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Prime Minister ²

sent over (surprise,
surprise) by the Chancellor's
office. But with a plan.

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CEB
THE BOARD ROOM
INLAND REVENUE
SOMERSET HOUSE

FROM: A J G ISAAC

DATE: 6 FEBRUARY 1986

CHANCELLOR OF THE EXCHEQUER

MEETING WITH MR FOWLER: THE PROWSE ARTICLE

pa with
pro on
personal
taxation.

attached 1. You have asked for quick comments on the article by
Michael Prowse in today's Financial Times.

General

2. In general, the line of criticism is familiar - from
earlier articles by the Institute for Fiscal Studies, the
Equal Opportunities Commission and the European Commission.

The pragmatists

4. Mr Prowse christens his first line of attack "pragmatic".
Can we not remove the "sexist" element in the present
legislation, without producing so many losers?

5. Certainly, it would be possible to make cosmetic changes,
cleaning up the language in the Taxes Acts, without making

cc Chief Secretary
Financial Secretary
Minister of State
Economic Secretary
Sir P Middleton
Mr Cassell
Mr Byatt
Mr Monger
Mr G P Smith
Mr Cropper
Mr Scholar

Sir Lawrence Airey
Mr Isaac
Mr Lewis
Mr Painter
Mr Mace
Mr Pinder
Mr Eason
Mr Hudson
PS/IR

a substantive change in the tax liabilities. This was an option floated in Sir Geoffrey Howe's Green Paper on taxation of husband and wife. Virtually everyone* who responded (though they differed on what was the right solution) agreed that this would be a waste of time.

6. Any substantive reform has to tackle the married man's allowance, and its consequence that the two-earner couple get more than the equivalent of two single allowances. Any reform therefore must either cost money or produce losers.

Arguments of principle

7. Mr Prowse then goes on to argue that a system of mandatory separate taxation (MST), combined with increased cash benefits for children and others, would provide a better tax regime than transferable allowances. He develops four main arguments:

- value for money
- effect on low incomes
- effect on incentives
- the treatment of marriage.

Value for money

8. This is the familiar argument that the Chancellor would be "throwing away money" by giving tax relief for "idle wives": the rich stockbroker's wife who chooses to stay at home for coffee mornings and golf. It would be better - and more consistent with Mr Fowler's approach - to target relief by confining cash benefits to those with children etc.

9. The main reply to this is given by the important Chart 2.5 in the draft Green Paper (copy attached). This shows:

*from the Conservative WNAC through to the TUC and EOC.

- Certainly, looking after children accounts for the largest number of women not working - 63 per cent.
- But there are another 12 per cent who are permanently unable to work, looking after relatives, etc.
- And a further 12 per cent who are now over 50, whom no-one would reasonably expect to enter the labour market for the first time, or after a long absence (for example, Mr Fowler's own White Paper recognises that the widow's pension should be paid to someone who is widowed over 45, or has drawn widowed mother's allowance until she is over 45).

10. Thus, there are only 12 per cent of wives under 50, not working or caring for children etc, or not disabled. So, if you are not going to penalise the "deserving" cases at paragraph 9 above, there is no enormous pot of gold to redistribute to families with children. And some would say that there are "deserving" cases even in this final 12 per cent. For example, suppose that a girl is married to a coal miner working in the Valleys. There is precious little work for women at home. If she was single, she could leave Wales and look for work elsewhere. But do we expect her to leave her husband in Wales? Or him to leave his job?

11. Underlying all this is the question whether it is any business of Government - or civil servants - to decide which wives are "deserving" and which wives are "idle".

12. Finally, there would be technical or administrative problems under MST in stopping income splitting between married couples (so as in effect to transfer income between each other, rather than allowances).

Effect on low income families

13. Mr Prowse says, correctly, that ^x increases in tax thresholds will do relatively little to raise the net income

x if people claim the benefit to which they are entitled (which some do not).

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of poor families in the post-Fowler world, where family credit etc are calculated by reference to net income after tax.

14. This is the familiar argument of poverty versus the poverty trap. Even on a revenue neutral basis, transferable allowances would take 100,000 people out of the poverty trap; on a "no losers" basis, they would take 200,000 people out of the trap.

15. By contrast, in the post-Fowler world, increases in child benefit would (as now) add to the net income of poor families but would not help with the poverty trap.

16. On a revenue neutral basis, the Prowse approach (mandatory separate taxation) would reduce the tax threshold for some 10 million married men of working age by some £1,250 a year. This would bring an additional ½ million families into tax for the first time - most of these in the poverty trap.

17. There would be similar unhappy consequences for the elderly - with no cheap and easy way of compensating them.

Incentives

18. This is the familiar argument that transferable allowances would be a disincentive for married women seeking work.

19. Certainly, the change would remove the present special incentive for married women to go out to work. Virtually everyone who responded to the Green Paper agreed that there was no justification for the present arrangements - which are more generous to a 2-earner couple than those in any other country.

20. You will already be very familiar with the argument here.

Treatment of marriage

21. The final familiar argument is that it is wrong in principle for the tax system to recognise marriage. We do not propose to give transferable allowances between brother and sister. So why give transferable allowances between husband and wife?

22. It seems to me that there are three main answers to this line of argument.

23. First, the Government believes in marriage.

24. Second, the argument breaks down when you try to apply it in the real world, and to the capital taxes. For example, it would be absurd to impose capital transfer tax if the ownership of the family home is transferred from the husband's name to the couple jointly. The tax system cannot completely ignore the fact that marriage exists and affects how people behave. And the old Estate Duty regime showed how much injustice and hardship resulted, when tax was imposed on the widow who wished to go on living in her old family home.

25. Finally, ~~for these reasons~~, no tax system in the civilised world adopts Mr Prowse's approach of mandatory separate taxation or tries to pretend that marriage does not exist.

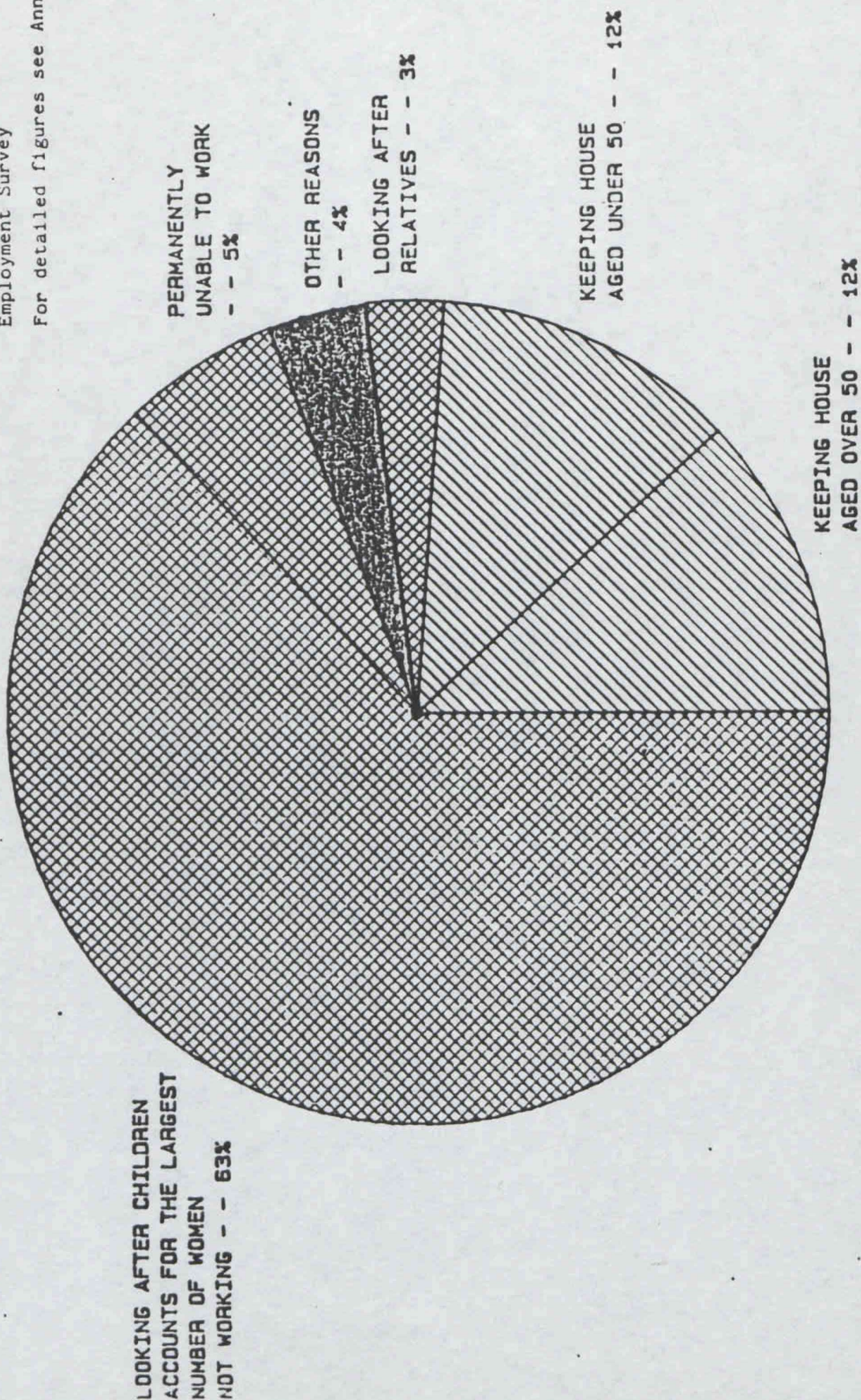
C.L.C.A.

A J G ISAAC

CHART 2.5 : REASONS GIVEN BY MARRIED WOMEN FOR BEING
ECONOMICALLY INACTIVE

Source: DE/OPCS 1980 Women and
Employment Survey

For detailed figures see Annexe 6, Table



IT LOOKS as though Mr Nigel Lawson—through his personal tax reforms—may be about to do a Kenneth Baker. Emulating the Environment Secretary, the British Chancellor is shortly to issue a discussion paper containing plans so contentious and implausible as to render even the implementation improbable.

Mr Baker's implausible scheme involves turning the fiscal clock back several centuries and replacing domestic rates with a poll tax—the sort of feudal levy Henry VIII might have approved.

Mr Lawson believes passionately that tax allowances should be transferable between marriage partners. The tax system, he told the Conservative Party conference last autumn, is "disfigured" because wives who stay in the home cannot transfer their allowances to their husbands.

The scheme for transferable allowances is to be set out in detail in a long-delayed green paper now expected on March 18th (Budget day). The main elements were laid out in last year's Budget address.

This said that every adult would get the same standard tax allowance irrespective of sex or marital status. Husbands and wives would be taxed separately on earned and (more surprising) investment income. But if either was unable to make full use of his or her allowance, the unused portion could be transferred to the other.

Absurdities

At first sight, this may sound an admirable scheme. It would, after all, eliminate absurdities in the present matrimonial tax regime which dates from Napoleonic days. The symmetrical treatment of husband and wife would replace today's blatant sex discrimination: under existing law, a wife's income is regarded for tax purposes as her husband's; he is legally responsible for the joint return.

A standard allowance for all adults would also sound a long-overdue death knell for the bloated married man's allowance (MMA). Just by walking up the aisle, a man can qualify for an allowance that is almost 1.6 times the single allowance—in 1985-86, £3,455 against £2,205.

Under present rules, married couples fall into three arbitrary categories. In the traditional family, where only the husband works, a couple gets only the MMA. If both spouses work, the couple gets 2.6 times the single allowance—the MMA plus the wife's earned income allowance (technically a concession granted to the husband).

Oddest of all, in a "role reversal" family where only the wife works outside the home, the couple still receives 2.6 times the single allowance. Since the wife's earnings belong to the husband for tax purposes, the MMA and the wife's allowance are available as offsets.

Mr Lawson's proposed reform would simplify things. Every married couple, courtesy of transferability, would qualify for the equivalent of two single allowances. It would be immaterial for tax purposes whether one or both spouses worked. The sex of a lone breadwinner would not matter. Two adults, simply by virtue of marriage, would never be able to qualify for more than the overall allowance of two single, working adults.

Mr Lawson is paddling towards the wrong rapids

Michael Prowse raises some practical and philosophical objections to next month's green paper on personal tax reforms

Ashley Ashwood



Almost everybody agrees the existing regime of household taxation is begging for reform. The debate has raged for more than a decade. Sir Geoffrey Howe, Mr Lawson's predecessor, produced an agonised, inconclusive green paper in 1980. The difficulty is that people do not agree what should be done. There is no sign of a consensus behind the Lawson plan.

The Chancellor is likely to come under fire from two directions—from those with pragmatic and those with philosophical objections.

The pragmatists will say: "By all means eliminate sex discrimination from the code but don't risk your neck with anything more ambitious. Give husbands and wives dual responsibility for the couple's tax affairs, rename the MMA the married couple's allowance but don't contemplate a reform that would result in a radical redistribution of income. The last thing we want are millions of disgruntled losers."

The scale of potential gainers and losers is alarming. Note first that the reform could not be phased in on a "revenue-neutral" basis—so that the Exchequer did not lose money. Revenue neutrality would imply a standard transferable allowance of £2,400. Married couples who both earned would then lose £250 a year; single earner couples, £350.

Reform could be contemplated only, as Mr Lawson has conceded, on the basis of "no cash losers." This would mean closing the yawning £1,250 gap between the MMA and the single allowance by raising the latter. The cheapest option would be to freeze the MMA in money terms, so that inflation ate away its real value, while simultaneously over-indexing the single allowance.

The goal might be a standard

allowance of £2,880—roughly midway between the present MMA and single allowance. Inflation at 5 per cent a year would whittle the MMA down to this level in four years. The single allowance would have to be raised by 30 per cent over the same period, or by 7 per cent a year, which would be roughly in line with expected

phasing, there would be no way of obscuring the fact that two-earner married couples would lose steadily and substantially: their 2.6 allowances would dwindle to only 2.

What of the philosophical objections? The political storm of the transition would be worth weathering only for a very attractive destination. Yet

Almost everybody agrees the existing, dotty regime of household taxation is begging for reform. The difficulty is that people do not agree what should be done.

growth.

The cost of the exercise would be some £3bn-£4bn; reform would thus preempt a large slice of future tax cuts. But could any Chancellor survive a four-year transition during which some tax payers gained so much at the expense of others?

The process would be further complicated by the need either to phase in the transferability of allowances or gradually to raise the single-earner couple's allowance. Otherwise, at the end of the transition, such couples would suddenly enjoy a windfall—two single allowances in place of only 1.6.

But however ingenious the

a whole raft of tax experts, pressure groups and official bodies (including the European Commission, a House of Lords Select Committee, the Equal Opportunities Commission, the Child Poverty Action Group and many others) believe Mr Lawson's goal is misconceived. He is paddling towards the wrong rapids: he has overlooked a simpler, cheaper and fairer alternative.

This alternative is known as "individual, independent taxation" (IIT). The idea is that every adult should be taxed separately and should have the same standard tax allowance. As under the Lawson plan, the

MMA would have to be phased out. The big difference is that the standard allowance would not be transferable in any circumstances.

The central charge against the Chancellor's scheme is that it is wasteful and arbitrary. Every married man, regardless of circumstances, would have potential access to two standard tax allowances. What is the rationale for this?

Mr Lawson says it would end "discrimination" against the family with young children where the wife has to stay at home. Perhaps. But it would do so in a grossly inefficient way: every single-earner married couple would gain—not just those with special needs.

Much of the revenue raised by scrapping the MMA would be thrown away in quite unjustifiable tax concessions. The Chancellor would, for example, be granting extra tax allowances to childless stockbrokers whose wives stay at home because they enjoy coffee mornings and tennis.

By contrast, the IIT approach is more austere and logical. It is neutral towards the institution of marriage: a spouse who stays at home is treated like anybody else outside the labour market; he or she does not get an allowance to set against somebody else's income. All single-earner couples would receive just a single tax allowance.

But IIT is quite consistent with the sensible dictum that the tax and social security system should respond to need. If a couple has children or other dependants (and demographic trends means the number of households supporting the elderly will rise sharply), it deserves assistance. But this need is quite independent of marital status: all households

with dependants need special help, not only married couples. Under the IIT alternative, all the money raised by phasing out the MMA (and more if the Chancellor were generous) would be available to meet need wherever it occurred. Unlike the Lawson plan, it would be consistent with the Fowler doctrine that relief should be carefully targeted. It would be possible, for example, to finance a substantial increase in benefits for children and for disability.

A supposed advantage of transferable allowances is that they alleviate the poverty trap—a description of the way poor families lose most, if not all, of a rise in income through high taxes and lower benefits. The force of this argument (weak anyway because the trap affects less than 2 per cent of taxpayers and so cannot justify changes affecting every household) has been much reduced by Mr Norman Fowler's social security reforms. Transferability would give the single earner households that dominate the trap a bigger overall allowance but this might leave them little better off.

Under the new social security rules, benefits are based on net income. This means that a higher total allowance due to transferability will be less effective in reducing poverty. As Mr Andrew Dilnot at the Institute for Fiscal Studies has pointed out, if higher allowances result in a £1 increase in net income, many poverty trap families will end up only 5p better off (under the new rules, withdrawal of family credit disposes of 70p; withdrawal of housing benefit absorbs 24p of what is left).

The Lawson plan has other disadvantages. A wife's allowance would be available to a family whether or not she worked. Thus if she did work, the family's extra earnings would be taxed at 30 per cent from the first penny. Many women might regard this as a new and considerable disincentive to seek paid employment. The Treasury is thought to like this implication because it might slow growth of the labour force and improve the unemployment figures. The Prime Minister, however, is said to have taken a dim view of this tax on female enterprise.

Vulnerable

The Chancellor's scheme is vulnerable to criticism even from those who favour transferability. It does not show much respect for the individual that the privilege is granted to married partners only. There are many other stable household types. Why, for example, should a brother living with his sister not be able to exploit her tax allowance if it is unused? In Mr Lawson's world, this couple would deserve only half of the tax allowance of a single-earner married couple. Why?

At bottom, the Chancellor's plans look like straightforward fiscal discrimination in favour of marriage. The traditional male breadwinner household, which stand to get two instead of 1.6 allowances could be forgiven for believing that Mr Lawson's intention is to enhance rather than abolish the MMA.

Like Mr Baker, the Chancellor looks set to issue proposals that are politically controversial yet lack much economic merit. Why not accept that the tax system should be kept as simple as possible through the adoption of IIT, and the social security system fashioned to cope efficiently with need wherever it occurs?