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Budget file

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MR TURNBULL

FAMILY TAX ALLOWANCE

The attached note describing a Family Tax Allowance shows it is worth looking at carefully.

The attractions of a Family Tax Allowance are:

- it helps the low-income working family.
This is the group which suffers most at present from the poverty/unemployment traps as their low post-tax pay doesn't support a family as generously as benefits do;
- it might help break the log-jam on cutting benefit expenditure for children. It would make it easier to hold or reduce CB and abolish FIS;
- it goes with the grain of the Prime Minister's views. It re-invents something close to the old child tax allowance. It shifts support for families from the benefit system to the tax system.

There obviously are difficulties. But they should be superable:

- it is an increase in the Revenue's administrative burden. They need to know whether tax-payers have children: information they do not have at present. But this problem should not be exaggerated. The notice of coding could include a question whether the tax-payer has children. And less than 100 per cent take-up is not the end of the world as the position can always be corrected later. If the problem is the staff cost, Norman Fowler could 'give' the Chancellor the extra staff from his own manpower savings arising from the benefit reviews;

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- £1½ b. on Family Allowance takes 300,000 people out of tax compared with 600,000 from £1½ b. spent on raising existing allowances. But the 600,000 figure includes a lot of peripheral groups not very important for the employment figures (part-time women, OAPs). Only 60,000 - 10 per cent - are family heads. On this test the Family Tax Allowance is five times as good;
- the Family Tax Allowance does not help the young single unemployed man - a crucial sector of the unemployed. But he should benefit particularly from Norman Fowler's other proposals to raise the employers' LEL to £100.

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FAMILY TAX ALLOWANCE - SUMMARY

- Proposal - introduce Family Tax Allowance, ie a flat-rate allowance payable to all families with children.
- Cost
- estimated at £180-200 million for every £100 of the allowance.
 - for a revenue cost of £1.5 billion the allowance could therefore be set at £800 per family.
 - the same sum of £1.5 billion would finance an across-the-board increase in tax allowances of $7\frac{1}{2}$ per cent (£235 on the married man's allowance and £150 on single person's and wife's earned income allowances).

Effects on Family Incomes

- Family Tax Allowance of £800 worth £4.60 a week in cash terms to all taxpaying families with children.
- over 6 million families would gain.
- $7\frac{1}{2}$ per cent general increase in allowances worth only £1.35 a week for a 1-earner couple with children and £2.20 a week for a 2-earner couple with children.

Effects on Poverty and Unemployment Traps

- Family Tax Allowance of £800 would take 300,000 low-income families with children out of tax, most of whom are likely to be eligible for FIS and/or Housing Benefit and therefore in the poverty trap.
- among FIS families less than half would remain liable for tax after introduction of Family Tax Allowance, compared with over three-quarters now.
- $7\frac{1}{2}$ per cent general increase in thresholds would take 600,000 taxpayers out of tax, but only 10 per cent of these are family heads with dependent children; the numbers of FIS families remaining liable for tax would be reduced by only about 5 per cent.
- unemployment trap significantly improved for family men because take-home pay increased by nearly £5 a week and income out of work unchanged.

Effects on Labour Market

- Family Tax Allowance would reduce need for married women with dependent children to seek paid work.
- could also ease upward pressure on male wages by increasing take-home pay.

in terms of removing families from tax, the family Tax Allowance is therefore 5 times as effective

FAMILY TAX ALLOWANCE

Proposal

1. This note examines the effects of introducing a Family Tax Allowance, ie an allowance payable to all families with children, with the amount of the allowance being the same for all such families irrespective of the number of children.

Cost

2. As a rough rule of thumb it is estimated that a Family Tax Allowance of £100 per family would cost £180-200 million at 1984/5 income levels. If therefore the Chancellor's scope for fiscal adjustment in the forthcoming Budget is £1.5 billion, this sum could be used to finance a Family Tax Allowance of about £800 per family. If instead the same sum of £1.5 billion were used to pay for a general increase in existing income tax allowances, the amount of the increase would be around $7\frac{1}{2}$ per cent, ie married man's allowance up from £3155 to £3390, single person's and wife's earned income allowance up from £2005 to £2155, and so on.

Effects on Family Incomes

3. A Family Tax Allowance of £800 would be worth £4.60 a week in cash terms for a family with children paying tax at the standard rate. In comparison an across-the-board increase in existing allowances of $7\frac{1}{2}$ per cent would be worth £1.35 a week for a married man with wife not working, £2.20 a week for a 2-earner couple and £0.85 a week for a single person. For a family with children in which only the husband is working, the Family Tax Allowance is thus worth almost $3\frac{1}{2}$ times as much as a general increase in allowances, while for a family in which both husband and wife are working the Family Tax Allowance is worth roughly twice as much as a general increase in allowances. The comparison is summarised in the following table:

type of taxpayer	1984/5 allowance	1984/5 allowance + £800 Family Tax Allowance		1984/5 allowance + $7\frac{1}{2}$ per cent	
			cash gain £ p.w.		cash gain £ p.w.
1-earner couple with children	3155	3955	4.60	3390	1.35
2-earner couple with children	5160	5960	4.60	5545	2.20
1-earner couple without children	3155	3155	-	3390	1.35
2-earner couple without children	5160	5160	-	5545	2.20
single-parent family	3155	3955	4.60	3390	1.35
single person	2005	2005	-	2155	0.85

4. These hypothetical comparisons are confirmed by a more detailed analysis based on EAO's tax-benefit policy simulation model (which uses a representative sample of about 9000 actual families to assess the effects of tax or benefit changes). The model shows, for example, that among all couples with children the average gain under the Family Tax Allowance system is about £4 a week (this is less than the hypothetical gain of £4.60 a week as some couples do not have any earnings or have earnings below the value of their new allowance), while among all single-parent families the average gain is about £1.40 a week (around half of all single parents do not work and so do not benefit from the new allowance). In contrast, the average gain stemming from an across-the-board increase of $7\frac{1}{2}$ per cent in existing allowances is only about £1.40 a week for couples with children and only about £0.45 a week for single-parent families. Married couples without children gain nothing from the Family Tax Allowance but about £1.60 a week on average from a $7\frac{1}{2}$ per cent in thresholds. The Family Tax Allowance concentrates fiscal support entirely on families with children, whereas a general increase in allowances benefits all taxpayers (including, for example, pensioners, who receive nearly 15 per cent of all the gains from such an increase).

Effects on the Poverty and Unemployment Traps

5. The effects of an £800 Family Tax Allowance on the poverty trap are illustrated for a 2-child family (wife not working) in Figure 1 attached. (The effects of a $7\frac{1}{2}$ per cent increase in existing allowances are also shown for comparison). The figure shows the values of total income support (= income from all sources, including means-tested benefits such as FIS and Housing Benefit, less income tax, NI contributions and housing costs) corresponding to different levels of gross earnings from employment. The flatter the TIS schedule between different earnings levels, the higher the effective marginal tax rate and hence the deeper the poverty trap.

6. The main effect of the Family Tax Allowance is to narrow the range of income in which there is an overlap between the payment of income tax and the receipt of means-tested benefits (the combined effects of which can result in marginal tax rates of over 100 per cent). By raising the point at which low-income families with children start paying tax, the Family Tax Allowance lifts some families out of tax altogether and hence out of the poverty trap. A $7\frac{1}{2}$ per cent increase in tax allowances has the same effect but over a much narrower range of income.

8. In terms of numbers affected, it is estimated that a Family Tax Allowance of £800 per family would take 300,000 families with children out of the tax net (200,000 couples with children and 100,000 single-parent families). A high proportion of these families are likely to be receiving FIS or Housing Benefit (or both) and are therefore currently affected by high marginal tax rates. Among FIS families it is estimated that less than half would still be liable for income tax after introduction of the Family Tax Allowance, compared with over three-quarters at present. In comparison, an across-the-board increase in existing allowances of $7\frac{1}{2}$ per cent would take about 600,000 taxpayers out of tax, but only about 10 per cent of these would be family heads with dependent children (the rest being pensioners, working wives and single persons). The number of FIS families still liable for tax would be reduced by only about 5 per cent.

Other Effects

9. By targetting fiscal support on families with children, a Family Tax Allowance may reduce the need for married women with children to seek paid work. (At present about half of all mothers with dependent children go out to work, a third full-time and two-thirds part-time). This could release jobs to be filled by the unemployed including school-leavers. In addition, by increasing take-home pay for a significant proportion of the male labour force, the new allowance may reduce upward pressure on wages (though a general increase in thresholds would also have this effect). Finally, the revenue cost of the allowance would not count as public expenditure, in contrast to an equivalent increase in Child Benefit.

FIGURE 1: TOTAL INCOME SUPPORT

(2-child family, wife not working)

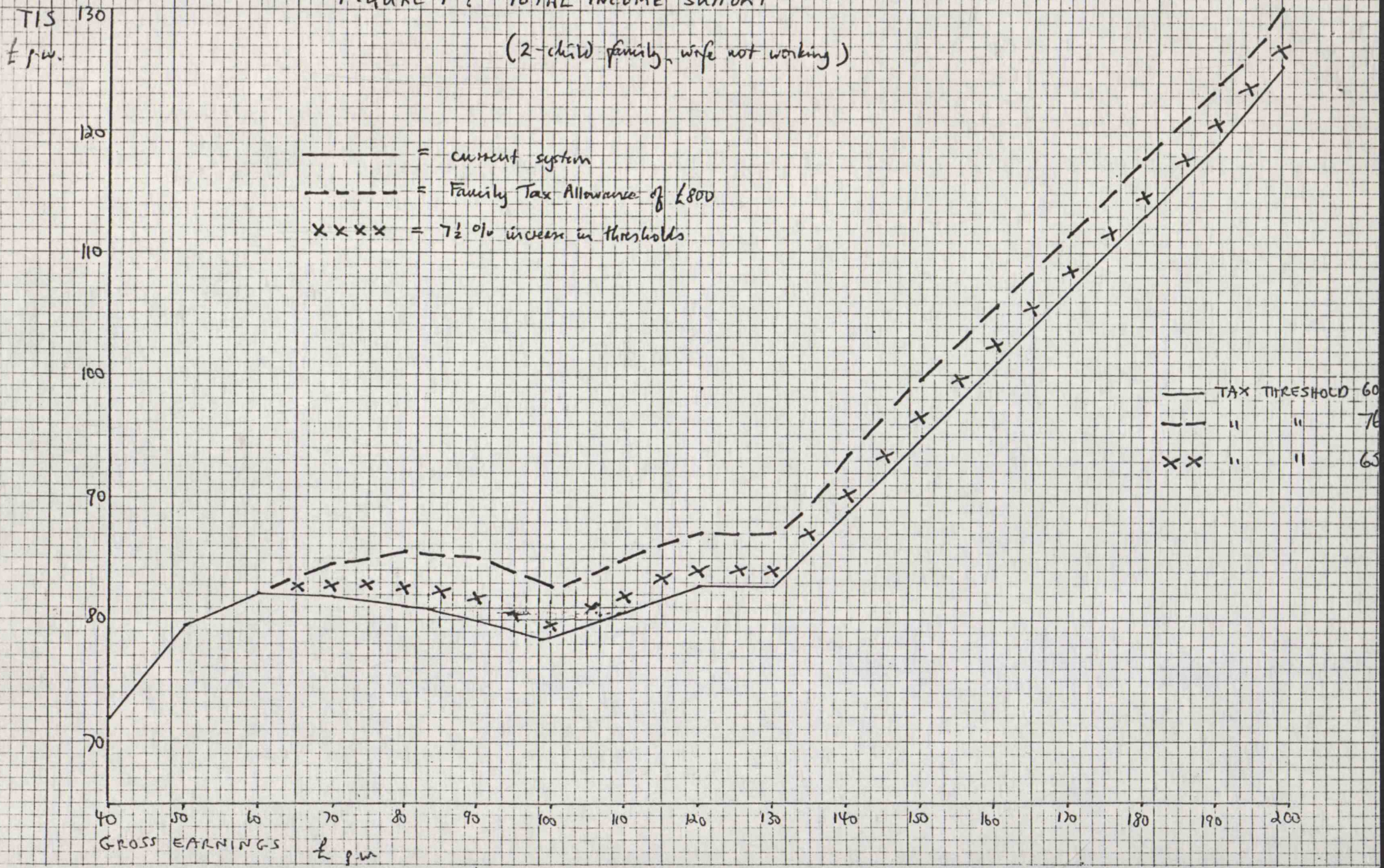


FIGURE 2 : REPLACEMENT RATIOS

(2-child family, wife not working)

