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P 01891

PRIME MINISTER

Green Paper on Personal Taxation

Meeting of Ministers at 4.30 pm on Wednesday, 29 January

BACKGROUND

At the meeting you held on 16 January the Chancellor of the Exchequer was asked to produce, in consultation with the Social Services and Employment Secretaries, further material on the distributional implications of his proposed reform. He was also asked to pursue bilaterally with the Social Services Secretary Part III of the proposed text about the longer term relationship between the income tax and social security and National Insurance systems; and you made it clear that, although the Group accepted that a Green Paper would need to be published with the Budget, the text would need to be much "greener" than the present draft.

Distributional Implications: Chancellor's minute of 28 January

2. The Chancellor's paper examines the distributional implications by occupational status, family type and income range, and the implications for the poverty and unemployment traps, of two options:-

(a) the "no losers" option described in the draft Green Paper, with a full year revenue cost of some £5 billion and a standard transferable allowance of £2830, representing one half of the the combined tax allowances currently available to a couple where both partners work;

(b) a revenue neutral option giving a transferable allowance of £2215 (£10 per year higher than the current single person allowance).

3. The detailed effects are displayed in the tables attached to the



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paper, and described from paragraph 8 onwards. The calculations assume implementation of the new social security reform, and that the tax changes happens in one step. A working assumption is also made in the case of the revenue neutral option that age allowance would continue at its present level, but become transferable; and that the additional personal allowance (APA) would continue at its present level.

4. The Chancellor's covering minute contrasts the gainers among all family and income types who would (by definition) result from the "no losers" option, with the 5 million or so losers (almost entirely among two earner couples) resulting under the revenue neutral option. He also stresses the more beneficial effects of the "no losers" option on the poverty and unemployment traps, on the numbers in receipt of family credit and housing benefit, and on those who both pay tax and receive income related benefits. The main features may be summarised as follows.

Effects by Family Type

5. The main effects can conveniently be summarised in the following table:-

	<u>"No losers" Option</u>	<u>Revenue Neutral Option</u>
<u>Family Type</u>		
(a) <u>husband only working</u>	Nearly 3m gain over £10 a week (2m = families with children)	Small number of losers; 2.8m gain £5-10 a week (1.9m = families with children)
(b) <u>both working</u>	<u>1.7m gainers</u> (but majority no change)	few gainers; <u>3.6m lose</u> £5-10 a week (<u>1.6m with children</u>)
(c) <u>single working taxpayer</u>	Majority gain £2-5 a week	No change
(d) pensioners	Majority (60%) do not pay tax and are unaffected. Given assumption that age allowance retained, both options show mostly gains, with some 0.75m gaining over £5 a week in each option.	



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Effects by Income Range

6. On the "no losers" basis, one-third of those with gains over £10 a week have incomes of £5-10,000, and a further 40 per cent are in the £10-15,000 income band. Over 55 per cent of those with incomes over £20,000 also gain more than £10 a week. On the revenue neutral basis, no one earning less than £5,000 loses, but there are few gains either. In the £5-10,000 income band about half would have no income change, and 20 per cent would gain more than £5 a week. As income rises, there are more losers than gainers, reflecting the fact that two earner couples form an increasing proportion of the higher income groups.

Poverty and Unemployment Traps

7. The following table shows the numbers taken out of marginal withdrawal rates of over 70 per cent and replacement ratios of over 80 per cent.

	"No loser" Option	Revenue Neutral Option
<u>Poverty Trap</u>		
Numbers taken out of marginal withdrawal rates of over 70%	240,000	100,000
<u>Unemployment Trap</u>		
Numbers taken out of replacement ratios of over 80%	250,000	100,000
<u>Numbers in receipt of benefit</u>		

8. Under the "no losers" option, the number of families entitled to Family Credit is reduced by over a quarter, and those entitled to Housing Benefit by 150,000. The numbers are much smaller for the revenue neutral option. Similarly, under the "no losers" option the numbers (about 1½ million) liable both to pay tax and receive income related benefits would be reduced by more than a half. The reduction would be about 200,000 under the revenue neutral option.



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MAIN ISSUES

9. The main issue addressed by the Group at their last meeting was whether the estimated revenue cost of one step introduction of the "no losers" option - some £5 billion - justified the objectives that it would achieve. In presenting the proposal the Chancellor appeared to put equal stress on two aspects of the reform - the distributional effects, particularly for families with low incomes and high costs; and the removal of discrimination against married women in their tax affairs and the family (with more weight being put on the distributional effects than in previous presentations of this reform). The Group were not convinced that the predicted effects justified either in social or political terms the massive preemption of resources involved; and you were also concerned at the effect an apparent £5 billion "give away" might have on the markets.

10. The analysis in the Chancellor's further paper does not entirely allay these doubts. It would, for example, be difficult to justify spending £5 billion to achieve the relatively modest effects on the poverty and unemployment traps shown in the table in paragraph 7 above (only two and a half times the improvements achieved by the revenue neutral option). Nor is it clear that, given the nature of the reform (a change in the structure of personal taxation to remove present discrimination), some losses among two earner couples would not be tolerable on the basis of a less costly option. Even on the revenue neutral option there are very few losses among pensioners, and substantial gains (and few losses) among couples where the wife is not working. Again, although the possibility was raised at the last meeting, the paper does not consider the possibility of, say, some kind of family tax allowance as a more effective means of directing help towards families, without adding to public expenditure.

11. In his covering minute, however, the Chancellor has adopted a new approach. He acknowledges (bottom of page 3) the dangers of appearing to preempt £5 billion of resources and, while strongly sticking to the "no losers" option, points out that the cost could be cut (to no



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revenue loss if necessary) by phasing in its introduction. The attachment to his covering minute shows that the speed of introduction could be varied (and if necessary halted) and that the change could be financed entirely out of the annual provision for revalorising tax allowances, with no claim on the fiscal adjustment at all (although this would result in real losses, if allowances were not adjusted). He therefore recommends that, while the reform should continue to be displayed on the basis that full transferability and no losers is the eventual aim, no decision on phasing in should be taken now, and it should be made quite clear that that judgement will be made nearer the date of introduction in the light of economic conditions at the time.

12. You will wish to take the views of the Group, and in particular the Social Services and Employment Secretaries, on whether they would be prepared to accept this new approach, or whether they still wish to advocate alternative means of achieving at least some of the Chancellor's distributional objectives. The Chancellor's proposal, with appropriate redrafting, would certainly leave the issue very much "greener" than before, and would go a long way to meet your own concern about the impact of a £5 billion "give away" and future pre-emption of resources. It would also leave genuinely open the precise pace at which the changes would be made, so that decisions could be made in the light of available resources and priorities at the time. But, however green the disclaimers, the fact is that the proposals would still create a very strong presumption that the Government were committed to the reforms on a no cash losers basis; and that its introduction as speedily as possible would have first claim on available resources. This would still be seen in contrast with the cost saving social security reform (one of Mr Fowler's main concerns) and would not make it easy to contemplate for some years any further major tax or social reform involving any substantial competing claim on resources. Very great care would also need to be taken in presenting the reform in the Green Paper on a "no losers" basis not to obscure the fact that, if it proved necessary to phase the reform over several years, using the revenue set aside for revalorisation,



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real tax losses would occur. It would be unfortunate to repeat the mistakes of the social security Green Paper by presenting incomplete or misleading information on the effects of the reform. You may therefore wish to invite the Chancellor to say something about how he would propose to display the distributional effects on the new approach in the Green Paper.

Other aspects of the Green Paper

13. Part II of the Green Paper is concerned with the implications of transferable allowances for other allowances and taxes (eg age allowance, additional personal allowance etc). The detailed discussion and proposals, as well as lengthening the Green Paper, tend to make the central reform appear "whiter" and more set in concrete than the revised approach above would warrant. Although these problems must be acknowledged, the general "greenness" of the paper would be enhanced if this part of the text were considerably shortened, or the discussion relegated to a technical Annex. The Chancellor, to whom I have mentioned this, would accept the latter, and you may wish to put the suggestion to him.

14. Part III is concerned with the tax system in the longer term (relationship between the tax and social security systems etc). I do not think you need to discuss this at this meeting. I understand that discussions on the text between Treasury and DHSS officials are making good progress, and you can revert to it at a future meeting when a full revised text is available for consideration.

NEXT STEPS

15. Subject to discussion, it may be possible to make do with one more meeting of this Group to which the Chancellor should be invited to bring a complete revise of the Green Paper. This might be towards the middle or end of next week, after which the Chancellor would need to circulate the final text for clearance to the Cabinet. I under-



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stand that the Treasury's final date for getting the text to the printers in time for publication with the Budget is 28 February, though there is no doubt a little leeway in this.

HANDLING

16. I suggest that you concentrate the discussion on Part I of the Green Paper, the basis of the Chancellor's paper, and only touch very briefly on Parts II and III as in paragraphs 13 & 14 above. You will want to ask the Chancellor of the Exchequer to introduce his paper, and the Social Services and Employment Secretaries to comment, before opening the discussion to the Group generally for wider comment.

CONCLUSIONS

17. You will wish the Group to decide:-

(i) whether the Chancellor's new approach (no cash losers but no commitment on phasing of introduction) is acceptable or whether alternative options or approaches should still be explored;

(ii) whether Part II of the draft Green Paper should be substantially reduced or relegated to a technical annex;

(iii) to invite the Chancellor to bring back a revised draft of the Green Paper for further consideration by the Group at their next meeting in a week or so's time.

J B UNWIN

28 January 1986
Cabinet Office