

PRIME MINISTER

CHILD TAX ALLOWANCES AND CHILD BENEFIT

I attach an important note from Andrew Dunlop (Policy Unit) about child support.

You asked the Chancellor earlier this year to consider the reintroduction of child tax allowances. There has been no response as yet.

The Policy Unit note considers two main issues:

- the merits of different approaches to child support
- the action to be taken in the short term.

Review of Child Tax Allowances

Andrew Dunlop's note considers the relative merits of child tax allowances and continuation of child benefit. Each has merits and drawbacks. And the merits of a child tax allowance approach might, from a different starting point, be thought persuasive.

But it does have known disadvantages: it rewards those on higher incomes most; under the separate taxation system it could end up helping the husband rather than the mother; and attempts to refine the approach add to the complexities of the income tax system.

Policy Unit conclude that it may be better to go on with child benefit. Its simplicity (including direct payments to the mothers) and surprising distributional efficacy should not be ignored. It can be thought of as a kind of universal family tax benefit (or even a tax credit). And there may be scope for improving the way in which it works - including Andrew's idea of setting it at Budget time.

Short Term Problem

The immediate issue, however, is what to do about child benefit for 1991-92. The Policy Unit conclude in favour of uprating child benefit in full in 1991-92. The public expenditure cost would be high - some £350 million per annum.

Treasury will resist this strongly. It is a very difficult

public expenditure round. Priority has been given to keeping down community charges. Indeed, Mr. Newton accepts a full uprating may not be possible because of the public spending difficulties. (The costs of the DSS programme are likely to increase substantially in any case because of estimating changes and higher unemployment rather than policy changes.)

Nonetheless, there could be legal problems if the Government were to try and freeze child benefit for a further year.

You may therefore conclude, for the wider reasons set out in Andrew Dunlop's minute, that some increase in child benefit in 1991-92 is justifiable, but at a lower cost than £350 m.

Treasury might not resist.

The issue is therefore whether to uprate child benefit in full next year. Other possibilities include:

- a less than full uprating of child benefit;
- a restructuring of child benefit, i.e., so it is paid at a slightly higher rate for the first child, but less for the second and subsequent children; the cost could be contained below £350 m;
- a distinction between children under five (paid at a higher rate for the reasons set out in Andrew Dunlop's minute) and others - again to contain the total cost.

#### Conclusion

You clearly need to discuss the long-term options on child support with the Chancellor and the Social Services Secretary at some stage. But there is the immediate difficult decision on child benefit.

The Chancellor and the Chief Secretary are coming to see you on Wednesday morning.

Content to discuss with them then their plans on child benefit?

BHP  
BHP

28 September 1990

jd c:\wpdocs\economic\child

£ 17½ bn

— £ 8½ bn

Soc Sec

Df. Supp.

H. R. A.

Com Un.

War Widow

UAT on Govt.

£ 3bn increase

Increase in Spending is £ 13bn

Discretionary Expend.

Transport DTI

NI

Scotlnd. Wales. Eur

Soc. Sec. (—)

Employment of total programme TSC's all right  
Other programmes down

Health

(F.C.O. - Transport)

£ d<sup>n</sup> Home Office — Defence

Soc Sec ⇒ — Revised Homes

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28 September 1990

CHILD SUPPORT

You asked the Chancellor some time ago to examine the feasibility of a child tax allowance. He has yet to report back. This issue is now becoming more pressing as it cannot be disentangled entirely from the PES discussions on child benefit.

The immediate question is should child benefit be frozen for a fourth successive year? The longer term issue is whether or not child benefit should be radically restructured or replaced eg. by child tax allowances.

This note assesses the options and recommends that you take an early opportunity to raise this issue with the Chancellor.

Political Context

Your recent speeches on the family have raised the stakes. There is now a widespread expectation that the Government intends to be more supportive of families. Moreover Mr Kinnock has now entered the fray with a speech on family policy which commits Labour fully to restore the value of child benefit to its 1987 value.

There are two further considerations:

1. The ambiguous 1987 Manifesto commitment on child

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benefit ("paid as now and direct to the mother") will not run a second time.

2. There is growing pressure (not least from within the Conservative Party) for a more general allowance for child care costs.

All this means that a clear long-term policy position is required.

Guiding Principles

The two key decisions are (a) whether to continue a system of child support which offers some help to all families and (b) whether child benefit remains the best way of achieving this.

The 1985 Green Paper, 'The Reform of Social Security', identified two specific objectives of child support policy:

- to provide help for families generally;
- to provide extra help for low income families.

In recent years greater emphasis has been put on the second objective at the expense of the first.

A clear set of principles on which to base policy is now needed. These might include:

1. **Universality:** the justification for child support is to help parents meet the cost of bringing up children. Although child-rearing is predominantly a matter of private interest, it is not exclusively so. The

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country benefits from a new generation of taxpayers and workers. And well brought up children must help social cohesion. On these grounds child support should continue to be available to all.

2. **Taxable Capacity:** the taxation and benefits system should make some allowance for the fact that a family's taxable capacity is less because more people are dependent on a given income.
3. **Neutrality:** The decision of a mother to stay at home to look after the children, or to go out to work, is one for her or perhaps the whole family to take. The tax and benefits system should not influence that choice one way or the other.

Current Position

For the last three years child benefit has been frozen at a rate of £7.25 per child. A proportion of the resulting savings has been used to increase the child allowances within income support and family credit. The aim has been to achieve better targeting of poorer families.

If the objective now is to develop a credible family policy, then this approach is no longer sustainable:

- first, as Keith Joseph has argued "personal cash allowances climb while the only tax recognition of the costs of dependent children - tax-free child benefit - is frozen, so that the effective discrimination against the family with dependent children becomes worse each time personal cash allowances are raised." ("Rewards of Parenthood")

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- second, by financing the extra support for poorer families from savings on child benefit the burden falls on other families rather than general taxation.
- third, better targeting of poorer families has its limitations. Only 50 per cent of those eligible for family credit take it up. In addition the Treasury estimate that some 600,000 families on low incomes are ineligible for family credit (e.g. because they are working less than 24 hours a week).

The Options for Change

There are four broad options:

1. Replace child benefit by child tax allowance;
2. Restructure/retarget child benefit;
3. Keep child benefit (with or without uprating), but add other elements in support of the family eg increase Married Couples Allowance;
4. Uprate child benefit.

1. Child Tax Allowances (CTA)

At present child benefit is worth £377 a year per child. The rate of a CTA would need to be £1510 a year per child to produce an equivalent sum for a basic rate taxpayer.

CTAs have obvious attractions. They leave taxpayers with more of their own money. The Treasury estimate that 6

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million taxpayers would pay less tax, with 1 million taken out of tax altogether. By contrast child benefit involves taking money from taxpayers in order to give it back to them in the form of cash at the Post Office.

But there are fundamental problems with CTAs:

- CTAs would be of little use to many mothers. Nearly half of married women with children do not work. And of the working mothers about 40 per cent do not earn enough to pay any tax at all. Only a third of all mothers earn enough to take full advantage of CTAs. In order, therefore, to benefit from CTAs many mothers would have to go out to work. This would be a perverse incentive which would cut across the aims of our family policy.
- This problem could be overcome by making CTAs transferable. But this raises another difficulty. One of the most valued features of child benefit is that it is paid directly to the caring parent and is, therefore, more likely to be spent on the child. This would be lost under a transferable CTA. A cash payment would be removed from the mother to give a tax allowance to the father. This is not good politics when we are already losing support amongst younger women. Moreover it would be an administrative nightmare to introduce a CTA that could first be set against the mother's income with the balance offset against the father's.
- CTAs are even more poorly targeted than child benefit. Whereas the cash value of a CTA to a basic rate taxpayer would be £377 per child, it would be



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worth £604 to a higher rate taxpayer. And those not on benefit, but not paying tax, would lose out completely. This could be partially rectified by making family credit more generous. But this would increase the numbers dependent on means-tested benefits. And 600,000 low income families would still lose.

The Treasury calculate that the net effect of introducing a scheme of transferable CTAs, with compensation for low income families, would be to reduce public expenditure by £3 billion (as the CTAs would represent revenue foregone). But there would be a £200 million increase in borrowing.

Clearly the numbers of losers could be eliminated by introducing CTAs on top of child benefit. This would be very expensive. Alternatively it might be possible partially to replace child benefit with CTAs: child tax allowances for those with sufficient income to use them, and child benefit for the rest. But what is the point? We would end up with a more complex, and expensive system for no obvious gain. Indeed there would be a perpetual problem of matching the value of benefit to the value of the allowance.

2. Restructure Child Benefit

There are two ways in which child benefit could be retargeted:

a. By redefining eligibility

David Willetts and others have argued that child benefit should only be paid to the under fives. And the payment to them would be doubled to £14.50.

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The rationale behind this proposal is that the greatest disruption to family budgets occurs when the wife gives up work to have a baby. The family budget is reduced to one income. And although the costs of children rise as they get older, the mother has greater opportunities to meet those costs by taking on part-time work e.g. when the children are at school.

But the statistics of what actually happens in real life are more complex than that. There is no one clear point at which mothers return to work.

Mothers in Paid Work

<u>Age of youngest child</u>	<u>Full Time %</u>	<u>Part Time %</u>	<u>All Working %</u>
0 - 2	11	19	30
3 - 4	11	35	46
5 - 9	14	48	62
10+	27	45	74

(General Household Survey).

This proposal may seem superficially attractive: More mothers might be encouraged to stay at home when the children are young. But there would be many losers (two thirds of the children attracting child benefit are over 5). And it would generate a no-win argument about the costs of children at different ages. This is frankly not a feasible option for the Manifesto.

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b. By means-testing Child Benefit

This would be achieved either by removing child benefit from higher rate tax payers or taxing the benefit.

Neither of these is an attractive proposition:

- it would undermine our credibility as the Party of the family.
- taxing child benefit would also increase the numbers of people paying a high marginal tax rate of over 70 per cent;
- there would be severe administrative difficulties from taxing child benefit. Whose income - the man or woman - do you tax? Which income do you consider for the self-employed?

3. Married Couples' Allowance

An option would be to retain Child Benefit, but add other elements to support the family.

One suggestion you asked us to look at was the idea that the Married Couples' Allowance (MCA) would be increased where the wife is not working.

For example, the MCA might be raised from £1720 to £2000. This would be worth about £1.30 a week to basic rate taxpayers. The cost would be over £200 million.

In theory this proposal would be valuable as a signal towards a more neutral tax system between working and non-working

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mothers. But there are substantial practical difficulties in this approach. Restricting the higher rate of MCA to couples where the wife is not working would be difficult to define and enforce. The evidence suggests that women are moving constantly in and out of work: part-time and seasonal particularly. Retargeting the MCA in this way would certainly complicate the tax system and the task of the Inland Revenue.

4. Up-rate Child Benefit

Up-rating next year just for the current year's inflation (assumes RPI of 10 per cent) would cost about £350 million net of the compensating reductions in means tested benefits, (two thirds of this is already allowed for in current spending plans). It would take the rate of child benefit to £8 a week per child.

An up-rating fully to restore the value of child benefit would cost about £1 billion in total. It would take child benefit to £9.50 a week. (This huge commitment was offered by Mr Kinnock in his family <sup>policy speech</sup> ten days ago.)

A full restoration of the value of child benefit is clearly out of the question and the Opposition are vulnerable on how they could responsibly afford it. But if family policy is to be a government priority in the run-up to an Election then the one year's up-rating at a cost of £350 million is realistic.

Is such a move justified given the criticisms that are often made of child benefit? I believe it is. For all its faults child benefit has some very positive features:

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First, child benefit is not as poorly targeted as is sometimes thought. Only 8 per cent of families receiving child benefit include a higher rate taxpayer. The great mass of it is going to people in middle-income brackets - those hardest hit by high mortgage rates and the Community Charge.

Second, child benefit should not be treated as a social security benefit in the normal sense. It is akin to a child tax allowance in that it offers all families a portion of tax free income. There is a strong case for treating it as such.

Third, it would be a mistake to underestimate the importance of the simple principle of a direct cash payment to the mother. We supported this in 1975 and explicitly iterated it in the 1987 Manifesto. Tampering with it could be politically unwise.

### The Longer Term

One suggestion worth considering further is that in future child benefit should be dealt with at the time of the budget. Like personal allowances it would be increased by the amount of inflation unless a decision was taken not to do so. This would retain the flexibility to freeze in a difficult year, but would indicate that it was no more likely to be frozen than personal allowances. To reinforce this change the name of child benefit might be changed to, say, a child allowance.

### Conclusion

Clearly you need to consider, and discuss, with the Chancellor his promised paper on child tax allowances before taking a firm view on the way forward. However it seems evident that the arguments against a fundamental upheaval of

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the Child Support system are fairly compelling.

If we were not starting from where we are now, child tax allowances would be an attractive option. But given that we are, increasing child benefit does seem the simplest and fairest way of giving additional help to families with children both this year and over the longer-term. This could be the last chance to up-rate before an election. It would help to re-establish our credentials as the Party of the family and head-off demands for child care vouchers.



ANDREW DUNLOP