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PRIME MINISTER

REFORM OF PERSONAL TAXATION

At our last meeting I was asked to prepare material on the distributional effects of the proposed reform of Personal Taxation. The attached paper, which has been agreed at official level with DHSS and Department of Employment, analyses, as requested, the effect of moving to transferable allowances on both a revenue neutral and a no cash losers basis.

As the paper shows, the revenue neutral option has major disadvantages:-

- While 3.7 million working couples, 2.6 million of them with children, would gain, there would be 5.2 million losers, mainly among two-earner couples.
- Hardly anyone earning less than £100 a week would gain. While half of those in the £100-£200 a week income range would have no change in income, 20 per cent would gain just over £5 a week. Those earning above £200 a week would lose on average, with the loss increasing with income.
- The effects on both the poverty and unemployment traps would be very small, providing little offset to the increased numbers of those who will be brought into high marginal rates as a result of the social security changes.



Perhaps more important, the assumption of revenue neutrality would be taken as a signal that we had implicitly abandoned our objective of reducing the overall burden of income tax.

The whole object of the Green Paper is to suggest how any scope for income tax reduction, as and when it arises, might sensibly be used. The question of introducing it on a revenue neutral basis would not, in practice, arise: if, contrary to our published hopes and intentions (see the Green Paper "The Next Ten Years: Public Expenditure and Taxation into the 1990s" - Cmnd 9189) we found ourselves unable to reduce income tax in the 1990s, then the proposed reform would simply have to be shelved. Thus public presentation on a revenue-neutral basis would be doubly mistaken: first, it would imply a retreat from our declared objectives amounting to a tacit admission of likely failure on the fiscal front (including, crucially, over the control of public expenditure) and, second, it would imply a readiness to introduce a reform in circumstances in which we would not in fact do so.

If, by contrast, we were to display the proposed reform on a no-cash-losers basis, then the following distributional consequences would emerge:

- By definition there would be no losers. 12½ million working families would be gainers, while the remaining 4 million have no change in their net income. Among pensioners, 2¼ million taxpayers would gain, and the remaining 3½ million would have no change in their net income.
- The most substantial gains would be among couples where the wife is not working, most of them with children. But nearly 7 million working single people (half of them under 25) would gain more than £2 a week.



- The biggest proportionate gains are among those with below average earnings.
- The numbers in the unemployment trap would fall substantially - by 250,000, for those with replacement ratios of more than 80 per cent. The number of families in the poverty trap would also fall - by almost a half for those with marginal rates of more than 80 per cent.
- The reduction in the numbers affected by high marginal rates broadly offsets the increase due to the social security changes. So the Green Paper proposals and the Social Security White Paper could be presented as a coherent package.
- The changes would make the low paid less dependent on the State. Those in receipt of Family Credit would be reduced by a quarter, and the numbers entitled to Housing Benefit would also fall.
- After the White Paper social security changes, about 1½ million people will both pay tax and receive income-related benefits. Transferable allowances on a no loser basis would reduce this number by more than half.

Nevertheless, I accept that the presentation of this in the Green Paper as presently drafted is unsatisfactory. It could be held to pre-empt £5 billion of resources, which was not the intention and would clearly be unacceptable if it were; it might call into question our reputation for fiscal prudence, something we cannot allow.



The right answer to this difficulty is, I believe, to illustrate the possibilities of phasing the introduction of the scheme, while making it clear that full transferability on a no losers basis is our eventual aim. As the attached annex illustrates, phasing can in principle cut the cost to any figure we choose. The change could even be financed entirely out of the annual provision for indexing allowances (in which case there would be no claim on the fiscal adjustment at all).

There is no need to take a decision now to phase in transferable allowances over a particular period. Indeed, it would be wrong to do so. That judgement can be made much nearer the date of introduction in the light of economic conditions, the room for manoeuvre and competing claims at the time. And we can also review the speed of the introduction of the new system as we go along. If necessary, the transition could stop before full transferability was achieved.

Conclusion

The no losers option would achieve, at a pace we can decide later in the light of circumstance at the time, the main objectives of reform:

- A well-targetted increase in tax thresholds, especially for those families with low incomes and high costs.
- A major improvement in the poverty and unemployment traps.
- The opportunity for married women to have the same privacy and independence in tax matters as their husbands.



- The removal of discrimination against the family and marriage.

I fully accept the need to make it absolutely clear that there is no Government commitment to provide resources on any given scale over a particular period of time. But I think this point can be most effectively made by demonstrating the scope for phasing, while underlining the possibility that the transition to full transferability can be arrested for as long as we choose at any stage. This approach would allow us to present our objectives for reforming the structure of personal taxation in a positive light, without appearing to make promises that no Government can guarantee to keep.

I am copying this to Willie Whitelaw, Norman Fowler, Norman Tebbit, David Young, John Wakeham and John Moore.

N. L.

N.L.

28 January 1986

*(approved by the Chancellor
signed in his absence)*