

Dear Mr McDonnell,

Eradicating in-work poverty

At Tax and the Family we are very supportive of your aim to eradicate in-work poverty. We recognise that your plans go much wider than changing the structure of tax and benefits, but that is the area on which we concentrate and on which we can comment.

There are two points which we should like to make as in our view they get insufficient attention.

First the issue of marginal rates. There is a lot of discussion about the impact on incentives of a 45% or 50% top rate of tax (+2% NIC) for people on high incomes. But the marginal rate for people with much lower incomes is very considerably higher. For those still on tax credits and receiving housing benefit, the marginal rate can be over 90%. One of the reasons for introducing universal credit was to reduce those rates, but in many cases it will still be 80% and the impact is likely to be greater than with tax credits as the effect of an increase in income in one month is to reduce the credit in the next month.

How can people – and we are talking here of a third of working families – possibly make their way out of poverty if they are faced with marginal rates as high as these? Are not rates at these levels bound to make people reluctant to take on extra work?

A major issue is of course that, if the safety net for those not in work or on very low incomes is high enough to take them out of poverty, then the cost of social security will be enormously high if the amount of the benefit is not withdrawn very rapidly once incomes begin to rise.

One way of meeting this problem is to look at our income tax system, and this brings us to our second point.

The safeguards which accompanied the introduction of independent taxation in 1990 had been fully withdrawn by 2000. Now every taxpayer, whatever their family circumstances, is eligible for the same personal allowance (this year £12,500). As a consequence, a single person without dependants can enjoy a good standard of living, while a single earner family on a similar income will be paying over £1,000 in income tax and NIC even though they may be in poverty.

Income tax ought to reflect how well off people are. To do this, household circumstances have to be taken into account. This is what happens in Germany, France and the US. Our failure to do so in the UK is one of the reasons why the number of households in poverty remains so high. The personal allowance has nearly doubled in the past ten years, but most of the benefit has ended up in households in the top half of the income distribution. If these resources had been focussed on families, the number in in-work poverty would be lower, the number facing confiscatory high marginal rates would be lower, and there would be less income inequality.

If inequality and child poverty is to be reduced, it would be sensible to focus any tax reductions that can be afforded on in work households caught in the benefit trap.

One way of ensuring that the tax system reflects the size of a family would be to build on the very limited transferable allowance for married couples by giving it to all single earner couples – married, civil partners, and cohabiting – at the full rate, rather than the one tenth rate today. There may be less need to help two earner couples, but single parents would certainly need comparable support and it may be that something akin to the Additional Personal Allowance introduced in 1990 would be the way forward.

We have set out these ideas in the most general terms. We should be happy to discuss them in greater depth with members of your team if that would be helpful.

Yours sincerely,

Don Draper and Leonard Beighton.
