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Take poor families out of tax!

LORD BLACKWELL

INTRODUCTION

Amongst advocates of a lower (and simpler) tax economy, there is increasing support for the notion that one of the most effective and socially desirable targets for tax reduction would be to raise the thresholds at which poor families start paying income tax.

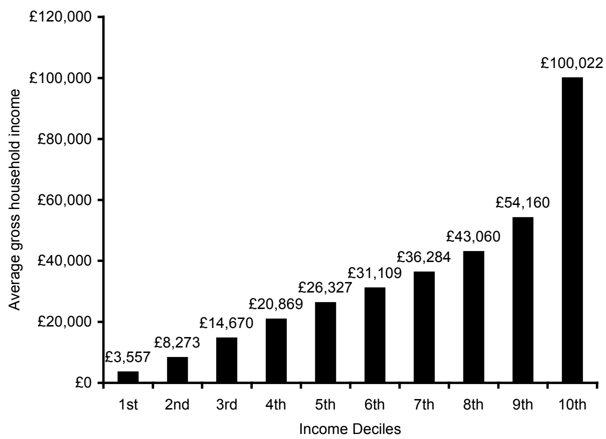
Raising thresholds can also be combined with a policy of allowing unused allowances to be transferred between couples with dependent children. This would be a highly targeted way of reducing taxes on those who need it most – low income families where only one parent is working. The drawback has always been the assumed cost.

New data supplied by the Treasury now indicate that such a policy, if introduced with transferable personal tax allowances of £7,500 each, would cost the Exchequer only £10.7 billion a year in lost revenue – which would be partially offset by a reduction in some benefits. No couple with children would start to pay income tax until their joint income exceeded £15,000 per year (see Parliamentary Question, Lord Blackwell: 17 October 2005: House of Lords Column WA109).

While £10.7 billion is not a trivial sum, it could easily be afforded over a parliament if government committed to grow public spending at a slower rate than GDP growth in order to move gradually towards a lower tax, more competitive economy.

Based on household income data for 2003/4, over 20% of households with children are receiving wages and other income (before tax and benefits) of less than £15,000 per year.

NON RETIRED FAMILIES WITH CHILDREN – DISTRIBUTION OF GROSS HOUSEHOLD INCOME (BEFORE TAX AND BENEFITS), AVERAGED BY DECILE (2003/4)



Yet, as the table overleaf shows, families with gross income averaging around £15,000 are, in aggregate, paying out over £1,700 of that income in income tax, and contributing a further £4,900 in National Insurance, council tax, VAT, duty and other taxes. These families then (on average) receive £6,761 back in tax credits, child benefit and various welfare benefits.

The average tax take, including duty and VAT, is higher for low income families than for those closer to the average income – rising from 38% (close to the national average) for mid-income families to over 90% in aggregate for the poorest 10%. This is clearly unfair and unaffordable for those at the bottom of the scale. But, in addition, the benefits and tax credits which funnel back money to these same households creates a huge, costly and demotivating dependency culture. As families find that they are increasingly reliant on state hand-outs rather than their after-tax earnings to support their family, the incentive to work is dulled and more time and effort goes into working the system.

Of course the Government claims that it is ameliorating these problems by labelling some of these benefits 'tax credits'. In reality, the requirement to fill in extensive claim forms means that, for most recipients, they are no different from any other benefit. Yet they have the disadvantage that, since they are calculated on the previous year's income, many families find that their income fluctuates widely: if their income rises, they may find themselves faced with an unexpected and unaffordable bill to pay back credit payments that they have already spent.

THE COST OF HIGHER THRESHOLDS AND TRANSFERABLE ALLOWANCES

The proposal, costed by the Treasury, involves:

- raising the personal income tax threshold to £7,500 (combined with abolishing the 10% band, and with the 40% tax band continuing to start at the same Gross Income level); and,
- making these higher allowances transferable between couples with dependent children (defined as those in receipt of child benefit) so that one earner couples would not be disadvantaged by losing the carer's own personal allowance.

The attraction of this policy is that:

- it removes the poorest from tax altogether – the maximum tax reduction they can receive – without creating high tax cuts for the better off;
- it ensures that no family seeking to raise children on a low wage will pay any income tax until their family income exceeds £15,000, regardless of whether there are one or two earners;

Non- retired families with children – Impact of tax and benefits on net household income, averaged by income decile (2003/4, lowest five deciles only) (i)

£	1st	2nd	3rd	4th	5th
Gross Income	3,557	8,273	14,670	20,869	26,327
Income tax (before tax credits)	-360	-864	-1,728	-2,440	-3,272
National Insurance	-138	-414	-841	-1,192	-1,589
Council Tax Paid	-339	-446	-625	-730	-829
VAT and duty	-2,161	-2,501	-3,098	-3,363	-3,862
Other taxes	-274	-309	-344	-399	-524
Total tax take (before tax credits/benefits)	-3,272	-4,534	-6,636	-8,124	-10,076
% of Gross Income	91.9%	54.8%	45.2%	38.9%	38.2%
Tax credits (ii)	614	1,335	2,041	1,766	1,522
Other means tested benefits	4,179	4,319	2,405	1,327	704
Child benefit	1,298	1,386	1,355	1,263	1,242
Other non – means tested benefits	1,017	902	960	1,050	479
Total benefits/tax credits (ii)	7,108	7,942	6,761	5,406	3,947
Net income after tax/benefits	7,393	11,681	28,067	18,151	20,198

(i) Since these are aggregate figures across households in each decile they do not represent any individual household – for example households on the average income of the bottom decile would not be paying any income tax; and average benefits reflect some households not in work who are eligible for benefits not available to those in work.

(ii) Tax credits include both those treated as benefits and those treated as negative income tax.

Source: www.statistics.gov.uk/StatBase/Expodata/Spreadsheets/D8241.xls

- it removes the discrimination against families where one partner chooses to act as a carer and currently loses their tax allowance – these are the families that currently pay the highest tax bill;
- it produces a highly targeted tax gain for these low income families of up to £1972 per year – almost £40 per week.

By comparison, a 1p reduction in the basic rate of tax would produce minimal benefit for the low income families – and do little to move them out of the benefit/dependency culture – while producing much larger tax reductions for the better off (see Table in Annex 1 for calculations).

TAKING POOR FAMILIES OUT OF TAX IS AFFORDABLE

While £10.7 billion is a significant amount of revenue, it would not be unaffordable in the context of a sustained commitment to move to a more modest growth in public spending over the lifetime of a parliament. As has been argued a shift towards a lower tax burden is essential if the UK is to have a competitive, high growth economy (see by the same author, *Why Britain can't afford **not** to cut taxes,* CPS, October 2004).

Achieving this does not depend on finding one-time savings to 'cut' unproductive government spending – though such savings should be made. Government spending on key services can and should grow over time. But it should grow public spending at a slower rate than the growth in the economy as a whole. Then, over time, public spending would fall as a percentage of GDP.

Furthermore, if tax rates are unchanged, tax revenues will grow faster than the economy. As a consequence, more controlled growth in public spending means that over time tax rates can be reduced so that their share of the economy falls in line with spending.

These arguments were originally set out in *Freedom and Responsibility – a manifesto for a smaller state, a bolder nation* (CPS, 2003) and were incorporated in the Conservative Party manifesto in the 2003 General Election. The numbers set out then are updated overleaf.

Impact of proposed £7500 transferable income tax allowances on post-tax family incomes

Category	Family Income	Current tax	New tax	Tax Reduction
1 earner couple	£10,000	£872	nil	– £872
	£15,000	£1,972	nil	– £1,972
	£25,000	£4,172	£2,200	– £1,972
	£50,000	£11,958	£9,986	– £1,972
2 earner couple*	£10,000	£21	nil	– £21
	£15,000	£645	nil	– £645
	£25,000	£2,845	£2,200	– £645
	£50,000	£8,345	£7,700	– £645
Single person	£10,000	£872	£550	– £322
	£15,000	£1,972	£1,650	– £322
	£25,000	£4,172	£3,850	– £322
	£50,000	£11,958	£11,636	– £322

* Data for the 2 earner couple assume each has equal income. Tax paid currently would be greater (and savings from proposed policy also potentially greater) if one earner had higher income than their partner.

Illustrative Impact of slower spending growth on scope for tax reductions (figures in real terms £ billions at 2005/6 prices)

	2005/6	2010/11	Average annual growth rate %
GDP(i)	1240	1389	2.3%
Current plans for total managed expenditure (ii)	518	585	2.4%
% GDP	41.8%	42.1%	
Slower growth in total managed expenditure	518	556	1.4%
% GDP	41.8%	40.0%	

(i) Based on March 2005 Budget Report projections to 2009/10, with one further year added at the trend growth rate
(ii) Based on March 2005 Budget Report projections to 2009/10, with spending ratio to GDP maintained at the same level for 2010/11.

Public spending is currently forecast to be 41.8% of GDP in 2005/6 – up from 37.1% in 1999/200. If, for example, public spending growth was limited to an average annual growth rate of just under 1% less than GDP growth per annum over the next five years, its share of GDP would drop to around 40% again over that period. This would mean that alongside a £58 billion real terms increase in public spending, taxes – subject to other economic factors – could be reduced by £29 billion in 2005/6 prices – more than enough to take poor families out of tax and to meet other priorities to reduce and simplify the UK's high tax burden.

Annex One

Impact of 1p reduction in basic rate of income tax

Category	Family Income	Current Tax	Tax reduction
1 earner couple	£10,000	£872	- £30
	£15,000	£1,972	- £80
	£25,000	£4,172	- £180
	£50,000	£11,958	- £303
2 earner couple*	£10,000	£21	-
	£15,000	£645	- £11
	£25,000	£2,845	- £111
	£50,000	£8,345	- £ 361
Single person	£10,000	£872	- £30
	£15,000	£1,972	- £ 80
	£25,000	£4,172	- £180
	£50,000	£11,958	- £303

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