Written evidence submitted by Tax and the Family

Evidence to the Treasury Select Committee

Summary

Our evidence looks at an area of the tax system most in need of reform.

Unlike other areas of Government policy, income tax takes no account of household incomes. Our evidence covers five issues relating to income tax which arise as a consequence.

(i) Lack of fairness. A taxpayer's liability to income tax may not reflect his/her ability to pay.
(ii) Poverty. As a result, a taxpayer in poverty can be liable for significant amounts of income tax
(iii) Escaping poverty is very difficult because of high marginal rates.
(iv) Inequality will get more marked if these issues are not tackled.
(v) As we seek to build back better and recover from the covid pandemic, now is the time to tackle these issues. We suggest some immediate ways forward.

Our figures relate to England, Wales and Northern Ireland, but the position would not be significantly different in Scotland.

Who are we

Tax and the Family was founded by two former members of the Inland Revenue, Don Draper and Leonard Beighton. John Avery Jones, a retired Judge in the Upper Tax Tribunal, chairs our board. Our aim is to widen understanding of the way in which the tax system works for families and to promote changes which would make it fairer.

We are submitting this evidence because the issues we raise are not understood at all widely. Many families who have been affected by covid are unfairly treated by the tax system, and changes in it which dealt with the less well off, especially those with children, more fairly would help society rebound from the pandemic more securely.

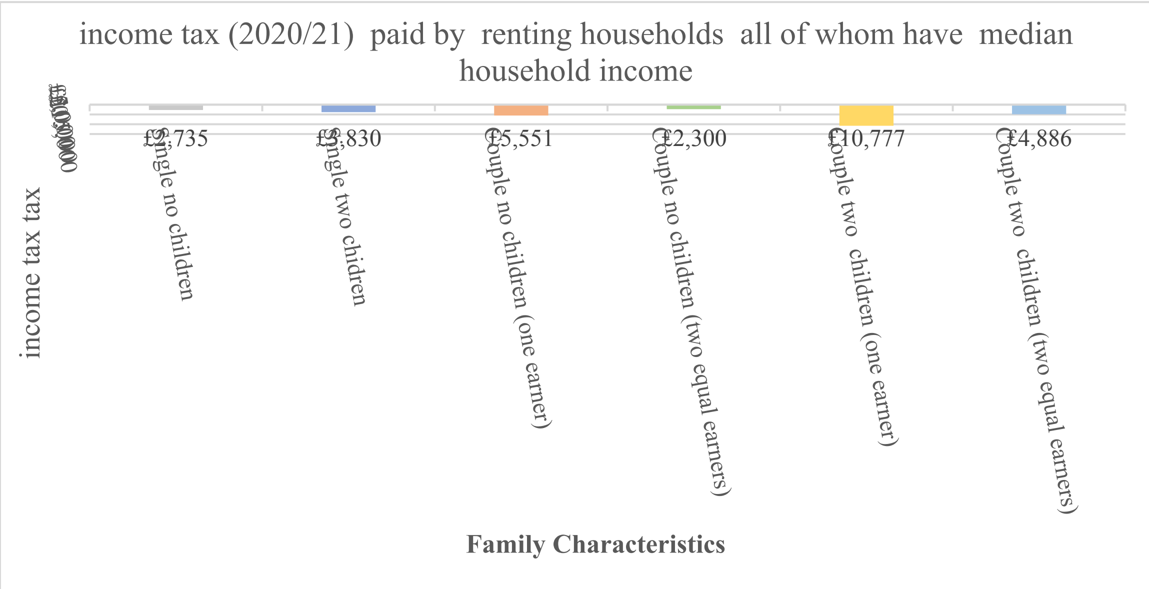
Lack of fairness

A taxpayer's income tax liability often does not reflect their ability to pay. This is because their liability takes little or no account of the number of people they have to support. A taxpayer who is supporting several children and a partner pays the same, or nearly the same, tax as a single person without dependents. Unlike the benefits system which is based on the size and make-up of the household, under independent taxation a taxpayer's liability depends on their income only[1].

The official figures for income inequality have always taken account of household incomes, that is income net of tax and benefits. Government policy generally is based on these figures. Exceptionally the income tax system does not take this approach.

The problem to which this gives rise is not the tax on low pay, but the tax on families with low household incomes. In order to have a household income net of tax and benefits of the same size as that of a single person without dependents, a family with children will need a much higher gross income. It is of course gross income on which income tax is payable.

The chart below is based on the latest DWP household income figures after housing costs[2]. It shows the income tax paid by five different households[3] all of whom have median household incomes[4] and therefore a similar standard of living and paying rent equal to the local housing allowance in a City (Leeds) where rents are typical of the country as a whole.[5] They are all equally well off but their tax liabilities vary enormously.



1 The only exceptions are the comparatively small marriage allowance and the High Income Child Benefit Charge which disadvantages families.

2 Households Below Average Income 2018/1, DWP March 2020.

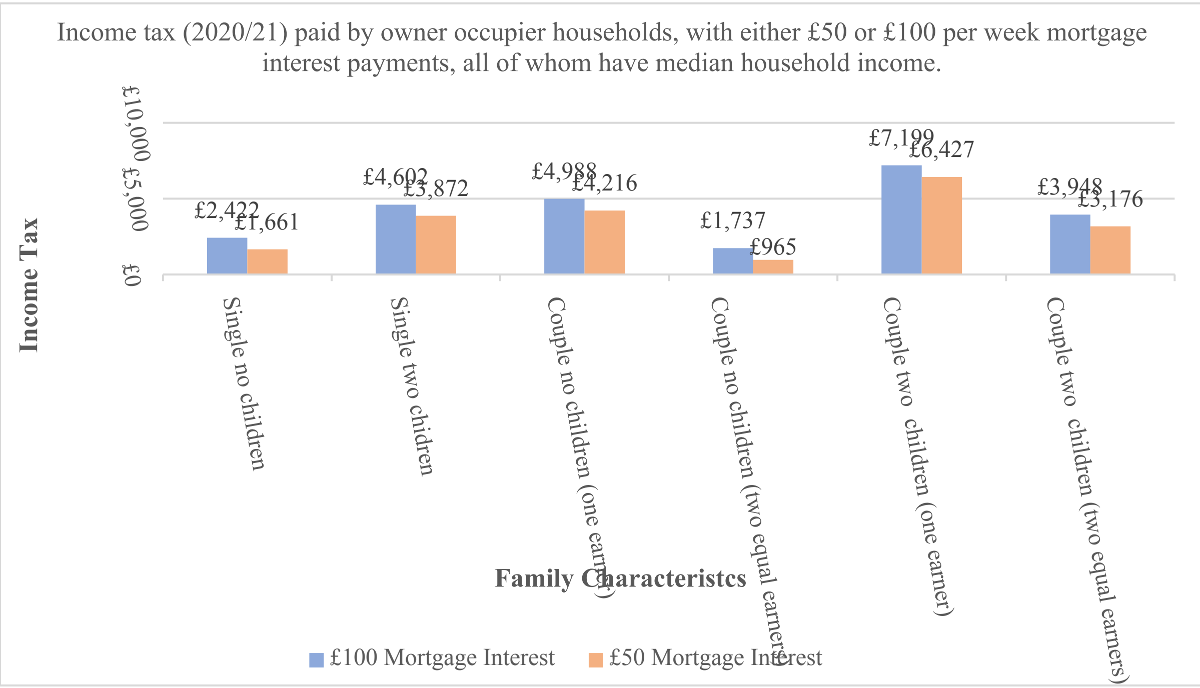
3 The couple households are assumed to be entitled to the marriage allowance.

4 The relationship between households of different make-up and sizes is determined by DWP using factors (known as equivalisation factors) which have been agreed internationally. The median income for 2018/19 was published by DWP in March 2020. It shows for a single individual £17,900; for a couple with no children £26,800; and for a couple with two children under 14 £37,500. These figures are before housing costs.

5 In the case of households with children needing a 3 bedroom house this is £161 per week. Families with median household incomes living in more expensive parts of the country will have higher gross incomes and pay more tax.

It will be seen that, a single parent with two children on a median income after housing costs may be paying income tax of almost £4,000 and a one earner married couple with two children over £10,000, By comparison, a couple without children pays half that amount, a single person without dependants may be paying less than £3,000. If it is correct, as is commonly done, to measure living standards by household income[6], and fairness is foundational, it is difficult to justify such big differences.

The chart below shows the same information for owner occupiers paying mortgage interest, as might well be the case with someone who has lost their job as a result of Covid. The figures differ from ones in the previous chart because, unlike rent payments, universal credit does not take account of mortgage interest payments, with the result that owners paying mortgage interest need a higher gross income to have any given after housing cost income.

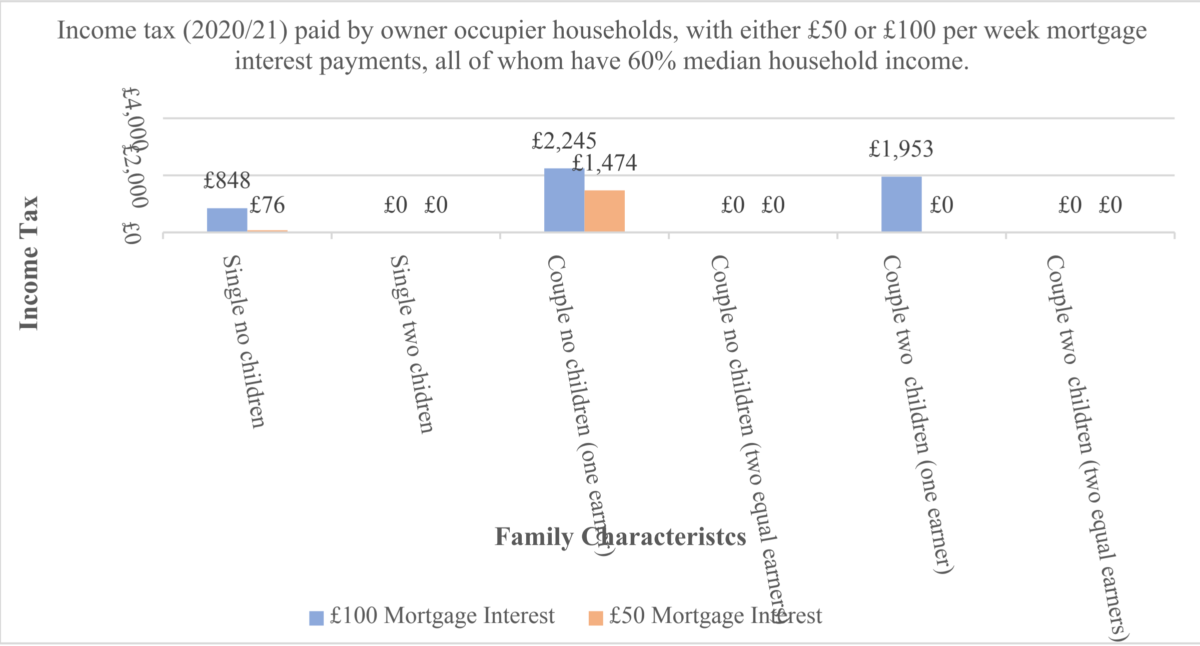


Poverty

The picture is more complex at 60% of median income, usually regarded as the upper bound of poverty. Our modelling suggests that households who are renting are unlikely to be paying income tax if they are entitled to universal credit[7], but they

6 Living standards, poverty and inequality in the UK: 2020 IFS, June 2020.
7 This appears to be the case however high the rent provided it qualifies. i.e. it is within the local

may have significant liabilities if they are paying mortgage interest or are having to pay rent above the local housing allowance. The chart below shows the income tax paid by five different households paying mortgage interest all of whom have incomes equal to the 60% median.



It will be seen that a married one earner couple with two children paying mortgage interest of £100 per week may be paying income tax of almost £2,000. By comparison, a single parent with two children may not be paying tax. A single person without dependents may be paying £850.

How can it be right that anyone on the poverty line has to pay income tax?

Escaping poverty

The problems which families on low and modest incomes face are compounded by high marginal rates. The marginal rate paid by a household is made up of income tax, NIC, and the withdrawal of means tested benefits. The very highest marginal rates of over 90% which occurred in a small minority of cases under the legacy system have been reduced with the introduction of universal credit. But it is still 75%, plus 9% if a student loan is also being repaid. In the case of a one earner couple with two children renting in Leeds, the 75% marginal rate runs up to incomes of £49,901: in the case of a single parent with two children it runs up to incomes of £45,364.

We have used Leeds as an example as a city with a typical level of rents, but in cities with higher rents, let alone those in London, these marginal rates will apply to incomes over £50,000 where income tax at the higher rate is also due and child

Housing Allowance and the accommodation is appropriate.

benefit is withdrawn. Even though NIC is then only 2%, the marginal rate for a family with two children is 60.2%[8] even if means tested benefits have been fully withdrawn by then.

Marginal rates at this level apply to very many people with children. They make it very difficult, if not all but impossible, for a family to escape poverty. Moreover under the legacy system the marginal rate was largely obscured: if a taxpayer earned more in one month, the addition went into the mix which affected the tax credit in the following year. But under universal credit any increase in income in one month affects the credit in the next month. The marginal rate is more apparent.

Inequality

Inequality will get even more marked if nothing is done to bring income tax more closely in line with the income inequality measures, especially if, as is possible, the rate of income tax has to be increased in due course to help recoup the costs of the covid pandemic.

Now is the time to tackle these issues

The problem of high marginal rates is a long standing one which can be only be tackled piece by piece over the long term except at enormous cost. It is all the more important therefore to tackle the issues of unfairness, poverty and inequality highlighted here.

The problem of making the income tax system fairer is made more difficult by a failure to understand which households are in the better off half of the population and which in the less well off, and which are already paying more than their fair share. Tax changes such as increases in the personal allowance which have been presented as helping the low paid and by implication the less well off have in fact benefited mainly households in the top half of the income distribution[9].

The High Income Child Benefit Charge is a very good example of this failure of understanding. The then Prime Minister, David Cameron, referred to its affecting the wealthiest 15% of families[10] and the then Chancellor of the Exchequer, George Osborne, to the top 15% of the income distribution[11]. But because it was drawn up in terms of the gross incomes of individuals, some families in the top decile of the income distribution escape the Charge, whereas others in the third, fourth and fifth deciles pay it, Indeed, because the starting and cut-off points have not been indexed, it now affects some families in the sixth decile, ie in the poorer half[12].

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[8] For a family with two children child benefit is now £35 a week, which equals £1,820 a year. This is withdrawn over an income range of £10,000, giving a marginal withdrawal rate of 18.2%. This is in addition to higher rate tax of 40% plus NIC of 2%. The marginal rate goes up by 7.25% for every additional child.

[9] £10,000 personal allowance: who would benefit? James Browne, IFS, 9 March 2012. The IFS have told us that this would still be the same today.

[10] Hansard, 7 March 2012, col 841,

[11] Hansard, 6 March 2012, col 798.

To make the income tax system fairer, ways have to be found for bringing income tax liabilities closer into line with household income and for ensuring that any tax increases do not fall on households in the poorer half of the population.

Decades ago, income tax liabilities reflected, albeit a bit roughly, the size of a taxpayer's family. Over the years this relationship weakened until it was wholly removed with the introduction of independent taxation and the changes which followed in the 1990s. It can be restored without threatening the independence of husband and wife which is at the heart of independent taxation.

The covid pandemic will have left a large number of families in significant financial difficulty. To help them and to assist the economy to recover, immediate measures which the Select Committee could consider include:

(i) Increasing child benefit, which has been largely frozen since 2010, with a significant increase in the starting and cut-off points for the High Income Child Benefit Charge.
(ii) Reintroducing child tax allowances.
(iii) Increasing and widening the scope of the marriage allowance, possibly to the point where it is fully transferable for all couples.

There may be a case in the longer term for looking at a more radical solution such as joint assessment, but for the time being a measure such as one of these would make a significant difference to the lives of those affected by the issues raised in this paper.

The Committee should be aware that the worst way of tackling the issue would be any further increase in the personal allowance, A large proportion of the benefit of so doing would go to those in the top half of the income distribution. At the most any further increase should be limited to indexation, though there are many other limits in the tax system generally which are not indexed, such as that for the HICBC as mentioned above.

Any tax increases which have to be made as a result of all the expenditure following covid must not make the position worse for the less well off and the opportunity should be taken to make their position better. In practice this means households with children. If there is to be any levelling up, a start needs to be made in bringing income tax liabilities into line with household income distribution.

Further work

[12] Our modelling would suggest that a single earner couple with two children paying rent of £161 a week would need to earn £58,191 to have a median income,

Tax and the Family would be very willing to enlarge on these immediate measures or on any of the issues discussed in this paper if the Committee would find it helpful. We have produced tables which enable the impact of tax and benefits, and thus on living standards, to be measured.

September 2020