Budget and Spending Review 2021 representation

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Making the Tax System Fairer for Families

Introduction

We are pleased to have the opportunity to make a representation to the Treasury ahead of the Budget and Spending Review 2021.

The Catholic Union is a membership organisation dedicated to the defence of Catholic values in Parliament and public life, and the promotion of the common good.

The Centre for Enterprise, Markets and Ethics is a non-denominational, Christian-inspired think tank and charity in the field of business and economics.

The Benedict XVI Centre is a research centre at St Mary's University, Twickenham, London.

Summary

Our tax system has long been in need of reform to make it fairer for families. As we recover from the pandemic, there has never been a better time to ensure that the tax system does not discriminate against single-earner families who forsake a wage to look after their children or elderly parents. This, in turn, requires that we put the family unit at the heart of our tax system as happens in much of continental Europe.

We are calling for the Treasury to move towards fully transferable tax allowances and bands. This is not only equitable, but, in the long term, it could also save taxpayers money as the annual cost of family breakdown is estimated at over £50 billion.

The way our current tax system interacts with the Universal Credit system discourages family formation. This arises because, at present, benefits are allocated on the basis of household income whereas tax is calculated on individual income. This imbalance needs to be corrected.

This Budget and Spending Review is an opportunity to help deliver on the Conservative's manifesto commitment to make Britain the greatest place in the world

to start a family: it is currently far from being so. Ending the uplift in welfare payments and the increase in National Insurance means it's even more important that the Treasury delivers a tax system that supports families. We propose that the first move towards this proposal is made immediately by Increasing the amount of the personal allowance that can be transferred to spouses.

Background

The question of the appropriate unit for taxation is contested in economics. We argue that the family should be thought of as the *prima facie* unit of taxation. The economic arguments are finely balanced when we consider the tax system alone. However, when we look at the impact of the welfare and tax systems combined, it is clear that the current tax system in the UK – which is wholly focused on taxing individual income – is flawed.

In the UK, individuals receive tax-free allowances and the rate at which tax is paid increases with an individual's income. This means that a family with two adults, in which one, for example, earns £70,000 a year whilst the other takes on caring responsibilities at home pays considerably more tax than the same family which has earnings split across the two adults. In the first case, the family receives one tax-free allowance and in the second case two. In the first case, the single earner will pay higher rates of tax because some of their income is above the basic rate band. In the second case, because neither individual's income is above the basic rate band, no higher rate tax will be paid. In this particular case, it should also be noted that the couple will not receive child benefit if there is a single earner with an income of £70,000 per annum whereas they would receive child benefit if their income were split. In general, in the UK tax system, two households in receipt of the same income pay very different levels of tax depending on the split of the income between the individuals. This amounts to unjust discrimination against households where incomes are unevenly split, perhaps because one of the adults undertakes caring responsibilities.

The UK system is not unique by international standards, but most countries do things differently. What are the economic arguments?

Interestingly, when international comparisons of inequality are made, the household is the starting point for the calculations of disposable income.[1] In the UK, the Office for National Statistics (ONS) evaluates inequality based on the household and not individual income.[2] The distribution of disposable income across households is then determined and this is used to calculate inequality measures. Indeed, to do otherwise would be bizarre. It is worth illustrating this with a *reductio in absurdum* case. Imagine two cities, A and B. In A, every individual earned £25,000 and all households had two adults. In B, one adult in each household earned £50,000 and the other, caring for elderly parents, earned nothing. If inequality is measured on a household basis, the measure would demonstrate, correctly, that there was perfect equality in both cities. If inequality was measured by looking at individual incomes, city B would give the impression of having much greater inequality as half its citizens would have no income. In addition, the absolute poverty rate would be 50 per cent.

Though some technical adjustments are made before inequality measures are calculated, the focus, in those measures, is on household income. It would be absurd to do otherwise. This alone provides a strong case for taxing on the basis of family resources rather than individual resources. The latter approach, presupposes that individuals live atomistically and do not share resources with others in their family.

Indeed, a progressive tax system based on taxing individual income will act to increase measured household inequality according to standard measures by redistributing money from poor single-earner households to richer two-earner families.

In the United Kingdom, all benefit payments are based on family income. This means that, as family income rises, benefit payments are reduced. Also, if an individual who is earning money forms a household with somebody who is not, the couple lose significant amounts in welfare benefits. In our tax system, which uses the individual as a unit of taxation, the couple do not gain through lower taxation when forming a household. This is quite unlike in many other countries where, if a non-earner and an earner formed a household, the earner would receive two tax-free allowances. The

[1] See: https://data.oecd.org/inequality/income-inequality.htm . Some adjustments are made for the different living costs incurred by different sized households.

[2] ONS - Household income inequality, UK: Financial year ending 2018

reduction in the couple's tax bill then helps to compensate for the loss of welfare benefits.

The International Federation for Family Development (IFFD) found overwhelming evidence for the positive outcomes that come from family stability, some of which include: higher life expectancy, lower risks of mental illness and drug addiction, higher academic achievement, increased discipline in fulfilling legal duties and social contributions to society. There is also a clear benefit to the Treasury in seeing stable family life, with the Centre for Social Justice stating that family breakdown costs taxpayers £51 billion per year – a figure that was estimated before the pandemic and is likely to be significantly higher now. It can genuinely be said that, in the UK, we subsidise people to live apart – almost as if the creation of families brings what economists call "negative externality". It almost seems as if politicians believe that family formation is damaging and needs to be financially penalised in the same way as the consumption of cigarettes or sugar.

The last major work on couple penalties in the tax and benefit system was by Adam and Brewer (2010). They concluded (page 6): "68% of existing couples in the UK face a penalty in the 2010–11 tax and benefit system, 27% face neutrality and 4% face a premium…The sum of all couple penalties amounts to £34.7 billion a year…". The couple penalties are concentrated in families with children: "By family type, almost all (95% of) couples with children have a couple penalty, as do 81% of pensioner couples and 41% of working-age couples without children." Their conclusion is similar to ours that the penalty on family formation arises from: "…paying out benefits and tax credits according to family circumstances but levying income tax according to an individual's income".

Progressive taxation works under the assumption that those with greater resources should contribute more. To base the resources available for taxing on an individual assessment rather than an assessment at the level of the family simply ignores reality. Of course, many households have only one member and so this debate is irrelevant for them. But, when adults live together (whether married or not), they share resources. Whether somebody is rich or poor depends not only on their individual earnings but on the earnings of others in their household. Philosophically, it makes sense to levy taxes based on the capacity of the family to pay.

Not doing so is not just inequitable, it distorts decision-making. Given the very strong bias against single-earner families in the tax system that is quantified below, we are artificially encouraging families to become two-earner families and/or to organise their working patterns so that they have a roughly even split of incomes between the family members. When we also consider the discrimination against family formation arising from the interaction of the tax and welfare systems, our whole fiscal approach can be described as being explicitly anti-family. Of course, other factors may be to blame too, but it is worth noting that the UK has one of the highest rates of prevalence of single-parent families in the developed world[3].

Indeed, the UK, in some senses, arrived at our current place by accident rather than by design Our current tax system traces much of its roots to the early 1980s when the then Chancellor of the Exchequer, Nigel Lawson, sought to implement a tax system that would be "neutral and fair" to the individual.[4] But there was a caveat. In his memoirs Lawson argued that, "…after careful study, I came to the firm conclusion that this should be a system of independent taxation, with the allowances freely transferable between husband and wife."[5] The premise was rather straightforward:

> "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. […] 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."[6]

This was never achieved. Lawson describes how Prime Minister Thatcher, "…did not like the idea at all". Her reaction came as a surprise to Lawson since she undoubtedly highly valued the importance of the family. In practice however, Lawson points out that "…she strongly identified with two-earner couples".[7]

Re-confirmed as Chancellor following the 1987 general election, Lawson ultimately settled for what he describes as a "halfway house" where there is independent taxation

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[3] https://www.oecd.org/els/soc/SF_1_2_Children_in_families.pdf

[4] https://www.youtube.com/watch?v=jTfjcXmY1R0

[5] Lawson Memoirs, p 882

[6] Ibid. p 883

[7] Ibid. p 882

but without fully transferable allowances. Families would however benefit from a 'Married Couple's Allowance' which originally represented the difference between the single allowance and the married man's allowance in the old system.[8] However, even at the beginning, this was a poor substitute for transferable allowances, but it was, in any case, gradually withdrawn. Though, bizarrely, it was kept for pensioners.

The current UK tax system

The current income tax system in the United Kingdom is almost entirely based on taxing individual earnings. This leaves single-earner families at a significant tax disadvantage. Unlike other western democracies, such as France or Germany, the UK makes minimal provision for family 'dependants' (i.e., non-earners or low-earners within a household).

In practice, this results in very high levels of average tax rates for single earner families. The family as a unit therefore needs some form of recognition as a distinct entity within the tax system. This does not mean that the family ought to be placed on preferential terms, but rather on fair terms – recognising the fundamental human and financial needs that dependants have within the unit of the family so that all families with the same resources pay the same level of tax.

The family as a unit gains even greater significance when viewed through the prism of Catholic teaching and the Judaeo-Christian tradition which underlies a Conservative approach to economic life (for example, respect for private property, the right to economic initiative, and so on). The family is an intrinsic and fundamental part of creation. Within the catechism of the Catholic Church the family is often considered to be the "principal cell or building block of human society". This view is fundamental to the understanding of marriage and family life for many of the 4.5 million Catholics in Britain. We come together in families to share goods and share tasks. Those families in which individuals take on caring responsibilities should not be taxed much more heavily than families with the same income where both are working as happens now.

If we quantify the extent of the discrimination against families with an uneven split of earnings due to caring responsibilities, we see that the amount of Income Tax paid by a household earning £30,000 annually varies from £1,000 to £3,500 depending on

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[8] Ibid. p 885

how the earnings are split between its members. The family in which one parent undertakes caring responsibilities or other unpaid work will pay the higher amount. The family in which both go out to work and earnings are split evenly between the two adults will pay the lower amount.

Indeed, it is rather startling that a family on average earnings of £40,000 would be in the poorest 40% of the population and a single person earning £40,000 per year would be in the top 20% wealthiest.

In other words, the income tax system places single earner families in the most unfavourable tax position compared with two-earner families who are an otherwise identical position in terms of their income. This situation is exacerbated when National Insurance contributions are taken into account.

As noted above, the reason for this lies in the move to individual taxation in Britain in the late 1980s. Each individual is given a tax-free allowance and then there are bands of income taxed at progressively higher rates. But these bands cannot be aggregated within the family. If two individuals in a family are each earning £12,500, they pay no income tax at all. On the other hand, if one individual is earning £25,000 and the other stays at home to look after children or frail elderly relatives, the family will pay income tax on £12,500 of their income.

This does not accord with the most basic Christian (or, indeed, economist’s) understanding of the family. We come together in a family to share income, goods and responsibilities. A family’s tax position should not depend on how we do share divide income and these tasks but on the resources the family has at its disposal.

Particular examples of the “penalties” to single-earner couples are given below. It should be noted that, these penalties exist wherever there is an uneven split of earnings between the couple, though they reduce as the split becomes more even.

Taking into account only income tax:

- The amount of income tax paid by a household earning £20,000 annually varies from £0 to £1,500 depending on the household earnings’ composition, with an effective average income tax rate of 0–7.5%.

- The amount of Income Tax paid by a household earning £30,000 annually varies from £1,000 to £3,500 depending on the household earnings' composition, with an effective average income tax rate of 3.3–11.7%.
- The amount of Income Tax paid by a household earning £70,000 annually varies from £9,000 to £15,000 depending on the household earnings' composition, with an effective average income tax rate of 12.9-22.1%.

If we take account of income tax, National Insurance contributions, the child benefit tax charge and the marriage allowance then:

- The amount of the Income Tax and National Insurance Contributions paid by a household earning £30,000 varies from £1,502 to £4,894 depending on the household earnings' composition, with an effective average tax rate varying between 5% and 16%. This would result in the single-earner family paying £3,392 more in tax compared with dual-earner household on the same level of income. The single-earner family would have to earn an additional £4,988 per annum to have the same disposable income as the dual-earner family with a 50-50 split of incomes.
- The amount of the Income Tax and National Insurance Contributions paid by a household earning £70,000 varies from £14,302 to £22,237 depending on the household earnings' composition, with an effective average tax rate varying between 20%–32%. This would result in the single-earner family paying £7,935 more in tax compared with the dual-earner household on the same level of income. The single-earner family would have to earn an additional £13,681 to have the same disposable income as the dual-earner family with a 50-50 split of incomes (that is the grossed up amount of the different in tax paid).
- The amount of the Income Tax and National Insurance Contributions paid by a household earning £140,000 varies from £56,637 to £42,997 depending on the household earnings' composition, with an effective average tax rate varying between 31% and 40%. This would result in the single-earner family paying £13,640 more in tax compared to dual-earner household on the same level of income. Again, grossing this up, the single-earner family would have to earn about £23,500 more to have the same disposable income as the dual-earner family with a 50-50 income split.

It should be remembered that, in all these cases, the dual-earner family is also more likely to accrue two state pensions than the single-earner family.

These differences in the earnings necessary to obtain the same disposable income between families with the same gross incomes are huge and they are unjustified unless it is believed that, as a matter of public policy, two-earner families with very similar earnings should be encouraged with all the consequences for the provision of care for children and the elderly that this would entail.

Possible solutions

The most obvious solution to this problem is to treat the family or household as the unit of taxation. Tax-free allowances and tax bands would be given to a household and based on household composition. If there are two adults, they would receive two bands of tax-free income, as currently happens, but these could be used by the household as a whole. A household in which one spouse earned £25,000 and the other had no paid work, would have a tax-free income of £25,000, just like a household in which both spouses worked. This does not entail a complete overhaul of the current individual-based tax system, but it would at least offer some recognition that family composition has a significant impact on the financial health of the household and consequently, on its ability to pay taxes. It would ensure horizontal equity. It would, in effect, end the discrimination against families in which incomes were uneven because one or other parent took on the majority of caring responsibilities. A starting point would be an increase in the amount that can currently be transferred under the Marriage Allowance, with a view to moving towards fully transferable Personal Allowances and tax bands.

A fully transferable Personal Allowance would not be cheap. David Goodhart estimated in 2016 that the cost to the Treasury would be in the region of £5 billion – a significant amount of money, but still less expensive than the cost of the uplift in Universal Credit and Working Tax Credits, and a much smaller amount than the estimated cost to the taxpayer of family breakdown. But, to repeat the point made earlier, dual-earner families are very favourably treated within the tax system and so any reform may involve some redistribution.

This approach is well within the mainstream of international tax systems. It does not involve some harking back to days gone by in which we had stereotypical views of the role of men and women in family life. In France for instance, family taxation is based on a "quota", or the number of adults and children within a household. The term in French is "quotient familial" and looks at the entire composition of the household to determine the number of dependants, and the subsequent amount of tax payable. Similarly, the German tax system makes provisions for families by a principle of 'income splitting' by which the family income is combined and then divided between husband and wife for tax purposes so that they can make maximum use of tax free allowances. The German system also makes special provisions for dependants in the form of child tax free allowances which, it could be argued, is better than the provision of cash benefits.

The pernicious impact of the interaction of the tax and welfare systems

When the UK's tax system is super-imposed on the welfare system, the result creates very serious problems. Welfare benefits are taken away as family income increases. So we have a welfare system based on family income and a tax system based on individual income. This means that, if you have a non-earning individual with the responsibilities of a child (in practice, this is normally a mother) with a partner (possibly the father or somebody who would become a stepfather) who is earning, if they form a family together they will lose their welfare benefits. At the same time, they will pay penal rates of tax because of the situation described above. If the mother were able to transfer their tax-free allowance to the father, the loss of welfare benefits would be compensated by a reduction in the tax paid by the father which would represent the increased responsibilities that come with family formation.

Jonathan Williams, Family Policy Officer for CARE argues that, "By forcing a married couple to be treated as two individuals, the UK tax system fails as good public policy. […] our tax system is philosophically incoherent. Stable families and stable marriages are the bedrock of a strong and flourishing society." The UK has a rate of lone parenthood that is 50 per cent higher than the EU average and perhaps this is not a surprise given the interaction of our tax and welfare system.

The family plays a key role in the physical, emotional, and spiritual growth of its members. Recognising the family as a unit of taxation will not only benefit the family itself but wider society. Therefore, government needs recognise the importance of the family within the wider socioeconomic dynamics of life in the UK as happens in many other countries. Above all, it should not discriminate, as it does very strongly, against families in which one parent takes on the majority of caring responsibilities. In moving to a tax system that took into account family composition, it would also reduce significantly the penalty on family formation for those on low incomes.

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