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REFORM OF PERSONAL TAXATION

Note of a further meeting
at 10 Downing Street on
Wednesday 29 January 1986
at 4:30pm

PRESENT

Rt Hon Margaret Thatcher
Prime Minister

Rt Hon Viscount Whitelaw
Lord President of the
Council.

Rt Hon Nigel Lawson MP
Chancellor of the Exchequer.

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

Rt Hon Lord Young of Gratham
Secretary of State for
Employment.

Rt Hon John Wakeham MP
Parliamentary Secretary,
H M Treasury.

Rt Hon John Moore, MP
Financial Secretary,
H M Treasury.

Mr Anthony 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 minute of 28 January from the Chancellor of the Exchequer to the Prime Minister, to which was attached a note about methods of phasing in transferable allowances and a paper analysing the impact of the introduction of transferable allowances on a no cash losers basis, as described in the draft Green Paper, and on a revenue neutral basis.

2. The Chancellor of the Exchequer said that he was discussing separately with the Secretary of State for Social Services



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Part III of the draft Green Paper about the longer term relationship between the income tax and social security systems and the system of national insurance contributions, and would provide a revised text for consideration by the Group in due course. He suggested that the present meeting should concentrate on the economic and distributional effects of the introduction of transferable allowances.

3. He remained convinced that the distributional effects of the change to transferable allowances should be illustrated on the 'no cash losers' basis. Because of the large number of substantial gainers and losers, no Conservative Chancellor of the Exchequer would ever wish to make the change on a revenue neutral basis. To propose the change on such a basis would be seen as admitting that the Government were unlikely to have room in the medium and longer term for real reductions in the burden of taxes; in other words, this would amount to a forecast of failure in the Government's objective to keep the growth of public expenditure below that of the Gross Domestic Product. There were both genuine and presentational problems of cost; these could best be overcome by making clear that the phasing-in period could be as long as economic circumstances required, and by giving the Government some freedom of manoeuvre in determining whether the restructuring of allowances was to be in addition to or in substitution for normal inflation-proofing increases. In practice most taxpayers would see an increase in their cash thresholds each year during the phasing-in period, so there need be no cash losers whichever choice the Government made. The advantage of introducing transferable allowances on the no cash losers basis, rather than on the revenue neutral basis was that the change could be shown to be much more effective in giving the largest proportionate gains to the lowest paid and in reducing - by a half - the overlap between liability to tax and eligibility for benefit. The price of the social security changes now being implemented, which achieved substantial reductions in the marginal tax rates faced by people in the poverty and unemployment traps (achieved by determining entitlement to benefit on the basis of income net rather than gross of tax), was a substantial increase in



the number of people covered by the tax/benefit overlap; the introduction of transferable allowances would helpfully complement the social security changes by reversing this undesirable side effect. Responses to the latest Conservative Political Centre contact brief showed a substantial measure of support for the principle of transferable allowances; their presentation on the basis of an extended phase-in period, and without any prior Government commitment to any step in the phase-in process, should overcome any difficulty in the financial markets.

4. In discussion the following main points were made.

(a) Possible future simplifications of the personal tax system - self-assessment, non-cumulation within a financial year, etc - were separate issues not directly related to the introduction of transferable allowances. The computer system should be flexible enough to cope with adjustments to cumulative tax payments by husbands and wives as their incomes fluctuated within each financial year.

(b) Preparation would be needed, both in terms of legislation - to enable Inland Revenue to secure all the new information they needed, and to adapt the present provisions relating to the indexation of allowances - and in terms of the development of flexible computer systems, before any steps could be taken to begin the process of introducing transferable allowances. Depending on the response to the Green Paper, the necessary legislation could be included in the 1987 or 1988 Finance Bills.

(c) Transferable allowances as put forward by the Chancellor of the Exchequer would have a substantial beneficial impact on incentives to work in the cases of single earner families. Such families would receive a substantial increase in their post-tax incomes, and couples would no longer face the indefensible situation where their average tax rate increased when the wife gave up work. On the other hand, there would inevitably



be complaints that married women restarting work would immediately face a marginal tax rate of 30 per cent or more (depending on their liability to pay national insurance contributions) on their first £ Sterling of income.

(d) Because relatively more of the advantage of tax allowances would be enjoyed by single earner households, any given real increases in tax thresholds once the change had been made would be more effective than at present in floating families out of the poverty trap.

(e) The basic inequity in the present personal tax system was the fact that working wives in effect received a single person's allowance while their husbands received the preferential marriage allowance. This produced the absurd situation that the family could face widely differing tax rates depending on the distribution of some total earned income as between the husband and the wife. This inequity, coupled with the aggregation of unearned income, was impossible to defend; under present arrangements married women were deprived of independence in their own financial affairs, and at the same time given an undesirable and unnecessary incentive to go out to work.

(f) To the extent that the objective of the change was to improve the relative position of families with children, the introduction of some kind of Family Tax Allowance could be a much more effective way of concentrating the benefit on the target group for any given Exchequer cost. Even if this possibility were not discussed in detail in the Green Paper, some mention should be made of it, and it should not be altogether dismissed.

(g) More work was needed to ensure that the presentation of the change in the structure of personal tax allowances was not inconsistent with that of the changes in social security benefits currently before Parliament. In the case of social



security benefits, the Government had given illustrative figures in both cash and real terms, showing substantial numbers of losers in each case. This presentation in effect abstracted from normal price-indexation arrangements, and showed how benefit entitlements would change in real terms. To the extent that transferable allowances were introduced in substitution for normal indexation adjustments, there would be real losers as there were in the case of the social security changes; if transferable allowances were financed entirely out of the provision which would otherwise have been allocated to price-indexation, and there were no aggregate real reductions in taxation, the overall effect in real terms, and the impact on numbers in the poverty trap, would be exactly as set out in the revenue neutral case, even though there would be no cash losers. Conversely, the change would only have the impact on numbers in the poverty trap shown in the no cash losers case if it were actually made on a no real losers basis, given that entitlement to social security benefits would be uprated in line with inflation.

5. THE PRIME MINISTER, summing up the discussion, said that the Group endorsed the Chancellor of the Exchequer's intention, in presenting the possible change to a system of transferable allowances, to avoid any Government commitment on either the extent or the timing of the change; although it had major attractions, and would remove the serious inequities which disfigured the present system, it would not be appropriate to decide now that implementation of the change should necessarily have first claim on any room there might be for real reductions in the burden of personal taxation in the years after 1990. But the Group remained concerned about the presentation of the economic and distributional effects of the change; that presentation had to be reconcilable with the presentation of the social security changes the Government were now implementing, and had to avoid disturbing financial markets by holding out the prospect of tax reductions regardless of the conjunctural situation. On the other hand, to the extent that the case for a change was made by showing distributional effects



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under which there were no losers, the full benefit of these effects could only be claimed if the change were made on a no real losers basis. Great care would be needed in the presentation to avoid accusations of inconsistency. The Chancellor of the Exchequer and the Secretary of State for Social Services should therefore reconsider the presentation of the change to transferable allowances in the light of the discussion, having regard also to the position taken by the Government in presenting the distributional effects of the current social security changes.

6. 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, to reconsider the presentation of the economic and distributional effects of the change to transferable allowances, in accordance with the Prime Minister's summing up of the discussion.
3. Noted that the Chancellor of the Exchequer would submit a revised text of the complete Green Paper, taking into account the points made at the Group's first two meetings, for consideration by the Group in mid-February 1986.