



10 DOWNING STREET

From the Private Secretary (2)

Prime Minister

The meeting today touched on poverty and employment traps. Policy Unit have prepared a note this - attached.

You may also like to look at the terms of reference and scope of the benefit reviews. They cover poverty and unemployment traps.

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MR. REDWOOD

POVERTY AND UNEMPLOYMENT TRAPS

The Prime Minister saw your note about the poverty and unemployment traps over the weekend. Her comment on it, which I assume relates to the proposal in the Annex to raise extra revenue from VAT, was as follows:

"The increase in the RPI and the consequent wage claims would set us off on the wrong path just when we need to keep wage increases down."

MR. D. BARCLAY

29 May 1984

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23 May 1984

PRIME MINISTERWHY WORK?: POVERTY AND UNEMPLOYMENT TRAPS

The poverty and unemployment traps are damaging to jobs prospects and to people's self-esteem. Everyone agrees that something ought to be done about them. There are two suggested solutions on offer.

The Opposition solution is to raise Child Benefit by a large amount. This scheme does not work. The poverty trap is caused by the combined effects of paying income tax and suffering a sharp withdrawal of Family Income Supplement and Housing Benefit as income rises. For a married couple with two children, income in the ranges of £60-£90+ a week suffers tax and benefit loss of more than £1 for every additional pound of earnings. If you raise Child Benefit, then these families will be better off, as they will receive an untaxed benefit whether they are in work or out of work. However, it will still leave them facing benefit withdrawal and tax rates in excess of 100 per cent over a wide range of incomes.

By definition, raising Child Benefit can have no impact on the poverty trap for people without children.

What the Opposition fails to say is that raising Child Benefit would only reduce the poverty trap if, at the same time, means-tested benefits are cut. Abolishing or reducing Family Income Supplement and/or Housing Benefit would, of course, cut the poverty trap; but, at the same time, it would increase poverty. It is the economics of the madhouse to suppose that you can pay extra money to all the children in the land, finance this by cuts in the means-tested benefits that do most to relieve poverty, and, as a result, leave those who are poor better off. Instead, it would make the poorest families much worse off as the means-tested benefit was cut.

The Government approach to reducing the impact of the poverty and unemployment traps is to raise tax thresholds. Given time and enough resources, this can cure the problem without necessarily having to cut back on means-tested benefits. If everyone who was married with 2 children came into tax at £90 a week instead of just over £60 a week, then instead of paying a rate of tax and benefit withdrawal of 105 per cent on their marginal income, they would pay a combined rate of 75 per cent. Similarly, the single person in the income range £40-£85 a week receiving Housing Benefit, currently pays a marginal rate of tax and benefit withdrawal of almost 75 per cent. To the extent that tax thresholds could be raised, this marginal rate would be reduced from 75 per cent to 45 per cent.

The problem with this approach, whilst working in theory, is that in practice it is very expensive to get to a final solution. It will cost £9,500 million of lost tax revenue to take the single and married man's allowances up to the point where most people are taken out of the poverty trap. This sum would take everybody who was married with children above the Family Income Supplement threshold before paying income tax.

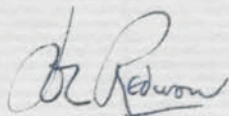
Whilst £9,500 million sounds like a lot of money, it is possible to think of ways of reallocating the tax burden so that thresholds can be raised by this amount. Raising thresholds would, of course, give tax advantages to people over the whole spectrum of incomes, and not just those affected by the poverty and unemployment traps.

The attached graphs show just how the trap operates for a single person and for a married family with 2 children. It demonstrates quite vividly that those benefits - Family Income Supplement and Housing Benefit - which do most to relieve poverty because they are well-targetted on those in need, are also by definition those which do most to exacerbate the poverty trap. We could not afford to switch away from targetted benefits for those in need to general benefits distributed widely throughout the population. It is, however, possible in the reviews of Housing Benefit, Supplementary Benefit and other welfare payments, to take into account the impact the current taper and the spread of benefit a long way up the income scale does have on worsening the traps.

Conclusion

The Chancellor is right in his main thrust to go for raising tax thresholds. It is an urgent problem. It must be worthwhile to work if we wish to cure unemployment. It must be possible to climb out of poverty without being trapped by the state tax and benefit system: otherwise self-reliance will be no more than a dream for the lower-paid.

In order to make an impact and win the debate, it is necessary to be bold, and to try and lift those on the main means-tested benefits out of the poverty trap as quickly as possible. At the same time, in the welfare reviews, reducing the range of incomes over which these means-tested benefits are paid is a necessary adjunct and would be acceptable politics against the background of a major increase in tax thresholds for those on lower incomes. The Annex shows a way of achieving the necessary changes in taxation to raise thresholds.



JOHN REDWOOD

SECRET

LASABA

22 May 1984

INCOME TAX

The current aim of policy is to increase thresholds.

1. As more people are taken out of tax, the poverty and unemployment traps are reduced. It is more worthwhile to work or earn more.
2. It makes little sense to tax single people on 21 per cent of average male earnings (33 per cent for married men) when there are means-tested benefits available up to average earnings.
3. We have one of the lowest starting points for income tax in the world, coupled with one of the highest rates for people coming into tax.
4. There is a general strategy of switching tax from income to expenditure, to improve the incentives for work and effort, and to give people some more discretion over how and when they pay their tax. This helps reduce avoidance and evasion, where the growing black economy is having a considerable impact on the relative net incomes of those who play the game and those who don't.

It would be possible, to take everybody on Family Income Supplement out of the tax system; but very difficult to take everybody on Housing Benefit out of it. A rough Treasury estimate is that it would involve losing £20 billion of tax revenue to take thresholds above the present Housing Benefit level, as it has gone so far up the income scale. It is therefore necessary to revamp Housing Benefit, targetting it more accurately on those in greatest need. Against the background of taking all these people out of tax, the extra taper entailed on the means-tested benefits would not increase, but would help to reduce the poverty and unemployment traps, as the savings are going to raising tax thresholds.

The arithmetic of the changes is:

Cost of increasing single person's tax threshold from £2,000 to £3,200 (current married man's threshold), and married man's threshold from £3,200 to £4,950 (the point at which FIS runs out for a 2-child family): £9.5 billion

Possible Sources of extra revenue:

1. Taxation of pension funds: £3 billion

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| 2. | Abolition of married man's allowance for married couple where wife is working: | £1.5 billion |
| 3. | Broadening the VAT base: | £2.5 billion; or |
| 4. | 5 per cent VAT on all non-VAT items: | £2.5 billion |
| 5. | Extra tax on company cars: | £0.2 billion |
| 6. | Gas levy: | £0.5 billion |
| 7. | Selling oil leases: | £0.1 billion |
| 8. | Fiscal adjustment possible in any given year: | £2 billion |

Reductions in Benefit:

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| 9. | Cuts in housing benefit to target it more accurately: | £1 billion |
| 10. | No revaluation of Child Benefit: | £0.2 billion |

Other PE Reductions:

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| 11. | Public expenditure reductions: | £2 billion |
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<u>TOTAL:</u>	<u>£13 BILLION</u>
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1. Taxation of Pension Funds

Pension funds currently enjoy tax relief in four forms:

- a. relief from Corporation Tax on contributions;
- b. relief from employee's income tax on contributions;
- c. exemption from income tax and CGT on income and gains on investments;
- d. tax exemption on lump sum payments on retirement.

a. and b. are reasonable reliefs. Wages are an offset for Corporation Tax, and pension payments are taxed, so taxing contributions would be double taxation. The tax exemption on the lump sum is popular and provides a tax incentive to save for retirement. The exemption on investment income and capital gains is the correct one to question.

2. Abolition of Married Man's Allowance for Married Man where Wife is Working

Raising the threshold to £3,200 for a single man would mean the married man with a working wife would be no worse off as a result of this change, and his wife would be better off, as her tax allowance would go up by £1,200. Only the very low-paid wife would suffer, and it could be objected that this change makes low-paid, part-time work either unpopular, or drives it into the black economy. It would be possible to devise ways of dealing with this at the cost of some revenue loss.

3. Broadening the VAT Base

The Government is pledged to switch from income to expenditure taxes. This means broadening the VAT base. It is not realistic to propose taxing all food items at 15 per cent. Therefore VAT could either be increased by taxing construction (£825 million), books and magazines - not newspapers (£170 million) and 40 per cent of presently untaxed food (£1,400 million), or by a lower-rate of 5 per cent on all currently untaxed items.

4. Extra Tax on Company Cars

The policy of putting up the tax on company cars to encourage rational private sector pay policies is a good one. The income benefit attributed to cars should be doubled to be realistic. Many companies now buy foreign cars, but the motor industry will still protest strongly about such changes.

It does not raise substantial revenue, but does force companies and employees to make more sensible decisions about the need for company motor cars and their worth.

5. Gas Levy

The gas levy on cheap Southern Sector gas does not capture much of the benefit for the Treasury - unlike Petroleum Revenue Tax on oil. It could be at least doubled, yet Southern gas would still be a bargain to BGC. This entails a transfer from BGC profits to the Exchequer: BGC have more than enough cash and profit at their disposal.

6. Oil Leases

New oil leases in the North Sea and Channel should be auctioned, not given away.

7. Housing Benefit

As people enjoy more tax relief from rising thresholds, Housing Benefit should be reduced for those near average earnings.

8. Child Benefit

There would be no need to increase this, in view of the massive increase in thresholds.

9. Other Public Spending Reductions

The reductions in Regional Aid, bus subsidy, urban programme and other areas under review should be brought up to a total of, say, £2 billion and used for lowering tax.

This list provides a substantial surplus (£3.5 billion) over the amount of money required to make the changes to allow for the natural haggling that would occur.

The purpose of the package would only be gained if it was done in one go. The married man would no longer pay tax on 30 per cent of average earnings: tax would start at 50 per cent of average earnings (the highest threshold for at least 30 years). The Government could state that the poverty trap had been cured, and that no-one would suffer marginal rates higher than 75 per cent as a result of removing the overlap between FIS and income tax. It would make it more worthwhile to work, begin the process of creating clear water between means-tested benefit levels and the payment of income tax, and would be seen as a major move in the right direction. It would be bold enough to go down well.

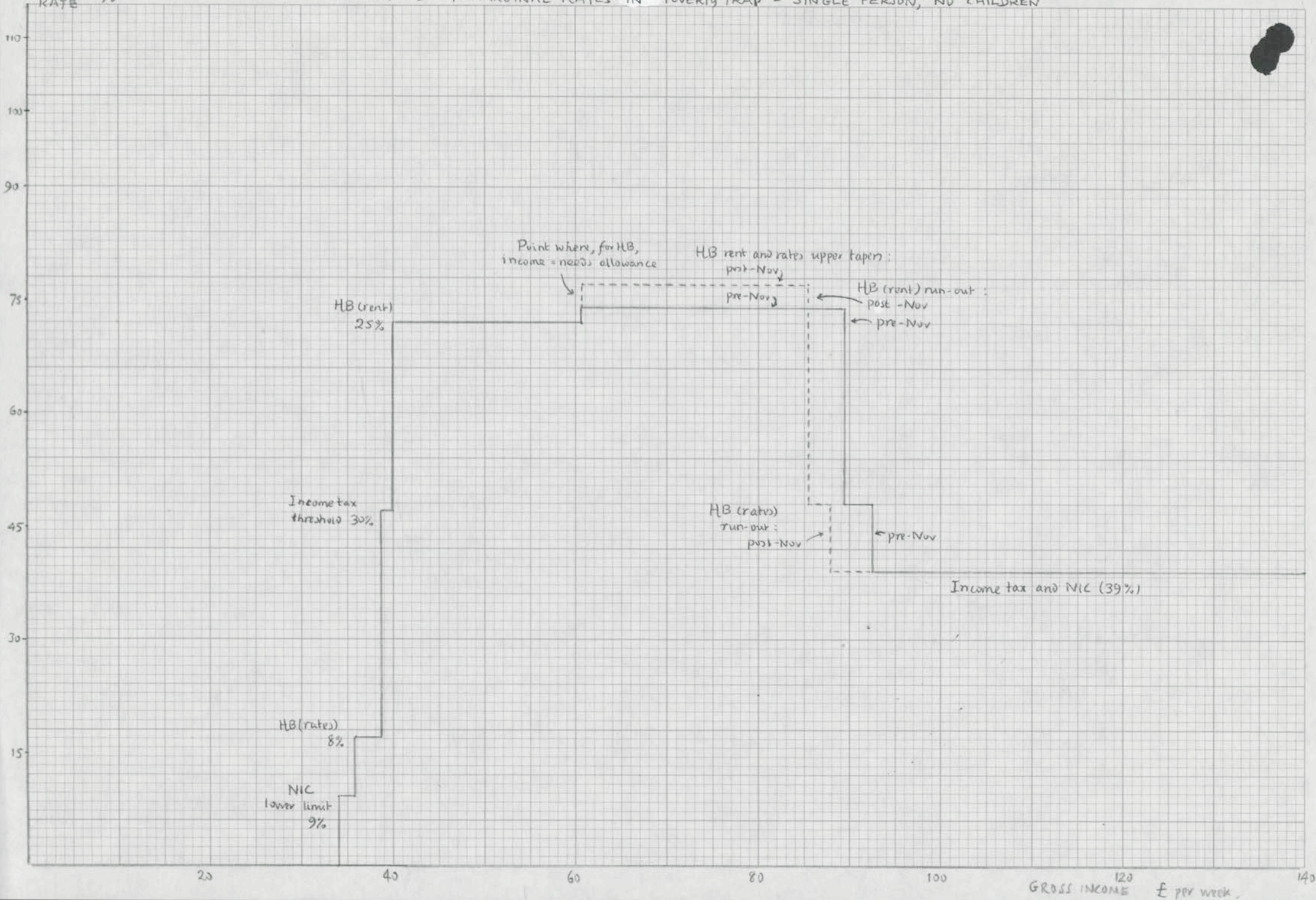
The reason everyone would feel much better off is because they would be. One-third of the savings could be paid for by taxing pension funds, a levy on future income. Those in unfunded schemes would be particular beneficiaries. Their contribution rates should be adjusted to even up the results a little.

Conclusion

There are political objections to each of the detailed measures proposed to find the £9.5 billion. But presented as a whole, as part of a concerted drive to higher thresholds and restoring the incentive to work, the overall package has considerable political attraction.

MARGINAL RATE %

PROFILE OF MARGINAL RATES IN POVERTY TRAP - SINGLE PERSON, NO CHILDREN



MARGINAL RATE %

PROFILE OF MARGINAL RATES IN POVERTY TRAP - MARRIED COUPLE, 2 CHILDREN

