

CONFIDENTIAL

Ref. A086/672

PRIME MINISTER

Green Paper on Personal Taxation

FLAG A C(86)7

BACKGROUND

The Chancellor of the Exchequer announced in last year's budget statement his intention to issue a Green Paper "later this year" on the reform of personal income tax. He made it clear that the Green Paper would favour a system of transferable allowances (TA) between husband and wife; and that it would also discuss a range of further options that would be available by 1989, when the computerisation of PAYE had been completed, such as non-cumulation and closer integration between the tax and benefit systems. There is therefore wide anticipation of the contents of the Green Paper, which the Chancellor of the Exchequer proposes should be published with the Budget.

2. Part I of the draft discusses the case for a reform in personal allowances, and how a TA system might work; Part II discusses the more detailed implications for other allowances and taxes; and Part III discusses the tax system in the longer term, with particular reference to the relationship between taxes and benefits and the case for closer integration of national insurance contributions and income tax. The present draft has been settled following discussion in three meetings of an ad hoc Group of Ministers under your chairmanship. At those meetings a good deal of disquiet was expressed at:-

- the effect on the markets of an apparent commitment to a £5 billion "give away" in the early 1990s, which could preempt the scope for other fiscal changes for several years;
- the contrast between the Chancellor's "no loser" proposals, and the social security reform (with some 2.5 million cash losers), which could make the task of getting the current

CONFIDENTIAL

social security Bill through the House more difficult;

- doubts as to the political appeal of the reform in view of its treatment of professional women as opposed to non-working wives, and the disincentive to the latter to resume work.

3. As a result, extensive changes have been made to the original draft to meet these points. In particular:-

- the draft is now very much greener. It is made clear that the reform would only be introduced as and when resources permitted, and that if necessary it could be phased in over a number of years (eg to ensure that no revenue loss occurred beyond what would have been required for statutory revalorisation of personal allowances). The Group also agreed that there could be no question of legislation before the next election;
- the presentation of the distributional effects (in the tables attached to Annex 4) is now consistent with the social security presentation. There are two sets of tables: the first shows the effects of introducing the change in one year on a no cash losers basis (on this assumption the real effects would be the same as the cash effects); the second shows the real effects of phasing in the change over a period long enough to ensure that there was no loss of revenue beyond what would have been required for indexation of allowances. The text makes it clear, however, that the second presentation is "an extreme one" and that a move to TA should be seen as part of the process of tax reduction, in line with the Government's declared objective of reducing the total burden of taxation.

MAIN ISSUES

4. Given the endorsement of the text by your Group, and the improve-

CONFIDENTIAL

ments to its contents and presentation, it should not be necessary (subject to the point at (iii) below) to discuss the draft at length in Cabinet. Discussion might, however, focus on some of the following issues:-

(i) Extent of Commitment: The potential cost of this reform, depending on a number of factors such as inflation, the basic income tax rate, and the phasing in period, is considerable. The table in chapter 3.7, for example, shows that a two year transition at 2.5 per cent inflation could cost some £4 billion at 1985-86 prices. Some Ministers may be reluctant to allow the Chancellor to pre-empt amounts of this kind for a tax reform that is unlikely to be universally popular - the more so in view of the pressures on their own expenditure programmes. If such arguments are mounted, it will be necessary to reinforce the point that publication of the Green Paper does not imply any Government commitment either on substance or timing; and that, more specifically, it is not the intention to legislate before the next election. You may also wish to remind the Cabinet of the Government's commitment to reducing the burden of income tax, of which public expenditure restraint must remain a prior condition;

(ii) Political Appeal: it may also be argued that there is likely to be little political advantage in the reform. The changes will be unpopular with those who consider themselves disadvantaged (eg professional women and wives wishing to resume work), whereas no credit will be gained from those who can expect to be better off. It would therefore be unwise to move into the next election with such an implied commitment, however green, round the Government's neck. Against this it can be argued that the present personal allowances system is widely agreed to be indefensible and unfair; and that there is likely to be considerable support for arrangements that respect privacy as between husband and wife, are better attuned to the life cycle of families, and would make


CONFIDENTIAL

future increases in allowances more cost effective in terms of taking people out of the poverty and unemployment traps. Given the widespread expectations, not to publish the Green Paper would also be difficult to explain;

(iii) Distributional Implications and effects on Families:

Although the reform is primarily justified as an overdue structural change in the tax system, the Chancellor also claims substantial social and distributional advantages for it. For example, depending on the duration of the phasing, it will take substantial numbers out of the poverty and unemployment traps; reduce the number of families entitled to Family Credit and Housing Benefit and of those liable both to pay tax and receive social security benefits; and concentrate the gains on families with only one spouse working (both with and without children). It may be argued, however, that, such objectives could be achieved more cost-effectively by more specific "targetting" on the relevant groups, particularly families, whether through the tax or the social security systems. This has been the burden of the Social Services Secretary's criticism of the proposal, and I understand that he proposes to repeat his views in a further minute to you (with limited circulation) this evening. This is likely to renew the proposal for a Family Tax Allowance (FTA) which would still be consistent with the main structural reform. Compared to the Chancellor's TA system, an FTA of £750 would concentrate the benefits on families with children (some 1.4 million more families with children would gain) and have a larger impact on the poverty and unemployment traps and on the numbers caught in both the tax and benefits net. It would thus reinforce the Government's policy towards families and perhaps help to mitigate some of the criticism of the recent child benefit uprating. On the other hand, there would be corresponding losers - some 2.5 million (though mostly less than £2 a week) among childless couples where both partners are working; and it would add a fresh complication to the

CONFIDENTIAL

CONFIDENTIAL

tax system at a time when the Government's aim is to simplify it. It might also be criticised as reversing the policy that support for children should be concentrated in the social security benefit system and not duplicated in the tax system, although both approaches have coexisted without serious problems for many years.

If the Social Services Secretary still wishes to press this option, you will wish to seek views on whether it should be displayed in the Green Paper. The Chancellor of the Exchequer will argue that it would be wrong to mention just one alternative, and that it would in any case undesirably reopen the whole issue of child support. There might, however, be some advantage in at least including a brief reference to the possibility of an FTA in the text in order to show that the Government had not overlooked the option and was still concerned about families. The possibility will certainly be raised by commentators when the Green Paper is published. In the time available it would not be possible to work the option up in detail. But a few sentences would suffice and could quickly be provided and I understand from the Treasury that such a limited change could be incorporated in the text in time for publication.

5. Subject to any discussion on the above issues, particularly (iii), you may be able to reach agreement fairly quickly that the Chancellor should be authorised to publish the draft Green Paper on Budget Day subject to any detailed drafting amendments and to revision of the figures to take account of the taxation measures to be announced in this year's Budget.

HANDLING

6. You will wish to invite the Chancellor of the Exchequer to introduce his paper and the Social Services Secretary, as the Minister most closely affected by it, to comment. You may then wish to invite



CONFIDENTIAL

comments only from those Ministers who have any points of substance to make.

CONCLUSIONS

7. You will wish to invite the Cabinet to decide whether the Chancellor should be authorised to publish the Green Paper, subject to detailed drafting amendments and updating of figures to take account of the Budget, on Budget Day.

REA

ROBERT ARMSTRONG

26 February 1986
Cabinet Office

CONFIDENTIAL