

SECRET

hie

DG2AWB



bc BG #
5

10 DOWNING STREET

From the Private Secretary

19 February 1986

INCOME TAX: RATES VERSUS THRESHOLDS

The Prime Minister has seen and noted the Chancellor's minute of 18 February. This was touched on at the bilateral today, and the Chancellor pointed to the help which had been given to people at the top and bottom of the income distribution. The Prime Minister offered no comment.

David Norgrove

mg

Mrs. Rachel Lomax,
H.M. Treasury.

SECRET



4

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

INCOME TAX: RATES VERSUS THRESHOLDS

I thought you put up an excellent show on Panorama last night. But it is unfortunate that your remarks on taxation have been misinterpreted by some in the press as indicating your support for channelling any available scope for tax reductions into raising tax thresholds rather than reducing the basic rate of tax. We have discussed this before and, as you know, my own view is that the case for raising thresholds has been considerably over sold. Indeed I see a strong case for making a reduction in the basic rate our next priority, as and when we can prudently afford to reduce the burden of income tax.

Press comment has gone well beyond what you actually said. You pointed out that the Government had done pretty well by the people in the top half of the income distribution, and it was right to reward success, adding "but I don't think the Government should take money for the top half due to the bottom half. I feel that we owe quite a debt to people in the bottom half. We have taken in my view too high a proportion of their income in tax."

In practice, of course, we have done a great deal for those right at the bottom of the income scale, as well as for those at the very top. Tax thresholds have been raised by 20 per cent in real terms since 1979. In the 1985 Budget we introduced reduced National Insurance contribution rates for the lowest paid so that the combined marginal rate for those earning less than £60 a week is now 35 per cent and, for those earning less than £100 a week, 37 per cent, rather than the full 39 per cent that applies to those around average earnings.



The true picture is that while we have done a great deal for those both at the top and the bottom, we have not done enough for those in the middle; the burden of tax and National Insurance contributions for those on average earnings is still higher than it was in 1978-79 (29 per cent as against 27.8 per cent). This affects very large numbers of people, including the unmarried nurse you quoted on £140 a week who still pays £40 a week in tax.

In fact, even in static terms, the nurse would be helped more by a reduction in the basic rate than an increase in tax allowances costing the same amount. The same would be true of any single person or working wife earning more than about £120 a week; the equivalent "crossover point" for a married man is also below average earnings at about £180 a week.

But it is not the static position that matters most. What is of critical importance to incentives is the marginal rate of tax. Again, this is something we have reduced significantly both for those at the top - through changes in the higher rates - and at the bottom - through taking some people out of tax altogether and by introducing reduced rates of employee NICs. For the great majority in the middle, however, there has been little change. The combined marginal rate when we took office was $39\frac{1}{2}$ per cent (33 per cent income tax plus $6\frac{1}{2}$ per cent employees NICs); today - nearly 7 years later - it is still 39 per cent (30 per cent income tax plus 9 per cent employee NICs).

It seems clear to me therefore that our top priority must be to reduce the basic rate of tax, as and when we have the scope to afford it - which is not of course this year. As a result of what we have done so far, our tax thresholds, as a per cent of average earnings, are not low by international standards - they are close to the international average, and actually



higher than in Germany and the US. It is interesting that President Reagan believes that thresholds should not be set too high, so as to give as many people as possible an interest in lower marginal tax rates. That is why he has concentrated his tax reform proposals on reducing tax rates. Much the same reasoning led us to argue that everyone should make some contribution to local taxation.

What is unusual about the UK tax system is our initial rate of tax, which is among the highest in the OECD; our rate of 30 per cent compares with 22 per cent in West Germany, 15 per cent in Japan, and only 11 per cent in the US. And, under our present system, the starting rate can only be reduced by lowering the basic rate of tax.

While there is of course merit in raising tax thresholds, the case for doing so has been greatly exaggerated and a sense of proportion is badly needed. As David Howell recently pointed out, only a minority of those taken out of tax by threshold increases are "needy"; about 20 per cent are married men, and the remainder are juveniles, pensioners and working wives. Norman Fowler's Social Security reforms will further weaken the case for raising thresholds as a way of improving incentives for the lowest paid. Once means tested benefits are calculated on a net income basis, tax reductions will be offset in part by reduction in benefits. This will be equally true of cuts in tax rates and increases in allowances. What this means is that the choice between rates and thresholds should turn on their effect on the majority, not on those at the bottom of the income scale, who will be helped by the Social Security reforms.

I appreciate that some people are concerned that reductions in the basic rate of tax would give disproportionate benefits to the rich. But that does not follow at all. The tax burden on



the rich is largely determined by the structure of higher rates. This, if we see fit, can always be changed independently of any change in the basic rate to limit the gains to those at the top.

All in all, I believe we have reached a point where we have already done a great deal of what needed to be done on thresholds. Our next priority should be to reduce the basic rate. Once we have made a significant reduction there, it will be time to look again at thresholds.

If you agree with this, it is important that we start to alter the climate of opinion in this direction. As I said earlier, this might be best achieved by pointing out how much we have done not merely for those at the top, but also for those at the bottom - and also perhaps by stressing the importance of marginal rates of tax. A cut in the basic rate would reduce marginal rates for 14 million working taxpayers - 95 per cent of the total. The basic rate is also the marginal rate for the vast majority of unincorporated businesses and for the self employed. And while incorporated businesses have seen corporation tax on their profits reduced from 52 per cent to 35 per cent (and 30 per cent for small companies) unincorporated businesses have had no reduction at all in their marginal tax rate on profits since the 1979 Budget. At the least, we must make it clear that the Government's aim is to make progress on both fronts as and when we prudently can - both by raising thresholds, and by cutting the basic rate.

N.L.

18 February 1986