2 : PHASING IN THE NEW SYSTEM

1. Chapter 3 mentions the possibility that the new system of transferable allowances could be phased in without cash losers over a period of, say, two years. This would be achieved by having a transitional year during which only part of the wife's allowance would be transferable to her husband. (Under the present system the Married Man's Allowance is already transferable in full from the husband to the wife if the husband has insufficient income of his own to use it up).

2. The precise details of how the phasing would work would be decided nearer the time but taking 1985-86 allowance levels as the starting point the following steps illustrate how the phasing in might be achieved for couples of working age. Similar phasing in arrangements could be devised for elderly couples.

Year 1 (partial implementation)

- (i) Disaggregate incomes of husband and wife and allow Wife's Earned Income Allowance to be set against any income of the wife.
- (ii) Raise single allowance and wife's allowance to £2,525.
- (iii) Reduce Married Man's Allowance to £3,135.
- (iv) Introduce transferable component of £1,400 within wife's allowance.

Year 2 (full implementation)

- (i) Raise single allowance to £2,830.
- (ii) Convert wife's allowance into a single allowance.

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(iii) Replace Married Man's Allowance by single allowance of £2,830.

(iv) Make single allowance fully transferable between spouses.

The Chart below illustrates diagrammatically how the transition will take effect.

3. A change on these lines would probably split the total cost of the change fairly equally between the two years. But it would be possible to distribute the cost differently by changing the size of the transferable component in the wife's allowance during the year of partial implementation. The table below shows that phasing in along the lines described above would achieve the change to transferable allowances without any reduction in the total allowances available to two-earner couples.

ILLUSTRATIVE ALLOWANCE LEVELS FOR COUPLES OF WORKING AGE DURING PHASING IN

		£ One-earner couple	£ Two-earner couple
Present system	Husband	3,455	3,455
	Wife	-	2,205
	Total	<u>3,455</u>	<u>5,660</u>
Year 1 (partial implementation)	Husband	3,135	3,135
	Transferred from wife	<u>1,400</u>	-
	Total for husband	4,535	3,135
	Wife	-	<u>2,525</u>
	Total for couple	<u>4,535</u>	<u>5,660</u>

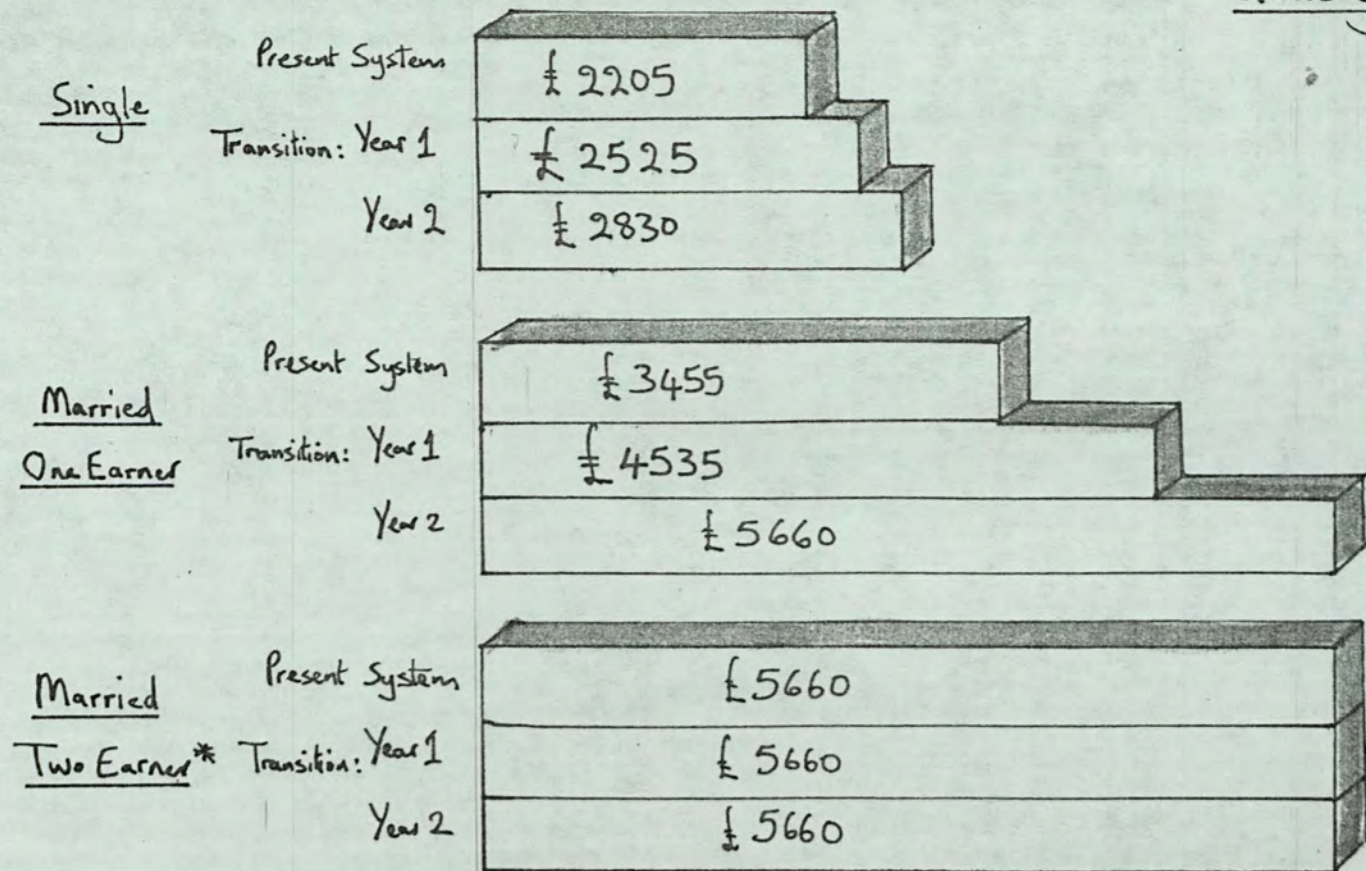
Year 2 (full implementation)	Husband	2,830	2,830
	Transferred from wife	<u>2,830</u>	<u>-</u>
	Total for husband	5,660	2,830
	Wife	<u>-</u>	<u>2,830</u>
	Total for couple	<u>5,660</u>	<u>5,660</u>

4. Similar phasing-in arrangements could be devised for elderly couples.

ANNEX 2

Chart 1

Levels of Allowances for different Family Groups under
The Present System and Fully Transferable allowances [phased in over
a two year period]



[For illustrative purposes this is based on 1985/86 levels of allowances]

* Including Breadwinner Wives

ANNEX 3 : HOW TRANSFERABLE ALLOWANCES WOULD WORK

1. When the new system of transferable allowances was running, husbands and wives would be treated independently. They would each be responsible for making their own returns (when those are required) and for paying their own tax.
2. Husbands and wives would also be more closely involved in the calculation of their code number for PAYE purposes.
3. Before the start of the tax year, a married man or a married woman would need to decide whether to transfer any or all of their allowance. Normally a husband or wife expecting to have income for the coming year which would exceed the level of the personal allowance (say £2,830) would not elect to make any transfer to their partner. If, however, they expected to have less income than £2,830, they would normally wish to keep enough of their own allowance to set against their expected income and transfer the balance. If one partner expected to have no income, then he or she would naturally elect to transfer the whole of the allowance to the other. Examples 1, 2 and 3 below illustrate these cases.

Example 1

	£		£
A earns	8,000		
B earns	15,000		
No transfer			
		Allowance to A	2,830
		Allowance to B	2,830
		Total	5,660
			No transfer

Example 2

£

A earns	1,500		
B earns	15,000		
- A transfers	1,330		
		Allowance to A	1,500
		Allowance to B	2,830
		<u>plus transferred</u>	<u>1,330</u>
		Total	<u><u>5,660</u></u>

Example 3

A has no income			
B earns	15,000		
- A transfers full	2,830		
		Allowance to A	-
		Allowance to B	2,830
		<u>plus transferred</u>	<u>2,830</u>
		Total	<u><u>5,660</u></u>

4. If a husband or wife decided to transfer part or all of the allowance, they would tell the tax office. The tax office would then set the PAYE code numbers of both the husband and wife in accordance with that decision. It would not be necessary for all married couples to make fresh elections each year. An election once made could run on from year to year until the husband or wife decided to change it.

5. During the course of the tax year, husbands and wives would have the right to revoke or vary any election they had made previously. In this way the system would be able to respond flexibly and quickly to changes of circumstances. For example, if a wife stopped work to have a baby, she would be able to transfer any unused balance of her allowance to her husband so that he could benefit as soon as possible from the extra allowance. Example 4 below illustrates this.

Example 4

- i. At the start of the year a husband and wife are both in paid work, and there is no transfer of allowances between them.
- ii. After three months the wife leaves employment to have a baby. Up to that time she has earned £1,500. On giving up work she asks her tax office to transfer the balance of her allowances to her husband.
- iii. The tax office makes a repayment to the wife of any tax deducted from her earnings and arranges for the balance of her allowances (£2,830 - £1,500 = £1,330) to be transferred to her husband.
- iv. Over the year as a whole, the position of the partners is then:

Allowances to wife (equal to her income)	£1,500
Allowance to husband	£2,830
plus transferred	£1,330
	<hr/>
Total	£5,660

6. If, on the other hand a husband or wife who had not been in paid work at the start of the year (and who had transferred their allowance to their partner) began a new job they could ask the tax office to end the transfer and give their own full tax allowance in their own PAYE code. (If the husband or wife did not alter the transfer of allowances, tax would be payable on all the earnings.) Their partner's allowance would then be reduced correspondingly. Example 5 below shows how this would work.

Example 5

- i. At the start of the year only the husband is in paid work and his wife has transferred her allowance to him.
- ii. After three months the wife takes up paid employment. On doing so she asks the tax office to end the transfer of her allowance to her husband.
- iii. The wife's tax office gives her the benefit of her full allowance in her PAYE code. The husband's tax office adjust his PAYE code so that he has only his own allowance. The husband's new code is introduced on a non-cumulative basis so that the husband does not suffer a large tax deduction in the week or month when the change is made.
- iv. After the end of the year the tax office reviews the husband's position and checks the amount of tax deducted. Any underpayment of tax would be collected (as at present) by adjusting the husband's PAYE code for a succeeding year (or years).
- v. Over the year as a whole the position of the partners would be:

Allowance to husband	£2,830*
Allowance to wife	£2,830
	<hr/>
Total	£5,660

*after non-cumulative reduction in his PAYE code from month 4.

7. After the end of the tax year, the tax office would review a couple's tax position and check that each had paid the right amount of tax on the basis of the chosen division of allowances between them. For the purpose of calculating tax liabilities at the higher rates, however, the transfer of allowances would only have effect to the extent that the transferring partner's allowance exceeded his or her own income; if, for example, a wife's income was only £1,000, the transferred amount could not exceed £1,830 (£2,830 - £1,000). These arrangements would ensure that where a transfer of allowances was made, the right amount of tax was collected in total from the couple.

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ANNEX 4 : ILLUSTRATIONS OF THE EFFECTS OF TRANSFERABLE
ALLOWANCES

Introduction

1. For operational reasons, a system of transferable allowances could not be introduced until 1990-91; and the Government's aim would be to phase in the new arrangements from 1990-91 over, say, two years. Obviously, the precise figures for allowances under the new structure and the precise figures for effects on individual taxpayers will depend on further developments in tax thresholds, and in incomes and prices generally, between now and 1990. The Government consider it important, however, that people should have as clear a view as possible of the effects of the change in structure. In order to help illustrate these effects the first part of this annex compares - against the present income tax regime - a system of transferable allowances in which the cash level of allowances available to a two earner couple would be the same as it is now; and the level of allowances available to a one-earner couple is raised to the same level. The comparison is on the illustrative assumption that the transferable allowance system could be introduced now in one step. The second part of the annex provides further comparisons of this illustrative system of transferable allowances against options within the present income tax structure which would have an equal revenue cost.

Illustrative transferable allowance system

2. The transferable allowance in the illustrative system would be £2,830. A married couple would receive twice this amount - £5,660 - giving a two-earner couple the same total allowances as at present (£3,455 married man's allowance + £2,205 wife's earned income allowance = £5,660).

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3. If the illustrative system could be introduced in one step, the direct revenue cost compared with 1985-86 levels of allowances etc, would be £5.3 billion.

4. Table 1 shows the numbers of taxpayers in the main groups which would be affected by the introduction of fully transferable allowances. In 1985-86, about $7\frac{3}{4}$ million single people and $9\frac{3}{4}$ million married couples of working age will pay income tax. Of the married couples, in 45 per cent of cases only the husband is earning, while in 3 per cent only the wife is earning, and in just over 50 per cent both spouses have earnings. In about a third of these two-earner couples, the wife earns less than £2,205 - the maximum of the wife's earned income allowance.

5. About $1\frac{1}{4}$ million elderly single people and 1.3 million elderly married couples will pay income tax in 1985-86. Among these married couples, 40 per cent of wives have earned income of their own, either from current employment or from an occupational pension from a previous employer (or both).

TABLE 1: NUMBERS OF TAXPAYERS BY GROUP

	1985-86	Thousands of which liable at higher rates
<u>Taxpayers of working age</u>		
<u>Single people</u>	7,750 ⁽¹⁾	110
<u>Married couples</u>		
Husband only earning	4,400	230
Wife only earning	300	..
Husband and wife earning		
- wife earns less than £2,205	1,800	110
- wife earns over £2,205		
couple do not elect	3,100	210
couple elect	170	110
<u>Elderly taxpayers</u>		
Single people	1,250	55
Married couples		
without wife's earned income	800	45
with wife's earned income	500	50

(1) includes 375,000 single parents.

6. Table 2 compares the illustrative transferable allowance system with the 1985-86 income tax regime. It shows differences in tax liability by income range for six main groups of taxpayers. The following paragraphs describe the effects on the different groups in greater detail.

Table 2 (cont)

	<u>Elderly single</u>				<u>Elderly married couples</u>			
Below 5	700	30	0.80	1.1	180	15	1.50	1.7
5 - 10	380	20	1.20	0.9	680	185	5.30	4.0
10 - 15	90	15	3.60	1.5	210	85	7.80	3.4
15 - 20	40	5	3.70	1.1	110	35	5.90	1.8
20 - 30	30	10	5.30	1.2	60	35	11.10	2.4
30 - 50	15	5	6.40	0.9	30	35	23.60	3.2
50+	5	1	7.00	0.5	10	30	50.80	3.1
TOTAL	1,260	90	1.40	1.1	1,280	420	6.30	3.2

(1) including single parents

(2) about 100,000 couples in this group would have increased tax bills as a result of withdrawal of minor personal allowances.

Taxpayers of working age - single people

7. In 1985-86, the allowance for a single person is £2,205. Under the illustrative transferable allowance system, it would be £2,830: that is £625 higher. At this level of allowance, there would be 680,000 fewer single people of working age paying tax and the tax bills of the seven million who would be liable at the basic rate would be £187.50 (£3.60 per week) lower. The change for the 110,000 single people currently liable at higher rates would be greater.

- One earner couples

8. The allowance available in 1985-86 to a married couple where the husband is the sole earner is £3,455. Under the illustrative system it would be to £5,660, twice the amount of the single transferable allowance. This is £2,205 higher. At this level of allowance, there would be 600,000 fewer one earner couples paying tax and the tax bills of the 3.6 million who would be liable at the basic rate would be £661.50 (£12.72 per week) lower. The change for the 230,000 couples currently liable at higher rates would be greater.

9. Under the present tax system, couples where the wife is the sole earner, in general, receive the same allowances as couples where both spouses are earning, since they receive both the married man's allowance and the wife's earned income allowance. Under the illustrative system of transferable allowance, the amount of allowances available to such couples would be the same as in 1985-86. The husband would be able to transfer to his wife any allowance unused against his investment income.

- Two earner couples

10. The effect of the illustrative system on two earner couples depends in part on the amount of the wife's earnings. At present, the total allowances available to a two earner couple are £5,660; but £2,205 of this can be set only against the wife's earnings. Under the illustrative arrangements, the whole of the £5,660 would be available to the couple whatever the split of their income. The 1.8 million couples where the wife's earnings are below £2,205 would therefore pay less tax under the illustrative arrangements than at present. The difference would depend on the amount of the wife's earnings and table 2 shows that it would average about £5.80 per week. Under the transferable allowance system, most two earner couples where the wife earns more than £2,205 would have available between them the same allowance as at present and their combined tax bill would not change. Since the allowances would be split equally between them, however, in practice, the wife would find a reduction in the amount of tax deducted under PAYE and her husband a corresponding increase.

11. Under the present rules, some 170,000 two earner couples find it beneficial to elect to have the wife's earnings taxed separately. These couples are, in effect, taxed as two single people on their earned income with a single allowance each. Under the system of transferable allowances, therefore, each spouse would have an increase in allowance of £625. Where both spouses were liable at the basic rate, the couple's combined tax bill would be £375 (£7.21 per week) lower.

12. Finally, there are at present some 210,000 two earner couples liable to tax at higher rates where the wife's earnings are over £2,205 but who do not find it beneficial to elect. Under the illustrative system, they would receive the same amount of allowances in total. Where the wife's

earnings were between £2,205 and the illustrative transferable allowance of £2,830, the couple's combined tax bill would not change. Where the wife's earnings were greater than this, their combined tax bill might be reduced under the illustrative system, since income taxed at present at a marginal rate above 30 per cent might become liable at a lower rate of tax as a result of the disaggregation of each spouse's income and the operation of the separate set of rate bands to which each of them would be entitled.

Elderly taxpayers

13. Under the present arrangements, age allowance is income limited. Single people and married couples where one of the spouses is aged 65 or over are entitled to age allowance in full if their total income does not exceed £8,800. Above this level, the allowance is withdrawn by £2 for every £3 increase in income, so that elderly single people become entitled only to the basic allowance at an income of £9,528, and elderly married couples at £10,000. Table 3 shows the numbers of elderly taxpayers in 1985-86 in the various categories. The illustrative transferable allowance system does not include a higher level of allowance for elderly taxpayers.

Table 3

ELDERLY TAXPAYERS (1985-86)

	Single	No wife's earned income	Wife's below £1,405	Numbers in thousands		
				earned £1,406- £2,205	income £2,205+	Total married couples
Age allowance in full	1,025	590	115	50	50	805
Reduced age allowance	30	30	20	5	15	70
Basic allowance only						
- liable at basic rate	140	135	55	40	100	330
- liable at higher rates	55	45	10	10	30	95
TOTAL	1,250	800	200	105	195	1,300

- Elderly single people

14. At present, one million elderly single taxpayers receive the full age allowance of £2,690. Under the illustrative system, they would receive £2,830. At this level of allowance there would be 55,000 fewer elderly single taxpayers and the tax bills of the remainder would be £42 (81p per week) lower. Allowances for the 30,000 elderly single people who now receive an abated age allowance would be between £140 and £625 higher under the illustrative system, depending on the amount of the abatement. The effect of the system on the remaining 195,000 - who are entitled only to the basic allowance - would be the same as for single taxpayers of working age.

- Elderly married couples without wife's earned income⁽¹⁾

15. At present, the allowance available to the 590,000 taxpaying elderly married couples with total incomes below £8,800 where only the husband has earned income (earnings or pension) is £4,255. Under the illustrative system of transferable allowances, it would be £5,660. An allowance at this level would remove 320,000 couples from tax and the tax bills of the rest would be £421.50 (£8.10 per week) lower. The effect of the illustrative system on the 180,000 elderly couples with total incomes above £10,000 would be the same as for one earner couples of working age.

(1) This group includes couples where the wife has a category B NI pension on the basis of her husband's contributions. Category B pensions are treated as earned income of the husband and cannot be set against the wife's earned income allowance.

- Elderly married couples with wife's earned income

16. At present, an elderly married couple with total income below £8,800 where the wife has earned income of at least £2,205 has available allowances of £4,255 (married age allowance) plus £2,205 (wife's earned income allowance), a total of £6,460. Under the illustrative system of transferable allowances, the allowances available to the 50,000 taxpayers in this position would be £5,660; that is £800 lower. With allowances at this level, some 30,000 couples would be brought into tax. A further 50,000 couples who have wife's earned income of between £1,405 and £2,205 would also receive a lower level of allowances than at present as would some 15,000 couples whose total income was between £8,800 and £10,000. There are, therefore, at present up to 150,000 elderly couples who, under the illustrative system of transferable allowances, would receive a lower amount (up to £800) of allowances than at present. In practice, when introducing a system of transferable allowances, the Government would make special arrangements, so that couples in this position would not experience a reduction in the combined cash amount of their main personal allowances compared with the year before transition to the transferable allowance system began. In the illustrative system, the revenue cost of this protection would be about £30 million. The effect of this protection has been included in table 2, so that the couples concerned have allowances unchanged from 1985-86 levels. Under the illustrative system, allowances available to the remaining 130,000 elderly couples with wife's earned income, who receive age allowance in full or in part, would be higher than at present. The position of the 245,000 elderly married couples with total income of over £10,000 would correspond to that of a couple of working age with a similar split of income between husband and wife. About 115,000 - those with wife's earned income of less than £2,205 - would have a higher level of allowance under the illustrative system; the rest would have the same level of allowances in total under the present and the illustrative arrangements.

Single parents

17. Under the 1985-86 tax regime single parents may claim the additional personal allowance (APA) of £1,250 as well as the single person's allowance of £2,205. About 430,000 single people have sufficient income to benefit from the allowance including 70,000 who will pay no tax. The direct revenue cost of the allowance is about £150 million. Table 4 below analyses current beneficiaries by income range.

TABLE 4

Single parents benefiting from the additional personal allowances in 1985-86

Range of total income

<u>£</u>	<u>numbers</u>
under 5,000	150,000
5000-10000	200,000
10,000-15,000	55,000
15,000-20,000	15,000
over 20,000	10,000
Total	430,000

Under the illustrative tax regime, the APA would be withdrawn, leaving single parents with a tax allowance of £2,830 - a reduction in allowance of £625. But the 430,000 current beneficiaries of APA would be compensated by the cash benefit which would replace it. This benefit would be fixed at such a level that no single parent would be worse off in cash terms as a result of this change.

Minor personal allowances

18. In 1985-86 around 450,000 taxpayers benefit from the Dependent Relative Allowance, 20,000 from the Housekeeper's Allowance and a small number, fewer than 5,000, claim the Son's/Daughter's Services Allowance. The revenue cost of these allowances is about £16 million. Table 5 below summarises the number of beneficiaries of minor personal allowances by taxpayer status.

TABLE 5

Taxpayers benefiting from Minor Personal Allowances in 1985-86

<u>Taxpayers under 65</u>	Numbers
Single	240,000
Married couples: wife not working	70,000
Married couples: wife earning up to £2,205	25,000
Married couples: wife earning over £2,205	100,000
Total under 65	<u>435,000</u>
 <u>Taxpayers over 65</u>	
Single	25,000
Married	15,000
Total over 65	<u>40,000</u>
Total benefiting	475,000

All except about 100,000 two-earner married couples would receive increased personal allowances under the illustrative regime.

Higher rate tax

19. The total number of single people and married couples liable to higher rate tax in 1985-86 is estimated at 920,000. Under the illustrative system of transferable allowances 680,000 individuals would be liable at higher rates. 150,000 of these would be single people (150,000 fewer than at present), 490,000 would be married with a spouse who was not liable at higher rates and a further 40,000 would be married to a spouse who was also a higher rate taxpayer. About $\frac{1}{4}$ million couples who are liable to higher rate tax at present would not be liable at higher rates under the illustrative system. About two-thirds of these couples would be two earner couples who do not make a wife's earnings election under the present arrangement. Table 6 gives more detail on the effect of the illustrative system on married couples. No couple not currently liable to higher rate tax would be liable under the illustrative system of transferable allowances.

Table 6

MARRIED COUPLES LIABILITY TO HIGHER RATE TAX

Liability to higher
rate tax under
illustrative system

Couples liable to higher rate tax in 1985-86

	One earner couples	Two earner couples		Total
		Non-electing	electing	
Neither spouse liable	70	165	10	245
One spouse liable	205	195	90	490
Both spouses liable	-	-	20	20
TOTAL	275	360	120	755

Disaggregation of investment income

20. Under a system of transferable allowances, the investment income belonging to a wife would be taxed as hers and not, as now, aggregated with her husband's income and taxed as his. For the [93 per cent] of taxpaying married couples who are currently liable only at the basic rate, this disaggregation of investment income - as distinct from transferable allowances - would not, by itself, have any effect on their combined tax bill. However, married couples who are liable at higher rates would in general benefit from disaggregation (if the wife has investment income not covered by her tax allowance and her marginal tax rate is lower than her husband's). If in the illustrative system of transferable allowances, a wife's investment income was treated as her husband's for tax purposes instead of being disaggregated, the revenue yield would be about £90 million. Table 7 shows an analysis of the 140,000 couples who would have lower tax bills within the illustrative system as a result of disaggregation and the extent of the reduction. These estimates are based on the current recorded distribution of investment income between husband and wife, allocating joint income equally between the spouses.

Comparisons with other equal cost changes to the income tax system

21. This section of the annex compares the illustrative system of transferable allowances described in paragraph 2 with an option:

to increase the basic allowances within the present income tax structure by 27 per cent (with equal cash increases in the age allowances);

This alternative option has the same revenue cost as the introduction of transferable allowances in a single step.

TABLE 7

EFFECTS OF DISAGGREGATING INVESTMENT INCOME OF MARRIED COUPLES
WITHIN ILLUSTRATIVE SYSTEM OF TRANSFERABLE ALLOWANCES

	Reductions in tax									
	<u>less than £250</u>		<u>£250-£500</u>		<u>£500-£1000</u>		<u>over £1000</u>		<u>Total</u>	
	Nos ('000)	Amount (£m)	Nos ('000)	Amount (£m)	Nos ('000)	Amount (£m)	Nos ('000)	Amount (£m)	Nos ('000)	Amount (£m)
<u>1 earner</u>										
Annual income;										
below £50,000	8	1	4	1	5	3	4	8	21	13
above £50,000	-	-	-	-	1	-	5	20	6	20
<u>2 earner</u>										
Annual income;										
below £50,000	60	5	12	4	11	8	6	10	89	27
above £50,000	10	1	3	1	4	3	7	25	24	30
<u>Total</u>	78	7	19	6	21	14	22	63	140	90

The following table shows the levels of allowances for taxpayers of working age:

	Illustrative system of transferable allowances	Alternative equal cost option
Single	2,830	2,805
One earner	5,660	4,395
Two earner	5,660	7,200
Basic rate	30%	30%

22. Table 8 compares the proportions of the income tax burden borne by each of the main groups of taxpayers under this alternative option with their share of the burden under the illustrative system of transferable allowances. Under the alternative option, the share of the burden borne by the different groups of taxpayers would remain broadly similar to the position in 1985-86, although the relative advantage of two earner couples would be even greater than it is now. The relative reduction in burden on couples where the wife is not earning, which is an important feature of transferable allowances, would not be produced.

TABLE 8

Percentage of Total Income tax paid by various family types

	<u>Transferable Allowances</u>	<u>Increase in present allowances allowances of 27%</u>
<u>Taxpayers Aged Under 65</u>		
Single	27.1	27.2
Married 1 Earner	20.3	24.9
Married 2 Earner		
wife earns up to £2,205	10.3	10.4
wife earns over £2,205	31.4	26.8
<u>Taxpayers Aged over 65</u>		
Single	4.7	4.3
Married	6.2	6.4

23. Table 9 compares average rates of tax by range of income for one and two earner couples of working age. Retaining the present structure of income tax would perpetuate the higher average rates of tax borne by one-earner couples compared with two earner couples at a similar level of income.

TABLE 9

Average Rates of Tax for married couples
(at various levels of gross income)

Income Range (£ thousand)	<u>One earner couples</u>		<u>Two earner couples</u>	
	Transferable Allowances	Increase in present allowances of 27%	Transferable Allowances	Increase in present allowances of 27%
0-5	0	1.5	0	0
5-10	6.9	11.1	7.8	6.3
10-15	12.7	15.8	14.2	11.7
15-20	16.9	19.1	17.3	15.2
20-30	20.6	22.5	20.4	19.0
30-50	28.2	30.0	25.5	25.3
50+	41.5	42.9	38.7	39.0

24. Table 10 shows the numbers of taxpayers in each of the main groups who would pay more or less tax under the illustrative system of transferable allowances compared with retaining the present tax structure. This shows that the great majority of single people of working age would be slightly better off under the illustrative system of transferable allowances; although single parents and those currently benefiting from minor personal allowances would do better under the alternative option. One-earner couples would gain allowances of £1,265 under transferable allowances compared with retaining the present tax structure, worth £7.30 per week at the basic rate; and 420,000 more would be taken out of tax by transferable

allowances. Two-earner couples of working age where the wife earns less than £1,265 would have an increase in allowances and would therefore do better under transferable allowances . The remaining two-earner couples would do better if the present structure was retained, except for some 70,000 with substantial amounts of investment income who would benefit from disaggregation of husband's and wife's income under transferable allowances. A high proportion of elderly single taxpayers would be better off under the present structure, while about half taxpaying elderly married couples would be better off under transferable allowances. The number of elderly married couples liable to tax would be reduced by about one quarter under either scheme.

Table 10

Comparison between illustrative system of transferable allowances and increase in personal allowances by 27% (Option 1)

			Pay less tax under transferable allowances	No difference	Pay less tax under Option 1
<u>Taxpayers of working age:</u>					
Single	Nos	(thous)	6,550	630	570
	Av reduction	(£ per week)	0.20	-	2.25
		(% gross income)	0.2%	-	1.7%
Married Couples: - wife not working (1)	Nos	(thous)	4,060	170	170
	Av reduction	(£ per week)	7.30	-	4.40
		(% gross income)	3.3%	-	2.6%
- wife working - earns £2,205 or below	Nos	(thous)	9.10	70	830
	Av reduction	(£ per week)	3.60	-	3.00
		(% gross income)	1.5%	-	1.2%
- wife working - earns over £2,205	Nos	(thous)	70	-	3,530
	Av reduction	(£ per week)	4.20	-	8.30
		(% gross income)	0.5%	-	2.8%
<u>Elderly taxpayers</u>					
Single	Nos	(thous)	120	50	1,080
	Av reduction	(£ per week)	0.50	-	2.30
		(% gross income)	0.1%	-	2.3%
Married Couples	Nos	(thous)	700	250	350
	Av reduction	(£ per week)	4.60	-	7.50
		(% gross income)	2.0%	-	3.2%

(1) including men marrying during the year. Their wives are treated for tax as single people during the year of marriage.

ANNEX 5 : TIMETABLE FOR CHANGE

1. The proposed introduction of transferable allowances and the end of aggregation of husbands' and wives' incomes would affect 11 million married couples, about 1 million employers, and some 600 Tax Offices. By any standards it would be a major change. The Government have set in hand the planning for this change and, subject to the response to this Green Paper, intend to legislate during the lifetime of this Parliament.

2. A system of transferable allowances would require information from taxpayers, which is not held in many cases at present, and new administrative facilities in the Inland Revenue. As the Chancellor explained in his 1985 Budget speech, the new system could be introduced as soon as the new facilities are available - that is, from April 1990.

3. Transferable allowances would bring two major consequences in personal tax administration.

4. First, tax offices would need to be geared to making more adjustments, assessments, or repayments of tax as husbands and wives avail themselves of the benefits of the new system. At present, such adjustments are needed for only one PAYE taxpayer in six. Handling the extra end-of-year work economically would require full computer support.

5. Second, there would need to be an efficient mechanism for linking the tax records of a husband and wife. For the great majority of couples, these records are not linked at the moment. It is not necessary under the present system: although a married couple's tax liability depends upon their joint income, the long basic rate band means that over 90 per cent of couples pay tax at that rate only. So PAYE will collect the right amount of tax in the majority of cases without needing to link a husband and wife's records.

6. The new links would require two new facilities:

- An index and tracing facility, so that information about a change in, say, a husband's employment position could be directed quickly and economically not only to his own tax office, but also, where appropriate, to his wife's tax office. (A PAYE taxpayer's records are kept in the office dealing with his employer's affairs, so when a husband and wife have different employers, they are quite likely to have different tax offices.)
- Facilities to transfer such information electronically between the tax offices concerned. Relying on written correspondence would be too slow, and would give rise to substantial over-payments and underpayments of tax.

7. The Inland Revenue are already engaged on two major computer projects. A pilot system for the computerisation of PAYE (referred to as "COP") has been running in the West Midlands for over a year. It is now being extended across the country, region by region, and will be complete by late 1987 or early 1988. When fully implemented, COP is likely to be the biggest on-line computer project in Europe. Staff in the 600 Tax Offices will have access to 17,000 terminals for COP, linked to mainframe computers in 11 regional processing centres.

8. The procedures for taxing self-employment income under Schedule D are also being computerised (CODA). This further development, which will be in place by 1989, will use the same mainframe computers as COP, but will increase the number of terminals to 25,000.

9. The Revenue plan to enhance this basic computer system by two further developments:

- a nationwide data transmission network. The network, which will use over 900 British Telecom circuits, will link the 600 tax offices into the computing facilities and will connect them with each other and with the offices responsible for collection and enforcement.

- a computer-based index. This will maintain up to date records of each taxpayer, his or her employer (or self-employment), and will be able to hold the necessary information to connect the tax records of married couples. The index, which is already running on an experimental basis in Scotland, will provide rapid access to vast amounts of stored data.

10. Chart 1 shows the timetable for the administrative changes, alongside the other preparations for transferable allowances. COP and CODA are already in hand, to provide computer support for the present tax system. They will provide the foundation for running the new system, and in particular for carrying out extra end-of-year work.

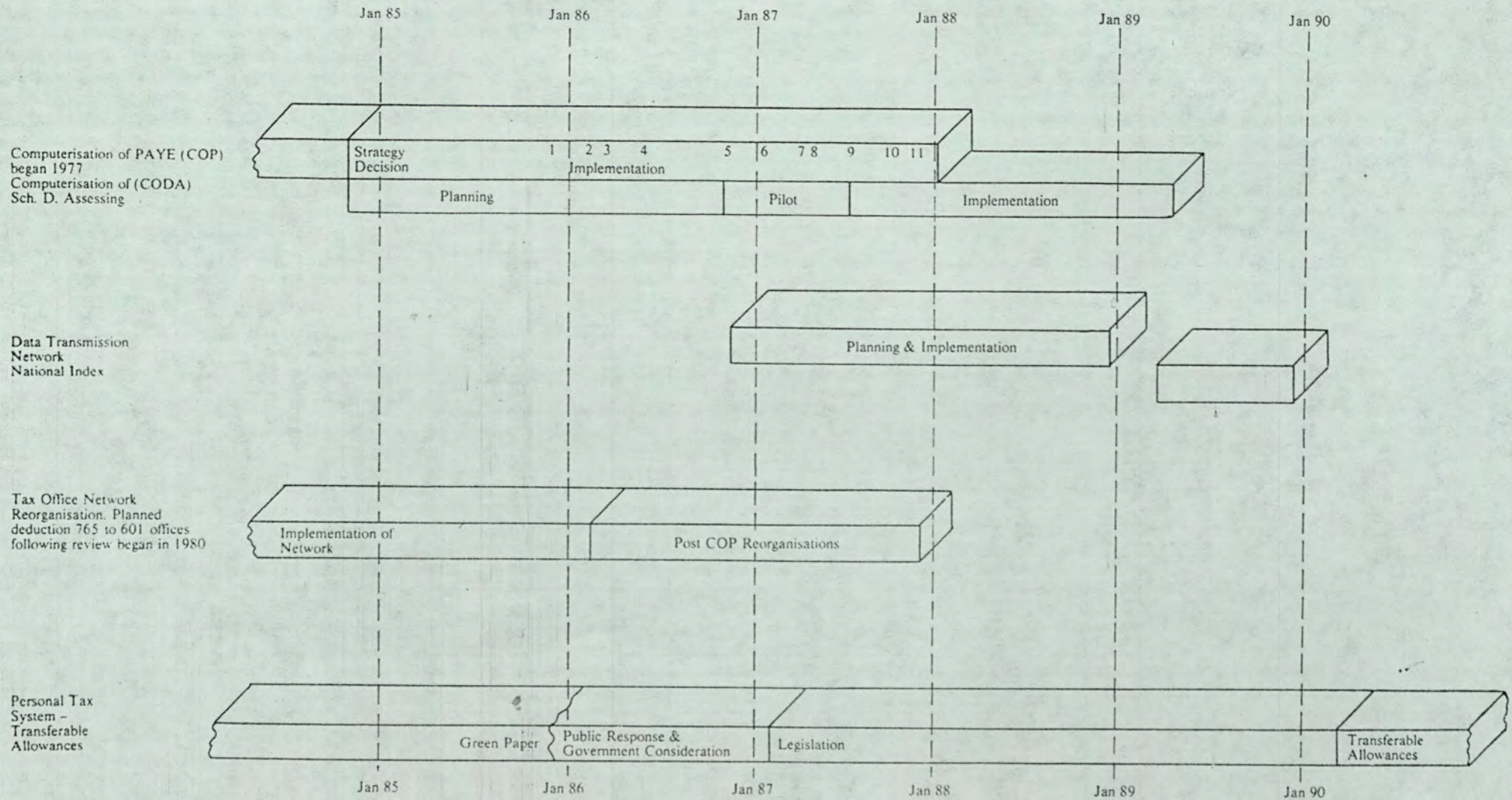
11. As a first step, the Revenue will be using the computer facilities in the COP and CODA systems, and the new integrated data network, to set up the new national index. This will be completed as soon as possible after the other facilities are in place. Between April 1988 and April 1990 the Revenue will be asking married couples for the information necessary to establish links between their records, complete the national index, and give the appropriate allowances. The new system could then come into operation from April 1990. (Annex 6 describes how transferable allowances would work in practice.)

12. The new system would impose considerable additional work on tax offices. In particular, they would have to handle the tax affairs of many millions of married women who

would, for the first time, be treated as taxpayers in their own right. The new computer support facilities described earlier would be an essential requirement to undertake this extra work efficiently, but there would also be a need for additional staff - possibly in the region of 5,000. There would be full consultation about the change to the new system with the staff and departmental unions in the Revenue.

ANNEX 5

Chart 1



Key to order of COP implementation by region: 1 West Midlands 2 Eastern Counties 3 Wales 4 South East 5 N. Ireland & Scottish LPs 6 Greater Manchester 7 South Yorkshire 8 South West 9 North West 10 North 11 London

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ANNEX 6 : MARRIED WOMEN IN THE LABOUR FORCE

Introduction

1. This Annex gives some detailed information about the increasing participation of married women in the labour force over the past 50 years. It also sets out some recent evidence on the reasons why married women do not seek paid work at particular times.

Participation in the Labour Force

2. Chart 2.4 in Chapter 2 illustrates the steady rise in the proportion of married women with paid jobs.

3. Table 1 provides the detailed information on which the chart is based, and also gives information about men in the labour force. The table shows that while the size of the total workforce has continued to show an increase for each year that figures are presented, the number of economically active men - that is, those who are working or looking for work - has recently declined from the number counted in the 1971 census. The number of females has on the other hand continued to show a steady rise, almost entirely due to the increasing participation of married women.

4. Table 2 shows more clearly how the share of married women in the labour force has expanded.

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TABLE 1

Number and activity rate of people of working age, by sex and marital status (for women), 1921-1984, Great Britain (numbers in thousands)

<u>Males and females</u>	<u>People of working age*</u>		
	<u>Number</u>	<u>Number EA</u>	<u>AR</u>
1921	30750	18559	60.4
1931	30416	20057	65.9
1951	31250	21564	69.0
1961	31885	22736	71.3
1966	32014	23579	73.7
1971	32361	23947	74.0
1981	32228	24560	76.2
.....
1981	32425	25048	77.2
1983	32801	24980	76.2
1984	33043	25484	77.1
<u>Males</u>			
1921	14575	13006	89.2
1931	14917	14107	94.6
1951	15674	14968	95.5
1961	16427	15506	94.4
1966	16589	15418	92.9
1971	16939	15495	91.5
1981	16790	15188	90.5
.....
1981	16895	15232	90.2
1983	17147	15072	87.9
1984	17327	15202	87.7
<u>All Females</u>			
1921	16175	5553	34.3
1931	15499	5950	38.4
1951	15576	6596	42.3
1961	15458	7230	46.8
1966	15425	8161	52.9
1971	15422	8452	54.8
1981	15438	9372	60.7
.....
1981	15530	9817	63.2
1983	15654	9908	63.3
1984	15716	10282	65.4
<u>Married Females</u>			
1921	7949	713	9.0
1931	8355	904	10.8
1951	10388	2574	24.8
1961	10904	3727	34.2
1966	10916	4776	43.8
1971	11134	5444	48.9
1981	10536	5988	56.8
.....
1981	10685	6338	59.3
1983	10731	6433	59.9
1984	10788	6727	62.4
<u>Other Females</u>			
1921	8226	4840	58.8
1931	7144	5046	70.6
1951	5188	4022	77.5
1961	4554	3503	76.9
1966	4509	3385	75.1
1971	4288	3008	70.1
1981	4902	3384	69.0
.....
1981	4845	3478	71.8
1983	4923	3475	70.6
1984	4928	3556	72.2

Sources: Censuses of Population 1921-1981, Labour Force Surveys 1981-84

* upper limit: males 64 years
females 59 years except for 1921 (64 years)

lower limit: 1921 12 years
1931 14 years
1951-71 15 years
1981-84 16 years

TABLE 2: Shares in the labour force 1921-1984, Great Britain

	Men*		All Females*		Married Women*		Total*	
	No. 000's	% of total	No. 000's	% of total	No. 000's	% of total	No. 000's	% of total
1921	13656	70.5	5701	29.5	733	3.8	19357	100
1951	15649	69.2	6961	30.8	2658	11.8	22610	100
1971	16029	63.5	9205	36.5	5815	23.1	25234	100
1981	15527	61.1	9879	38.9	6286	24.7	25406	100
.....
1981	15645	60.0	10432	40.0	6663	25.6	26077	100
1984	15416	58.9	10764	41.1	7046	26.9	26179	100

* Includes persons of all ages above minimum school leaving age.

Sources: Censuses 1921-1981; 1981 and 1984 Labour Force Surveys

In the 1920s very few married women worked or sought paid employment; they represented less than 4 per cent of the labour force and only about one seventh of all women who worked. By 1951, married women's share of the labour force had grown to nearly 12 per cent - slightly over one-third of all women who worked. In 1984, the latest year for which figures are available, nearly $\frac{2}{3}$ of all women in paid work (or looking for work) were married, and married women's share of the labour force had doubled to 27 per cent.

Reasons for not working

5. The reasons given by married women for not working or seeking paid employment were one of the topics covered in a representative survey of women aged 16-59 carried out in Great Britain by the Department of Employment and OPCS in 1980(*). These reasons are summarised in Chart 2.5 of Chapter 2; the detailed information is set out in Table 3.

(*) J Martin and C Roberts (1984) Women and Employment: a Lifetime perspective HMSO London.

TABLE 3

REASONS GIVEN BY MARRIED WOMEN FOR NOT BEING IN PAID EMPLOYMENT

This table sets out the reasons given by married women, aged 16-59, (excluding full-time students), for not being in paid employment or seeking paid work, according to their stage in the life cycle.

	Life cycle stage							All women not in paid employment or seeking paid work	Base for row %s
	Childless, aged:		Youngest child aged:			No child under 16, aged:			
	Under 30	30 or over	0-4	5-10	11-15	Under 50	50-59		
Permanently unable to work	%	%	%	%	%	%	%	%	
	*	26	1	2	7	17	15	5	
	%	-	4	5	10	15	53	100	79
Looking after children	%	*	96	78	44	8	2	63	
	%	1	71	21	6	1	1	100	906
Looking after other relatives	%	*	0	3	6	4	9	3	
	%	-	2	17	15	6	50	100	48
Keeping house	%	*	2	14	35	63	64	24	
	%	4	5	10	12	13	50	100	344
Other reasons	%	*	1	3	8	8	10	4	
	%	2	13	13	14	10	43	100	62
All women not in paid employment or seeking paid work	%	*	100	100	100	100	100	100	
	%	1	47	17	8	5	19	100	1439
Base for column %s		23	671	247	115	73	271	1439	

0 (Less than 0.5%)

* (Base too small to show percentages)

Source: DE/OPCS 1980 Women and Employment Survey.

Note: The percentage figures may not always total 100 because of rounding.

6. Over 60 per cent of married women who are not in paid work have dependent children, and over 70 per cent are either looking after children or other relatives, or are prevented from working by ill health. Moreover, of the women who have no children under 16 and do not give one of these specific reasons for being economically inactive, at least 50 per cent* are aged 50 to 59 and therefore at an age when finding employment would be very difficult. Moreover, women aged over 50 in 1980 are of a generation which was less likely than married women now are to work when they were younger. Women who did not go out to work when younger are less likely to be able to enter the labour market in their fifties than those who did. This group also includes women who were unable to enter the labour market earlier because of responsibility for young children, relatives or other dependants. Women in this position similarly find it difficult to enter the labour market in their fifties, even though their earlier domestic responsibilities have now ended.

7. This age group also understandably accounts for the largest percentage (53 per cent)* of women who are permanently unable to work.

* There will be some women aged 50-59 who have never had children and who will therefore appear in the column headed "Childless, aged 30 or over".

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ANNEX 7 : PERSONAL ALLOWANCES FOR MARRIED COUPLES IN OTHER
COUNTRIES

Introduction

1. This annex looks at the relative level of personal allowances available to single people and married couples in most of the EEC countries, Australia, New Zealand, Canada, Sweden, Japan and the USA. It also provides some information about the basic systems of taxing married couples in those countries.

2. It should be recognised that difficult problems arise in making any sort of international comparison. Comparisons can rarely be of like with like, or show the whole picture. So conclusions drawn from some of the material in this annex could be misleading unless its limitations are appreciated.

3. The information provided may be subject to change, although it is as up to date as possible.

4. The first purpose of this annex is a specific one: to look at the ratios of allowances between single and married taxpayers, in different countries. The comparisons are complicated by the fact that not all countries provide basic personal allowances for everyone of the kind applying in the UK system. The term 'allowances' is therefore used here to refer to whatever system of giving relief for personal circumstances applies in each country.

5. Some assumptions have been made to simplify the comparisons:

a. for a one earner married couple it is assumed that the husband is the sole wage earner and the wife has no income.

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b. No account has been taken of 'allowances' given for children or other dependants or because of age, disability or the status of the taxpayer (for example widowed, divorced, single parent)

c. The comparisons assume that income is from employment.

6. The table below shows the ratio of 'allowances' in the different countries in three cases:

[Insert table]

Country Details

7. United Kingdom

Married couples are taxed jointly on their combined incomes. A married man receives a Married Man's Allowance, which is about 1½ times the Single Person's Allowance, to set against any income of the couple. If his wife is working she has the Wife's Earned Income Allowance which is equivalent in size to the Single Person's Allowance, but can only be set against her earned income. More details are given in Annex 1.

8. Australia

Husband and wife are taxed separately. A spouse is entitled to a tax 'rebate' where he/she maintains the other spouse. The 'rebate' operates by reducing the tax payable by the amount of the rebate. If the rebate exceeds the amount of tax due there is no refund or carry forward of any 'excess' rebate.

Where the supported spouse has income above a specified amount the rebate is reduced by \$1 for every \$4 by which the spouse's net income exceeds that amount.

The schedule of tax rates includes a zero rate band. The first tax rate above this is 30 per cent. The ratios therefore take into account the maximum value of the tax rebate at the 30 per cent rate to a one earner couple.

9. Belgium

A comparison cannot usefully be made because allowances for employment income vary with income up to a maximum level. Furthermore the tax position of married couples varies depending upon the size of their total net income.

10. Canada

Husband and wife are taxed on an individual basis, but a married person supporting a spouse is entitled to a further allowance over and above that available to single taxpayers. This further allowance is reduced \$ for \$ if the supported spouse's income exceeds a set level.

11. Denmark

Since 1983 a system of fully transferable allowances and independent taxation has applied. This does not extend to investment income which is aggregated with the income of the spouse with the highest earned income.

12. France

The French have a family quotient system under which income of the family (including children) is aggregated and then divided by a certain coefficient. The tax is calculated on

the resulting amount and then multiplied by the same coefficient to get the total tax due. For a husband and wife only, the coefficient is 2 and the effect is therefore similar to the German system. The ratios in the table are not based on allowances but on the effect of this system on the zero rate band only.

13. Germany

Married couples have the option of individual or joint taxation. There is effectively a zero rate on an initial portion of taxable income: that portion is doubled for married couples who are jointly assessed and is the basis of the ratios given above. Where the couple opt to be taxed jointly their total income is divided by two and the tax calculated on that part. The result is then multiplied by two to arrive at the total tax due. This gives married couples an added advantage particularly where their incomes are of different sizes: the effect is that part of the larger income, which would otherwise be taxed at a higher rate, is aggregated with the smaller income and taxed at a lower rate.

14. Ireland

Married couples can choose to be taxed separately or jointly. The allowance for a married couple taxed jointly is double the single allowance. Joint taxation is usually of greater benefit to a married couple, especially where one spouse has little or no income, because they enjoy tax bands which are twice the width of those for single people.

15. Italy

Taxpayers are allowed credits (as opposed to personal allowances) which operate as a deduction from the total tax due. A husband and wife are assessed separately, although

an additional tax credit is available to them if one spouse has taxable income not exceeding a specific level. Certain tax credits vary with income levels so a simple comparison is not possible.

16. Japan

Individuals are taxed separately but a special exemption is available for a spouse who has no income, or income which does not exceed a specified level. In addition, an 'employment income deduction' is available but as this varies with the level of income, a comparison is not possible. Investment income can also be taxed separately but it may be aggregated if the income of the 'household' exceeds a specified level. The 'household' can include children, parents and grandparents if they live together.

17. Netherlands

Allowances vary and are broadly dependent upon age, size of income and whether or not the taxpayer lives with someone (not necessarily a spouse). A comparison is not therefore possible.

18. New Zealand

A husband and wife are taxed separately. Taxpayers receive tax 'rebates' against income. (These 'rebates' operate in a similar way to Australian rebates.) The 'principal income earner' rebate is available to most individuals with below average earnings and varies with income. In the case of a married couple this rebate is given to the spouse with the higher income or, where incomes are equal, to whichever spouse opts for it.

A special rebate was also available for a dependent spouse but this was abolished with effect from 1 April 1983.

The ratios given in the table are only based on the entitlement to the 'principal income earner' rebate and will apply only on the assumption that the income of the single taxpayer and of the partner in the married couple claiming the rebate is identical.

19. Sweden

Individuals pay both National Income Tax (at progressive rates) and Local Income Tax (at a flat rate which can vary from area to area). A personal deduction is given to all taxpayers but only for local income tax. Husband and wife are taxed separately on their earned income. All taxpayers benefit from a zero rate band on National income tax upon which the ratios are based. In addition a married couple where one spouse has no income, or income below a specified level, is entitled to a tax credit of 30 per cent of the difference between that spouse's income and the specified level. The maximum credit will therefore go to a one earner couple.

The investment income of a married couple is aggregated with that of the spouse with the highest earned income. Liability for the tax due on the investment income is then split between the spouses in proportion to the amounts of their respective investment income.

20. USA

Married couples can be taxed separately but in practice most opt for joint taxation. This is generally more beneficial, because a different scale of tax rates applies with wider

bands, which includes a larger zero rate band, than is available to single taxpayers and married couples who are taxed separately. One and two earner couples filing joint returns both receive double the exemption given to a single taxpayer. In addition, two earner couples, taxed jointly, get an extra exemption equivalent to 10 per cent of the lesser of \$30,000 or the amount of the lower earning spouse's earned income. The benefit of this exemption will vary according to the size of the lower income but has a maximum value of \$3,000. This is reflected in the ratios set out in the table.

Personal Allowances in other Countries

Single:	One Earner	Single:	Two Earner	One Earner	Two Earner
	Married Couple		Married Couple	Married Couple:	Married Couple

United Kingdom:

a. Present System	1:1.57	1:2.57	1:1.64
b. Transferable Allowances	1:2	1:2	1:1
Australia	1:1.72	1:2	1:1.16
Canada	1:1.87	1:2	1:1.07
Denmark	1:2	1:2	1:1
France	1:2	1:2	1:1
Germany	1:2	1:2	1:1
Ireland	1:2	1:2	1:1
New Zealand	1:1	1:1	1:1
Sweden	1:1	1:2	1:2
USA	1:1.6	1:1.6 (2.5 max)	1:1 (1.55 max)

A comparison of allowances is not possible for all the countries included in the annex. (See text for details.)

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