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REFORM OF PERSONAL TAXATION

Note of a Meeting at
10 Downing Street on
Thursday 16 January
1986 at 11:30 am.

PRESENT:

Rt Hon Margaret Thatcher MP
Prime Minister.

The Rt Hon Vicount Whitelaw
Lord President of the Council

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer

The Rt Hon Norman Fowler MP
Secretary of State for
Social Services.

The Rt Hon Lord Young of Graffham
Secretary of State for
Employment.

The Rt Hon John Wakeham MP
Parliamentary Secretary,
Treasury.

The Rt Hon John Moore MP
Financial Secretary,
Treasury.

Mr Antony Newton MP
Minister of State
Department of Health and Social Security
(Minister for Social Security)

SECRETARIAT

Mr J B Unwin
Mr A J Wiggins

The Meeting considered a memorandum by the Chancellor of the Exchequer covering a draft of his proposed Green Paper on the Reform of Personal Taxation. It also had before it a minute of 15 January to the Prime Minister from the Secretary of State for Social Services and a letter of 15 January to the Chancellor of the Exchequer from the Secretary of State for Employment.

2. The CHANCELLOR OF THE EXCHEQUER said he had promised in his 1985 Budget Speech to issue a Green Paper on the Reform of Personal Taxation, which would specifically canvass the case for a change to fully transferable income tax personal allowances. He had made clear that the Green Paper would also cover longer term issues relating to possible integration of the systems of taxation and social security benefits, and the rationalisation of income tax payments and national insurance contributions. The Green Paper published by his predecessor had put forward transferable allowances among a number of other possibilities; although some of those who responded to that document had preferred other approaches, there was a substantial measure of support for transferable allowances. In particular, it had been clear that fully transferable allowances were strongly to be preferred to a system providing only for partially transferable allowances. The Government's policy was to reduce the burden of income tax, as economic circumstances permitted; he had concluded that such a reduction should be achieved, after the computerisation of the income tax system which would be complete by 1990, by the introduction of a system of fully transferable allowances on a no cash loser basis. This approach would serve a number of objectives: it would remove the present injustice in the tax treatment of married women and enable them to manage their own financial affairs separately from those of their husbands; it would remove the tax penalty currently attaching in some circumstances to marriage; it would improve the position of many families in the poverty and unemployment traps, which were generally dependent upon a single earner; and it would establish a system under which any given increase in personal allowances would be much more effective than under the present system in keeping poor people out of the tax net. The advantages of the proposed system could be clearly seen by considering the average tax rates paid by couples at different stages in their life; examples could be given under the present system where tax took a higher proportion of the total family income when a wife stopped work, despite the substantial reduction in that income, but under the proposed new system this effect would be removed, and it would not matter what proportion of total income is earned by either partner - the tax bill would be the same. The presentation of the Government's approach in the Green Paper would require great care; it would be made absolutely clear that

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the changes would be introduced only as the position of the economy permitted, and there would be no commitment to any particular timescale within which the tax reductions would take effect. It would also be made clear that the revenue costs of the change would depend on the length of the transitional period and the rate of inflation at the time, and a range of figures would be presented on alternative assumptions rather than the single aggregate figure of £5.3 billion. (That figure could be further placed in context by pointing out that indexation in the last three Budgets had reduced personal tax payments during the current year by more than £6 billion.) Notwithstanding the proposals in the Green Paper, future Governments would still have complete freedom to decide how any available 'fiscal adjustment' should be allocated between public expenditure programmes and tax reductions; to the extent that the prospect held out of a reduction in the tax burden implied some 'tilt' of policy in that direction rather than towards higher public expenditure, that would be all to the good - all the other pressures faced by the Government were in favour of higher public expenditure. The Green Paper had been promised in the 1985 Budget, and its publication could not now be delayed beyond the 1986 Budget; this meant that work on its preparation would have to go ahead very rapidly, in order to produce a final text by the middle of February.

3. In discussion, the following main points were made.

(a) Although the cost and timing of the change could not be determined precisely at this stage, the implied prior commitment on the extent and shape of future tax relief would be a major issue at the next Election and throughout the period of the next Parliament. Given the possible conflicts of priorities, the presentation of the Chancellor's proposals would require the greatest care.

(b) It was essential that Ministers should understand fully the distributional implications of the Chancellor's proposals; studies should be made comparable with those made recently in the cases of the Review of Social Security and the Reform of Local Government Finance. Although a substantial part of the benefit would go to poor families, richer single earner

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couples would also be major beneficiaries. An analysis was needed of the proportion of the benefit going to people in different family circumstances and in different income brackets.

(c) The Green Paper would be published while the Social Security Bill was currently before the House. Attention would be focussed on the fact that the Reform of Social Security was being implemented on a broadly revenue neutral basis, with substantial numbers of cash losers including some poorer pensioners, but that personal taxation was to be reformed on a much more generous basis. Ministers should also have before them information about the impact of the introduction of fully transferable allowances on a revenue neutral basis.

(d) A substantial part of the case made by the Chancellor of the Exchequer rested on the benefits which would accrue to poorer families facing the poverty and unemployment traps. If the objective was to help families, and the Green Paper was to carry conviction, alternative approaches to this objective would need discussion. It would be argued that increases in child benefit would be a better way of directing help towards families, but it would also be possible to introduce some kind of family tax allowance which would have many of the same effects and avoid large increases in public expenditure.

(e) The Government's social security reforms removed the marginal tax rates of 100 per cent or more hitherto faced by some poor families. But because entitlement to family credit would depend on after tax income, tax reductions would in future be partially offset by reductions in entitlement to benefit. The overall effect of this was to lengthen the income range over which high marginal tax rates applied. The proposed new arrangements for transferable allowances would usefully complement the social security changes, since they would have the effect of shortening the range of income where poverty trap marginal tax rates applied.

(f) Although the change would be well received by married women who were not at work, they would resent the fact that when

they returned to work either their husband would face an increase in tax or they would receive lower earnings net of tax than their colleagues - in practice the effect would be the former. Alternatively the proposed new arrangements might have the effect of inducing married women to join the black economy in order to avoid these tax effects. The result could be pressure for reinstatement of something like the present arrangements.

(g) Although transferable allowances would have a beneficial effect on the poverty and unemployment traps, the tax system should not be regarded as a precise instrument to direct additional resources to people in need - that was the task of social security benefits. On the other hand, it was argued that it was important for the Government to reduce the number of social security beneficiaries by increasing incentives to work; it might be that higher priority would need to be attached to measures which would have this effect on people at lower income levels than to general reductions in taxation which applied right up the income scale.

(h) The material about the future relationship between personal taxation, social security benefits and national insurance contributions should be discussed separately between Treasury and Department of Health and Social Security Ministers, who should report back to the present Group as soon as possible.

THE PRIME MINISTER, summing up the discussion, said that the Group recognised the advantages, equitable, practical and political of a system of transferable allowances. But they were concerned that the Government's approach might be seen as committing the Government to a particular form of tax reduction in preference to possible other social and economic priorities. Before Ministers could undertake any further commitment to an endorsement of the approach proposed by the Chancellor of the Exchequer, full information should be provided to the Group on the distribution of the benefit by income group and family type and on the impact of the change on people at different income levels and in different family circumstances. This latter analysis should be done on a basis

comparable with the analyse made of the impact of the changes in social security and of the reform of local government finance. The Group accepted that a Green Paper would need to be published at the same time as the Chancellor of the Exchequer's 1986 Budget, but the text would need to be much 'greener' than the present draft; although it would not be possible to canvas a wide range of options, the change would need to be considered on a revenue neutral basis as well as on the basis of no cash losers, and a variety of options should be considered for the length of the transitional period. It should be made absolutely clear that there was no Government commitment to complete, or even to initiate, the process of introducing transferable allowances; and the possibility should be left open that only a partial transfer would be effected (ie the process would stop at some point during the transition); at the same time it should be made clear that fiscal relaxations, whether directed towards introducing transferable allowances or to increasing public expenditure, would only be made when economic circumstances permitted, and that there was no commitment to the future form of any such relaxation. The next step would be to consider further the distributional implications of the proposed change, on the basis of a paper prepared by the Treasury in consultation with the Department of Health and Social Security and the Department of Employment.

The Group -

1. Took note, with approval, of the Prime Minister's summing up of their discussion.
2. Invited the Chancellor of the Exchequer, in consultation with the Secretary of State for Social Services and the Secretary of State for Employment, to provide material about the distributional implications of the proposed change, on the lines indicated by the Prime Minister in her summing up.
3. Noted that the Chancellor of the Exchequer would discuss separately with the Secretary of State for Social Services the draft text about the longer term relationship between the income tax and social security systems and the system of National Insurance Contributions, and would prepare a revised text for consideration by the Group.

Agenda for Further Meetings

1st Meeting

Paper by

(i) Distributional implications (including poverty and unemployment traps and alternative means of achieving same objectives)

Treasury and DHSS in consultation with Department of Employment.

(ii) Alternative approaches to achieving sex equality objectives (eg through partially transferable allowances) on different cost and/or phasing assumptions;

Treasury

(iii) Any detailed points on the proposals on other allowances, with particular reference to the implications for the social security reform;

DHSS

2nd Meeting

? longer-term issues (tax-social security integration etc)

DHSS

3rd Meeting

Consideration of revised draft and any outstanding issues.

Treasury