Family-Friendly Taxation

How to restore fairness to the tax system

BY THE RT HON RANIL JAYAWARDENA MP
& TOM CLOUGHERTY

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Introduction

When we think about how well-off people are, we do not tend to consider them as wholly atomised individuals. Instead, we look at their household circumstances. How much income does the family as a whole receive? How many adults and dependent children are there to clothe, house, and feed? A family's standard of living does not just depend, after all, on how much the highest earner brings in (although this is obviously a factor) but rather on a broader view of that family's income and unavoidable outgoings. Indeed, this is how government statistics on poverty and inequality work, and is the basis on which the welfare state operates.

Yet in almost every respect, the British tax system looks at things differently – basing how much tax someone should pay solely on their individual earnings, with no reference to the bigger picture. We mostly take this for granted today, but it is actually a fairly recent phenomenon – at least in its current, extreme form – dating back to the introduction of so-called 'independent' taxation in 1990. And, while not unique internationally, this approach certainly marks Britain as something of an outlier among its peers. Most OECD tax systems do significantly more for families, relative to individuals, than ours does.

'This is an issue that is rising up the political agenda, and pro-family policy reforms should certainly be part of any vision for the future of British conservatism'

Like so much of British public policy, the hyper-individualistic focus of the personal tax system does not reflect high principle or grand design, but rather an accident of history and short-term political expediency. The late Lord Lawson, who instigated the shift to 'independent' taxation in the 1980s, always intended that it be accompanied by transferable allowances to even out the impact on families. But his vision was compromised in its implementation, and then undermined by his successors.

There has recently been a flourishing of interest in family-friendly tax reform on the British right. Reports from Policy Exchange and Onward have made the case for taxing families more fairly.[1] And multiple Conservative leadership candidates made it part of their platforms last summer. This is an issue that is finally rising up the political agenda, and pro-family policy reforms should certainly be part of any vision for the future of British conservatism. But in our view, there is also a compelling case for *this* government to act ahead of the next general election.

As we detail in the following chapters, there are serious problems with the way we tax families in the United Kingdom today. For one thing, families with the same

1 See Stanley et al., 'Family Fortunes', Onward (2021) and Booth & Rogobete, 'Taxing Families Fairly', Policy Exchange (2022). The latter makes the important point that 'The family is the most fundamental level at which economic resources are distributed' (p. 12).

overall earnings can pay wildly different amounts of tax – and have very different disposable incomes as a consequence, hitting the quality of life of millions. This is the result of pairing a highly 'progressive' tax structure with the individual as the sole tax unit – and it is getting worse right now, as frozen tax thresholds combine with high inflation to make many more people higher rate taxpayers. Policies like the child benefit tax charge and withdrawing childcare subsidies from higher earners, which create punitive marginal rates and cliff edges in the tax system, do not help.

Families in which one person stays at home (or works only part time) to look after young children, or care for elderly or disabled relatives, are particularly affected by this aspect of the tax system – with one-earner households facing *much* higher tax bills than households in which the same income is split equally between two earners. This disparity undoubtedly inflates demand for state services, whether it is taxpayer-funded nursery places or care for the elderly. We all pay more. It seems deeply unconservative. Surely we should support people who *choose* to take on caring responsibilities – or at least make sure the state does not discriminate against them, as it does at the moment?

'There are serious problems with the way we tax families in the United Kingdom today'

The reforms we propose later in this report would particularly help families with children. It makes sense to prioritise such tax cuts because they bring relief at a time in life when people's finances are particularly stretched – but also because we, as a country, ought to be doing everything we can to support family formation and parenthood as we face up to the realities of an ageing population. Our nation needs more children as we seek to build a healthy economy, but this is not an exercise in social engineering; it is about removing the barriers to people supporting the children they *want* to have. It is about giving people control over their lives.

We know our focus on dramatically expanding the *marriage* allowance will be controversial in certain quarters. But we think it is right that the legal advantages of coupledom should be tied to people making a binding legal commitment to each other, whether through marriage or civil partnership, both of which are open to everyone. We also cannot overlook the evidence that marriage leads to greater family stability and, even adjusting for income and education, better outcomes for children. At the moment, our tax and benefit systems combine to create a severe 'couple penalty' for less well-off Britons. Anything we can do to redress the balance constitutes a step in the right direction.[2]

Of course, it is not just in the taxation of earnings and the provision of benefits that the state can interfere with family finances in an unfair way. Inheritance tax, too, remains an unjust imposition by government into what ought to be *family* affairs. It is complex, costly, and economically distortionary. Abolishing it could strike a simultaneous blow for the family and for economic dynamism. At the very least, it is high time Conservatives made good on their pledge to raise the threshold to £1 million for every estate.

2 On the couple penalty, see Brewer & Adam, 'Couple premiums and penalties in the UK tax and benefit system', Institute for Fiscal Studies (2010). On the benefits of marriage, see Worringer & Odone, 'Family Structure Matters', Centre for Social Justice (2020).

We believe that this report makes a powerful case both for immediate change – on the marriage allowance, child benefit, and inheritance tax – and for further research to develop a more all-encompassing pro-family agenda for a future government. We hope it is taken seriously as a plan of action by our friends and colleagues across the conservative movement.

Executive Summary

- The British tax system is unfair towards families, because it focuses almost exclusively on individual incomes without reference to *household* income.

- This contributes to the couple penalty in the benefits system, while also causing major 'horizontal equity' problems in the tax system: two families with the same overall income can end up paying dramatically different amounts of tax depending on how income is distributed within a couple.

- As a rule, the more unevenly distributed income is within a couple, the higher the tax burden they will face. This is particularly unfair to couples in which one person stays at home or only works part time because of care responsibilities, whether looking after a child or caring for an elderly or disabled relative.

- A couple with two children and £25,000 of household income will face an average (overall) tax rate ranging from 0% to 15% depending on how their earnings are divided; at £50,000, the range is 16-23%; at £75,000, it is 21-33%; and at £100,000, it is 24-35%.

- We believe the tax system needs to be more family-friendly, as this is crucial for the long-term economic growth we all need.

- In this report, we will look at some of the ways in which we could fix this problem – and inheritance tax, another unfair and unpopular tax that cuts against people's desire to look after their families.

- It is important to highlight that this is not a radical agenda. It is correcting an existing injustice. Indeed, the United Kingdom does far less for one-earner married couples with children than most other countries.
    - An individual earning the average (mean) wage will pay less tax in the United Kingdom than in France, Germany, or the United States (and less than the OECD average).
    - By contrast, a one-earner married couple with two children and the *same* income will pay more tax than they would in France, Germany, or the United States (and more than the OECD average).

- We also need to address the problem of the high-income child benefit charge, which claws back child benefit between £50,000 and £60,000 of individual income. This not only contributes to the wider problem we describe, but also hits affected parents with shockingly high effective marginal tax rates.

- The withdrawal of childcare subsidies based on *individual* income over £100,000 also penalises families with an uneven income split, and creates a massive cliff edge.

- The main way the tax system currently tries to address this issue is via the marriage allowance. But this is mostly a symbolic policy with little real impact. It is also poorly designed and suffers from low take-up.

- In the short term, we should turn the marriage allowance into a *fully transferable personal allowance*. One hundred percent of unused personal allowance should be transferable to a spouse (not 10%) and there should be no income restrictions on making use of the allowance (at present, only basic rate taxpayers can use it).

- The table below shows the fiscal impact of various options for implementing this reform, as modelled by PolicyEngine:

Fully transferable personal allowance for...	Fiscal Cost
Married couples with a child below school age	£2.1bn
Married couples with a child of primary school age or younger	£3.1bn
Married couples with a child of school age or younger	£3.6bn
All married couples	£6.1bn

- Under this system, the bias against single-earner couples would end so long as total family income did not exceed £62,840, or the household did not contain a higher (or additional rate) taxpayer. At higher income levels, there would still be some unfairness – although less than in the current system.

- Over the longer term, however, we should look towards a more comprehensive reform of family taxation in the United Kingdom. One of the most attractive systems, though also the most expensive, is the French 'quotient familial', which not only equalises tax between families but lowers your tax bill according to the number of dependent children you have. This could also be adapted to help those looking after elderly relatives, alongside wider reforms of childcare support and other benefits.

- This reform option is much more expensive than making the personal allowance fully transferable, but adopting this model is a good aspiration for conservative tax reform over the longer term.

- We should also base the high-income child benefit charge on household income not individual income, and withdrawal should take place at a set taper rate over a wider range of income. (At the moment, your effective marginal tax rate between £50,000 and £60,000 depends on how many children you have.)

- Solving the issues with childcare subsidies is difficult – you cannot easily taper a benefit in kind, and it is unrealistic to expect nurseries to charge parents completely individualised rates depending on how much they earn. But you can at least base withdrawal on household income rather than individual income.

- The best solution would be to turn childcare subsidies into a simple refundable tax credit for parents with children below school age. (Refundable means that if you don't have enough income to use all the credit, the balance is paid out to you as a cash benefit.) You could potentially roll such a tax credit and a reformed child benefit together to greatly simplify and rationalise the system.

- The report also looks at inheritance tax, which is not only extremely unpopular but administratively burdensome and economically distortionary. The example of Sweden has shown that abolishing inheritance tax can spur growth and economic dynamism, as well as being wildly popular.

- In the long run, the goal in the United Kingdom should be to abolish inheritance tax altogether, while also making changes to capital gains tax to avoid the so-called 'lock-in effect' (this would somewhat offset the cost of abolition).

- In the nearer term, the Government should make good on George Osborne's 2007 pledge to raise the inheritance tax threshold to £1m. The cost of doing this could be partially offset by rationalising various allowances and exemptions.

How Britain Taxes Families

Since the introduction of 'independent taxation' in 1990, the British tax system has focused almost exclusively on *individual* incomes and paid little attention to household or family finances.

The justification for this system, introduced by Nigel Lawson, was simple. Under the old arrangements, which had been in place for centuries, a married woman's income was treated simply as a top-up to her husband's earnings. By separating out the two, women were being recognised as equal – not least in having the ability to conceal their exact income from their husbands, just as their husbands could with them.

However, this system has had problematic outcomes – particularly as we have increased the individual personal allowance and made income tax more progressive.

'British families can end up paying wildly different amounts of tax depending on how income is distributed within the family'

The fundamental issue is one of *horizontal equity* – the idea that two families with the same overall income ought to pay the same amount of tax. In reality, British families can end up paying wildly different amounts of tax depending on how income is distributed *within* the family. This is an inevitable consequence of combining a progressive tax structure (in which tax rates rise as your income does, through the basic rate and on to the higher and additional rates) with the individual as the sole tax unit.

Take a family consisting of a married couple and two children, with an income of £50,000. If that income is split evenly between spouses, each will pay £3,978 of income tax and National Insurance in the 2023/24 tax year – for a total of £7,956. However, if one member of the couple earns the full £50,000, while the other stays at home to look after the children, the worker will face a tax bill of £11,726[3] – £3,770 more than the family with the 50/50 split.

The problem is scarcely any less pronounced at a lower income level. Say the same family had an income of £25,000. If the income were split evenly, neither member of the couple would pay income tax or National Insurance at all (since both individual incomes would fall below the personal allowance for income tax and primary threshold for National Insurance). But if one person earned the full £25,000, they would pay £3,726 in tax.[4]

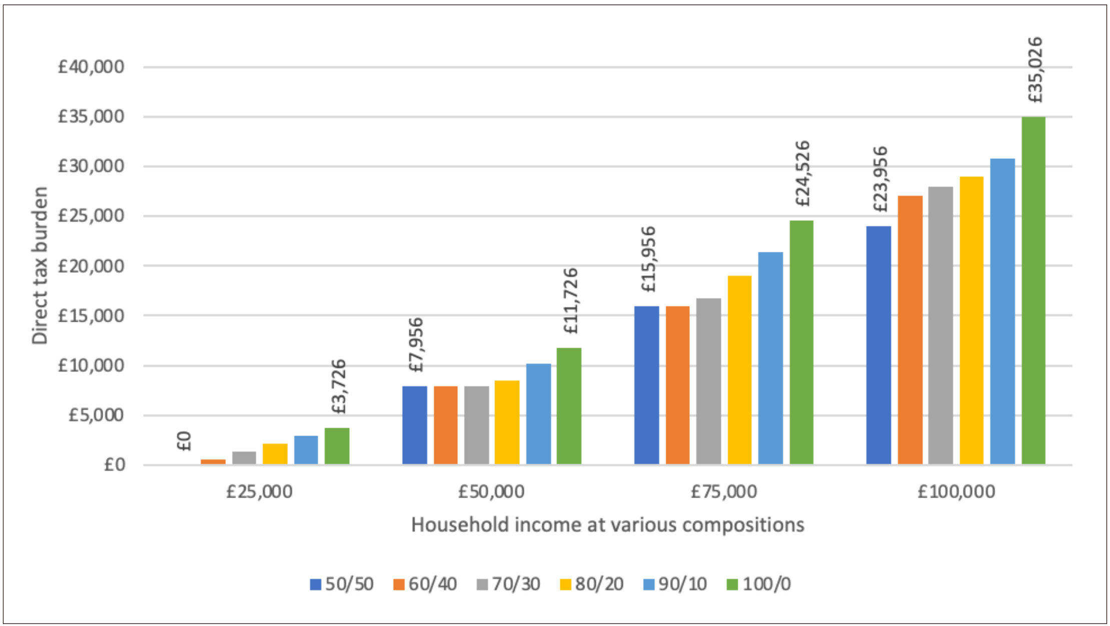
3 The marriage allowance (more on which below) has been factored in to this calculation.

4 As above.

However, it is as you move up the income scale that the disparities become starkest. If a £75,000 household income is split evenly, the tax bill is £15,956; if it all accrues to one person, £24,526. That is a gap of £8,570 – due, in part, to the fact that such a family would have to repay £2,075 in child benefit through the tax system (we deal with the child benefit tax charge in detail below).

Figure 1, below, shows the direct tax burden faced by families at four different household income levels, depending on whether that income is split 50/50, 60/40, 70/30, 80/20, 90/10, or 100/0. The underlying figures take account of the marriage allowance and the child benefit tax charge, but assume the families in question are not claiming Universal Credit.[5]

Figure 1: Household tax burdens at different income levels and compositions



Another way to think about this is to say that the more unevenly divided earnings are within the couple, the higher their overall tax rate will be. As Figure 2 shows, a family with income of £25,000 will face an average tax rate of between 0% and 15% depending on how earnings are divided; at £50,000, the range is 16-23%; at £75,000, it is 21-33%; and at £100,000, it is 24-35%. It is therefore possible for one family on £50,000 to pay almost the same tax rate as one with double the income.

What is causing this phenomenon? As mentioned above, it's all due to the design of our tax system. If we had completely flat taxes – i.e., everyone paid the same tax rate on every penny they earned – there would not be any difference in terms of how much tax different households paid. But that's very far from the system we currently have.

To ram home the point, let's imagine a married couple with two children and combined earnings of £60,000. First, let's assume that they have an equal income split, with earnings of £30,000 each.

To work out their income tax liability, you'd subtract £12,570 (the personal allowance) from each salary, then multiply the remainder by 20% (the basic rate of income tax).

5 It is likely that many families in the £25,000 category would receive some Universal Credit. Even at £50,000, some families would likely be eligible.

So: (30,000 - 12,570) * 20% = £3,486. Then there's National Insurance. Again, subtract £12,570 (the primary threshold) from each salary, and multiply what's left by 12%. So: (30,000 - 12,570) * 12% = £2,092. Thus, each earner pays £5,578, and the couple pays £11,156 combined.

The crucial thing to notice is that with an even split of earnings, the couple can take advantage of two income tax personal allowances and two National Insurance primary thresholds – which means that £25,140 of their income is not subject to tax. With two children, this couple will also receive a total of £2,075 in child benefit each year.

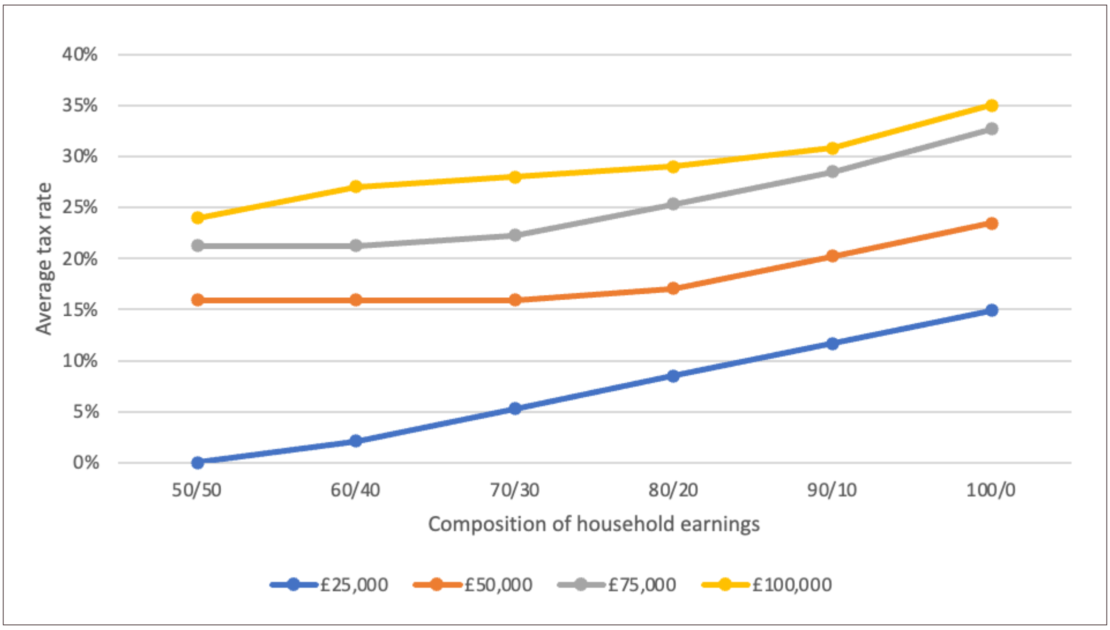
However, if all £60,000 accrued to one earner, things would look rather different. The first £12,570 would not be subject to tax. Earnings between £12,570 and £50,270 would be taxed at 32% (20% income tax and 12% National Insurance), which comes to £12,064. The next £9,730 would be taxed at 42% (40% income tax and 2% National Insurance), which comes to £4,087. The total would be £16,151.

With only one set of tax-free allowances to set against the income, as well as some tax being paid at the higher rate, this couple will pay almost £5,000 more than the other one.

But that isn't the end of it. Once one member of a couple with children earns more than £50,000, child benefit starts to be clawed back via the child benefit tax charge – which is calculated as 1% of your child benefit for every £100 you earn over £50,000. At £60,000, then, all child benefit must be repaid. For our couple with two children, this adds another £2,075 to their tax bill, taking the total to £18,226 – £7,070 more than the couple with evenly divided income.

You do not need to believe in complete horizontal equity between households to think that this disparity is far too extreme to justify. It is also a problem that will only grow worse in the current environment of high inflation and frozen tax thresholds, as more and more people are dragged into higher tax bands.

Figure 2: Household average tax rates at different income levels and compositions



There is a disconnect between relative living standards and tax burdens

In a series of reports for Tax and the Family, Don Draper and others have advanced a more sophisticated argument against independent taxation as it currently operates in the United Kingdom.[6]

They note that when we measure poverty or living standards, or carry out distributional analysis of government policies, we do two things. First, we look at households rather than individuals. In most contexts, this is sensible, because most of us do not live as financially atomised individuals; we live as members of a family that pools and shares its resources. Second, when determining how well-off a given household is, we take account of how many adults and children the household contains. This obviously makes sense: to achieve a given standard of living, all else being equal, people in couples, and with more dependents, will need more money.

As an illustration of this point, Table 1, which is reproduced from this year's Spring Budget, shows how much gross income different types of household would need to be at the median in each income decile.

As you can see, a household income in the low £50,000s puts you in the second-richest income decile if you are a single adult, but nearer the bottom than the top if your household contains two adults and two children. Yet our tax system barely takes this into account when deciding where the burden of taxation should fall.

Table 1: Median gross income (£) for different household compositions (2023/4 tax year)

Median gross income of households in decile	1 adult	1 adult and 1 child	2 adults	2 adults and 1 child	2 adults and 2 children
Top decile	77,300	*	116,000	159,000	198,200
Ninth decile	52,400	*	76,900	100,900	124,400
Eighth decile	41,900	*	61,500	81,800	101,500
Seventh decile	35,000	47,200	51,900	67,400	84,800
Sixth decile	30,200	44,200	44,800	59,000	70,700
Fifth decile	25,800	32,200	38,200	50,500	58,900
Fourth decile	21,700	29,000	32,600	42,400	50,900
Third decile	18,300	24,100	27,600	35,300	42,600
Second decile	15,000	20,200	23,000	29,100	34,700
Bottom decile	10,900	14,800	16,400	21,300	23,300

*Source: HM Treasury, 'Impact on households: distributional analysis to accompany Spring Budget 2023', 15 March 2023, p. 17. *Deciles left blank because of insufficient sampling sizes in official data.*

In fact, things are even more complicated than Table 1 suggests (as the Treasury itself points out). You would get a more accurate representation of relative living standards if you looked at net incomes – that is, after taxes have been taken off. Yet as we have already seen, how much tax the families represented in Table 1 will pay depends to a large extent on how earnings are distributed between the adults in that household.

For illustrative purposes, though, let's take Table 1 at face value. The £58,900 of income that the two-adult, two-child family in the fifth decile receives would likely include

6 See https://www.taxandthefamily.org/reports-1.

£2,075 of child benefit. So they would have earnings of £56,825. If we assume that this is a one-earner family, this sum would be subject to £14,817 of income tax and National Insurance and a child benefit tax charge of £1,416 – giving a total of £16,233. That is significantly more than the single adult in the ninth decile would pay (£12,959).

Indeed, you do not have to assume a single-earner household, or a higher rate taxpayer, or the application of the child benefit tax charge to produce a result that shows the tax burden does not necessarily track living standards. Even if the two-adult, two-child household in the sixth income decile had a 50:50 earnings split, they would pay a combined total of £13,916 – almost £1,000 more than the single adult in the ninth decile.

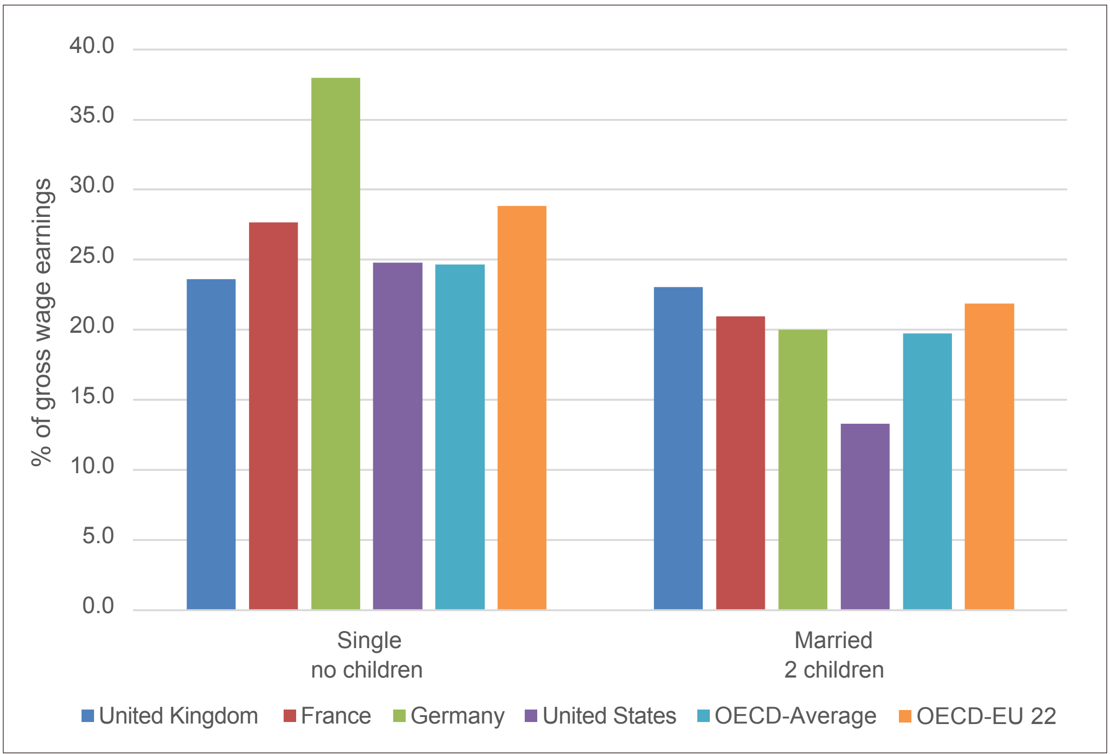
Needless to say, you could push this line of analysis too far. Making the taxation of income perfectly proportional to living standards would be nigh-on impossible and might introduce an absurd degree of subjectivity into the tax system. What we should take away from this analysis, however, is that there is a strong *fairness* case for treating families better in the tax system and reducing the burdens they face. This is especially (but not exclusively) so for families in which earnings are unevenly distributed.

How do other countries do it?

As it happens, many other countries – including Britain's most obvious comparator nations – treat families rather more generously than we do.

Using data from the OECD's 2023 'Taxing Wages' report, Figure 3 compares the tax burden (comprised of income tax and employee social security contributions – i.e., the equivalent of National Insurance) for two different households. On the left is a single adult with no children earning the average wage. On the right is a married couple with two children, with one partner earning the average wage.

Figure 3: Income tax plus employee contributions, 2022



Source: OECD, Taxing Wages 2023

Two things should be apparent from this visualisation. First, for a single adult on the average wage, Britain is a relatively low-tax country. He or she will face an average tax rate of 23.6% in the United Kingdom, versus 24.8% in the United States, 27.7% in France, and 38% in Germany. (The average for all OECD countries is 24.7%, while the average for European OECD members is 28.8%.)

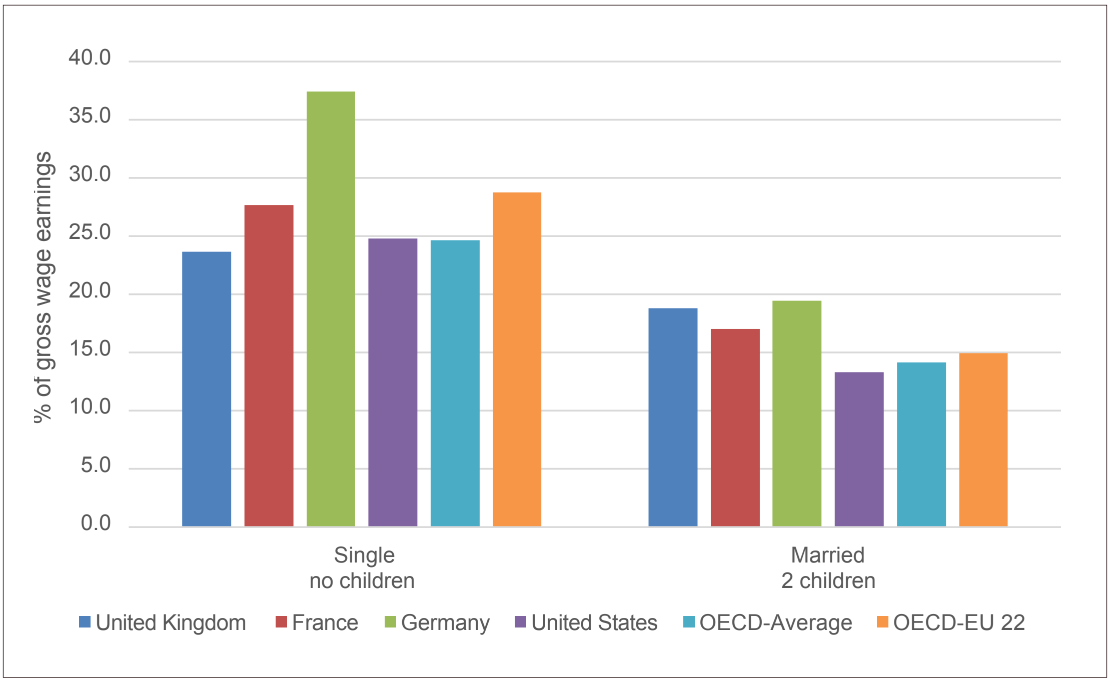
However, for the one-earner married couple with two children, the picture is rather different. At 23.1%, their average tax rate is fractionally lower than that faced by a single adult with the same earnings. But that average tax rate is higher than that faced by a similar family in France (21%), Germany (20%), or the United States (13.3%), as well as being higher than both the total OECD average (19.8%) and the European OECD average (21.9%).

To see this even more clearly, we can look at the gap between the two rates – that paid by the single adult, and that paid by the single-earner married couple with kids. In Britain, the rates are practically the same (0.6 percentage points lower for the family). But in France, the family rate is 6.7 percentage points lower, in the United States 13.3 percentage points lower, and in Germany 18 percentage points lower. The average differential across the OECD is 4.9 percentage points; among European OECD countries it is 6.9 percentage points.

To put it straightforwardly, the British tax system is much harsher to single-earner couples than other countries.

Of course, we cannot just look at the tax system in isolation. But fortunately, the OECD's Taxing Wages report also provides data that includes benefits – as shown in Figure 4.

Figure 4: Income tax plus employee contributions less cash benefits, 2022



Source: OECD, Taxing Wages 2023

For the single adult with no children, the underlying numbers are practically identical to those in Figure 3. For the single-earner married couple with two children, the picture does change slightly, flattening out the differences between the United Kingdom and other countries. Once cash benefits are factored in, this single-earner household faces an average tax rate of 18.8% – slightly lower than in Germany (19.5%), but still higher than in France (17%) or the United States (13.3%), and above the European-OECD and all-OECD averages (15% and 14.1% respectively).

‘Britain obviously relies more on benefits to support families than it does on the tax system’

The differences are clearly less pronounced once cash benefits are factored into the calculations. But they still exist. For example, the tax rate differential between the two households in question is 4.8 percentage points. That's less than France (10.6 ppts), the United States (11.5 ppts), and Germany (18 ppts). It is a bit less than half the average gap across the OECD (10.5 ppts) and a bit more than a third of the average gap among European OECD countries (13.8 ppts).

What can we take away from these figures? First, whichever way you cut it, other developed countries seem to tax single-earner married couples with children more lightly, on average, than the United Kingdom. The opposite is true of single adults with the same earnings. This suggests that policymakers should at the very least consider making the British tax system more family friendly.

Second, compared with other countries, Britain obviously relies more on benefits to support families than it does on the tax system. This is a legitimate policy choice. However, because Universal Credit and legacy benefits are means-tested, and because child benefit is clawed back from individuals earning £50,000-60,000, it also means the British system becomes less fair the further up the income scale you go.

More Taxes, More Problems

So far, we have talked mostly about the overall design of our tax system, and in particular the unfairness between single-earner and dual-earner couples. But there are a number of specific flaws in our tax regime that can lead to families in particular circumstances facing eye-wateringly high marginal tax rates.

We have already touched on two of these 'tax traps' – the marriage allowance and the child benefit tax charge – in the previous section. The third relates to the withdrawal of childcare subsidies from families in which one person earns more than £100,000, and probably represents the most severe 'cliff edge' in the entire tax system.

The marriage allowance

The marriage allowance was introduced in 2015 at the tail end of the Coalition government, making good on David Cameron's manifesto pledge to recognise marriage in the tax system. It is the only widely available tax relief that nudges Britain in the direction of family-based taxation, and attempts to address the basic fairness problem we outlined above.[7]

'In the 2023/24 tax year, the marriage allowance lets people transfer up to £1,260 of unused personal allowance to their spouse, provided that the spouse earns more than them but is, nevertheless, a basic-rate taxpayer'

Unfortunately, the marriage allowance is both limited and poorly designed, and has always suffered from low take-up.

In the 2023/24 tax year, the marriage allowance lets people transfer up to £1,260 of unused personal allowance to their spouse, provided that the spouse earns more than them but is, nevertheless, a basic-rate taxpayer. In other words, the spouse must be earning between £12,570 and £50,270 to take advantage of the allowance.

Here's how it works. Say that you earn £20,000. The first £12,570 of that would be free of income tax. The next £7,430 would be taxed at 20%. Your total income tax bill would be £1,486. Now let's say you have a spouse who only earns £10,000. They have £2,570 left of their personal allowance, which means they are able to transfer £1,260 to you. That increases your personal allowance from £12,570 to £13,830, which in turn means you only pay basic rate tax on £6,170 of income. This leaves you with an income tax bill of £1,234, which is £252 lower.

7 The married couple's allowance, a grandfathered-in version of an old tax relief, is available if at least one member of a couple was born before 6 April 1935.

There is a problem: as soon as one partner becomes a higher-rate taxpayer, the marriage allowance is withdrawn in its entirety. At that threshold, an extra penny of income costs a married couple £252 in additional tax. It is possible to think of this as another tax band, just 1p wide, in which income is taxed at a rate of 25,200%. To see any increase at all in post-tax income after crossing the higher rate threshold, the taxpayer in question would have to increase their earnings by £435.

Admittedly, the number of couples affected by this quirk in the tax system is likely to be small. About a third of Britain's 12 million or so married couples are thought to be eligible for the marriage allowance, but fewer than half of them claim it – with perhaps two million or so couples missing out. It may be that the allowance is poorly advertised, or simply too complicated to be readily understood. It is also possible that the tax break is not significant enough to make the bureaucratic rigmarole of applying worthwhile.

> **'About a third of Britain's 12 million or so married couples are thought to be eligible for the marriage allowance, but fewer than half of them claim it – with perhaps two million or so couples missing out'**

Of those who do claim the marriage allowance, it may be that most are not at risk of pushing through the higher rate income tax threshold. Perhaps a quarter of those eligible are pensioners, and therefore unlikely to see big increases in their income.[8] Most are in the 'lower-middle of the income distribution', according to the IFS.[9] Nevertheless, with tax thresholds frozen and inflation running high, there will inevitably be more couples falling over the marriage allowance cliff-edge now and in the years ahead through the straightforward operation of fiscal drag.

The slow take-up of the marriage allowance and the extremely high effective marginal tax rate that it creates at the boundary between basic rate and higher rate income tax are indicative of a poorly designed policy. We can and should do better – a challenge we return to in the next section.

The child benefit tax charge

The child benefit tax charge (CBTC) is another Coalition-era policy, introduced by then-chancellor George Osborne in 2013 as part of the government's 'austerity' programme. As noted above, it is intended to recoup child benefit paid to households that contain a higher-rate taxpayer. Since its inception, therefore, it has required such taxpayers to pay a charge equivalent to 1% of their child benefit for every £100 they earn over £50,000. The result is higher effective marginal tax rates between £50,000 and £60,000 for affected parents.

There are a few things worth noting about the way the CBTC works.

First, it no longer applies just to higher rate taxpayers – the higher rate threshold is slightly higher than the trigger for the CBTC now, at £50,270.

8 Joyce, 'The New Tax Break for Some Married Couples', Institute of Fiscal Studies (2013).
9 Adam, 'Taxing Couples', Institute for Fiscal Studies (2018), p. 9.

Second, and more importantly, the CBTC's £50,000 threshold has not changed since 2013. Had it risen with inflation, it would kick in at approximately £66,200 today. The result is that many more families are having their child benefit clawed back than was originally envisaged. Tax and the Family have estimated that more than 20% of families eligible for child benefit are now subject to the CBTC.[10] HMRC data suggests that the number of taxpayers either declaring a liability for the CBTC or opting out of receiving child benefit rose from 763,000 in 2013 to nearly a million in 2020 – and that is before inflation took hold.[11]

Before the CBTC was introduced, David Cameron claimed that it would only affect the wealthiest 15% of families.[12] That wasn't actually right – there's a big difference between 'the wealthiest 15% of families' and 'families containing someone who ranks among the top 15% of income taxpayers', but it's a forgivable error in the heat of Prime Minister's Questions. Nevertheless, Tax and the Family have calculated that if you really wanted to target the CBTC at the best-off 15% of families, you would have to set the CBTC threshold above £100,000.[13]

> **'HMRC data suggests that the number of taxpayers either declaring a liability for the CBTC or opting out of receiving child benefit rose from 763,000 in 2013 to nearly a million in 2020 – and that is before inflation took hold'**

Third, there are a couple of administrative points to consider. On the one hand, taxpayers who are liable to pay the CBTC must file a self-assessment tax return – even if they would not normally do so. This raises the bureaucratic costs of the tax system (both to taxpayer and tax collector) and leaves people open to fines if they are, understandably, not on top of the rules.

On the other hand, parents who are aware of the CBTC and decide not to claim child benefit at all may miss out on National Insurance credits if they stay at home while their children are young. For parents earning less than the lower earnings limit, registering for child benefit ensures they receive National Insurance credits for the first 12 years of their child's life. In turn, this helps to ensure that they are eligible for the full state pension in retirement. (Claiming child benefit but opting to receive it at a zero rate is an alternative for families in this situation – but many do not realise it.)

Fourth, as we indicated above, there are massive horizontal equity issues with the CBTC. A family containing two earners, each receiving £49,999 (and so £99,998 overall), will get the full amount of child benefit. That is currently £1,248 per year for a first child, and £827 per year for each subsequent child. Yet a family in which one earner makes £60,000 will receive no child benefit at all – irrespective of how little their spouse earns. This is no fairness at all in this arrangement.

Fifth, the CBTC creates very high effective marginal tax rates for parents earning between £50,000 and £60,000. And because the charge is calculated based on a percentage of child benefit received for every £100 over the threshold you earn,

10 Beighton et al., 'The Taxation of UK Families 2021', CARE and Tax & the Family (2022), p. 39.

11 See https://www.gov.uk/government/publications/high-income-child-benefit-charge-data/high-income-child-benefit-charge.

12 Hansard, 7 March 2012, Col 841.

13 Beighton et al., 'The Taxation of UK Families 2021', CARE and Tax & the Family (2022), p. 38.

the exact marginal tax rate you face is linked to how many children you have. One percent of £1,248 is £12.48 and 1% of £827 is £8.27. If you are charged that amount for every £100 you earn, you are essentially adding 12.5% for the first child and 8.25% for every subsequent child to your marginal tax rate. The table below shows how that plays out.

Table 2: Effective marginal tax rates for those facing the child benefit tax charge, the higher rate of income tax, and the upper rate of National Insurance

Number of children	Effective marginal tax rate
1	54%
2	63%
3	71%
4	79%
5	88%

To be clear, this means that someone with five children, earning £55,000, will effectively keep just 12p of every additional pound that he or she earns. That is an extreme example, of course. But looking back at Table 1, we can see that a two-adult, two-child family earning £55,000 would actually be in the bottom half of the earnings distribution after adjusting for household size – yet if that income came from a single earner, they would be subject to a 63% effective marginal tax rate. That is considerably more than the 47p combined top rate of tax that applies to the very highest earners.

There is one further point to make. Because these marginal tax rates depend on how much child benefit you receive, the problem is only going to get worse as time goes by, and child benefit rises with inflation. Child benefit already rose by just over 10% in April. If it were to rise by another 10% next year, you would end up with effective marginal tax rates of 65% with two children and 83% with four children.

From a tax design standpoint, the child benefit tax charge is ludicrously ill-thought through. And from a taxpaying family's perspective, it is deeply unfair. It therefore needs substantial reform at the earliest opportunity.

The withdrawal of childcare subsidies

This report is not the place for an exhaustive examination of our labyrinthine system of childcare subsidies – or, indeed, the wider supply side issues that raise costs in the nursery sector and thereby impose a heavy financial burden on working parents. But given that, over the next few years, the government plans to extend 30 hours free childcare to all children between nine months old and school age, it is worth noting a couple of important ways in which the childcare subsidy regime connects with our broader themes and arguments. After all, any problems are going to become far more widespread as it is expanded to encompass more families.[14]

14 The IFS estimates that the Government's childcare expansion plans will make it responsible for 80% of all pre-school childcare in England, up from a little under half today. See https://ifs.org.uk/news/childcare-reforms-create-new-branch-welfare-state-also-huge-risks-market.

The key thing to note here is that 'tax free childcare' and '30 hours free childcare' are both withdrawn in their entirety as soon as one parent's individual income exceeds £100,000.[15] In other words, a couple who each earned £99,999 (or £199,998 combined) would receive full childcare subsidies; whereas a couple in which one person earned £100,001 and their partner earned £8,685 (the minimum required to qualify), would get neither tax-free childcare nor 30 hours free childcare.

The financial disparity here will be very significant. Tax-free childcare is worth up to £2,000 per child per year. It is harder to attach a precise cash value for parents to the 30 hours offer, as childcare costs vary across the country, but £5,500 per child per year is a reasonable ballpark figure.

This means that if we assume the couples in our example above each have two children under the age of three, then the higher earning couple would receive £17,000 in government childcare support, whereas the other couple, with a combined income 45% lower, would get nothing at all.[16]

The following analysis from the Institute for Fiscal Studies throws the cliff edge problem into sharp relief.[17]

> *The distortions that [the extension of free entitlements] can create are among the most severe you will ever see within a tax and benefit system. A parent with two children under three whose childcare provider charges England's average hourly rate for 40 hours per week would, after these reforms, find that their disposable income (i.e. earnings net of tax and childcare outgoings) falls by £14,500 if their pre-tax pay crosses £100,000. Disposable income would not recover its previous level until pre-tax pay reached £134,500, meaning a parent earning £130,000 would be worse off than one earning £99,000.*
>
> *For those with higher childcare costs the distortions are even more absurd. A similar parent paying average London rates for childcare, using 50 hours per week, would see a £20,000 fall in disposable income when their pre-tax earnings cross £100,000. Disposable income would not recover its previous level until pre-tax pay reached £144,500.*

The complete withdrawal of childcare subsidies at £100,000 of income creates a huge cliff-edge that will either completely distort behaviour or else impose a massive financial penalty on parents who cross the threshold. And the withdrawal of subsidies is based on individual income without any reference to total *household* income – which means, yet again, that we are bound to treat families with the same overall income very differently depending on how that income is distributed within the couple.

15 In practice, many parents will be able to manage their 'adjusted net income' to keep it under £100,000 – for example by making pension contributions or charitable donations. However, this will not always be possible, and in any case the distortion of economic decision-making that it entails is something that the tax and benefits system ought to avoid wherever possible.

16 Parents of three- and four-year olds will still be eligible for '15 hours free childcare' if one of their incomes rises above £100,000 – softening the blow slightly.

17 See https://ifs.org.uk/news/childcare-reforms-create-new-branch-welfare-state-also-huge-risks-market.

It is worth pointing out that this also interacts with one of the worst features of the tax system, at least from the point of view of marginal tax rates – the withdrawal of the personal allowance. Once you cross the same £100,000 threshold for individual income, the Government removes £1 of your personal allowance for every £2 you earn. As one of the present authors pointed out in his 2018 Centre for Policy Studies report 'Make Work Pay', this means that you are effectively playing a tax rate of 62% on your income until your salary reaches £125,140.[18] The combination of the two, as the IFS notes, is hugely painful – and another source of profound unfairness between single-earner and dual-earner couples, given that a couple who both earn £99,999 will keep both their childcare entitlement and their two personal income tax allowances.

18 Clougherty, 'Make Work Pay', Centre for Policy Studies (2018).

Restoring Fairness for Families

We have shown in the previous chapter that the British tax system is unfair to families, by comparison with other countries – and in particular that it is unfair to families in which only one person earns.

You might say – especially if you are sitting in the Treasury – that this is perfectly fine. The more people there are in the workforce, the better.

We believe that this is unfair. Couples should be able to make the lifestyle choices that are most appropriate for them, and for their needs. In particular, it seems grossly unfair that people should be punished via the tax system if they leave the workforce to raise children or look after an elderly or disabled relative – not least because this is the kind of behaviour that we would probably want to encourage. That's before you get into the hideous costs of childcare for those couples that do both work.

So, in this section we examine three options for reforming the way income tax applies to married couples: a transferable personal allowance; income splitting, based on Germany's model; and France's 'quotient familial'. We also look at ways to fix child benefit and the childcare subsidy regime, before concluding with some thoughts on inheritance tax.

‘National Insurance is very close to being an extension of income tax in everything but name. There is a National Insurance Fund, but it is basically just an accounting device’

But it is worth addressing two overarching issues at the outset. First, why do our main proposals only apply to income tax and not also National Insurance? This is a fair question. After all, National Insurance is very close to being an extension of income tax in everything but name. There is a National Insurance Fund, but it is basically just an accounting device.[19]

Nevertheless, there are real differences between National Insurance and income tax. National Insurance is only levied on labour earnings, is not paid by those who have reached the state pension age, and is assessed separately for each pay period (weekly or monthly) and each employment. Income tax is different in every respect. National Insurance contributions are still used to assess eligibility for certain benefits – most importantly the state pension. And, of course, there is an employer side to National Insurance that does not exist for income tax.

19 See Martin, 'Abolish NICs', Centre for Policy Studies (2011) for good background on this topic.

Applying our reforms to National Insurance would therefore raise a whole host of complexities and necessitate other (potentially controversial) reforms that we do not have space to do justice to here. None of this is to say that do not want to reform National Insurance too – just that it is a larger topic for another day.[20]

The second issue is whether we are right to focus our reforms on married couples. It seems very old-fashioned to be discriminating against those who are married rather than co-habiting – judgemental, even.

In principle, the reforms we outline below could of course be applied to cohabiting couples too. Nonetheless, we have chosen to focus on married couples (or, indeed, those in civil partnerships) for three reasons. First, because we think it is right to expect that people should make a lasting, legal commitment to each other before they are able to access beneficial tax arrangements. Second, because marriage has well-established social benefits that are worth recognising and supporting through the tax system. And third, because it makes our proposals a good deal more affordable.

A transferable personal allowance

The most straightforward thing we could do to improve the taxation of families in our tax system would be to make the personal allowance fully transferable between spouses. This is, in fact, what Nigel Lawson intended when he introduced independent taxation in the 1980s. When outlining the idea in 1985, he said:

> *Everyone, man or woman, married or single, would have the same standard allowance. But if either a wife or a husband was not able to make full use of their allowance, the unused portion could be transferred, if they so wished, to their partner.*[21]

Yet by the time independent taxation was introduced in the 1988 Finance Bill, the transferable allowance element had been 'regrettably watered-down'.[22] It was then chipped away at further over the course of the 1990s by successive Conservative chancellors, and abolished completely by Gordon Brown.

David Cameron's marriage allowance re-established the principle of a transferable personal allowance in 2013, but in an extremely limited form (as discussed above).

Significantly expanding the marriage allowance so that it becomes a fully transferable personal allowance would, however, be a pretty simple thing. You would only need to make two significant changes from the current system. First, make it so that up to 100% of any unused personal allowance can be transferred from one spouse to another (rather than 10% as at present). Second, remove the limitation that means it can only be claimed by basic rate taxpayers.

20 It is also worth noting that because of the strange structure of National Insurance, with its 12% standard rate and 2% upper rate, it can actually soften the single-earner penalty at higher income levels.

21 Lawson, foreword to 'Independent taxation – 25 years on' by Draper and Beighton, CARE (2013).

22 Ibid.

To illustrate what we propose, let's imagine two married couples, each with a combined income of £60,000. The first couple earn £30,000 apiece and so each pays £3,486 of income tax (£6,972 in total). In the second couple, one person earns £60,000 and the other doesn't work. In this case, under the current system, the working member of the couple would pay £11,540 of income tax.

However, a fully transferable personal allowance would change things. After such a reform, the non-earner would be able to transfer any unused personal allowance (in this case £12,570) to their partner. The earner would then be able to reduce their taxable income by £25,140 (i.e., 12,570 * 2), leaving £34,860. That sum falls within the basic rate limit (£37,700) and is therefore taxed entirely at the basic rate of income tax, 20%. Their tax bill is reduced to £6,792 – the same as the couple with the 50:50 income split.

In other words, a fully transferable personal allowance will completely solve the horizontal equity problem so long as one of the following conditions is met: a) total household income is £62,840 or lower (i.e., the basic rate limit plus two personal allowances); or b) the household does not contain a higher or additional rate taxpayer.

At higher income levels, couples will still face higher tax bills the more unevenly their incomes are split – because at that point, you will inevitably get different couples paying the higher rate of tax on different portions of their (combined) incomes, leading to different tax liabilities. Nevertheless, as Table 3 shows, the differences will in most cases be less pronounced than they would be today.

In short, this reform might not be a complete and perfect solution to the problem we have identified, but it would eliminate it for many families and make it less severe for many others.

Table 3: Household income tax liabilities with and without a fully transferable personal allowance, at various income levels and compositions

	£25,000		£50,000		£75,000		£100,000	
	Without	With	Without	With	Without	With	Without	With
50/50	0	0	4,972	4,972	9,972	9,972	14,972	14,972
60/40	486	0	4,972	4,972	9,972	9,972	16,918	16,918
70/30	986	0	4,972	4,972	10,418	10,418	18,918	18,918
80/20	1,486	0	5,486	4,972	11,918	11,918	20,918	20,918
90/10	1,986	0	6,486	4,972	14,432	12,404	23,432	22,404
100/0	2,486	0	7,486	4,972	17,432	12,404	27,432	22,404

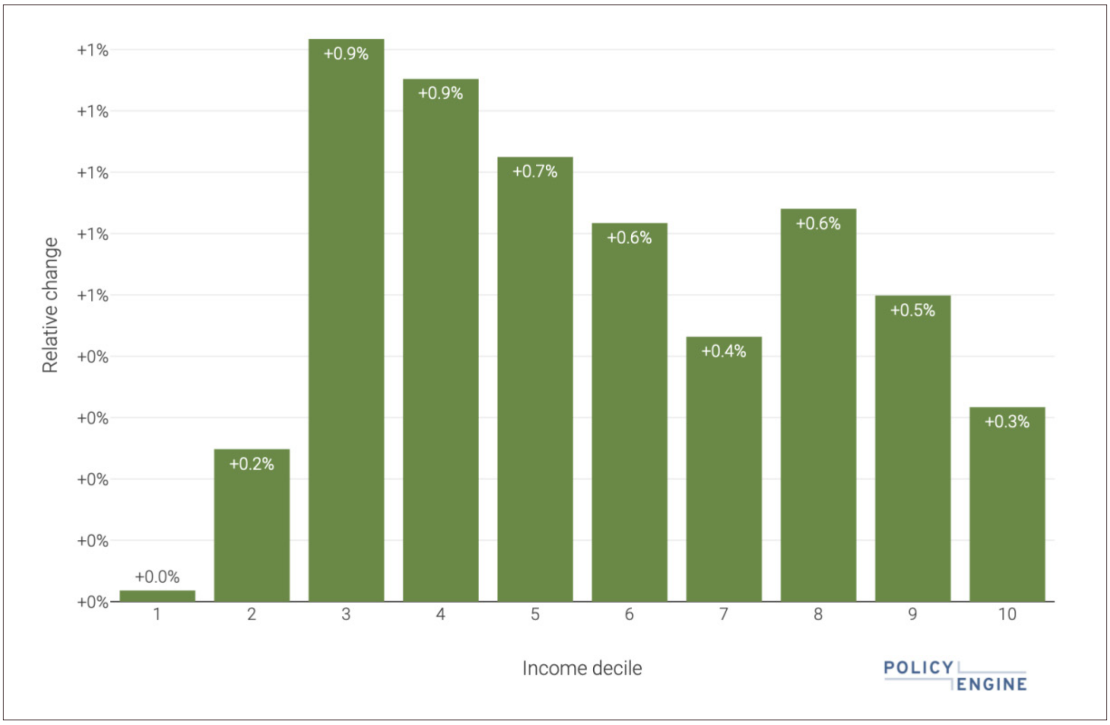
Some people will be instinctively suspicious of this proposal. They will think it benefits the rich, not least because the one-earner couple in our example will self-evidently have one person with a higher salary than the family in which the income is split evenly.

But in fact, this reform is actually fairest to the poorest.

The team behind the online tool PolicyEngine have helped us to estimate the cost and distributional consequences of this proposal, and various others. They estimate that introducing a fully transferable personal allowance for all married couples would:

- Cost £6.1bn.
- Reduce poverty by 4.3%.
- Benefit 22% of households.
- Increase the net income of 11% of households by more than 5%.
- Boost net income across all households by 0.5% on average.

Figure 5: Average impact of transferable personal allowance on net household income, by income decile



Needless to say, £6.1bn is not an insignificant sum, especially in today's straitened fiscal circumstances. So if you wanted to reduce the cost of introducing a fully transferable personal allowance, you could target it more narrowly – for example by restricting it to married couples with children.

There is a good case for prioritising families with children. First, couples with children need the extra money more – with more mouths to feed, they have higher costs and lower taxable capacity. Second, having children – especially young children – makes it more likely that one member of the couple will want to stay at home rather than go to work. This is something that policy ought to be sympathetic towards.

Table 4 therefore shows the budgetary impact of introducing a fully transferable personal allowance for a) married couples with a child below school age; b) married couples with a child of primary school age or younger; c) married couples with a child of school age or younger; and d) all married couples.

Table 4: Fiscal cost of different reform options (fully transferable personal allowance)

Fully transferable personal allowance for…	Fiscal Cost
Married couples with a child below school age	£2.1bn
Married couples with a child of primary school age or younger	£3.1bn
Married couples with a child of school age or younger	£3.6bn
All married couples	£6.1bn

Clearly, restricting the application of a fully transferable personal allowance to married couples with children makes the reform significantly more affordable. Indeed, we believe introducing a fully transferable personal allowance for married couples with children is an excellent candidate for the tax cuts that the Government has long hoped to introduce in 2024/25. It would cost significantly less than the oft-mooted penny off the basic rate of income tax, which comes in at around £5bn. And while it would benefit fewer households, those who did benefit would be much more likely to notice. It would also complement the Government's plans to ease financial pressures on young families by boosting taxpayer-funded childcare support.

One final issue that would have to be ironed out were a fully transferable personal allowance introduced is how it would interact with the withdrawal of the personal allowance starting at £100,000 of individual earnings, mentioned above.

In an ideal world this aspect of the tax system would simply be scrapped – there is no real justification for effectively taxing earnings between £100,000 and £125,140 at 60%, and the earnings beyond that level at 45% (with a further 2% in each case for National Insurance). Regrettably, however, such a change does not seem likely to occur any time soon.

Were the same withdrawal to apply to transferred personal allowances too, you could potentially end up in a situation in which a high-earning individual pays a 40% marginal income tax rate up to £100,000, a 60% marginal rate to £125,140, a 65% marginal rate up to £150,280, and then 45% on any further earnings. In other words, a bad situation would become worse.

The most expedient option, in our view, is that if a fully transferable personal allowance is introduced, any transferred allowance should not be subject to withdrawal at £100,000.

The German model: income splitting

But what if we want to move beyond transferable personal allowances and come up with bolder, longer-term, pro-family reforms? The obvious place to start is with the approach used in Germany and various other countries: income splitting.

The principle is a simple one. To work out how much tax a married couple should pay, first combine their incomes, then divide the result by two. Then, calculate how much tax an individual with that income would owe, then double that amount to arrive at the couple's total tax liability.

Such an approach ensures that even with a progressive tax structure and the individual as the fundamental tax unit, married couples with the same *combined* income will always pay the same amount of tax – irrespective of how that income is split.

To illustrate with an example, let's say that you have a married couple with a household income of £80,000. Under the current system, if that income were split evenly, each spouse would pay no income tax on the first £12,570 (the personal allowance) and then 20% on the remaining £27,340. That amounts to £5,486 of income tax each, and £10,972 overall.

If one person earned all £80,000, they would pay no income tax on the first £12,570 (the personal allowance), 20% on the next £37,700 (the basic rate limit), and then 40% on the remaining £29,730 (the higher rate) – so that is £0 + £7,540 + £11,892 = £19,432, which is £8,460 higher than the total income tax bill for the couple with the 50:50 earnings split.

'Under the German approach, married couples with the same combined income will always pay the same amount of tax – irrespective of how that income is split'

Under income splitting, however, you would tax the second married couple in exactly the same way as the first one – by splitting their total income in half, applying the individual income tax to it, and then doubling the result. At least as far as income tax is concerned, income splitting will ensure equity between households with the same overall incomes – income tax burdens and average tax rates will be the same however earnings are divided.

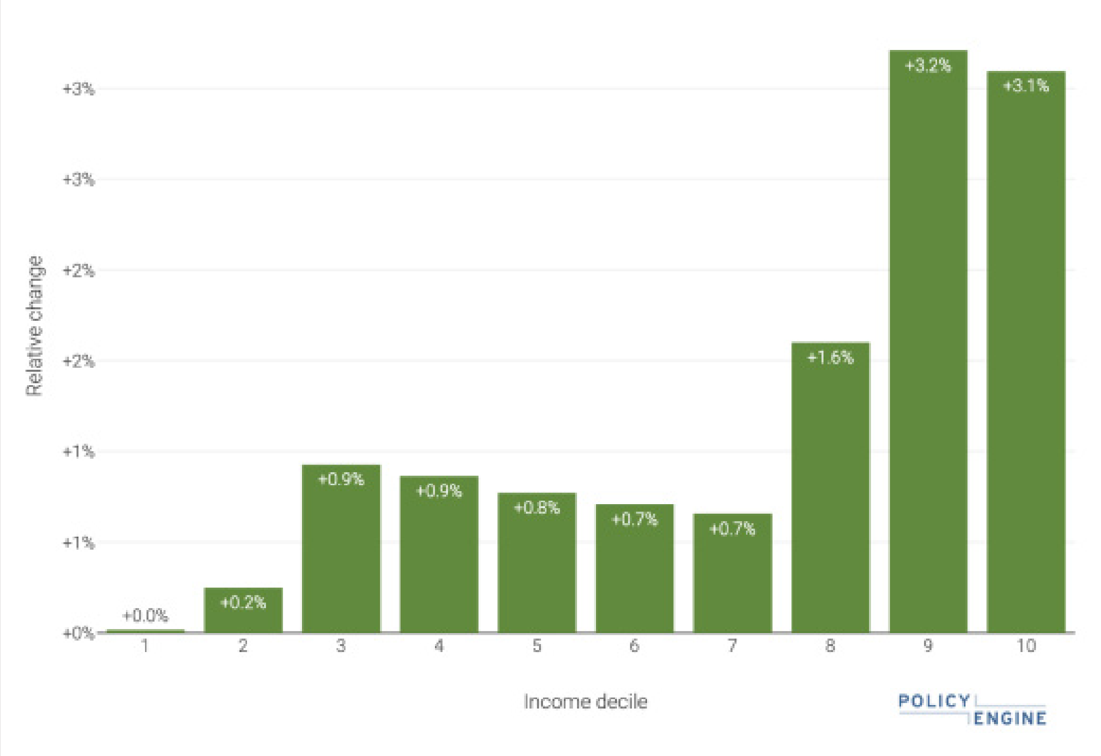
There are other advantages to adopting income splitting. First, it could ensure that things like the child benefit tax charge, the withdrawal of childcare subsidies, and the tapering of the personal allowance (and other allowances) only occur once total household income has crossed the relevant threshold – which is a much fairer way to do things. Indeed, assuming that the £50,000 and £100,000 trigger points for those measures were maintained, only couples with combined income double those levels would be affected. Thus these unfortunate elements of our tax system would apply to far fewer people – a good result.

Second (and relatedly), you could introduce income splitting without having to change anything else about the structure of the tax system. In effect, you would still be using the individual as the tax unit – you would just be adjusting individual incomes to reflect household incomes and ensure fairness across the income spectrum. This is more practical than, say, adopting the American system of opt-in joint taxation for married couples, with allowances and tax bands doubled in size, and everyone filing an annual tax return. The effect, though, would be identical.

According to PolicyEngine modelling, allowing all married couples to use income-splitting to determine their income tax bill would have a fiscal cost of £19.2bn. Like a fully transferable personal allowance, it would reduce poverty by 4.3%. It would benefit more households than a transferable personal allowance (34% would be better off) and household gains would be larger (net income up 1.6% on average, with 18% of households gaining more than 5%).

However, the distribution of these gains would look rather different to those of transferable personal allowances, as Figure 6 shows.

Figure 6: Average impact of income-splitting on net household income, by income decile



How does this dramatic difference come about? The key thing to appreciate is that whereas our first suggested reform only allowed couples to pool their tax-free personal allowances, income-splitting also allows them to transfer any unused part of their basic rate limits – or, indeed, of the other income tax bands. Whereas transferable personal allowances didn't fully equalise income tax across different household compositions at higher income levels, this reform – income splitting – does. But, of course, that also means a) that this reform is more expensive and b) that the additional gains go mostly to richer households.

You could reduce the fiscal impact of income splitting by restricting it to married couples with children of various ages as Table 6 shows, but the shape of the distributional analysis would look largely the same. As a short-term measure, then, the politics of income splitting might be difficult – as, indeed, would the budgetary impact.

Table 5: Fiscal cost of different reform options (income splitting)

Income splitting for…	Fiscal Cost
Married couples with a child below school age	£5.2bn
Married couples with a child of primary school age or younger	£8.9bn
Married couples with a child of school age or younger	£10.9bn
All married couples	£19.2bn

Income splitting carries great intellectual appeal and should be a longer-term goal of conservative tax reform. But it is probably not a practical option in the short run – both because of its large fiscal cost, and because (partly as a result) it would require a whole host of other changes to be made to the tax and benefit system at the same time. For now, it would be better to focus on extending a fully transferable personal allowance to as many married couples as possible.

A fairer share: France's 'quotient familial'

Before we dismiss income splitting altogether, it is worth looking at another way of doing it. The French income tax system works on the same fundamental principle as the German one – divide total income, apply the individual income tax, then multiply the result to determine tax liability. But it also factors children into the calculation.

To determine the so-called 'quotient familial' used for income splitting, the French system assigns 1 share to a single adult, 2 shares to a married couple, 0.5 shares to the first and second dependent children, and 1 share to each subsequent dependent child. Thus, a family composed of a married couple and two children would have a 'quotient familial' of 3. To arrive at their income tax liability, they would divide combined income by 3, apply individual income tax bands to the result, and then multiply by 3.

'The French income tax system works on the same fundamental principle as the German one – but it also factors children into the calculation'

A few examples will help illustrate how this might work in the British income tax system. For simplicity's sake, let's assume a household income of £50,000 in each case.

- First, a single individual with no children. As at present, they would pay £7,486 of income tax.
- Second, a single parent with a dependent child. They would divide their income by 1.5 (1 for the adult, 0.5 for the child) and then apply the usual income tax bands. That gives an initial calculation of (£33,333 - £12,750) * 20% = £4,153. Now multiply that by 1.5, to get £6,229 – a saving of £1,257 versus the first example.
- Third, a married couple with two children. They would divide their income by 3 (1 for each adult, 0.5 for each child) for an initial calculation of (£16,667 - £12,750) * 20% = £819. Now multiply that by 3, to get £2,458. Depending on how earnings were distributed, this couple would currently pay between £7,956 (assuming an even split) and £11,978 (assuming a single earner) in the United Kingdom.
- Fourth, a married couple with four children. They would divide their income by 5 (1 for each adult, 0.5 for each of the first two children, and 1 for each subsequent child). The initial calculation would be (£10,000 - £12,750) * 20%, which of course results in no income tax liability at all.

Predictably, the reality of the French system is slightly more complicated than these examples suggest. For one thing, there is a cap on the benefit taxpayers can gain by using the quotient familial – to simplify somewhat, this is currently set at €1,678 per dependent half part. In general, only the best-off families are affected.

The second thing, of course, is that you cannot simply import France's version of family taxation into the British system and say: 'Look at these tax cuts!' The huge tax cuts for parents that the examples above imply would have to be offset by higher taxes elsewhere in the system, or a reduction in state spending, to the tune of many, many billions of pounds.

Nevertheless, the *principle* behind the French system is very appealing. It goes beyond simply taxing households with the same total income the same amount, and actively reduces the tax burden for families with dependent children. This makes a lot of sense – as discussed above, the more people (and more dependents) a household has, the higher its costs will be, and the lower its standard of living at any given income level. Taxing families in this way may also contribute to France's relatively high birth rate and relatively large family sizes – something that shouldn't be sniffed at, in an age of demographic decline across the developed world.

'Taxing families in this way may contribute to France's relatively high birth rate and relatively large family sizes – something that shouldn't be sniffed at in an age of demographic decline'

The quotient familial also makes provision for single parents (something a transferable personal allowance or standard income splitting would not do without modification) and, indeed, for disabled household members (who get an extra 'half share'). If you were introducing such a system in the United Kingdom, it would be helpful to include elderly relatives in the same household in the tax calculation – not least because supporting intergenerational living can help reduce both child care costs and social care costs. These kinds of ideas merit careful consideration as our birth rate falls and our population ages.

Nevertheless, there would be challenges in shifting to family tax model like that of France. Clearly, you would need to calibrate the system carefully so that fairness to families did not come at the expense of unfairness towards single adults – who may come to resent paying heavy tax rates to support other people's children. (It is worth noting, though, that everyone benefits from more children in the long run – without them, an ageing population will place an unbearable burden on a dwindling number of working age Britons.)

Furthermore, to an even greater extent than the income splitting discussed above, adopting a quotient familial would require comprehensive rethinking and reform of the tax and benefits systems. You could not look at income tax in isolation – either from the rest of the tax system, or indeed from the various other things that we do to support children and families at the moment.

Yet this may be a fruitful avenue for further research, which could inform the next generation of Conservative thinking on tax reform. It could also help to answer some of the key demographic challenges that we face as a country.

Perhaps, too, there is scope to rationalise and simplify our offer to families in Britain, while also making it more generous. With France's quotient familial in mind, we could develop ways to more closely integrate family tax and benefits – and sweep up away much of the complexity and inefficiency that characterises the current situation.

Reforming child benefit and childcare subsidies

The child benefit tax charge was a bad policy when it was introduced, and its short-sighted design means that has become even worse as time has gone by.

To recap, the main issues are that it imposes very high marginal tax rates (which get higher the more children you have) and that it takes effect based on individual income rather than household income. Both are deeply iniquitous.

The simplest thing way to solve these problems – all else being equal – would be to scrap the child benefit tax charge and revert to the universal system of child benefit that we had from its introduction in the late 1970s until 2013. The only problem with this is that it would cost the Exchequer roughly £2.5bn, with the gains going exclusively to the top half of the income distribution. It might therefore be hard to prioritise, politically speaking.

> **'The child benefit tax charge was a bad policy when it was introduced, and its short-sighted design means that has become even worse as time has gone by'**

However, the Government could at least introduce a household income criterion, saying that the child benefit tax charge will not apply if total household income is below a certain level (which should be higher than the current threshold – and ideally double). Putting such a qualification into operation should not be too difficult – during the self-assessment process, when a taxpayer would otherwise be required to pay the charge, they could simply have the option of ticking a box that said 'household income below X' and be required to give their partner's National Insurance number or unique taxpayer reference for verification purposes.

We should also address the effective marginal tax rate issue, by replacing the current charge structure with a single, straightforward taper rate for the benefit – set, for example, at 5p or 10p per £ earned over the threshold – until its value hits zero.[23] The fiscal cost of these reforms would still be meaningful, but substantially lower than abolition.

Reforming childcare subsidies is an even more challenging issue – not least because the Government is in the middle of a huge expansion of its taxpayer-funded offer and will likely have limited bandwidth for making other changes in the short term.

The obvious thing to do would be to base withdrawal of 'tax free childcare' and '30 hours free childcare' on household income rather than individual income. This would come at a fiscal cost – presumably the threshold would have to be raised significantly if transitioning to a household basis – but we are not talking about an enormous number of people here. Administratively, a household basis should not be an issue. After all, both members of a couple's earnings already factor into eligibility for childcare subsidies (both must be working, neither can earn over £100,000).

23 The downside of this approach is that the child benefit tax charge would raise effective marginal tax rates over a larger band of income – albeit by far less than the current system. As a result, more people would experience the higher EMTRs. There would also be an issue for taxpayers whose child benefit charge ended up overlapping with the withdrawal of the personal allowance.

Such measures would move the cliff edge that we highlighted earlier, but would not completely eliminate it. Tax free childcare could easily be tapered rather than withdrawn in its entirety once the threshold is crossed. But tapering eligibility for 'free' hours of nursery care is more difficult. Requiring nurseries to charge different parents different amounts based on their particular entitlement could be extremely complex and burdensome for a sector already weighed down by bureaucratic costs.

A better solution would be to turn both main elements of the childcare subsidy regime into a tax credit, which could either be set against income tax or, if the value of the credit exceeded the tax liability, paid out in cash provided certain conditions were met. Indeed, it is possible to imagine merging such a credit with child benefit, to create a single 'child element' within the income tax system (with a higher value in the pre-school years, and a lower one thereafter).

'Moving from today's highly complicated set-up to a single, straightforward family tax credit would be a huge improvement on the status quo'

One advantage of turning subsidies into a tax credit (or indeed a cash grant) is that it would improve the economics of the nursery sector. At the moment, the taxpayer generally does not pay the true market rate for the hours of 'free' childcare it supports. This means that nurseries that participate usually have to cross-subsidise 'free hours' by charging more for not-free hours – or for children/parents who do not qualify for government support. Nurseries are also known to load as many charges as possible into incidentals (food, nappies, activities, etc) to top up the inadequate funding they receive for 'free' hours. By effectively giving money to parents and letting them decide what to do with it, you would expect nursery pricing to become more rational and more transparent, which might help to foster greater competition and keep down costs.

At the relevant ages, such a tax credit could be tied to actual expenditure on formal childcare. Or it could be made more flexible, by reducing parents' tax liabilities and giving them extra cash when they need it most – whether to pay for nursery or a registered child minder, to compensate a friend or relative who looks after the children, or to make it possible to take more time off work while children are young. If the government wanted to, any such tax credit could be tapered away smoothly at the desired level of income. The cliff edge that characterises the current system could be eliminated.

Moving from today's highly complicated set-up to a single, straightforward family tax credit would be a huge improvement on the status quo, as well as being a major step towards a tax system that resembles that of France in its family-friendliness. It is certainly worth further research as part of a future agenda for Conservative tax reform.

The Problem of Inheritance Tax

As we have seen, the structure of Britain's tax system means that families can get a pretty rough deal at times, with absurdly steep marginal rates and other arbitrary penalties creating economically damaging distortions which ripple out across the economy. This leaves us all worse off – not just those with children.

But there are also specific taxes which reflect in microcosm the unfair and counterproductive way families can be treated by the tax system as a whole. Britain's version of inheritance tax is one such levy. Not only is it intuitively unfair (and deeply unpopular for that reason), but it is also impractical to administer and economically damaging in its effects. Many of the recent proposals for reform would only deepen these problems. Hence why we have decided to include inheritance tax in this study, and examine the issue in depth.

How inheritance tax works in Britain

The modern system of inheritance tax was introduced in 1986 to replace the invidious 'capital transfer tax', which had replaced the old estate duty dating back to the 19th century. However, the term 'inheritance tax' is, as academic tax experts have pointed out, something of a misnomer.[24] Our system of inheritance tax is not a levy on the earnings of inheritors, but rather on the estate of the deceased. It is a tax on property, not income; on the stock of wealth, not the flow of earnings.

'At the core of the system is a 40% flat rate applied to estates in respect of all transfers except between spouses and civil partners, so long as the value of the estate exceeds the 'nil-rate band''

The United Kingdom is therefore an international outlier, being one of just four OECD countries which imposes an estate tax, rather than a tax on the value of the assets that beneficiaries receive from the deceased donor.[25] A number of OECD countries do not in fact tax estates or inheritances at all, including Australia, Czechia, Canada, Norway and Sweden.

Inheritance tax is Britain is also comparatively complicated. At the core of the system is a 40% flat rate applied to estates in respect of all transfers except between spouses and civil partners, so long as the value of the estate exceeds the 'nil-rate band'. This has been set at £325,000 since 2007. George Osborne announced plans to lift the threshold to £1 million in 2007, but following the financial crisis and under the strictures of coalition, this plan was dropped.

24 See https://committees.parliament.uk/writtenevidence/77977/html.

25 The other OECD countries with an estate tax are Denmark, South Korea and the USA. See https://www.oecd.org/tax/tax-policy/inheritance-taxation-in-oecd-countries-brochure.pdf.

Instead, following the 2015 election, a 'main residence' allowance of £175,000 was introduced for family homes passed on to children or grandchildren (provided that the estate as a whole was worth less than £2 million). Combined with the ability to transfer unused inheritance tax allowances between spouses (introduced in 2007), this has effectively raised the main inheritance tax threshold to £1 million in certain specific cases.[26]

This convoluted system is further complicated by a host of carve-outs and exemptions. For instance, there is business relief on some assets and agricultural relief on others, and a reduced rate of 36% is applied to some assets if more than 10% of the total estate is left to charity. The rules around gifts – wealth transfers between living family members – are even more voluminous: who gives what to whom when really matters, with a taper rate applied to many assets transferred in the years preceding the donor's death according to the 'seven-year rule'.[27] In practice, it is up to family members to declare recent gifts and keep track of any consequent liabilities they might have in the event of the death of a loved one. So as well as being tortuously complicated, inheritance tax in Britain can also be very intrusive into family life.

'Inheritance tax is often justified as a levelling tax on the super-rich. But because it is so riddled with exemptions, the truly wealthy and well-advised often avoid paying it altogether'

The practical case against inheritance tax

The complexity of inheritance tax in Britain is hard to understate. It raises less than 1% of tax revenue for the Exchequer, but according to analysis by the TaxPayers' Alliance, accounts for 10% of Britain's tax code.[28] This is great for accountants, but less so for everyone else. Indeed, given the range of exemptions available, fewer than 5% of deaths result in anyone paying inheritance tax, yet half the time executors have to fill in inheritance tax forms anyway.[29] In other words, the administrative burden of inheritance tax, both to the Exchequer and to grieving relatives, is already massively disproportionate to the amount of revenue raised.

Inheritance tax is often justified as a levelling tax on the super-rich. But because it is so riddled with exemptions, the truly wealthy and well-advised often avoid paying it altogether. Instead, those whose wealth is tied up in the family home can be the hardest hit. And given that national house prices have risen by 47% in real terms since 2007 (and by 82% in Greater London), the £325,000 nil-rate band means fiscal drag is drawing more and more people into the paying inheritance tax. (Especially since the nil-rate band has been frozen until 2027/28.)

Many mooted reforms have been suggested, such as those set out in the Institute for Fiscal Studies' Mirrlees Review.[30] But many are likely only to exacerbate inheritance tax avoidance. That is because the focus of such reforms tends to be on making

26 Had these allowances kept pace with inflation, the nil rate band would be £520,000 today, and main residence allowance would be £230,000.

27 See https://www.gov.uk/inheritance-tax/gifts.

28 See https://www.taxpayersalliance.com/time_to_scrap_inheritance_tax.

29 Office of Tax Simplification, 'Inheritance Tax Review – first report' (2018).

30 Institute for Fiscal Studies, 'Dimensions of Tax Design' (2010) and 'Tax by Design' (2011).

inheritors pay inheritance tax, on the basis that taxing wealth transfers helps to level the playing field and create greater equality of opportunity.

This is perfectly logical, if one accepts their starting point. However, if bequests were taxed once in the hands of the recipient, rather than the tax being levied on the deceased's estate, this would lead to bequests being taxed more heavily than gifts during somebody's lifetime – unless they were also taxed. The burden of keeping track of gifts would fall all the more heavily on inheritors. Given the complexities involved, many more people would be at risk of inadvertently slipping into tax evasion. More straightforward avoidance is also likely to be rife. Indeed, in some ways, this would represent a return to the hard-to-enforce and ill-fated capital transfer tax of 1975-86.

The economic case against inheritance tax

According to the Office for Budget Responsibility (OBR), inheritance tax raised £6.1 billion in 2021/22. They expect it to raise around £7.2 billion this year and £8.4 billion by 2027/28.[31] As a share of the overall tax take, it will thus trend upwards to around 0.75%, triple the level of a decade ago, thanks mainly to fiscal drag.

'According to the Office for Budget Responsibility (OBR), inheritance tax raised £6.1 billion in 2021/22'

While not a major source of revenue, it nevertheless has huge deadweight costs and creates significant economic distortions. By taxing transfers to the next generation, we discourage work, savings and investment. Better to consume your capital now or take early retirement than wait for it to go to the taxman after you die.

Generally, we should aim to conform our tax system to the principle of tax neutrality – the idea that taxes should be structured so that people's decisions are made based on economic merits, not for tax reasons. But the prospect of paying inheritance tax can radically alter economic decision-making. Relatively few people pay inheritance tax, but without it, it is safe to assume that many more people would have larger estates at the time of their death. Higher savings – foregone consumption – across the economy would enable higher levels of investment, helping to address what has been a chronic weakness of the British economy in recent decades.

As a tax on wealth transfers, inheritance tax also contributes to effective marginal tax rates comparable to some of the other absurd cliff edges facing families as highlighted elsewhere in this report. Inherited money may already have been taxed when it was earned, when it was invested, and when it produced any returns. It is likely be taxed again when spent by the recipient. As the 2020 Tax Commission's Single Income Tax report showed, earned income that is saved and invested in a company for 35 years at a 10% return, and then inherited, could face a total effective tax rate as high as 95%.[32]

31 Office for Budget Responsibility, 'Economic and fiscal outlook – March 2023', p.148.
32 Ibid, pp.291-292.

Another feature of the British tax system that interacts with inheritance tax to create distortions and unintended outcomes is that capital gains liabilities are wiped at death. This incentivises people to hold assets until they die, rather than selling up and occurring capital gains tax in the process. Better that assets should pass to their heirs, who will not be liable for any of the capital gains accrued since the assets were first purchased, sometimes decades previously.

This is an eminently rational position for individuals to adopt under the current tax system, but this 'lock-in effect' is bad for economic growth. In effect, inheritance tax is functioning as a sort of turbocharged version of stamp duty land tax, a transaction tax which is widely recognised as one of the most economically damaging taxes currently levied by government, gumming up markets and inhibiting the efficient allocation of scarce resources.

Of course, there are provisions allowing people to pass on assets in the form of a gift while they are still alive. But as with gifts generally, if the benefactor dies before seven years are up, the inheritance tax liabilities on gifts falls on inheritors. In the first three years, the rate is 40%, then it tapers to 32%, 24%, 16% and 8% before falling to zero.

'Sweden abolished inheritance tax in 2004. The result was a boom in entrepreneurship, economic growth and tax revenues'

This can create a great deal of uncertainty for beneficiaries. Suppose a parent who is a pensioner makes a large cash gift to their adult child, the value of which exceeds the various exemptions. The child could put this money to use. But if the family were to be unlucky and the parent die unexpectedly, the child may be stung for inheritance tax. If the money is already spent or locked up in a business venture or investment vehicle, they may have to foot the tax bill from other earnings, if indeed they can.

Questions of misfortune and fairness aside, the rules around gifts can thus also lock in otherwise productive assets, at least for several years.

The Swedish experience highlights how inheritance tax can be a drag on growth. Sweden abolished inheritance tax in 2004, in a move that enjoyed very broad cross-party support. The result was a boom in entrepreneurship, economic growth, and tax revenues that the tax had previously suppressed.[33]

In the first instance, the abolition of inheritance tax resulted in the return of large family businesses to Sweden (many had moved abroad in the 60s, 70s and 80s to escape inheritance tax). In fact, Swedish tax authorities found that 8,000 wealthy individuals moved assets back into the country in one four-year period.

But perhaps more importantly, there was surge in assets being transferred, not just between family members, but also to external owners for businesses. Moribund capital was rapidly shifted into younger, more innovative hands and more productive uses. And family businesses also became more entrepreneurial in general, for previously inheritance tax had weighed heavily heavily on investment decisions.

33 See https://www.telegraph.co.uk/tax/news/sweden-ditched-inheritance-tax-business-boom.

Despite its massive economic impact, Sweden's inheritance tax had raised less than 1% of revenue, much as in the United Kingdom today. After it was abolished, overall tax revenues actually went up thanks to the return and more efficient allocation of capital within the country boosting economic growth.

Anders Ydstedt, of the Svenskt Näringsliv – the Swedish equivalent of the CBI – contends that this 'shows that if you abolish a stupid tax that is complicated and forces wealthy people to leave the country, you get more tax revenue when they return. That is the Swedish experience.'[34] It is an experience we would clearly do well to heed.

In summary, inheritance tax is an inefficient tax which penalises work, savings, investment and capital accumulation, distorting behaviour with potentially significant aggregate economic consequences over time. But perhaps even more importantly, it discourages people from providing for the next generation – which is fundamentally at odds with people's sense of fairness.

'While only around 4% of people actually pay inheritance tax on their estates, it is far more unpopular than taxes which pretty much everyone pays, like VAT or income tax'

The moral case against inheritance tax

While only around 4% of people actually pay inheritance tax on their estates, it is far more unpopular than taxes which pretty much everyone pays, like VAT or income tax. It is even more disliked than stamp duty or fuel duty.[35] Indeed, polling consistently finds that 50% of voters think inheritance tax is either 'unfair' or 'very unfair', while just 20% think it is either 'fair' or 'very fair' (with the remainder split roughly evenly between 'neither' and 'not sure').[36]

This polling points to a moral intuition or sentiment which, if not innate and universal, is certainly pretty firmly embedded in the British psyche. There is just something unseemly about the state inserting itself into transfers between family members and trying to take a cut, especially when it is from parents to their children and grandchildren. It is the state pitted against a mother's or father's love and self-sacrifice for their children, and their desire to see their offspring thrive in the world and do better than themselves.

Many philosophers and political theorists of a conservative bent have tried to explain, elevate and even systematise this moral intuition into a principle of ethical or political action, beginning in the modern era with the likes of David Hume, Adam Smith and of course Edmund Burke – who famously characterised society as a contract between the dead, the living and the yet unborn.

Of course, inheritance tax with a threshold of £325,000 is not Bolshevism red in tooth and claw. But it still feels instinctively unfair to most people. It also has the effect of weakening many of the values which we should hold dear. There are worse

34 Ibid.

35 See https://yougov.co.uk/topics/politics/articles-reports/2015/03/19/inheritance-tax-most-unfair.

36 See https://yougov.co.uk/topics/politics/trackers/how-fair-is-inheritance-tax.

taxes and worse intrusions into the family sphere than inheritance tax, but it still cuts against our ambition to create a more family-friendly tax system. And it is not even doing a particularly good job of what it is meant to do, which is to help level the playing field within society by pulling back those families who have got too far ahead.

Reform or abolish?

Inheritance tax is hard to administer, economically damaging and morally objectionable to many Britons. So what should we do about it?

As noted above, inheritance tax receipts of around £6-8 billion represent a tiny fraction of overall revenues – 0.7% to 0.75%. Outright abolition would not therefore have a major impact on the public finances in the long run. The counterargument to this would be that given the fiscal constraints any Government is likely to be operating under in the near future, tax cuts are better targeted elsewhere – for example, at the proposals in earlier sections.

‘Inheritance tax receipts of around £6-8 billion represent a tiny fraction of overall revenues – 0.7% to 0.75%’

We would certainly argue that many of the other changes in this report should take priority over abolishing inheritance tax, if we care about improving outcomes for as many families as possible. On the other hand, abolishing inheritance tax would be popular among voters. And as most observers expect the Conservatives to lose the next election in any case, leaving a landmine for a subsequent Labour government would not be the worst idea in the world. Much as Gordon Brown's 45p higher rate of income tax detonated with great effect underneath the Truss government, an attempt to reintroduce a ‘death tax’ could see middle England explode under Labour.

We also propose a quid pro quo for the Treasury. Abolishing inheritance tax should be accompanied by a change to capital gains tax rules, so that rather than forgiving historical capital gains at death, heirs would acquire the deceased's original cost basis along with any inherited assets. If these assets were subsequently sold, the heirs would have to pay capital gains tax – where applicable – on the entire historic gain, not just the gain since they inherited the asset. (Though if the heirs wanted to live in the family house or keep the family business going, there would of course be no capital gains tax to pay in the first instance.)

Increased capital gains tax receipts would help to offset any lost revenue from raising the inheritance tax threshold, while eliminating one of the most significant economic distortions that the tax causes – the ‘lock-in effect’.

But what if abolishing inheritance tax outright is off the cards? We should still take action in the short term to make it fairer and simpler by honouring George Osborne's 2007 pledge to raise the nil-rate band to £1 million.

Many estates can exempt £1 million from inheritance tax already, but only though combining four different allowances between spouses/civil partners, two of which only apply to primary residences. The rationality of the tax system would be much improved if the government simply said that the first £1 million of every estate was free from inheritance tax, while dramatically simplifying various allowances and exemptions

Restricting the inheritance tax net to only the highest-value estates would mean that the vast majority of families who have lost a loved one could simply self-certify that no inheritance tax was owed, removing the need for extensive paperwork.

The fiscal implications of these moves would be small, but the political pay-off could be significant. And it fulfils the ambition set out elsewhere in this report of making Britain's tax system less distorting, simpler to administer, and above all fairer for families.

Conclusion

This report has argued that the way the British income tax system is structured places an unfair burden on many families, especially those with a single earner, or in which earnings are divided unevenly between partners. As a rule, the less equally split a married couple's incomes are, the higher the average tax rate they will face.

We have also highlighted the poor design of various family-related aspects of the tax and benefits system, which can result in extremely high effective marginal tax rates or even severe cliff edges – points in the tax system at which increasing your income actually costs you money.

No one would have set out to design a tax system that operates as ours does today. And, indeed, we are something of an international outlier in how little our tax system does for families, relative to individuals. So there is not only a strong case for reform, but also a variety of overseas models we could examine and learn from.

'When it comes to personal taxes, our suggestion is that ministers give priority to introducing a fully transferable personal allowance for married couples with children. Depending on the precise details, this would have a fiscal cost of between £2.1bn and £3.6bn'

We believe Conservative reformers need to engage in some serious long-term thinking about how to make our tax system, and our economy, more family-friendly. France's *quotient familial* is especially appealing as an alternative model, since it factors children into the tax calculation, and could inspire efforts to simplify and integrate child benefit and childcare subsidies with the tax system here in Britain.

But there is also a case for immediate action, as the Government considers how and where it might reduce taxes before the next election. When it comes to personal taxes, our suggestion is that ministers give priority to introducing a fully transferable personal allowance for married couples with children. Depending on the precise details, this would have a fiscal cost of between £2.1bn and £3.6bn. We think it would prove popular – helping hard-pressed families at the most financially-stretched time in their lives, while also underlining Conservative commitment to the family and advancing the principle of fairness.

Ideally, such an upgrade on the marriage allowance should be accompanied by reform of the child benefit tax charge, both to limit its application to the best-off families and to smooth out its effect on marginal tax rates. The withdrawal of childcare subsidies, too, should be based on household income.

The combination of immediate action and more fundamental long-term ambition also applies to our analysis of inheritance tax. This 'death tax' is desperately unconservative – an effort by the state to insert itself into transfers within families and take a cut. It offends the basic sensibilities of many Britons – which is why it is so wildly unpopular, despite its narrow application. Inheritance tax is bureaucratic and distortionary, and we would be better off without it – as the Swedish example has shown. That should be the ambition. At the very least, though, this Government should make good on the promise of a simple, £1m threshold before the opportunity slips away.

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