PREM 49/2897

2897

CONFIDENTIAL

10 DOWNING STREET

THIS FILE MUST NOT GO OUTSIDE 10 DOWNING ST

FILE TITLE:		SERIES
TAX		TREASURY
		PART: 2
PART BEGINS: 22 DECEMBER 2001	PART ENDS: 12 APRIL 2002	CAB ONE:

Labour Administration

Part closed

PREM 49/2897

PART

CLOSED

DATE CLOSED	12 APRIL 2002

Series : **TREASURY**

File Title : **TAX**

Part : **2**

Date	From	To	Subject	Class	Secret
08/01/2002	PIU	PD(SV)	Orphan assets	C	
18/01/2002	PD(ME)	PM	VAT on housing	C	
25/01/2002	PD(MH)	PM	Environmental Taxes	C	
04/02/2002	PD(JN)	PPS	Tax reliefs - candidates for abolition	C	
15/02/2002	PPS	PM	Tax	C	
19/02/2002	PM	CH/EX	CSR and Tax increases	C	
19/02/2002	PPS	PM	Options for increasing tax - IFS ideas	C	
28/02/2002	PD(SS)	PM	Budget Strategy for Health	C	
01/03/2002	Pacific Islands PM	PM	Personal tax reforms: the child tax credit and the working tax credit	U	
03/03/2002	SS/DTLR	CH/EX	Tax relief on employer-funded Occupational Health Support	U	
04/03/2002	PD(AA)	PM	tough choices and charges II	C	
04/03/2002		PPS	From David Irwin of SBS - Payroll for SMEs	U	
07/03/2002	PD(JN)	SCU	Tax Information - VAT and NICs	C	
08/03/2002	PPS	PM	Taxes	C	
12/03/2002	SS/WAP	CH/EX	Tax relief on employer funded occupational health support	U	
13/03/2002	PPS	PM	Tax	C	
21/03/2002	PD(SV)	PM	Carter Review of Payroll	R	
01/04/2002	PPS	PM	Red Tape	U	
09/04/2002	PD(CO)	PPS	Tax Credits	R	
12/04/2002	Ch.Staff	PM	TAX "selling it"	C	

From: Jonathan Powell
Date: 12 April 2002

PRIME MINISTER

TAX

I think this will be a bigger problem than we have recognised up to now. My suggestions on how to deal with it are:

a) expectations: the public are likely to be shocked by the scale of the increase. We need to raise expectations rapidly. Your interviews at the weekend will help. But the fact that most media commentators have fixed on £5bn is a major problem;

b) the proposal: if you can reduce it to 0.9p or 0.75p, it would be much easier to sell publicly.

c) selling it: you need to badge it as 1p for the health service. We committed ourselves in the last election to increasing investment in the public services without destabilising the economy. The only way in which we could do this without increasing taxes would be to run up debt. That would put us back into the cycle of boom and bust. The choice is clear: more investment in public services under Labour or tax cuts under the Tories. In other words, we need to take this on the chin and make a virtue of the fact that we are not hiding the pain. If there are any hidden surprises in the Budget that people find out about a few days later, it will undermine any good we do by being up front about this increase.

d) accusation of breaking election promises on tax increases: we made it clear in the election that investment in the public services was our top priority. We said that we would put schools and hospitals first. That is what we are doing. And we are doing it in a way that is fair to all, in which people contribute according to their ability to do so through National Insurance not Income Tax. We remain the major country in Europe with the lowest taxes. (**While you cannot admit this is the same as Income Tax, do not try wriggling with Jesuitical defences or we will be burnt**.)

e) other lines of attack:

(i) the money will be wasted: No. The Health Service is getting better bit by bit. Go and ask the NHS professionals. But the NHS needs to know that for the next five years, it will get a sustained period of investment. That is what we are offering (the key here is announcements making it clear that the money is going straight into services not into some great black hole at the centre of government);

(ii) it is old Labour tax and spend: we need some bold new Labour step in parallel with the Budget, preferably a surprise. If possible, a major reform in the Health Service, eg announcing a date for the opening of a series of hip and eye factories under private management;

(iii) it is anti business (we are doing what we always said was wrong in Europe by imposing a tax on jobs): the Treasury should try and

square Digby on the day of the Budget. The measure for small business may help a bit. We need examples on how we have the least taxed business in Europe.

This is going to be a long battle but first impressions will be crucial on how the public see the tax increase. I am certain the Tories will oppose it and I am certain that the Daily Mail will run "Labour Tax Bombshell". We need to put it into a different context from day one.

JONATHAN POWELL

file

From: Carey Oppenheim
Date: 9 April 2002

JEREMY HEYWOOD
ANDREW ADONIS

cc: Jacob Nell
Emma Churchill

TAX CREDITS

1. Threshold for withdrawing CTC

- gainers/losers/cost/savings for different thresholds (700m cost if no losers)
- transparency of change
- interaction with other tax/NI changes/EMA/CB

2. Economy at the bottom end while still tackling child poverty

- what cost are they assuming – (£1-1.5bn for CTC and 0.5bn for WTC)
- what scope for tightening here:

  responsiveness

  threshold for when CTC/WTC first reduces

  withdrawal rate

  working tax credit phased in for those without

  children/unemployment hot spots????
- PSA new child poverty target - should be in place 2006/7 (otherwise too close to half way point)
- Conditionality – what further measures esp for lone parents, given extra spend (skills for those with older children?)

3. Child Trust Fund/Saving Gateway

- what's the deal
- see the Budget wording

- underpin by correspondence

CAREY OPPENHEIM

10 DOWNING STREET

PM

This is the outline of our possible big initiative on red tape. We ran out of time to get it in the Budget. But still worth pursuing hard.

I agree

92

Strongly plus announcement of a De-reg Unit reporting to the PM.

RED TAPE

- The best solution is to get the whole task of handling NICs, PAYE, WFTC, SMP etc off small firms' backs by getting private sector service providers to do the work for them.

- There are already a number of firms who provide this sort of service. However:

  - not all of these are using software/coding that is compatible with the Inland Revenue's systems;

  - the cost to many small businesses of buying the software can be prohibitive (£100 - £350);

  - and on top of that there is the annual cost of running of the software;

  - the services are not fully automated at present – for example, some coding changes are currently sent out by post. Full automation would cut costs.

- To get more small firms to use these service providers, we need to do some or all of the following:

(i) persuade the service providers to cut their costs. This could be done through political pressure to reduce charges (eg requiring all

"accredited" providers to charge no more than some reasonable amount to be determined) or through indirect persuasion (eg agreeing in return to give them some cash flow benefit from WFTC/PAYE etc payments);

(ii) provide a one-off cash discount (say, £100) to small firms to subsidise the cost of signing up to an accredited service provider. This could be limited to those who apply via the SBS, to boost the latter's role and profiles. Or it could be limited to small firms in deprived areas;

(iii) reduce the cost of the underlying service, by accelerating the Revenue's computerisation and e-business liaison programme.

- To bottom-out these options we should ask a senior private sector figure [eg Martin Taylor, Chris Haskins] to do a report for us for the PBR, working with the SBS, the Inland Revenue and the e-Envoy, to look at ways of cutting red tape by further encouraging the take-up of automated payroll systems by small businesses.

pps\red tape vlb

8U

Patricia Hewitt MP
Minister for Small Business and E-Commerce

cc: JON
P

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The Rt Hon Gordon Brown MP
Chancellor of the Exchequer
HM Treasury
Treasury Chambers
London
SW1P 3AG

6 March 2001

Dear Gordon,

Helping small businesses with payroll

Dawn and I spoke recently about the work the Inland Revenue has been doing to help small businesses with payroll administration. Our officials have been discussing this, with a view to a possible announcement in tomorrow's Budget.

I understand your concerns about offering incentives, though this scheme does differ from the earlier voucher scheme. That was designed for SMEs handling their own payroll, rather than encouraging SMEs to outsource payroll to an automated payroll provider.

From my own discussions with small businesses, I believe that an initiative along these lines would be warmly welcomed. There is no doubt that small businesses fear the administrative burden associated with taking on staff, and it ranks pretty high amongst their complaints. This is nothing new: complaints about the complexity of PAYE codings and statutory maternity pay go back many years. But because our government recognised the considerable potential of payroll administration for wider social reforms - particularly through your programme of tax credits - there is a real advantage to be gained in making life simpler for small businesses now.

The attached submission explains how we could encourage small businesses to make use of the services of commercial payroll providers. The IR is already developing standards that will promote the expansion of the payroll providers market.

The Rt Hon Gordon Brown MP March 2001

Employers would notify the payroll provider of the names and other details of employees, and in turn the provider would deal on the employer's behalf with the Inland Revenue.

The IR and SBS should also work together to promote these services. We propose that this approach should be piloted in 10 areas, including those with Single Regeneration Budget support and rural areas. We will monitor the uptake of such services by small businesses, assess the time savings by small business users, and review whether uptake could be improved by a suitable incentive of around £100 to SMEs with fewer than five employees.

I believe this would be a thoroughly practical and popular programme, and hope that you will feel able to include it in Budget 2001.

Best wishes,

Patricia

PATRICIA HEWITT

To: 1. Ms Hewitt
2. Chancellor of the Exchequer

ci: PS/Prime Minister
PS/Secretary of State
David Irwin SBS
Peter Waller SBS
Andrew Pinder E-Envoy
Philip Rutnam HMT
Barry Glassberg Inland Revenue
Ed Richards No 10 Policy Unit
Dan Corry DTI
Chris Hayes Cabinet Office

From: David Andrews
Director, Regulatory Issues
Small Business Service

Tel: 215 5779

Date: 6 March 2001

SUPPORTING SMALL BUSINESSES IN PAYROLL ADMINISTRATION

Issue

How to help reduce the burden of payroll administration for smaller businesses.

Timing

2 Urgent. We believe that small businesses and their representatives would welcome an announcement in Budget 2001.

Recommendation

3 Government incentives to encourage small business take up of the services of private sector intermediary payroll support providers.

Background

4 One of the main regulatory burdens faced by smaller businesses is in the administration of payroll. There is strong evidence that the cost of payroll administration is disproportionate for small businesses.

5 Many businesses already use the services of an intermediary provider to administer their payroll. However, many smaller and, in particular, micro businesses, have resisted taking on this help, largely on grounds of cost. Even minor changes to the tax details of individual employees, for example, a change in tax code, can prove administratively onerous for these businesses and divert their attentions from their priorities in running their businesses. As

the administrative process becomes more complex, they are more likely to make mistakes and require as a result, additional guidance from Inland Revenue (and generate additional administrative costs for the Revenue themselves).

6 We need to take careful account of the lessons of earlier consultation and pilot work in this area. The previous consultation on the voucher scheme concluded that cost was not the real issue for SMEs doing their own payroll administration. The help they needed was in understanding and administering tax changes and training in the use of commercially available software. Learning from this consultation it is evident that help could be made available more effectively by encouraging SMEs to get established with IT payroll providers who are developing services to reduce the administrative burden on small businesses.

Conclusion

7 Government should actively encourage small business take up of the services of private sector intermediary payroll support providers. We need a careful assessment of the availability and effectiveness of current commercial services, linked to improved payroll advice to be provided locally by Inland Revenue Business Support Teams working with Business Link advisers. This would be piloted in 10 Business Link areas, including rural areas and SRBs. We should leave open the possibility of providing modest incentives for small businesses to use electronic payroll services.

David Andrews

DAVID ANDREWS

SIMPLIFYING PAYROLL ADMINISTRATION

The Government recognises the concerns that small businesses have with administering payroll. We are encouraging private sector providers to enhance their products and services to enable small firms to administer their payroll most economically and efficiently. Providers should be able to:

- automate the receipt and application of payroll coding notices by sending these electronically; and
- calculate the pay due to each employee, taking account of all their entitlements, including tax credits.
- The Inland Revenue will provide guidance and technical support to commercial providers, as they have already done successfully for the private sector software developers in helping them to offer the current range of products.Minimum standards will be set for providers who will be able to deal electronically with the IR. This will be of real benefit to small businesses in helping to cut the amount of time and money they have to spend on administration.

We will encourage small businesses to make use of these services :

- The Inland Revenue Business Support Teams and the Business Links will provide targeted help to promote the take up of electronic payroll services in 10 pilot areas, including those with Single Regeneration Budget support and rural areas.

SUPPORTING SMEs IN PAYROLL ADMINISTRATION

BACKGROUND INFORMATION

Private sector service providers include Netstore, Rutherford Webb, Oracle, Fujitsu Siemens and Sage.

Some of these providers can provide a full payroll service for companies, including administering tax credits etc. To do so, they have to use software and coding compatible with the Inland Revenue systems. But currently not all of the transactions are dealt with electronically. For example, some of the coding changes are still sent through the post rather than by e-mail. It is the full automation and take-up of these services that incentives could encourage.

The cost of these software products varies considerably. The software tends to cost between £100 and £350. If the service provider then runs the service (rather than doing it 'in-house'), there would then be an ongoing charge. The size of this charge depends on the size of firm in question. Of course, many SMEs use accountants to deal with these issues.

The Inland Revenue e-business team and the SBS are involved in ongoing discussions with a number of service providers. The Inland Revenue team is working closely with these providers to ensure their products are compatible with the IR coding systems.

To: 1. Ms Hewitt
2. Chancellor of the Exchequer

From: David Andrews
Director
Regulatory Issues
Small Business Service

Tel: 0207 215 5781

Date: 5 March 2001

ci. PS/Prime Minister
PS/Secretary of State for Trade & Industry
David Irwin (SBS)
Andrew Pinder (E-Envoy)
Philip Rutnam (HMT)
Barry Glassberg (Inland Revenue)
Ed Richards (No 10 Policy Unit)
Dan Corry (DTI)

SUPPORTING SMALL BUSINESSES IN PAYROLL ADMINISTRATION

Issue

How to reduce the burden of payroll administration for smaller businesses.

Timing

Urgent. We believe that businesses and their representatives would welcome an announcement in Budget 2001.

Background

One of the main regulatory burdens faced by smaller businesses is in the administration of payroll. The process is becoming increasingly complex as more and more measures are administered via the payroll, including tax credits, collection of student loans, stakeholder pensions, PAYE, NICs, SSP and SMP. There is strong evidence that the cost of payroll administration is disproportionately higher for small businesses.

Many businesses already use the services of an intermediary provider to administer their payroll. However, many smaller and, in particular, micro businesses, have resisted taking on this help, largely on grounds of cost. Even minor changes to the tax details of individual employees, for example, a change in tax code, can prove administratively onerous for these businesses and divert their attentions from their priorities in running their businesses. As the administrative process becomes more complex, they are more likely to make mistakes and require as a result, avoidable guidance from Inland Revenue.

Recommendation

Government should provide incentives to encourage small business take up of the services of intermediary payroll support providers. The attached paper, in the form of a draft announcement, outlines two options for providing that incentive:

1. A cash incentive to be offered to micro-businesses who engage the support of an approved intermediary provider.

2. A dedicated payroll advice service to be provided by Business Link advisers working closely with Inland Revenue Business Support Teams.

Our strong preference would be for you to announce option 1 along the lines of the attached statement. If you are content with either of these proposals, the Small Business Service will work with the Revenue Departments and the Office of the E-Envoy to take forward your preferred option.

DAVID ANDREWS

SIMPLIFYING PAYROLL ADMINISTRATION

The Government recognises the concerns that small businesses have with administering payroll. We are encouraging private sector providers to enhance their products and services to enable small firms to administer their payroll most economically and efficiently. Providers should be able to:

- automate the receipt and application of payroll coding notices by sending these electronically; and
- calculate the pay due to each employee, taking account of all their entitlements, including tax credits.

The Inland Revenue will provide guidance and technical support to these providers, as they have already done successfully for the private sector software developers in helping them to offer the current range of products.

This will be of real benefit to small businesses in cutting the amount of time and money they have to spend administering the tax and benefit system.

The SBS and Inland Revenue will draw up new minimum standards of service and costs that service providers will be expected to meet if they wish to be approved.

<u>Option 1</u>

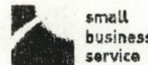
Increasing the uptake of these services and products by small businesses by providing cash incentives of £100 to those SMEs using them for the first time. This would encourage small firms to hand over the entire task of administering PAYE etc to private sector service providers. The cash incentive would be paid through the providers to reduce bureaucracy. [Note this would cost

around £50m if half of the firms with fewer than 5 employees were to take it up]

Option 2

Increasing the uptake of electronic payroll administration through the joint effort Business Links and Inland Revenue's Business Support Teams to enable them to provide dedicated support through the Business Link Advisors. This approach might begin with trials in 10 Business Link areas, including deprived areas. These trials will assess how comprehensive, economic and effective the service is for payroll administration by small businesses.

Memorandum To – Solution – by fax



To: Jeremy Heywood ✓ ca David Andrews

From: David Irwin
Chief Executive
david.irwin@sbs.gsi.gov.uk
020 7215 5558

4 March 2001

Payroll for SMEs

There is little doubt that managing payroll is one of the biggest headaches for those small businesses who employ people. There are now eight possible debits and credits administered via the payroll: PAYE, NICs, SSP, SMP, WFTC, student loans, stakeholder pensions and CSA attachment orders. Administering the payroll is, therefore, time consuming and prone to error.

There are a number of ways in which the Government could make up for this – since the proprietor of a business gets no benefit whatsoever from administering payroll debits and credits. The most obvious one is simply to pay compensation, as happens for example with SMP for the very smallest businesses where the business is given back 105 per cent of the SMP. A better solution, however, might be to look at ways of removing the burden altogether.

There are two key problems associated with payroll administration. The first is the receipt and application of various coding notices, for example, PAYE codes, WFTC amounts, etc. These generally come by post and have to be applied to each member of staff on an individual basis, even if the payroll is computerised. The second problem is the calculation of the pay for each person, though businesses do tend to computerise this. There are a number of payroll bureaux, including some which work via the web, though all still require the intervention of the business whenever a coding notice arrives.

An Application Service Provider (ASP) should be able to automate all this, enabling the Inland Revenue and others to send coding notices electronically. As we discussed on the phone earlier, we have initiated discussions with ASPs regarding the scope for providing a fully automated payroll service for small businesses and to ensure that there are no technical difficulties. I have already met with someone from Fujitsu Siemens, and am now in the process of arranging a meeting with the six or so ASPs who may be interested in offering payroll services. Once we have established that there are no technical difficulties, we then need to persuade the Inland Revenue and others that they should transmit coding notices electronically. We have already started discussions with the IR and do not anticipate any problems.

The ASP could calculate all the details for each business, passing back pay slips and summaries to the business to pay staff and the Inland Revenue itself. Alternatively, it could offer to pay all the staff on behalf of the business and pay the Inland Revenue on behalf of the business. This would potentially allow the ASP to cover the payment of WFTC out of its normal cash flow, whereas many businesses seek money in advance and are, it seems, often having difficulty in getting it. These aspects all need considerable work before a scheme is launched. And we should be willing to include any ASP who can demonstrate that they can meet our requirements.

This would reduce the administrative burden on the business to one of notifying changes of staff, changes of salary or wages, changes of hours, etc. For businesses with web access, this could all be done via the internet; for others, it could be done by phone.

There are likely to be three costs associated with a scheme of this sort – a fixed charge per business to set up a 'business account'; a fixed charge per person on the payroll to set up a 'personal account'; and a charge per person every time the payroll calculation is run (presumably either weekly or monthly in the majority of cases). As we discussed, there may be merit in the Treasury agreeing to make a contribution towards the first two of those charges, with the emphasis on the cost of setting up the business accounts, since that is likely to be the same for every business. This would then help the smallest businesses the most.

I don't know what the costs might be, but would guess that a business account might cost in the region

small business service

of £50-100 to set up, and then a further £5 per person. I would guess that the cost of running the service would be very low, since it would all be automated. There is still a significant number of businesses who are not on the internet. This may encourage them to wire up, though we would need to ensure that businesses could benefit from the service irrespective of whether they are on the net.

We discussed the scope for encouraging businesses to sign up via their nearest Business Link or via the Business Link website (to be launched at the beginning of April). I would welcome that, not least because we could then e-mail employers whenever regulation changed. We are intending to set up such a service, but having to register to get the grant would encourage many more to do so!

David Andrews will look first thing Monday morning at the scope for bringing some ASPs together immediately to discuss this further. As Phil W-O suggested, it may be better simply to say that the treasury and Small Business Service are working together to launch this new service promptly.

Hope this helps

David

To: Mrs Hewitt

From: Andrew BURKE
Assistant Director/
AOS G02

Tel: 020 7215 0763
Fax: 020 7215 4250

Date: 2 March 2001

ci: PS/SoS
David Irwin
Mark Gibson
Peter Waller
David Andrews
Angela Evans
Guy Leeser
Dan Corry
Andrew Pinder

Application Service Provider (ASP) for SMEs – Progress Report

Issue

To investigate the feasibility of a Government-backed Application Service Provider (ASP) for SMEs to simplify payroll administration by enabling transactions to be handled electronically.

Timing

Routine.

Background

We are pressing Revenue to look at ways to simplify payroll administration for SMEs and have discussed the idea of a Government-backed ASP for SMEs (raised at the Andersen Consulting seminar on the Knowledge Economy White Paper). The proposal was for SMEs to be able to save time and so costs by having their payroll, VAT and perhaps other business to Government transactions handled electronically, particularly those with the Inland Revenue.

You agreed that ASP should not be included in the White Paper because its feasibility had not been worked out. However, it was agreed that this idea should be pursued separately with officials at Inland Revenue. This note reports on the feasibility of an ASP following my initial meeting with Inland Revenue on 27 February.

Consideration

ASPs are delivering a crucial element of the Revenue's strategy - encouraging the private sector to produce value-added products, as has happened with self-assessment and the payroll standard. Their aim is to provide more proactive support, particularly for SMEs, across a range of IT and non-IT initiatives, in the context of their e-strategy, employers programme and business support teams. I attach a note of all that the Revenue are doing and propose to do to help reduce the payroll burden for SMEs (Annex A).

All of these initiatives have been based on customer surveys and feedback and developed to improve the service they offer businesses, particularly small

ones. This on-going process is part of Revenue's long term aim of being an enabling Department. Currently, they are developing a range of initiatives to support SMEs, such as their employer's programme (Annex 1), their e-strategy – which they presented to you on 17 October (Annex 2) and their business support teams. The aim of all these initiatives is to reduce the burden of SMEs administering payroll.

As part of Revenue's e-Business strategy, which has been approved by Ministers and the E–envoy, it is encouraging the private sector to develop value-added products. However, the strategy does not encompass the development of a Government funded and supported ASP available over the Internet. As well as the potential competition issues this would involve substantial cost and would attract severe criticism for any shortcomings. The agreed policy, in line with the strategy, is to help the private sector offer these services with the Revenue offering guidance and technical support to Software developers and employers (Annex 3). These commercial products are already widely used but Revenue believe that there is considerable scope for them to be developed further to provide comprehensive assistance on payroll administration at reduced cost.

The Office of the E-envoy have expressed their willingness to assist because they want to encourage any initiatives that support the Prime Minister's aim.

Recommendation

The advice from Revenue following our initial meeting is that the best way of achieving reductions in employer burdens is for them, together with the SBS, to continue to work with the private sector to enable and encourage them to enhance their products to provide comprehensive assistance on payroll administration. This approach, which is wholly consistent with their e-Business strategy approved by Ministers and the E- envoy is already yielding results and will continue to do so over the next year. We consider this to be a sensible starting point that will simplify the administration of payroll for SMEs but we will closely monitor whether Government should do more.

Separately, we will continue to work with the Revenue to look at ways of simplifying payroll administration for SMEs. An important aspect will be simplifying the administrative rules, in particular those determined by other Government Departments, such as Statutory Sick Pay and Statutory Maternity Pay, but administered by Revenue through PAYE.

Andrew Burke

Annex A

Inland Revenue help available to businesses/employers

Current

This sets out the main help etc offered to businesses and employers. Revenue can provide further detail, if required - e.g. the full list of workshops offered by their Business Support Teams; contents of various packs etc.

1. Employers (also see programme definition, Annex 1)

Phone

- Prospective/"new" employers ie employers with less than 3 years' experience in employing people: New Enterprise Support Initiative helpline, Tel 0845 60 70 143, open Monday - Friday 8am - 8pm, weekends and bank holidays 8am-5pm. Offers help and advice for new employers on payroll issues administered by IR (e.g. PAYE, National Insurance, benefits / expenses, statutory sick pay [SSP] and maternity pay [SMP], collection of student loans, working families / disabled persons tax credits etc). Also acts as a registration point for all new employers - results in issue of New Employer's Starter Pack - see below. Has a hand-off facility to the C&E VAT helpline.

- Employer's helpline (help and advice as above, but for more experienced employers). Tel 0845 7 143 143. Open Monday - Friday, 8. am - 8pm (weekends and bank holidays 8am – 5pm) Has a hand-off facility to the C&E VAT helpline.

- Employer's Orderline – facility for employers to order wide range of forms and guidance for tax / NI / etc purposes, , produced mostly on paper but also including some in electronic format (eg Employer's CD-ROM and video on Tax Credits). Tel 0845 7 646 646. Open Monday - Friday, 8am - 8pm and Saturday 10am - 1pm. Or Fax on 0870 2 406 406 at anytime. Or use Orderline Website at any time, at www.inlandrevenue.gov.uk/employers/emp-form.htm

(Revenue are developing plans to review possibility of using computer-assisted information-handling techniques – Case Based Retrieval - to assist Orderline operators and to assist employers on the Web.)

- Contracted out employment group - handles queries from all employers who have "contracted out" of SERPS - 0845 9 150 150 Open Monday - Friday, 8.30am - 5 pm.

- E-business Helpdesk - handles queries from employers and agents who want to know more about, or are interested in doing business with us electronically using the Internet service for PAYE, or Magnetic Media or Electronic Data Interchange. Telephone 0845 60 55 999 or email helpdesk@ir-efile.gov.uk Open 0800-2200 Monday to Friday and 1000-1800 at the weekend

- Other specialist Helplines too, covering National Insurance International services, National Minimum Wage, Payroll Standard (accreditation system for payroll software products) and Stakeholder Pensions. Fuller details available on request.

Website

- Inland Revenue website: Special site for Employers within the Revenues website containing guidance, publications and sources of help available to employers (www.inlandrevenue.gov.uk/employers/index.htm) Also employers can book up Business Support Team workshops and one to one help via the site. - see below.

New Diary /Planner and improved presentation, navigation and links in place from November 2000. Revenue's plans for future:-

  - ongoing work to further enhance presentation/Navigation/Search and hyperlinks;
  - Also improvements being made to Employer's CD-ROM for 2001;
  - Plans to review possibility of trialing Case Based Retrieval for Statutory Maternity Pay.

- Inland Revenue website: extensive background and detailed information for employers and agents on the Internet service for PAYE.

- Internet service for PAYE - this service enables employers, agents and payroll bureau to send a range of forms and returns over the Internet. Initially, the forms supported will be the employers end of year return (P35, P14, P38A), but this will quickly be extended to include P46 and P11D, with other forms being added later in the year.

- Inland Revenue works closely with software vendors to support them in the development of payroll products that can send output over the Internet, but employers that do not use a payroll package can still use the Internet service as Inland Revenue is providing PAYE forms online to complement the service.

- Inland Revenue already provides an EDI service for employers and contractors that allows them to electronically exchange certain forms with Revenue. Customers of this service are big companies and payroll bureaux that act for a large number of small employers who send information to the payroll bureau over the Internet.

Face to face

- Business Support Teams. Offer free help / support principally to new / small employers, through

- workshops on a range of tax / NI etc issues (e.g. PAYE, NI, SSP, SMP, Internet service for PAYE etc) and

- educational / support visits to employers' premises, to talk through the employer's responsibilities on payroll, how best to achieve them, and help resolve any problems, misunderstandings etc

- Inland Revenue enquiry centres. Approximately 300 of these call-in centres offer help and advice.

Written

- New Employer Starter Pack. A pack issued when employers register their PAYE scheme with us (via the NESI helpline - see above). Provides them with a starter guide to setting up their payroll, and deducting tax and NI etc accurately ; also points them to further sources of help / advice (eg written guidance, NESI helpline, BSTs etc). Plans in place for first phase of re-design to be launched in Summer 2001. Will be further enhancement in summer 2002.

- Employer's Annual Pack [EAP]- a pack of information, forms and guidance sent automatically to all employers each year - usually late January / early February. This focusses on the core information etc they need about end-of-tax-year payroll tasks (eg to do their End Year returns (due in 6 May)) and the tasks involved in starting the new tax year. Again, points them towards further sources of help and advice, should they need it, including the Orderline. Improved pack 2001. Feedback/consultation loop established for further enhancements for 2002.

- Budget update pack - again, sent automatically to all employers after the Budget, to advise them of any changes relating to their tax/NICs responsibilities and processes. Will be enhanced in line with EAP 2001 for 2001 issue.

- Employers' Bulletin – a payroll newsletter sent automatically to all employers, issued 3 times a year. Provides early advice on new developments that will affect their tax/NI etc responsibilities and processes.

- A host of other written guidance etc, available on the website or via the Employer's Orderline (see above). A major programme of work will lead to on-going enhancements not just to the Packs above but also to other areas of known difficulty such as our guidance on Expenses Payments and Benefits-in Kind and on SMP and SSP. And the aim is that these enhancements will take place in a co-ordinated way between paper and electronic media, with a common goal of improving the focus, style/presentation and navigation of the material.

2. Businesses (non - corporate)

Phones

- Prospective/new business: Helpline for the Newly Self-employed – for those who need to register with Inland Revenue as self-employed (for Class 2 NIC purposes, but will also achieve registration result for tax purposes). 08459 15 45 15, 8am to 8pm, seven days a week. Registration results in issue of 'Starting up in Business'

guide. Helpline also offers ongoing help and advice on Class 2 NIC, and a dial link with the SA helpline - see below - for self-assessment queries.

- Self assessment helpline. Offers help and advice on completing self assessment return (deadline 31 Jan annually). 0845 9000 444, open evenings and weekends

- SA tax return help sheets and leaflets. 0645 00 0404; open 8am - 10pm, 7 days a week.

- E-business Helpdesk (telephone 0845 60 55 999 between 0800-2200 Monday to Friday and 1000-1800 at the weekend or email helpdesk@ir-efile.gov.uk) supports the Internet service for Self Assessment - both customers and software developers who are designing products to compliment this service.

- Arranging payments for self assessment by debit card - 0845 30 51 000; open 8am - 10pm, 7 days a week. Also available over the Internet 24 hours a day.

- Working Families Tax Credit: a helpline for people - including the self employed - wishing to apply for Working Family Tax Credits. 0845 60 95 000, Monday - Friday, 7.30am - 6.30 pm.

- Construction industry scheme helplines for contractors/sub-contractors operating in the business industry. Help with understanding registration process, and voucher system. Sub-contractors - Tel 0845 30 00 581, open 7 days a week, 8am - 10pm; contractors - Tel 0845 73 35 588, open Monday - Friday, 8.30 am - 5pm. Orderline for both (for documents, vouchers etc); Tel 0845 30 00 551, 7 days a week, 8am - 10pm.

Website

- www.inlandrevenue.gov.uk/startingup – electronic version of the 'Starting up in business' guide

- Inland Revenue website: extensive background and detailed information for those interested in the Internet service for Self Assessment.

- Inland Revenue website: Internet service for Self Assessment which allows individual self assessment taxpayers to send their tax return over the Internet. A range of compatible software and online forms is available, some of which are free. All of the compatible products will automatically carry out the tax calculation for the taxpayer if they wish.

Face to face

- Business Support Teams - offer free help and support to new and small businesses through workshops and visits to business premises, where they will advise on such issues as record keeping, how to complete self assessment return etc (NB visits available from April 2001 onwards) and support electronic submission of employers end of year return (P14s/P35s).

- Inland Revenue enquiry centres - see above.

Written

- 'Starting up in business' guide, offering basic overview of tax / NI requirements, record keeping, basics on VAT and pointers to further help / assistance (including SBS / BL). Also video "Cutting through the red tape"" marketing the pack and our services.

- SA tax return guidance – tailored and sent out automatically with the tax return offering detailed guidance on its completion (and, if the customer wishes to self - calculate, how to do the calculation).

3. Businesses (corporate)

Phones

- Orderline for the Corporation Tax Self Assessment tax return, guidance supplementary pages - Tel 0845 30 06 555; open 8am - 10pm, 7 days a week.

Website

- www.inlandrevenue.gov.uk/ctsa/index.htm

Face to face

- BSTs - From April 2001 BST's can offer one-to-one help for new corporate businesses.

- IRECs - see above

Written guidance

A range of leaflets and booklets available, in particular CTSA/bk4 - A general guide to CTSA.

The future

Revenue are looking for ways that they can improve the service they provide to employers and businesses both in the short and longer term. In the short to medium term (for example see Annex 1). For the longer term, their study of the personal tax system now under way will examine the scope for further modernisation.

Annex 1: Employer Programme

The Employer Programme will be responsible for improving the Department's focus on employers. It will work particularly closely with the National Insurance, Electronic Business, Tax Credits and New/Small Business Programmes.

a) *Objectives*

- Support IR's long term move towards being an enabling department
- Reduce the burden on business by minimising employer compliance costs
- Increase customer satisfaction in the levels of support and service provided by the IR.

b) *Approach*

- Help employers understand their obligations and entitlements by improving the quality of the materials (e.g. forms and guidance) we use to deal with them and ensuring a successful transition to electronic media
- Reduce ongoing rework, boundary issues and duplication by improving co-ordination of employer work
- Facilitate a continuing culture change, to ensure that front line staff deliver the Departmental strategy of encouraging and supporting employers to claim entitlements and comply with their obligations
- Establish good, consistent communications internally and externally
- Improve policy making and operational delivery, by increasing the Department's understanding of employers, and by working with others to render legislation and procedures more straightforward for employers to operate.

Annex 2: Inland Revenue E-Business Strategy

1. Inland Revenue has adopted a 'Build and Learn' approach. This means that they will trial new approaches and be ready to adapt in the light of customer reaction.

2. Inland Revenue has a dedicated e-services group, with a senior full-time Director of E Services accountable for delivering the e-service strategy. A prioritisation process for proposed new initiatives will allow the Revenue to maintain progress towards the vision and respond effectively to changing demands and circumstances.

3. Customers will have a variety of electronic entry routes.

    - Some will choose to enter via the Revenue's web site or a government-wide portal such as UK Online.
    - Others will enter via links on commercial portals such as Yahoo, Freeserve or Natwest.com.
    - Increasingly the software products and on-line services that customers use will have been commercially developed.

4. Customers will be able to deal with Inland Revenue via intermediaries such as accountants, payroll bureaux, the Post Office, CAB and other commercial and voluntary organisations. Revenue will have provided help to those organisations to ensure that most of such contact will be electronic.

    Inland Revenue recognises that working with the private sector can lead to a win-win-win situation. Some customers will benefit from going to an intermediary; intermediary gets value from the customer contact; we get value from the net result. Delivering our services through intermediaries will be a key way in which we address the problems of the digital divide.

5. Customers will be encouraged to use electronic channels, and the Government Gateway will enable departments to deliver more e-services.

    - The main incentive for them to do so will be a faster more accurate service.
    - Where appropriate some wholly manual or paper alternative services may be withdrawn.
    - New services, or changes to existing services will have been designed with a view to making electronic channels as the preferred delivery vehicle.

6. Customers will be offered a variety of "joined up" services. Some of these may be provided by departments, but increasingly by intermediaries or software solutions.

7. By 2005, customers will be able to choose from a variety of ways of doing business with Inland Revenue. They will be able to deal with Revenue wholly electronically via digital TV, mobile phones, PCs and whatever technological innovations occur to enable "self service" on interactive and secure web sites.

Annex 3: Revenue technical support for Software developers and employers.

Inland Revenue already provides extensive support to the payroll software industry. All this activity leaves the employer free to choose the payroll product that is best suited to his business needs.

- Payroll Standard. Launched in March 2000. Sets out the minimum requirements for a payroll product likely to be used by small employers.
- Payroll Standard Accreditation scheme. From Sept 2000 software can be formally tested against the IR Payroll Standard and where the product fully complies with the Standard the product will be accredited and will be able to display the Payroll Standard logo on marketing material.
- Electronic Exchange Certification Scheme. Internet and EDI software products are checked and tested to ensure that they meet the Revenue's requirements for exchanging electronic versions of PAYE forms via Internet or EDI.
- Mag Media Test Facility. Employers and much more recently software houses have been able to test magnetic tape output to make sure that it meets IR requirements. This has enabled employer magnetic tape submissions at end of year (forms P14) to process more quickly.
- Initial validation investigation study on processing of P14 data on IR systems.
- Third Party Validation Service, introduced in April 2000. To enable software companies to check that their legislative driven changes to payroll have been correctly developed before being supplied to customers/employers
- IR guides and specifications for payroll software. How to program specific areas of payroll. The tax table spec. was first published in 1984. the NI spec in 1998 (although NI Guidance for software has been around much longer), Tax Credits and Student Loans in 1999, Stakeholder pensions in 2000 and in May 2001 a new spec for Statutory Sick Pay and Statutory Maternity Pay.
- Notes for Payroll Software Developers. A newsletter introduced in 1984 and written specifically for the payroll software industry.

Further services are also available for employers, and are particularly attractive to larger employers.

- P14 Error Investigation/Correction. A review is undertaken of the error reports produced by the worst 500 employers. Revenue will contact the employer and notify them of the errors and how to correct them for the next End of Year Return.
- Payroll Cleanse. Compares personal details data for EOYR submissions held by employers for employees against the Departments computer systems. Discrepancies are investigated and corrected which results in fewer rejections (the biggest problems being temporary NINO, incorrect NINO and out of date address).

Annex 4: Study of Personal Tax – terms of reference

1. To study, in consultation with stakeholders, the scope for modernising the operation of the UK's personal tax system (including income tax, National Insurance Contributions and tax credits, and related matters affecting employers' payrolls, such as collection of student loans, statutory sick pay and statutory maternity pay) taking account of:

- the wider economic and social objectives for the system
- developments in Europe and globally
- trends in employment patterns and a range of future scenarios
- the opportunities opened up by e-technology for re-defining roles and responsibilities, establishing new partnerships, streamlining processes and delivering more customer focused services
- the desirability of minimising the overall costs of the system, especially the compliance costs of individuals, and employers and other third parties
- evidence of what is working well and where there are problems
- the desirability of simplifying the system or finding better ways of coping with complexity
- the balance between doing work during the year and concentrating it after the end of the year
- the Inland Revenue business direction and the opportunities for joining up related services provided by the Inland Revenue and other Government Departments and agencies
- the people, resource and organisational implications involved in delivering changes in the system.

2. To make recommendations.

3. To make an interim report on findings within the next 12 months with further reports at dates to be determined.

4. Overall the study is expected to last about 2 years but this may be subject to change in the light of the progress of the study or other factors.

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File (In inbox)

From: Simon Virley & Oly Jones
Date: 21 March 2002

PRIME MINISTER

cc: Jonathan Powell
Jeremy Heywood
Andrew Adonis
Geoffrey Norris
Ed Richards

CARTER REVIEW OF PAYROLL

An update. The Budget will include a response to Patrick Carter's recommendations on payroll services. HMT are still working on the details, but it seems likely to include making it compulsory for large firms to submit payroll returns 'on-line' by 2004/05, and a cash incentive for smaller firms to encourage them to do so (with the aim of making it compulsory for all firms over the longer term). We think this is a sensible package. If you agree, it would be helpful if you could remind the Chancellor of your desire to see a positive response to the Carter report in the Budget.

Detail

Patrick Carter's review was published alongside the Pre-Budget Report. Carter recommended:

- making it compulsory for large firms to submit payroll returns 'on-line' by 2004;

- giving a financial incentive to small firms to encourage them to do so, with the aim of making it compulsory for them too at a later date (e.g. 2007).

This package could:

- help ease payroll burdens for employers;
- save Inland Revenue staff and time costs; and
- help meet wider e-government objectives for getting services 'on-line'.

The PBR welcomed the review and invited comments on its proposals. Around 60 responses were received, mostly from representative organisations like the CBI, FSB and BCC. The responses included familiar criticisms of the burdens

and complexity of dealing with payroll issues, particularly given recent developments like the WFTC, student loans, stakeholder pensions, and a call for *all* firms to be given financial help to deal with payroll issues. But on the *specific questions* raised by the Carter report:

- there were surprisingly few objections to the idea of compulsion for large firms;

- however, many respondents thought that the threshold for this should be higher than the 50 employees Carter had suggested (and should be defined in terms of full-time equivalents rather than a headcount basis to take account of part-time employees);

- most were in favour of financial incentives, and against compulsion, for small firms.

Clearly, the costs of any package will depend on the size of the financial incentive and the number of firms it applies to. But, to give an illustration, a £100 incentive for firms up to 50 employees, with a take-up rate of 40%, would cost about £58m pa. The Inland Revenue think that savings of their time might amount to about half this initial cost, making the *net* cost around £25-30m pa.

Extending a £100 incentive to firms up to 250 employees would only cost another £1.5m pa. (assuming take-up of 40%). However, an incentive of this size would make little or no difference to firms of this size and the most widely used definition of 'small' firms is those with 0-50 employees. We therefore favour sticking with 50 employees as the threshold. (We could push back the date when it becomes mandatory to 2005, thereby bringing it in line with the Government's wider e-delivery targets, if a concession does prove necessary.) We also think the Budget should include a strong signal that it will become mandatory for *all* firms to submit returns 'on-line' in future (without being precise about dates at this stage).

We have fed these points back to HMT and Inland Revenue at official level. If you agree with the broad thrust of the recommendations, **it would be helpful if you could remind the Chancellor, in one of the pre-Budget bilaterals, of your desire to see a positive response to the Carter report in the Budget.**

SIMON VIRLEY/OLY JONES

(F)

From: Jeremy Heywood
Date: 13 March 2002

PRIME MINISTER

cc: Jonathan Powell
Andrew Adonis
Alastair Campbell
Sally Morgan
Robert Hill
Peter Hyman

TAX

You asked for more imaginative thinking on tax! The problem is that to raise an extra £10 billion a year there is no real alternative but to build on the existing tax system. I have spent much of the last 15 years trying - and failing - to identify new and interesting ways of raising money!

First a reminder of the basic numbers. The existing PBR projections imply a gradual rise in the tax burden over the SR2002 period from 36.4% in 2002-3 to 36.7% in 2005-6, reflecting the impact of fiscal drag. These numbers are fairly cautious. For example, they assume that oil prices remain constant in real terms at $22.90 a barrel (today's price is $23.70) and they assume that VAT revenues fall over time as a proportion of total consumption. I suspect that when the final numbers are done the Treasury may be able to raise the revenue numbers (and of course the implied tax burden) by, say, £5 billion a year.

The PBR forecast allows for extra DEL spending in the SR2002 period, without any change in taxes, of :

O	12	24

No.10 advisers think we need a further

12	17	20

over and above these PBR numbers. So even if the revenue figures are revised up by £5 billion a year we will still need tax increases of up to £15 billion a year by 2005-6. This is obviously way above what is politically sustainable. **So even before we start talking about tax increases we need to cut back on the projected spending increases, particularly (in my view) on Health and Defence.**

On the assumption then that we are seeking to raise around £10 billion rather than £15 billion, I think we should consider the following:

i) **principled tax reform:** the two best candidates are extending VAT to new construction on green field sites (£1.5 billion) and a reform of North Sea Oil taxation (up to £1 billion).

ii) **a temporary increase in VAT**: we could look at the idea of introducing **for a temporary period only** a 2½% VAT surcharge, perhaps called the Public Services Levy, to raise extra money to finance reform of the public services. The argument would be that we were 2 years into comprehensive 10-year reform plans for the NHS, Transport, the CJS and Education. To finance the transitional costs (eg 100 rather than 10 City Academies; a massive expansion in IT; refurbishment of all GP premises; more roads and an acceleration of the Tube investment etc etc), we need extra money. But this phase will not last forever. So we would "sunset" the tax increase in 2010. When the time came the Government of the day

could obviously seek legislation to extend the surcharge for a further period. But the default option would be to allow the 2½% increase to lapse.

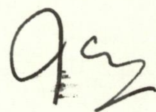
iii) **direct tax reform:** we could phase in the abolition of the NICs Upper Earnings Limit over three years, by charging 3.5% above the UEL from April 2002; 7% from April 2003 and the full 10% from April 2004. This would raise £5.9 billion a year. Of this we might devote 50% to financing higher spending and the rest to a visible and symbolic tax cut eg a big expansion of the 10p band or a large increase in the threshold for top rate tax (for £3 billion a year we could lift the 40p tax threshold from £35k to £40k). Taken together, this would remove a major anomaly in the tax/NIC system, raise money for investment in the way that everyone is expecting, give you some money to moderate the losses and muddy the "tax hike" story. A more cautious NIC variant would be simply to impose a 2½% surcharge above the UEL. Again this could be announced as a temporary levy.

I know you are very hesitant about NICs. But I believe there is quite a strong case for a package approach rather than putting all your eggs in the VAT basket. In contrast to changes in direct taxation, increases in VAT push up the RPI (1% on VAT pushes up RPI by 0.65%) and could therefore led to the double whammy of higher taxes and higher interest rates (the MPC would be particularly worried if the one-off increase in the RPI was accompanied by an increase in wage settlements). In addition, increases in VAT would need to be offset by an increase in benefit payments to protect the poor. This could easily claw back 20% of the revenues, requiring an additional 1% to be added to the rate increase.

I suspect it is these difficult second round effects as much as politics that are inclining HMT more towards NICs.

Finally, alongside any or all of these options you could introduce an annual statement of performance on the public services, audited by the independent inspectorates (or the NAO), which would go to every household in the country. It would set out simply and clearly how much had been spent during the year and what had been achieved.

Does any of this attract you?



JEREMY HEYWOOD

0171 238 0665

From the Secretary of State
for Work and Pensions

DWP Department for Work and Pensions

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Rt Hon Gordon Brown MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
London SW1P 3AG

12 March 2002

Dear Gordon

TAX RELIEF ON EMPLOYER FUNDED OCCUPATIONAL HEALTH SUPPORT

I have seen Stephen Byers' letter of 3 March to you. Of course detailed work will be needed to ensure the area can be properly ringfenced as intended. However in principle I think this has merit and should be looked at further.

Once people move from sick leave to incapacity benefit they are very likely to remain there for a number of years. The cost of this is very high and, as you know, we are working hard to develop effective ways of moving people back into work. It therefore makes sense to do what we can to encourage employers to act in ways that seek to keep employees in work. If we can make this proposal work it could be a helpful measure.

I have copied this letter to the Prime Minister, John Prescott, David Blunkett, Stephen Byers, Alan Milburn, Patricia Hewitt, Barbara Roche, Paul Boateng and Sir Richard Wilson.

Yours

ALISTAIR DARLING

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CONFIDENTIAL - PERSONAL

f.

From: Jeremy Heywood
Date: 8 March 2002

PRIME MINISTER

cc: Jonathan Powell
Andrew Adonis

TAXES

The attached note by Jacob sets out details of possible tax and spending changes for the Budget. Assuming that our aim is to raise about £12 billion (around 1% of GDP in 2003/4), you have the following broad options:

- VAT package: extension of the main rate to new housing construction on green field sites (GB is cautious; but EB favours!); plus an increase in the main rate to 20-21%; (depending on how much compensation you wanted to give to the poorest households who would be hit disproportionately hard)

- NICs package: abolition of the Upper Earnings Limit plus 1.25% on main employee rate and 4% on self-employed rate (they are massively under-taxed at present). To give you some idea of the impact, the person on £50,000 a year would lose about £2,000 a year from the abolition of the UEL and a further £500 a year from the increase in the rate - about £50 a week.

- a mixed package: there are obviously endless mix and match permutations. If you were going for a package along these lines I would opt for something like the following:

- VAT on new construction (£2900m – but less, probably around £1500 mn if only greenfield)
- Align NIC Upper Earnings Limit with threshold for higher rate tax (£900m)
- Raise NICs on the self-employed to the employee rate (£1100m)
- 1p on VAT (£4000m)
- Increase in Air Passenger Duty (£500m)
- Increase North Sea oil taxation (£500 mn)
- £30 per car on Vehicle Excise Duty (£1000 mn)
- 2.5% on insurance premium tax (£960 mn)
- Double landfill tax (£750m)

Assuming VAT on non-greenfield new build is out, that would still leave us nearly £1 bn short of the target. But we could probably make that up through various anti-avoidance ruses. On top of this you need to bear in mind that the baseline already assumes a 2p increase in petrol duties, in line with the RPI.

I have not included here any of AA's spending hard choices. All of these (and much more) would be needed to get spending down to the assumed £12 billion envelope.

How do you want to take this forward?

James Nell

p.p. **JEREMY HEYWOOD**

From: Jacob Nell
Date: 7 March 2002

JEREMY HEYWOOD

TAX COSTINGS

This note provides some additional information on tax costings in response to your request for a view on what a "stealth" package of tax increases might looks like, which I have worked up together with Simon Virley. The note includes:

- Costings for a "stealth" package of charges and tax increases;
- IFS costings for a package of NICs measures
- Annex 1 with information on VAT, including estimates on how much is raised by the application of VAT to different goods and services;
- Annex 2 with information on National Insurance Contributions
- Annex 3 with information on the current breakdown of Government receipts by category of tax.

1. Costings for a "stealth" package

Charges

Andrew is currently managing an ongoing Policy Directorate project to work up a set of tough options on charging. Although the full set of measures set out here may raise £2.5 bn, a much lower proportion will actually be available to fund increased public spending, for the following reasons:

1) Some of the financial benefit is simply from being less generous on the introduction of a new policy (the Children's Tax Credit) than would otherwise be the case, and is strictly a reduction in additional spending rather than a way of raising finance;

2) In some cases (Child Benefit) the financial gain will be in AME not in DEL;

3) In some cases the cost of the new charge may largely fall in public sector bodies (as is the case for instance with landfill tax, which will largely be paid by local authorities), and so not raise additional finance from the private sector to finance public services;

4) In some cases the charge will be collected by another public sector body, such as local authorities or the police. In order for the increase in revenues collected to be available for increasing public expenditure elsewhere HMT would have to reduce funding to the body in line with the increase in revenues collected.

A very rough estimate suggests that, once these figures are taken into account, the net DEL effect of implementing all of these measures is about half the finance raised at £1.3 bn. However, some of the additional non-DEL finance raised will be going to fund activities that might otherwise have been funded out of DEL, and savings in AME can be transferred at the Chancellor's discretion into DEL.

At the current stage, the following charging options look to be plausible frontrunners.

Charge	Finance Raised	Net DEL effect	Sensitivities
Charging for missed GP and outpatient appointments	£250 mn	£230 mn	The disorganised poor
Full recovery of charges in personal injury cases	£140 mn	£140 mn	Higher insurance premiums/employer costs
Abolition of welfare foods scheme	£130 mn	0	Poor mums with young babies
5% real interest rate on student loans	£250 mn	£250 mn	Graduates pay more for their student loans
Raising tuition fee to 30% of average course cost	£100 mn	£100 mn	Parents of richer students pay more
Freeze Child Benefit for 1 year	£200 mn	0	Parents and their children; looks desperate.
Not extending Children's Tax Credit up the income scale	£750 mn	0	Parents with household income £40k-£70k; this is only a reduction in the cost of introducing the CTC, not a saving over the PBR baseline
Household waste charging	£100 mn	£50 mn	All households
Utility lane rental	£250 mn	£200 mn	Large utility companies
Planning charges	£150 mn	£100 mn	Homeowners building extensions
Selling uncollected court debt	£100 mn	£100 mn	Criminals who are in arrears
Increased seized assets	£100 mn	£20 mn	Criminals

Options on abolition or restriction of tax reliefs that look to be plausible, given Manifesto commitments and current developments:

Tax relief	**Net Finance Raised**	**Sensitivities**
Abolition of VAT zerorating on construction of new dwellings	£2400 in first year; £2900 mn after 3 years as impact on inflation and benefits wears off	Increase the price of new homes, reduction in demand; restriction to greenfield only raises less
Restrict personal tax allowances for higher rate taxpayers to the basic rate tax-payers allowance	£2600 mn (IFS figure)	Higher rate taxpayers
Freezing income tax allowances, starting and basic rate limits	£1800 mn	All taxpayers; looks desperate
Total	£7300 mn	Various

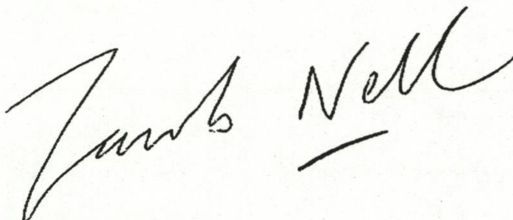
Options on increasing taxes that look plausible, given Manifesto commitments and current developments:

Tax	Net Finance Raised	Sensitivities
0.5% increase in VAT standard and reduced rate	£1550 mn in first year, £1900 mn after three years	1% increase in VAT increases inflation by 0.65% and so increases £110 bn benefits bill by £715 mn
Excess profit tax on North Sea oil	From zero to £2000 mn	Oil companies may reduce exploration activity
Raise Air Passenger Duty by £2.50	£500 mn	State of airline industry; landing charges increased
Double landfill tax from £15 per tonne to £30 per tonne	£750 mn gross, £250 mn net	Since most of the tax is paid by councils, the net finance raised from the private sector will be small – perhaps 1/3 of the gross figure
Increase petrol and diesel duty by 1p	£400 mn	Fuel protests; disparity between EU excise rates
Increase VED by £10	£300 mn	Motorists
Increase insurance premium tax by 1%	£300 mn	State of insurance industry
Increase beer duty by 1p	£100 mn	Probably regressive impact
Raise Class 4 NICs rate (self-employed) from 7% to 10%	£825 mn	Hits self-employed (taxidrivers, builders etc.)
Increase Upper Earnings Limit to starting point of higher rate tax	£900 mn	Higher rate tax payers
Total	Ca. £5.5 bn	Various

2. IFS costings for their proposals on NICs

The IFS discuss measures that could raise over £12 bn from changes to National Insurance in their Green Budget 2001, as summarised in the table below. Note that there is some overlap between the proposals. For instance, the £5.9 bn from abolishing the UEL includes the £900 mn from raising the UEL to the higher rate threshold.

NICs measure	Finance Raised	Sensitivities
Raise Upper Earnings Limit to the higher rate threshold	£900 mn	Commitment not to raise upper rate of tax; hits single earner couples harder
Abolish Upper Earnings Limit	£5900 mn	Commitment not to raise the upper rate of tax; hits single earner couples harder
Equalise contributions from the self-employed (Class 4 NICs rate) with those from the employed	£2300 mn	Massive rise in tax for self-employed (taxidrivers, builders)
Raise Class 1 (employee) and Class 4 NICs rate by 1 percentage point	£3300 mn	Commitment not to raise income tax
Make unearned income (rent, dividends) subject to employee NICs for non-pensioners	£1600 mn	Disincentive to asset holding and wealth creation; undermines contributory principle



JACOB NELL

Annex 1: Value Added Tax

How it works

Whenever a firm sells any good or service they pay VAT – normally 17.5% of the value of whatever they've sold – so to the consumer it adds 17.5% to the price of most goods and services.

The firm can reclaim VAT on the goods or services they've bought as part of their business – hence to the firm the net effect is paying tax on the value they add in the process. VAT applies to petrol, tobacco and alcohol after excise duty (so we effectively charge VAT on duty).

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There's no published breakdown of the breakdown of what products we raise VAT. But Stephen has calculated roughly, in the table set out below how much VAT was raised in 2001 by different elements of final household expenditure. These figures include the VAT on business supplies which is then claimed back in producing any of the goods and services below.

Source	Value	Percentage
Restaurants and hotels	£11 billion	18%
Alcohol and tobacco	£4 billion	6.5%
Motor vehicles	£4.5 billion	7.3%
Vehicle fuel and lubricants	£2.4 billion	3.9%
Vehicle spares and repairs	£2.7 billion	4.4%
'Recreational Services' sporting events etc	£2.7 billion	4.4%
TVs, radios, stereos, cameras, etc	£2.6 billion	4.3%
Adult clothing	£4.2 billion	6.8%
Personal Care (hairdressing etc)	£2 billion	3.3%
Telephone and telex	£2.3 billion	3.8%
Furniture;	£1.6 billion	2.6%
Games, toys, and hobby equipment	£1.5 billion	2.4%
Jewellery clocks and watches	£500 million	0.8%
Total from these sources	£42 billion	68%

VAT rates

Basic VAT rate is 17.5%
Reduced rates with costs (in 2001-02) of the reduced rate, or exemptions are:

Reduced rate of 5% on:

- domestic fuel and power - £1.65 billion ;
- residential conversions - £100 million;
- sanitary products.

Zero rates on:

- Food* - £8.7 billion;
- Construction of new dwellings - £3.25 billion;
- Domestic passenger transport* - £1.7 billion;
- International passenger transport - £250 million;
- Books, newspapers and magazines* - £1.6 billion;
- Children's clothing* - 950 million;
- Water and Sewage - £950 million;
- Drugs and supplies on prescription - £750 million;
- Supplies to charities - £150 million;
- Ships and aircraft above a certain size - £550 million;
- Vehicles and other supplies to disabled people - £300 million;

*Manifesto pledges to maintain the zero rate on this.

Some goods are also VAT exempted. This means that VAT is not charged on these goods, but unlike zero rate goods VAT cannot be claimed back on goods and services bought by firms producing these – so VAT still increases the price of these goods as VAT on supplies is still charged.

Exempted goods and services include:

- Rent on domestic dwellings - £3.4 billion;
- Rent on commercial properties - £500 million;
- Private education - £250 million;
- Health services - £550 million;
- Postal services - £400 million;
- Burial and cremation – £50 million;
- Finance and insurance - £100 million;
- Betting and gaming and lottery - £700 million;
- Small traders (turnover under £54,000) - £100 million

Annex 2: National Insurance Contributions (NICs)

How it Works

- Employees pay NICs at 10% on their weekly income between £87.01 and £575.
- Employers pay NICs at 11.9% on weekly earnings above £87.

There's a 1.6% employees rebate for contracting out of State Earnings Related Pension scheme. Employees NICs is deducted at source in the same way as PAYE Income Tax.

There is also a reduced rate for married women.

- Flat rate of £2 a week if you earn more than £3,955 a year (Class 2);
- 7% of profits between £4,535 and £29,900 a year (Class 4).

Self-employed NICs is meant to reflect both employers and employees contribution. There is a lower rate to reflect both their reduced entitlement to benefit (and a historic political aim to encourage small business).

What Benefits depend on NICs contributions

Paying enough NICs entitles you to:

- Incapacity benefit
- Jobseeker's Allowance*
- Maternity Allowance
- Retirement Pension
- Widowed Mother Allowance
- Widows Payment
- Widows Pension

*The self-employed are not entitled to contribution-based jobseeker's allowance (only income based jobseeker's allowance). Because of this self-employed NICs is set to be lower rate than employees and employers NICs.

How much does it raise?

Raises:
- £65.2 billion in 2001-02
- £67.0 billion in 2002-03

In 2001-02 this is raised through:

Class 1 (employees)	25.9	
Class 1 (employers)		36.1
Class 2 (self employed)	0.3	
Class 4 (self employed)	1.8	
Others (Class 1A, 1B and 3)	1.1	
Total	£ 65.2 billion	

this goes to

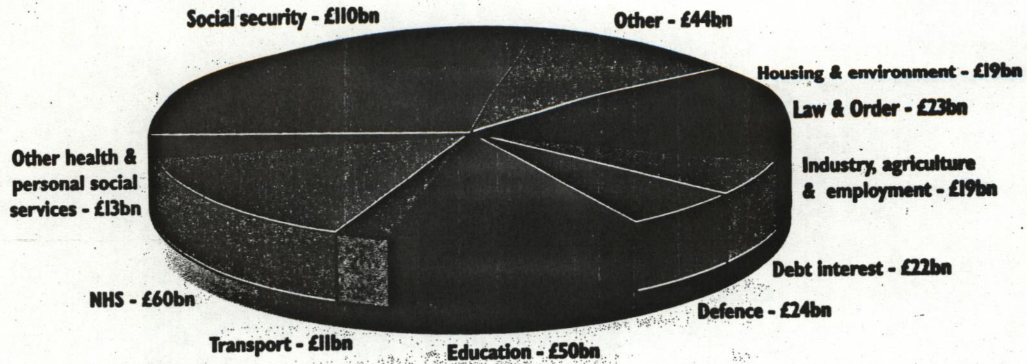
the National Insurance Fund	57.9
the National Health Service	7.3

More details of revenue, where it goes, estimates and rates here:
http://www.gad.gov.uk/publication/pdf/2002uprating.pdf

GOVERNMENT SPENDING AND REVENUES

Chart 1.1: Government spending by function

Total managed expenditure: £394 billion

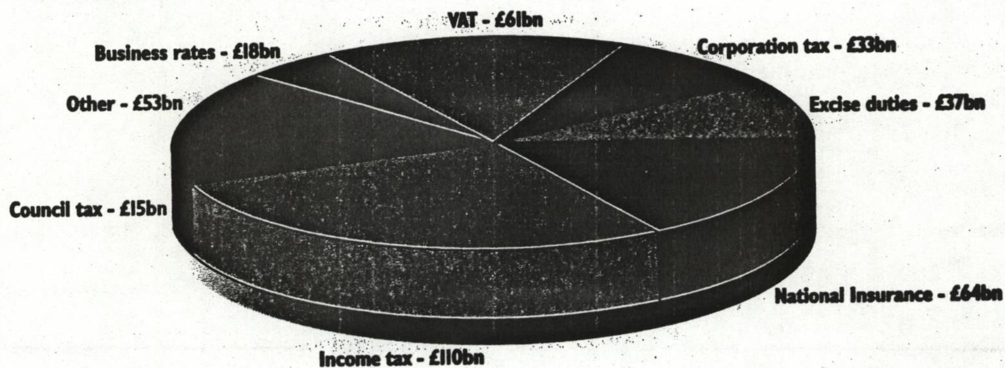


Source: HM Treasury, 2001–02 figures. Other expenditure includes spending on central administration, culture, media and sport, international cooperation and development and public service pensions, plus spending yet to be allocated and some accounting adjustments.

1.36 Chart 1.1 presents public spending by main function. Total public spending (Total Managed Expenditure – TME) is expected to be around £394 billion in the current financial year, 2001–02. TME is divided into Departmental Expenditure Limits (DEL), shown in Table B15, and Annually Managed Expenditure (AME), shown in Table B13. A number of DELs, especially those of the devolved administrations, contribute to spending on more than one function. Chart 1.1 also includes spending by local authorities, rather than the grants they receive from central government, which are included in Tables B13 and B15 in Annex B.

Chart 1.2: Government receipts

Total receipts: £391 billion



Source: HM Treasury, 2001–02 figures. Other receipts include capital taxes, stamp duties, vehicle excise duties and some other tax and non-tax receipts (eg. interest and dividends).

1.37 Chart 1.2 shows the different sources of government revenue. Public sector current receipts are expected to be around £391 billion in 2001–02. Table B11 provides a more detailed breakdown of receipts consistent with this chart.

Table B11: Current receipts

	Outturn	Projections	
£ billion	2000-01	2001-02	2002-03
Inland Revenue			
Income tax (gross of tax credits)	105.9	109.7	116.1
Corporation tax[1]	32.4	33.3	35.0
Tax credits	-5.2	-7.6	-9.0
Petroleum revenue tax	1.5	1.4	1.4
Capital gains tax	3.2	2.9	1.8
Inheritance tax	2.2	2.4	2.5
Stamp duties	8.2	7.4	7.7
Social security contributions	60.6	64.3	65.7
Total Inland Revenue (net of tax credits)	**208.9**	**213.8**	**221.1**
Customs and Excise			
Value added tax	58.5	61.3	63.7
Fuel duties	22.6	22.2	23.0
Tobacco duties	7.6	7.8	7.7
Spirits duties	1.8	1.9	2.0
Wine duties	1.8	2.0	2.0
Beer and cider duties	3.0	3.0	3.1
Betting and gaming duties	1.5	1.4	1.3
Air passenger duty	1.0	0.8	0.8
Insurance premium tax	1.7	1.8	1.8
Landfill tax	0.5	0.5	0.5
Climate change levy	0.0	0.6	1.0
Aggregates levy	0.0	0.0	0.2
Customs duties and levies	2.1	2.1	2.3
Total Customs and Excise	**102.2**	**105.4**	**109.6**
Vehicle excise duties	4.5	4.5	4.7
Oil royalties	0.5	0.5	0.5
Business rates[2]	17.3	18.1	18.4
Council tax	14.2	14.8	15.8
Other taxes and royalties[3]	9.0	9.6	10.3
Net taxes and social security contributions[4]	**356.5**	**366.7**	**380.4**
Accrual adjustments on taxes	2.3	0.3	0.2
less own resources contribution to EU budget	-6.3	-5.8	-5.4
less PC corporation tax payments	-0.1	-0.1	-0.2
Tax credits[5]	5.2	6.1	6.5
Interest and dividends	5.8	4.3	4.0
Other receipts	19.0	19.7	20.7
Current receipts	**382.2**	**391.2**	**406.2**
Memo:			
North Sea revenues[6]	4.3	5.4	5.2

[1] *Includes advance corporation tax (net of repayments):*
Also includes North Sea corporation tax after ACT set off, and corporation tax on gains.
Gross of R&D tax credit (zero in 2000-01, £0.1 billion in 2001-02) and tax credit for cleaning contaminated land sites (£50 million in 2001-02) which are scored within the tax credits line.
[2] *Includes district council rates in Northern Ireland paid by business.*
[3] *Includes money paid into the National Lottery Distribution Fund.*
[4] *Includes VAT and 'traditional own resources' contributions to EU budget. Net of tax credits. Cash basis.*
[5] *Excludes Children's Tax Credit, and other tax credits which score as a tax repayment in the national accounts.*
[6] *Consists of North Sea corporation tax (before ACT set-off), petroleum revenue tax and royalties.*

file

From: Jacob Nell
Date: 7 March 2002

PETER HYMAN

cc: Jeremy Heywood
Andrew Adonis
Derek Scott
Simon Virley
Stephen Balchin

TAX INFORMATION - VAT and NICs

This note provides some additional information on VAT and NICs, as requested, and some information on the IFS proposals on NICs, which I have worked up together with Simon Virley and Stephen Balchin.

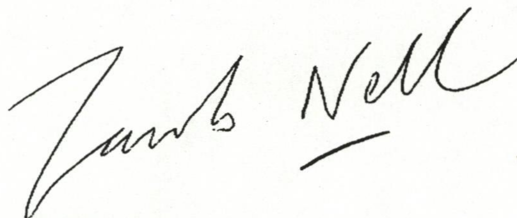
The note includes:

- Data on the Institute for Fiscal Studies proposals in the Green Budget for raising finance from National Insurance Contributions;
- Annex 1 with information on VAT, including estimates on how much is raised by the application of VAT to different goods and services;
- Annex 2 with information on National Insurance Contributions;
- Annex 3 with information on the current breakdown of Government receipts by category of tax.

IFS proposals on NICs

The IFS discuss measures that could raise £14 bn from changes to National Insurance in their Green Budget 2001, as summarised in the table below:

NICs measure	Finance Raised	Sensitivities
Raise Upper Earnings Limit to the higher rate threshold	£900 mn	Commitment not to raise upper rate of tax; hits single earner couples harder
Abolish Upper Earnings Limit	£5900 mn	Commitment not to raise the upper rate of tax; hits single earner couples harder
Equalise contributions from the self-employed (Class 4 NICs rate) with those from the employed	£2300 mn	Massive rise in tax for self-employed (taxidrivers, builders)
Raise Class 1 (employee) and Class 4 NICs rate by 1 percentage point	£3300 mn	Commitment not to raise income tax
Make unearned income (rent, dividends) subject to employee NICs for non-pensioners	£1600 mn	Disincentive to asset holding and wealth creation; undermines contributory principle
Total	£14000 mn	Various



JACOB NELL

Annex 1: Value Added Tax

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ANNEX 3: GOVERNMENT RECEIPTS BY CATEGORY OF TAX

GOVERNMENT SPENDING AND REVENUES

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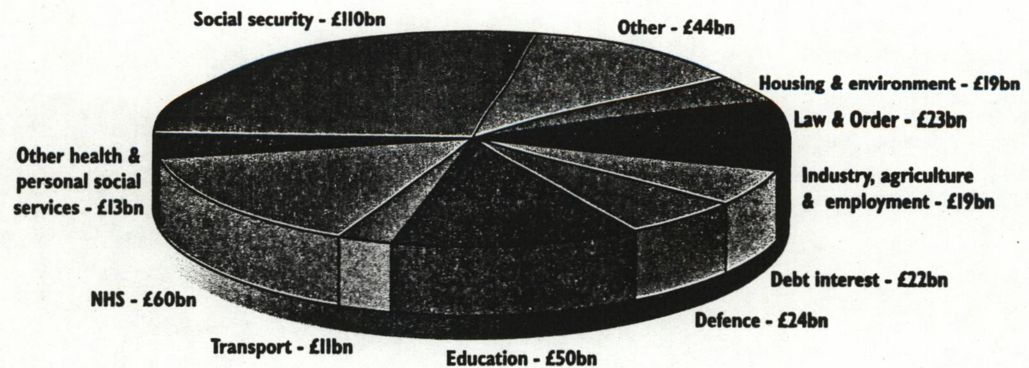

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Chart 1.2: Government receipts

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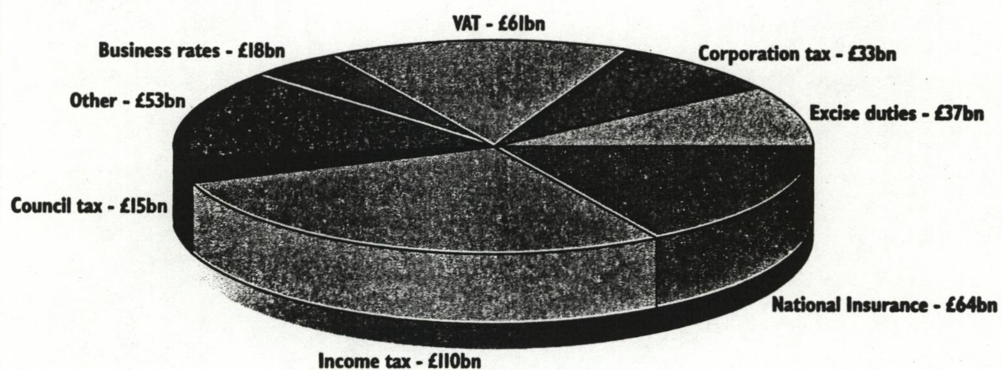

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SOURCE: PBR, NOVEMBER 2001

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Social security contributions	60.6	64.3	65.7
Total Inland Revenue (net of tax credits)	**208.9**	**213.8**	**221.1**
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Value added tax	58.5	61.3	63.7
Fuel duties	22.6	22.2	23.0
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Beer and cider duties	3.0	3.0	3.1
Betting and gaming duties	1.5	1.4	1.3
Air passenger duty	1.0	0.8	0.8
Insurance premium tax	1.7	1.8	1.8
Landfill tax	0.5	0.5	0.5
Climate change levy	0.0	0.6	1.0
Aggregates levy	0.0	0.0	0.2
Customs duties and levies	2.1	2.1	2.3
Total Customs and Excise	**102.2**	**105.4**	**109.6**
Vehicle excise duties	4.5	4.5	4.7
Oil royalties	0.5	0.5	0.5
Business rates[2]	17.3	18.1	18.4
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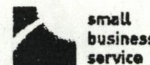
[3] Includes money paid into the National Lottery Distribution Fund.
[4] Includes VAT and 'traditional own resources' contributions to EU budget. Net of tax credits. Cash basis.
[5] Excludes Children's Tax Credit, and other tax credits which score as a tax repayment in the national accounts.
[6] Consists of North Sea corporation tax (before ACT set-off), petroleum revenue tax and royalties.

cc: SV
GN

Memorandum



Can you work this up asap today GS

To: Jeremy Heywood | David Andrews

From: David Irwin
Chief Executive
david.irwin@sbs.gsi.gov.uk
020 7215 5558

4 March 2001

Payroll for SMEs

There is little doubt that managing payroll is one of the biggest headaches for those small businesses who employ people. There are now eight possible debits and credits administered via the payroll: PAYE, NICs, SSP, SMP, WFTC, student loans, stakeholder pensions and CSA attachment orders. Administering the payroll is, therefore, time consuming and prone to error.

There are a number of ways in which the Government could make up for this – since the proprietor of a business gets no benefit whatsoever from administering payroll debits and credits. The most obvious one is simply to pay compensation, as happens for example with SMP for the very smallest businesses where the business is given back 105 per cent of the SMP. A better solution, however, might be to look at ways of removing the burden altogether.

There are two key problems associated with payroll administration. The first is the receipt and application of various coding notices, for example, PAYE codes, WFTC amounts, etc. These generally come by post and have to be applied to each member of staff on an individual basis, even if the payroll is computerised. The second problem is the calculation of the pay for each person, though businesses do tend to computerise this. There are a number of payroll bureaux, including some which work via the web, though all still require the intervention of the business whenever a coding notice arrives.

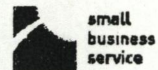
An Application Service Provider (ASP) should be able to automate all this, enabling the Inland Revenue and others to send coding notices electronically. As we discussed on the phone earlier, we have initiated discussions with ASPs regarding the scope for providing a fully automated payroll service for small businesses and to ensure that there are no technical difficulties. I have already met with someone from Fujitsu Siemens, and am now in the process of arranging a meeting with the six or so ASPs who may be interested in offering payroll services. Once we have established that there are no technical difficulties, we then need to persuade the Inland Revenue and others that they should transmit coding notices electronically. We have already started discussions with the IR and do not anticipate any problems.

The ASP could calculate all the details for each business, passing back pay slips and summaries to the business to pay staff and the Inland Revenue itself. Alternatively, it could offer to pay all the staff on behalf of the business and pay the Inland Revenue on behalf of the business. This would potentially allow the ASP to cover the payment of WFTC out of its normal cash flow, whereas many businesses seek money in advance and are, it seems, often having difficulty in getting it. These aspects all need considerable work before a scheme is launched. And we should be willing to include any ASP who can demonstrate that they can meet our requirements.

This would reduce the administrative burden on the business to one of notifying changes of staff, changes of salary or wages, changes of hours, etc. For businesses with web access, this could all be done via the internet; for others, it could be done by phone.

There are likely to be three costs associated with a scheme of this sort – a fixed charge per business to set up a 'business account'; a fixed charge per person on the payroll to set up a 'personal account'; and a charge per person every time the payroll calculation is run (presumably either weekly or monthly in the majority of cases). As we discussed, there may be merit in the Treasury agreeing to make a contribution towards the first two of those charges, with the emphasis on the cost of setting up the business accounts, since that is likely to be the same for every business. This would then help the smallest businesses the most.

I don't know what the costs might be, but would guess that a business account might cost in the region



of £50-100 to set up, and then a further £5 per person. I would guess that the cost of running the service would be very low, since it would all be automated. There is still a significant number of businesses who are not on the internet. This may encourage them to wire up, though we would need to ensure that businesses could benefit from the service irrespective of whether they are on the net.

We discussed the scope for encouraging businesses to sign up via their nearest Business Link or via the Business Link website (to be launched at the beginning of April). I would welcome that, not least because we could then e-mail employers whenever regulation changed. We are intending to set up such a service, but having to register to get the grant would encourage many more to do so!

David Andrews will look first thing Monday morning at the scope for bringing some ASPs together immediately to discuss this further. As Phil W-O suggested, it may be better simply to say that the treasury and Small Business Service are working together to launch this new service promptly.

Hope this helps

David

From: Andrew Adonis
Date: 4 March 2002

FAXED - To PM's Party/CHOGM

PRIME MINISTER

cc: JJH, SM, JN, RH, CO, JR

TOUGH CHOICES AND CHARGES II

This is a second note on tough choices and charges (you took the first out to CHOGM with you). It incorporates Carey's assessment of options for Child Benefit and the Child Tax Credit, and Justin's options on policing, legal aid and criminal justice. You have also had sent out a note by Martin Hurst on waste handling and charging.

Could you give a steer case by case? We will work up those that get past first base for a fuller note to you next week - along with those you wanted worked up from the first note.

In the case of child benefit and the Child Tax Credit, it is essential to consider the options together. In particular, I doubt you will want to freeze Child Benefit rates at the same time as taking it away from 16-18 year-olds - which would be two hits on the middle classes. Of the two, withdrawing CB from 16-18 year-olds looks the preferable - since it is an educational argument about targeting resources to encourage staying-on beyond 16 more effectively through EMAs, whereas freezing CB will look like a repeat of the Tory policy and the first stage on the way to abolition.

NB
The changes made by myself on pages 2 & 3, were as instructed by Carey Oppenheim.
Steven
4/3/02

CHILD BENEFIT AND CHILD TAX CREDIT

Child benefit goes to all families with children, helping 7 million families and 12.7 million children. As a universal benefit it is costly - £8.7bn per annum. But it is the only form of financial support that goes to **all** families – it aims to improve horizontal equity – ie between those with and without children.

The Child Tax Credit (ICC formerly) brings together all the other forms of family support (the child elements of income support, working family tax credit and the Children's Tax Credit). It will go to the majority of families – some 5.2 million out of 7 million. It is directed towards middle and lower income families with the prime aim of tackling child poverty and encouraging people into work – it will also go to the mother. Cost estimates range from £1-£1.5bn – over £2bn depending what we decide to do for those on higher incomes (see later). The Child Tax Credit sits on top of universal child benefit.

There are a number of choices:

<u>Option 1. Abolish Child Benefit for 16-19 year olds</u>

Arguments as set out in AA's earlier note. This raises around £850m of which £550m would almost certainly need to be spent on EMAs. Child benefit is £15.90 a week for the eldest child. EMAs are set at £40 a week per child and go to families with joint incomes of £25,000 and under.

What does this mean for families?

The picture on losers is complicated by the interaction of this change and Child Tax Credit (see below).

Families with joint incomes of ~~£42,000~~ £25,000+ with a child in 16-19 year-old age range would lose around £830 a year from the abolition of child benefit.

~~Families with joint incomes between £25,000 and £34,000 would be more than compensated for their loss on child benefit by getting child tax credit – which is likely to be in the region of £25+ per child and £10 family premium.~~

~~Families with joint incomes between £34,000 and £42,000 may still gain (but to a lesser extent) as they get a portion of child tax credit – it tapers away between these two thresholds.~~

Pros/Cons

We would need to present this as a shift of resources to investment in education - rather than as taking something away from the top. And it would have to be backed up by strong evidence of the effectiveness of EMAs in tackling educational disadvantage.

Option 2. Freeze Child Benefit

- Freeze child benefit in the year that the Child Tax Credit comes in – 2003/4 – A freeze in the first year of the spending review yields £200/215/235m.
- Freeze child benefit in **each** year of the SR – this yields £200m/415m/650m.

What does this mean for families?

Child benefit goes up to £15.90 next April 2002. Freezing it would be a loss of 40p a week from 2003/4 – just over £20 over the year. The majority of these families (5 million out of 7 million) will get the Child Tax Credit to compensate. If child benefit is frozen over 3 years the losses accumulate – but still small figures – around £60 pa for the eldest child.

The pros/cons

In policy terms this option has some attractions - it raises quite substantial sums of money instantly – there is no legislation required, no delivery issues and it still retains the principle of some support for all families. Also the loss is spread thinly. **However, if you go for abolishing CB for 16-19 year-olds at the same time as a freeze it will be very difficult politically**. We would find it hard to escape accusations of ditching child benefit altogether.

Option 3. Child Tax Credit – taking the pain on higher income losers

If you want to cap extra spending on Child Tax Credit at £1-1.5bn, the CTC would have to taper out between a family income of £34,000 and £42,000. This

means 1 million higher income losers (they lose because they currently get the Children's Tax Credit but won't get the new one). If we were to have **no** losers CTC has to go up to a family income of £78,000 - the cost of this is £700/735/770m. Clearly there are range of options in between these two.

What does this mean for families?

A family that is getting Children's Tax Credit (now) but who won't qualify under the new system would lose £10 a week or £520 a year. However, it is important to note that people **don't receive their current Children's Tax Credit as a cheque in the post – it is an adjustment to the PAYE code – so the losses are not as visible.**

Pros/Cons

To go for the 1 million losers would be quite difficult politically – as some people will have had their Children's Tax Credit for just a couple of years. However, given that it is an adjustment to their PAYE code – this makes it less risky. Also the new credit will get rid of the current anomaly where a couple with one higher rate tax payer and mother at home with the children don't qualify – the new system is based on a proper assessment of joint income.

The question is – is this the best use of £700m in the next CSR? It is not clear to me that the state should be making payments on top of child benefit to people on joint incomes of £78K. If the Child Tax Credit runs too high up the income scale we also lose the rationale of putting money into CTC rather than universal child benefit. **And once we entrench Child Tax Credit so high up the income scale it will be very difficult to move downwards.**

Combining All Three Options

In our view it would be very difficult to go for all three options together – given the hit on middle income families. It seems to us essential to hold the line hard on Child Tax Credit not going too far up the income scale (ie. beyond £42K) – if you don't do this now, when CTC is being launched, it will be very difficult to change the thresholds in future. On the child benefit options, withdrawing it from 16-18 year-olds raises most money, fits effectively with an extension of EMAs (for which there is now a strong basis on the evaluation of the pilots), and is compensated for, for all but higher earners (post-£42K), by the new CTC.

Freezing child benefit rates for under-16s is less attractive – and not attractive at all if you go for the 16-18 option.

Before making decisions it is essential to get HMT to model the combined impact of these changes on families at different income levels, average losses and numbers of losers. As well as the cost of measures to soften the blow in part.

Carey will come back to you with some figures – but in the interim do any of the above options seem likely runners?

Mode of trial

You had a note on options from Justin last week. But to recap:

The most controversial option politically (full Auld including abolishing right to elect jury trials) yields the biggest savings, though even Derrys' preferred option (Mags < 12 months) yields £12-16m a year. Given that Auld reforms are not due to be implemented until April 2005, these reforms are unlikely to generate cash savings in the SR period - we may be able to realise some immediate short-term cashable savings in 2005/06 which would grow towards the 'long-term realisable' figure over the following years. We should also begin to realise savings in kind (eg extra court capacity) almost immediately on implementation, though scale of these will depend on both performance of the system and decisions about converting savings into cash.

Option	Saving pa (short-term realisable)	Saving pa (long-term realisable)	Savings pa, inc in kind (eg court capacity for attrition)
Auld (3 tiers, right to elect abolished)	**£20-23m**	**£26-30m**	**£51-57 m**
Mags < 24 mths abolish right to elect	£20-24m	£26-31m	£48-56m
Mags < 12 mths, abolish right to elect	£17-20m	£22-26m	£39-46m
Mags < 24 mths retain right to elect	£11-15m	£14-19m	26-34m
Mags < 12 mths retain right to elect	**£9-12m**	**£12-16m**	**£21-28m**
Simple abolition of right to elect (original Mode of Trial bill)	£8-11m	£10-15m	£17-26

Charging of football clubs and entertainment venues for policing

Police white paper floated the option of football clubs, night-clubs and pubs paying a contribution towards the additional policing costs associated with their customers – building on voluntary arrangements already in place (eg in Liverpool city centre and the Bluewater shopping centre in Kent). HO are currently working up an amendment to the police reform bill which would enable forces to charge entertainment venues to recover some of these costs. Likely to be extremely controversial with the Premier League and FA as well as the licensed industry and vigorously opposed by DCMS and DTI – but could raise significant sums. (A charge of £10k to £15k on every licensed premises for example would yield 110,000 x £10-15k = £1bn to £1.65bn). Full cost recovery of the costs of policing football matches (all Premiership and league grounds and excluding within ground costs which are already the responsibility of clubs) would yield £75m.

Interested?

Recovery of seized assets

Government has already set a target of doubling the amount of assets recovered from organised criminals by 2005 (to £60m a year) - using the new Criminal Assets Recovery Agency and powers in the proceeds of crime bill. HMT have agreed that up to £20m can be re-invested in law enforcement activity or community anti-drugs projects. HMCE (informally and off the record - no formal targets yet agreed) believe that we could be more ambitious and aim at seizing £60m by 2004; £100m by 2005 and then £40m on top of this each year thereafter - yielding £300m pa by 2010. To provide an incentive to HMCE and the new Agency to maximise the assets seized we should push for a significant proportion of this to be ploughed back into law enforcement work and raise the £20m cap.

Interested?

Fine enforcement

As at Sept 01 there were £225m worth of uncollected Court fines for criminal offences (compared to a fine income for the year Oct 00 to Sept 01 of £232m). Fine enforcement rate is currently around 63%. Performance on enforcement of criminal confiscation orders (of the assets of convicted criminals) is much worse. Between April 01 and Jan 02, Customs & Excise have secured confiscation orders to a value of £31.2m (a 300% increase on the figure for the whole of the previous year) but they estimate their enforcement rate is only around 15%. Of course, enforcement is important not only to ensure we tap a ready (and in case of criminal asset confiscation - apparently limitless) source of revenue but also because it deters crime, and promotes confidence in the system.

Magistrates' courts have recently taken over from the police responsibility for enforcing fines and confiscation orders. LCD have fairly modest plans for improving performance (a 5% improvement target - devolved down to local courts to deliver - and a netting off scheme starting in April whereby they will re-invest £10m of fine income into enforcement by courts).

Proposal: We are exploring with LCD a proposal to contract out (either at a national or regional level) enforcement of fines and confiscation orders. Contractors would be able to keep a proportion of the extra income they generate as an incentive to raise performance. (There is an analogy with a deal that Capita have recently signed with the BBC to collect TV licence revenue).

Subject to us exploring the practicality of this proposal with LCD and HMT, this appears to be a win-win proposal. There will be risks around the enforcement powers given to contractors, and the opposition of magistrates courts - but as courts already contract out enforcement on an individual basis, these should by resolvable.

Take forward?

Civil legal aid

We have already withdrawn access to civil legal aid for personal injury cases, on the basis that the market will provide (on a no-win, no-fee basis). We could look at extending this, with the obvious target being clinical negligence cases. We could also look at raising thresholds for civil legal aid (eg by taking account of property equity) to target more effectively at needy groups. And we should look at raising performance in recovering criminal defence costs (currently 1% of biggest cases generate 47% of costs).

We need to do more work on this and come back to you, if you are interested?

FROM THE SECRETARY OF STATE

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The Rt Hon Gordon Brown MP
Chancellor of the Exchequer
H M Treasury
Parliament Street
LONDON
SW1P 3AG

3 March 2002

Dear Gordon,

TAX RELIEF ON EMPLOYER-FUNDED OCCUPATIONAL HEALTH SUPPORT

I wrote to you on 17 October 2001 with my Budget representation. I am writing to you again about one particular measure in it: occupational health tax relief for occupational health support. I think there is a very strong case for a potentially popular but inexpensive tax relief.

My responsibilities for health and safety at work have meant that I have spotted what seems to be an unhelpful and damaging lacuna in the tax system. It seems to work against some of the excellent policies that you and others (Alan Milburn and Alistair Darling, for example) are pursuing, such as the pilots in the newly offered Job Retention and Rehabilitation Pilots – part of the New Deal for Disabled People – that encourage rehabilitation of people who are on the brink of losing their jobs.

Model employers provide help to their injured or sick employees to help them get back into work. PowerGen, for example, has an innovative scheme that helps their injured employees – typically manual labourers – who are either off sick or unable to pursue their normal job, to be given occupational health and rehabilitation, so as to stay in close touch with the labour market. However, this occupational health is treated as a perk. The only exceptions are if the firm admits that it was responsible for the injury (never clear; and anyway you will be able to see immediately why firms do not admit responsibility readily if there is a risk of later being sued) or if repairing the injury can be said to give little or no benefit to the worker affected

As a result of the existing tax rules, the employee faces an income tax charge on occupational health. This may bear on the worker, which seems unfair and unjustified, given that the firm may be responsible and the individual may not be rich enough to afford the occupational rehabilitation (or the tax arising) on their own. Alternatively, an employer can choose to bear that tax, paying 122% of the cost of the occupational rehabilitation. It is easy to see why that sort of disincentive will inhibit other firms from following

PowerGen's excellent example.

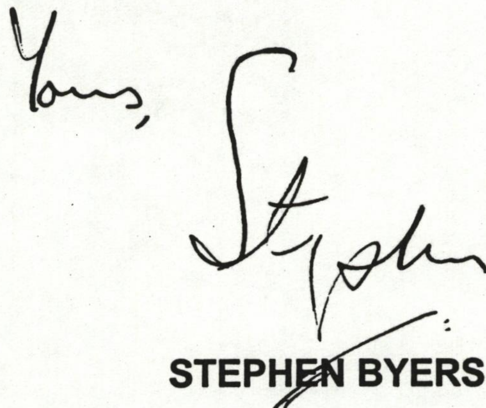
I therefore propose that you announce, in your Budget this April, a new tax relief. The Income Tax change would not arise if the service was provided by the employer as a result of **the employee either not being able to work or not being able to undertake their normal job.** So a manual labourer whose injury prevents them from doing their normal job, and is currently on light duties, would not face an income tax charge if the employer helped them with their occupational rehabilitation. The employer is paying for the occupational health support to get the employee back their normal job; whether the employee benefits from having their injury repaired is beside the point.

I can see real attractions in this measure. It would certainly have a range of positive presentational angles: the market failure arguments are similar to those that apply to the rehabilitation pilots in the New Deal for Disabled People; and it would help with the reversal of the much-criticised swelling of the Incapacity Benefit list that took place under the previous Government. It would also be cheap (the estimated cost would be £7million a year) and our best estimate is that it would have savings worth of the order of £50 million a year.

I know your officials are concerned that this could lead to reversing your previous decision to end the tax relief for private medical insurance (PMI). I wholeheartedly support that decision on PMI. And I have no intention of proposing something that unwinds it. I'm therefore proposing something rather smaller, so that it can be introduced in this Budget, and to provide further reassurance that this is separate from PMI, I would be content for tax exemption to be limited to OH support directly funded by the employer, and so exclude all private medical insurance.

I attach a note setting out the costs and benefits in the form of the new Integrated Policy Appraisal (IPA). (My Department is launching the IPA as a good practice tool across government this week. Colleagues may like to consider whether a similarly integrated approach would be helpful to them. It certainly helped us with the assessment of our SR2002 bids and in preparing the accompanying Sustainable Development Report.)

I'm copying this letter to the Prime Minister, John Prescott, Alistair Darling, David Blunkett, Alan Milburn, Patricia Hewitt, Barbara Roche, Paul Boateng and Sir Richard Wilson.



STEPHEN BYERS

Integrated Policy Appraisal summary

Contact details:	Name: Scott Dennison	Division: CEP

Policy/project title:	Tax Relief on Employer-Funded Occupational Health Support
Brief description of policy/project	Policy proposal is to remove the current income tax liability on employees who receive employer provided occupational health (OH) support services. OH support when funded by an employer on behalf of his or her employee is currently treated as a taxable benefit and therefore the value of such support is subject to the 22% standard rate of income tax. The only exception to this is where the employer accepts that he/she is wholly at fault for the condition.
Objectives	To improve health and safety at work by reducing the number of lost work days due to ill health and reducing the flow of people who move from Statutory Sick Pay and on to long-term Invalidity Benefit (IB). The provision of this tax relief should encourage greater provision and take-up of employer provide OH support. It will help to rectify the market failure created by long term unemployment due to remediable ill-health, an externality which is currently borne by the Exchequer in the form of IB payments and the economy as a whole via lost productivity.
Success criteria	The increase in the number of employees who accept and receive employer provided OH support increases; A reduction in the number of lost days due to remediable ill-health at work, with corresponding increases in employee and firm productivity; A reduction in the flow of workers moving from Statutory Sick Pay to long-term IB and an increase in the number of workers who leave IB and return to the work place;

State here the base case against which the policy or project is being compared for the purposes of appraisal, e.g. against do-nothing, do-minimum, alternative option.

The Do-Nothing case, in this context, would see a continuation (ceteris paribus) of the number of workers who leave Statutory Sick Pay to claim long-term IB (currently around 3,000 a week). Employers would continue to face the disincentive of having to pay for 122% of the price of any OH support they wish to provide to their employee, or passing this on directly to their employee.

		Qualitative assessment	Quantitative measure(s)
ECONOMIC	Public accounts and public service	The proposal should lead to savings for the Exchequer via a reduction in Incapacity Benefit payments. The proposal will result in some Exchequer costs in the form of forgone tax revenues; these however are likely to be (and to remain) relatively small. The proposal should impose minimum administrative costs as it will be administered through the existing tax system. It should reduce burdens on the NHS and local Benefit Agencies.	Exchequer Savings: (gross) if the proportional increase in demand for and supply of OH support assumed below is correct the estimated savings are likely to be around **£54m** in each subsequent year. This will be as a result of fewer workers moving from SSP to long-term IB. Exchequer Cost: approximately **£7m in the base year,** increasing to around **£8.4m per annum** if there is a subsequent proportional increase in demand for and supply of OH support. Benefit/cost: a ratio of 6:1
	Consumers	The consumers, in this case potentially all employees, benefit by being able to accept OH support services without incurring tax liability on the value. This should encourage employers to provide funding for such support and in turn encourage the market to increase the supply of OH support plans as a distinct product from standard Private Medical Insurance.	Labour Force Survey evidence shows that there is a negative relationship between the length of time a worker is absent form work due to ill health and the probability that they will return to work.
	Business	The proposal should lead to a reduction in the costs facing businesses as a result of fewer employee absences from work. There may be an element of deadweight loss where the tax relief is provided to those firms who already provide OH support, to the extent that they do not increase their supply.	The average cost to business for a typical absence from work has been estimated at £1600. If the proportional increase in OH support resulted in half of those workers in receipt of the support avoiding a typical absence from work there would be savings to business of about **£9m** (in the first year).

SOCIAL	Public health and safety	This proposal will have a positive impact on health and safety at work and the work environment. The proposal should reduce demands on the NHS in two ways: firstly by treating ill-health at an early stage it should reduce the incidences of chronic work-related ill health dealt with by the NHS; secondly, there is likely to be a substitution effect whereby work-related ill health is treated outside the NHS, allowing the NHS to concentrate resources elsewhere. The proposal is specifically aimed at enabling people to return to work after illness, but also at preventing people being absent from work due to health in first instance by encouraging pro-active treatment funded by employers.	Evidence from several case studies in Powergen shows that employer funded OH support is successful in enabling workers to return to normal duties following ill health. For example, following the introduction of OH services in Powergen's distribution business absences due to musculo-skeletal problems fell from 9% of total absences to 2% (between 1995 and 2001).
	Crime	The Home Office has argued for such a proposal to help deal with the growing number of police officers who are absent from duties due to work-related ill health.	2001: 5% of total available police officer days were lost due to sickness (HSE) Reducing the number of police officers who are absent from work due to ill health should enable better policing and have a correspondingly positive impact on crime statistics.
	Social capital, community and education	Generally negligible, although an overall increase in public health may increase access to and participation in sports and leisure pursuits.	
ENVIRONMENTAL	Climate change	Negligible	
	Air quality	Negligible	
	Landscape	Negligible	
	Land use, waste and water	Negligible	
	Biodiversity	Negligible	
	Noise	Negligible	
	Other	None	

Distributional impacts

Will the policy or project impact unevenly in respect of any of the following?	*Description of differential impacts across groups (quantified where possible)*
Deprivation and income groups:	We can expect a more positive impact on lower income groups than for higher income groups because most low paid workers are employed by SMEs and the incentive impact of the tax relief for such firms is likely to be high.
Age:	Broadly even across different groups.
Gender:	The working conditions in many female dominated occupations e.g. hairdressers, dry cleaners are more likely to cause gradual deterioration of health, dramatically visible in the long term, and therefore risks are considered insignificant. Such jobs are often characterised as being highly demanding and having low employee control, factors which can lead to stress. The tax relief will therefore give them a greater incentive to accept Occupational Health and help remedy some of these problems.
Disability:	According to the "Aitchison Report", disabled people are on average three times more likely to be unemployed than non-disabled people. The tax relief complements the New Deal for Disabled People, and helps to address similar market failures.
Race:	Broadly even across different groups.
Regions and localities:	Broadly even across different groups.
Rural areas:	Broadly even across different groups.
Small firms:	Small firms on average are most likely to under-provide OH support. SMEs will have a new incentive to provide Occupational Health due to this Tax Relief.
Other effects that vary across different groups:	Broadly even across different groups.

Risk

Summary of main risks identified, of any special assumptions made.

There is a risk that the incentivising effect of this measure is insufficient to bring about the projected increases in OH support services due to the elasticities of supply and demand being more inelastic than assumed here. The elasticity of demand and supply for Occupational Health, assumed initially as 1 may not be an accurate representation of the behavioural effects of this measure, especially as there is likely to be a distinction between short-term and long term elasticity of demand. Minimal risk exists in terms of application. A tax system already exists therefore it is simply a question of offering the relief.

Faxed 6.3.02

10 DOWNING STREET

PM

This confirms all my worst fears on this.

This is a very good [IFS] summary of the position on tax credits.

In essence, it confirms that we will face a choice on the ICC between increasing the cost of introduction to £2.7 billion in 2003/4 (cf: minimum of £2 billion) or accepting 500,000 middle more losers.

The paper also highlights:

10 DOWNING STREET

- the absence of any rationale for extending the WFTC to people with no children

- the low take-up rates of the WFTC etc. I had not realised that take up was lower than when this was called family credit!

All this simply adds £3 billion to our financing gap for 2003/4 and beyond.

5. Personal tax reforms: the child tax credit and the working tax credit

The government has promised to announce the rates of two new tax credits – the child tax credit and the working tax credit – in Budget 2002. These credits will be introduced in 2003–04 and are likely to have a full-year cost of £2–3 billion a year. In addition, after a lamentable lack of public discussion and openness, many of the operational details may be announced in the Budget; these details will determine whether the people who the credits are aimed at understand them and choose to claim them.

This chapter explores some options for the initial rates and total exchequer cost. As the child tax credit is the most direct mechanism the government will have to meet its child poverty targets, we show by how much the new tax credits could reduce child poverty. We also discuss what operational details need to be announced in the Budget and whether the credits will succeed as a new form of means test. Box 5.1 summarises what the credits are and how they will work.

Box 5.1. What do we know about the new tax credits?

In 2003–04, two new tax credits will be introduced: the *child tax credit* will bring together three parts of the existing tax and benefit system that support families with children, and the *working tax credit* will support those with or without children in low-paid work.

Some of the details of how the credits will work are known:

- They will be based on gross taxable income, jointly assessed for a couple, including savings income. The capital limits in existing means-tested benefits will not apply.
- They will depend on annual income. Most families will initially apply in the summer, at which point an interim award will be made, based on annual income in the previous tax year. Payments may change if circumstances change during the year and will be reconciled at year-end if the interim award proves to be inaccurate.
- People who apply in mid-year, or whose income changes significantly, will have an award based on their estimate of current-year income. Payments will be reconciled at year-end if this estimate was inaccurate.
- The child tax credit will be paid direct to the main carer. It will not depend on whether the main carer or his or her partner is working, nor will recipients face any new obligations to look for work.
- The working tax credit will be paid by employers. The self-employed will receive it direct from the Inland Revenue.

5.1 What are these credits? Why are they being introduced?

The child tax credit and the working tax credit are being introduced for different reasons. The aim of the child tax credit is to simplify support for families with children, so that parents have a clearer idea of how much they can expect to receive in respect of their children and so that families do not need to claim different benefits or tax credits when their circumstances change. The government thinks that the present system is complicated because there are four main ways by which financial support is directed to families for their children, three of which depend on income (see Box 5.2). From 2003–04, there will be just two: universal, non-means-tested child benefit and the new, means-tested child tax credit. All families will continue to be entitled to child benefit and around 80% will be entitled to the child tax credit. The structure of the child tax credit and the working tax credit, and how they correspond to the existing tax and benefit system for families with children, are shown in Figures 5.1 and 5.2.

Box 5.2. Tax credits and changes in support for children under Labour

What is being abolished?

The *children's tax credit* reduces income tax bills of 5 million income-taxpaying families with children. It was introduced in 2001, partly paid for by abolishing the married couple's allowance. It will be subsumed within the child tax credit in 2003–04.

The *working families' tax credit* (WFTC) provides in-work support to 1.2 million low-paid families working 16 or more hours a week. It was introduced in 1999 to replace a benefit called 'family credit'. It will be subsumed within the child tax credit and the working tax credit in 2003–04.

The *childcare tax credit* pays 150,000 families also receiving the WFTC up to 70% of eligible childcare costs. It was introduced in 1999 and is formally part of the WFTC. It will be subsumed within the working tax credit in 2003–04.

Child allowances in income support provided extra money to 1.5 million families with children claiming income support. Income support was introduced in 1988, and the child allowances will be subsumed within the child tax credit in 2003–04.

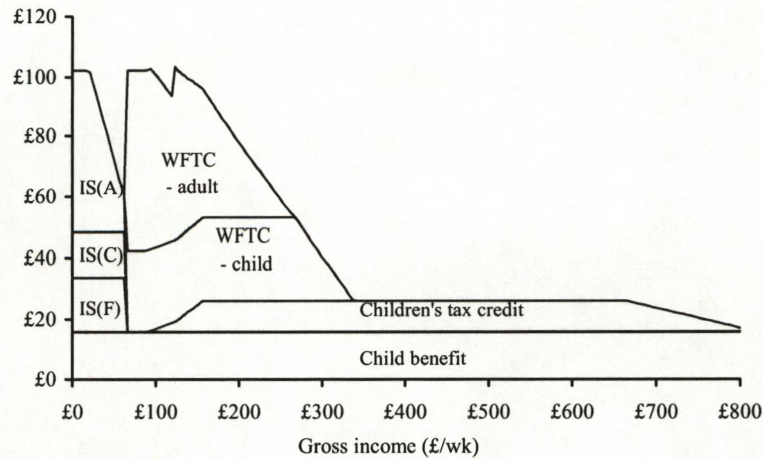
What's new?

The *child tax credit* will provide income-related support to the main carer. Around 5.7 million families – all but the richest 20% – should receive it. The *working tax credit* provides in-work support to around 1 million single people or couples in low-paid work. Both will be introduced in 2003–04.

What's staying?

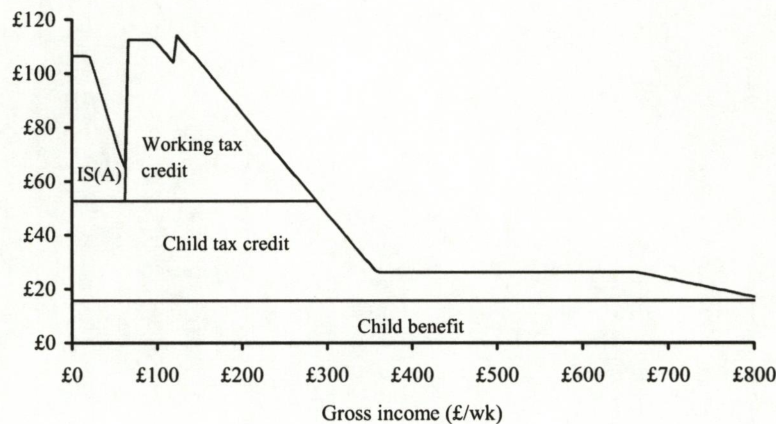
Child benefit is a universal, non-means-tested payment for all mothers and lone fathers. All 7 million families with children in the UK receive it. It was introduced in 1977, and nothing is due to happen to it in 2003–04.

Figure 5.1. Financial support for a family with a child under the current system



Notes: April 2002 rates. IS(A) is the adult allowance, IS(C) is the child allowance and IS(F) is the family premium in income support.

Figure 5.2. Forming the new tax credits from the present system



Note: Assumes that new tax credits are implemented immediately and that a family qualifies for working tax credit at 16 hours of minimum-wage work.

The child tax credit is replacing the child credits in the working families' tax credit (WFTC), so the government needs to introduce some new form of compensation if existing WFTC claimants are not to lose out when it is abolished (compare Figures 5.1 and 5.2). The working tax credit will play this role, but it will be available to families in full-time work and on a low income whether or not they have children.

The stated aim of the working tax credit is to reduce poverty and improve work incentives amongst those without children. There is little evidence, though, to support the introduction of an instrument such as the working tax

credit to tackle these aims.[1] First, people working full-time tend not to be in poverty on government definitions, so the direct impact of the working tax credit on poverty looks likely to be small. Second, the government has presented no evidence that an insufficient financial reward is deterring families without children from working, which contrasts strongly with the research findings that supported the introduction of the WFTC.[2] And, as we discuss later, the working tax credit might improve the reward to work for some but it will worsen it for others.

5.2 Issues for Budget 2002 (I): What will the credits cost and who will gain?

The government has promised to announce the initial rates of the new tax credits in Budget 2002. This will allow the new tax credits, finally, to be included in its public finance projections. Since it announced them in November 1999, the government has kept the cost of the new tax credits out of the public finance projections. Its reasoning is that it is impossible to give a costing until it has decided on the final rates and operational details. However, it would have been (and still is) perfectly possible for the government to publish indicative initial rates and cost estimates, even if these are not the actual rates used when the credits are introduced, or to estimate their cost under a range of assumptions. This would have been much more in keeping with the spirit of the government's 'Code for Fiscal Stability'.[3]

We present below four options for the child tax credit. In our baseline system, the new tax credits closely replicate the existing structure of support for families with children assuming that no low-income families lose out. We then present three more generous alternatives: an option where no better-off couples with children lose from the abolition of the old children's tax credit, and two options that do more for the poorest families to help the government meet its ambitious child poverty targets. We then present two possible options for the working tax credit for those without children. For all options, we model the cost, the distributional impact and the change in poverty rates and we discuss the impact on work incentives.

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[1] For more details, see M. Brewer, T. Clark and M. Myck, *Credit Where It's Due? An Assessment of the New Tax Credits*, Commentary no. 86, Institute for Fiscal Studies, London, 2001 (www.ifs.org.uk/taxben/taxcred.shtml). At the time that that document was written, the credit now known as WTC was called the employment tax credit.

[2] HM Treasury, *Work Incentives: A Report by Martin Taylor*, The Modernisation of Britain's Tax and Benefit System no. 2, London, 1998.

[3] The about-to-be-abolished children's tax credit, for example, was included in the public finances two years before it was introduced, but was finally introduced at £520 a year rather than the Budget 1999 suggestion of £416 a year. Cost estimates of the WFTC were published 18 months before its introduction, and then altered as the government changed its forecasts, increased the rates and changed various operational rules before it was finally introduced.

Four options for the child tax credit

We modelled the impact of four different systems for the child tax credit. The parameters are summarised in Table 5.1. This table also gives the aggregate cost of each option and its impact on poverty. All these reforms are expensive: under our assumptions, the new system of credits for families with children would cost £2 billion a year to introduce, and a system with no well-off losers would cost a total of £2.7 billion. The anti-child-poverty options necessarily cost even more money: our options are £1.4 billion and £3.4 billion more expensive than the base system – such large spending increases might not occur in Budget 2002, but they illustrate what scale of spending will be needed to reduce child poverty according to the government's definition. These costs exclude the cost of extending the working tax credit to those without children, discussed below. These costings imply that the child tax credit will be worth around £11 billion a year in total: the additional £2–2.7 billion cost of introducing it comes on top of £9 billion a year that is currently spent on the existing children's tax credit and the child allowances in WFTC and income support. This is a substantial sum – more than is spent on child benefit (£9 billion in 2001–02) – and it makes clear just how much the tax and benefit system supports families with children.

The main gains and losses from introducing our base system for the child tax credit are the following:[4]

- Out-of-work families will gain. The combination of our child tax credit and child benefit is greater than income support child rates, by £4.35 a week for the first child and by £3.50 for each subsequent child (April 2002 values).
- Families currently receiving WFTC cannot take full advantage of the existing children's tax credit for two reasons. First, people with incomes less than around £8,000 a year pay insufficient income tax to benefit fully from the existing children's tax credit. Secondly, people on the WFTC taper see the tax cut that the old children's tax credit represents partially offset by a reduction in WFTC. When the existing children's tax credit is incorporated into the new child tax credit, these families will gain by up to £10 a week.
- The new tax credits will be assessed against gross income rather than net income as currently used by the WFTC. This is likely to benefit two-earner couples currently receiving WFTC.
- Some couples higher up the income distribution will be worse off because the child tax credit will be withdrawn against joint income, whereas the existing children's tax credit is withdrawn only against the higher income

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[4] For more details, see M. Brewer, T. Clark and M. Myck, *Credit Where It's Due? An Assessment of the New Tax Credits*, Commentary no. 86, Institute for Fiscal Studies, London, 2001 (www.ifs.org.uk/taxben/taxcred.shtml).

Table 5.1. Some options for the child tax credit

	Value of per-child credit, £/wk	Value of family credit, £/wk	Higher threshold, £/wk (£/yr)	No. of families who will gain	No. of families who will lose	Cost each year	Reduction in child poverty, % points
Base option	£26.45	£10.40	£663.75 (£34,515)	3.6m	900,000	£2.0bn	3–4
No 'better-off' losers	£26.45	£10.40	£1,327.50 (£69,030)	4.4m	<50,000	£2.7bn	3–4
Child poverty 1	£31.45	£10.40	£663.75 (£34,515)	3.8m	900,000	£3.4bn	6–7
Child poverty 2	£36.45	£10.40	£663.75 (£34,515)	4.0m	900,000	£5.4bn	7–11

Notes: We assume that the child tax credit is made up of a small fixed amount per family, with low-income families receiving extra credit for each child. The 'higher threshold' is the point where the fixed amount per family starts to be withdrawn (see Figure 5.2). There are around 12 million children in the UK, so a fall of 10 percentage points in child poverty represents around 1.2 million children. Poverty estimates are very sensitive to modelling assumptions, and so a range has been given. 'Winners' are families gaining by £1 or more a week. 'Losers' are families losing by £1 or more a week. Details common to all systems are summarised in Table 5.2 and further explained in M. Brewer, T. Clark and M. Myck, *Credit Where It's Due? An Assessment of the New Tax Credits*, Commentary no. 86, Institute for Fiscal Studies, London, 2001 (www.ifs.org.uk/taxben/taxcred.shtml). Costs are given in April 2002 prices and effects modelled as if the new tax credits were introduced in April 2002.
Source: IFS tax and benefit model, TAXBEN, based on 1998–99 Family Resources Survey.

Table 5.2. Assumptions common to all options

Structure of the credits	The child tax credit consists of a payment for each child and a fixed payment for each family. The working tax credit consists of a payment for each family (with a full-time bonus for families with children working 30 hours or more per week).
Lower threshold and taper	The taper rate for both credits is 37.4%. The working tax credit starts to be withdrawn when gross family income exceeds the 'lower threshold', assumed to be £94.50 a week (£4,914 a year). For families with children, it will be fully withdrawn once gross income reaches around £255 a week (£13,260 a year). Beyond this point, the per-child payments of the child tax credit start to be tapered away. Once they are fully withdrawn, families are left with just the £10.40 a week per family payment.
Higher threshold and taper	Beyond the 'higher threshold', the per-family payment part of the child tax credit is withdrawn at 6.66% of income.
Working tax credit	When modelling the child tax credit options, the working tax credit for families with children was assumed to be £60 a week. Values for those without children are given in Table 5.3.
Definition of income	We assume that the credits are assessed against gross taxable income jointly assessed for couples.
Interactions with other benefits	The parameters of housing benefit and council tax benefit are adjusted so that none of the extra child support for those currently on income support is offset by reductions in housing benefit or council tax benefit.

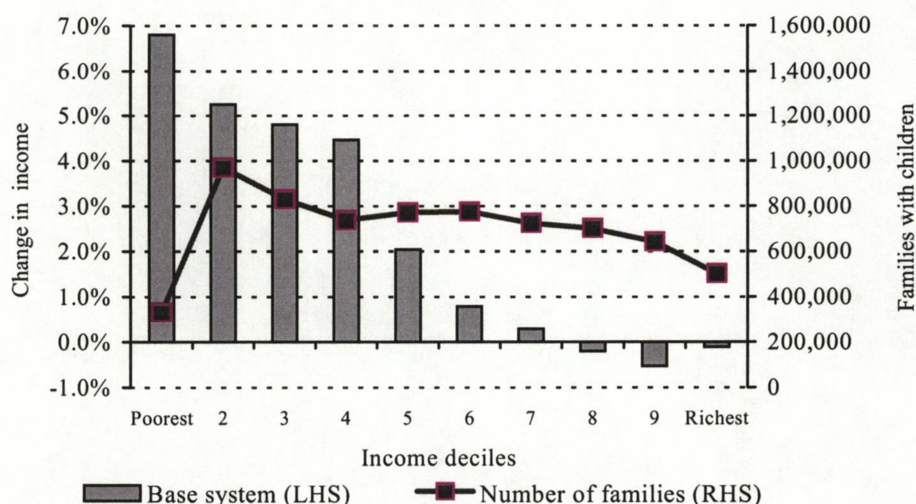
Note: Full details available from the author.

in a couple. This will affect some couples where both adults earn but neither earns more than £42,000.[5] They could lose up to £10 a week.

Under our assumptions, 5.7 million of the 7 million families with children in the UK will be entitled to some child tax credit. Looking at all families with children, 3.6 million families will gain more than £1 a week from the reform, 2.5 million will be relatively unaffected financially and 0.9 million will lose by more than £1 a week. Almost all of the losers are two-earner couples who suffer from the move to full joint assessment – about 26% of two-earner couples with children could lose, many losing the full value of the children's tax credit, or £520 a year at present. The other losers are families with high amounts of non-earned income which is currently disregarded by the WFTC.[6]

Poorer families will gain substantially more as a proportion of their income than richer families from the introduction of the new tax credit. The full distributional impact on families with children is shown in Figure 5.3,

Figure 5.3. Likely effect of the child tax credit and the working tax credit on incomes of families with children



Notes: Income deciles are derived by dividing all families (with and without children) into 10 equally sized groups according to income adjusted for family size. Decile 1 contains the poorest tenth of the population, decile 2 the second poorest and so on, up to the top decile (decile 10), which contains the richest tenth. This graph shows the impact of introducing the child tax credit and working tax credit on families with children only: the interpretation is that the new tax credits will increase incomes of working-age families with children in the poorest tenth of the population by 6.8%.

Source: IFS tax and benefit model, TAXBEN, based on 1998–99 Family Resources Survey.

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[5] Depending on decisions in Budget 2002, £42,000 will be approximately the maximum income someone can have and still benefit from the existing children's tax credit from April 2002.

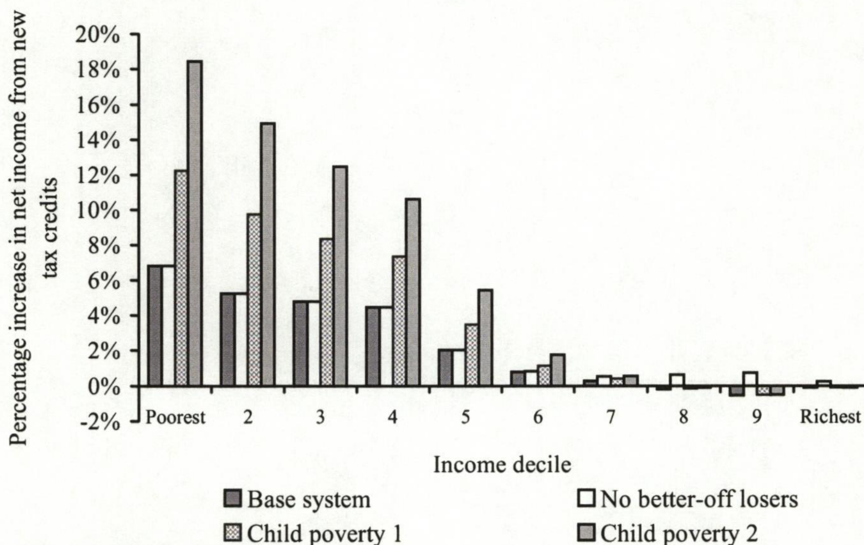
[6] Government numbers suggest that 1.4 million better-off families with children could lose in this way – a greater estimate than ours as it counts families that lose at all, rather than losing by at least £1 a week. (See reply to question from Mr Webb, *Hansard*, 2 November 2001, col. 880W.)

which also shows the number of families with children in each income decile. The gains for the poorest families with children are substantial – an average gain of £12 a week for families with children in the bottom four deciles – especially when considered on top of the significant increases in benefits and tax credits for the poorest families with children since April 1999.[7] Lone parents gain by more, on average, than couples with children (£10.70 a week rather than £4.06 a week) because they tend to be found at the bottom end of the income distribution.

The impact on work incentives is small and mixed.[8] The incomes that families with children can receive if they do not work will rise, which will reduce the incentive to work at all, but the net incomes people on low wages can obtain in work have also increased, partially offsetting the first effect. The reforms will change the effective tax rates[9] of about a third of parents: around 2.3 million will see their marginal deduction rates increase (as the increased generosity of the child tax credit means more people will face a tax credit withdrawal) and 1.8 million will see them decrease (mostly because the credits will be assessed against gross income, which helps second earners in couples).

Our other options for the child tax credit have qualitatively similar impacts (except that there are no better-off losers under the appropriately titled option), and these are summarised in Table 5.1 and Figure 5.4.

Figure 5.4. Four options for the child tax credit



Notes and source: As for Figure 5.3.

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[7] See M. Brewer, *The Structure of Welfare*, Election Briefing Note no. 11, Institute for Fiscal Studies, London, 2001 (www.ifs.org.uk/election/ebn11.pdf).

[8] It is analysed in more detail in M. Brewer, T. Clark and M. Myck, *Credit Where It's Due? An Assessment of the New Tax Credits*, Commentary no. 86, Institute for Fiscal Studies, London, 2001 (www.ifs.org.uk/taxben/taxcred.shtml).

[9] An effective tax rate (or marginal deduction rate) measures how much of an extra pound of income is lost in income tax and National Insurance payments and withdrawn benefits or tax credits.

The child tax credit will help the government reduce child poverty as it attempts to hit its target for 2003–04.[10] Our base option could reduce child poverty by around 3–4 percentage points (360,000–480,000 children), and spending a further £3.4 billion on increasing the child credits could reduce child poverty by a total of 7–11 percentage points (840,000–1,320,000 children). The latter is an expensive and generous option: as Figure 5.4 shows, it would involve increasing incomes for families with children in the bottom three deciles by over 12%. Box 5.3 discusses what these figures actually mean for the government's target.

Box 5.3. Measuring the impact of the child tax credit on child poverty

The Treasury has recently clarified that its claim to have reduced child poverty by 1.2 million children in 2001 was compared with a hypothetical world where benefits and tax credits had been increased only in line with inflation since 1997 (see HM Treasury, *Tackling Child Poverty: Giving Every Child the Best Possible Start in Life*, London, 2001). The combined effect of underlying changes in demographics, employment and the earnings distribution over the past four or five years has worked in the opposite direction, so the actual fall in child poverty will be less than 1.2 million.

In 1996–97, there were 4.4 million children in families below 60% of median income after housing costs. The Chancellor is reported to have said that if the government had only increased benefits and tax credits in line with inflation, then child poverty would have risen to 4.7 million by 2001–02. But the result of government tax and benefit reforms is modelled to have reduced child poverty to 3.5 million, a fall of 1.2 million (John Carvel, 'Tories scorn Brown on child poverty', *The Guardian*, 13 December 2001). So, if this forecast is accurate – and we won't know for sure until official figures are released in Spring 2003 – child poverty will only be 900,000 lower in 2001–02 than it was in 1996–97. Even this forecast could be optimistic, though: child poverty had fallen by only 300,000 to 4.1 million by 1999–2000 (IFS Press Release, 'Latest poverty and inequality figures', 13 July 2001); official figures for 2000–01 (published on 11 April) will show whether the further fall of 600,000 needed to meet the Chancellor's forecasts actually materialised.

Our estimates of the impact of the child tax credit are on the same basis as the government's: they estimate how much child poverty will fall compared with a hypothetical world where the new tax credits are not introduced. The actual change in child poverty between now and 2003–04 could be higher or lower than we estimate, depending on factors such as changes in earnings and employment, and the take-up rate for the new tax credits.

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[10] The Department for Work and Pensions and the Treasury have a joint target to reduce the number of children in poverty by 'at least a quarter by 2004' against the 1998 baseline, defined as children in households with income below 60% of median (Department of Social Security, *Public Service Agreement, 2001–2004: Technical Note*, London, 2002 (www.dss.gov.uk/publications/dss/2000/psa_tech/psatech.pdf)).

The impact of the working tax credit on those without children

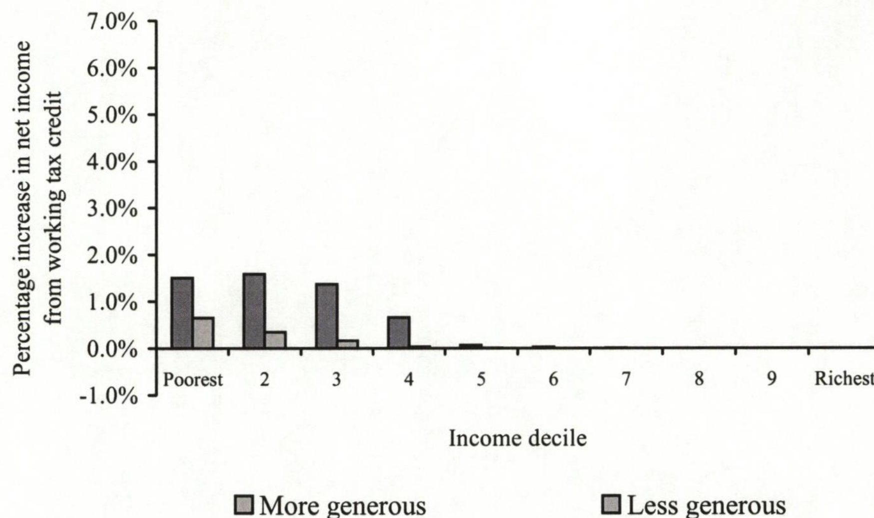
The impact of the working tax credit on those without children is straightforward: people working full-time but on a sufficiently low income to qualify for some tax credit will see their income rise. No one will lose from the reform. The size of the increase depends upon the levels of the credits chosen by the government: we present two options in Table 5.3. The more generous option assumes that the value of the working tax credit for couples without children will be equal to the current basic credit in WFTC, and that single adults will receive less (with the £30 difference approximately equal to the difference in income support rates for a single person and a couple); the less generous option uses figures mentioned in press articles around the time of the 2001 Pre-Budget Report.[11]

Table 5.3. Some options for the working tax credit for those without children

	Value of credit for couples, £/wk	Value of credit for single people, £/wk	Number of families entitled	Cost each year	Reduction in adult poverty, % point
More generous option	60	30	450,000	£370m	0.4
Less generous option	35	10	300,000	£290m	<0.1

Source: Author's calculations using IFS tax and benefit model, TAXBEN, based on 1998–99 Family Resources Survey.

Figure 5.5. Distributional impact of the working tax credit for families without children



Notes: As Figure 5.3. The vertical scale is directly comparable to the left-hand one in Figure 5.3.
Source: IFS tax and benefit model, TAXBEN, based on 1998–99 Family Resources Survey.

[11] See, for example, Larry Elliot, 'Chancellor to extend tax credits', *The Guardian*, 26 November 2001.

Entitlement to the working tax credit for those without children is limited to those on low incomes: under our options, couples will need a joint weekly income of less than about £255 or £185 for the more and less generous options respectively to be entitled to anything, and single people less than £175 or £120. Combined with the restriction to workers over 25 working full-time, this means that very few people will be entitled. The overall distributional impact of our two options on non-pensioner families without children is correspondingly small, as shown in Figure 5.5. The more generous option goes to 450,000 families and costs around £370 million, and the less generous option goes to 300,000 families and costs around £290 million (a 'family' meaning either a single person without children, or a cohabiting or married couple without children). The direct impact on poverty is negligible: a fall of 0.4 of a percentage point or 20,000 adults for our more generous option and nothing at all for the less generous option.

In a document accompanying the Tax Credits Bill, the Inland Revenue said that

> The working tax credit will provide support for working households which have neither dependent children nor a worker with a disability or illness, provided the applicant is in full-time employment. *This will increase work incentives for all low-income households* … Specifically, the working tax credit will help tackle the unemployment trap that arises when the difference between in and out of work incomes is too small to provide an incentive for those currently out of work to take a job. *The new tax credits will also help tackle the poverty trap which discourages those already in work, or with working partners, from working longer hours, moving to a better paid job or entering work*, because higher in-work income is offset by reduced in-work support and higher tax and National Insurance Contributions.[12]

This only tells half the story: the impact on work incentives is ambiguous. The working tax credit will improve the financial reward from moving into work for some and worsen it for others. But it will also worsen the poverty trap for almost all those without children who become entitled to it: on our estimates, around 500,000 people will see their effective tax rate increase while around 50,000 will see a fall, and the net effect is to increase the number of adults facing marginal deduction rates between 50% and 70% by around 250,000.[13]

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[12] Emphasis added. Source: Inland Revenue, *The New Tax Credits: A Regulatory Impact Assessment*, London, 2001 (www.inlandrevenue.gov.uk/ria/ntcria.pdf).

[13] For more detail, see M. Brewer, T. Clark and M. Myck, *Credit Where It's Due? An Assessment of the New Tax Credits*, Commentary no. 86, Institute for Fiscal Studies, London, 2001 (www.ifs.org.uk/taxben/taxcred.shtml).

5.3 Issues for Budget 2002 (II): How will the credits work in practice?

The child tax credit replaces three parts of the tax and benefit system that currently work very differently: different methods of payment, different periods over which income is assessed, different obligations on recipients to inform the authorities of changes in circumstances and different degrees of responsiveness to changes in entitlement. All of these details need to be decided upon for the new tax credits, and getting them right is vital if the credits are to succeed. First, these details will directly determine whether the reform manages to introduce a less intrusive form of support than traditional means-tested benefits. Secondly, they will determine the degree of responsiveness built into the new credits, which will affect the operation of the safety net and determine how efficiently resources are targeted.

Some details were announced in a consultation document in July 2001 and some immediately after the 2001 Pre-Budget Report.[14] In summary, claimants should certainly find the new credits very different from existing means-tested benefits. The Inland Revenue hopes that an annual system will be simpler to understand and administer, and less intrusive for claimants. But the conflicting aim of targeting the credits effectively has forced the government to compromise on achieving simplicity and predictability for families whose composition or income changes significantly during a year. Indeed, the apparent need for families to monitor their annual income, average hours of work and childcare costs may well increase complexity and uncertainty for some families.

What do we know about how the credits will work?

The innovative feature of the new tax credits is that they will depend on annual income (rather than a snapshot of income assessed every six months, as with the WFTC). The attraction of this is simplicity. But there are two problems with assessing support on annual income. First, it may give a very misleading impression of income for families whose circumstances have suddenly changed dramatically. Secondly, annual income is only known with a lag: tax-year income is only known, for example, in about July after the end of the tax year. For these two reasons, the new tax credits will not be a 'pure' annual system.[15] The safety net will be preserved because the Inland Revenue has said that families with children who claim income support or jobseeker's allowance will automatically receive the maximum amount of child tax credit regardless of their previous income; this is entirely sensible. The Inland Revenue will get round the second problem – that annual income is only

[14] See: Inland Revenue, *New Tax Credits: Supporting Families, Making Work Pay and Tackling Poverty*, London, 2001; HM Treasury, Press Release 132/01, 2001.

[15] The earned income tax credit in the USA, by contrast, is a pure annual system: see M. Brewer, 'Comparing in-work benefits and the reward to work for families with children in the US and the UK', *Fiscal Studies*, vol. 22, pp. 41–77, 2001, which compares the USA and UK systems for supporting families with children.

known with a lag – by initially setting interim tax credit awards based on estimates of annual income.[16] This is more problematic. To prevent people from systematically underestimating their income and claiming too much tax credit, the Inland Revenue will need to check these estimates against actual annual income (when it is finally known), and make retrospective changes to tax credit awards if the estimates are wrong by a 'significant' amount.

This is a substantial drawback as it will add uncertainty: families cannot be sure that they will not have to pay back the credits they are currently receiving. To give a specific example, a couple with two children who earned £17,000 in the previous tax year might have a provisional tax credit award of around £2,500 a year. But if their income rose to £19,000 early in the tax year, then – depending on what the Inland Revenue's definition of a 'significant' income change is – they might have to repay up to £748 of tax credits at the end of the tax year if they forgot to inform the Inland Revenue when the pay rise happened.[17] It is theoretically possible for some people to be liable to hand back almost all of their provisional annual award.

Widespread occurrence of these sorts of overpayments would clearly pose major difficulties for the Inland Revenue and for claimants. But the Inland Revenue has given no idea of how many people experience these sorts of income changes. It is possible that the administrative costs of the new system could be greater than those of the systems it replaces, although, again, the Inland Revenue has given no estimates of these.

What needs to be announced in Budget 2002?

Two crucial details that ought to be known by Budget 2002 are:

- what the Inland Revenue defines as a 'significant' income change;
- how the working tax credit will depend on hours of work.

By defining a 'significant' income change, the Inland Revenue is determining how large a change in annual income needs to be before a recalculation of tax credits is triggered. As discussed in Brewer, Clark and Myck (2001),[18] there is a trade-off between targeting/responsiveness and simplicity of administration of the new system:

- Small or narrow thresholds improve the targeting and responsiveness of the system but increase compliance and administrative costs.
- Broad thresholds could mean that the government would continue to pay tax credits to families whose circumstances have improved dramatically

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[16] In fact, there will be two ways that tax credit awards are assessed. Most families will initially apply for tax credits in the summer, and their interim award will be based on their past year's annual income. But people who apply in mid-year or who suspect that their previous year's income is a very bad estimate of their current year's income could have their award based on their own estimate of current-year income.

[17] This assumes that the taper rate is 37.4%.

[18] M. Brewer, T. Clark and M. Myck, *Credit Where It's Due? An Assessment of the New Tax Credits*, Commentary no. 86, Institute for Fiscal Studies, London, 2001 (www.ifs.org.uk/taxben/taxcred.shtml).

and leave families whose circumstances have deteriorated going without. On the other hand, broad thresholds would be simpler for all to operate, and they would dull the impact of the high marginal deduction rates typically associated with benefit or tax credit withdrawal.

The working tax credit will only be paid to families with children who work 16 or more hours a week and to those without children who work 30 or more hours a week. This weekly hours-of-work requirement sits oddly with an annual system. Clearly, some form of averaging needs to take place, so the challenge is to find a definition of average hours worked that is easy for all to understand and implement. As payment of the working tax credit is conditional on working sufficient hours, it seems that there will be a responsibility on people claiming the working tax credit to monitor their (average) hours of work and to report to the Inland Revenue if they are no longer working sufficient hours to qualify. The new system risks producing considerable hassle and uncertainty for people whose hours of work fluctuate between above and below the required level: they might have to make repeated claims for the working tax credit within a year (by contrast, the WFTC has six-month fixed awards, so people currently make a maximum of two claims a year).

5.4 Will the Inland Revenue manage to increase take-up of the new tax credits?

The new tax credits confirm the Labour government's belief in targeted, means-tested support assessed against joint family income. The main practical disadvantage of means-tested benefits is that people have to apply for them and not everyone does, either because they do not know they are eligible or because they decide not to apply. The WFTC take-up rate has been estimated at 62%, lower than that of family credit (72% in Summer 1999) and much lower than the estimated take-up rates for income support and housing benefit (over 95% in 1999–2000). Only 72% of entitled families with children had claimed the children's tax credit by December 2001 (although some of those who have not yet claimed can claim it through self-assessment).[19] People who do not claim benefits or tax credits tend to be entitled to small amounts; even so, non-take-up of the WFTC, for example, saved the government £1.4 billion a year in 2000–01.[20] By contrast, income tax cuts affect income taxpayers

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[19] Sources: WFTC take-up rates from S. McKay, *Low/Moderate Income Families in Britain: Work, WFTC and Childcare in 2000*, DSS Research Report no. 161, Corporate Document Services, Leeds, 2002. Family credit take-up rates from A. Marsh, S. McKay, A. Smith and A. Stephenson, *Low-Income Families in Britain*, DSS Research Report no. 138, Corporate Document Services, Leeds, 2001. Take-up rates of other means-tested benefits from Department for Work and Pensions, *Income Related Benefits: Estimates of Take-Up in 1999–2000*, London, 2001 (www.dss.gov.uk/asd/tu9900f.pdf). Children's tax credit take-up rates from *Hansard*, 4 December 2001, col. 203W, answer to question by Mr Webb.

[20] Author's calculations from S. McKay, *Low/Moderate Income Families in Britain: Work, WFTC and Childcare in 2000*, DSS Research Report no. 161, Corporate Document Services, Leeds, 2002.

automatically, and most universal benefits are claimed by virtually all who are entitled.

There are many ways that the introduction of the child tax credit might change take-up behaviour compared with the existing tax credits and benefits:

- The child tax credit will go to the majority of families with children, with all save the richest fifth (on our 'base case' assumptions) entitled to something. This could reduce the number of families that do not claim benefits or tax credits because they do not know that they are entitled, and could reduce the number of families that do not bother claiming benefits or tax credits because they think they will only be entitled for a short time.
- The nature of the means-test process will be different from existing instruments. Until we see the actual claim forms, though, and know how awards will react to changes in circumstances, it is not clear whether this will increase or decrease take-up compared with the current system. The material released by the Inland Revenue suggests that the claim forms will require more information than the existing children's tax credit, but perhaps less than is required for claiming the WFTC.

There is more cause for concern over the working tax credit for people without children. Even on our more generous assumption, average awards are less than £20 a week. It is impossible to forecast what take-up rates will be for this group, but related reforms in the past suggest that it could be very low – and even lower initially because people seem to take time to realise that they are entitled to support.

5.5 Tax credits and the public finances

The Inland Revenue has said that 'In line with the accounting treatment of the existing tax credits, WFTC and [the disabled person's tax credit], the child tax credit and the working tax credit will be accounted for out of the Inland Revenue's gross revenues, that is, the direct taxes collected by the Inland Revenue'.[21] If the government goes through with this, it will reclassify £4 billion of social security expenditure into forgone tax revenues, immediately lowering the government's favoured definition of the tax burden by 1 percentage point.

The tax burden is, of course, not a number of any real economic significance – what matter for the macroeconomy are the size of public sector net borrowing (PSNB), the quality of public services and the degree of redistribution that the tax and benefit system achieves, and what matters for individuals is how the tax and benefit system affects incentives; none of these factors should be affected by the decision to label a transfer as a tax credit rather than as expenditure. It is also difficult to decide on what is the 'correct' way to classify tax credits, particularly when they are assessed on joint income. Given this, the crucial factor is that the Treasury and Inland Revenue treat a certain

[21] Source: paragraph 210 of Inland Revenue, *Tax Credits Bill: Explanatory Notes*, London, 2001.

area of government activity in a consistent manner in their accounts. So far, this government is failing to do this: in common with previous governments, it counted family credit (the predecessor of the WFTC) as social security spending; but it treated WFTC as negative tax revenue. The quote above shows that the new tax credits look set to continue this shift. Under the European System of Accounts (1995), used by the Office for National Statistics, it is likely that only some of the child tax credit and the working tax credit would count as forgone tax revenue, with the majority counting as government spending.

Mike Brewer

From: Simon Stevens
Date: 28 February 2002

PRIME MINISTER

cc: Jonathan Powell
Jeremy Heywood
Andrew Adonis
Dominic Hardy
Sally Morgan
Alastair Campbell
Peter Hyman

BUDGET STRATEGY FOR HEALTH

Issue: **the health reform package to be unveiled alongside the Budget; and stakeholder handling.**

If the DH settlement is announced on April 17th, we have 8 weeks in which to:

- finalise the reforms to be announced alongside the Budget/Wanless report
- decide how to package the reforms for public consumption
- agree the sequence of public and private events leading up to the Budget.

Taking each in turn:

1. THE NEXT PHASE OF NHS REFORM

The reform agenda has moved a long way in the eight months since the election. Five aspects in particular have moved to the fore: devolution to PCTs; public-private relations; the importance of patient choice; the role of contestability; and the health-social care interface. These rightly complement – rather than overturn – the standards and accountability architecture put in place in your first term

(CHI, NICE, NSFs and league tables). The Budget now provides the hook to set out in a coherent whole the further reforms we have been signalling since the election.

The leading candidates for inclusion in the reform package are as follows. We can discuss them in detail at your internal SR 'awayday' next Thursday.

- **a stronger incentive structure for hospitals.** This entails a new hospital payment mechanism. In future hospitals – be they public or private –would be paid for elective surgery on a fee-per-operation, rather than 'block contracts'. In this way, money would genuinely follow the patient, rewarding hospitals that expanded output to deliver the 300,000 extra routine operations we need each year in order to cut maximum waits to 6 months by 2005.

- **patient choice of provider for all elective surgery nationwide.** Building on the cardiac patient choice scheme starting this July, providing patient choice is the flipside of creating the new payment incentive structure for hospitals. There are also powerful ideological reasons why the reform package needs to occupy the 'choice' territory, rather than ceding it to the opponents of the NHS.

- **a single public and private healthcare inspectorate/regulator.** This means legislating to combine CHI, the health-related bit of the new National Care Standards Commission, and the health vfm bit of the Audit Commission into a single new health regulator. Not only will this simplify the burden on frontline providers, it will exemplify our pragmatism regarding a mixed economy of provision. There are two tricky policy decisions associated with this. First,

whether also to merge in with it the social care regulators ie the SSI, the Social Care Regions and the social care element of the NCSC. This is superficially attractive, but in my view there is a real danger of overstretch if the same organisation is supposed to be quality-assuring, say, East Kent's hospitals and Haringey's child protection services. There is therefore a case for going for a single health regulator and a single social care regulator. **Do you have an initial view?** The second issue is whether the new health regulator should continue to be accountable to Government (as CHI and NCSC are) or to Parliament. In time I think there is a case for the latter, but it would be an extremely high risk step at this point. **Initial view?**

- **new incentives at the health-social care interface.** This would be legislating to introduce the Scandinavian system by which local authorities become financially responsible for bed blocking. It provides a way of ensuring a generous social services settlement is used to tackle this key problem. The alternative - which would be less palatable to local government - would be to ringfence the entirety of the social services budget.

- **framework for more flexible working practices.** We should be able to announce the framework for the new GP contract, giving much more responsive primary care services. This will have to be legislated for. We may also be able to say something about progress on the 'Agenda for Change' talks with nurses, and the new consultant contract.

- **new freedoms for high performing organisations** – putting flesh on bones of 'foundation hospitals' and introducing the concept of 'foundation PCTs' -

freer from hierarchical accountability and able to form self-managing networks across the country.

- **possible 'rights and responsibilities' charging package** eg for missed appointments. This would need legislation. (See separate options paper from Andrew and me.)

Are you broadly content with the shape of this package?

Specific comments on any of the proposals?

Other items you think should be included?

Other 'B' list possibilities for inclusion include:

- setting up NHS Plus as a freestanding trading company selling NHS occupational health services to employers (already it has 105 sites, national reach, and a turnover of £12 million)
- reform of clinical negligence system: a White Paper is in preparation
- new measures on genetics: a Green Paper is in preparation

2. PACKAGING THE REFORM MEASURES

It is vital that any reform package is not seen as ripping up the NHS Plan and starting again. First, this would allow the Opposition to claim that there has been

no serious reform over the last two years. And second, the NHS would seriously ab-react to what they would see as further disruption and short termism.

So the message has to be that we are not replacing the NHS Plan. Its diagnosis remains the right one: lack of capacity, need for standards and accountability, weak incentives, inflexible demarcartions, need for greater consumer power and choice etc. Its objectives and its targets are the ones we are still committed to: cutting waiting, world class cancer and cardiac services, better care for older people etc. Instead, what we are now doing is strengthening the mechanisms for ensuring that extra investment translates into improved services. And we are quickening the speed at which we are able to expand and modernise the NHS.

The options for setting out the further reform package therefore include one or more of:

- **a White Paper**, or other Command paper, perhaps branded as 'Next steps in delivering the NHS Plan'. The material could either be organised under your four reform principles, or be referenced back to each of the chapter headings of the original NHS Plan.

- **a new Delivery Contract/PSA**. This is not totally straightforward: it would need to tread a fine line between describing the 'new' outputs we would be funding, without further raising public expectations or provoking a backlash from the NHS about yet more targets.

- **a framework for a Bill** detailing the main further reforms to be legislated on in the next session. These would include a single public and private healthcare

regulator; the new NHS-social care interface incentives; and reforms to the GP contract.

Are you comfortable with these reform 'vehicles'?
Are there other ways you would like to package the next phase of reform?

On timing, I understand Gordon wants to publish Wanless on the day of the Budget (although Wanless himself was arguing for doing it a week before). Our reform package could either be published on April 17th, or probably better the next day accompanied by a Commons statement by Alan (or you?). **Which timing option sounds best?**

There is also the option of having a meeting of the NHS Modernisation Board here at No 10 – either the night before, day of, or day after the Budget. **Thoughts?**

3. SEQUENCING IN THE RUN UP TO THE BUDGET

Peter is giving you an overview note on this. We need to use the next 8 weeks to:

- work intensively on key commentators to convince them and the country that a) we are as serious about reform as we are investment, and b) our reforms are both coherent and likely to succeed. It may make sense for Gordon to stay focused publicly on making the case for a tax-funded health service, rather than publicly postulating his own parallel set of supply-side reforms outwith

the work No 10/Adair/Alan is embarked on. Derek Wanless will also be briefing journos in a series of set pieces over the next 4-6 weeks.

- recreate the pro-NHS coalition amongst leading NHS stakeholders that was so successful in launching the NHS Plan. The Modernisation Board is the key to this. Most will be fine, and when push comes to shove they should play ball. But unfortunately mid-April coincides with a difficult period for industrial relations, so some of the union leaders (Bogle, Chisholm, Malone, Prentis) may well play to the gallery. For example, the BMA's highly volatile GP Committee has long been scheduled to meet on 18 April to decide whether to support or reject the framework agreement for a new GP contract. Furthermore, this time round we cannot simply bring the Modernisation Board stakeholders in the night before, spring further reforms on them, and expect them to support us. There is a related handling issue in engaging them substantively if they are unaware that the health SR will be contained in the Budget alongside Wanless, rather than in June/July with the rest of the SR. **How important do you think it is to be able to 'spring' on people the fact that the health settlement is in the Budget?** Either way, it is crucial that you see the key players in the run up to the Budget, and possibly participate in a series of themed seminars, discussions and lectures. **Happy to do so?**

- A further question is whether - as well as handling commentators and stakeholders - we are also trying to launch a high profile 'national public debate' on NHS reform in the run up to the budget, running alongside the debate on funding levels and mechanisms. If so, that implies visits across the country, staff Q&As, public meetings and so on. There are pros and cons –

again it could be read inside the NHS as a rejection of the NHS Plan and the search for something new. **Thoughts?**

Finally, assuming the NHS SR2002 settlement is announced in the Budget, there is a question about whether to announce the social services figures at the same time. I think this makes sense, but it needs to include the social services SSAs not just the social service grants sitting within DH's DEL. **Do you agree?**

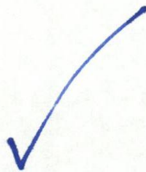
Simon Stevens

SIMON STEVENS

10 DOWNING STREET

PM

You should look at the IFS's ideas on how to raise taxes.



4. Options for increasing tax

There are at least two reasons why the government may want to put up taxes in Budget 2002. First, as discussed in Chapter 2, the Chancellor may need to raise around £5 billion as a result of the implementation of the measures currently under consultation (such as the new credits) and a possible desire to restore the level of caution in the public finance forecasts seen in the last two Budgets. Second, there may be a need to fund any increase in public expenditure that is being planned for Spending Review 2002. This chapter considers possible options that the government has for increasing tax. We shall see that election tax promises should not prevent the government from raising new revenue, if that is its objective.

4.1 The range of possible tax rises

There are many potential sources of additional tax revenue available to the government. Some of the main ones are listed in Box 4.1.

The government clearly has a huge number of tax increases that it could theoretically make while adhering to its manifesto pledges. But few of these look like attractive ways to raise significant revenue. Excise duty increases, which were a major source of extra revenues during Labour's first term, look unlikely during this Parliament. Although tax on beer and wine could be increased, there is evidence that cross-border shopping would mean that increasing the duty on spirits could actually lower revenues.[1] Concerns over increased smuggling may also limit attempts to raise significant new revenue from tobacco tax. Higher fuel taxes, meanwhile, while beneficial to the environment, might look politically unappealing after the fuel protests.

Increases in the rates of several other taxes would involve a direct reversal of the policy that the government has hitherto been promoting, which might make for political difficulties. For example, the government has given heavy emphasis to the cuts it has made to the rates of corporation tax and capital gains tax, and so it might be loath to increase these now.

The government could try to raise revenue from corporate profits without increasing the corporate tax rate, something it succeeded in doing during its first term. For example, it could look at further broadening the corporation tax base. However, economic downturns have traditionally been accompanied by increases in the generosity of capital allowances aimed at stimulating investment. The government has also ruled out the most obvious method of expanding the tax base that has arisen in recent consultations.[2] Given this and

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[1] See I. Crawford, Z. Smith and S. Tanner, 'Alcohol taxes, tax revenue and the Single European Market', *Fiscal Studies*, vol. 20, pp. 287–304, 1999.

[2] The government ruled out introducing restrictions to the deductibility of interest costs related to overseas investments. See page 11 of HM Treasury, *Large Business Taxation: The Government's Strategy and Corporate Tax Reforms*, London, July 2001.

the lack of any tax-raising proposals in the Pre-Budget Report, it would be surprising if the government turned to the corporate sector for additional revenue in this Budget.

Another option would be to introduce new taxes, although this would take time, assuming adequate consultation is undertaken. Any proposals for new taxes made in the Budget would likely be of a tentative nature, with scope for significant modification before eventual introduction in a few years' time. On these grounds, it seems unwise to devote much space to the large number of potential taxes that the government could introduce.

Box 4.1. Possible revenue-raising tax reforms

Tax	Reform	Ruled out by manifesto pledge?
Income tax	Increase basic rate	Yes
	Increase higher rate	Yes
	Increase lower rate	No
	Decrease personal allowance	No
	Restrict personal allowance to basic rate	No
	Lower basic-rate threshold	Yes
	Lower higher-rate threshold	No
National Insurance	Increase employee rate	No
	Increase employer rate	No
	Increase rate for self-employed	No
	Raise or abolish upper earnings limit	No
	Reduce earnings at which payment starts	No
VAT	Increase rate	No
	Extend to extra goods	Partially
Corporation tax	Increase standard rate	No
	Increase lower rate	No
	Increase 10% rate	No
	Lower profit thresholds	No
	Reduce capital allowances	No
Capital gains tax	Increase rates	No
	Increase taper length	No
	Reduce individual allowance	No
	Reduce trust allowance	No
	Reduce investment reliefs	No
Excise duties	Increase fuel duties	No
	Increase alcohol duties	No
	Increase tobacco duties	No
Inheritance tax	Increase rate	No
	Increase taper length	No
	Raise threshold	No
Stamp duty	Increase rates	No
	Reduce thresholds	No

Given all these difficulties, we will concentrate on the three biggest taxes in terms of revenue raised: income tax, National Insurance and VAT. These together currently provide 57% of all tax revenue.[3]

4.2 VAT

Value added tax (VAT) is charged at 17.5% on most purchases and accounts for 15% of tax receipts.[4] One way to raise revenue using VAT would be to extend it to some of those goods that are currently tax-exempt or zero-rated. However, the scope for raising revenue in this way is severely limited if the government sticks to its manifesto pledge 'not to extend VAT to food, children's clothes, books, newspapers and public transport fares',[5] since these items account for approximately half of the revenues forgone in exemption and zero-rating.[6] The alternative of increasing the rate at which VAT is charged has not been ruled out, and we discuss this reform here.

We model the effects of increasing the rate of VAT by 2.5 percentage points, which would take the rate to 20%. The reform package considered leaves the rate unchanged on those goods – for example, domestic fuel and energy supplies, children's car seats and women's sanitary products – that are currently taxed at 5%. This tax increase would raise a little less than £9 billion, equivalent to a little over 3 percentage points on the basic rate of income tax. Although large, this increase is not without recent precedent – Norman Lamont increased VAT by 2.5 percentage points in the March 1991 Budget when revenue was wanted to reduce community charge bills.

Figure 4.1 plots losses as a percentage of disposable income for households at different points in the income distribution. At least in the middle of the income distribution, the effect is seen to be approximately proportional. That is, on average, the VAT increase costs households at most income levels around 2% of their disposable income. Given that poorer households might be expected to spend a higher proportion of their income, this might seem surprising, for we might have expected more of their income to be liable to this point-of-sale tax. But this effect is offset by the fact that the poor spend a greater proportion of their income than do the rich on essentials such as food and children's clothing, which are not subject to VAT.

Still, there are two notable exceptions to the pattern of proportionality. Households in the poorest tenth lose more, with a 3.5% reduction in the purchasing power of their disposable income. And households in the richest 10% lose only 1.8% of their disposable income. This is because income that is not spent is not immediately liable to VAT, and the richest households save

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[3] Source: HM Treasury, *Financial Statement and Budget Report*, Hc279, London, 2001 (www.hm-treasury.gov.uk/budget/bud_index.cfm).

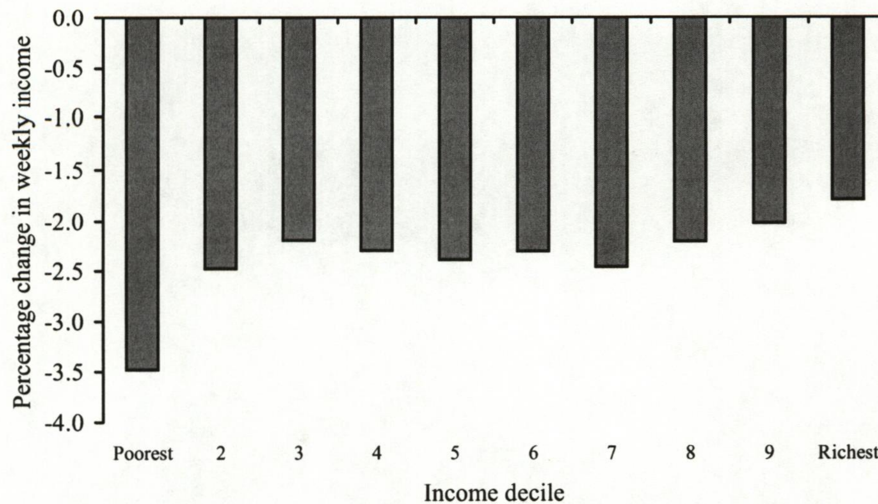
[4] Source: HM Treasury, *PBR: A Summary Leaflet*, London, 2001.

[5] Page 10 of Labour Party, *Ambitions for Britain* (Labour's manifesto 2001), London, 2001 (www.labour.org.uk/lp/new/labour/labour.wwv_main.main?p_cornerid=364778).

[6] Source: Table A3.1 of HM Treasury, *Financial Statement and Budget Report*, Hc279, London, 2001 (www.hm-treasury.gov.uk/budget/bud_index.cfm).

most heavily (and spend least heavily) out of their income, while the poorest households spend most heavily.

Figure 4.1. Losses across the income distribution from increasing VAT to 20% on goods currently taxed at 17.5%



Note: Income deciles are derived by dividing the total population into 10 equally sized groups according to household income adjusted for family size. Decile 1 contains the poorest tenth of the population, decile 2 the next poorest 10% and so on, up to the richest tenth in decile 10.
Source: IFS tax and benefit model, TAXBEN, run using data from the Family Expenditure Survey 1997–98; scale adjusted for consistency with government figures due to systematic underestimate of VAT take.

The salience of these departures from proportionality is reduced by two additional considerations. First, some households at the bottom of the income distribution may be spending a lot relative to their income because they anticipate that their low income is only temporary. Secondly, when higher-income households spend the wealth that they are building up, VAT will be levied then.

This reform to VAT has been seen to be approximately proportional across most of the income distribution but regressive in its treatment of households at the extremes of the income distribution. Implementing this reform in isolation would therefore represent something of a break with the redistributive direction of reforms introduced in Budget packages during Labour's first term in office. The government might, therefore, prefer to use direct taxation if it wants to raise tax revenue, because this would offer greater scope for progressive packages. We now consider some methods of raising revenue using direct taxes.

4.3 Income tax

Income tax is the largest source of government revenue, accounting for over a quarter of receipts.[7] But there are significant constraints on the ability to raise new revenue from it. The government has pledged not to 'raise the basic or top rates of income tax',[8] which rules out the most obvious means of raising significant revenue. In addition, there are limits on the alternative means to raise income tax that were used at various points over the 1990s. Reductions in the generosity of 'fringe' allowances, such as the married couple's allowance and MIRAS, are now less of an option as most have already been abolished. Freezing in cash terms the main income tax parameters (explained in Table 4.1) would raise relatively little – just under £1 billion[9] – because of low inflation and would be incompatible with the government's pledge to widen the 10% tax band in real terms. So, if significant extra income tax revenue is to be raised, an 'imaginative' way of doing it must be found. One option is restricting the value of the personal allowance.

Table 4.1. The 'default' 2002–03 income tax system

Term	Definition	Gross income when reached	Taxable income when reached
Personal allowance	Gross income on which no tax is paid. Income immediately above this is taxed at 10% (the starting rate).	£4,615	£0
Basic-rate threshold	Taxable income at which 22% tax rate (the basic rate) begins.	£6,535	£1,920
Higher-rate threshold	Taxable income at which 40% tax rate (the higher rate) begins.	£34,515	£29,900

Note: The table is for a childless single person under 65 receiving only earned income and paying no tax-deductible pension contributions from their income. It shows the values that the main tax parameters will assume under the default indexation that occurs if the Budget makes no announcements on these.

Restricting the personal allowance to the basic rate of tax

One revenue-raising reform to income tax that has been discussed in the past,[10] and which could still be implemented, would be to restrict the personal allowance (PA) to the basic rate of tax. The income tax system in the UK

[7] Source: HM Treasury, *PBR: A Summary Leaflet*, London, 2001.

[8] Page 10 of Labour Party, *Ambitions for Britain* (Labour's manifesto 2001), London, 2001 (www.labour.org.uk/lp/new/labour/labour.wwv_main.main?p_cornerid=364778).

[9] Source: HM Treasury, *Tax Ready Reckoner and Tax Reliefs*, London, 2001 (www.hm-treasury.gov.uk/mediastore/otherfiles/TRR01Draft6%20-%20final.pdf).

[10] See, for example, J. McCrae, 'Simplifying the formal structure of UK income tax', *Fiscal Studies*, vol. 18, pp. 319–34, 1997.

currently has three tax bands (a starting rate of 10%, a basic rate of 22% and a higher rate of 40%) and an unrestricted PA. The PA allows taxpayers to reduce their tax rate to zero on £4,615 of their income in the 2002–03 tax system.

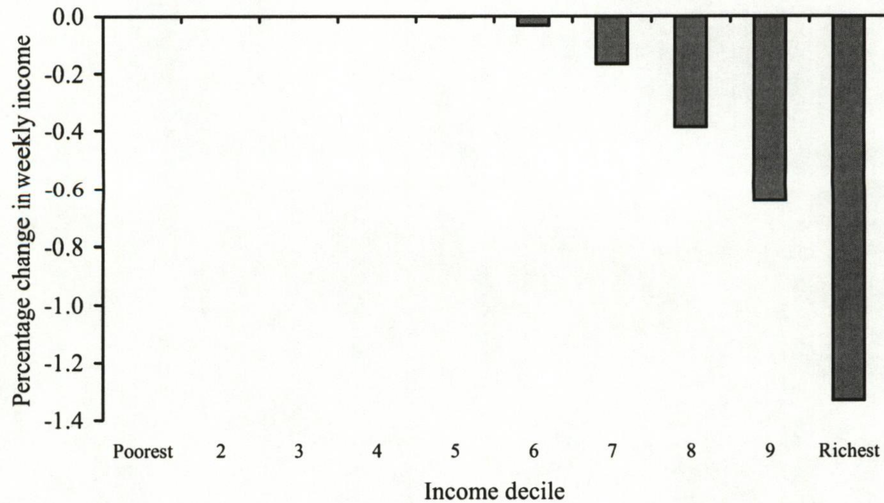
An unrestricted allowance affects the level of gross income at which other tax bands begin: each tax band becomes effective when gross income exceeds its threshold *plus* the PA. (The figures in the third column of Table 4.1 are calculated by adding £4,615 to the figures in the final column in the table.) This structure means that the PA offsets the tax liability on the top tranche of income – the segment taxed at the highest rate. For higher-rate taxpayers, the allowance reduces the tax rate from 40% to 0% on the top £4,615 of income, making the year's allowance worth £1,846. But for an individual whose income places them in the middle of the basic-rate tax band, the allowance is worth less: its effect is to reduce the tax rate from 22% to zero on the top tranche of income, so the allowance is worth just 22% of £4,615, or £1,015.30.

Restricting the PA to the basic rate of tax would mean that it could only be offset against basic- and starting-rate liabilities, and so could never be worth more than its value to a basic-rate taxpayer – £1,015.30. The reform would decouple the amount of gross income at which higher-rate tax starts being paid from the level of the PA. That might appeal to the government because it would then be able to raise the PA in the future without giving greater benefit to higher-rate taxpayers than to basic-rate taxpayers. This would mean that the level of gross income at which the higher-rate marginal rate of tax becomes effective is reduced from £34,515 to £29,900. Anybody with an income of more than £29,900 loses out from this reform. An individual earning more than £34,515 loses a total of £830.70 each year (about £16 per week) from the reform. In total, the reform would raise about £2.6 billion.

Figure 4.2 shows the effect of this reform on the average incomes of families across the income distribution. Since only those with incomes above £29,900 can lose from the reform, the losses are confined to the top half of the income distribution. It is unsurprising that the reform is progressive, taking (on average) a greater proportion of family income from richer households. The largest losses are felt amongst the richest 10%, in which families lose an average of 1.3%, or £11.20 per week.

Restricting the personal allowance would have the effect of floating about a million people onto the higher, 40%, income tax rate. From an economic point of view, it is not obvious why the government should be concerned about this growth – it is the *average* tax rate that matters for people's living standards, and the average tax rate of those people who are floated into higher-rate tax by the reform will change only modestly as the great bulk of their income would continue to be taxed at 22%. Also, in terms of incentives, 40% is not an especially high marginal tax rate, being only 8 percentage points higher than the 32% effective tax rate paid by many basic-rate taxpayers (made up of a 22% marginal income tax rate and a 10% employee National Insurance rate).

Figure 4.2. Losses across the income distribution from restricting the personal allowance to the basic rate of tax



Note: As for Figure 4.1.
Source: IFS tax and benefit model, TAXBEN, run using data from the Family Resources Survey 1998–99.

But there might be political or presentational difficulties. The increase in the number of higher-rate taxpayers would reinforce a long-standing trend – their number has increased to 2.6 million in 2001–02 from 2.1 million in 1997–98 and 1.7 million in 1990–91, mainly because thresholds have generally risen only in line with prices while earnings have risen more quickly. If, for some non-economic reason, the growing numbers of modestly high earners on a marginal income tax rate of 40% were seen as problematic, then the reform would become less attractive.

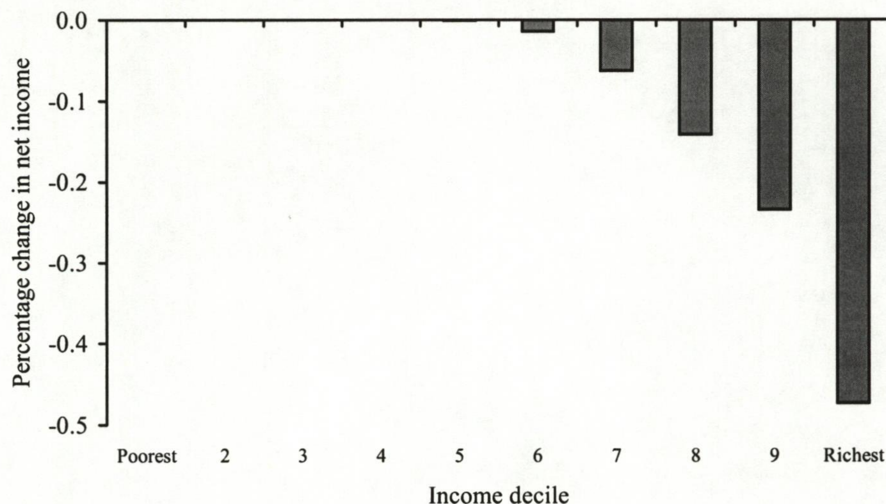
4.4 National Insurance

National Insurance has been widely seen as a likely target for increasing taxes, especially since the government's refusal to rule out increases during the general election campaign. The mechanics of National Insurance mean that changes could not be announced with immediate effect, but the government could use the Budget to pre-announce reforms. Perhaps an obvious target would be to scrap or increase the cap – the upper earnings limit (UEL) – above which no further employee contributions are payable. Other possibilities would be to raise more money from the self-employed or to increase the main National Insurance rates. Finally, it would also be possible to extend National Insurance to those sources of unearned income currently covered only by income tax.

Increase or abolish the upper earnings limit

One possibility would be to raise the UEL (and the upper profits limit – UPL – the equivalent cap that applies to the self-employed) from the currently planned level of £585 per week to £664 per week (from £30,420 to roughly £34,515 per year), so that it matches the higher-rate income tax threshold. This could be seen as consistent with previous Labour reforms, such as the increase to the level of the personal allowance for the point where National Insurance becomes payable, in that it would better align the income tax and National Insurance systems.

Figure 4.3. Losses across the income distribution from raising the UEL and UPL to the higher-rate income tax threshold



Note: As for Figure 4.1.
Source: IFS tax and benefit model, TAXBEN, run using data from the Family Resources Survey 1998–99.

Increasing the UEL and UPL to the higher-rate threshold would raise approximately £0.9 billion. The reform would be very progressive, as shown in Figure 4.3: the richest 10% would provide two thirds of the revenue, losing on average 0.5% of their disposable income. The bottom half of the income distribution would be almost entirely unaffected by the change because the effect is limited to high earners (those on more than £585 per week). In cash terms, the highest loss would fall on anyone earning over £664 per week, representing a flat-rate loss of £6.64 a week (£345.28 a year) for individuals in this position.[11]

The government could go further and abolish the UEL (and UPL) altogether. This would raise far more – around £5.9 billion – since this would mean that *all* earnings above the UEL would be newly liable for National Insurance at

[11] This illustrative calculation is for an individual who is opted out of SERPS, the State Earnings-Related Pension Scheme. If they were opted in, the loss would be larger, at £7.90 per week.

10%.[12] Abolishing the UEL would be highly progressive. Indeed, it would be an even more progressive reform than merely raising the ceiling, as the amount of extra tax paid by high earners would rise continuously with earnings for all those being paid more than £585 per week.

The abolition of the UEL, like an increase in higher-rate tax, would hit couples where one person did most of the earning harder than it would those where the earnings were split equally between partners. This is because no one would pay any extra National Insurance on the first £585 (£30,420 a year) of earnings each week, so, for example, a couple earning £25,000 a year each would escape the extra charge entirely, whereas a couple with the same gross income but with one partner earning £50,000 a year would have to pay an extra £37.65 a week (or around £1,960 a year). In practice, the hardest-hit group of families would be single-earner couples with children: on average, they would lose £15.98 per week.[13]

A potential objection to the abolition of the UEL would be that it would further weaken the 'contributory principle' of National Insurance. The link between contributions and benefits has been in decline since 1961, when contributions that graduated with earnings were first introduced. Abolishing the ceiling would weaken the link further as it would see the contribution of the highest earners increase significantly, without there being any commensurate increase in the benefits they were entitled to.

The dilemmas of compensation

Although we have seen that the effects of abolishing the ceiling on National Insurance contributions are actually very heavily concentrated in the upper reaches of the income distribution, the government might wish to offer some compensation to certain groups. In particular, it might want to protect moderately high earners – those on, say, £30,000 to £40,000 a year (people who are often labelled 'middle Britain' in spite of their relatively high position in the income distribution).

One way of compensating such people would be to reduce the rate of employee National Insurance contributions. A 2 percentage point reduction in the employee rate would be sufficient to compensate someone on earnings of around £37,000 per year fully and would ensure that the tax increase could not cost more than £4.82 per week for anyone earning less than £40,000. But this would cost the exchequer £6.5 billion, which is more than the abolition of the ceiling would raise in the first place. This is because so much money would end up being directed towards people on lower earnings and because the yield

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[12] We assume that the UEL would be maintained at its current level in its role as a cap on the band of income where the contracted-out (of SERPS) rebate applies on both employer and employee contributions. If the UEL were not maintained as the upper limit on income where this discount ceased being available, then the scale of the tax rise would be very significantly reduced. But there would be no justification for abolishing the limit on this discount unless SERPS were to be increased for the highest earners, which would be out of line with recent pension policy which has concentrated on increasing pension entitlement for the poorest.

[13] Source: IFS tax and benefit model, TAXBEN, run using data from the Family Resources Survey 1998–99.

from abolishing the UEL itself would be reduced. In short, it is an infeasible means to compensate if the aim is to raise revenue.

Another means of compensation, which might seem more targeted, would be to cut the higher rate of income tax from 40% to 30% for all gross income up to £40,000 per year, after which the 40% rate would continue to apply. This would cost £2.0 billion, and so reduce the yield from abolishing the ceiling from £5.9 billion to £3.9 billion.[14] This change to higher-rate tax would mean that the effective marginal rate of tax on the tranche of income between £34,515 and £40,000 would remain unchanged at 40% (post-reform, this would be made up of 30% income tax and 10% National Insurance), whereas the 10 percentage point increase in the marginal rate of tax would still be felt in full by those earning over £40,000. But the policy has serious flaws.

First, such higher-rate tax adjustments cannot have any impact on the taxation of earners in the £30,420 to £34,515 bracket, the lowest-income people to be hit by the initial reform. This is because their earnings are liable to the extra National Insurance when the ceiling is abolished but are not sufficient to attract higher-rate tax, so the reduced higher rate is of no value to them. Second, compensation would be incomplete for those in the £34,515 to £40,000 bracket because they too would lose out on the increased effective tax rate on that part of their income that falls between £30,420 and £34,515. Indeed, a higher proportion of the tax increase represented by the abolition of the ceiling is being offset for someone on £40,000 than for someone on £35,000, because in the former case full advantage can be taken of the reduced 30% higher rate.[15]

Any compensation based on the introduction of a new reduced income tax band would have disadvantages that are additional to the failure to compensate effectively. It would mean creating an extra tax band, a complication that might have adverse consequences for self-assessment and the reconciliation of income that is taxed at source. It would also involve redistribution towards those paying higher-rate tax on unearned income, which is not liable for National Insurance.[16] For example, a high-income pensioner on £50,000 a year would see their tax liability fall on that part of their income covered by the new tax band. Redistributing to such well-off groups might seem undesirable when policy is aiming to raise revenue overall.

These attempts to compensate particular groups for the abolition of the UEL essentially amount to attempts to mimic the effects of income tax reform – an increase in the higher rate of income tax, possibly coupled with a modest increase in the higher-rate threshold. The problems of complexity and

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[14] Source: IFS tax and benefit model, TAXBEN, run using data from the Family Resources Survey 1998–99.

[15] Better-targeted compensation could be achieved by introducing a new 12% income tax band in the £30,420 to £34,515 income bracket, although justifying an income tax schedule in which marginal rates rise from 0% to 10% to 22% and then fall back to 12% before finally rising to 40% might seem to pose presentational difficulties!

[16] In this chapter, we count pension income as unearned because it is not liable for National Insurance, although in other contexts it might be classified as earned.

unwanted distributional effects that emerge when attempting such a simulation suggest that income tax reform might be better done directly.

Increase contributions from the self-employed

A different system of National Insurance applies to the self-employed and it is much more generous: the contribution rate is lower than for employees (at 7% compared with 8.4% for employees contracted out of SERPS and 10% for employees contracted into SERPS) and there is no equivalent to the employer element. The self-employed do pay an additional flat-rate contribution of £2 per week and also have reduced benefit entitlement. But even accounting for this reduced benefit entitlement, the government calculates that, in 2000–01, the earnings of the self-employed gave rise to £2.3 billion less in National Insurance contributions than they would have done had they been taxed under the Class 1 (employer/employee) system.[17]

Increasing National Insurance contributions for the self-employed is therefore an option that would raise revenue and simultaneously alleviate an apparently unfair anomaly in the existing system. This could be done in a number of ways: the rate could be increased to 8.4% to match that paid by employees (opted out of SERPS); it could be further significantly increased, reflecting the fact that the self-employed do not currently pay employer contributions; and the UPL could be scrapped, since for employees there is no cap on employer contributions. The government might also wish to abolish Class 2 (flat-rate) contributions, which would remove another anomaly and provide a little compensation in a form worth proportionately more to low-earning self-employed.[18]

Increase the rate of National Insurance contributions

Rather than reforming the structure of National Insurance, the government could instead choose simply to increase the main National Insurance rates. It could do this either on the employee or the employer side. Economic theory suggests that, in the long run, the incidence of the tax should not be affected by who initially pays it – if employer contributions increase, then wages will eventually decline relative to what they would otherwise have been. So, here we model in detail only one option – an increase in the employee rate. The eventual effects of an increase in the employer rate should be similar, but more progressive as there is no cap on contributions on the employer side. We assume that the rate on self-employed profits increases in line with the employee rate.

A 1 percentage point rise in employee and self-employed rates would raise approximately £3.3 billion[19] and would be fairly progressive, as shown in

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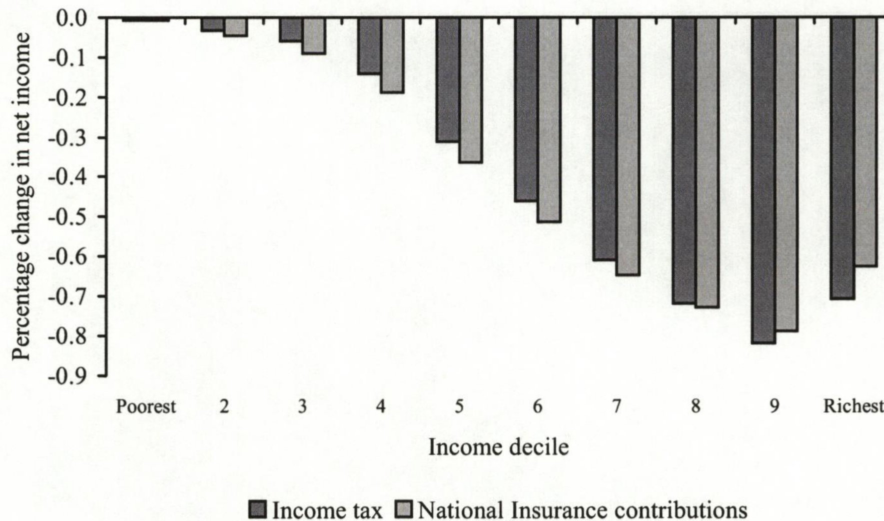
[17] Source: HM Treasury, *Financial Statement and Budget Report*, Hc279, London, 2001 (www.hm-treasury.gov.uk/budget/bud_index.cfm).

[18] For a fuller discussion of the treatment of the self-employed in the National Insurance system, see L. Chennells and A. Dilnot (eds), *The IFS Green Budget: January 1999*, Commentary no. 76, Institute for Fiscal Studies, London, 1999.

[19] Source: HM Treasury, *Tax Ready Reckoner and Tax Reliefs*, London, 2001 (www.hm-treasury.gov.uk/mediastore/otherfiles/TRR01Draft6%20-%20final.pdf). An increase of 1

Figure 4.4. The hardest-hit would be two-earner couples, who would lose a little over £4 per week on average.[20] As can be seen from the graph, the reform has very similar effects to putting a penny on the basic rate of income tax; it also raises a comparable amount. Raising income tax would, in fact, be slightly more progressive: the basic rate takes effect at a higher income level than National Insurance contributions (because of the 10% income tax band) and stops being paid at a higher income level (the higher-rate threshold is higher than the UEL), so raising the basic rate of income tax would tax low earners less and high earners more than increasing the rate of employee National Insurance contributions.[21] But the fact that income tax rises can be closely mimicked by National Insurance again indicates the lack of economic consequence from keeping to the income tax pledge.

Figure 4.4. Losses across the income distribution from raising the basic rate of income tax and the employee National Insurance rate by 1 percentage point compared



Notes: As for Figure 4.1. Employee National Insurance reform incorporates 1 percentage point increase in the rate of self-employed contributions.
Source: IFS tax and benefit model, TAXBEN, run using data from the Family Resources Survey 1998–99.

Integrate National Insurance and income tax

A more radical way to raise revenue from National Insurance would be to integrate employee National Insurance contributions into the income tax

percentage point in the employer rate (together with an increase of 1 percentage point on the self-employed) would raise more – £4 billion – because contributions are uncapped.

[20] Applies to two-earner couples both with and without children. Source: IFS tax and benefit model, TAXBEN, run using data from the Family Resources Survey 1998–99.

[21] This is complicated slightly by the disproportionate amounts of unearned income at the top (savers) and the bottom (pensioners) of the income distribution.

system. This would leave National Insurance as a pure employers' tax. This might help simplify the tax system, and it would also raise revenue because of differences between the two taxes. In particular, it would increase taxation on sources of unearned income that are subject to income tax but not National Insurance. This would hit pensioners particularly hard, but that could be prevented by simply excluding them. The extra tax payable on unearned income for non-pensioners alone would yield around £1.6 billion a year.

4.5 Conclusion

Possible sources of significant extra tax revenue in the 2002 Budget are National Insurance and VAT. But the decision to rule out the main forms of income tax increases might come to be seen as disadvantageous should the government want to increase tax significantly. For the pledge limits the potential to raise revenue from the single biggest tax, and it does so more severely now than it did in Labour's first term, as many of the means used to increase income tax revenue without changing the rates are now exhausted. It might also seem disingenuous if income tax rate rises are simulated using National Insurance. Indeed, the National Insurance option might seem less distributionally appealing than the income tax option: National Insurance cannot be used to raise money from the unearned income of the wealthy and would have a greater impact on moderately high earners.

Stuart Adam, Tom Clark and Matthew Wakefield

File copy

TB 07/02
19 February 2002

Chancellor **cc Duty Clerk**

1. We know this CSR is really tight, but we have the necessity of putting NHS funding on a secure footing and building investment in the country's infrastructure, education and security systems.

2. This will mean some tax increases, probably around 1% of GDP, which will still leave us with a lower tax/GDP ratio than any other major EU country. But 1% GDP increase – around £10-12bn – will be insufficient, for our spending needs. We will need to find more from within existing programmes, by tough choices in other budgets and by some increases in charges within Departments to fund extra programmes eg abolition of CB for over 16 year olds to fund greater schools investment.

3. The absolute priorities are these:

- NHS – where a real terms increase of 7/8% is necessary.
- Education – it can't be less than last time, and if it is not more, will have to be far more clearly focused on schools and universities.
- Transport – where the commitments are pretty much made.
- Defence – we cannot deliver a bad settlement for them. I know it's not what you want to hear but given 11 September and what will happen in Iraq, it is essential. If we don't, we will lose everything we have established, rightly, since 11 September and before.

- Crime – this is really tough – there are massive increases being asked for. The problem is asylum and any periperal bids and programmes. We need to take a really hard position on turning back asylum seekers. The numbers are falling – down 15% this year on last but it's still the application levels that are too high. But even if we manage all this, we can't let police numbers drop.
- Overseas Aid – a significant increase, at least, is already promised and in any event, is right.

4. In all other areas, we are going to have to be very tough. We must find some spending programmes to cut: I believe there are huge amounts in various "regeneration" programmes, in some bits and pieces of schemes, which often add little but add up to a lot of money.

5. Then there are tough choices within budgets to raise money. If a budget is getting a good settlement, we should at least force them to raise some additional sums from within their portfolios, eg prescription charges; or airport duty; landfill tax; or policing of various events done now for free ie the pain should not all be borne by the ordinary taxpayer. I am not under estimating the difficulties but I do believe that, as part of a coherent whole, the country will understand if it genuinely delivers on their priorities.

6. We then, having decided the areas of problem we will have, - not the precise details but the outline of the pain – need to work out a strategy to build up to April. Presumably in April we will have the hard tax questions

answered. So the CSR will be more where it is spent. In which case, we have around six weeks to mould expectations. My judgement is that we should be very open and honest about it.

1) Public services need investment.

2) What has gone in so far, has yielded results, but more catching up needs to happen.

3) We are combining it all with change and reform and that, too, is yielding results; and the staff in the services are up for it.

4) We are raising taxes but still well within the limits of most EU countries and well below the EU average.

5) The result will be to save money and provide opportunity because if we don't fund the services together, we will pay separately and the less well off won't be able to afford it.

6) So: we maintain a strong economy; we build public services to provide opportunity for all; and achieve a stronger, modern, fairer Britain.

7. Me and you should do this together – ie share the burden and responsibility. It should be seen as a joint effort. This will help carry it and show a untited Government placing the true choices before people.

TB

From: Jeremy Heywood
Date: 15 February 2002

PRIME MINISTER

TAX

I attach a useful note from Jacob which looks at the current tax reliefs and suggests various ways in which a lot of revenue could be raised.

Most of these ideas are obviously political non-starters. The most promising are probably:

- raising VAT to 20 per cent (though, quite apart from the politics, this would push up the RPI and hence RPI-related benefits spending etc);
- extending VAT to new housing construction on green field sites. Worth up to £1.5 billion;

- restricting further higher rate tax relief for pension contributions. An easier and more sensible way of raising tax revenues from 40p taxpayers than putting up the marginal rate. But could only be done as part of a wider deregulatory package on private sector pensions;

- raising the UEL. An obvious and relatively painless way of getting £1 billion or more. You could also look at doing something more imaginative like abolishing the UEL and then cutting the top rate of tax by 10p. This would be a tax simplification and would automatically cut the value of tax reliefs while leaving marginal rates unchanged;

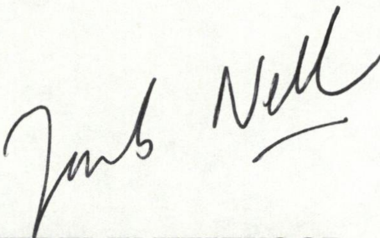
- raising NICs on the self-employed – currently they pay far less than their fair share;

- reforming North Sea oil taxation. Though with oil prices down now you could only raise perhaps £500m a year or so without causing problems for the industry;

- taxing redundancy payments and pension lump sums;

- extending VAT to private education and health, and putting the revenues back into the public sector.

Talking to Ed Balls today, I think the Treasury are indeed thinking of setting a spending envelope for DEL which will allow the same growth rate for spending as in SR2000. Ed said that he thought that that implied tax increases of £12-14bn not £17-18bn as we have estimated. We will meet next week to try to reconcile these numbers. But either way these are very large numbers and assume that we can find £6bn or more savings on the bids we were presenting to you yesterday. That will be exceptionally difficult without cutting the Health and Defence bids.



p.p. **JEREMY HEYWOOD**

From: Jacob Nell
JEREMY HEYWOOD
Date: 04 February 2002

cc Andrew Adonis
Peter Hyman
Geoffrey Norris
Derek Scott
Simon Virley

TAX RELIEFS - CANDIDATES FOR ABOLITION

You asked for advice in your note of 18/01 on tax reliefs that could be abolished to finance additional public expenditure. This note identifies some tax reliefs that are candidates for abolition, plus information on some other revenue-raising and expenditure-cutting options, set out in detail in Annex 1. There are additional Annexes on (a) a summary of the main tax increases of the last 10 years, (b) a full list of the principal tax expenditure and structural reliefs from the last Budget Red Book.

As my starting point, I assume that the purpose is to identify about £15 bn in additional revenues above revenues arising from trend growth by 2005-06 in order to finance the PM's ambitions on public expenditure. Derek Scott will be providing further advice on the economic consequences of increasing taxes.

I have tried in general to identify options where there is an additional reason in terms of incentives or fairness or some other government priority for the incidence of the tax to be altered. I have also avoided options where there is an explicit Manifesto commitment.

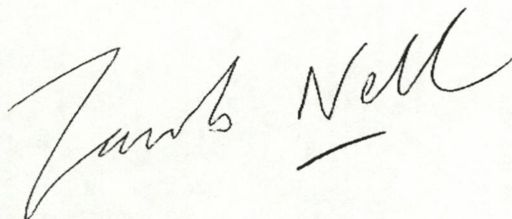
These options tend to involve increases in the burden of tax on individuals rather than on business. This is partly because I assumed that there was not much of a market for increasing the direct burden of taxation on business, partly because of the recent decline in corporate profitability and corporation tax yield. It is also since the vast majority of tax reliefs are for individuals as earners, savers and spenders and not for business. Business benefits from less than £25 bn of tax reliefs - about 15% of all tax reliefs - of which the vast majority (£19 bn) is due to capital allowances.

Over the last ten years there have been two clear changes to tax expenditures and structural reliefs. Firstly, there was broad agreement that the tax relief provided to owner occupiers through relief on mortgage interest and the tax relief provided to married couples were difficult to justify. These tax reliefs - worth about £10 bn at the start of the 1990s - were gradually eliminated in a series of cuts.

Secondly, GB has been expanding the use of tax reliefs to transfer a substantial proportion of benefit expenditure into the tax system, through the introduction of WFTC and the planned child credit and employment tax credit, and to provide various incentives to business to act in certain ways. These business tax reliefs include tax relief for the film industry (costing ca. £100 mn pa), for venture capital (costing £190 mn pa) and for business in deprived neighbourhoods (costing £130mn pa). He is now introducing an R&D tax credit in the Budget (costing perhaps £500 mn pa, depending on design), and he has raised the option of a training tax credit (possible cost £500 mn pa).

Although it is difficult to be precise about the combined value of the reliefs, since abolishing one relief will change the yield from other reliefs, in broad terms the estimated cost of the principal tax expenditure and structural reliefs in 2000-01 amounted to £130-150 bn. Consequently financing the PM's public expenditure ambitions from this source alone would require restricting tax expenditure and structural reliefs by about 10%. The options mentioned here would by themselves, if implemented, increase revenues by over £20 bn per annum. This note also presents some information on other revenue raising and benefit cutting options worth respectively £18 bn and £8 bn per annum, plus, for reference, information on the major tax increases (over £1 bn per annum) of the last ten years and on the main tax reliefs.

The costings have been done using Treasury documents, including the Tax Ready Reckoner, and Work and Pension Statistics 2001. However in some cases - notably the costings for restrictions on tax relief for pension contributions, benefit changes and North sea oil taxation - the costings are back of the envelope order of magnitude guesses.



JACOB NELL

Annex 1. Detailed costings of abolition of various tax reliefs, benefit cuts and other potential sources of funding

Measure	Revenue Raised, £ mn
Restriction of tax relief on pension contribution	4000
Abolition of VAT zero-rating on new build	3000
Abolition of VAT zero-rating on rents	3500
Abolition of VAT zero-rating on water/sewerage	1000
Abolition of VAT zero-rating on postal services	400
Abolition of exemption of capital gains from disposal of main residence	3500
Removing income tax reliefs for disability allowances	900
Restricting personal tax allowances for higher rate taxpayers	2600
Equalisation of self-employed NICS contribution rates with employed NICS contribution rates	440
Freezing income tax allowances, starting and basic rate limits	1800
Total from reduction of tax reliefs	**21140**
Raising old age benefit entitlements to state retirement age	1200
Raise state retirement age to 67	4000
Equalise IS and JSA	1500
Abolish bereavement allowance	500
Abolish industrial injuries benefit	400
Total from benefit reductions	**7600**
Restructure North Sea taxation (higher tax rate when oil price high)	0-5000
Increase UEL to starting point of higher rate of tax	900
Abolish UEL	5900
Increase VAT to 20%	9500
1p on petrol and diesel duty	400
Total tax options	**19200**
Total options	**47940**

Notes on summary table

1) Options for raising finance through abolition of reliefs.

1) Restriction of tax relief on pension contributions. At the moment all pension contributions up to 17% of salary are tax exempt, on the grounds that you will be taxed when you draw a pension and you shouldn't be taxed twice on the same income. Restricting tax relief on pension contributions to the basic rate would raise about £4 bn, while capping the tax-exempt contributions that can be made to a pension fund in any 1 year at a level of about £15,000 might raise about the same amount.

2) Abolition of VAT zero-rating on certain services. VAT exemptions cost about £25 bn a year in revenue foregone, which implies that if all VAT exemptions were abolished the rate could be cut to 10% and current tax yield would be maintained. However, there are Manifesto commitments against abolishing VAT on food, children's clothes, books, newspapers and public transport fares, which covers over 60% of exemptions. Plus having lowered VAT on domestic fuel to 5% it would be difficult to raise it again. But there are still options on widening the scope of VAT, notably by bringing new build (£3 bn), rent (£3.5 bn), water/sewage services (£1 bn) and postal services (£0.4 bn) into the scope of VAT.

3) Abolition of exemption of capital gains from disposal of main residence. This would raise up to £3.5 bn. It would be levied on the increase in the value of a house over the period of ownership.

4) Removing income tax reliefs for disability allowances. This would raise about £900 mn from the better off and working disabled, who also receive a range of benefits.

5) Restricting personal tax allowances for higher rate taxpayers. This proposal by the IFS in their Green Budget would restrict the benefit from a personal tax allowance to the level experienced by a basic rate taxpayer (i.e to about £1000 rather than to £1800), and would mean all earning over £30,000 paid up to £800 pw more. It would raise £2.6 bn.

6) Equalisation of self-employed National Insurance contributions with the National Insurance contributions of the employed At the moment the self-employed pay lower NICs than the employed - a benefit worth £2.3 bn. For instance the self-employed NICS contribution rate is 7% as opposed to at least 8.4% paid by employees. If the rates were equalised this would raise £440 mn.

7) Freezing income tax allowances, starting and basic rate limits. Instead of uprating income tax tax allowances and thresholds by inflation they could be frozen. This would raise £1.8 bn.

2: Options for raising finance from cutting benefits

a. Raising all old age benefit entitlements to the state retirement age (65 for men, and 60 for women, gradually rising to 65 from 2005 to 2015). A wide range of old age benefit entitlements are paid to the 60-65 age group, who are 2.8 mn strong, including Winter Fuel Payment/free transport provision/dependant increases/age additions/pensioner premia in HB/CT/IS. Savings - £1-£1.5 bn.

b. Raise the state retirement age to 67. This would save about £4 bn

c. Set all income replacement benefits for people of working age at the JSA level. Basically this means cutting IB for new claimants to the JSA rate, and saying that they get help with the extra costs of disability from the extra cost disability benefit DLA. Long term IB is £69.75 per week (£3627 per year) and adult JSA is £53.05. Moving to the JSA rate for the IB caseload would save 1.5 mn recipients x £20 x 52 weeks = savings £1.5 bn.

d. Abolition of bereavement allowance – just have the one off bereavement payment. Savings of about £0.5 bn.

e. Abolition of industrial injuries benefit – covered by general system of disability benefits and compensation from employers. Savings of £200-400 mn.

These measures would probably yield £8 bn in savings in the long run. But the savings would take a long time to fully accumulate, since the existing caseload would be protected. First year savings would probably be £500 mn rapidly rising £2 bn in five years and then climbing more slowly to £8 bn over a further 20 years. If legislation were introduced in the next session (02/03) it would probably start 03/04 and yield cash savings of something like 500/800/1200 over the SR2002 period. But since it improves the long run fiscal position of the government and under RAB a cost or benefit is scored in full once it arises, it may allow a substantial increase in borrowing, consistent with fiscal prudence.

Annex 2. Major tax increase over the last 10 years

Measures	Worth (£ million)	In	Or in 2001/02 prices *(£ million)*	Notes
March 1991 Budget				
Increase VAT to 17.5%	5,515	1992-93	6,877	Linked to reduction of poll tax.
March 1993 Budget (Lamont's attempt to sort out the public finances)				
Married couples allowance restricted to 20%	1,170	1995-96	1,366	
Not uprating income tax allowances with RPI	780	1995-96	911	
Taxation of dividends	870	1995-96	1,016	
VAT on domestic fuel and power	950	1994-95	1,141	Increase to 8%.
Road fuel duty up 3% in real terms future Budgets	950	1995-96	1,109	Road fuel duty escalator – worth increasingly more in future years.
November 1993 Budget (Clarke's first)				
Married couples allowance restricted to 15%	1,060	1996-97	1,200	
Mortgage Interest Relief restricted to 15%	950	1996-97	1,075	
Road fuel duty up 5% in real terms future Budgets	815	1996-97	923	Increased rate of escalator announced in March 1993. Increased further in 1997 Budget.
Insurance Premium Tax	840	1996-97	951	
November 1996 Budget				
Phasing out profit related pay.	1,700	1999-00	1,773	Took effect in Labour's first years – but announced by last Govt.
July 1997 Budget (Gordon Brown's first)				
Mortgage Interest Relief restricted to 10%	950	1999-00	991	
Abolition of payable tax credits	5,400	1999-00	5,633	The 'raid on pension funds'
Windfall Tax on privatised utilities	2,600	1998-99	2,777	One off tax with revenue over 2 years worth £5.3 billion in total.
March 1998 Budget				
Abolish ACT and introduce quarterly payment of corporation tax	2,000	2000-01	2,050	This revenue is from timing changes going from annual to quarterly payments.
Married couples allowance restricted to 10%.	1,080	2000-01	1,107	
Bring forward road fuel escalator to March	1,150	2000-01	1,179	
March 1999 Budget				
Abolition of Married couples allowance	2,050	2001-02	2,050	Twinned with introduction of Children's tax credit
Abolition of mortgage Interest relief from 1/4/00	1,400	2001-02	1,400	
Climate Change levy	1,750	2001-02	1,750	Measures since announcement have reduced revenue to £1 bn.

The estimated costs of reliefs and allowances given in Table A3.1 cannot be added up to give a meaningful total. The combined yield of withdrawing two related allowances could differ significantly from the sum of individual costs. Similarly the sum of the costs of component parts of reliefs may differ from the total shown.

More details on individual allowances and reliefs can be found in the HM Treasury publication *"Tax Ready Reckoner and Tax Reliefs"*, November 2000.

Table A3.1: Estimated costs of principal tax expenditure and structural reliefs

	£ million	
	Estimated cost for	
	1999–00	2000–01
TAX EXPENDITURES		
Income Tax		
Relief for:		
Approved pension schemes	11,500	12,400
Approved profit sharing schemes	190	200
New all-employee share ownership plan	0	80
Approved discretionary share option schemes	100	60
Approved savings-related share option schemes	420	410
Personal Equity Plans	1,000	950
Individual Savings Accounts	120	450
Venture Capital Trusts	100	190
Enterprise Investment Scheme	110	130
Profit related pay	900	130
Vocational training	55	50
Exemption of:		
First £30,000 of payments on terminatin of employment	1,100	1,100
Interest on National Savings Certificates including index-linked certificates	180	200
Tax Exempt Special Savings Account interest	375	400
Premium Bond prizes	90	130
SAYE	90	60
Income of charities	925	950
Foreign service allowance paid to Crown servants abroad	100	100
First £8,000 of reimbursed relocation packages provided by employers	300	300
Tax Credits:		
Life assurance premiums (for contracts made prior to 14 March 1984)	110	100
Mortgage interest and life annuities interest	1,600	70
Working Families' Tax Credit	1,010	4,600
Disabled Person's Tax Credit	20	100
Capital gains tax		
Exemption of gains arising on disposal of only or main residence	3,100	3,400
Retirement relief	210	170
Inheritance tax		
Relief for:		
Agricultural property	90	90
Business property	110	110
Exemption of transfers to charities on death	310	320
Value Added Tax		
Zero-rating of:		
Food	8,200	8,150
Construction of new dwellings (includes refunds to DIY builders)	2,700	2,900
Domestic passenger transport	1,550	1,600

Table A3.1: Estimated costs of principal tax expenditure and structural reliefs

	£ million	
	Estimated cost for	
	1999–2000	2000–2001
International passenger transport	200	200
Books, newpapers and magazines	1,450	1,500
Children's clothing	1,000	1,050
Water and sewerage services	1,000	1,000
Drugs and supplies on prescription	600	650
Supplies to charities	150	200
Ships and aircraft above a certain size	350	400
Vehicles and other supplies to disabled people	250	250
Lower rate on domestic fuel and power	1,600	1,550
STRUCTURAL RELIEFS		
Income tax		
Personal allowance	32,500	32,100
Income tax and corporation tax		
Double taxation relief	6,000	6,000
Corporation tax		
Reduced rate of corporation tax on policy holders' fraction of profit	450	400
National insurance contributions		
Contracted-out rebates occupational schemes:		
Occupational schemes deducted from national insurance contributions received	5,890	6,310
Occupational schemes (COMPS) paid by the Contributions Agency direct to scheme	110	120
Personal pensions	2,390	2,570
Value Added Tax		
Refunds to:		
Local authorities and Northern Ireland government of VAT incurred on non-business purchases	3,700	3,900
The BBC and ITN of VAT incurred on non-business purchases	250	250
Central Government, Health Authorities and NHS Trusts on contracted-out services and projects under private finance initiative	1,850	1,950
RELIEFS WITH TAX EXPENDITURE AND STRUCTURAL COMPONENTS		
Income Tax		
Married couple's allowance	1,900	0
Age-related allowances	1,400	1,700
Additional personal allowance	160	0
Relief for maintenance payments	70	5
Exemption of:		
British government securities where owner not ordinarily resident in the United Kingdom	850	850
Child benefit (including one parent benefit)	830	880
Long-term incapacity benefit	200	140
Industrial disablement benefits	80	80
Attendance allowance	220	220
Disability living allowance	390	410
War disablement benefits	90	80
War widow's pension	60	60
Income tax and corporation tax		
Capital allowance of which:	17,900	18,700

Table A3.1: Estimated costs of principal tax expenditure and structural reliefs

	£ million	
	Estimated cost for	
	1999–2000	2000–2001
Temporary first year allowances for SMEs	300	170
Corporation tax		
Small companies' reduced corporation tax rate	1,700	1,800
Starting rate of corporation tax	0	150
Capital gains tax		
Indexation allowance and rebasing to March 1982	500	400
Taper relief	130	320
Exemption of:		
Annual exempt amount (half of the individual's exemption for trustees)	2,000	1,500
Gains accrued but unrealised at death	1,100	1,100
Petroleum revenue tax		
Uplift on qualifying expenditure	200	300
Relief for exploration and appraisal expenditure	30	50
Oil allowance	300	600
Safeguard: a protection for return on capital cost	300	250
Tariff receipts allowance	70	100
Exemption for gas sold to British Gas under pre-July 1975 contracts	140	170
Inheritance tax		
Nil rate band for chargeable transfers not exceeding the threshold	5,600	5,900
Exemption of transfers on death to surviving spouses	1,100	1,200
Stamp Duties		
Exemption of transfers of land and property where the considerations do not exceed the threshold	240	200
National insurance contributions		
Reduced contributions for self-employed not attributable to reduced benefit eligibility	2,400	2,300
Value Added Tax		
Exemption of:		
Rent on domestic dwellings	2,850	3,000
Rent payable by exempt businesses on commercial property	450	500
Private education	350	350
Health services	500	500
Postal services	400	400
Burial and cremation	100	100
Finance and insurance	100	100
Betting and gaming and lottery	750	750
Small traders	100	100

JEREMY HEYWOOD

From: Jacob Nell
Date: 04 February 2002

Cc: Andrew Adonis
Peter Hyman
Geoffrey Norris
Derek Scott
Simon Virley

TAX RELIEFS - CANDIDATES FOR ABOLITION

You asked for advice in your note of 18/01 on tax reliefs that could be abolished to finance additional public expenditure. This note identifies some tax reliefs that are candidates for abolition, plus information on some other revenue-raising and expenditure-cutting options, set out in detail in Annex 1. There are additional annexes on (a) a summary of the main tax increases of the last 10 years, (b) a full list of the principal tax expenditure and structural reliefs from the last Budget Red Book.

As my starting point, I assume that the purpose is to identify £15 bn in additional revenues above revenues arising from trend growth by 2005-06 in order to finance the PM's ambitions on public expenditure. Derek Scott will be providing further advice on the economic consequences of increasing taxes.

I have tried in general to identify options where there is an additional reason in terms of incentives or fairness or some other government priority for the incidence of the tax to be altered. I have also avoided options where there is an explicit Manifesto commitment.

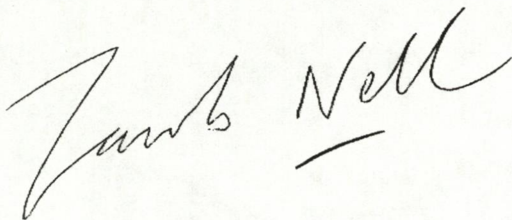
These options basically involve increases in the burden of tax on individuals rather than on business. This is partly because I assumed that there was not much of a market for increasing the direct burden of taxation on business, for political reasons and because of the recent decline in corporate profitability and corporation tax yield. It is also since the vast majority of tax reliefs are for individuals as earners, savers and spenders and not for business. Business benefits from less than £25 bn of tax reliefs – about 15% of all tax reliefs - of which the vast majority (£19 bn) is due to capital allowances.

Over the last ten years there have been two clear changes to tax expenditures and structural reliefs. Firstly, there was broad agreement that the tax relief provided to owner occupiers through relief on the mortgage interest and the tax relief provided to married couples were difficult to justify. These tax reliefs – worth about £10 bn at the start of the 1990s - were gradually eliminated in a series of

cuts. Secondly, GB has been expanding the use of tax reliefs to transfer a substantial proportion of benefit expenditure into the tax system, through the introduction of the WFTC, and the planned child credit and employment tax credit, and to provide various incentives to business to act in certain ways. These business tax reliefs include tax relief for the film industry (costing ca. £100 mn pa), for venture capital (costing £190 mn pa) and for business in deprived neighbourhoods (costing £130 mn pa). He is now introducing an R&D tax credit in the Budget (costing perhaps £500 mn, depending on the design), and he has raised the option of a training tax credit (possible cost £500 mn).

Although it is misleading to be precise about the combined value of the reliefs, since abolishing one relief will change the yield from other reliefs, in broad terms the estimated cost of the principal tax expenditure and structural reliefs in 2000-01 amounted to £130-150 bn. Consequently financing the PM's public expenditure ambitions from this source alone would require restricting tax expenditure and structural reliefs by about 10%. The options mentioned here would by themselves, if implemented, increase revenues by over £20 bn per annum. This note also presents some information on other revenue raising and benefit cutting options worth respectively £18 bn and £8 bn pa, plus, for reference, information on the major tax increases (over £1 bn per annum) of the last ten years and on the main tax reliefs.

The costings have been done using Treasury documents, including the Tax Ready Reckoner, and Work and Pension Statistics 2001. However in some cases - notably the costings for restrictions on tax relief for pension contributions, benefit changes and North Sea Oil taxation - the costings are back-of-the-envelope order of magnitude guesses.



JACOB NELL

Annex 1. Detailed costings of abolition of various tax reliefs, benefit cuts and other potential sources of financing

Measure	**Revenue raised, £ mn**
Restriction of tax relief on pension contributions	4000
Abolition of VAT zero-rating on new build	3000
Abolition of VAT zero-rating on rents	3500
Abolition of VAT zero-rating on water/sewarage	1000
Abolition of VAT zero-rating on postal services	400
Abolition of exemption of capital gains from disposal of main residence	3500
Removing income tax reliefs for disability allowances	900
Restricting personal tax allowances for higher rate taxpayers	2600
Equalisation of self-employed NICS with employed NICS	440
Freezing income tax allowances, starting and basic rate limits	1800
Total from reduction of tax reliefs	**21140**
Raising old age benefit entitlements to state retirement age	1200
Raise state retirement age to 67	4000
Equalise IB and JSA	1500
Abolish bereavement allowance	500
Abolish industrial injuries benefit	400
Total from benefit reductions	**7600**
Restructure North Sea oil taxation	2000
Increase UEL to starting point of higher rate of tax	900
Abolish UEL	5900
Increase VAT to 20%	9500
1p on petrol and diesel duty	400
Total tax options	**18700**
Total options	**47440**

Notes on summary table

1) Options for raising finance through abolition of tax reliefs.

1) Restriction of tax relief on pension contributions. At the moment all pension contributions up to 17% of income are tax exempt, on the grounds that you will be taxed when you draw a pension and you shouldn't be taxed twice on the same income. Restricting tax relief on pension contributions by higher rate taxpayers to the basic rate of tax would raise about £4 bn, while capping the tax-exempt contributions that could be made to a pension fund in any 1 year to £15,000 would raise about the same amount.

2) Abolition of VAT zero-rating on certain services VAT exemptions cost about £25 bn a year in revenue foregone, which implies that if all VAT exemptions were abolished the rate could be cut to 10% and current tax yield would be maintained. However, there are Manifesto commitments against abolishing VAT on food, children's clothes, books, newspapers and public transport fares, which covers over 60% of exemptions. Plus having lowered VAT on domestic fuel to 5% it would be difficult to raise it again. But there are still options on widening the scope of VAT, notably by bringing new build (£3 bn), rent (£3.5 bn), water/sewage services (£1 bn) and postal services (£0.4 bn) into the scope of VAT.

3) Abolition of exemption of capital gains from disposal of main residence. This would raise up to £3.5 bn. It would be levied on the increase in the value of a house over the period of ownership.

4) Removing income tax reliefs for disability allowances. This would raise about £900 mn from the better off and working disabled, who also receive a range of benefits.

5) Restricting personal tax allowances for higher rate taxpayers. This proposal, made by the IFS in their Green Budget, would restrict the benefit from a personal tax allowance to the level experienced by a basic rate taxpayer (i.e to about £1000 rather than to £1800), and would mean all earning over £30,000 paid up to £800 pw more. It would raise £2.6 bn.

6) Equalisation of self-employed National Insurance contributions with the National Insurance contributions of the employed At the moment the self-employed pay lower NICs than the employed – a benefit worth £2.3 bn. For instance the self-employed NICS contribution rate is 7% as opposed to at least 8.4% paid by employees. If the rates were equalised this would raise £440 mn.

7) Freezing income tax allowances, starting and basic rate limits. Instead of uprating income tax tax allowances and thresholds by inflation they could be frozen. This would raise £1.8 bn.

2: Options for raising finance from cutting benefits

a. Raising all old age benefit entitlements to the state retirement age (65 for men, and 60 for women, gradually rising to 65 from 2005 to 2015). A wide range of old age benefit entitlements are paid to the 60-65 age group, who are 2.8 mn strong, including Winter Fuel Payment/free transport provision/dependant increases/age additions/pensioner premia in HB/CT/IS. Savings - £1-£1.5 bn.

b. Raise the state retirement age to 67. This would save about £4 bn.

c. Set all income replacement benefits for people of working age at the JSA level. Basically this means cutting IB for new claimants to the JSA rate on the basis that they get help with the extra costs of disability from the extra cost disability benefit DLA. Long term IB is £69.75 per week (£3627 per year) and adult JSA is £53.05. Moving to the JSA rate for the IB caseload would save 1.5 mn recipients x £20 x 52 weeks = savings £1.5 bn.

d. Abolition of bereavement allowance – just have the one off bereavement payment. Savings of about £0.5 bn.

e. Abolition of industrial injuries benefit – covered by general system of disability benefits and compensation from employers. Savings of £200-400 mn.

These measures would probably yield £8 bn in savings in the long run. But the savings would take a long time to fully accumulate, since the existing caseload would be protected. First year savings would probably be £500 mn rapidly rising to £2 bn over five years and then climbing more slowly to £8 bn over a further 20 years. If legislation were introduced in the next session (02/03) it would probably start 03/04 and yield cash savings of something like 500/800/1200 over the SR2002 period. But since it improves the long run fiscal position of the government and under RAB a cost or benefit is scored in full once it arises, it may allow a substantial increase in borrowing, consistent with fiscal prudence.

3) Options for raising finance from tax rises

a. Increase VAT to 20%. Raises £9.5 bn.

b. Restructure North Sea oil taxation to capture more rent (excess profit above normal rate of return) for state. Depending on oil price, raises £0-5 bn per annum.

c. Increase Upper Earnings Limit to the starting point of the higher rate of tax. Raises £0.9 bn.

d. Abolish Upper Earnings Limit. Raises £5.9 bn.

e. 1p on petrol and diesel duty. Raises £400 mn.

4) Other - Joining the Euro.

This will of course cost a substantial amount to join – holding a referendum, printing and distributing notes and coins, printing and distributing information and running information campaigns. This upfront cost may be as large as £2 bn. But there will be two windfall gains. Firstly, not all the legacy currency (sterling) will be changed into euro. Since after the legal cut off date sterling notes still in circulation are no longer a liability of the Bank of England, they can be written off, and the corresponding assets on the balance sheet transferred to the Treasury. The money issue is £27 bn, and so if 5% of the sterling issue were not changed for euro there would be a windfall gain of £1.3 bn. Secondly, since we only have 9% of the UK and euro 11 note issue, and 15% of the UK and euro 11 GDP, and our share of ECB profits or seignorage[1] will be determined by our share of GDP, we will have higher central bank profits – about 1 beuro or £600 mn more pa.

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[1] Seignorage is the money that a central bank makes from its issuing authority. A central bank can purchase assets that generate a yield - say 5% in the case of bonds - using non-interest bearing banknotes, which cost a negligible amount to print and distribute. So a central bank will make a return of about 5% on the stock of banknotes in circulation. Bank of England profits in 2000-01 were £1.5 bn.

Annex 2. Major tax increase over the last 10 years

Measures	Worth (£ million)	In	Or in 2001/02 prices *(£ million)*	Notes
March 1991 Budget				
Increase VAT to 17.5%	5,515	1992-93	6,877	Linked to reduction of poll tax.
March 1993 Budget (Lamont's attempt to sort out the public finances)				
Married couples allowance (MCA) restricted to 20%	1,170	1995-96	1,366	
Not uprating income tax allowances with RPI	780	1995-96	911	
Taxation of dividends	870	1995-96	1,016	
VAT on domestic fuel and power	950	1994-95	1,141	Increase to 8%.
Road fuel duty up 3% in real terms future Budgets	950	1995-96	1,109	Road fuel duty escalator – worth increasingly more in future years.
November 1993 Budget (Clarke's first)				
MCA restricted to 15%	1,060	1996-97	1,200	
Mortgage Interest Relief restricted to 15%	950	1996-97	1,075	
Road fuel duty up 5% in real terms future Budgets	815	1996-97	923	Increased rate of escalator announced in March 1993. Increased further in 1997 Budget.
Insurance Premium Tax	840	1996-97	951	
November 1996 Budget				
Phasing out profit related pay.	1,700	1999-00	1,773	Took effect in Labour's first years – but announced by last Govt.
July 1997 Budget (Gordon Brown's first)				
Mortgage Interest Relief restricted to 10%	950	1999-00	991	
Abolition of payable tax credits	5,400	1999-00	5,633	The 'raid on pension funds'
Windfall Tax on privatised utilities	2,600	1998-99	2,777	One off tax with revenue over 2 years worth £5.3 billion in total.
March 1998 Budget				
Abolish ACT and introduce quarterly payment of corporation tax	2,000	2000-01	2,050	This revenue is from timing changes going from annual to quarterly payments.
MCA restricted to 10%.	1,080	2000-01	1,107	
Bring forward road fuel escalator to March	1,150	2000-01	1,179	
March 1999 Budget				
Abolition of Married couples allowance	2,050	2001-02	2,050	Twinned with introduction of Children's tax credit
Abolition of Mortgage Interest Relief from 1/4/00	1,400	2001-02	1,400	
Climate Change levy	1,750	2001-02	1,750	Measures since announcement have reduced revenue to £1 bn.

ANNEX 3

The estimated costs of reliefs and allowances given in Table A3.1 cannot be added up to give a meaningful total. The combined yield of withdrawing two related allowances could differ significantly from the sum of individual costs. Similarly the sum of the costs of component parts of reliefs may differ from the total shown.

More details on individual allowances and reliefs can be found in the HM Treasury publication *"Tax Ready Reckoner and Tax Reliefs"*, November 2000.

Table A3.1: Estimated costs of principal tax expenditure and structural reliefs

	£ million Estimated cost for	
	1999–00	2000–01
TAX EXPENDITURES		
Income Tax		
Relief for:		
Approved pension schemes	11,500	12,400
Approved profit sharing schemes	190	200
New all-employee share ownership plan	0	80
Approved discretionary share option schemes	100	60
Approved savings-related share option schemes	420	410
Personal Equity Plans	1,000	950
Individual Savings Accounts	120	450
Venture Capital Trusts	100	190
Enterprise Investment Scheme	110	130
Profit related pay	900	130
Vocational training	55	50
Exemption of:		
First £30,000 of payments on terminatin of employment	1,100	1,100
Interest on National Savings Certificates including index-linked certificates	180	200
Tax Exempt Special Savings Account interest	375	400
Premium Bond prizes	90	130
SAYE	90	60
Income of charities	925	950
Foreign service allowance paid to Crown servants abroad	100	100
First £8,000 of reimbursed relocation packages provided by employers	300	300
Tax Credits:		
Life assurance premiums (for contracts made prior to 14 March 1984)	110	100
Mortgage interest and life annuities interest	1,600	70
Working Families' Tax Credit	1,010	4,600
Disabled Person's Tax Credit	20	100
Capital gains tax		
Exemption of gains arising on disposal of only or main residence	3,100	3,400
Retirement relief	210	170
Inheritance tax		
Relief for:		
Agricultural property	90	90
Business property	110	110
Exemption of transfers to charities on death	310	320
Value Added Tax		
Zero-rating of:		
Food	8,200	8,150
Construction of new dwellings (includes refunds to DIY builders)	2,700	2,900
Domestic passenger transport	1,550	1,600

Table A3.1: Estimated costs of principal tax expenditure and structural reliefs

	£ million Estimated cost for	
	1999–2000	2000–2001
International passenger transport	200	200
Books, newpapers and magazines	1,450	1,500
Children's clothing	1,000	1,050
Water and sewerage services	1,000	1,000
Drugs and supplies on prescription	600	650
Supplies to charities	150	200
Ships and aircraft above a certain size	350	400
Vehicles and other supplies to disabled people	250	250
Lower rate on domestic fuel and power	1,600	1,550
STRUCTURAL RELIEFS		
Income tax		
Personal allowance	32,500	32,100
Income tax and corporation tax		
Double taxation relief	6,000	6,000
Corporation tax		
Reduced rate of corporation tax on policy holders' fraction of profit	450	400
National insurance contributions		
Contracted-out rebates occupational schemes:		
Occupational schemes deducted from national insurance contributions received	5,890	6,310
Occupational schemes (COMPS) paid by the Contributions Agency direct to scheme	110	120
Personal pensions	2,390	2,570
Value Added Tax		
Refunds to:		
Local authorities and Northern Ireland government of VAT incurred on non-business purchases	3,700	3,900
The BBC and ITN of VAT incurred on non-business purchases	250	250
Central Government, Health Authorities and NHS Trusts on contracted-out services and projects under private finance initiative	1,850	1,950
RELIEFS WITH TAX EXPENDITURE AND STRUCTURAL COMPONENTS		
Income Tax		
Married couple's allowance	1,900	0
Age-related allowances	1,400	1,700
Additional personal allowance	160	0
Relief for maintenance payments	70	5
Exemption of:		
British government securities where owner not ordinarily resident in the United Kingdom	850	850
Child benefit (including one parent benefit)	830	880
Long-term incapacity benefit	200	140
Industrial disablement benefits	80	80
Attendance allowance	220	220
Disability living allowance	390	410
War disablement benefits	90	80
War widow's pension	60	60
Income tax and corporation tax		
Capital allowance of which:	17,900	18,700

Table A3.1: Estimated costs of principal tax expenditure and structural reliefs

	£ million Estimated cost for	
	1999–2000	2000–2001
Temporary first year allowances for SMEs	300	170
Corporation tax		
Small companies' reduced corporation tax rate	1,700	1,800
Starting rate of corporation tax	0	150
Capital gains tax		
Indexation allowance and rebasing to March 1982	500	400
Taper relief	130	320
Exemption of:		
Annual exempt amount (half of the individual's exemption for trustees)	2,000	1,500
Gains accrued but unrealised at death	1,100	1,100
Petroleum revenue tax		
Uplift on qualifying expenditure	200	300
Relief for exploration and appraisal expenditure	30	50
Oil allowance	300	600
Safeguard: a protection for return on capital cost	300	250
Tariff receipts allowance	70	100
Exemption for gas sold to British Gas under pre-July 1975 contracts	140	170
Inheritance tax		
Nil rate band for chargeable transfers not exceeding the threshold	5,600	5,900
Exemption of transfers on death to surviving spouses	1,100	1,200
Stamp Duties		
Exemption of transfers of land and property where the considerations do not exceed the threshold	240	200
National insurance contributions		
Reduced contributions for self-employed not attributable to reduced benefit eligibility	2,400	2,300
Value Added Tax		
Exemption of:		
Rent on domestic dwellings	2,850	3,000
Rent payable by exempt businesses on commercial property	450	500
Private education	350	350
Health services	500	500
Postal services	400	400
Burial and cremation	100	100
Finance and insurance	100	100
Betting and gaming and lottery	750	750
Small traders	100	100

From: Jacob Nell
Date: 6 February 2002

JEREMY HEYWOOD

cc: Andrew Adonis
Derek Scott
Simon Virley

IFS GREEN BUDGET FORECAST AND INTERNAL NO. 10 FORECAST

You asked for a note on the IFS Green Budget Forecast of spending in SR2002, and the differences and similarities with our internal budget forecasts.

PBR 2001 macro and fiscal forecast

Both our forecast and the IFS forecast take as a basis the PBR 2001 forecasts, which are summarised below.

Treasury View PBR 2001							
	Outturn		Projections				
			SR2000		*SR2002*		
			Yr1	*Yr2*	*Yr3/Yr1*	*Yr2*	*Yr3*
Key Macro Assumptions	99/00	00/01	01/02	02/03	03/04	04/05	05/06
Price growth (GDP deflator)	**2.50%**	**1.75%**	**2.25%**	**2.25%**	**2.50%**	**2.50%**	**2.50%**
Output growth	**2.75%**	**3.00%**	**2.25%**	**2.00%**	**3.00%**	**2.25%**	**2.25%**
Nominal GDP	**907**	**946**	**989**	**1032**	**1089**	**1141**	**1196**
Fiscal projections							
Current receipts	**364.6**	**382.2**	**391.2**	**406**	**430**	**452**	**474**
Capital receipts (asset sales)	**4.8**	**4.1**	**4**	**4**	**4**	**4**	**4**
Total receipts	**369.4**	**386.3**	**395.2**	**410**	**434**	**456**	**478**
Current expenditure	**325.3**	**344.5**	**367.6**	**389**	**411**	**430**	**450**
Capital expenditure	**23**	**23.5**	**29.8**	**33**	**37**	**39**	**41**
Total expenditure	**348.3**	**368**	**397.4**	**422**	**448**	**469**	**491**
Fiscal deficit (PSNB)	**21.1**	**18.3**	**-2.2**	**-12**	**-14**	**-13**	**-13**
TME	**343.4**	**363.5**	**393.6**	**418.3**	**444.3**	**465**	**487**
o/w DEL	**179.3**	**190.9**	**212.5**	**229.6**	**245.1**	**257.2**	**270.3**
o/w AME	**164.1**	**172.6**	**181.1**	**188.7**	**199.2**	**207.8**	**216.7**

The implicit forecast for TME was found by calculating total expenditure net of asset sales, using the forecasts of current spend, capital spend and assets sales. AME was forecast on the basis of the PBR assumption of 1.75% growth. The implicit DEL forecast was then found by subtracting AME from TME.

No 10 budget

At present our internal forecast is that to meet the PM's ambitions spending will have to increase by 11.7/18.4/22.7 bn over and above the PBR 2001 forecast

over the SR2002 period. The difference between the No. 10 forecast and the PBR 2001 forecast is largely due to continued high growth rates in spending on the PM's priority areas of health, education, crime and transport, as well as to our internal forecast including an estimate of the cost of the new tax credits (child tax credit, working tax credit and R&D tax credit) in AME. This spending increase amounts to an annual average real terms increase of 4.2% in TME which can be financed by either increasing borrowing by an average of £7 bn pa or increasing taxation by an average of £7 bn per annum or by a mixture of the two.

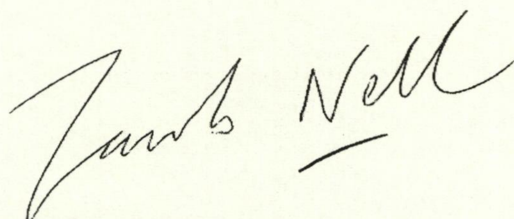
No 10 adjustment to PBR 2001 forecast, £ bn

	2003/04	2004/05	2005/06
PBR 2001 DEL forecast	245.1	257.2	270.3
No. 10 DEL forecast	254	273.9	292.2
Difference	8.9	16.7	21.9
PBR 2001 AME forecast	199.2	207.8	216.7
No. 10 AME forecast	202	209.5	217.5
Difference	2.8	1.7	0.8
Total difference	11.7	18.4	22.7

IFS Green Budget

The IFS forecast the increase in borrowing or taxation that will be required under various SR2002 spending scenarios (see p.19-20, Green Budget). Their option 7 is almost exactly the option that we are currently working on.

Planned growth in public expenditure	Real increase in spending	Annual increase in taxation or borrowing required, £bn
1. No real increase	0.0%	-10
2. Same as expected trend GDP growth	2.5%	0
3. As 2 + NHS 6.4% pa	3.1%	2.5
4. As 3 + education at 5.4% pa	3.5%	4
5. As 4 + transport at 8.4% pa	3.6%	4.5
6. All spending at average rate 99/04	3.5%	4
7. All spending at average rate 2001/04	4.3%	7



JACOB NELL

(F)

From: Martin Hurst
Date: 25 January 2002

PRIME MINISTER

Cc: Jonathan Powell
Jeremy Heywood
Robert Hill
Mike Emmerich
Simon Virley
Matthew Elson
Geoffrey Norris
Jo Simons

My priority now is to raise money, though broadly I support green tax neutral measures or even some at a small cost.

ENVIRONMENTAL TAXES

Taxation has been one of our green success stories, and one worth protecting. We have reformed vehicle and company car tax, introduced the climate change levy (CCL) and aggregates tax, increased landfill tax and given tax relief for energy efficiency, green technology and clean fuels. The Budget documents have been a high profile and widely applauded example of environmental appraisal.

Using the tax system to promote the environment has two advantages, both explicitly reflected in the Manifesto:

- It uses the market to deliver environmental improvements.
- It can raise money by taxing 'bads' not 'goods' (or avoids public spending).

Revenue raising is on our agenda. But green taxes tend to impact on sensitive groups: motorists, individual industries/ industry in general, farmers.

Do you have views on possibilities for this Budget (details overleaf):

- Waste/recycling: sharp increases in landfill tax (could raise over £750m), consultation on product charges (e.g. on tyres, bottles, old style light bulbs).
- Transport: tax help for sulphur free fuel, biofuels, low Carbon vehicles; lorry tax reform; respecifying 'red' diesel to promote cleaner fuel; consultation on greening air passenger duty. None need have much cost.
- Business: tax assistance for CHP (cost of £40m), energy efficiency (£10m), pledge to review the working of the CCL, help for green technology.
- Agriculture: pesticides/fertiliser taxation could raise £ several hundred million, but now may not be the time. We could instead pledge a more general item in the next PBR, in response to the Policy Commission.

You have also seen Mike Emmerich's note on VAT on housing. The final issue is fuel duty – other considerations will dominate for this Budget, but a duty cut would be very hard to present from a climate change perspective if oil prices stay lower than a year ago.

Waste/recycling

The PIU's waste study will offer an interim report in February, in time to influence the spending review. We will give you a note then, but in short the picture is not good. We are way behind the rest of Europe on recycling and reuse and much more dependent on landfill. We also generate far more waste.

Landfill tax has risen year on year over the past Parliament and will rise again next year. A trebling in landfill tax, over the next 5-10 year period, has been suggested. Even this would still leave the costs of landfill disposal below those on the continent. It could raise over £750m, and would go a fair way towards securing the reductions in landfill that we have been set by the EU. It would be preannounced – half the tax is paid by LAs, the rest from business - to incentivise investment in recycling infrastructure, rather than just hitting budgets.

The PIU report will also consider options for **charging households by the type of waste** (so paper collection could be free, while plastics would be more expensive). Council tax would be reduced to offset the effect on the average household. Although not a Budget measure this is a potentially important but politically controversial tool that will need careful handling.

Another way of getting the message and incentives to households might be to impose highly visible **charges on 'wasteful' goods** – as exist in much of Northern Europe. Examples might include non-recyclable bottles, conventional lightbulbs, certain types of batteries, and some tyres. There is however a trade off - revenue raised is quite low, and costs of tax collection quite high. More work is needed before introducing them, but we could consult.

Transport

Transport tax measures have been at the heart of the green side of all Labour Budgets. The tax system now promotes clean fuels, such as gas, and cleaner versions of conventional fuels such as ultra low Sulphur petrol. It promotes

electric and gas vehicles, and the more fuel-efficient end of the conventional vehicle park. And it helps company's green commuting plans.

But recent research confirms that road users are still under-taxed relative to the costs they impose on the environment. And without road/congestion charging, rural users pay more relative to these costs than urban users.

Last November's PBR consulted on a **new system of lorry taxation**. All lorries would face a road user charge, perhaps distance related. UK hauliers would get an equivalent amount back through lower taxes elsewhere. (This means foreign hauliers will pay for our roads, in the way UK hauliers do in Northern Europe).

We could with this introduce a **separate, lower, rate of duty on diesel used by hauliers**. We could then compensate them for the new road charges, and bring their duty rate down towards European levels, without costly cuts in duty for diesel cars/vans (a major cause of air pollution - an 'amber' status PSA target).

The PBR also pledged **tax help for low Carbon vehicles** – we imagine you will want to push this (the manifesto pledged to help hybrid vehicles and fuel cells, and a consultation document has now proposed ambitious targets for take up). Idea include lower/zero VED, and reduced excise duty.

Biofuels (also supported in the manifesto) could receive further help – they probably need this to render economic the best technologies such as bioethanol. But going further to those (such as biodiesel from oil seed rape) where the economic/environmental case may not stack up would prove costly. There is a good case for announcing help for **Sulphur-free petrol** from 2003 – this fuel is necessary for the 30 per cent improved fuel efficiency that the new GDI engines should bring. Care would be needed in design, to avoid cost to the exchequer.

We could clean up the filthy **'red' diesel** used by farmers, construction vehicles, trains, quarries etc. At present, despite paying around 1/10 of the duty of ordinary diesel these groups use fuel with 40 times the Sulphur! A tightening in Sulphur limits to only 10 times that of ordinary diesel would raise fuel prices to those users by significantly less than 1p a litre (although farmers could complain at even this). Going to the same Sulphur levels would raise prices by 2-3p.

Finally, the most undertaxed part of transport is air transport. Given the state of the industry post September 11 this may not be the time to increase taxation, and in any case the obvious measure – air fuel tax – can only be done with other

countries (although a unilateral voluntary agreement with UK air industries to restrict CO2 may be deliverable). But we could move towards reform of **air passenger duty** to reflect factors such as noise/pollution (a consultation document has already sought views on 'charging' for NOx and noise, and this might alternatively best feature in the Aviation White Paper).

Business

The Combined heat and power (CHP) industry is not doing well at present, because of high gas prices. The Government's target of 10% of energy from CHP by 2010 is way off being met. There has been strong lobbying for **CHP to be exempted from the climate change levy**. There is some logic to this, but it would cost £40m.

The Climate Change Levy, which began last year, has not been universally popular. But together with the associated negotiated agreements it is estimated to save 5 million tonnes of Carbon – and it is therefore a very important plank in our climate change strategy. It raises over £1bn, ploughed back in lower employer national insurance. It could be worth announcing that we will **review the working of the levy** in a year's time – industry would welcome this.

DEFRA have proposed a package of more or less well thought out **measures on energy efficiency**. Jo Simons will give you a note on energy efficiency around the end of February - after the publication of the PIU energy report. There are, like waste, no easy solutions. The DEFRA options for tax breaks are quite detailed, covering lower VAT on high efficiency boilers and stamp duty changes, but you may wish to signal your support in principle.

The last Budget consulted on, and the PBR took forward, **corporation tax incentives** for investment in certain types of green technology. The first tier of technologies to benefit in this way is in the areas of energy saving, water use/ pollution and cleaner fuels and vehicles. This is useful, and something on which we can build. It will encourage investment and, if properly, targeted innovation. Other areas to which the incentives could be extended include other environmental clean up issues such as contaminated land and animal welfare (helping farmers reduce the cost of complying with regulation for example).

We might also encourage Treasury to think whether the tax system could do more to help **R&D in areas where technologies are still over a decade away from market**, such as fuel cells and nuclear fusion.

Agriculture

The pesticides voluntary reduction package - which was set up to let the industry show sufficient improvements in performance to render a pesticides tax unnecessary - started in April 2001. The PBR stated that it would be reviewed in the run up to the 2002 Budget (with a possible tax should it not have delivered).

When you looked at this last year Nick, as MAFF minister, was opposed to a **pesticides tax** under any circumstances, and you agreed. Margaret, as DEFRA minister, has said she would prefer the voluntary package to work, but thinks that we should not rule out a tax. There is a clear and comprehensible rationale for a tax – most people think of pesticides as bad. And properly designed it could work. Paul Boateng has been bullish on this with the NGOs. It is not the only way to clean up farming. But it has the advantage of not involving public spending, and perhaps even freeing up some money for related spending.

DEFRA have only more recently started looking at the huge issue of diffuse water pollution. Put briefly, they have done a lot to clean up 'point sources' of pollution, such as sewage farms and heavy industry. But farming – through general nitrate and phosphate deposition – has barely started to tackle pollution.

The nitrate vulnerable zones legislation will tackle the nitrate problem, at disproportionate cost. A **fertiliser tax** would help also tackle phosphates. If we want to do this, it may well be the best instrument available. Can't do it at present.

The timing is not good however for either measure. A farming backlash before we have responded to the Policy Commission would not be helpful. And the environmental part of farm costs will rise sharply with the nitrates legislation. So while we may need the threat of pesticides tax to deliver a reasonable voluntary agreement, there is much to be said for playing this long. We could suggest an item in the next PBR on the Policy Commission, perhaps including some of the DEFRA work on diffuse pollution. Meanwhile, we could seek another year's grace on the voluntary pesticides scheme.

MARTIN HURST

File

From: **Mike Emmerich**
Date: **18 January 2002**

cc **Jeremy Heywood**
Sally Morgan
Andrew Adonis
Derek Scott
Geoffrey Norris
Martin Hurst
Jo Simons
Natalie Acton

PRIME MINISTER

VAT ON HOUSING

At the awayday we discussed the difficulty there is likely to be in putting major investment into housing. This re-enforces the need to look creatively at other levers, including tax and the planning system, which can help to meet our objectives. There is a short-term opportunity to do so and to raise revenue by extending VAT to cover new build houses and reducing the rate on repairs, maintenance and improvement. This note sets out the policy and handling issues and invites your view on whether you would like to see this taken forward as a Budget starter.

Policy Issues
The present VAT structure for housing is anomalous. We charge the full rate of 17.5% on repairs, maintenance and improvements (RMI) despite our wish to improve housing conditions and make best use of the existing housing stock. At the same time we have a zero rate for the building of new houses on greenfield sites despite our objective to concentrate new building on existing brownfield sites.

Reform of VAT could be designed so as to help to contribute to these and other Government objectives:

a) **Regeneration**. Making better use of and improving the condition of the existing housing stock through repair and improvements, rather than building new homes in greenfield sites contributes to this objective. This points to reducing the rate of VAT on RMI;

b) **dealing with environmental disbenefits** of building houses on greenfield sites and taking account of the positive regeneration benefits from developing brownfield land for housing. This points to a higher rate of VAT on new greenfield housing and a lower rate on new brownfield housing. This objective is reflected in the PSA target that 60% of new homes should be built on previously developed land and through conversions to existing buildings;
c) **Improving the Housing Stock**. There is an existing PSA floor target here too. The issue figures large in the current housing strategy review;
d) **An efficient tax system.** The positive externalities associated with RMI and brownfield development (in terms of better quality of urban life), and the negative externalities of greenfield development (environmental degradation etc), point to differential rates of VAT.
e) **A fair tax system**. Reducing VAT on RMI is a progressive tax shift. Raising it on greenfield is also progressive.
f) **Countering the informal economy**. Construction is the biggest sector in the informal economy. Lower VAT on RMI would reduce the price advantage of illegal working.
g) **Wider economic benefits**. Regeneration of deprived and run down areas has wider supply side benefits for the economy. A reduced need for new housing (through increased RMI) also frees up investment for other more productive use.

Depending on the package chosen, VAT reform could also raise substantial revenue. Turning to specifics

The imposition of VAT on new development. The introduction of VAT on new greenfield housing will reduce the price of greenfield land for development, reducing the incentive for greenfield landowners to sell. This will have very little effect on London and the South East because even with a 17.5% tax land is so valuable that owners will be prepared to sell. It would bite elsewhere with the positive benefit of deterring sprawl at city fringes; all the more so if you opt to maintain the zero rating of brownfield development. The 17.5% differential between greenfield and brownfield sites will bolster urban property markets and so help in tackling the major problem of abandonment and dereliction in low demand areas in the North and the Midlands. Demolition and redevelopment of unwanted and unsuitable stock is needed to regenerate these areas. Reducing VAT on RMI will help, but introducing a higher rate of VAT on greenfield than brownfield will provide a strong impetus to renewal in these areas.

Extending VAT to greenfield developments raises £1.6bn in revenue.

Reducing VAT on repairs, maintenance and improvement. There are two choices here: reducing VAT to 5% or more modestly to 10%. Analysis suggests that around 80% of the tax cut would be passed on to consumers leading to an 8.5% reduction in prices if you reduce VAT to 5%.

Reducing VAT to 5% costs more than a reduction to 10% - £550m rather than £920m, a saving of £370m.

Handling

In considering these proposals you need to bear in mind where colleagues, notably GB and JP are on the issue, how it squares with the manifesto and other policy statements, and how the issue will play with opposition parties given their stated views.

JP is strongly in favour reform in this area. SB will be too. The Rogers Urban Taskforce recommended harmonisation of rates but the subsequent Urban White Paper ducked the issue. GB may not be unsympathetic to reform here but is said to feel bound by commitments he has made. There is no record of any such commitments.

The manifesto commitment is fairly specific to key areas: "We renew our pledge not to extend VAT to food, children's clothes, books, newspapers and public transport fares." We have already extended the scope VAT in some very technical ways (anti-avoidance) although this would, of course, be far higher profile.

The Tories had little to say about VAT in the manifesto and nothing at all on this precise issue. R&I have not been able to track down anything subsequent of note. The Lib Dems proposed to harmonise VAT in their 2000 sustainability strategy, though they seem to have been silent since then.

It is worth bearing in mind that, whatever Conservative policy is on the issue, and regardless of their own past policy reverses, they have traditionally enjoyed strong support from the building contractors the value of whose greenfield land holdings will be affected.

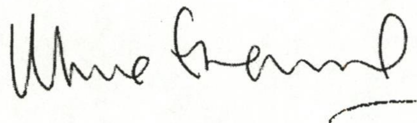
Summary

There is a very strong case for taking VAT reform forward in Budget 2002. If you agree, there are a number of options. We have only preliminary analysis from DTLR and Customs. At this stage we don't recommend harmonisation (and neither do DTLR – though Treasury may). You would raise more revenue and deliver better regeneration outcomes by:

- extending the scope of VAT to cover greenfield (but not brownfield) development. This would raise revenue of £1.6bn;
- reducing the rate of VAT on renovation, maintenance and improvement from 17,5% to either 10% or 5% at a cost of £550m or £920m

If you wish to take this forward, we will come back to you with further details if the arguments or numbers change significantly.

A DTLR paper setting out these ideas in more detail is attached to this note.



MIKE EMMERICH

VAT ON HOUSING

This note summarises DTLR views on the case for reforming VAT on housing. It is clearly daft to have VAT on something that we want (repair etc) and not on something we don't (especially building new homes on greenfield sites). But that is the situation we are in. Arguably there is a case for moving on each separately. Put together it makes an excellent package that, under our proposals, would produce net revenue. Alternatives are available that produce a revenue neutral package if that is preferred.

There are two elements to the reform:

(1) the introduction of VAT on building new homes; and
(2) the reduction of VAT on housing repair, maintenance and improvement (RMI).

2. The note sets out the objectives will be met by the reform in general and by the option we have proposed in particular.

Summary

3. The present VAT structure for housing is anomalous and damaging. We charge the full rate of 17.5% on repairs, maintenance and improvements (RMI) despite our wish to improve housing conditions and make best use of the existing housing stock. At the same time we have a zero rate for the building of new houses on greenfield sites despite our objective to concentrate new building on existing brownfield sites.

4. Any reform of VAT should be designed so as to help to contribute to several Government objectives:

a) **Regeneration**. Making better use of and improving the condition of the existing housing stock through repair and improvements, rather than building new homes in greenfield sites contributes to this objective. This points to reducing the rate of VAT on RMI;

b) **dealing with environmental disbenefits of building houses on greenfield sites and taking account of the positive regeneration benefits from developing brownfield land for housing**. This points to a higher rate of VAT on new greenfield housing and a lower rate on new brownfield housing. This objective is reflected in the PSA target that 60% of new homes should be built on previously developed land and through conversions to existing buildings;

c) **Improving the Housing Stock.** The recent trilateral on housing showed that HMT, DTLR and DWP are firmly united in believing this a key policy and political objective.

d) **an efficient tax system.** The positive externalities associated with RMI and brownfield development, and the negative externalities of greenfield development, point to differential rates of VAT;

e) **a fair tax system.** Reducing VAT on RMI is a progressive tax shift. Raising it on greenfield is also progressive.

f) **countering the informal economy.** Construction is the biggest sector in the informal economy. Lower VAT on RMI would substantially reduce the price advantage of illegal working.

g) **wider economic benefits.** Regeneration of deprived and run down areas has wider supply side benefits for the economy. A reduced need for new housing (through increased RMI) also frees up investment for other more productive use.

5. Depending on the package chosen, VAT reform could also raise revenue. The option we have put forward would raise approximately £700 million.

6. The measure is consistent with Manifesto commitments and with the Chancellor's recent comments about VAT, for example on Breakfast with Frost. It is also in the spirit of the report from Lord Rogers.

7. Our preferred option for VAT reform would involve reducing VAT on RMI from 17.5% to 5% (the lowest permitted rate), keeping brownfield new build zero-rated, and introducing VAT at 17.5% on greenfield new build.

8. Econometric analysis of the RMI market has allowed the estimation of how much of the tax cut would be passed on to consumers, and the implications in terms of the demand and supply response. **The tax cut would be progressive** and output would increase by **£700m**. This will help improve housing conditions, and through encouraging better use of the existing housing stock, help reduce the pressure for new housing.

9. The imposition of 17.5% on new greenfield housing will depress the price of greenfield land. The tax will therefore effectively fall on landowners[1]. House prices will barely be affected. Introducing VAT will send out a clear signal to the market about our policy objectives for brownfield and greenfield development, reinforce other Government policies, such as PPG3 on housing and planning obligations, and help the planning system deliver the 60% target in a more economically efficient way. The 17.5% differential between greenfield and brownfield also sits very well with proposals for a Housing Market Renewal Fund to deal with abandonment of old and unsuitable housing, particularly in the North.

10. The effect on greenfield development will vary around the country, and will be largest in Northern regions where betterment levels are relatively low. **But our analysis is that the overall impact is likely to be enough to bridge the gap between where we are now and the 60% PSA target.**

11. **The overall distributional impact of the tax change will be progressive.** Both the impact of increased VAT on greenfield new building and the VAT cut on RMI are progressive. These effects will be reinforced by the true incidence of VAT on greenfield being felt largely by landowners.

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[1] In the short run, many housebuilders are landowners because they hold 2-3 years supply of landbanks.

12. **The package as a whole will help the regeneration and renewal of housing and disadvantaged areas more generally, particularly in the North**. The net effect of the package is to transfer resources from the South to Northern regions. This effect could be reinforced through the use of the additional £700m revenue raised.

13. The effects of the packages are described in more detail below:

Detailed Analysis

Preferred option (A) - (17.5%/0%/5%, i.e. 17.5% on greenfield new build, 0% on brownfield new build, and 5% on RMI)

RMI

14. Our analysis shows that, for RMI expenditure as a whole, reducing the rate of VAT to 5% will mean:

- 80% of the VAT reduction will be passed onto the consumer, meaning a fall in prices of 8.5%;
- RMI output will increase by **£700m** (7%);
- the measure will have a greater than proportionate effect on those in lower income groups and so is a progressive tax cut;
- the size of the informal economy will fall by one-quarter.

15. This will lead to better use of the existing housing stock as well as improving its condition, reducing pressure for new housing. Increasing extensions, for example, will help reduce new housing demand.

16. Our econometric analysis indicates an RMI elasticity of supply of 3.4. Combined with Customs' estimates of the elasticities of demand (-1 for improvements and -0.25 for repairs and maintenance), this indicates that:

- 77% of the tax cut will be passed on for improvement work;
- 93% of the tax cut will be passed on for R&M work.
- £700m (7%) additional work will be carried out.

17. The table overleaf shows the progressive nature of reducing VAT on RMI. It shows, for each household income quintile[2], the proportion of income saved per household as a result of the VAT reduction. People in lower income groups pay more VAT on RMI as a proportion of their income is higher than richer people, so the VAT cut is progressive. The table also shows how this would compare to a similar sized reduction in income tax – the cut in RMI is much more progressive.

18. As requested, we have shown both the expected incidence of the VAT cut – with 80% passed through to consumers – and what happens if the effect of the VAT change is fully passed on to consumers. This makes no difference to its progressivity.

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[2] Based on data from Construction Forecasting and Research Ltd (1996) – *'Repair, Maintenance and Improvement in Housing'* and the Family Expenditure Survey.

Saving from a cut in VAT on RMI (% of household income)

Income Quintile	Effect of VAT cut (as % of household income): expected incidence of the tax cut	Effect of VAT cut (as % of household income): if tax cut fully passed on	Effect of cut in income tax (as % of household income) costing the same as the VAT cut
Bottom	0.28%	0.22%	0.03%
2nd	0.20%	0.16%	0.06%
3rd	0.14%	0.11%	0.10%
4th	0.14%	0.11%	0.13%
Top	0.09%	0.07%	0.17%

New build

19. Introducing VAT on new greenfield housing:

- on its own, could shift 150 hectares (ha) from greenfield to brownfield development. This could bridge the gap between the current proportion of housing on brownfield (57%) and the target of 60%, even without taking into account the additional "signal" effect of such a change;

- will provide a clear signal to the market about our policy objectives to make better use of the existing housing stock and brownfield sites rather than developing greenfield sites for housing. This signalling effect may help to depress the price of greenfield land further and dissuade such development from taking place;

- will support and reinforce other Government policies such as PPG3 and planning obligations;

- help the planning system achieve targets for the re-use of brownfield land in a more economically efficient way.

20. The introduction of VAT on new greenfield housing will reduce the price of greenfield land for development, depressing the betterment available and reducing the incentive for greenfield landowners to sell. Indeed, where the VAT is greater than the betterment to the landowner, less greenfield land will be sold for development.

21. Our analysis shows that a number of areas across the country, particularly in the North, where greenfield development will be affected. This is a difficult effect to estimate, but the table below shows the number of local authority areas in each region (55 in total), where the *average* greenfield landowner's betterment will be wiped out by a 17.5% rate and the estimated amount of greenfield development in these areas.

22. This is our central estimate of the amount of greenfield development that either shifts to brownfield or does not go ahead. It is subject to wide margins of error. We only have data for average betterment in local authority areas; but not all the greenfield land in these areas will cease to be attractive for development. On the other hand, some greenfield land in other LA areas not listed here will also be affected.

Region	LAs affected	Potential amount of greenfield land affected (hectares)	Land affected as a % of greenfield land developed for residential use[3]
North East	8	26	14.9%
North West	15	18	4.1%
East Midlands	11	63	14.3%
West Midlands	5	6	2.1%
Yorkshire and the Humber	6	17	4.4%
East	4	5	1.1%
South West	5	13	2%
South East	1	1.5	0.2%
London	0	0	0%
Total	**55**	**150**	**4.2%**

23. Where there is a reduction in greenfield sites for housing development, there would be some substitution into brownfield land. The 150 hectares identified above equates to 4.2% of annual greenfield development (for residential use[3]). If this were substituted into brownfield development, it would increase the percentage of new housing on brownfield development to 3 percentage points[4], i.e. from 57% to 60% - hitting the PSA target. The proportion of new dwellings on brownfield has remained around the 57% mark since 1995 (data are only available up to 1998). Such a shift would therefore be significant.

24. However, even this positive outcome takes no account of the signal effect of the measure, which will have a further impact. Resulting lower land prices may dissuade landowners to bring forward land for development. Changes to planning obligations, the subject of a forthcoming consultation document, are likely to increase the betterment captured, thus reducing the greenfield land price further and so increase the effectiveness of the measure. It will also support the planning policy guidance for housing, PPG3, which gives a clear priority to brownfield sites.

25. The 17.5% differential between greenfield and brownfield sites will help in tackling the major problem of abandonment and dereliction in low demand areas in the North and the Midlands. Demolition and redevelopment of unwanted and unsuitable stock is needed to regenerate these areas. Reducing VAT on RMI will help, but introducing a higher rate of VAT on greenfield than brownfield will provide a strong impetus to renewal in these areas.

26. The proposed changes to VAT will also help to ensure that the greenfield land that does come forward for development is the most productive for development purposes. In this way, VAT reform should help relieve some of the pressure on the planning system, allowing it to achieve the 60% brownfield target in the most economically efficient way.

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[3] This includes land for institutional and communal accommodation. Such accommodation is excluded from the calculations of dwellings for the 60% target.

[4] Assuming the current densities (22 dwellings per hectare on greenfield land and 29 dwellings per hectare on brownfield land). However, even if – contrary to expectation – this leads to 150 ha less greenfield development and no additional brownfield development, the VAT change would still shift previously-developed from 57% of the total to 60% - hitting the PSA target.

27. The impact on greenfield development is likely to be greatest in the North where betterment levels are much lower than in the South East for example. A higher rate of tax would be required to have a bigger effect in these areas.

28. All the above analysis is based on the expected incidence of the tax change – mainly landowners. We were also asked to look at what happened if the VAT was fully passed on to consumers.

29. In that case, the impact on greenfield development would be much larger. The tax change would also be much more progressive. Although 17.5% on greenfield new build would raise £1.6 billion, the bottom quintile would lose only 0.03% of their income. The top quintile would lose 0.26%.

30. Overall, our preferred option would – if the tax change were fully passed on – have the following progressive structure. (Positive figures are gains to individuals, i.e. tax cuts.)

Effect of option A (% of household income) if VAT changes fully passed on

Income Quintile	Net effect of VAT reform	VAT on RMI cut to 5%	VAT on greenfield increased to 17.5%
Bottom	+0.25%	+0.28%	-0.03%
2nd	+0.09%	+0.20%	-0.11%
3rd	-0.11%	+0.14%	-0.25%
4th	-0.15%	+0.14%	-0.29%
Top	-0.17%	+0.09%	-0.26%
Average	-0.10% (£+680m revenue)	+0.14% (-£920m)	-0.24% (+£1600 m)

31. This paper only looks at the substantive issues and principles of reform, to enable a decision to be reached in principle. There are a number of significant second-order issues – treatment of RSLs, the possibility of transitional arrangements – that are not dealt with here.

Regional Impact of the Package

32. The following table shows the regional distribution of the effect of the proposed VAT reform. As it is a revenue-raising option, the overall effect is to raise revenue of about £700m across the country. Most regions therefore have a net negative impact (as with any tax-raising change). However, the North of England gains from the VAT reform.

33. There is generally redistribution of income from the South to the North and to Wales, and also to London (because of the small amount of greenfield development that takes place in London). The South East outside London, which has the most greenfield new build and also where such building imposes the largest external costs, face the most adverse effects.

Region	Costs from VAT on greenfield new build (£m)	Savings from lower VAT on RMI (£m)	Net impact (£m) (Negative = tax cut)
North East	51	-109	**-57**
North West	104	-164	**-60**
East Midlands	196	-41	**155**
West Midlands	126	-76	**50**
Yorks and Humber	124	-79	**45**
East of England	68	-22	**46**
South West	199	-42	**157**
South East(ex Lon)	356	-21	**335**
Greater London	46	-101	**-55**
Scotland	153	-64	**89**
Wales	82	-116	**-34**
Northern Ireland	96	-84	**12**
Total	**1600**	**-920**	**680**

(In this table, **negative** figures represent gains for the regions, i.e. VAT reductions.)

Presentation

34. Our preferred option would be presented as a structural change to the VAT treatment of housing, rather than a revenue raiser. It would be a re-balancing of VAT to reflect the positive impacts associated with repairing the existing housing stock and building new houses on previously developed land, and the negative impacts of greenfield development. The change will help the delivery of the Government's 60% target and would be presented as such. The benefits of the complete package would be:

- increased RMI means a reduced need for new build, in all parts of the country including the South East;
- positive regeneration benefits, both from RMI and a switch to brownfield new build, in the areas (i.e. the North) where these benefits are most needed;
- help in achieving 60% target for building new houses on brownfield land and helping the planning system to achieve this at lower economic cost;
- sending out an important signal to the market about the Government's objectives and priorities for building new housing on brownfield rather than greenfield sites.

35. In response to accusations that Daily Mail-style assertions this represents 'VAT on your home', we would argue that:

- The package would have a negligible impact on housing costs;
- Prices paid by homebuyers would be hardly affected, the VAT yield will be offset in the form of lower greenfield land prices;
- Important to see this package as a whole. Most people would gain. They would pay less VAT because of lower VAT on RMI;
- Greenfield housing imposes environmental costs, whilst brownfield housing and RMI have benefits. It is right that the tax system takes this into account.

Other options

36. We were also asked to consider three other options. They are:

	Greenfield new build	Brownfield new build	RMI
Option B	5%	0%	5%
Option C	17.5%	5%	5%
Option D	5%	5%	5%

Our view is that B is better than C, and D is the least desirable option. Options C and D actually put VAT up on something we want to encourage. This would be presentationally very difficult (as well as strange economics).

Option B **(5%/0%/5%)**

37. This option is similar in structure to option A and has similar - but smaller - advantages. But the impact on greenfield development will be much less significant and it would not raise any extra revenue.

38. The reduction in VAT on RMI is still very beneficial, helping to improve the condition and make better use of the housing stock, and reduces the size of the informal economy. The higher rate of VAT on new greenfield houses than brownfield houses provides a good signal to the market. But the number of areas where betterment will be wiped out by the introduction of a VAT rate of 5% will be much smaller.

39. This could be presented as an important change in VAT, which reflects the positive impacts associated with repairing/improving existing housing and re-using brownfield sites and the negative impacts of building on greenfield sites. This is an overall reduction in housing costs for the public.

40. This option retains the zero rate of VAT for brownfield development, avoiding any risk that some brownfield sites become financially unviable through the introduction of VAT, which is a potential cause for concern with option C.

Option C **(17.5%/5%/5%)**

41. There is a clear beneficial impact from the reduction in VAT on RMI as for options A and C. A higher rate of VAT on greenfield than brownfield still provides a very strong signal about priorities for development. But the direct impact is less because of the differential of 12.5% with brownfield. This would be a good revenue raiser.

42. However, there is a risk that some brownfield sites become unviable or unprofitable for housing development because of the introduction of the 5% rate of VAT. The betterment on brownfield is likely to be less than on greenfield because of:

- the alternative use of the land, and
- the higher costs of land reclamation.

43. This could mean that betterment is wiped out on brownfield sites. The impact would be very site specific, but it could cause some sites to be put forward for non-residential development and others might not be developed at all. If there were a reduction in brownfield sites this would put extra pressure on greenfield development.

44. This option generates some helpful signals, but introducing a positive rate of VAT on brownfield confuses them. There is a concern that this could be counterproductive for the brownfield target; it will depend on the relative profitablity of greenfield and brownfield sites in each area. The data does not exist for the analysis of this issue. This would be an unnecessary extension of VAT, which does not hit any policy objectives.

45. Presentationally, introducing VAT on brownfield would be a very strange thing to do. It would muddy the presentation of the beneficial impacts of reducing VAT on RMI and introducing VAT on greenfield.

Option D **(5%/5%/5%)**

46. As with all the other options, there are clear benefits from reducing VAT to 5% on RMI. This package also creates tax neutrality between the building of new houses and the repair of existing ones.

47. We can see the attraction of this option. It would be easiest for Customs to administer. It gives up all our zero rates in one go. It might also seem easier for builders to administer as it removes some of the dividing lines in the tax system with different rates RMI and new build. However, complexity and differential VAT rates would remain, as commercial buildings would still be subject to VAT at 17.5%, so it is by no means a complete answer even on this front.

48. More seriously from the point of view of pursuing our objectives, this option does not contain a signal between greenfield and brownfield development. Applying

the same VAT rate to new houses on greenfield *and* brownfield would be administratively easier, but could be counter-productive for the 60% target. This is a much bigger risk than in option C. Greenfield sites typically have larger betterment than brownfield. As a result, more brownfield sites than greenfield sites could become unprofitable as a result of applying VAT, leading to fewer brownfield sites used for housing development and pushing away from the 60% target.

49. As with option C, this option would include an unnecessary extension of VAT to something we actively want to encourage – re-development of brownfield sites for housing.

DTLR
December 2001

SV
I agree with this

From : Stephen Aldridge
Date : 8th January 2002

Simon Virley **cc** Geoff Mulgan

ORPHAN ASSETS

1. You asked for comments on the suggestion made by Frank Field through David Blunkett, just before Christmas, that a windfall tax should be introduced on the orphan assets of life insurance companies. I'm sorry I haven't responded sooner but now attach a short note.

2. The note is based on publicly available information (on the web and elsewhere). We haven't spoken to anyone about it.

3. The note concludes that the case for such a tax doesn't appear to be strong with arguments for and against. However, there are reviews underway of with-profits policies (by the FSA) and of the medium and long term retail savings industry (by Ron Sandler). Both of these are touching on the issue of orphan assets. It may therefore be appropriate to return to the question of the tax treatment of orphan assets once these reviews are completed (later this year).

4. No doubt the Sandler Review could be asked, if necessary, to look more closely at the issues involved than it currently plans (at present orphan assets are not a central focus of the Review).

5. Happy to discuss.

Stephen Aldridge
Performance and Innovation Unit

ORPHAN ASSETS

Key points

- orphan assets are funds held by life insurance companies in excess of the amounts needed to fulfil their obligations to policyholders;

- recent estimates suggest the stock of orphan assets has a value of around £10bn. Most of this is accounted for by a relatively small number of companies;

- in the case of mutual insurers, the benefit of orphan assets accrues entirely to policyholders. In the case of non-mutual insurers, the benefit of orphan assets normally accrues to policyholders and shareholders in the proportions 90% : 10%. However, there is no general rule about this – the proportions can and do vary depending on individual companies' circumstances, practices and statements;

- the FSA is currently conducting a review of with-profits policies, including the apportionment of orphan assets. Though the FSA believes consumers have not been disadvantaged by current arrangements, a recent FSA issues paper raises the question whether policyholders' rights might be strengthened by (e.g.) the appointment of an independent expert to represent them;

- Frank Field has suggested that there is a case for a windfall tax on orphan assets to raise revenues for public services. This has obvious superficial attractions and has some parallels with proposals made several years ago to tax the windfall gains arising from building society demutualisation. To the extent that orphan assets give older-established companies in-built advantages, such a tax could also be good for the competitive dynamics of the insurance industry;

- but there are also significant downsides :

    - (i) it would clash with the claims of policyholders and/or shareholders to orphan assets, which have been explicitly acknowledged in past Government statements on the issue – though arguably such claims are much stronger for past than current generations of policy- and/or shareholder;

- (ii) orphan assets are already governed by the same tax regime as other assets held by life insurance companies. It's not clear how a more penal regime for orphan assets would be justified;

- (iii) the burden of any tax would fall most heavily on life companies that had, prudently, decided not to pay out all their surplus assets. This could create perverse incentives to minimise the holding of surplus assets in future;

- (iv) it would undermine the role orphan assets play in underpinning the solvency of the insurance industry. One reason for Equitable Life's problems was its policy of distributing all surplus assets; and

- (v) the existence of orphan assets provides a cushion against volatile financial markets for policyholders. It is not clear that removing this cushion would be conducive to the efficient functioning of savings markets or the promotion of business investment. However, this is to some extent an ex post rationalisation : volatility and, indeed, the solvency of the industry could be addressed in other ways.

- as well as the FSA review of with-profits policies, Ron Sandler is currently undertaking a review for the Government of the medium and long term retail savings industry. The Sandler Review will touch on the question of orphan assets and their impact on the industry. A more thorough review of the tax treatment of orphan assets might therefore be undertaken once the Sandler Review is completed (later this year). However, on the basis of this initial assessment, the case for a windfall tax does not appear to be strong with arguments both for and against.

What are orphan assets?

1. Orphan assets are funds held by life insurance companies in excess of the amounts needed to pay policyholders their promised annual and terminal bonuses. They are sometimes also referred to as "ownerless assets" since, in non-mutual insurance companies, it may not be clear whether the assets concerned belong to policyholders or shareholders or some combination of the two.

2. Such assets are likely to have come from a number of sources :

- some may have been injected by shareholders in years gone by;

- whilst others may simply result from excess returns to life funds which, with the benefit of hindsight, should have been allocated to past generations of policyholders. With advances in technology and actuarial techniques since the 1960s, this is now much less likely to happen.

3. Orphan assets differ from unclaimed assets, for which there is an identifiable owner but which have remained dormant or unclaimed for some period of time.

How much are such assets worth?

4. Various estimates are quoted for the value of orphan assets held by life insurance companies. At the recent stock market peak, it was suggested that life insurance companies held orphan assets worth in excess of £20bn. More recent estimates in the financial press suggest a value of around £10bn.

5. Orphan assets are not evenly distributed amongst life insurance companies. It is suggested that a relatively small number of companies (including the Prudential, CGNU and Legal & General) account for the great majority of the stock of orphan assets. This partly reflects the long history of these companies. But policy factors are also important : companies such as Equitable Life have had a longstanding policy of paying out all surplus funds to policyholders.

Who has ownership claims on orphan assets?

6. In the case of non-mutual life insurance companies, the benefits of orphan assets are normally apportioned as follows : 90% for policyholders and 10% for shareholders. Indeed, some life insurers have this 90 : 10 rule enshrined in their articles of association.

7. However, there is no general rule governing the apportionment of orphan assets between policyholders and shareholders. Depending on a company's circumstances, practices and statements different apportionments are legally possible.

8. In the case of mutual life insurance companies, the benefits of all orphan assets go to policyholders.

What is the current policy towards orphan assets?

9. The distribution of orphan assets between policyholders and shareholders is guided in the case of non-mutuals by the concept of policyholders' reasonable expectations.

10. A Ministerial statement in 1995 noted that : it was "common practice to make distributions to policyholders and shareholders in the proportion 90-10". In assessing policyholders' reasonable expectations, the regulatory authorities would, the statement continued, "expect this ratio to be used as the basis of attribution between policyholders and shareholders, unless there was clear evidence, based on a company's circumstances, statements or practice, that a different proportion was appropriate ...".

11. The Financial Services Authority (FSA) has powers to intervene to ensure companies meet the reasonable expectations of their policyholders (though there is currently no formal requirement for companies to seek regulatory approval for plans to apportion orphan assets).

Are there any plans to change current policy?

12. The FSA is currently conducting a review of with-profits policies. As part of this, it published an issues paper on the apportionment of orphan assets in October 2001 with a deadline for responses of mid-December. The conclusions of the review will be published in the Spring of 2002.

13. The issues paper argues consumers have *not* been disadvantaged by current arrangements. However, the Axa Sun Life case, and the criticism it attracted from consumer groups, may have prompted a re-think (Axa fought off a High Court challenge from 1,800 policyholders at the end of 2000 to apportion £1.7bn of orphan assets in the ratio 70 : 30 in favour of shareholders).

14. The FSA issues paper raises the question whether the process of attributing assets should be reformed. Options suggested include : the appointment of an independent expert to represent policyholders' rights or new powers for the FSA to act on behalf of investors.

Is there a case for taxing orphan assets?

15. It has been suggested by Frank Field that there is a case for a windfall tax on orphan assets to raise extra revenues for public services. Such a proposal has obvious superficial attractions and has some parallels with proposals made several years ago to tax the windfall gains arising from the demutualisation of building societies. To the extent that orphan assets give older-established companies in-built advantages, such a tax could also be good for the competitive dynamics of the insurance industry.

16. But there are also significant downsides :

- there are other stakeholders with strong claims on these assets : policyholders and/or shareholders – as explicitly acknowledged in past Government statements on the issue. However, such claims are arguably much stronger for past than current generations of policy- and shareholder;

- orphan assets are already governed by the same tax regime as other assets held by life insurance companies. It's not clear how a more penal regime for orphan assets would be justified;

- the burden of any windfall tax would fall most heavily on life companies that had, prudently, decided not to pay out all their surplus assets. This could create perverse incentives to minimise the holding of surplus assets in future;

- orphan assets help to underpin the solvency of the insurance industry. Equitable Life's financial difficulties have been compounded by its policy of paying out all surplus assets. Other insurers have used the cushion of orphan assets to help deal with one-off costs such as pension mis-selling; and

- the existence of orphan assets provides a cushion against volatile financial markets, enabling life companies to hold a higher proportion of their assets in more rewarding but higher risk assets (such as equities) and allowing them to smooth the payment of bonuses paid to policyholders. It is not clear that removing this cushion would necessarily be conducive to the efficient functioning of savings markets or the promotion of high levels of business investment. However, both this consideration and the preceding one is to some extent an ex post

rationalisation : orphan assets are not the only way of protecting with the solvency of the industry or of dealing with volatility.

Conclusion and next steps

17. On the basis of this initial assessment, the case for a windfall tax on the orphan assets of life insurance companies does not appear to be strong with arguments both for and against.

18. Ron Sandler is currently conducting a review of the medium and long term retail savings industry for the Government whilst the FSA is conducting the separate review of with-profits policies mentioned above. Both are due to report during the course of 2002. The Sandler Review is expected to touch on the question of orphan assets and their impact on the industry. A more thorough review of the tax treatment of orphan assets might therefore be undertaken once the Sandler Review is completed.

Performance and Innovation Unit
January 2002