CARE RESEARCH PAPER

independent taxation – 25 years on

Does it meet today's needs?

Foreword by The Rt Hon. the Lord Lawson of Blaby
Chancellor of the Exchequer 1983-89

By Don Draper and Leonard Beighton
Fiscal Policy Consultants

Care

Published by CARE
ISBN 978-0-905195-18-6

CARE
53 Romney Street / London SW1P 3RF
020 7233 0455 mail@care.org.uk

www.care.org.uk

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foreword

More than a quarter of a century ago, in my 1985 Budget speech, I made the case for a system of independent taxation with transferable allowances. I explained it in these terms:

> Everyone, man or woman, married or single, would have the same standard allowance. But if either a wife or a husband were not able to make full use of their allowance, the unused portion could be transferred, if they so wished, to their partner.
>
> This reform would produce a more logical and straightforward system. Far more people would be taken out of the poverty and unemployment traps, and indeed out of tax altogether, for a given sum of overall tax relief, than is possible under the present system. It would end the present discrimination against the family where the wife feels it right to stay at home, which increasingly nowadays means discrimination against the family with young children.

This was followed, a year later, by the publication of a Green Paper on the subject, and then, in my 1988 Finance Bill, legislation to implement genuinely independent taxation of husband and wife, accompanied by a regrettably watered-down version of transferable allowances. This, in turn, was duly enacted in 1990, after I had left office.

The watering down of the transferable allowances part of the package had occurred largely because of the then Prime Minister's pronounced lack of sympathy for mothers who stayed at home to look after their young children rather than going out to work; indeed the transferable element was later eliminated altogether in subsequent Budgets.

Yet the case for transferable allowances remains as strong as ever, for precisely the reasons I gave in 1985. In particular, as the detailed analysis in this Report demonstrates, it is not only family friendly but provides a far more cost-effective means of reducing the tax burden on low-income households than can be achieved by an across-the-board increase in personal allowances.

At long last, the Prime Minister has promised 'shortly' to introduce legislation to achieve this, as was promised in the 2010 Coalition Agreement. It is to be hoped that this thorough study, the latest event in a sustained and informed campaign by CARE, will help to bring about a long overdue reform.

The Rt Hon. the Lord Lawson of Blaby
Chancellor of the Exchequer 1983-89

July 2013

preface

More than 25 years after Nigel Lawson announced the introduction of independent taxation, it is important that we stand back to assess the extent to which the goals and objectives of what was a fundamental redesign of our tax system have been achieved.

This careful review demonstrates that, sadly, the redesign has not lived up to expectations. The solution that it advances, transferable allowances for married couples, was part of the original plan. The decision to drop that provision has had far reaching implications not just for the tax burden on one-earner families but also on their marginal effective tax rate, with a marked impact on work incentives.

While the report considers a number of potential policy solutions, the one it favours is the introduction of transferable allowances – the part of the original proposal that Nigel Lawson was forced to drop.

The case for this change is further compounded by the fact that the introduction of a transferable allowance for married couples is one of the Conservative manifesto and Coalition Agreement commitments for 2010-15. The report concludes that David Cameron needs to take swift action to honour this pledge if it is to be in place before the next General Election.

Looking beyond April 2015, the report asks what other steps can be taken to better recognise family responsibilities in our tax system, making it more just and improving work incentives.

I very much hope that this important and timely report will be closely studied as we consider the remaining priorities for this Parliament and look to the next. We urgently need a more family-friendly tax system, not least so that we become less dependent on benefits and freer to be a real aspiration nation.

Nola Leach
Chief Executive, CARE

July 2013

note by authors

For not far short of 20 years we have been working as consultants for CARE on issues relating to tax, marriage and the family. Over this time we have written a number of reports, most recently also looking beyond the UK to consider the position in other OECD and EU countries.

This report takes us another step forward. Throughout the 1980s there was very considerable discussion about personal taxation. This led to the introduction of independent taxation in the 1988 Finance Bill. We look to see how far, 25 years later, the intentions of those who were concerned with shaping those discussions have been realised. Independent taxation focussed on the individual, but its introduction was accompanied by safeguards for the family, and in this report we examine how families have fared. For the reasons which we explain, the answer is, alas, not too well.

We are most grateful to Lord Lawson, whose project this was, for contributing the Foreword. We should like to thank CARE for the support which they have given not only to this review but also to the work we have been doing on family taxation since the mid 1990s. For much of the last 20 years CARE has been alone in seeking to raise concerns about the way in which the tax and tax credit system has impacted on families. We are thankful for the continuing support of Nola Leach and Dan Boucher, CARE's Director of Parliamentary Affairs.

We are deeply grateful to Alistair Pearson, a management consultant who has so generously given his time and expertise to act as our project manager and editor. We thank especially David Binder for his considerable efforts on the statistics and charts. Thanks are also due to Chris Buttenshaw and Kate Bertaut and her team for getting this document ready for publication, and to Janet Horgan and Philippa Taylor for their continuing help and encouragement. Finally, we make it clear that the responsibility for any errors is ours, and that the views we expressed are our own and not necessarily those of CARE or other members of the team.

Don Draper and Leonard Beighton
July 2013

Between them, Leonard and Don have over 60 years' experience of advising Governments on tax policy. They have watched the way in which the income tax system has developed over many decades. They have been the driving force behind the research published by CARE over the last 20 years on tax and benefits issues affecting families.

Leonard was Deputy Chairman of the Board of Inland Revenue between 1992 and 1994. Since he retired, he has continued to work on taxation in a variety of forums and in 2011 was honoured to be appointed an honorary fellow of the Chartered Institute of Taxation. Don has a particular interest in the taxation of the family.

acronyms

APA:	Additional Personal Allowance
ASHE:	Annual Survey of Hours and Earnings
CARE:	Christian Action Research and Education
CTC:	Child Tax Credit
DWP:	Department for Work and Pensions
ESC:	Employer Supported Childcare
HICBC:	High Income Child Benefit Charge
HMRC:	Her Majesty's Revenue and Customs
IFS:	Institute for Fiscal Studies
JRF:	Joseph Rowntree Foundation
MCA:	Married Couples Allowance
METR:	Marginal Effective Tax Rate
MIS:	Minimum Income Standard
NICs:	National Insurance Contributions
OECD:	Organisation for Economic Co-operation and Development
PAYE:	Pay As You Earn
TBMT:	Tax Benefit Model Tables
TBRM:	Tax Benefit Reference Manual
WBA:	Widow's Bereavement Allowance
WEIA:	Wife's Earned Income Allowance

independent taxation
25 years on

Executive Summary

1. This is a review of the system of independent taxation that was introduced in 1990. It looks at the background to and the objectives set for this reform, and considers its impact on families. The report argues that the objectives have not been met, and asks whether the time has come to change the way in which families are both taxed and supported. It suggests a way forward for both the present Parliament and the next.

2. Families are bearing a much greater share of the income tax burden than they were in 1990. Tax credits have offset the burden on some families very considerably (and can exceed income tax payments), but they have resulted in very high marginal rates for many families which will be even higher when tax credits are converted into Universal Credit. The marginal rates which some families face are so high that even a doubling of income may have little effect on what a family has to live on.

Which taxpayers are better off and which are worse off?

3. The unspoken assumption underlying most discussion of tax policy is that the 'better off' should bear a heavier share of the tax burden than those who are 'worse off'. It is important therefore to understand where people fit in the distribution of incomes. Pre-tax incomes are a poor guide because they do not take account of the number of adults or children in the family. Single people without family responsibilities are higher in the income distribution than are families at all the income points considered except 50% of median earnings. A one-earner couple with two children will be the least well off at all income levels except 50% of median earnings, at which it will be the second least well off of the six households considered.

Independent taxation

4. Independent taxation was introduced following a prolonged debate in the 1980s about how the tax system should apply to families, which culminated in a Green Paper published in 1986[1]. The reformers wanted to make the tax system fairer for married women, to allow married women to keep their tax affairs private, and to reduce the discrimination against one-earner married couple families. There were three main objectives[2]:

[1] *The Reform of Personal Taxation,* March 1986, Cmnd 9756

[2] Ibid., para 2.4

- to give married women the same opportunity for privacy and independence in tax matters as their husbands.
- to remove discrimination against marriage and the family.
- to be able to raise tax thresholds in a cost-effective way so as to reduce the tax burden on families with low incomes. The low tax thresholds many such families faced were contributing in no small measure to the employment and poverty traps.

5. The pre-1990 system had long been out of step with contemporary society in that it denied women independence and privacy in tax matters. In tackling that issue, the intention was to treat a husband and wife equally and to provide a better deal for the family. The pre-1990 system bore hardest on many married couples at times when they had the responsibility of a young family or caring responsibilities. If a one-earner couple and a two-earner couple had the same income, the two-earner couple paid substantially less tax. There was also concern that the low tax thresholds were affecting incentives by bringing people into tax at low levels of income. At the time, this was mostly an issue for one-earner families caught in the unemployment and poverty traps that arose when the tax and social security systems overlapped.

6. There could be a tax penalty on marriage because a married couple's tax bill could be higher where the wife had investment income. To prevent this and to support one-earner families generally, a system of transferable allowances was proposed in the 1986 Green Paper. However, in the event this was not introduced. Instead we had independent taxation which, in order to support families, was coupled with the Married Couples Allowance (MCA) and the Additional Personal Allowance (APA). These allowances were first reduced in value before being finally withdrawn in 2000.

Income tax burdens in 1990 and 2013

7. Since 1990 income tax rates have come down. In 1990 the basic rate was 25%; in 2013 it is 20%. The tax threshold for single people has risen significantly, with the result that the tax burden on single people has fallen. In 1990 a single person on 50% median income paid 12.9%; a comparable person now pays 5.9%. At median income the figures are 18.9% and 12.9% respectively.

8. By contrast, the tax threshold for families is scarcely higher in real terms than it was in 1990, with the result that, even though the basic rate is lower, the income tax burden on some families is much the same as it was then. In 1990 the income burden on one-earner married couples (with and without children) on median income was 5.9%. In 2013/14 it is also likely to be 5.9%.

9. The higher rate income tax threshold is also lower in real terms than it was in 1990, and many families, particularly one-earner families, who would have paid only basic rate tax in 1990 pay higher rate tax now.[3] The threshold is now so

[3] 4.3 million taxpayers are paying higher rate tax in 2013/14, compared with 1.7 million in 1990/91.

low that a family with three or more children may be paying higher rate tax even with a disposable income below the level regarded by the Joseph Rowntree Foundation as an acceptable minimum.

10. Tax credits were introduced because the tax system took no account of family responsibilities and child poverty had increased as a result, with 3.4 million children in poverty by 1997/98. In 2012 there were still 2.3 million children living in families with incomes before housing costs below 60% of the median.[4] 1.6 million children in poverty were in couple families and 0.7 million in single parent families. 4.1 million families have been receiving tax credits or the equivalent through benefits. Of these, 2.1 million were families in work.

11. For families on and below the median wage, tax credits compensate for the failure of the income tax system to take account of the family. For a family with two children on the median income, tax credits will exceed income tax payments. However, for the 60% of working families not entitled to tax credits, the income tax burden may be higher than it was in 1990. The reduction in tax rates and the increases in the tax threshold have not fully compensated for the loss of the MCA and the APA.

Universal Credit

12. Universal Credit is replacing tax credits. As a result, one-earner in-work couples are likely to be slightly better off. Single parents working less than 16 hours a week also seem likely to be better off; those working 30 hours or more a week are likely to find themselves slightly worse off. Families in rented accommodation and entitled to housing benefit will be better off as a result of a change to the withdrawal rate. Families with savings of more than £16,000 will be much worse off: at present they receive tax credits, but they will not be entitled to the Universal Credit.

13. Universal Credit has the benefit of recognising a second parent, which reduces the couple penalty. However, it will not compensate much better than tax credits do today for the failure of the income tax system to take account of marriage or family responsibilities. The problems created by an income tax system which ignores the family are likely to remain.

Marginal rates

14. A major problem is that independent taxation coupled with an income related tax credit system has all but destroyed incentives for the 40% of working families entitled to tax credits. Even a doubling or trebling of income may not significantly affect the family's disposable income – the money the family has to live on.

15. In 1990 typical families faced a Marginal Effective Tax Rate (METR) of 34%. They now face a METR of 73%; this will increase to 76.2% when families are switched over to Universal Credit. Non-earners in a tax credit couple family moving into any paid work face a METR of at least 41%; this rises to 65% under Universal Credit.

[4] *Households Below Average Income 2011/12,* Department for Work and Pensions, 2013.

In 1990 non-earners taking a job with an income below the income tax threshold might have kept all their income.

16. These high marginal rates will become more apparent on the switch to Universal Credit because the impact of an increase in income will reduce the credit immediately and not a year or more later as under tax credits.

17. Families in full-time work cannot easily break free of the welfare system. They are trapped by an income tax system which does not recognise marriage or family responsibilities and which has had to be supplemented by a heavily means tested tax credit system. The incentive to move from income support into paid work will improve and the very highest METRs will disappear under Universal Credit, but overall the change from tax credits will do little to resolve the issue.

High Income Child Benefit Charge

18. The new High Income Child Benefit Charge (HICBC) cancels out, in part or in whole, child benefit for those families where one spouse or partner has an income which exceeds £50,000: it cancels out child benefit wholly where the income exceeds £60,000. As a consequence it reduces the privacy which couple families who are not entitled to tax credits have had since 1990 because spouses or partners will need to know whether or not the other's income exceeds £50,000. Over 800,000 families have a taxable income which exceeds £60,000, and over 300,000 have incomes between £50,000 and £60,000. A family with two children with an income of £60,000 stands to lose £30,000 over 18 years. This additional tax burden on families affects many families who are not in the top 15% of the income distribution. Some families caught by the HICBC are in the poorer 50% of the population.

19. There are three implications. First, couples where one spouse or partner has an income of over £50,000 are affected while couples with a similar household income spread more equally between them are not. Second, 15% of couples are affected but, contrary to Ministers' stated intentions, the majority of these are not among the wealthiest 15%. Third, the marginal rate of withdrawal depends on the number of children and not on income so that, in addition to the 40% higher rate income tax charge, the marginal rate for large families is very high – indeed in some cases over 100%. The HICBC can overlap with tax credits, and this will push the METR even higher.

Childcare

20. Childcare costs are an important factor in determining whether work pays. Some families on incomes as high as £300,000 are due to receive help with childcare costs. The amount of support the Government is proposing to give two-earner families and single parents is in marked contrast to the lack of support given to one-earner couples.

Conclusions

21. Measured against the aims set in the 1980s for the reform of personal taxation, independent taxation has been a failure:

    - Independent taxation was intended to give married women privacy over their tax affairs. The 2 million couples with children who have to claim tax credits (or in future, Universal Credit) or the equivalent have no privacy, and others have lost privacy as a result of the HICBC.
    - One-earner families face more fiscal discrimination in 2013 than they did in 1990.
    - In real terms the tax threshold has scarcely risen for families, while it has risen significantly for single people without family responsibilities. For most of the last 23 years, the tax threshold that has applied to families has been lower in real terms than it was in 1990.

22. The marginal rates that apply to families are much higher than they were in 1990.

23. Without the MCA and the APA, the tax burden on families has increased where tax credits have not been available. Where tax credits have been due, METRs are extremely high. This will not change with the switch to Universal Credit.

Policy recommendations

24. A way has to be found for supporting in-work families other than through a means tested credit system. The early introduction of a partially transferable allowance for married couples and civil partners, as envisaged during the July 2013 debates on the Finance Bill,[5] would be a sensible first step. It should be in the 2014 Finance Bill and in operation by April 2015. However, this limited proposal would not come anywhere near dealing with the problems identified in this report. More fundamental reform is necessary.

25. A fully transferable allowance would reduce discrimination against one- earner couples, increase the threshold for low and middle income families, and reduce the imbalance between one- and two-earner families.

26. Transferable allowances would reduce entitlement to Universal Credit. So a high proportion of the personal allowance should be available for transfer. They would reduce marginal rates for some families even where a non-earner moves back into paid work. Other non-earners, however, would find their METR increasing although by less when they switch over to Universal Credit.

27. Transferable allowances would not help single parents. One possibility would be to reintroduce the APA. But to do so would reinforce the couple penalty.

28. The cost of introducing transferable allowances would be considerable. But much less than the increases in personal allowances seen in recent years and which have been less well targeted on the less well off. In any event they could be introduced in stages.

[5] Hansard, 2 July 2013, cols 877-882

29. If transferable allowances were not pursued, an alternative which would benefit married couple families, cohabiting families with children, and single parent families would be to reintroduce the MCA and APA. The MCA and APA came in together in 1990 to prevent married couple households and other families from losing out as a result of independent taxation. Marriage would be recognised. This option would not increase the METR on non-earners in a couple family moving back into paid work.

30. The major difference from transferable allowances would be that it would also benefit two-earner couples who have been less obviously disadvantaged by the introduction of independent taxation than have one earner couples. It would be less well targeted and might cost more. This does not therefore at present look the best option.

31. Looking further ahead into the next Parliament, there would be a good case for examining the introduction of optional joint taxation for couples. It might then be possible to have a more flexible approach and meet more of the objectives than seems to be possible today. The main beneficiaries would be couples with a single income and couples where the second income was not large enough to absorb the personal allowance. Where an election for joint assessment was made, it would reduce the incentive for non-earners to seek paid work.

32. A more radical option still would be to switch support for families in work back from tax credits and Universal Credit into the tax system. The welfare system would be left dealing with families who are not in work or had income below the tax threshold or perhaps also those who could not fully use their tax allowances. If it worked like the income personal allowance or in times past the child tax allowances, it would go a long way towards dealing with the marginal rate issue and improve work incentives: indeed it would be the only way of doing so. It would save considerable administrative costs, and reduce the welfare bill. The reduction in public expenditure would of course be broadly balanced by a loss of tax receipts. This option should be on the agenda for the next Parliament.

33. The one thing we must not do is stay where we are.

chapter 1 Introduction

1. This is a review of the system of independent taxation that was introduced in 1990. It looks at the background to and the objectives set for this reform, and considers its impact on families. The report argues that the objectives have not been met, and asks whether the time has come to change the way in which families are both taxed and supported. It suggests a way forward for both the present Parliament and the next.

Structure of document

2. The report is structured as follows:

- Chapter 2 looks at where families fit in the income distribution, showing which taxpayers are better off and which are worse off. Gross income is a poor guide as to how well off any particular taxpayer is.
- Chapter 3 examines the background to independent taxation – why it was introduced and what it was meant to achieve.
- Chapter 4 looks at what has happened to income tax since independent taxation was introduced in 1990.
- Chapter 5 considers the impact of tax credits, introduced in part because the income tax system took no account of family responsibilities.
- Chapter 6 assesses the overall direct tax burden, allowing for National Insurance Contributions (NICs) and child benefit as well as income tax and tax credits.
- Chapter 7 examines the likely impact of the Universal Credit, which will replace tax credits.
- Chapter 8 looks at the impact of these changes on Marginal Effective Tax Rates (METRs) – the amount which the Government takes back in one way or another from each extra pound earned.
- Chapter 9 discusses the new High Income Child Benefit Charge (HICBC) which impacts so capriciously on middle-income families.
- Chapter 10 looks at the impact of fiscal subsidies for childcare costs.
- Chapter 11 sets out the authors' conclusions, comparing outcomes with objectives.
- Chapter 12 examines ways of dealing with the problems thrown up by independent taxation – problems which few, if any, foresaw in 1990 – and makes proposals for this Parliament and the next.

Data sources

3. Income tax, NICs and tax credits are taken from the Tax Benefit Model Tables (TBMT) for the year 2010/11 provided by the Department for Work and Pensions (DWP), amended by the authors to take account of subsequent changes. Figures for earlier years are taken from the last published (2009/10) edition of the Treasury's Tax Benefit Reference Manual (TBRM) and the fiscal facts section of the website of the Institute for Fiscal Studies (IFS). International figures are derived from the 2011 edition of the OECD's Taxing Wages.

[6] TBRM figures for couples are for married couples. The income of a two-earner couple is assumed to be split 60:40.

[7] *Taxing Wages 2010/2011,* 2011 Edition, OECD, Paris 2012

chapter 2
Distribution of Incomes

This chapter looks at where families fit in the income distribution, showing which taxpayers are better off and which are worse off. Gross income is a poor guide as to how well off any particular taxpayer is.

- A taxpayer's position in the income distribution depends both on income and the size and composition of the household.
- Pre-tax income on its own is a poor indicator of how well off people are because it does not allow for the number of adults or children in the household.
- Single people are higher in the income distribution than all other taxpayers at all income points except 50% median earnings.
- A one-earner couple with two children will be the least well off except at 50% median earnings, where it will be the second least.
- A one-earner couple with two children paying higher rate tax in 2014/15 could be in the lower half of the income distribution.
- Any discussion of taxation needs to take account of where people are in the income distribution.

4. It is important to understand where households fit in the distribution of incomes. The unspoken assumption underlying most discussion of tax policy is that the 'better off' should bear a heavier share of the tax burden than those who are 'worse off'. When tax changes are made, one of the first questions asked is what the distributional effects are. Does the change benefit mainly those who are worse off or does it in the main benefit those who are better off? Most people probably assume that this is just another way of asking whether most of the benefit goes to those with high incomes or to those with low incomes. This is not the case.

5. In public debate, Ministers often imply that those with high incomes are the better off. We do not know whether in analysing tax proposals they use the more sophisticated definition that Government economists and statisticians use for working out the number of families in poverty or measuring income inequality. If

they do not, it is unsurprising that tax measures which are presented as targeted at the better off often hit families in the lower deciles of the income distribution.

6. As Table 2.1 and Chart 2.1 show, pre-tax income is a very poor guide as to who is better off and who is worse off. For example, a single person with no children at 100% median wage, shown in Table 2.1 as at the 68th percentile, appears just below the 7th income decile on Chart 2.1. This individual has an income higher than that of almost 70% of the population. By contrast, a one-earner couple with two children and the same pre-tax income is at the 27th percentile and appears well below the 3rd income decile on Chart 2.1, with an income lower than that of more than 70% of the population.

Table 2.1

Likely position of households in the income distribution in 2013/14 – percentiles

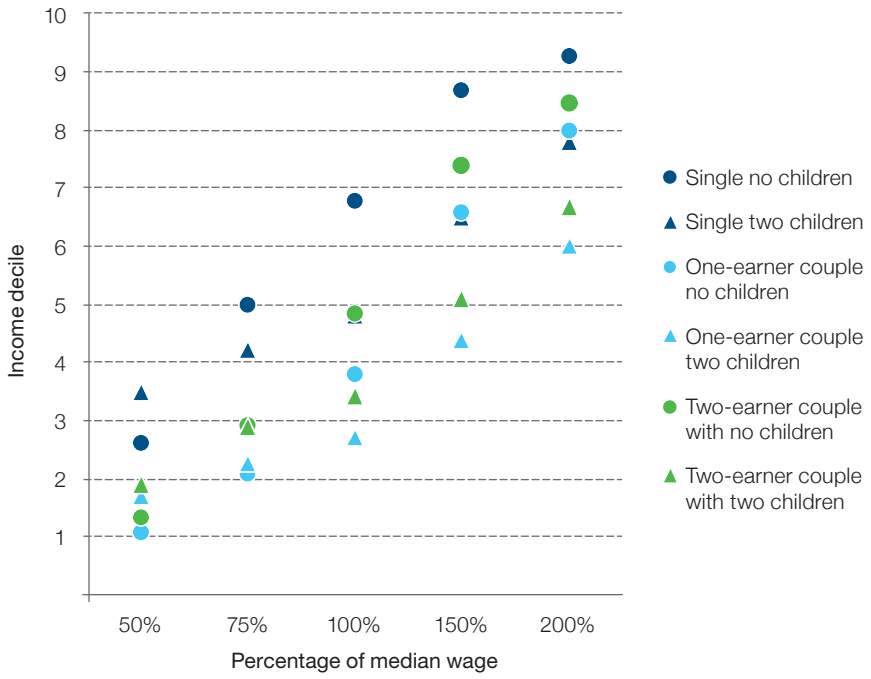
Percentage of median wage	Single person	Single parent two children	One-earner couple no children	One-earner couple two children	Two-earner couple no children	Two-earner couple two children
50% - £256 pw	26th	35th	11th	17th	13th	19th
75% - £384 pw	50th	42nd	21st	22nd	29th	29th
100% - £511 pw	68th	48th	38th	27th	48th	34th
150% - £767 pw	87th	65th	66th	44th	74th	51st
200% - £1,022 pw	93rd	78th	80th	60th	85th	67th

Source: IFS 'Where do you fit in?' calculator

Note: Calculations made in March 2013

Chart 2.1

Likely position of households in the income distribution in 2013/14



Note: Some of the income distribution percentages for different household types are the same. Where this is the case, for example with single people with two children and two-earner couples without children at 100% median wage, an overlap occurs, such that only one marker is fully visible at this point.

7. Single people without family responsibilities are better off than all other households except at 50% of median earnings. A one-earner couple with two children is considerably worse off than all other household types at and above 100% of median earnings. A one-earner couple with two children and an income of £41,450 (the higher rate threshold for 2013/14) would be earning just over 150% of median earnings, and would be in the lower half of the income distribution. Even a family earning £50,000, and therefore losing child benefit, may not be in the top half of the income distribution.

8. In working out where a person fits in the income distribution, Governments have always taken into account not only income but also the number of adults and children in the household. Income is adjusted to take account of the size and composition of the household. This, as the Department of Work and Pensions say, reflects the common sense notion that in order to enjoy a comparable

standard of living a household of three adults will need a higher income than a single person. To put incomes on a comparable basis, net income (pre-tax income minus income tax and NICs and council tax plus any child benefit or tax credits received) is adjusted for the number of people in the household and in the case of children their ages.[8] Official income distribution figures do not take account of childcare costs.

9. In any analysis of family taxation it is essential to understand where families are likely to fit in the income distribution. For example, increases in the tax threshold – the income point at which income tax starts to be paid – are often presented as benefiting the low paid and by implication the most deserving. In fact they benefit mainly those in the top half of the income distribution. Chart 2.2, published originally by the Institute for Fiscal Studies (IFS), shows the distributional impact at 2010 prices of increasing the income tax threshold to £10,000.[9] The cost of a £10,000[9] threshold is estimated to be £10.7 billion per year.[10] It would seem that most of this money is going to households in the top half of the income distribution. This is not just because tax reductions benefit those who do not pay tax at all but also because, as Chart 2.1 shows, single people and two-income couples are often in the top half of the income distribution. Many one-earner couple families are in the bottom half.

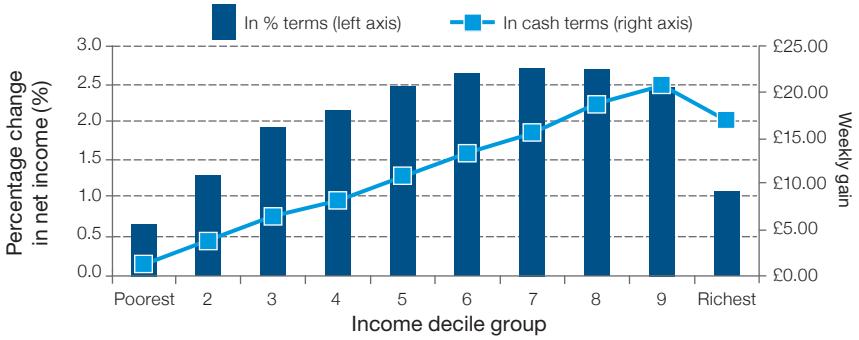
[8] The process is called equivalisation and the resultant measure of income is called equivalised income. For more information see *Households Below Average Income,* Department of Work and Pensions, Appendix 2, June 2010

[9] Adam et al., *Taxes and benefits: the parties' plans,* Institute for Fiscal Studies, 2010

[10] Institute for Fiscal Studies Budget presentation, March 2013

Chart 2.2

Distributional impact of increasing income tax threshold to £10,000



Source: Adam et al. *Taxes and benefits: the parties' plans,* IFS 2010

10. A tax system, such as that of the UK, which is based solely on the income of the individual and disregards family responsibilities, is bound to disadvantage families, particularly one-earner couple households. There are various reasons why incomes have become more unevenly distributed, but an income tax system which ignores the family is certainly one of them. It is difficult to see how incomes can be made more equal without changing the income tax system so that it takes account of the family. Most other tax systems do.[11]

[11] Pearson and Binder, *the taxation of families – international comparisons 2011,* CARE, 2012

chapter 3
Independent taxation:
why it was introduced and how it was meant to work

This chapter examines the background to independent taxation – why it was introduced and what it was meant to achieve.

- Independent taxation was introduced in 1990 following prolonged debate.
- The pre-1990 system was out of step with contemporary society. It denied married women independence and privacy in tax matters. For high income couples there was a tax penalty on marriage. It could create a tax penalty on marriage because a married couple's tax bill could be higher where the wife had investment income.
- The big gainers from independent taxation were high-income two-earner couples. Other families were potential losers.
- To prevent this, the 1986 Green Paper had originally proposed a system of transferable allowances.
- These were not introduced, and instead the Married Couples Allowance was introduced and the Additional Personal Allowance was retained.
- These allowances were subsequently phased out and finally withdrawn in 2000.

Before 1990

11. Before 1990, the income of a married couple was added together for tax purposes and treated as if it were the income of the husband. A married man had a personal allowance, which was just over one and half times the single person's allowance[12]. A married woman who was at work had her own allowance – Wife's Earned Income Allowance (WEIA) – which was the same as the single person's allowance, but all the allowances including the WEIA were in law given against the husband's income which included his wife's income. The system had its roots in the social legal concepts of the early nineteenth century.

12. This system of taxation could not continue. It was out of step with contemporary society. Moreover, there were anomalies which were difficult to defend:

    - a married couple where both spouses were in paid work got two and a half times the single person's allowance

[12] Single person under the age of 65

- a married couple where only the husband was in paid work got only one and a half times the single person's allowance
- a married couple where only the wife was in paid work got two and a half times the single person's allowance. Her income was treated as the husband's, so he could set against it both his married man's allowance and his wife's WEIA.

13. However, the pre-1990 system did not discriminate against single parents or cohabiting couples. An additional personal allowance (APA)[13] was given to one-parent families (and cohabiting couples with a child living with them). As a result, a single person with children received a total personal allowance equal to the married man's allowance, and was therefore in the same position as a one-earner married couple. There was also a Widows Bereavement Allowance (WBA).[14]

14. The pre-1990 system was particularly unpopular with some married women. It denied them independence and privacy in tax matters. It could create a tax penalty on marriage because a married couple's tax bill could be higher where the wife had investment income. It was also hardest on married couples when the wife was least able to take on paid work, for example when she had the responsibility of a young family, or of caring for an elderly relative at home.

15. Although the pre-1990 system did take account of the shared responsibilities of married people, in other ways it bore more harshly on married than on unmarried couples. This was where there would have been liability to higher rate tax when the couple were assessed jointly but not when assessed separately[15] and where both could claim the APA as an unmarried couple.[16] This was also the case where the couple had investment income or there were capital gains. A married couple's investment income was aggregated whereas an unmarried couple's was not.

13 In 1990/91 an Additional Personal Allowance (APA) equal in value to the Married Couples Allowance (MCA) was given to any woman who had the charge and care of children who was not married and living with her husband; any man who was not married and living with his wife; and any married man who was living with his wife but whose wife was totally incapacitated by physical or mental infirmity. The child had to be resident with the claimant. Only one deduction could be claimed irrespective of the number of qualifying children.

Where (i) a man and a woman not married to each other lived together as husband and wife and (ii) would each would have been entitled to the APA, neither was entitled to the Allowance except in respect of the youngest of the children. The amount was apportioned between the parents as they agreed or, failing agreement, according to the length of time for which the child resided with each. A special rule applied for the year of separation.

14 The WBA was introduced in 1980, to relieve some of the financial distress of bereavement. It was given for a limited period only, from the date of the death to the end of the following tax year, and applied against the widow's own income in this period. The WBA was abolished along with the MCA and APA. In his 1999 Budget the then Chancellor Gordon Brown announced that the MCA and those allowances tied to it - the APA, relief for maintenance payments, and the WBA - would be abolished from April 2000.

15 This was not a problem where incomes were earned and below the higher-rate threshold, as there was a WEIA which was the same as the single person's allowance.

16 Under the pre-1990 system a couple who lived together as man and wife could both claim the APA on top of their basic single allowances if they had two or more children. In effect, they received the equivalent of two married allowances. *See The Reform of Personal Taxation,* March 1986, Cmnd 9756, para 4.14. An earlier Green Paper had proposed rationalising provision for single parents by converting the allowance into an increased benefit. This idea was not pursued.

The changes made in 1990

16. The story begins in 1986 with Nigel Lawson's Green Paper entitled 'The Reform of Personal Taxation'.[17] Nigel Lawson proposed a system of independent taxation, seen as providing a better – not worse – deal for families. The Government of the day had three main objectives:

    - to give married women the same opportunities for privacy and independence in tax matters as their husbands
    - to remove discrimination against marriage and the family
    - to raise the tax threshold in a cost-effective way so as to reduce the tax burden on families with low income.[18]

17. Under the system as originally proposed in 1986, everyone – man or woman, married or single – would have a tax allowance in their own right, whether or not they were in paid employment. To recognise the shared responsibilities of a married couple, a spouse who did not have enough income to use up their own allowance would be able, if they wished, to transfer the balance to their partner. The incomes of a husband and wife would no longer be added together for tax purposes, and all taxpayers would be able to have independence and privacy in their tax affairs. The aim was that no couple would suffer a reduction in cash terms in their total allowances. The ultimate aim was to get to a position where two new-style allowances amounted to the same as the total allowances available to a two-earner couple before the change.[19]

18. The Green Paper argued that the tax system should not discriminate against families where one spouse wished to remain at home to care for young children. Transferable allowances would provide recognition through the tax system that, at different times and for different reasons, one partner in a marriage may be financially dependent on the other. With transferable allowances there would not have been discrimination against couples where, for whatever reason, one spouse was not in paid employment.

19. In the event transferable allowances were not introduced. There were a number of reasons for this. One was the fear that if a wife had transferred her personal allowance to her husband the husband would discourage the wife from going out to work, as this would increase his tax bill. Another was the administrative cost. Families might not have been able to decide whether to transfer an allowance until after the end of the tax year. This would have been expensive for a tax system which worked, as it did at the time, on the basis of avoiding the need for an end-of-year return. It appears, however, that for Nigel Lawson another consideration may have been that with the computerisation of income tax still being bedded in, the Treasury was told that transferable allowances could

[17] Op. cit.

[18] Ibid., para 2.4

[19] Ibid., para 3.3: "The ultimate aim would be to get to a position where two new style allowances amounted to the same as the total allowances available to a two-earner couple before the change."

not be introduced before 1993.[20] In his 1988 Budget Speech, he said that the reforms had two objectives – first, to give married women the same privacy and independence in their tax affairs as everyone else; and second, to bring to an end the ways in which the tax system could penalise marriage.

20. Under the system of independent taxation which was introduced in 1990 and still applies, the amount of income tax people have to pay depends on the rate of tax and the personal allowance – the slice of tax-free income to which they are entitled. Since 2000 everyone has been entitled to the same personal allowance, whether they were single or married, male or female, and whether they had children or were childless.[21] The result is that everyone pays the same amount of income tax if their income is the same.

21. Any major structural tax change involves a redistribution of the tax burden between different taxpayers, or between different stages in the life of the same taxpayer. It was recognised at the time that the big gainers from the introduction of independent taxation would be high-income two-earner couples, who were liable to higher rate tax when their incomes were aggregated, but only to basic rate tax when their incomes were taxed separately. There was a comparatively small number of these couples, but unsurprisingly they were particularly articulate in their criticisms of the pre-1990 system.

22. Ordinary two-earner couples whose combined income was below the higher rate threshold (which in real terms was much higher than it is today) were in effect taxed separately on their earned income. They stood to lose from the change to independent taxation because they would no longer get a tax-free slice of income equal to two and half times the single person's allowance. One-earner married couples also stood to lose as, instead of allowances worth 1.6 times the personal allowance (two and a half times if the wife was the sole earner), they would get only the single person's allowance. It was recognised in 1990 that this could not be allowed to happen.

23. The solution was for all married couples to have, not a transferable allowance, but rather an additional Married Couples Allowance (MCA) equivalent, initially, to the difference between the single allowance and the married man's allowance. This would for administrative simplicity go initially to the husband, but in the event of his not having the income to make use of it, he would be able to transfer it to his wife. The APA which single parents had been receiving was also to continue with the result that, in the short term, families did not lose out as a result of the introduction of independent taxation.[22]

24. Both allowances were subsequently phased out. They were originally given, like other personal allowances, as a deduction from the taxpayer's income before his or her tax liability was calculated, and in effect gave relief at the taxpayer's

[20] *The View from No 11: Memories of a Tory Radical,* Nigel Lawson, 1992, p 885

[21] In 2001/02 as in 2002/03 there was a child tax allowance which was worth £520, which was tapered away from higher rate taxpayers. This was replaced by the family element of the Child Tax Credit.

[22] From April 1993, a married man was able to transfer the whole MCA to his wife, or the wife was able to claim half the allowance independently.

marginal rate of tax. In 1994/95 the MCA was restricted to a fixed amount (20% of the allowance); it was no longer available at the taxpayer's marginal rate. It was restricted to 15% in 1995/96 and then to 10% in 1999/2000. The MCA was abolished from 6 April 2000 for people born after 1935. The APA was also abolished in April 2000. With the loss of these allowances, families began to be disadvantaged by independent taxation. It used to be said that these allowances were "something of an anomaly".[23] It now seems clear that in the absence of transferable allowances they were an essential if families were not to be disadvantaged by the change to independent taxation. We examine this in more detail in the next two chapters.

[23] Kenneth Clarke, Budget speech, 30 November 1993

chapter 4
Income Tax

This chapter looks at what has happened to income tax since independent taxation was introduced in 1990.

- Families, in particular one-earner couples, have lost out.
- Tax rates have come down, and the tax threshold for a single person without children is almost 60% higher in real terms than it was in 1990. As a result the income tax burden on a single person on a 50% median wage is less than half what is was in 1990. For a single person on a median wage it is almost a third less.
- By contrast the tax threshold for one-earner couples is almost the same in real terms as it was in 1990. The tax threshold for two-earner couples is only 23% higher.
- At 50% and 200% median wage, the income tax burden on a one-earner couple with two children is the same as or greater than in 1990. At median wage, it is 17% less. Two-earner couples have fared slightly better.
- Families well down the income distribution that were paying only basic rate tax in 1990 now pay higher rate tax. Some of these have an income below the Joseph Rowntree Foundation's minimum income standard.
- The allowances (MCA and APA) which prevented families from losing out from independent taxation were withdrawn.
- Tax credits were introduced to compensate for the fact that income tax took no account of family responsibilities.
- Most married women have enjoyed fiscal privacy except where families have had to claim tax credits, or where the HICBC arises.
- Some couples who would have faced a couple penalty in 1990 no longer do so, but in aggregate there are more couples facing such a penalty now than in 1990.
- Transferable allowances as envisaged in 2010 have not been introduced.

25. The total tax burden has changed comparatively little in the last 23 years. In 1990 tax was 35.5% of Gross Domestic Product; in 2012/13 it was 35.8%.[24] Also income tax (gross of tax credits) as a percentage of total taxation is much the

[24] Office of Budget Responsibility: Economic and Fiscal Outlook, March 2013, Cm 8573, Table 4.6 and Table 4.7

same: in 1990 it accounted for 28% of total taxation, and in 2012/13 for 27%.[25] The income tax burden (income tax as a proportion of gross income) on families is broadly similar to what it was in 1990. By contrast the income tax burden on single taxpayers has fallen significantly.

26. Six major changes have affected the tax paid by families:

- Tax rates have come down: in 1990 the basic rate of income was 25%, now it is 20%.
- The tax threshold – the income point at which tax starts to be paid – has for most of the last 23 years been lower in real terms[26] for families, even two-earner couples, than it was in 1990. For single taxpayers it is now almost 60% higher in real terms than it was in 1990. Even when the £10,000 threshold takes effect next April, the threshold for one-earner families will be scarcely any higher in real terms than it was in 1990.
- The higher rate threshold – the income point at which higher rate tax begins to be paid – has fallen in real terms. Families well down the income distribution who were paying only basic rate tax in 1990 are now paying higher rate tax. Some of these families have an income below the Joseph Rowntree Foundation's Minimum Income Standard (MIS).[27]
- The allowances that were introduced to protect families from losing out from independent taxation were withdrawn.
- Tax credits were introduced to compensate for the fact that the income tax system took no account of family responsibilities.[28] There has been a system of in-work income support for low-income families since the 1970s. The Family Income Supplement was introduced in 1971. This was replaced by Family Credit in 1988, which was itself replaced by Working Families Tax Credit in 1999.
- A High Income Child Benefit Charge (HICBC) has been introduced. For the first time since 1990 a partner's income is to be taken into account in determining the income tax liability of the other partner. The charge applies if there are children and one partner has an income of £50,000 or more.

25 Op. cit. and Institute for Fiscal Studies website, Fiscal Facts revenue aggregates

26 Figures adjusted for changes in the Retail Price Index (RPI)

27 The Joseph Rowntree Foundation publishes annual estimates of the Minimum Income Standard for the UK to reflect changes in costs and living standards. The standard is based on asking members of the public to identify the items and services a household would require to reach a minimum acceptable standard of living, covering essential needs and allowing household members to participate in society. For the latest estimates, see Donald Hirsch, *A Minimum Income Standard for the UK in 2013, Joseph Rowntree Foundation, June 2013.*

28 *The Child and Working Tax Credits: the modernisation of Britain's tax and benefit system – number ten,* HM Treasury, April 2002, p 4: 'The income tax system provides a light touch and non-stigmatising way of measuring income. An individual's income tax bill is almost exclusively determined by their income for the tax year. However, the tax system has traditionally been poor at recognising families' circumstances. For almost a generation, there was no proper recognition of children in the tax system and it failed to help families balance their work and caring commitments.'

27. It is against this background that we consider the extent to which the three objectives the Government of the day set in 1986 have been met.

Giving married women privacy and independence in tax matters

28. Most married women now have fiscal privacy, at least as far as income tax is concerned. They are responsible for their own income tax affairs. They do not have to disclose their income and savings to their husbands. However, for the 2.1 million couple families who receive tax credits or the equivalent[29] (more than a third of all couple families[30]), this has been a hollow victory. To claim tax credits, they have to complete a full disclosure of their incomes to each other and to HMRC. In 1990 most of these families would not have been making tax returns, and in effect married women in these families enjoyed a high degree of privacy. They now have none. It is only very affluent couple families that are allowed privacy. This will not change with the introduction of Universal Credit. In addition couples potentially liable to the HICBC have to disclose whether their income is liable to higher rate tax.

Raising the tax threshold in a cost-effective way

29. Raising the general tax threshold has been very costly and yet has not reduced the income tax burden on low income families. It has reduced the income tax burden for singles and to a lesser extent two-income couples. The increases in the personal allowance have not compensated families for the loss of the MCA and the APA.

30. In 1990/91 the tax threshold for a single taxpayer was £3,005 at a time when median income was £12,420; the threshold was then 24% of median income. However, it is often forgotten that for both a one-earner married couple and a single parent the threshold was £4,625, 37% of median income.

31. In 2000/01 (the year when the MCA and the APA were withdrawn) the threshold for single taxpayers, one-earner married couples and single parents was £4,385. The threshold for one-income families (both couples and single parents) was £240 lower than in 1990/91. In real terms (i.e. taking inflation into account) it was 48% lower: £2,234 in 1990 prices.

32. In 2013/14 the tax threshold for everyone had risen to £9,440, which is 35% of median income (estimated to be £26,648[31]). This represents a rise for single

29 HMRC tax credit statistics show that in December 2012 tax credits or the equivalent were received by 4.7 million households, of which 2.1 million were couples (1.9 million with children) and 2.6 million were single adults (2.2 million with children).

30 7.9 million families claim child benefit, for which there is over 90% take-up. Some of these families will be single parent households. 2.2 million single parents claim tax credits.

31 Median income in 2013/14 has been estimated by assuming that earnings have increased by 1% since April 2012. *The Annual Survey of Hours and Earnings,* Office for National Statistics, November 2012 shows gross weekly earnings of full-time employees in April 2012 as £506 (£26,384 per annum).

people of 58% in real terms compared with 1990. Even with the increase in April 2013 the threshold for one-earner families is barely any higher in real terms than it was in 1990.

33. Two income families have fared better but still less well than single people without dependants. In 1990/91 the threshold (assuming both had sufficient income) was £7,730. In 2013/14 it is £18,800, 23% higher in real terms. But for most of the last 23 years, it has been lower in real terms than it was in 1990.

34. Chart 4.1 shows the tax threshold in 1990 prices in 1990/91, 2000/01, 2012/13 and 2013/14 for single taxpayers, one-earner couples and two-earner couples.

Chart 4.1

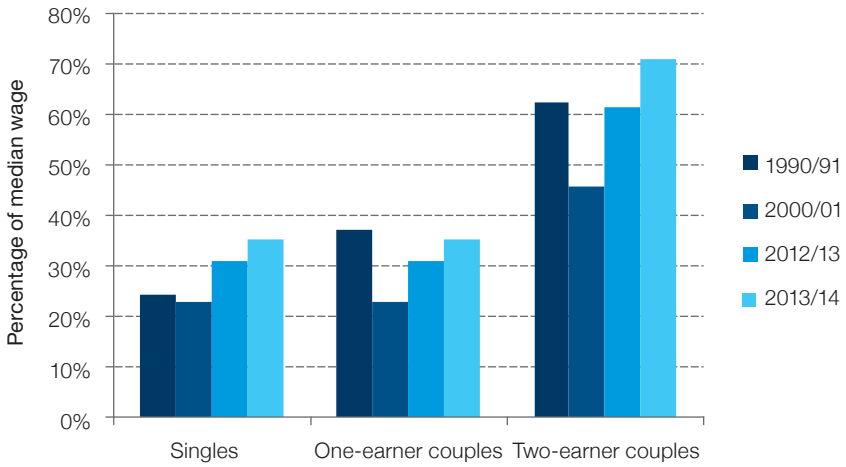
Income tax threshold for taxpayers aged under 65 at 1990 prices

Source: TBRM, TBMT and RPI

35. Chart 4.2 shows the tax threshold as a percentage of median wage in 1990/91, 2000/01, 2012/13 and 2013/14 for single taxpayers, one-earner couples and two-earner couples.

Chart 4.2

Income tax threshold for singles, one-earner and two-earner couples as percentage of median wage



Source: TBRM and TBMT

36. Even when the £10,000 threshold takes effect in April 2014, the threshold for one income families is likely to be only be 5% higher in real terms than it was in 1990.

37. Families, some of whom are in the lower half of the income distribution, have also been badly affected by the lowering of the higher rate threshold. In 1990 the higher rate threshold for a married couple was £26,755 i.e. more than twice the median wage. In 2013 the higher rate threshold is £41,450 i.e. just over one and a half times the median wage.

38. Although the current higher rate threshold may be at an appropriate level for single adults and two-earner couples, it is now far too low for one-earner couples with children. For a one-earner couple with two children, the higher rate threshold is only 15% above the Minimum Income Standard (MIS), the gross income estimated by the Joseph Rowntree Foundation (JRF) to be needed for a minimum acceptable standard of living.[32] A one-earner couple with three children needs a gross income of £41,519, which is £69 above the higher rate threshold. With four children the family needs a gross income of £45,821 to achieve the MIS, £3,831 above the higher rate threshold. By contrast the higher rate threshold[33] is more than double the MIS for a single working age adult, and 62% above it for a single parent with one child.

32 *A Minimum Income Standard for the UK in 2013,* Joseph Rowntree Foundation, June 1013, Table 4

33 Minimum Income Calculator www.minimumincome.org.uk

39. Table 4.1 compares with the higher rate threshold the gross incomes needed by selected household types to achieve the MIS. The households are assumed to be located in an urban area in the East Midlands. The figures will be higher for other parts of the country and for rural areas.

Table 4.1

Gross incomes needed for MIS compared with higher rate threshold 2013/14

	Higher rate threshold £41,450	
Household type	Gross income needed for MIS	Gap between threshold and MIS gross income
Single adult no children	£16,582	£24,868
Single parent one child	£25,586	£15,864
Single parent two children	£30,138	£11,312
One-earner couple one child	£30,835	£10,615
One-earner couple two children	£36,060	£5,390
Two-earner couple two children	£38,759	£2,691
One-earner couple three children	£41,519	-£69
One-earner couple four children	£45,281	-£3,831

Source: JRF Minimum Income Calculator and authors' calculations

Removing discrimination against marriage and the family

40. Far from removing the discrimination against marriage and the family, independent taxation has resulted in married couples and families of all types bearing an increasing share of the income tax burden.

41. The 1986 Green Paper identified two problems. The first was that under the pre-1990 system, couples could pay less tax if they were unmarried.[34] This arose in two ways. A cohabiting couple with children could be entitled to the equivalent of two APAs (equivalent of two married allowances), whereas on marriage they got only one married allowance. The other arose from the rule that for tax purposes a married woman's income was treated as that of her husband. This didn't matter where both were in work and the combined income was below the level at which higher rate was paid. However, it did matter where combined income was above the higher rate threshold or the wife had investment income.

42. The second problem was the way the pre-1990 system applied to married couples at times when they had responsibility for young children.[35] Under the pre-1990 system, if a one-earner and two-earner couple had the same income, the two-earner couple paid substantially less tax. The 1986 Green Paper saw this as discrimination between one-earner and two-earner couples, regarding the issue of whether a couple had one or two incomes as dependent on where they were

[34] Op. cit., para 2.0 and 4.14

[35] Op. cit., para 2.10

in the life cycle. Most women who did not have paid work had specific reasons for not going out to work: many were looking after children or other relatives, others suffered from ill health or found it difficult to enter the labour market after an absence due to domestic responsibilities. It seemed at the time anomalous that couples had much higher tax allowances than a one-earner family i.e. at a time when the one-earner couple would be under greatest financial pressure.[36]

Couple penalty

43. Independent taxation dealt with the couple penalty problem identified in the 1986 Green paper. Following the introduction of independent taxation, a married woman's income was no longer aggregated with that of her husband. However, couple families who would not have faced a couple penalty in 1990 now face one. The couple penalty now arises mainly from the tax credit system, which became necessary because the post-1990 income tax system ignored marriage and family responsibilities. As the Treasury pointed out at the time, for almost a generation there had been no proper recognition of children in the tax system, which failed to help families balance their work and caring commitments. Tax credits were an attempt to remedy this failure.

44. Many more taxpayers face a couple penalty in 2013 than did so in the 1980s. Moreover, those who do so now are largely in the poorer half of the population, whereas those who faced a couple penalty in the 1980s would have been mainly in the top half of the income distribution.[37] The IFS said in 2010 that 95% of all single people would incur a couple penalty if they married or started to live together as husband and wife. Half of these families would face a penalty of at least £101 per week. 89% of existing couples with children are incurring a couple penalty averaging £109 per week. The changes that resulted from the introduction of independent taxation have created a far more serious couple penalty problem than that which independent taxation was designed to solve. It remains to be seen to what extent Universal Credit will reduce the couple penalty.

The income tax burden

45. Under the pre-1990 system, a two-earner couple paid substantially less tax than a one-earner couple with the same income. It is still the case that two-earner couples have much lower income tax bills than one-earner couples with the same income. Table 4.2 compares the income tax paid by six household types in 1990/91 with the income tax burden in 2013/14. The income of the two-earner couple is assumed to be split 60:40.

36 Op. cit., para 2.1-2.14

37 For a fuller consideration of the couple penalty, see Draper, Couple Penalty 2008/09, CARE, 2009 and Adam and Brewer, *Couple Penalties and Premiums in the UK Tax and Benefit System,* IFS Briefing Note BN 102 2010, April 2010.

Table 4.2

Income tax as percentage of gross income in 1990/91 and 2013/14

	1990/91	2013/14	1990/91 - 2013/14 change (percentage points)
single person without children			
50% of median wage	12.9%	5.9%	-7.0
75% of median wage	16.9%	10.6%	-6.3
100% of median wage	18.9%	12.9%	-6.0
150% of median wage	21.0%	15.3%	-5.7
200% of median wage	22.6%	20.9%	-1.7
single parent two children			
50% of median wage	5.9%	5.9%	0.0
75% of median wage	12.3%	10.6%	-1.7
100% of median wage	15.5%	12.9%	-2.6
150% of median wage	18.6%	15.3%	-3.3
200% of median wage	20.2%	22.0%	1.8
one-earner couple no children			
50% of median wage	5.9%	5.9%	0.0
75% of median wage	12.3%	10.6%	-1.7
100% of median wage	15.5%	12.9%	-2.6
150% of median wage	18.6%	15.3%	-3.3
200% of median wage	20.2%	20.9%	0.7
one-earner couple two children			
50% of median wage	5.9%	5.9%	0.0
75% of median wage	12.3%	10.6%	-1.7
100% of median wage	15.5%	12.9%	-2.6
150% of median wage	18.6%	15.3%	-3.3
200% of median wage	20.2%	22.0%	1.8
two-earner couple no children			
50% of median wage	0.0%	0.0%	0.0
75% of median wage	4.2%	2.5%	-1.7
100% of median wage	9.4%	5.8%	-3.6
150% of median wage	15.7%	10.6%	-5.1
200% of median wage	17.2%	12.9%	-4.3
two-earner couple two children			
50% of median wage	0.0%	0.0%	0.0
75% of median wage	4.2%	2.5%	-1.7
100% of median wage	9.4%	5.8%	-3.6
150% of median wage	15.7%	10.6%	-5.1
200% of median wage	17.2%	14.6%	-2.6

Source: TBRM and TBMT

Note: The median wage was £12,420 in 1990/91 and is estimated to be £26,648 in 2013/14.

46. It will be seen that across the whole income range for which we have figures, the tax burden on single people has fallen since 1990. At 50% of the median wage, the tax burden is less than half that in 1990. For singles on the median wage, it is almost a third less; at 150% of the median wage it is a quarter less.

47. The picture for both one-earner couples and single parent families is very different. Their 2013/14 income tax bills are much the same as in 1990/91 at 50% of median income. Tax bills are lower at 75%, 100% and 150% of median income, but only by 14%, 17% and 18% respectively. The corresponding figures for singles are 37%, 32% and 27%.

48. The gap between the tax paid by one-earner couples and two-earner couples has grown wider since the introduction of independent taxation. In 1990/91 a two-income family with an income equal to the median wage paid 39% less tax than a one-earner family with the same income. In 2013/14 they pay 55% less. The aim of the 1986 reformers to close this gap[38] has come to nothing. Table 4.3 shows that the gap at median income and above has widened.

Table 4.3

Income tax as percentage of gross income in 1990/91 and 2013/14

Comparison of one- and two-earner couples with two children

	1990/91		2013/14		1990/91 - 2013/04
	one-earner couple	two-earner couple	one-earner couple	two-earner couple	increase in gap (percentage points)
50% of median wage	5.9%	0.0%	5.9%	0.0%	0.0
75% of median wage	12.3%	4.2%	10.6%	2.5%	0.0
100% of median wage	15.5%	9.4%	12.9%	5.8%	1.0
150% of median wage	18.6%	15.7%	15.3%	10.6%	1.8
200% of median wage	20.2%	17.2%	22.0%	14.6%	4.4

Source: TBRM and TBMT

38 *The Reform of Personal Taxation,* March 1986, Cmnd 9756, para 2.13

chapter 5
Tax Credits

This chapter considers the impact of tax credits – the extent to which the picture presented in Chapter 4 changes when tax credits are taken into account.

- One of the reasons for the introduction of tax credits was that income tax took no account of family responsibilities.
- 4.1 million families get tax credits or the equivalent, 2.6 million in-work families, 40% of all in-work families are in receipt of tax credits. The majority of these families have incomes of less than £30,000, but tax credits can reach much further up the income range, and may even overlap with the HICBC.
- For families on and below median earnings, tax credits have made a major difference. In 1990/91 a one-earner family with two children on median earnings bore an income tax burden of 15.5%. In 2013/14 their net tax burden is 4%.
- For some families not entitled to tax credits, the tax burden is higher in 2013/14 than it was in 1990/91. For these families, the reduction in rates and increases in the threshold have not fully compensated for the loss of the MCA and the APA.
- However, families who have benefited from tax credits now face a 73% marginal effective tax rate and have very little financial incentive to increase their income. In 1990 their marginal rate would have been 34%.
- A second earner's marginal rate could have been as low as nil in 1990/91. The lowest it can now be is 41%.

49. Income tax takes no account of marriage or family circumstances. Tax credits do not take account of marriage or indeed of a second parent, although they do take account of the number of children in the family. Single parent families get broadly the same tax credits as one-earner couples if their income is the same and the number of children is the same. The rules relating to childcare costs are more favourable for single parents, and where these apply single parents will receive a bigger award. The previous administration saw tax credits as counter balancing an income tax system which took no account of family circumstances. It is necessary therefore to look not only at income tax but also tax credits.

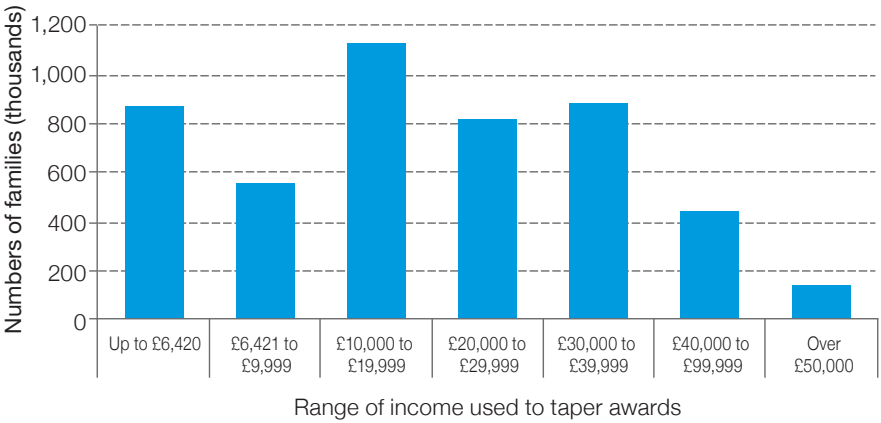
50. 4.1 million families (households with children) have been receiving tax credits or the equivalent child support through benefits. Of these, 2.6 million were in-work

families and 1.5 million had no adult in work.[39] There are 7.9 million families receiving child benefits (latest child benefits statistics, August 2012).[40] This means that over 50% of families currently face an effective marginal rate of at least 73%, and 40% of all in-work families face a 73% marginal rate.

51. The majority of families receiving tax credits have incomes under £30,000, with the majority of support going to families on incomes of £10,000 or less. As a result of the recent removal of the second income threshold, substantially fewer families with incomes over £30,000 receive tax credits. However, tax credits do still reach well up the income range. Families with above average incomes are affected by tax credits and as a consequence have high marginal rates. Chart 5.1 shows the number of families receiving tax credits in various income bands.[41]

Chart 5.1

Average number of in-work families receiving tax credits by income band in 2012



Source: *Child and working Tax Credit Statistics,* HMRC December 2012

52. Single parents and couples receive the same basic tax credits.[42] For larger families, tax credits stretch a long way up the income bands. Although the great majority of families receiving tax credits have incomes below £30,000, large families liable to higher rate tax and the HICBC may also be in receipt of tax credits. Table 5.1 shows the income points in 2013/14 at which tax credits cease to apply for a couple family or a single parent not claiming for childcare costs.

39 *Child and Working Tax Credit Statistics,* HMRC, December 2012, Table 2.1 and Figure 1.1

40 In 2012 7.9 million families were receiving child benefit (*Child Benefit Statistics,* HMRC, August 2012). Of these, 1.4 million were out of work (*Child and Working Tax Credit Statistics,* HMRC, December 2012, Table 1.1).

41 *Child and Working Tax Credit Statistics,* HMRC, December 2012

42 Single parents may receive the childcare element of the Working Tax Credit in circumstances where a couple family will not.

Table 5.1

Income points at which tax credits are phased out in 2013/14

Number of children in family	Income point beyond which no tax credits payable
1	£25,706
2	£32,329
3	£39,003
4	£45,625
5	£52,247

Source: TBMT

53. Table 5.2 shows the tax credits received in 2013/14 by families of different sizes on a median income, not claiming for childcare costs.

Table 5.2

Tax credits received by family on median income in 2013/14

Number of children in family	Tax credits received per annum
1	nil
2	£2,373
3	£5,093
4	£7,813
5	£10,533

Source: TBMT

Effect of tax credits on the tax burden

54. When tax credits are taken into account the picture presented in Chapter 3 does change. Table 5.3 below compares the income minus credits paid by six household types in 1990/91 with that in 2013/14. The income of the two-earner couple is assumed to be split 60:40.

Table 5.3

Income tax less tax credits as percentage of gross income in 1990/91 and 2013/14

	1990/91	2013/14	1990/91 - 2013/14 change (percentage points)
single person without children			
50% of median wage	12.9%	5.9%	-7.0
75% of median wage	16.9%	10.6%	-6.3
100% of median wage	18.9%	12.9%	-6.0
150% of median wage	21.0%	15.3%	-5.7
200% of median wage	22.6%	20.9%	-1.7
single parent two children			
50% of median wage	-10.9%	-52.0%	-41.1
75% of median wage	12.3%	-14.8%	-27.1
100% of median wage	15.5%	4.0%	-11.5
150% of median wage	18.6%	15.3%	-3.3
200% of median wage	20.2%	22.0%	1.8
one-earner couple no children			
50% of median wage	5.9%	-7.9%	-13.8
75% of median wage	12.3%	10.6%	-1.7
100% of median wage	15.5%	12.9%	-2.6
150% of median wage	18.6%	15.3%	-3.3
200% of median wage	20.2%	20.9%	0.7
one-earner couple two children			
50% of median wage	-10.9%	-52.9%	-42.0
75% of median wage	12.3%	-14.8%	-27.1
100% of median wage	15.5%	4.0%	-11.5
150% of median wage	18.6%	15.3%	-3.3
200% of median wage	20.2%	22.0%	1.8
two-earner couple no children			
50% of median wage	3.6%	-7.9%	-11.5
75% of median wage	4.2%	2.5%	-1.7
100% of median wage	9.4%	5.8%	-3.6
150% of median wage	14.6%	10.6%	-4.0
200% of median wage	17.2%	12.9%	-4.3
two-earner couple two children			
50% of median wage	-7.9%	-52.8%	-44.9
75% of median wage	6.9%	-22.9%	-29.8
100% of median wage	15.5%	-3.1%	-18.6
150% of median wage	14.6%	10.6%	-4.0
200% of median wage	17.2%	14.6%	-2 .6

Source: TBRM and TBMT

Note: A negative figure means that the "tax" liability of the household is negative i.e. credits exceed income tax payments.

55. Low income families are much better off than they were in 1990. In 1990/91 a one-earner family on 50% median wage with two children would have been receiving the family credit benefit, which would have exceeded their income tax payments. Their post-tax/credit income would have been 10.9% higher than their pre-tax income. In 2013/14 their post-tax/credit income will be 52.9% higher. A similar family on median earnings would have been paying income tax of 15.5% in 1990/91; in 2013/14 their net payment is likely to be 4.0%.

56. Two-earner families have benefited even more. In 1990/91 a two-earner couple with two children and a combined income equal to 50% of the median wage would have had a post-tax/credit income 7.9% higher than their pre-tax income. In 2013/14 it is likely to be 52.8% higher. Table 5.4 compares the tax minus credits of one- and two-earner couples with two children in 1990/91 and 2013/14.

Table 5.4

Income tax less tax credits in 1990/91 and 2013/14

Comparison of one- and two-earner couples with two children

	1990/91		2013/14		1990/91 - 2013/14
	one-earner couple	two-earner couple	one-earner couple	two-earner couple	increase in gap (percentage points)
50% of median wage	-10.9%	-7.9%	-52.9%	-52.8%	2.9
75% of median wage	12.3%	6.9%	-14.8%	-22.9%	2.7
100% of median wage	15.5%	15.5%	4.0%	-3.1%	7.1
150% of median wage	18.6%	14.6%	15.3%	10.6%	0.7
200% of median wage	20.2%	17.2%	22.0%	14.6%	4.4

Source: TBRM and TBMT

57. When tax credits are taken into account, households with children pay much less tax than households without children at and below median income, but bear the same tax burden at incomes of 150% of median income and above. The price of dealing with family responsibilities in this way rather than through the income tax system, as other countries do, is that families face confiscatory marginal tax rates. We look at this issue in more detail in Chapter 8.

chapter 6 Overall Direct Tax Burden

This chapter assesses the overall direct tax burden, taking account of NICs and child benefit as well as income tax and tax credits.

- Most households have a lower overall direct tax burden in 2013 than in 1990.
- Exceptions are couples without children at median income, and single parents and one-earner couple families with two children at 200% of median income.
- At all income points, the overall direct tax burden on families is lower than that on similar households without children, although the gap is narrower at and above median income.
- Families need a much higher gross income than single taxpayers to have a minimum acceptable standard of living. Because of the way the tax system works, a one-earner family with two children needs to earn more than twice as much as a single person without dependants to meet the Minimum Income Standard (MIS).
- There will be families who do not meet the MIS yet are required to pay higher rate tax. Tax credits and child benefits do not adequately compensate for the fact that the income tax system takes no account of the family.

58. The income tax burden on various households was considered in Chapter 4, and the effect of tax credits in Chapter 5. Now the overall direct tax burden is assessed, taking into account NICs and child benefit. When measuring the overall direct tax burden on families, it is customary to include child benefit (which replaced child tax allowances) as a negative tax.[43] Table 6.1 shows the overall direct tax burden on six household types when income tax, NICs, tax credits and child benefit are all included.

[43] The overall direct tax burden does not take account of VAT or any other indirect tax.

Table 6.1

Income tax plus NICs less tax credits and child benefit as percentage of gross income in 1990/91 and 2013/14

	1990/91	2013/14	1990/91 - 2013/14 change (percentage points)
	single person without children		
50% of median wage	19.2%	5.9%	-13.3
75% of median wage	24.1%	10.6%	-13.5
100% of median wage	24.1%	21.4%	-2.7
150% of median wage	28.9%	25.0%	-3.9
200% of median wage	28.5%	29.0%	0.5
	single parent two children		
50% of median wage	-16.7%	-61.0%	-44.3
75% of median wage	17.0%	-16.3%	-33.3
100% of median wage	17.0%	5.9%	-11.1
150% of median wage	22.5%	20.6%	-1.9
200% of median wage	23.1%	26.7%	3.6
	one-earner couple no children		
50% of median wage	12.2%	-2.9%	-15.1
75% of median wage	19.5%	10.6%	-8.9
100% of median wage	19.5%	21.4%	1.9
150% of median wage	26.6%	25.0%	-1.6
200% of median wage	26.2%	29.0%	2.8
	one-earner couple two children		
50% of median wage	-16.7%	-61.0%	-44.3
75% of median wage	17.0%	-16.3%	-33.3
100% of median wage	17.0%	5.9%	-11.1
150% of median wage	22.5%	20.6%	-1.9
200% of median wage	23.1%	26.7%	3.6
	two-earner couple no children		
50% of median wage	3.6%	-7.6%	-11.2
75% of median wage	9.6%	5.4%	-4.2
100% of median wage	9.6%	10.8%	1.2
150% of median wage	21.8%	17.9%	-3.9
200% of median wage	24.8%	21.4%	-3.4
	two-earner couple two children		
50% of median wage	-30.4%	-65.8%	-35.4
75% of median wage	17.7%	-29.0%	-46.7
100% of median wage	21.8%	-4.7%	-26.5
150% of median wage	25.9%	13.5%	-12.4
200% of median wage	27.9%	19.7%	-8.2

Source: TBRM and TBMT

Note: A negative figure means that the "tax" liability of the household is negative i.e. tax credits and child benefit exceed income tax payments and NICs.

59. Most households considered have a lower overall direct tax burden in 2013 than in 1990. The exceptions are one-earner households at 200% of median income, and couples without children at median income. This latter group does not get tax credits and has lost the MCA, introduced in 1990 when independent taxation came in.[44]

60. In 1990/91 a one-earner family with two children at 50% of median income had a negative overall direct tax liability of -16.7%. In 2013/14 the negative liability is likely to be -61%. As a proportion of gross income, net support to this type of family is more than three times what it was in 1990/91. The tax liability of a similar family at median income was 17% in 1990/91; in 2013/14 it is 5.9%, approximately one third of what it was.

61. However at 200% of median earnings (an annual income of just over £53,000), a one-earner family with two children has an overall direct tax liability higher than it was in 1990/91. This is due to a combination of factors – the loss of the MCA, the reduction in real terms of the higher rate threshold, and the HICBC. These families are not particularly well off. Chart 2.1 above shows that in 2013/14, 40% of the population is likely to be better off than these families, yet in many cases these better off households pay less tax. The one-earner family with two children is the only household type considered which has a higher overall direct tax burden in 2013 than in 1990.

62. At all income points the overall direct tax burden on families is lower than that on households without children, although the gap is narrower at and above median income. However, this does not mean that all is well. As shown in Chapter 2, households with children are less well off than other households with similar incomes when allowance is made for family size and composition.

63. The JRF has shown that families need a much higher gross income than single taxpayers to achieve a Minimum Income Standard (MIS). The JRF gross income figures take account of tax credits and childcare costs where appropriate. Table 6.2 shows for seven different household types the gross income needed to achieve the MIS, income tax payable and tax credits receivable.

[44] Single parents with two children have lost the APA, but would be entitled to tax credits of £45.59 pw if they had two or more children and incurred childcare costs of £300 pw..

Table 6.2

Households with MIS income in 2013/14

Gross income needed, income tax payable and tax credits receivable

Household type	Gross income needed for MIS	Income tax	Tax credits
Single adult no children	£16,852	£1,480	nil
Single parent one child	£25,586	£3,232	£2
Single parent two children	£30,138	£4,140	£9,884
One-earner couple one child	£30,835	£4,275	nil
One-earner couple two children	£36,060	£4,140	£836
Two-earner couple two children	£38,759	£3,972	£3,962
One-earner couple three children	£41,519	£6,461	nil
One-earner couple four children	£45,422	£8,385	nil

Source: JRF Minimum Income Calculator and TBMT

64. It is difficult to defend an income tax system that imposes higher rate tax on a family which may not even have a minimum acceptable standard of living (as shown in Chapter 4).[45] The current higher rate threshold may be right for single people without dependants but not necessarily for all families. Tax credits and child benefit do not adequately compensate for the fact that the tax system ignores the family. It is probably unrealistic to expect them to do so. As the JRF figures show, a one-earner couple with two children has to earn more than twice the amount of a single person without children to achieve a minimum income standard, even when tax credits and child benefit are taken into account.

65. The problem is not independent taxation as such, but the way it had to be introduced and the way it was subsequently developed. With hindsight, it is clear that it was a mistake not to introduce a transferable allowance and, not having done so, to drop the two allowances which were introduced to protect families. Tax credits were introduced in part because the income tax system failed to support families, but they do not prevent families who do not even achieve a minimum income standard from facing larger tax bills than other households with a higher standard of living. They also destroy incentives, as explained in Chapter 8. The answer is not to refine the tax credit or Universal Credit system further but to look again at how the income tax system should apply to families. The root of the problem many families face is not the tax credit or Universal Credit system, but the income tax system.

[45] This impact may change somewhat under Universal Credit, but that does not affect the general argument being made here..

chapter 7
Universal Credit

This chapter looks at the impact of the switch to Universal Credit, which begins in the autumn of 2013. It considers who are the winners and losers, and the effect on marginal rates and the couple penalty.

- Universal Credit is replacing tax credits and various means-tested income related benefits.
- Single parents working less than 16 hours a week are expected to be better off, but those working 30 or more hours slightly worse off.
- One-earner in-work couples will be better off.
- Families with savings of more than £16,000 will be worse off.
- Families in rented accommodation and entitled to housing benefit are better off. The very high marginal rates that currently apply to these families will be reduced.

66. The Universal Credit is replacing tax credits. We examine first whether families will be worse off or better off as a result of the introduction of Universal Credit. Secondly, we consider the extent to which the problems identified in the two previous chapters will remain when Universal Credit is fully operational.

67. The Universal Credit is replacing not only tax credits, but also housing benefit, Income Support, income-based Jobseeker's Allowance and the income-related Employment and Support Allowance. The plan is for this new Universal Credit to be fully operational by October 2017. However, from October 2013 all new claims for out-of work support will be treated as claims for Universal Credit. From April 2014 no new claims for tax credits will be accepted. There will be a gradual switchover between April 2014 and October 2017.

68. The Government says that welfare dependency has become a significant problem with huge social and economic costs. For people reliant on benefits, the incentives to move into work or increase earnings once in work can be very low. The hope is that Universal Credit will improve work incentives by allowing individuals to keep more of their earnings as they move into work, and ensuring a smoother and more transparent reduction in benefits as earnings increase.

69. Universal Credit will resemble the existing means-tested benefits. It will consist of a personal amount and additions for people in specific circumstances to reflect

differences in basic living costs. In this respect Universal Credit will differ from tax credits, the 'personal amounts' of which are the same for couples with children and single parents. However, the income point at which Universal Credit will start to be tapered is higher for single parents than for couples. It is also lower where housing benefit is claimed.

70. These are some of the more important differences between Universal Credit and tax credits:

- The withdrawal rate for earned income is 65% compared with tax credit withdrawal rate of 41%.
- The withdrawal rate for investment income is 100%, whereas for tax credits investment income is treated in the same way as earned income.
- Universal Credit is based on net of tax and NIC earned income.[46] Tax credits are based on gross income including investment income.
- Claimants with assets of £16,000 (excluding a principal private residence) will not be entitled to Universal Credit.[47]
- There is no de minimis rule for Universal Credit, whereas tax credits contain a de minimis rule for changes in income such that increases of up to £5,000 a year and reductions of £2,500 do not have to be reported.
- Universal Credit is not affected by the number of hours worked. The tax credit premiums for working 16 or 30 hours a week disappear.
- Universal Credit will be based on real time reported earnings, whereas tax credits are normally based on previous year's income and not generally updated.
- A 'Minimum Income Floor' is to apply to the self-employed. The self-employed are assumed to be earning the Minimum Wage for the hours claimed to be worked.[48]

71. The Department for Work and Pensions (DWP) published an Impact Assessment in December 2012. This shows that 3.1 million households will have a higher entitlement as a result of Universal Credit – on average gaining £168 per month. Approximately 1.9 million households will see an increase of more than £100 per month; 2.8 million households will have a lower entitlement. The average reduction will be £137 per month. The majority will have a reduction of less than £100 per month. Losers are to be allowed to keep their existing entitlement where

46 Other benefit income, e.g. child benefit, is ignored

47 Instead of taking account of the actual amount of investment income, as is done for tax credits, investment income below £300 is ignored altogether for tax credit purposes savings below £6,000 are ignored and an income of £31 per week is imputed for savings between £6,000 and £1,000. This follows means-tested benefits precedents. This involves a taper rate to interest income of more than 100%.

48 The self-employed will have to declare their earnings (except for new self-employed businesses with less than a year of activity) but the income cannot be less than the number of hours an individual is expected to work or be looking for work multiplied by the relevant National Minimum Wage (NMW). For someone over the age of 25 this would normally be 35 x NMW.

their circumstances remain the same. Not all these people are taxpayers or even in work. 1.3 million of those in work (working age only) earn below the tax threshold and 2.7 million are in work and earning above the tax threshold.[49]

72. Considering families with two children, the IFS has said[50] that:

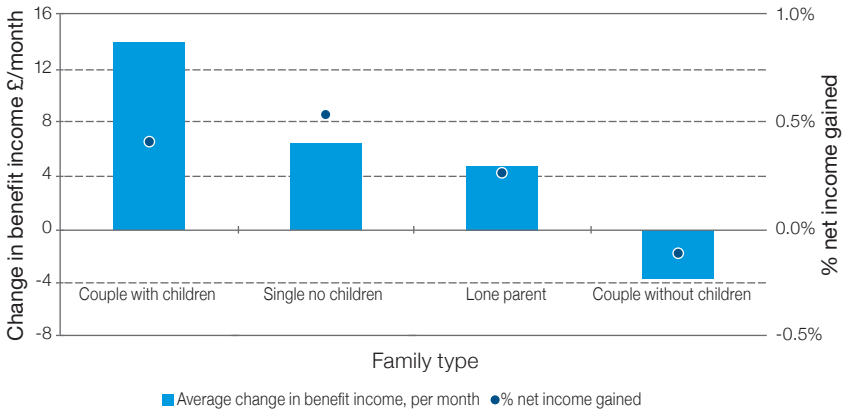
- one-earner in-work couples will be better off
- couples with savings of more than £16,000 will be worse off
- a single parent working less than 16 hours a week will be better off, but the difference is very little for those working between16 and 29 hours, and those working 30 or more hours per week will be slightly worse off.

These conclusions have been confirmed by the DWP.

73. Chart 7.1 shows the average change in net income by family type.

Chart 7.1

Average changes in net income under Universal Credit by family type (all working age households) before cash protection



Source: DWP Universal Credit Impact Assessment

Note: Changes in household entitlement captured here only reflect changes in transfer payments (benefits and tax credits) as a result of the move to Universal Credit.

74. Table 7.1 shows entitlement changes by household type and tenure type[51]. 66% of couples with children who are renting have a higher entitlement, only 18% a lower entitlement. This group benefits from a higher withdrawal starting point

49 *Universal Credit Impact Assessment,* Department for Work and Pensions, December 2012, Tables 4, 8 and 9

50 Op. cit.

51 *Universal Credit Impact Assessment,* Department for Work and Pensions, December 2012

and a reduced withdrawal rate. Taking housing benefit into account, the current METR could be over 90%. However, many single parent families will receive lower awards. The DWP say that the average reduction for those with a lower entitlement (£87 per month) is smaller than the average increase for those with higher awards. As a result lone parents as a group gain by £5 per month.

Table 7.1

Changes in household entitlement by family type and household tenure type

	Higher Entitlement	No change	Lower Entitlement (before cash protection)
	Figures may not sum due to rounding		
Under 25 No children	300,000 *(40%)*	300,000 *(47%)*	100,000 *(12%)*
Single No children	700,000 *(29%)*	1,100,000 *(47%)*	600,000 *(25%)*
Couple No children	300,000 *(35%)*	100,000 *(16%)*	400,000 *(48%)*
Lone Parent - Renting	400,000 *(28%)*	500,000 *(36%)*	500,000 *(36%)*
Lone Parent - No Rent	300,000 *(39%)*	100,000 *(9%)*	400,000 *(52%)*
Couple with Children - Renting	700,000 *(66%)*	200,000 *(17%)*	200,000 *(18%)*
Couple with Children - No Rent	400,000 *(39%)*	*	600,000 *(58%)*
All	3,100,000 *(37%)*	2,400,000 *(29%)*	2,800,000 *(34%)*

Source: DWP Universal Credit Impact Assessment

*** Note:** Fewer than 50,000 households

75. Table 7.2 compares the weekly tax credits and Universal Credit entitlements of three family types at five income points.[52] It would seem that two-earner couple families will lose out with the switch to Universal Credit because, by contrast with tax credits, entitlement is based on net of tax income.

Table 7.2

Tax credits / Universal Credit for families with two children in 2013/14 – weekly entitlement

	Tax credits			Universal Credit		
Percentage of median wage	single parent	one-earner couple	two-earner couple	single parent	one-earner couple	two-earner couple
50% - £256 pw	£150.05	£150.05	£150.05	£148.03	£155.72	£99.74
75% - £384 pw	£97.57	£97.57	£97.57	£77.53	£89.01	£13.47
100% - £511 pw	£45.50	£45.50	£45.50	£35.31	£46.79	£0.00
150% - £767 pw	nil	nil	nil	nil	nil	nil
200% - £1,022 pw	nil	nil	nil	nil	nil	nil

Source: TBMT and authors' calculations

52 Authors calculations based on information available in April 2013

76. Table 7.3 compares the income points at which tax credits and Universal Credit phase out. It seems that for single parents, Universal Credit will phase out at slightly lower income points than is the case under tax credits, and for couples at slightly higher income points. It will be seen that for both household types, Universal Credit interacts with both higher rate income tax and the HICBC. It seems odd that the state is on one hand supporting families and on the other penalising them.

Table 7.3

Income points at which tax credits and Universal Credit phase out - childcare credit not taken into account

Number of children in family	Income point beyond which no tax credits payable	Income point beyond which no Universal Credit payable* (single parent)	Income point beyond which no Universal Credit payable* (one-earner couple)
1	£25,706	£24,768	£26,019
2	£32,329	£30,764	£32,172
3	£39,003	£37,021	£38,273
4	£45,625	£44,686	£45,051
5	£52,247	£50,883	£52,247

Source: TBMT and authors' calculations

* **Note:** Assumes no rent payable

77. These cut off points are also important because they set the limit at which the 76.2% METR will cease to apply. It is clear that many families are locked in a system in which it is very difficult to increase disposable income through full-time work. Under tax credits, families with two children earning little more than the minimum wage will increase their disposable income by only £65 (16%) if they double their income. The figure would be even lower if the family were claiming housing benefit. Universal Credit will improve the situation for those entitled to housing benefit, but will make the situation worse for those not entitled to it. The marginal rate issue is considered in more detail in Chapter 8.

78. Table 7.4 compares tax credits received in 2013 by families of different sizes on median earnings with the Universal Credit they would receive if Universal Credit were fully operational. The annual entitlement under Universal Credit is lower for all families with two or more children.

Table 7.4

Tax credits / Universal Credit for families on median earnings in 2013/14 – annual entitlement

Family type	Tax credits	Universal Credit	Family type	Tax credits	Universal Credit
Single parent one child	nil	nil	Couple one child	nil	nil
Single parent two children	£2,373	£1,841	Couple two children	£2,373	£2,242
Single parent three children	£5,093	£4,561	Couple three children	£5,093	£4,962
Single parent four children	£7,813	£7,281	Couple four children	£7,813	£7,682
Single parent five children	£10,533	£10,001	Couple five children	£10,533	£10,402

Source: TBMT and authors' calculations

79. Table 7.5 compares tax credits received in 2013 by families of different sizes on 50% of median earnings with the Universal Credit they would receive if Universal Credit were fully operational. For families with two or more children, the annual entitlement under Universal Credit is lower for single parents but higher for couples.

Table 7.5

Tax credits / Universal Credit for families on 50% median earnings in 2013/14 – annual entitlement

Family type	Tax credits	Universal Credit	Family type	Tax credits	Universal Credit
Single person one child	£5,104	£4,998	Couple one child	£5,104	£5,400
Single person two children	£7,824	£7,718	Couple two children	£7,824	£8,120
Single person three children	£10,544	£10,438	Couple three children	£10,544	£10,840
Single person four children	£13,264	£13,158	Couple four children	£13,264	£13,560
Single person five children	£15,984	£15,878	Couple five children	£15,984	£16,280

Source: TBMT and authors' calculations

How Universal Credit affects the tax burden

80. Where housing benefit is not involved, it appears that the changeover will make little difference. Table 7.6 shows the position of various households without housing costs in 2013/14 if Universal Credit were applicable.

Table 7.6

Income tax less Universal Credit as percentage of income if Universal Credit were fully operational in 2013/14

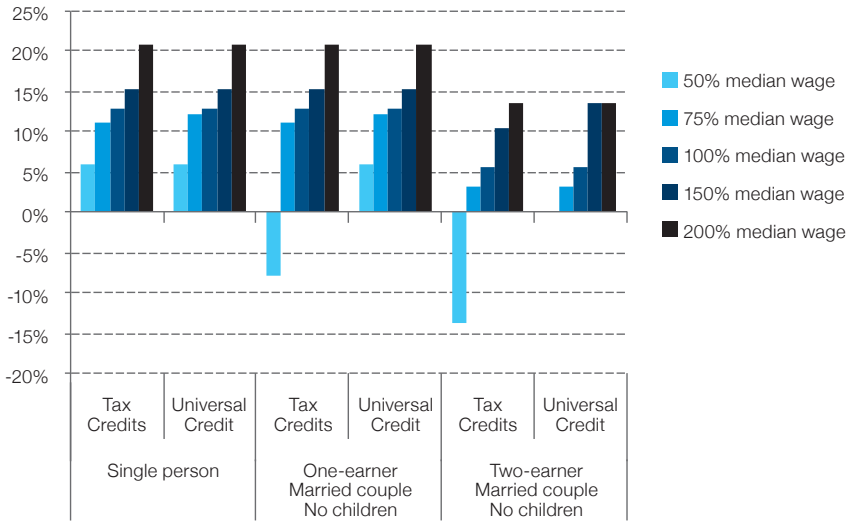
Percentage of median wage	Single person	Single parent two children	One-earner couple no children	One-earner couple two children	Two-earner couple no children	Two-earner couple two children
50% - £256 pw	5.9%	-52.3%	5.9%	-59.4%	0.0%	-58.2%
75% - £384 pw	12.3%	-7.9%	12.3%	-12.3%	3.2%	-11.9%
100% - £511 pw	12.9%	5.8%	12.9%	2.3%	5.8%	2.1%
150% - £767 pw	15.3%	15.3%	15.3%	15.3%	13.5%	10.6%
200% - £1,022 pw	20.9%	20.9%	20.9%	20.9%	13.5%	13.5%

Source: TMBT and authors' calculations

81. Chart 7.2 compares the effect on selected households of tax credits and Universal Credit.

Chart 7.2

Income tax minus tax credits / Universal Credit as percentage of gross earnings in 2013/14



Source: TMBT and authors' calculations

Couple penalty

82. The biggest gain from Universal Credit in cash terms, averaging £14 per month, is among couples with children. To this extent the Government can claim that they have done something to reduce the couple penalty but it will only make a small difference.[53] A substantial couple penalty is likely to remain for the foreseeable future.

Conclusion

83. The main groups expected to gain from the switch to Universal Credit are couples with children and families in rented accommodation. However, the reduction in the tax burden on these families seems likely to be modest, and compares unfavourably with the much larger reduction since 2010 in the tax liabilities of those taxpayers who have been the principal beneficiaries of independent taxation.[54] Universal Credit will not be an answer to the problems created by an income tax system which ignores the family.

53 *Universal Credit Impact Assessment,* Department for Work and Pensions, December 2012, para 38: "Universal Credit takes the first steps to address the penalty on couples imposed by the benefits system by rewarding families with children."

54 In 2010 the tax threshold for the under 65s was £6,475. Increasing the tax threshold to £10,000 results in a tax cut of £700, or £1,400 for some two-earner couples.

chapter 8
Marginal Effective Tax Rates

This chapter looks at the impact of independent taxation coupled with tax credits on marginal effective tax rates – the amount the Government takes back from each extra pound earned.

- A system of independent taxation coupled with tax credits has destroyed incentives for many in-work families. Many families face a marginal effective tax rate (METR) of 73%, shortly to increase to 76.2%. The rate for families in rented accommodation can be as high as 96%. In 1990 these families had a METR of 34%.
- In 1990 the METR for second earners was often 0%. It is now 41%, and under Universal Credit will rise to 65%, in some cases 76.2%.
- The switch from tax credits to Universal Credit will reduce the METR for families in rented accommodation but increase it for other families to 76.2%.
- These marginal rates are far higher than those that apply to those with the highest incomes.
- They not only weaken incentives but make it very difficult for many families, even with earnings well above the median wage, to increase their disposable income.
- These rates will be more apparent in future years with the introduction of Universal Credit and the switch to real time PAYE because changes in income will affect the credit paid immediately.
- Families in full-time work are trapped by a tax system which does not recognise marriage or family responsibilities and has to be supplemented by heavily means-tested cash credits.
- Other countries have much lower marginal rates because they have tax systems which do recognise marriage and family responsibilities.

84. The willingness to work or to increase income is affected by a person's marginal effective tax rate (METR) – the amount the Government takes back from each extra pound earned. This will be a combination of income tax, NICs and the withdrawal of tax credits and means tested benefits such as housing benefit and council tax benefit.

85. The switch to independent taxation coupled with the introduction of tax credits has seriously weakened incentives for many in-work families to increase their earnings. In 1990 the METR for a one-earner family on median income not in receipt of housing benefit[55] was 34% – the family kept 66% of any extra income. In 2013/14 the METR for families not in rented accommodation is 73% – they keep only 27p of any additional pound earned. In 1990 if a non-earner spouse took a part time job and their income was covered by the WEIA[56] they kept all their earnings. If their earnings exceeded the allowance their METR would have been 25%.[57] In 2013/14 their METR will be 41% if their earnings are below the tax threshold, and 73% if above it.

86. Table 8.1 compares the marginal rates of a one-earner family at various percentages of median earnings in 1990/91, 2010/11 and 2013/14. This comparison excludes families in rented accommodation, for which 1990/91 data is not available to the authors.

Table 8.1

METRs for a one-earner family with two children in 1990/91, 2010/11 and 2013/14

	1990/91	2010/11	2013/14
50% of median wage	78.2%	70.0%	73.0%
75% of median wage	34.0%	70.0%	73.0%
100% of median wage	34.0%	70.0%	73.0%
150% of median wage	34.0%	31.0%	32.0%
200% of median wage	40.0%	48.0%	42.0%

Source: TBMT

87. The replacement of tax credits by Universal Credits will ease the problem for families renting who receive housing benefit, but make it worse for those who are owner occupiers. The DWP say that 2.5 million Universal Credit families (1.4 million single parent families and 1.1 million couple families) are renting. Many of these should see their METR fall. But 1.8 million Universal Credit families (0.8 million single parent families and 1 million couple families) are not paying rent, and most of these will see their METR increase. Some of these families will be unemployed and consequently unaffected by income tax and NIC rates.[58]

88. The impact of higher marginal rates has been obscured in the past because three 'taxes' have been involved, and because the impact on tax credits can be delayed for up to a year. By contrast, under Universal Credit, the effect of increases in

55 The authors have not been able to ascertain the METR in 1990 where housing benefit was being claimed.

56 In 1990/91 this was £1,720, the same as the Personal Allowance – 14% of median wage.

57 Married women often paid no NICs in the 1990s.

58 *Universal Credit Impact Assessment,* Department for Work and Pensions, December 2012, Table 3

income will generally become apparent to families a month later as a result of the reduction in their credit.

89. As suggested in Chapter 4, one of the reasons why transferable allowances were not introduced when independent taxation came in was the concern that these would act as a disincentive for second earners. In 1986 transferable allowances would have raised the marginal rate from 0% to 29% (the then basic rate) when a non-earner moved into paid work. Now, however, because of tax credits, many second earners face a METR of 41% when moving into paid work, and this will rise to 65% when Universal Credit rules start to apply.

90. Table 8.2 shows the METR paid by second earners in 1990/91, 2010/11 and 2013/14.

Table 8.2

METRs for second earners in 1990/91, 2010/11 and 2013/14

Income of second earner	1990/91	2010/11	2013/14
Below the tax threshold	0.0%	39.0%	41.0%
Above the tax threshold	25.0%	70.0%	73.0%

Source: TBRM and TBMT

91. METRs are higher where the family is in rented accommodation. Table 8.3 shows illustrative rates for families in social housing, where rents are lower than for private housing. Figures are not available to make comparisons with 1990/91 for these families.

Table 8.3

METRs for one-earner couple with two children in rented accommodation in 2013/14

	Social housing rent £81 pw	Private tenancy rent £219 pw
50% of median wage	96.0%	96.0%
75% of median wage	78.4%	96.0%
100% of median wage	73.0%	90.5%
150% of median wage	32.0%	76.2%
200% of median wage	42.0%	42.0%

Source: TBMT

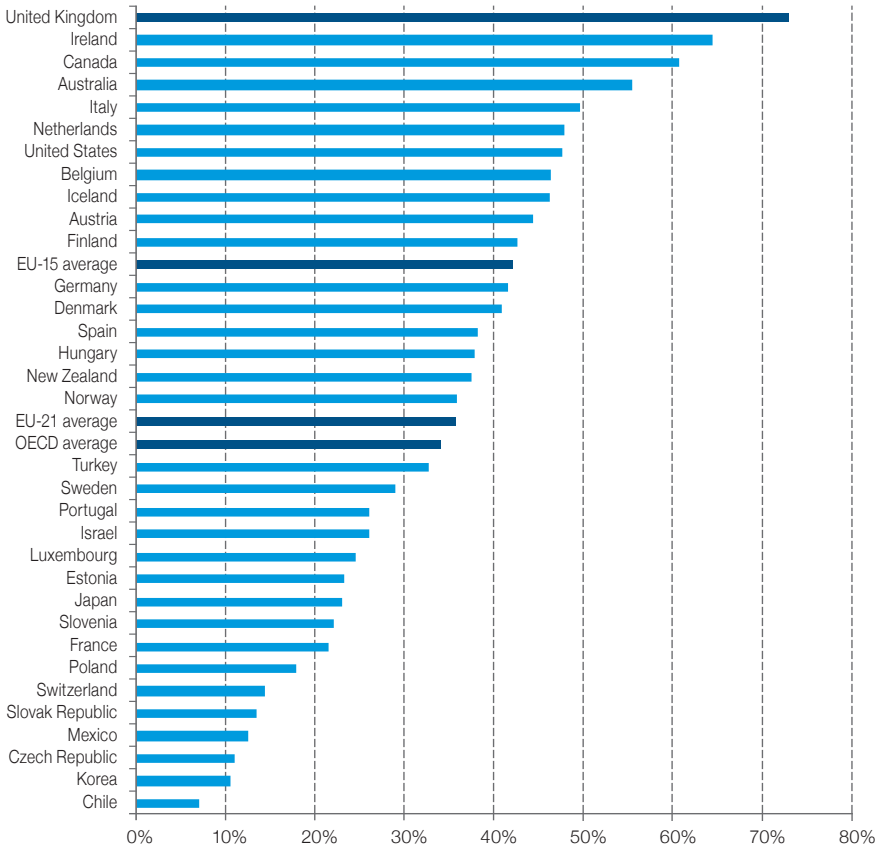
92. Those who designed independent taxation could not have been expected to foresee that the indirect result of having a tax system which takes no account of marriage or family circumstances would be that a family on median income would face a marginal rate of over 70%. As CARE has been pointing out for a number of years, the UK stands almost alone amongst large developed countries in having

a tax system which ignores marriage and family responsibilities and entirely alone in having a system which imposes a METR of 73% on families with a median income. In 2011, the latest year for which there is data, the OECD average was 34%. Moreover, the UK figure takes no account of "passported benefits", in particular free school meals, to which families are entitled if they are in receipt of Child Tax Credit, provided they are not also entitled to Working Tax Credit and have an annual gross income of no more than £16,190.

93. Chart 8.1 shows METRs in OECD countries in 2011(the latest year for which we have figures) for one-earner married couples with two children. The income point is 75% of the average wage as calculated by the OECD, which in the case of the UK approximates to the median wage that year (£26,124).

Chart 8.1

METRs at 75% of average wage for OECD countries in 2011 One-earner married couple with two children



Source: Pearson and Binder *the taxation of families – international comparisons 2011*

Effect on incentives of high METRs

94. The effect of high METRs can be seen by looking at a family's disposable income – the income available to feed and clothe the family after the Government's take has been deducted. Table 8.4 shows what relatively little effect a doubling, trebling or even quadrupling of income can have on a family's disposable income.

Table 8.4

Effect on weekly disposable income of increasing gross income 2013/14

Gross annual income	£12,500	£25,000	£37,500	£50,000
	Weekly disposable income before housing costs *percentage increase in disposable income*			
One-earner family				
One child	£362 *n/a*	£407 *18%*	£563 *64%*	£710 *106%*
Two children	£408 *n/a*	£472 *16%*	£577 *41%*	£723 *77%*
Three children	£473 *n/a*	£538 *14%*	£603 *27%*	£737 *56%*
Four children	£539 *n/a*	£603 *12%*	£668 *24%*	£750 *39%*
One-earner family in privately rented accommodation*				
One child	£256 *n/a*	£276 *8%*	£383 *50%*	£528 *106%*
Two children	£333 *n/a*	£345 *4%*	£381 *14%*	£473 *42%*
Three children	£409 *n/a*	£419 *2%*	£441 *8%*	£488 *19%*
Four children	£486 *n/a*	£495 *2%*	£515 *6%*	£544 *12%*

Source: Authors' calculations

* **Note:** The rent is taken to be £219 per week for a three-bedroom house, as per TBMT

95. A family of four (i.e. a couple with two children) on £12,500 in rented accommodation would see only a 4% increase in disposable income when gross income doubles and a 14% increase when it trebles. A similar family in non-rented accommodation would see an increase of only 16% from a doubling of income. A family of five (i.e. a couple with three children) in non-rented accommodation would see only a 27% increase in disposable income from a trebling of salary. For the same family, a 50% increase in gross income from £25,000 to £37,500 results in only a 12% increase in disposable income. Families are effectively 'locked-in' to their financial situation by the tax and tax credit systems.

96. Much has been made of the disincentive effect of the 50% marginal income tax rate on high earners. Independent taxation coupled with tax credits has created a much bigger disincentive effect for 5 million families caught in this tax trap. The

argument is that high marginal rates are unavoidable unless we have universal benefits. The international figures show that high marginal rates can be avoided with tax systems which take account of marriage and family responsibilities. The cost to the economy of high marginal rates affecting the large number of in-work families within the tax credit system must be considerable. It is surprising that economists have paid so little attention to this.

97. Universal Credit will substantially improve the position for the 2.5 families in rented accommodation, but the METR for a family on a median income not entitled to housing support will rise to 76.2%. For the owner occupier the situation gets worse. These families will keep less than 24p from every extra pound earned. The DWP have said that there will be 2.1 million taxpaying families caught in this tax trap - 0.5 million more than the number caught under the present system.[59] If it is appropriate to reduce the top rate of income tax for the 300,000 individuals with the highest incomes from 50% to 45%, why should 4.1 million families (50% of all families) be locked into a marginal rate of over 76%?[60]

98. Table 5.1 above shows the income points in 2013/14 at which tax credits cease to apply. They range from £25,706 for a family with one child to £52,247 for a family with five children. Families with incomes below these points, which in practice may well be higher where childcare credit is due or there are pension contributions, face these high marginal rates.

99. The Secretary of State for Work and Pensions said on the BBC Radio 4 Today programme on 1 April 2013: 'Full time work is when you break free from the welfare system'. Sadly this is not the case for many families. Families entitled to tax credits and the new Universal Credit are trapped. However hard they work, they will find it difficult to increase significantly their disposable income. Their standard of living is almost wholly determined by the state. Is this the result anyone wants?

Living wage

100. Another way of looking at the effect of a system which imposes high METRs is to look at the effect on increasing the minimum wage to a 'living wage'. A one-earner couple family with two children with the sole earner working 35 hours on the current minimum wage, not entitled to housing benefit and not incurring childcare costs, would currently have a disposable income (income after tax and NICs but gross of tax credits and child benefit) of £401 per week. If the wage were increased to a London living wage of £8.55 per hour, this would raise the family's disposable income by only £23 per week to £424. If child costs are £300 per week (tax credits maximum) the family's disposable income would increase from £611 to £634. In both cases the cost to the employer of the increase in gross income of £82.60 would be £94 when additional employer's NICs are taken into account. The benefit to the Treasury would be £69.

59 *Universal Credit Impact Assessment,* Department for Work and Pensions, December 2012, para 89

60 *Child and Working Tax Credit Statistics,* HMRC, December 2012
In December 2012, 1.9 million couple households with children and 2.2 million single parent families were entitled to tax credits or the equivalent support though benefits.

chapter 9
High Income Child Benefit Charge

This chapter discusses the new High Income Child Benefit Charge which impacts so capriciously on middle-income families.

- The High Income Child Benefit Charge (HICBC) cancels out child benefit, in part or in whole, for those families where one spouse or partner has an income which exceeds £50,000.
- It reduces the privacy which couple families who are not entitled to tax credits have had since 1990.
- A family with two children stands to lose £30,000 over 18 years.
- This additional tax burden on families will affect many who are not in the top 15% of the income distribution. Some families caught by the HICBC will be in the poorer 50% of the population.
- Couples where one spouse or partner has an income of over £50,000 are affected, while couples with a similar household income spread more equally between them are not.
- The marginal rate of withdrawal depends on the number of children and not on income so that, in addition to the 40% higher rate income tax charge, the marginal rate for large families is very high – in some cases over 100%.
- The HICBC can overlap with tax credits, pushing the effective marginal rate even higher.

101. The High Income Child Benefit Charge (HICBC) came into effect in January 2013. Under it, there is a charge where anyone entitled to child benefit has an income exceeding £50,000 or, if they are married or living with a partner, the spouse or partner has an income exceeding £50,000. In the latter case, the charge falls on the spouse or partner with the higher income. The charge claws back part of the child benefit or, if the income exceeds £60,000, all of it. Alternatively the person entitled to the child benefit may decide not to claim it, in which case there is no charge. When the income is over £50,000, 1% of the child benefit is clawed back for every £100 of income. The charge therefore cancels out the benefit fully where the income exceeds £60,000.

102. When the Chancellor of the Exchequer first announced the charge, he said that it was very difficult to justify a system that taxed people at high rates only to give it back in child benefit, or a system that taxed people on low incomes to pay for the child benefit of those earning so much more than them.[61] Subsequently he said that it was fair to ask those in the top 15% of the income distribution to make a contribution to the fiscal consolidation.[62] The following day the Prime Minister qualified this somewhat when he spoke of not giving child benefit to the wealthiest 15% of families.[63]

103. HICBC impacts on each of the three general themes which run through this booklet. It is interesting therefore that the Government has never sought to defend criticism of the charge except in the very broad terms indicated above. They have not responded to any of the points made in the following paragraphs.

One- and two-earner households

104. As soon as the charge was first announced, there was considerable comment of what was widely seen to be the unfairness that a two-earner couple could have a combined income almost twice as much as that of a single earner and yet not be liable to the charge which the latter had to pay.

105. The household is the relevant factor in so far as the charge applies if either partner in the couple has an income exceeding £50,000. But the total income of the household is not a relevant factor. In other words you have to look to both partners to see if the charge applies, but, if it does, then no regard is paid to the individual with the lower income. This is the obverse to the treatment for tax credits where the couple is looked at as a whole to find the family income, but the fact that they are a couple is then ignored as they are then treated no differently from a lone parent. In both cases there is an inconsistency which works to the detriment of single earner couples.

106. When the Chancellor of the Exchequer announced the HICBC, it was to apply to higher rate taxpayers – the higher rate threshold was then £42,475. In the event he raised the threshold to £50,000 and introduced the tapering provision. As a result, of the 1.2 million recipients of child benefit who would have been affected by the original proposal, only 750,000 are losing the benefit in whole or in part. This was the only concession which he made and, although very welcome, it did nothing to abate the criticism of unfairness towards single earner families.

107. One-earner couples already pay far more tax than two-earner couples with the same income, largely because they access only one tax allowance rather than two. A one-earner couple with two children with an income of £60,000 pays income tax of £13,829. A comparable two-earner couple, each earning £30,000, pays £8,217. After the HICBC is added, the one-earner couple's tax bill rises to £15,565. This is £7,348 more than that of the two-earner couple. Put another way,

61 Speech to the Conservative Party Conference, 4 October 2010

62 Hansard, 6 March 2012, col 708

63 Hansard, 7 March 2012, col 841

a one-earner family with two children and an income of £60,000 now pays 89% more tax than a comparable two-earner couple, each earning £30,000. Over the lifetime of the children, if child benefit is claimed for each child up to the age of 18, this represents a £30,000 increase in the family's tax bills.

108. Also, the HICBC has introduced the couple penalty into an area of the income distribution where it did not previously apply. One can see it most clearly by envisaging a man with an income of over £50,000 considering marrying or going to live with a woman who is receiving child benefit for one or more children. If he does move in, he will have to pay the charge, unless she agrees not to claim the child benefit.

109. The HICBC also reduces the privacy brought about by independent taxation, again in an area where it has hitherto remained intact. A spouse or partner will need to know whether or not the other's income exceeds £50,000 and, where both do, which of them has the higher income (although in some circumstances they may be able to get some limited assistance with this from HMRC).

Who will the HICBC effect?

110. As mentioned above, the Chancellor of the Exchequer referred to the HICBC as affecting people in the top 15% of the income distribution and the Prime Minister applied it to the wealthiest 15% of families. Whichever phrase is used however, in practice the distribution of income is measured on the basis of household income, not that of individuals. Income by itself is not a good guide to the position of a household in the distribution of income as this is also affected by the number of adults and children in the family.

111. The IFS estimate that about 820,000 families, in which at least one adult has a taxable income exceeding £60,000 per year, stand to lose all their child benefit as a result of the new income tax charge unless they change their behaviour in response. And about 320,000 families in which the highest-income adult is on between £50,000 and £60,000 would have some, but not all, of it clawed back. The affected families stand to lose an average of about £1,300 per year. The remaining 85% of families currently receiving child benefit will be unaffected for now, although, as the IFS point out, more families will be affected in time because the £50,000 threshold is planned to be frozen in cash terms.[64]

112. It is clear that the charge affects many families who are not in the top 15% of the income distribution. Our estimates suggest that some large families who are in the poorest 40% of the population are caught by the charge. The Government can claim that the HICBC currently only applies to 15% of families but it does not follow that these are the top 15% of families. Table 9.1 shows where families affected by the new charge are likely to fit in the income distribution in 2013/14 and how much income they are likely to need to be in the highest 15%.

[64] Robert Joyce, *Withdrawal symptoms: the new 'High Income Child Benefit charge',* Institute for Fiscal Studies, January 2013 http://www.ifs.org.uk/publications/6527.

Table 9.1

Where families on annual income of £50,000 and £60,000 fit in the income distribution

Family type	Position in income distribution with income of £50,000	£60,000	Family reaches 85% at income of
One child			
Single parent	85%	90%	£46,600
One-earner couple	67%	75%	£68,800
Two-earner couple	73%	81%	£63,875
Two children			
Single parent	76%	81%	£59,124
One-earner couple	58%	65%	£82,600
Two-earner couple	64%	72%	£73,800
Three children			
Single parent	67%	72%	£69,500
One-earner couple	49%	56%	£95,700
Two-earner couple	56%	64%	£88,643
Four children			
Single parent	58%	63%	£91,250
One-earner couple	42%	47%	£119,929
Two-earner couple	49%	55%	£99,071
Five children			
Single parent	52%	54%	£106,893
One-earner couple	37%	39%	£132,964
Two-earner couple	45%	48%	£114,714

Source: Authors' calculations

Effect on METR

113. As already mentioned, the marginal provision where the income being charged is between £50,000 and £60,000 is 1% of the child benefit for every £100 by which the income exceeds the former figure. Hence the marginal rate at which the HICBC is imposed depends not only on the income but also on the amount of the child benefit, and hence on the number of children in respect of whom the benefit is being paid.

114. The current rates of child benefit, which will not change until April 2014 at the earliest, are £20.30 per week for the first child and £13.40 for any subsequent children: these equate to £1,055.60 and £696.80 per annum respectively. The marginal rate of the HICBC, and the marginal rate when account is also taken of income tax at the higher rate of 40%, are set out in Table 9.2.

Table 9.2

HICBC marginal rates

Number of children in family	Amount of child benefit	Marginal rate of Charge	Marginal rate of Charge and income tax
1	£1,055.60	10.6%	50.6%
2	£1,752.40	17.5%	57.5%
3	£2,449.20	24.5%	64.5%
4	£3,146.00	31.5%	71.5%
5	£3,842.80	38.4%	78.4%

Source: Authors' calculations

Note: For any additional child the additional child benefit is £696.80, so that the marginal rate goes up by almost 7%.

115. As Table 7.3 shows, someone with income of more than £50,000 can be drawing tax credits if he or she has 5 children. Indeed if childcare tax credit is also due, then the level at which tax credit may be payable is even higher. Given that the taper rate of withdrawal of tax credits is 41%; this means that the METR could be all but 120%. In this instance the taxpayer would be £20 worse off for every additional £100 of income which he or she received. Maybe it is the Government's intention to encourage giving to charity so that taxpayers in this position can reduce their income until it no longer disadvantages them! This is only a temporary anomaly as it will not apply under Universal Credit.

116. One effect therefore of the way in which the HICBC has been introduced has been to bring in yet another instance of high marginal rates. A fairer approach would have been to have based the marginal charge once the threshold income had been reached at 1% of the amount of the child benefit regardless of the income. In this way, while someone with one child would have lost almost all their benefit if their income were £60,000, someone with two or more children would still have got some benefit until their income were quite a bit higher than that. Even including the higher rate income tax charge, the marginal rate would not then have exceeded 50%. In the absence of any explanation from the Government, we can only assume that a provision of that nature would have been thought to bring in insufficient revenue, so that, along with incentives, fairness took bottom priority in their policy.

chapter 10
Childcare

This chapter looks at the impact of fiscal subsidies for childcare costs.

- Childcare costs are an important factor in determining whether work pays.
- Two-income families, where both earners work 16 hours, and single parents who work 16 hours currently get help with childcare costs through tax credits.
- Some families also benefit from an Employer Supported Childcare (ESC) Scheme.
- From 2015 working families will be able to get tax relief for 20% of childcare costs of up to £6,000 for each child under 12.
- The current system of vouchers and directly contracted childcare through ESC will be closed to new entrants.
- Any family not claiming tax credits (later Universal Credit), where both parents are in work but neither earns £150,000 or more, will get this new tax relief.
- From 2016 the amount of childcare costs which can qualify for Universal Credit purposes is to increase from 70% to 85%.
- The amount of support the Government is giving two-earner families and single parents is in marked contrast to the lack of support given to one-earner couple families.

117. For many families the cost of childcare is as important as tax. Childcare costs have a negative impact on work incentives and can significantly reduce the financial return from work. Both the present Government and its predecessors have attached importance to getting non-earning parents into paid work and have provided help with childcare. It is necessary to take account not only of the cost of childcare but also of the tax reliefs and tax credits available to cover this cost. The support given to the two-earner family model is in marked contrast to the lack of support for one-earner families who have made a salary sacrifice.

118. The Resolution Foundation has said that the UK has some of the most expensive childcare in the OECD, accounting for a third of household income in some cases. Net childcare costs as a percentage of household income are said to account for 30% of household income (after housing costs) for a two-earner family with an income of around £40,000 and with two children under five in full-time childcare. For families with an income of £53,000, the cost of childcare amounts to 40% of income net of housing cost. For a single parent on an average wage, childcare

costs are 12% of income net of housing cost.[65] Unless stated, the tax and tax credit figures in this review do not take account of help with childcare costs.

119. Help with childcare costs is currently available both through tax credits and to a limited extent through the tax system. Through the childcare element of Working Tax Credit, families where each parent works 16 hours or more receive support for 70% of their childcare costs up to a weekly cap of £175 for one child or £300 for two or more. As with other tax credits, the credits are withdrawn as income increases at the rate of 41p in the pound. No family gets 100% of their child costs paid – the most they can get is 70%. Some employees can obtain a measure of tax relief where their employer operates a childcare voucher scheme.

120. Table 10.1 shows the amounts that could be received by single parents and two income couples on varying proportions of median wage claiming the maximum amounts allowed under the present tax credit rules.

Table 10.1

Maximum childcare tax credit per week for two children in 2013/14

	Tax credit before taper	Tax credits without childcare	Tax credits with childcare	Additional credits
50% of median wage	£210	£150	£360	£210
75% of median wage	£210	£98	£308	£210
100% of median wage	£210	£45	£256	£210
150% of median wage	£210	£0	£151	£150
200% of median wage	£210	£0	£46	£5

Source: TBMT

121. When available, childcare credit affects the income point at which tax credits run out, hence the upper limit of the 73% METR that applies to families not paying rent. Table 10.2 shows the income points at which tax credits run out with maximum childcare credit.

Table 10.2

Income points at which tax credits run out in 2013/14 – maximum childcare credit

Number of children in family	Income point at which tax credits run out
1	£793 pw - £41,349
2	£963 pw - £50,214
3	£1,090 pw - £56,836
4	£1,217 pw - £72,374
5	£1,345 pw - £79,414

Source: Authors' calculations

65 Alakeson and Hurrell, *the costs of childcare after housing costs,* Resolution Foundation, December 2012 Net childcare costs defined as the gross value of childcare used (including the value of the Early Years Entitlement) minus all support received specifically due to facing childcare costs.

122. The Government announced in March that, for families who currently receive childcare support through tax credits (and in due course Universal Credit), the support will cover 85% of childcare costs for households qualifying for the Universal Credit childcare element where either the lone parent or both earners in a couple pay income tax. This change will take effect in April 2016 as childcare support moves from tax credits into Universal Credit.

123. More controversially, the Government also announced a new tax-free Childcare Voucher Scheme which will be worth up to £1,200 per child. This will save a typical working family with two children under 12 up to £2,400 a year. The new scheme will be phased in from autumn 2015 and will ultimately be open to around 2.5 million families with children under 12. From the first year of operation, all children under 5 will be eligible, initially opening the scheme to 1.3 million families, and the scheme will build up over time to include children under 12.

124. To be eligible, families must have both parents in work, with each earning less than £150,000 a year, and will not already receive support through tax credits and later, Universal Credit. They will receive 20% – equivalent to the basic rate of tax – of their yearly childcare costs up to £6,000 per child.

125. This new tax-free childcare scheme massively extends the support currently available under the Employer Supported Childcare (ESC) scheme.[66] The Treasury say that for a family with two children, the new offer will be worth more than double the amount of a single claim for ESC, and will be open to around five times as many families. The current ESC scheme is offered by less than 5% of employers and used by around 450,000 families. It provides an income tax and NICs exemption equivalent to relief at the basic rate for childcare vouchers and directly contracted childcare and will be closed to new entrants as the new scheme is introduced. This scheme currently favours households on higher income.

126. The new arrangements when they take effect will further tilt the balance in favour of the two-earner family. One-earner families are beginning to ask why successive Governments fail to recognise the importance of the type of childcare provided by the stay at home parent. There is a growing body of literature which suggests that children do best when a parent is able to provide childcare at home and they find it particularly difficult to understand why at a time of financial austerity families with a combined income of up to £300,000 are being offered a tax break, whereas a tax charge (HICBC) is being imposed on other families with an income as low as £50,000. While opinion will always be divided as to the best form of childcare, the option of at home childcare is an entirely proper one, and it is difficult to see why Government would want to make this choice so difficult for families. The argument is usually made that the tax system should be neutral. The current tax system is clearly not, and seems about to become even less so.

[66] Employer Supported Childcare vouchers currently provide basic rate tax relief to parents who use childcare and whose employers voluntarily offer the voucher scheme. Parents can claim £55 a week free of tax and NICs if they are basic rate tax payers, £28 a week if they are higher rate tax payers and £22 a week if they pay the additional rate of tax. Employers have to offer vouchers to all employees to prevent the scheme being a perk for higher earners, with the exception of minimum wage employees who can be exempt.

chapter 11
Conclusions

This Chapter sets out the authors' conclusions, comparing outcomes with objectives.

Independent taxation was introduced primarily to make the tax system fairer for married women, to allow married women be able to keep their tax affairs private, and to reduce the discrimination against one-earner married couples families.

There were three main objectives:

- to give married women the same opportunities for privacy and independence in tax matters as their husbands .
- to remove discrimination against marriage and the family.
- to raise the tax threshold in a cost-effective way so as to reduce the tax burdens on families with low income.

NB. In addition the intention was to get a better balance between one- and two-earner families without disincentivising non-earners from moving into paid work.

Judged against these objectives independent taxation has failed:

- Although until this year married women have enjoyed complete privacy in respect of income tax, there has been no privacy for the 2 million in-work couple families (a quarter of all families) claiming tax credits or the equivalent.
- Independent taxation without transferable allowances has increased, not removed, discrimination against marriage and the family.
- For many families the tax threshold is scarcely any higher in real terms.
- The balance between one and two income families has worsened.
- Families who do not have a "minimum" income now pay higher rate tax.
- Tax credits have compensated for the failure of the income tax system to take account of the family, but families receiving them face very high marginal rates. They are trapped by the tax and tax credit system. If the main earner increases earnings the state takes back 73p of every extra pound earned.

No other country traps large numbers of families in this way. The root of the problem lies in a tax system which was introduced to make taxation fairer for married women but which has failed to do so.

127. This review has looked at the background to the introduction of independent taxation in 1990, which in essence is the system we have today. It looked at what it aimed to do, in particular to give married women a fairer deal. The income tax law as it then stood made married women second-class citizens. A married woman's income was treated as that of her husband, and she had to reveal full details of her income and savings to her husband. The pre-1990 system was indefensible in other ways, but the overriding objective in 1990 was to create a tax system where married women were treated as people in their own right, were not subordinate to their husbands and did not have to disclose their income and savings to their husbands.

128. Those who planned the introduction of independent taxation wanted

- to give married women the same opportunities for privacy and independence in tax matters as their husbands
- to remove discrimination against marriage and the family
- to raise the tax threshold in a cost-effective way so as to reduce the tax burdens on families with low income
- to get a better balance between one and two-earner families without disincentivising non-earners from moving into paid work.

129. In the absence of the transferable allowance proposed in the 1986 Green Paper, it was recognised that by itself independent taxation would disadvantage families. To avoid this, it was accompanied by the MCA and the APA.

Privacy

130. Until this year, married women have enjoyed complete privacy in respect of income tax. Couples have not had to disclose their income and savings to each other. This has now changed for families affected by the HICBC.

131. However, for the 2 million in-work couple families who receive tax credits or the equivalent (a quarter of all families), there has been no privacy for a decade or more. To claim tax credits couples have to fully disclose their incomes to each other and to HMRC. This will not change with the switch to Universal Credit. Even before 1990 many of these families would have enjoyed a high degree of privacy as in practice the family did not have to make tax returns. They now have none because of the need to claim tax credits.

132. The only couples who now have privacy are those with no children, those where the income of one is clearly above £60,000, or where both incomes are clearly below £50,000 and tax credits do not arise. Why, some ask, does the right to privacy only seem to matter for these groups?

Discrimination

133. The concern in the 1980s was that the pre-1990 system discriminated against one-income married couples. The income of married couples was aggregated

which meant that a married couple could be liable to higher rate tax where an unmarried couple would not. Single-earner married couples were also seen as disadvantaged as they in effect received tax allowances equivalent to 1.6 times the basic personal allowance whereas two-earner couples received allowances worth 2.6 times the basic personal allowance.

134. Independent taxation dealt with the income aggregation issue, but over time one-earner married couples have become even more disadvantaged. In 1990/91 the allowances given to a two-earner couple were some 60% more than those given to a one-earner couple. They are now 100% more. In 1990/91 the allowances given to a one-earner couple and a lone parent were 60% more than those given to a single taxpayer. With the withdrawal of the MCA and APA, one-earner families receive the same allowance as single people without family responsibilities.

Tax threshold

135. Independent taxation has failed to reduce the tax burdens on low-income families. Despite the recent significant increases in the threshold, the income tax threshold for most families is scarcely any higher in real terms than it was in 1990. As recently as last year, it was lower in real terms than in 1990 for some families. Even when the £10,000 threshold takes effect in April 2014, the threshold for one income families is likely to be only 5% higher in real terms than it was in 1990.

136. Raising the tax threshold for everyone has proved to be a very cost-ineffective way of helping poor families. Moreover, when families move to the Universal Credit, they will find that they lose 65% of the value of future increases in the tax threshold. This is because Universal Credit is linked to income net of tax. Families entitled to housing benefit have, for the same reason, derived less benefit from increases in the tax threshold than might have been thought.

137. Families with only a modest standard of living that would have been paying only basic rate tax in 1990 are now paying higher rate tax. Some families liable for higher rate tax earn less than the amount needed to achieve the JRF's MIS. These families have been disadvantaged by independent taxation.

Balance between one- and two-earner families

138. Looking at income tax on its own, the gap between one-earner and two-earner couples with children, which was of concern in 1990, has widened. This is largely due first to the withdrawal of the MCA, which was relatively more important for the one-earner couple, and secondly to the large increases in personal allowances since 2010, which have favoured the two-earner couple. The gap has also widened for families with incomes above the current higher rate threshold.

139. When tax credits are taken into account, the gap between one-earner couples and two-earner couples with the same pre-tax income narrows. The more children the couples have, the narrower the gap for families entitled to credits. After credits are phased out, the gap widens again. Universal Credit is likely to narrow the gap.

Incentives

140. The price paid for relying on tax credits for the recognition of family responsibilities has been the imposition of very high METRs. In 1990/91 very few families had a marginal rate higher than 34%. Now three quarters of all in-work families (the proportion on tax credits) face a METR of 73%, which will rise to over 76% as they are moved over to Universal Credit.[67] Although 2 million families will see their marginal rates go down quite markedly, 2 million others will see them rise. Any increase to over 76%, however minimal, is surely unacceptable. Families facing a marginal rate at this level will find it very difficult to improve their family finances and escape from "welfare dependency".

141. As the Treasury pointed out in 2002, the income tax system has for some years been poor at recognising family circumstances. As they said then "For almost a generation, there was no proper recognition of children in the tax system and it failed to help families balance their work and caring commitments".[68] It is now two generations since the income tax system ceased to take account of the family. Tax credits were intended to remedy this defect, but have resulted in the very high METRs, which 50% of all families face.[69] If the income of the sole or main earner increases, the state takes back 73%. If the non-earner moves into paid work, the state takes back a minimum of 41% of income, rising to 65% when Universal Credit rules start to apply. This cannot be right. No other country traps large numbers of families in this way.

142. The root of the problem lies in a tax system which was introduced to make taxation fairer for married women but which has cruelly failed to do so. However difficult it may be, a way has to be found for supporting in-work families other than through a means-tested credit system. We look at a number of policy options in the next chapter.

Tax burden

143. As expected, the biggest gainers from the introduction of independent taxation were two income couples with investment income who would have been liable to higher tax were their incomes aggregated. The higher rate threshold is now much lower in real terms than in 1990, so that the number of couples benefiting from independent taxation is very much larger.

144. Independent taxation without the MCA and the APA has had a profound effect on the distribution of the income tax burden amongst households. Looking at income tax on its own, single person households and two-earner couples have been the big winners and one-earner couples the big losers.

145. It needs to be borne in mind that when household size is taken into account, the single person without children will be much better off than a couple without

67 These figures take no account of council tax support and passported benefits of which free school meals are the most important.

68 *Child and Working Tax Credits,* HM Treasury, April 2002

69 This figure includes families who have no adult in work; the percentage for in-work families is 40%.

children on the same pre-tax income, and both will be much better off than a couple with two children. Independent taxation has not only resulted in a redistribution of the income tax burden away from single people to one-earner families, but also from those who are higher in the income distribution to those who are lower. It has also had the effect of benefiting two-income families more than one-earner families. None of this was foreseen in 1990.

146. The effect of tax credits should be considered when assessing the impact of independent taxation on tax burdens. Tax credits were seen as complementing the income tax system rather than as stand-alone benefits, which in many respects they resemble. It was for this reason that they were called tax credits and have been treated as tax reliefs in the national accounts to the extent that they do not exceed income tax payments.[70]

147. When tax credits are taken into account, the outcome for all households with children, whether one- or two-earner, has improved. Low income families are much better off than they were in 1990. Tax credits now boost pre-tax income by more than 50% for those on 50% of median earnings.

148. Tax credits compensate for the fact that income tax system does not take account of family responsibilities, but where they do not apply families have been left very much poorer as a result of independent taxation. Universal Credit is replacing tax credits. The DWP say that 800,000 couples with children will be getting a lower entitlement to Universal Credit than they have had to tax credits. Many of these are likely to have no entitlement at all.

149. Even when tax credits and child benefit are taken into account, a one-earner couple with two children has to earn more than twice the amount needed by a single person without children to achieve a minimum acceptable standard of living.

150. Table 11.1 shows the change in the overall direct tax burden over the period 1990/91-2013/14. There has been a reduction for most households considered. The exceptions are one-earner households at 200% of median income, and couples without children at median income.

Table 11.1

Change (in percentage points) in overall direct tax burden 1990/91-2013/14

Percentage of median wage	Single person	Single parent two children	One-earner couple no children	One-earner couple two children	Two-earner couple no children	Two-earner couple two children
50%	-13.3	-44.3	-15.1	-44.3	-11.2	-35.4
75%	-13.5	-33.3	-8.9	-33.3	-4.2	-46.7
100%	-2.7	-11.1	1.9	-11.1	1.2	-26.5
150%	-3.9	-1.9	-1.6	-1.9	-3.9	-12.4
200%	0.5	3.6	2.8	3.6	-3.4	-8.2

Source: extracted from Table 6.1

70 We understand that the Universal Credit will be treated as public expenditure in the national accounts and not as a tax off-set.

Summing up

151. Considering the objectives set in the 1980s for the switch to independent taxation, these are the outcomes:

- Giving married women privacy – largely failed
- Removing discrimination against the one-earner family – failed
- Raising the tax threshold for families – hardly changed, although other taxpayers have seen a big increase
- Better balance between one and two-earner families – now worse
- Not disincentivising – disincentives much greater for many families.

152. Taxpayers with children are bearing a larger share of the income tax burden than was the case in 1990. Without the MCA and the APA, the tax burden on families has increased where tax credits have not been available. Where they have been due, METRs are extremely high, and will remain so with the switch to Universal Credit. Moreover, families who are not well off can now be paying higher rate tax.

chapter 12
Policy Options

This chapter examines ways of dealing with the problems thrown up by independent taxation – problems which few, if any, foresaw in 1990.

- The introduction of transferable allowances on a more generous basis than that outlined by the Conservatives in 2010 would seem to be the best way forward. It should be included in the 2014 Finance Bill, taking effect in April 2015. The introduction of transferable allowances on the limited basis proposed in 2010 would be a welcome start.
- Transferable allowances would reduce discrimination against one-earner couples, increase the threshold for low and middle income families at a significantly lower cost than that of increasing it for everyone, and reduce the imbalance between one- and two-earner families. Most of the benefit would go to families in the lower half of the income distribution.
- Transferable allowances could be paid for by stopping any further increase in the personal allowance. When Universal Credit comes in the cost will be less than at present since the payments will be based on income net of tax.
- Another option would be to reintroduce both the MCA and the APA, with the advantage of benefitting both couple families and single parent families.
- Looking further ahead, there is a good case for considering optional joint taxation for couples, as in many other countries.
- A more radical option still would be to switch support for families in work back from tax credits and Universal Credit into the tax system. This may be the only way in which a substantial reduction in the number of families facing high marginal rates can be achieved.
- The one thing we must not do is stay where we are.

153. The current personal tax system does not meet properly any of the objectives set out for it in 1986 and is hardly fit for purpose. Nor is that conclusion much altered when account is taken of tax credits (shortly to be replaced by Universal Credit) which were introduced in part because the tax system took little account of the family. The root cause is an income tax system which takes no account of family responsibilities.

154. The income tax system should not unduly favour or disadvantage one household type over another. Well-off households should be paying more income tax than those who are less well-off and not, as at present in some cases, the other way round. In practical terms this means rethinking the way we tax and support one-earner families and indeed all households with children.

Transferable allowances

155. In 2010 the Conservatives proposed a transferable allowance of £750 for married couples and civil partners under which a spouse or partner who could not use her[71] personal allowance could pass part of it to her partner if he were a basic rate taxpayer. This proposal has not yet been implemented, but it has been debated in the House of Commons on a number of occasions, most recently at the Report stage of this year's Finance Bill.[72] In responding to the debate the Exchequer Secretary to the Treasury said that the Government supported the principle of transferable allowances, of recognising marriage in the tax system, and of legislation in the current Parliament (i.e. by May 2015).[73] Subsequently the Chancellor of the Exchequer confirmed that he would make an announcement on this in his Autumn Statement.[74]

156. This would be at least a start. The provisions for transferable allowances must be in the 2014 Finance Bill, and if at all possible foreshadowed in the draft 2014 Finance Bill to be published in December 2013, if they are to be fully operational by April 2015 (i.e. before the General Election). They should be in effect for 2014/15 even though for practical reasons PAYE taxpayers might not be able to have their code numbers adjusted during the tax year. Taxpayers who pay by self assessment would claim them when they made their tax return for that year. For 2015/16 PAYE taxpayers should be able to claim them in advance so that their tax deductions would take them into account from April 2015. Arrangements for spouses to transfer their allowances would need to be made at the same time.

157. Moreover, if the problems identified are to be addressed, there will need to be a fuller remedy. Where a spouse has little or no income she should be able to transfer the unused part of her personal allowance to her husband. This would at least go part of the way towards basing tax liabilities on household income, just as tax credits are based today and unified credit will be tomorrow in recognition of the fact that that is how stable couples live.

158. Where the husband was a higher rate taxpayer transferable allowances could apply at his marginal rate, at basic rate or not at all. The first of these possibilities would be the one which would be right in principle. But it would increase the cost

[71] For the sake of simplicity of presentation it is assumed that it is the wife who is staying at home to look after the children (or for another reason), but of course it could equally be the husband who is at home while the wife is in paid work. References to married couples include references to civil partners.

[72] Hansard, 2 July 2013, cols 877-882

[73] Ibid., col 881

[74] Huffington Post Politics 11 July 2013

and some might argue would unduly benefit those higher up the distribution of income. The very limited proposal put forward by the Conservative Party in 2010 was restricted to basic rate taxpayers. However to follow this possibility more generally would hike up the METR still further, and in some circumstances could even deny relief to families below the JRF's MIS. Hence to apply the transferred allowance at basic rate for all taxpayers would provide the best balance.

159. Transferable allowances would reduce the discrimination against one-earner couples which is inherent in the present system as one- and two-earner couples would be treated in broadly the same way, at least until the higher rate tax threshold was reached. As Frank Field MP commented at Report Stage of this year's Finance Bill, for those higher rate taxpayers fully affected by the HICBC, there is now no difference in the tax system whether or not they have children.[75]

160. The switch from tax credits to Universal Credit complicates the picture on incentives. Families claiming Universal Credit would not keep the full benefit of the transferred allowance. If a £10,000 allowance was transferred to a basic rate taxpayer this would reduce the recipient's income tax payments by £2,000, but this in turn would reduce the family's Universal Credit by £1,300. It would be important therefore that all or at the least a high proportion of the personal allowance should be available to transfer if the tax system is to be made significantly fairer.

161. The effect of transferable allowances on incentives would not be the same as it would have been had the proposal in the 1986 Green Paper been accepted. Indeed for some families transferable allowances would reduce their marginal rate from 76% to 32% or even to nil when Universal Credit is fully operational. This would be the case where the family are entitled to Universal Credit but would lose that entitlement as a result of the increase in net of tax income that would result from the introduction of transferable allowances. In this case the sole or main-earner's marginal rate would come down from 76% to 32%. And the non-earner's marginal rate would remain unchanged at nil or 32% depending on the amount earned.

162. Where a family remained entitled to Universal Credit, transferable allowances would increase a family's marginal rate from 65% to 76%. The impact would not be on the non-earner directly but through the effect on the main earner's tax bill. This increase in marginal rate would however be much less than it would have been in 1986 or 1990. In 1990 the loss of transferable allowances could have involved an increase in the family's rate from nil to 25%. For families who are not entitled to Universal Credit the effect of a non-earner moving into paid work would be to increase the tax of the main earner. The argument that transferable allowances would discourage a non-earner in a couple family from seeking paid work remains, but it does not apply in all cases and where it does it is weaker than it would have been in the 1980s. The beneficiaries of transferable allowances will on the whole be in the lower half of the income distribution – and certainly lower than those who have benefited from the very sizeable general increases in personal allowances which we have seen since 2010. These

[75] Ibid., col 882

increases in personal allowances will have increased income inequality; by contrast, transferable allowances would reduce it.

163. The net cost of introducing transferable allowances will be less than it would be now because of the effect on payments of Universal Credit, which will be based on income net of tax. While it will be far from insignificant, it will be less than that of the increases in personal allowances. It could be paid for by bringing these increases to an end, or at least restricting them to what was required to maintain the value of the allowances in real terms. If nonetheless the cost of introducing them in full were considered too high, they could initially and as a first step be limited to couples whose youngest child was below a given age or where the wife had caring responsibilities or where she or one of her children was disabled.

164. There are 2.3 million couple households where one partner is in work and the other is not.[76] The IFS have told us that in 2012 the cost of a £10,000 transferable allowance in 2015 prices would be £4.1 billion, or £3.1 billion if the higher rate threshold were reduced to prevent higher rate taxpayers from benefitting.[77]

165. These are large sums, but much less than the cost (estimated at £10.7 billion)[78] of increasing the personal allowance to £10,000. Transferable allowances would be a more cost-effective (as well as fairer) use of resources than increasing the personal allowance. They better target the poorest in-work families. The cost might come down to around £2.5 billion when the saving in Universal Credit is taken into account. This is less than double the cost (of over £1.4billion[79]) of the scheduled £560 increase in the personal allowance in 2015/16.

166. It would be necessary to decide whether transferable allowances should be limited to married couples and civil partners or whether it they should be extended also to cohabiting couples. Hitherto the arguments have been limited to married couples and the benefits which marriage provides, but a case could also be made for including cohabiting couples where the relationship is such that it would be appropriate to look to the household rather than to the individuals. To do so would bring the position in line with that in tax credits and the Universal Credit. The detailed rules for deciding whether two people were living together as husband and wife, which can cause difficulty in their application both for officials and for the people concerned, would need to be the same for both purposes.

167. Transferable allowances would, of course, do nothing for single parents. They too have seen their overall position worsen since the introduction of independent taxation as a result of the abolition of the APA alongside that of the MCA for married couples. Although overall, taking account of tax credits, their position is not as burdensome as it is for one-earner couples because there is one less

76 *Households Below Average Incomes 2010/11,* Department for Work and Pensions, June 2012 Table 3.1db shows that there are 6.7 million individuals living in families with one partner in work and one not. Table 4db shows that 2.1 million of these individuals are children. This leaves 4.6 million adults, i.e. 2.3 million couples.

77 Draper, Beighton and Pearson, *the taxation of families 2010-11,* CARE, February 2012, paragraph 172

78 Institute for Fiscal Studies, ibid.

79 Budget 2013, HC 1033, Table 2.1 (£1,370 billion)

person to support, there is at least a case for putting them back into the same relative position as they previously enjoyed.

168. The reintroduction of the APA alongside the introduction of transferable allowances for one-earner couples would help to reduce income inequality. On the other hand, a single parent who was getting the APA would lose it if he or she became part of a couple. So it would increase the couple penalty and discourage the forming of relationships.

169. To sum up: a transferable allowance would reduce the discrimination against one earner couples, increase the threshold for low and middle income families at a significantly lower cost than that of increasing the threshold for everyone, and it would reduce the imbalance between one- and two-earner families. For some families transferable allowances would reduce effective marginal rates. They could be accompanied by an APA for single parents but only at the expense of increasing the couple penalty.

170. Table 12.1 shows the effect on the income tax payments of one-earner couples looked at in this report.

Table 12.1

Income tax payable by a one-earner couple family with two children with and without a transferable allowance in 2013/14

Percentage of median wage	Income tax now (per week)	Income tax under transferable allowance
50% - £256 pw	£781.62	£0.00
75% - £384 pw	£2,116.48	£228.39
100% - £511 pw	£3,440.91	£1,552.81
150% - £767 pw	£6,110.62	£4,222.53
200% - £1022 pw	£11,138.24	£7,362.05

Source: TBMT and authors' calculations

Reintroducing the MCA and the APA

171. The MCA and the APA were introduced together in 1990 to prevent married couple households and other families from losing out as a result of independent taxation. A former Conservative Chancellor described them as "a bit of an anomaly".[80] However, they were an essential part of the structure of independent taxation if families were not to be disadvantaged.

172. The question arises therefore whether, instead of introducing transferable allowances, we might reintroduce the MCA and the APA, bearing in mind in particular that it would still give the advantage of transferability. Because they were an integral part of the structure of independent taxation and the MCA has been retained for some elderly couples, they might be relatively straightforward to reintroduce.

[80] Kenneth Clarke, Hansard, 30 November 1993, Col 935

173. A new MCA would of course apply also to civil partners. It might be split 50:50 between the spouses or partners unless they chose otherwise (as the present MCA is).

174. Where the allowances were enough to take a family out of Universal Credit entirely they would reduce the effective marginal rate from 76.2% to 32% for a basic rate main earner and from 65% to nil in the case of a second earner moving into paid work at the minimum wage. They would not increase the METR on non-earners in a couple family moving back into paid work.

175. Privacy for married women would usually be preserved. There would be a better balance between families and single taxpayers without family responsibilities. However, the balance between one and two income families would not be improved. Single parent families and cohabiting couples with children would benefit. It would need to be decided whether married couples without children should benefit as well as those with children.

176. As far as couples are concerned, the major difference from transferable allowances would be that it would also benefit two-earner couples who have been less obviously disadvantaged by the introduction of independent taxation than have one-earner couples. A MCA would be less well targeted and might cost more. We have not therefore pursued this option further.

Joint assessment

177. Looking further ahead, there would be a good case for examining the introduction of optional joint taxation for couples as is the case in many other countries. It might then be possible to have a more flexible approach and meet more of the objectives than seems to be possible today. Joint taxation would apply to both spouses equally, or partners if it extended to cohabiting couples. It would not of course entail going back to the pre-1990 system under which a woman's income was treated as that of her husband.

178. There are a number of options, which might be considered. France has a 'family quotient system' which applies both to married couples and to civil union partners. Family income is aggregated. Taxable income is divided into a number of shares: two shares for a married couple, one share for a single person, and a half share for each dependent child plus an additional half share for the third and each subsequent child; there is also an additional half share for each child of a single parent. Broadly, the tax payable is the tax payable for one share multiplied by the total number of shares. Germany has joint assessment, whereby income is split and any allowances are doubled. In the United States, married couples (and a head of household) can be assessed jointly or separately. They also have a different rate schedule.

179. The main beneficiaries of joint assessment would be couples with a single income and couples where the second income was not large enough to absorb the personal allowance. Where an election for joint assessment was made it would reduce, as would transferable allowances, the incentive for the non-earner to seek paid work. Put another way, it would reduce the pressure on the non-earner to seek paid work to supplement the family income.

Conversion of tax credit/Universal Credit allowances into tax reliefs

180. A more radical option still would be to switch support for families in work back from tax credits and Universal Credit into the tax system. The welfare system would be left dealing with families who are not in work or had income below the tax threshold or perhaps also those who could not fully use their tax allowances.

181. There is a considerable overlap between tax credits and income tax and there will be a considerable overlap between income tax and Universal Credit. There is something slightly odd about one Government department (HMRC) taking money from someone only for another Government department (DWP) to give some or all of it back. The absurdity is most obvious in the case of single parents where the cash payment is made direct to the income tax payer. Table 12.2 shows the income points in 2013/14 where tax credits are less than income tax payments.

Table 12.2

Income points at which income tax exceeds tax credits – single parent

Number of children in family	Income point at which income tax exceeds tax credits no childcare costs	Income point at which income tax exceeds tax credits maximum childcare costs
1	£20,440	£30,921
2	£24,924	£42,549
3	£29,356	£45,886
4	£33,841	£49,223
5	£38,534	£52,612

Source: TBMT

182. The great advantage of this option is that it might dramatically improve work incentives (if it operated like the income tax personal allowance or in times past the child tax allowance), save considerable administrative costs, and reduce the welfare bill. This reduction would of course be balanced by a loss of tax receipts. Some might see the reduction in public expenditure as an attraction; economists would be quick to point out however that this would be an accounting mirage as there would be no net effect on the balance of Government receipts and payments. Because of the possibility that incentives would be improved and there would be administrative savings this ought to be on the agenda for study for the next Parliament.

Conclusion

183. Serious consideration should be given to some form of joint assessment or moving some support for families back into the main income tax system. There is no perfect solution. Moving much of the support for families back into the income

tax system may be the only way in which a substantial reduction in the number of families facing high marginal rates can be achieved.

184. Meanwhile the introduction of transferable allowances appears to be the best way forward, paying for them by stopping the inexorable increase in the personal allowance which has not been a cost effective way of reducing the tax burden on many of the lowest income households. We would not recommend reintroducing the APA at the same time because of the increase it would introduce a new couple penalty.

185. The one course which must be rejected is to remain where we are. The many issues to which we have drawn attention in this report must not be allowed to remain unresolved. A fundamental review of the tax and benefit systems as they affect families must be undertaken with a firm course of action actively pursued in the light of the outcome.

independent taxation – 25 years on

Does it meet today's needs?

"The case for transferable allowances remains as strong as ever, for precisely the reasons I gave in 1985. In particular, as the detailed analysis in this Report demonstrates, it is not only family-friendly but provides a far more cost-effective means of reducing the tax burden on low-income households than can be achieved by an across-the-board increase in personal allowances."

"It is to be hoped that this thorough study, the latest event in a sustained and informed campaign by CARE, will help to bring about a long overdue reform."

The Rt Hon. the Lord Lawson of Blaby
Chancellor of the Exchequer 1983-89

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ISBN 978-0-905195-18-6

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