



Prime Minister ①
Please see ✓ FM

Ferdie's note on this (attached)

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

MLs 15/2

Agree to discuss - in the first

PRIME MINISTER

Yes
with the Chancellor rather than the FPG?
sub.
MLs 16/2

instance - with the Chancellor

CHILD SUPPORT AND THE POVERTY TRAP

Your Private Secretary's letter of 20 December asked me to let you have a note of the possibility of re-introducing an income tax allowance for child support and of re-introducing lower rate bands of income tax.

P49

2. We all share Ferdie Mount's deep concern about the poverty trap and about the burden of taxation on families and those on or below average earnings. But we cannot ignore that the main reason for this is the high level of public spending. The dilemma was ... made very clear in the note (of which I enclose another copy) that I have already circulated to the FPG. That said I am sure neither the re-introduction of child tax allowance or reduced rate band offer the right way out of this box.

3. In his note Ferdie compares the impact of child tax allowance and child benefits on take home pay, family support and the poverty trap. Perhaps I could look at those points one by one.

Take Home Pay

4. The original tax credit scheme, which I certainly favoured, was designed to do three things:

/i. On the



i. End the complexity of having several systems at the same time - which involved paying a cash benefit that was too small to help the poorest and yet taxing it in the hands of the richest.

ii. To provide the means of delivering, through a universal system, a sum that would help the poorest (which child tax allowances did not) even if they did not pay tax.

iii. To do it by means of a credit against the breadwinner's tax bill - which would have helped to keep up tax thresholds and so the level of take-home pay.

5. But as we know it did not work out like that. Under pressure before the Parliamentary Select Committee we were obliged to concede that the child credit should instead be paid as a cash benefit to the wife. Child benefit was thus diverted from the husband's take-home pay and given to the mother. This transfer "from wallet to purse" was hailed - though notably not by the TUC - as a major reform in its own right quite independent of the effect on total family support discussed below.

6. To reverse policies now and to provide at any rate part of child support via the father through the tax system would to some extent redress the harm done to the level of take-home pay. It would in effect restore the pre-1972 position with child tax allowances and family allowance alongside each other. But we would inevitably attract the same sort of political attack from the equal /opportunities



and poverty lobbies who forced the original change on our predecessors. We did not win the argument then and I see no reason to believe that we would win it now.

Family Support

7. The original tax credit scheme of 1971 envisaged that the abolition of child tax allowances and their substitution by child credits would offer particular help to families with too large an income to qualify for means tested benefits but too low an income to enjoy the full benefit of tax relief. As Ferdie Mount rightly points out ten years of inflation and indexation of social security benefits have changed all this. The tax threshold is all too often well below the threshold for means tested benefits and there is thus little to choose between a modest child tax allowance or a modest increase in child benefit as a means of family support. To me that underlines the priority of action on the main personal allowances. The choice between child benefit or a child tax allowance is a subsidiary question.

Poverty Trap

8. On the poverty trap the comparison is complex. The trap extends from about one quarter to three quarters of average earnings. Most families in the trap are in the upper part of this range. That means that a large increase in the tax threshold is needed to take a lot of families out of the poverty trap. And insofar as we make in-roads into the poverty trap by means of child tax allowances we would be doing so at the expense of the lower paid who did not have high enough earnings to benefit. That is just one facet of the all too familiar problem that measures to alleviate the poverty trap tend to increase the problems of poverty.

/Reduced Rate Band

Reduced Rate Band

9. Turning to the reduced rate band, clearly we must continue to work for lower tax rates and higher tax thresholds. Ferdie compares the position on income tax both here and overseas. His comparison as it stands is rather partial because it is important to look not just at tax but also social security contributions which ... tend to be higher overseas. I attach an annex to cover this point.

10. The case against a lower rate band, which would have to be reasonably narrow if it were not to be as expensive as a reduction in the basic rate is that it gives help, overwhelmingly, to the wrong people. Before we abolished the reduced rate band in 1979/80 25 per cent was the marginal rate for some 4 million taxpayers. Of these however 1.3 million were wives of men also in work, who were paying tax at the basic rate and above. Most of the remainder were juveniles or people in part-time employment. Relatively few adult primary earners - in particular relatively few of the family men whom we are looking to help - had earnings below the threshold for the full basic rate of tax. Today it would need a reduced rate band costing £1 billion to affect the same number of people as the old band did. But that would not meet the problem that we would be directing help at the wrong people.

11. If that same amount were used to increase tax thresholds by 6 per cent, it would take over half a million people out of tax entirely and save 300 Revenue staff. That compares with the 1,300 extra staff we would require to administer a re-introduced reduced

/rate band.



I remain convinced that we were right in 1980 to abolish the reduced rate band and to concentrate on raising thresholds and reducing the basic rate.

Staff Costs

12. We cannot ignore the question of staff costs. This of course has been one of our concerns throughout and it is quite distinct from what Ferdie describes as "the convenience of the Revenue". The Revenue saved 1,600 staff from the abolition of child tax allowances in 1979, a further 1,300 from the abolition of the reduced rate band in 1980 and another 300 from the higher thresholds that the abolition of the reduced rate band made possible. The changes also opened the way to other simplifications of the tax system which have helped the Revenue reduce staff by 11,000 since we took office.

13. To go back on these changes would be very costly in staff terms. The precise cost would obviously depend on the particular scheme. But it would make no sense whatsoever to try and run two schemes of child support side by side. DHSS now employ 1,800 staff in paying child benefit. Given our commitment to reducing civil service staff we could not retain child benefit and leave these DHSS staff in place while at the same time introducing child tax allowances and have the Revenue take back large numbers of staff.

Conclusion

14. Overall I have much sympathy with Ferdie Mount. The present position is unsatisfactory. But I do not believe that the right way forward is to try and go backwards in these two areas. Politically we would be reversing the actions of this Government and of the

/last Conservative



last Conservative administration. We would be attacked for the switch from purse to wallet. We would be criticised for being uncaring and insensitive towards the poor. I do not think we could carry our own supporters with us on such changes, let alone the country at large. I certainly do not think we could justify the waste of giving child support simultaneously to the father and the mother. And most crucially I do not see child tax allowances or a reduced rate band as ways of solving the problems of the poverty and unemployment traps. These are better tackled by raising thresholds and incentives are better tackled by reducing the basic rate of tax. And we cannot do either of those until we do much better still on public expenditure.

15. I am sending a copy of this minute to Norman Fowler and Ferdie Mount.

G.H.
14 February 1983

Econ Pol
Jup

MR. MOUNT

CHILD SUPPORT AND THE
POVERTY TRAP

The Prime Minister has seen your note of 15 February; and the Chancellor's of the 14th.

She intends to raise this with the Chancellor when she next sees him on 23 February.

I hear from the Treasury that the Chancellor is hoping you will be talking to the Financial Secretary and others, so there may be some merit in arranging that before next Wednesday.

M. C. SCHOLAR

17 February 1983

NR

15 February 1983PRIME MINISTERCHILD SUPPORT AND THE POVERTY TRAP
AND TAX ALLOWANCES FOR THE ELDERLY

The Chancellor's response is fair and sympathetic but negative. He recognises that what we now have is a travesty of our original tax credit scheme. Yet he believes that we are boxed in. And he sees no way out of the box except by a substantial reduction in public expenditure and an equally substantial rise in tax thresholds. After talks with Treasury and Revenue Officials, I still feel, however, that there is a modest but useful supporting role which a tax allowance for child support could play in this process.

1. The Chancellor acknowledges in paragraph 6 that "to reverse policies now and to provide at any rate part of child support via the father through the tax system would to some extent redress the harm done to the level of take-home pay". But he believes that the equal opportunities lobby would launch the same attack on the transfer from purse to wallet as they did when they forced the original change.

But we are not proposing to abolish child benefit. All we are saying is that a proportion of the money now earmarked for tax allowances should go to child support. This is just what the equal opportunities lobby want. That is why they propose the abolition of the married man's allowance (although they want the proceeds to be distributed in benefits). Our own supporters would welcome a tax allowance for children.

Moreover, the Chancellor recommends his own proposals for ITTA on the grounds that ITTA would tend to assist families with children more than the present system. Surely a Family Responsibility Allowance would be a much simpler way of doing this.

2. The original objection to child tax allowances - that they benefited only the middle and upper income groups - carries far less weight now, since almost all family men now pay income tax - and, I fear, will continue to do so for some years yet on the Chancellor's present projections for public expenditure.

3. We are in a new situation from ten years ago, and one in which families with children are relatively much worse off. How are we most likely to adjust the status quo to their advantage? There are three choices.

(a) Large increases in child benefit are not popular among our own supporters because of the painful revenue cost and because they are perceived as welfare benefits.

(b) Switching over to a system of husband-and-wife taxation which was rather more favourable to the non-working wife would be an extremely delicate political operation, because of the danger of infuriating the millions of losers, particularly the professional women.

(c) A family responsibility tax allowance - whether paid to all families now drawing child benefit or to those with at least one child under five - would be popular and painless.

4. There would be substantial staff costs. But there were very substantial, if hidden, public costs incurred when we switched over to child benefit as the sole means of child support; it meant a sharp rise in public expenditure and hence upward pressure on pay claims.

? offset by
an increase
in tax revenue
MCS

5. The case against reduced rate bands is, in the present situation, a strong one. Most of the benefit would not go to family men - but to juveniles and part-timers. Reduced rate bands would help family men (as they do on the Continent) only if thresholds were much higher - which is where we came in.

6. The Dependent Relative Allowance has been allowed to wither on the vine, principally on the grounds that help for the elderly is better "targeted" through benefits.

Officials argue that people in work should not be subsidised to look after an elderly parent - while elderly people living on their own get no extra help beyond the pension. There is said to be a lot of deadweight involved - people who do not in fact spend the allowance on co-resident parents, people who would look after granny, allowance or no allowance. It is even argued that we

should not "force" elderly people to live with their children.

All of this seems to miss the central point about taxation - which is that the Revenue ought to recognise in framing its demands the differing burdens that taxpayers have to meet. It is a question of equity, imperfect and approximate no doubt, but essential to the belief that the system is fair. Taxpayers who have a dependent elderly relative do in general have greater expenses and so have reason to expect some modest abatement in the Revenue's demands.

7. If we were proceeding majestically towards a full-blown tax credit system administered through the pay packet, then it might be conceded that tax allowances for children and the elderly were an impediment and a relic of an earlier system - "outmoded" to quote the DHSS paper on the Elderly.

But we are not so proceeding. We are trying to do our best with an overloaded and intellectually incoherent system which lays increasingly severe burdens, relatively, on families with dependent members under 16 and over 75. We are not responsible for the worst flaws in the system, but we are responsible for doing our best to alleviate them.

8. If you think that the theme is worth pursuing, would you like to discuss it with the Chancellor (I am sending him a copy of this note)?

Or would you like it discussed in the Family Policy Group?

fm
FERDINAND MOUNT

cc CST
FST
EST
MST(C)
MST(R)
Sir Douglas Wass
Sir Anthony Rawlinson
Miss Kelley
Mr Monger
Mr Moore
Mr Mountfield
Mr Robson
Mr Ridley
Mr Harris
Mr Kemp
Mr Isaac - IR
Mr Painter - IR
PS/IR
Mr Corcoran

CONFIDENTIAL



Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

Tim Flesher Esq
10 Downing Street
LONDON
SW1

26 November 1982

Dear Tim,

FAMILY POLICY GROUP

I attach a paper by the Chancellor which is designed to serve as background to the general discussion at the meeting of the Family Policy Group on 30 November.

Yours sincerely,

Jill Rutter

JILL RUTTER

FPG(82)4

The background to the group's workMemorandum by the Chancellor of the Exchequer

The purpose of this paper is to set out what I see to be some of the wider background against which we should take our decisions, and to comment briefly on our programme of work.

2. At the meeting of the Group on 10 September, the Prime Minister said that the main thread running through the programmes we discussed was the need to return to consumers the power to make their own choices, to return to them more of their own money to spend as they saw fit, and to pass to them control in many areas which are at the present controlled by bureaucracies. I agree, and in the key principles for the work of the Group which were set out in my note of 31 August I said as much. In my view the points which Ferdinand Mount makes in FPG(82)1 will help us towards achieving these aims.

3. But much depends on the overall economic picture. Economic decline does not make for a stable and contented society. Fostering individual responsibility, and substituting personal responsibility for a collectivist attitude - the aims of the Group - will continue to depend in large measures on the success of our economic policies. And we shall only succeed in restoring growth on a sustainable basis, and reducing unemployment - itself so corruptive of society - if we continue to implement responsible fiscal and monetary policies.

4. Which poses us with a dilemma. The Group will recognise how difficult, but how necessary it is to restrain public expenditure and control public sector deficits. Yet many of the individual proposals that are being put forward in FPG(82)2 will inevitably involve some additional public expenditure or some reduction in tax receipts. To that extent they would operate against the overall requirement to contain the public deficit.

5. This dilemma is not new. I have faced it in each of the four Budgets I have presented since we came to office. I have endeavoured to reconcile the containment of the public deficit with my desire to make room for worthwhile measures even though they involved some additional public expenditure or some reduction in tax receipts. I intend to continue this way, and I suggest that that is the way which the Group, too, should proceed. I would only ask that we bear the dilemma in mind. And I would suggest that as a matter of mechanics, and to help the work of the Group, the Treasury and the Inland Revenue should always be

consulted on the drafting of papers as appropriate where such costs are involved.

6. I have referred to my last four Budgets. I shall be presenting my fifth Budget to Parliament next Spring. Clearly some of the sorts of proposals which might be processed forward through the Group would be relevant to this, and could indeed be helpful in enabling me to present a useful and attractive social and political mix. Some of these I am already discussing with colleagues; for others I would hope that our work can be so organised that I have the benefit of the Group on matters which might be appropriate to my Budget. As always there will be other pressures and other imperative calls on whatever room for manoeuvre I may have. But I would hope that the views of this Group will be available to me. It might be useful if Treasury and Inland Revenue officials were to consider with the Secretaries the Group's programme of work with this in mind.

7. I turn to another point. As we agreed at our first meeting, we need to keep our discussions as specific and as practical as possible. And, indeed, insofar as anything might find its way into my Budget, that is only too obvious. From this point of view, we must not allow ourselves to be swamped under a tidal wave of paper - I note, for instance, that Appendices A to C by themselves call for no fewer than 19 papers from Group members. I do not think that we should take up time next Tuesday on procedural matters. But I am sure that we can in practice do all we want, and do it better, with fewer papers, more sharply focussed.

8. Finally, I attach a paper on the origins of the poverty and unemployment trap which is interesting in its own right but which should also provide useful background to our discussions of the tax and social security aspects of our work. It demonstrates what can happen when, with the best of intentions, successive Governments take decisions in the tax and social security field without consideration for their long-term implications. It is not going too far to say that if different decisions had been taken, the existence of the present Group might not be necessary.

THE ORIGINS OF THE POVERTY TRAP AND THE UNEMPLOYMENT TRAP

The unemployment trap can mean that people are little or no better off in work than out of work. The poverty trap affects people in work on low income can mean that an increase in their earnings results in little or no extra money in purse or wallet.

2. This note examines how this unsatisfactory and perculiar position has arisen and what can be done to improve it.

3. The traps arise from the overlap, or near overlap, of the tax and social security systems. Over the last 25-30 years the gap between benefits and tax thresholds has been compressed.

4. Benefits have been increased broadly in line with average earnings.

Thus we get :

	(% average earnings)			
	1950	1960	1970	1980
Supplementary Benefit (married couple)	29	31	30	30
Unemployment Benefit (man plus dependent wife)	26	30	32	29
Child Support (one child family tax allowances, FAM and child benefit)	7	5	3	4

While the figures move around a bit, the picture is one of a fairly stable relation with average earnings. Child support is something of an exception; the child support figures for FAM and child benefit alone (for a 2-child family) would be 2 per cent in 1950, 1 per cent in 1960, 2 per cent in 1970 and 8 per cent in 1980.

5. Meanwhile on the tax side, income tax thresholds have been rising generally in line with prices and so have been falling in relation to average earnings :

	(% average earnings)			
	1950	1960	1970	1980
Tax thresholds				
- for married man with no children	63	46	37	35
- for married man with 2 children	100	79	52	35
- for single man	39	27	25	23

Comparing the two tables above, it can clearly be seen that the gap between benefits and thresholds has declined dramatically. On the second table the differences over the period 1970 to 1980 in the figure for a married man with no children and for a married man with two children reflects the abolition of child tax allowances.

6. Why has the tax threshold fallen in this way? Two factors have been at work. First, the rise in public expenditure required higher and higher levels of taxation. Total tax receipts rose from about 30 per cent of GDP in 1955 to about 36 per cent in 1980. It is not easy to get a consistent series of figures over time for the share of public expenditure in GDP. Public expenditure in 1980 was about 44 per cent of GDP; in 1970 it was 38 per cent; in late 1950s it was around 32 per cent. The main programme responsible for the growth of total public expenditure is social security which has risen by the equivalent of about 5 per cent of GDP since the mid 1950s. Health, education and housing have also shown considerable but smaller increases.

7. Second, Governments have tended to seek higher tax receipts by way of direct taxation, not indirect taxation. In 1980 indirect taxes receipts were about the same percentage of GDP as in the mid 1950s and in the early 1960s. Over the same period income tax receipts rose by the equivalent of 3-3½ per cent of GDP and social security contribution by 2½-3 per cent of GDP.

8. In part this result - high expenditure coupled with high taxation - was genuinely unplanned. Successive Governments planned their expenditure on over-optimistic assumptions about economic growth. When that growth did not materialise the money had to be found from somewhere - so taxes were increased. It was easier to do this by failing to increase income tax thresholds than by raising rates of tax.

9. Internationally these same phenomena have been at work throughout the OECD - public expenditure rising as a percentage of GDP and the tax burden being shifted onto direct taxes and social security contributions. Our income tax thresholds are not much out of line with other countries, but we do start paying at a relatively high rate of income tax.

For married person without children in 1982 :

	Threshold (£)	Income tax rate (%)	Rate of income tax plus employees social security contribution (%)
UK	2445	30	39
USA	3270	12	19
Sweden	1710	30	30
Netherlands	3150	16	35
Japan	2730	14	19
Italy	1795	10	16
Germany	3000	18	35
France	3250	7	17

One reason why other countries have a lower onset rate of income tax is that they rely much more heavily than we do on social security contributions; in 1980 such contributions were about 17 per cent of UK total tax receipts compared with 43 per cent in France, 34 per cent in Germany, 35 per cent in Italy, 29 per cent in Japan and 26 per cent in USA. The final column of the above tables picks this up and shows the combined rate above the income tax threshold of both income tax and employees social security contributions. It does not, of course, pick up employers social security contributions which are relatively high in e.g. France.

10. The traps therefore arise from a contribution of :

- a. attempting to alleviate poverty and hardship. To do this social security benefits have been increased with earnings;
- b. using means testing to hold down the cost of benefits. Means testing means withdrawal of benefits as income rises and so acts in the same way as a tax;
- c. despite b. the cost of social security has risen markedly, as have the costs of certain other programmes;
- d. as a result of c. the tax burden has risen;
- e. tax has fallen increasingly on incomes rather than expenditure. This is partly a reflection of further policies to help the poor as indirect taxes tend to hit them relatively hard;
- f. the result of e. has been to hold down income tax thresholds (relative to earnings) and increase rates of income tax and of social security contributions. This has produced a compression of the gap between benefits and tax and, combined with the withdrawal of means tested benefits, high marginal rates of "tax" on in-work income.

11. What can we do? The long term answer is to work towards a reversal of the trends that have got us where we are. This means lower public expenditure as a proportion of GDP which in turn means slower growth of public spending and faster growth of GDP (in both cases relative to the past). This would lead to a reduction in the burdens on the taxpaying population.

12. In the short term this approach would involve concentrating whatever scope there is for tax reductions of income tax, particularly on thresholds.

13. The only other approach would be to reduce the benefits of social security recipients. This would mean cutting benefits in real terms. This would ease the traps both by cutting benefit income and by providing scope for tax cuts which would increase take home pay from work. The difficulties are obvious.

INTERNATIONAL COMPARISONS

1. As Mr Mount says in his note, the onset rates of income tax in the UK are high by international standards. But a comparison on this basis ignores social security contributions which have a similar impact on take-home pay and which are generally higher overseas than in the UK. If these are included, the difference in onset rates is less stark, particularly in the case of Germany (see Table 1 below).

2. Whilst it is true that UK thresholds are low by international standards, comparisons of this kind are notoriously difficult to make. They are affected by differences in the tax system, different levels of earnings (and the UK is low on the international scale), differences in purchasing power and variations in exchange rate. Table 2 therefore sets out the comparisons over a wider range of countries both in straight exchange conversion terms and in relation to the earnings of an average production worker.

TABLE 1

Comparative onset rates (i) excluding, and (ii) including, social security contributions.

	(i)	(ii)
UK	30%	38.75%
France	7.2%	17.7%
Germany	18.0%	35.0%

TABLE 2

Comparative thresholds in £ sterling and as percentage of average production worker's (APW) earnings for married couple (no children, employment income all the husband's) as at April 1982

	Thresholds in £ sterling	Thresholds as % of estimated APW earnings
France	£3,770	59
Germany	3,500	35
Italy	2,070	36
Japan	3,340	28
Netherlands	3,550	38
Sweden	1,190	17
USA	3,420	31
United Kingdom	2,445	33

NOTES

1. All thresholds take account of minimum deductions for expenses and other flat rate reliefs, etc.
2. The exchange rates used to convert the thresholds to sterling are those for 11 January 1983. Such conversions may not reflect differences in purchasing power between sterling and other countries.
3. The thresholds are those for 1982 (1982/83 for the United Kingdom). The Italian threshold is provisional. The thresholds relate to national tax.
4. Child benefits have been left out of account.
5. APW earnings are the average wage of male manual workers in manufacturing industry.
6. The estimates of APW earnings at 1 April 1982 have been provided by the Treasury. The estimates are derived from OECD figures for 1980; we understand however that the OECD itself has serious reservations about their validity as a basis for comparison.

Econ Pol,
Budget Pt 10

14 FEB 1983

