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Fiscal policy and the family

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Section 1: The unit of taxation – the family, the household or the individual?

Whether the household or the individual should be the appropriate unit for the assessment of taxation is contested in economics. We argue that the household should be the unit of taxation. This would normally be limited to those members of the household who are members of the same family. However, we will tend to use “household” and “family” interchangeably in the remainder of this paper.

The economic arguments for assessing tax on the basis of individual or family income are finely balanced when we consider the tax system alone. However, when we look at the impact of the welfare and tax systems combined, it is clear that the current tax system in the UK – which is wholly focused on taxing individual income – is flawed. The tax and welfare systems discriminate systematically against families with an unequal split of incomes and discriminate against family formation.

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

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

A primary consideration in tax policy is the desire to achieve horizontal equity. In other words, two tax units receiving the same income should be taxed in the same way.[1] If it is accepted that the unit of taxation should be the family or the household, then the current UK tax system is a long way from the principle of horizontal equity. As we shall show below, families with the same incomes, but with a different split of incomes between the adults in the households, can pay very different tax rates. But should the family be the unit of taxation? Or is the situation that pertains in the UK the most acceptable from an economic point of view.

Interestingly, when international comparisons of inequality are made, the household is the starting point for the calculations of disposable income.[2] In the UK, the Office for National Statistics (ONS) evaluates inequality based on household and not individual income.[3] Indeed, to do otherwise would be bizarre as an example easily shows. Compare two countries, A and B in households have two adults. In A, every individual earns £25,000. In B, one adult in each household earns £50,000 and the other adult, who is caring for elderly parents, earns nothing. If we measure inequality by looking at household incomes, both countries have perfect equality. If we look at individual incomes, country B would be far more unequal than country A and would have an absolute poverty rate of 50 per cent. This would not make any sense.

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

Indeed, all other things being equal, a progressive tax system based on taxing individual income will act to increase, rather than decrease, measured household inequality according

[1] Musgrave, R. A. (1967). "In Defense of an Income Concept". *Harvard Law Review*, 81(1), p. 44–62.
[2] Some adjustments are made for the different living costs incurred by different sized households. See: https://data.oecd.org/inequality/income-inequality.htm
[3] Office for National Statistics, "Household income inequality, UK: Financial year ending 2020".

to standard measures by redistributing money from poor single-earner households to richer two-earner families.

Despite this very strong argument against an individualised tax system, there are some economic arguments that point in the other direction.

One of the most comprehensive reports on the UK tax system was the Meade Report, published in 1978. Chapter 18 of this publication considered the matter of the individual and the family as a unit of taxation at some length. Overall, the report tended to favour taxation assessed at the level of the individual with some adjustments, especially in relation to investment income. But that conclusion was predicated upon the assumption that what the authors described as "home responsibility payments" would be given to non-earning spouses looking after children. Thus, an adjustment in the benefits system would be made to reflect the horizontal inequity arising within a tax system based on individual assessment. This would, of course, hugely increase welfare spending and involve taxing the resources of a family in order to then pay the same family benefits for looking after children and older people. There are many reasons why this is undesirable, but the conclusions of the Meade report cannot be used as arguments in favour of individualised taxation.

The other main comprehensive assessment of the tax system in the UK was published by the Institute for Fiscal Studies in 2011.[4] That report also considered the issue of the appropriate unit of taxation. It raised the question of horizontal equity and concluded that taxing households differently, depending on the split of incomes between members of the household, was not equitable.

However, Mirrlees *et al* made two other points that are important in any economic analysis. Firstly, they argued that using the family as a unit of taxation creates an artificial incentive to marry or cohabit (if the option of being taxed as a family unit is available to cohabitees). If two individuals have different earnings, they will be taxed less if they choose to cohabit or marry than if they remain single because they can make use of each other's unused tax allowances. However, this is not true in any country which uses the family as a unit of taxation if we also take into account the interaction of the tax system with the welfare system. In

[4] Mirrlees *et all*, (2011), "Special Issue: Special Issue on the Mirrlees Review", *The Journal of Applied Public Economics,* Volume 32, Issue 3, Pg. 319-453.

addition, quoting empirical work, they suggested that second earners have a higher elasticity of labour supply. This takes us into the territory of technical economics, but it means that the decisions of second earners are distorted to a greater extent by any given tax rate. According to economic theory we should therefore tax second earners less in such situations, which is exactly what tends to happen in the UK tax system. However, the extent to which second earners are taxed less is simply an accidental by-product of our individualised tax system super-imposed on the particular pattern of earnings in any given household. Our system is not somehow cleverly designed to take account of the points made by Mirrlees et al.

In addition to these arguments, it can be noted that couples with uneven incomes are more likely to be doing more "non-market", and therefore untaxed, work.[5] To the non-economist, it may seem strange to cite this as relevant. However, the argument can be illustrated with an example. Consider two families A and B. In family A, both partners work full-time and have similar earnings. In family B, one partner works full-time and earns considerably more than the other partner, who has a part-time job or no job at all. Combining the contributions of the two partners, family B as a whole spends less time in paid employment (including travel to work) than family A, and as a result has more time available for childcare, eldercare and domestic chores such as cooking, DIY, cleaning, and gardening. With less disposable time, family A is likely to rely more on professional carers or hire a cleaner or gardener. The taxes that are levied on those who provide these services (income tax, VAT, etc) are paid indirectly by family A, whereas the equivalent services in family B are provided by the untaxed labour of family members. An economist might say that family B has an untaxed income in kind. Individual taxation and the subsidy for professional childcare and eldercare might be seen as rough and ready ways of dealing with this anomaly.

This point is correct but, we believe, marginal.

Taking all things into consideration, Mirrlees *et al.* concluded as follows:

> Ultimately, the choice between individual and joint taxation depends on political value judgements about how far people should be viewed as independent individuals and how far as couples. Rather than making a judgement of our own, in this book we

[5] Apps, P., Rees, R. (2018), "Optimal family taxation and income inequality". *Int Tax Public Finance,* Vol. 25, p. 1093–1128.

simply take the current individual, annual assessment for taxes and joint, short-term assessment for benefits as given.[6]

As is clear, we do not agree with this. However, Mirrlees et al left out another crucial argument which outweighs all others – the interaction between the tax and benefits system.

In the United Kingdom, welfare payments are based on family income. This means that, as family income rises, benefit payments are reduced. This is reasonable. Welfare systems are designed to redistribute money from rich families to poor families. However, if an individual who is earning money forms a household with somebody who is not, the couple lose significant amounts in welfare benefits. In our tax system, which uses the individual as a unit of taxation, the couple do not gain through lower taxation when forming a household. This is quite unlike in many other countries where, if a non-earner and an earner form a household, the earner would receive two tax-free allowances. The reduction in the couple's tax bill then helps to compensate for the loss of welfare benefits. There is symmetry between the welfare and tax systems in such cases.

The International Federation for Family Development (IFFD) found overwhelming evidence for the positive outcomes that come from family stability. These include: higher life expectancy, lower risks of mental illness and drug addiction, higher academic achievement, increased discipline in fulfilling legal duties and social contributions to society.[7] It can genuinely be said that, in the UK, we subsidise people to live apart – almost as if the creation of families brings what economists call "negative externalities". It seems as if politicians believe that family formation is damaging and needs to be financially penalised in the same way as the consumption of cigarettes or sugar.

Contrary to the suggestion of Mirrlees *et al*, a tax system based on the individual as a unit of assessment discriminates against, rather than artificially encourages, marriage and cohabitation.

[6] *Ibid. p. 139*

[7] IFFD, (2017), "The Crucial Role of Families", https://www.un.org/ecosoc/sites/www.un.org.ecosoc/files/files/en/integration/2017/IFFD.pdf

The last major work on couple penalties in the tax and benefit system was by Adam and Brewer (2010).[8] They concluded: "68% of existing couples in the UK face a penalty in the 2010–11 tax and benefit system, 27% face neutrality and 4% face a premium…The sum of all couple penalties amounts to £34.7 billion a year…".[9] The couple penalties are concentrated in families with children: "By family type, almost all (95% of) couples with children have a couple penalty, as do 81% of pensioner couples and 41% of working-age couples without children." Their conclusion is similar to ours that the penalty on family formation arises from: "…paying out benefits and tax credits according to family circumstances but levying income tax according to an individual's income".[10]

The reversing of Mirrlees' argument in this way, combined with the horizontal equity argument, points strongly in the direction of the use of the family as the unit of taxation. Of course, the other economic arguments in favour of individual taxation still stand, but they seem to be of marginal importance.

Given this, it is extremely difficult to see how the views of the former Deputy Prime Minister, Nick Clegg, on the small transferable tax allowance that exists in the UK can be justified. He argued against it saying that there was a limit on what the state "should seek to do in organising people's private relationships" and that "We can all agree that strong relationships between parents are important, but not agree that the state should use the tax system to encourage a particular family form".[11] This view is widely held in Westminster, but it suggests a stunning lack of familiarity with the UK tax and benefit system for which he was responsible.

Taking everything into consideration, we argue that the basic unit of taxation should be the family or the household. This should also be the basic unit for the assessment of welfare benefits too. In the sections below, we show the bias against single-earner families in the current, individualised, UK tax system. We also make comparisons with other countries' tax systems.

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[8] Stuart Adam, Mike Brewer, (2010), "Couple penalties and premiums in the UK tax and benefit system", *Institute for Fiscal Studies*.

[9] *Ibid.* pg. 4.

[10] *Ibid*. pg. 5, 75.

[11] Simon Alford, (Dec. 18th 2011), "Clegg attacks marriage tax break plans", *The Times.*

Section 2: From families to individuals as the unit of taxation – a brief history

It might be thought that the conclusion of the previous section is “quaint” or “old-fashioned”. The UK’s individualised tax system seems deeply embedded. There has been some discussion of alternatives to our current tax system by organisations such as *Care*[12] and *Tax and the Family*[13]. As noted above, the Institute for Fiscal Studies has raised the question of couple penalties. Patricia Morgan has also undertaken research on this issue, concluding in Morgan (2007) that: “families should be allowed to retain resources on a par with those available to individuals without dependants, probably through transferring tax-free entitlements”.[14] Williams (2019) goes even further in arguing that arguing:

> By forcing a married couple to be treated as two individuals, the UK tax system fails as good public policy. […] our tax system is philosophically incoherent. Stable families and stable marriages are the bedrock of a strong and flourishing society.[15]

As noted above, there was opposition to the introduction of the marriage allowance, even within the coalition government of 2010-2015. But, taken as a whole, even that government’s policy was incoherent. The same government that brought in the small marriage allowance also brought in the withdrawal of child benefit in such a way that it discriminated strongly against single-earner families (see below).

Many other developed countries levy tax on the basis of family income. For example, in France and Germany, as will be described below, household incomes are, in effect, pooled and then divided between household members before calculating tax due.

Indeed, the UK, in some senses, arrived at our current place by accident rather than by design The treatment of the family in our current tax system traces its roots to the early 1980s when

[12] Leonard Beighton, Don Draper and Alistair Pearson, (2018), “The Taxation of Families”, *Care – Tax & the Family*, https://care.org.uk/uploads/pages/taxation-report.pdf

[13] Tax & the Family Reports, https://www.taxandthefamily.org/reports-1

[14] Patricia Morgan, (2017), “The War between the State and the Family: How Government Divides and Impoverishes”, Abingdon: Taylor & Francis, p. 148-149.

[15]Jonathan Williams, (June 18th, 2019), “Taxing Families in the UK”, *Institute for Fiscal Studies*, https://ifstudies.org/blog/taxing-families-in-the-uk

then Chancellor of the Exchequer Nigel Lawson sought to implement a tax system that would be "neutral and fair" to the individual.[16] But there was a caveat. In his memoirs Lawson argued that, "…after careful study, I came to the firm conclusion that this should be a system of independent taxation, with the allowances freely transferable between husband and wife."[17] The premise was rather straightforward:

> "Everyone, man or woman, married or single, would have the same standard allowance. But if either a wife or a husband were not able to make full use of their allowance, the unused portion could be transferred, if they so wished, to their partner. […] It would end the present discrimination against the family where the wife feels it right to stay at home, which increasingly nowadays means discrimination against the family with young children."[18]

This was never achieved. Lawson describes how Prime Minister Thatcher, "…did not like the idea at all". Her reaction came as a surprise since she undoubtedly valued the family. In practice however, Lawson points out that "…she strongly identified with two-earner couples".[19]

Re-confirmed as Chancellor following the 1987 general election, Lawson ultimately settled for what he describes as a "halfway house" with independent taxation but without fully transferable allowances. Families would however benefit from a 'Married Couple's Allowance' which originally represented the difference between the single person's allowance and the married man's allowance in the old system.[20] Even at the beginning, this was a poor substitute for transferable allowances, but it was, in any case, gradually withdrawn. Bizarrely, it was kept for pensioners.

A very limited marriage allowance was brought back by the coalition government, as noted above. For the 2019-20 tax year, the Marriage Allowance allows single earner couples or couples where one person earns less than £12,500 per year to transfer a £1,250 additional tax allowance to their partner. This would result in a maximum annual tax saving of up to

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[16] Tax & the Family, (2018), "An Interview with Lord Lawson about Independent Taxation", *YouTube*, https://www.youtube.com/watch?v=jTfjcXmY1R0

[17] Nigel Lawson, (1992), "The View from No.11: Memoirs of a Tory Radical", London: Bantam Press, p. 882.

[18] *Ibid*. p 883

[19] *Ibid*. p 882

[20] *Ibid*. p 885

£250.[21] The mechanism is complex and the total maximum benefit is small. It is also withdrawn as incomes rise. This was accepted by David Cameron who said: "This policy isn't about the money but about the message that people who make a lasting commitment should be recognised in some way."[22]

This seems to be a rather weak statement: surely, the strength of the "message" depends on the extent of the financial benefit. But the idea has been packaged in the wrong way from the beginning. The marriage allowance has been promoted as a way of rewarding marriage rather than a way of gradually ending discrimination against households where the split of earnings between individuals within households is uneven. Also, the marriage allowance cannot be said to have been successful. The take-up has been low: in 2019, fewer than half of eligible couples made use of the allowance.[23] Presumably, this is due to its complexity and relatively low value.

So, what are the financial impacts of our tax system on families with different earnings profiles?

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[21] GOV.UK, (2021), "Marriage Allowance", https://www.gov.uk/marriage-allowance

[22] David Cameron, (14 January 2019), "House of Commons Briefing Paper Number 4392: Tax, marriage & transferable allowances", p. 32.

[23] Sam Bromley, (26 June 2019), "Revised HMRC figures reveal more than 2 million people are missing out on this tax break", *Simply* Business, https://www.simplybusiness.co.uk/knowledge/articles/2019/06/marriage-allowance-hmrc-fluff-figures/

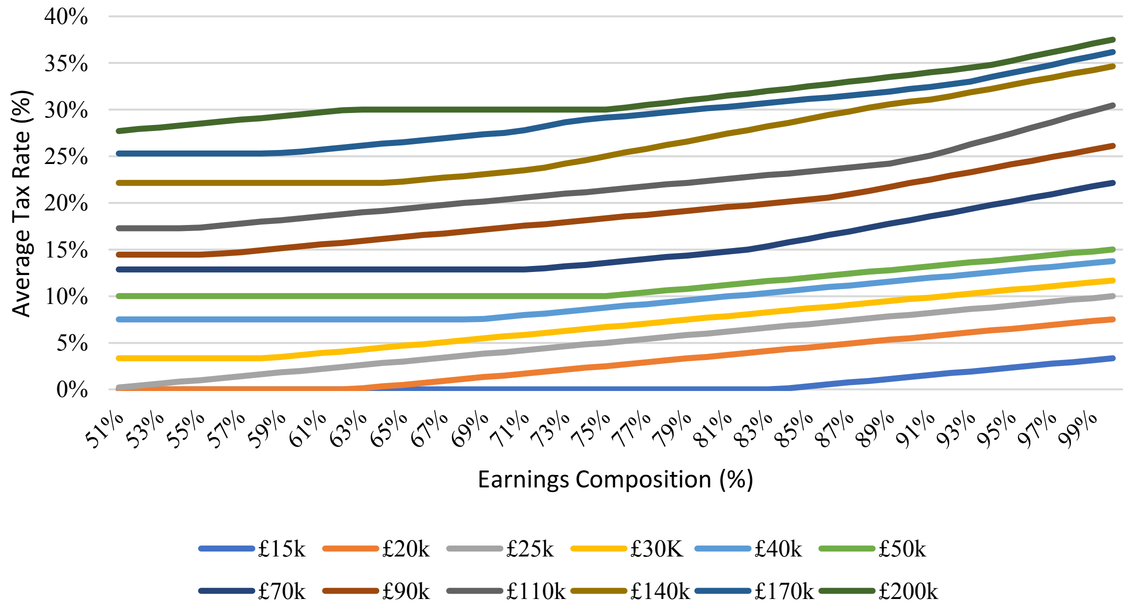
Section 3: Taxing families unfairly – the unequal treatment of households in the UK tax system

Here we quantify the extent of the variation of the tax burden between families with two earners and those with one primary earner. We look at the total tax paid in different situations and the average tax rates (ATR) of households where earnings are split in different ways between two main adults. We consider both income tax and national insurance and also examine the effect of child benefit withdrawal.

3.1 Income Tax

Figure 1 shows how the average tax rate changes for families with different levels of household incomes (shown by different coloured lines) as the split of income becomes more uneven. At the left-hand side of the figure, the average tax rate is that which prevails where there is a 50:50 split of income. The right-hand side represents a single-earner family. There is then every possible split in between those two extremes.

Figure 1: Average Tax Rate (ATR) at various income levels and earning compositions



The following specimen examples are worth noting. Median household earnings are about £30,000 per annum and so examples have been chosen at representative points below and above median earnings.

- The amount of income tax paid by a household earning £20,000 annually varies from £0 to £1,500 depending on the composition of household earnings, with an effective average income tax rate varying from 0–7.5%.
- The amount of Income Tax paid by a household earning £30,000 annually varies from £1,000 to £3,500 depending on the composition of household earnings, with an effective average income tax rate varying from of 3.3–11.7%.
- The amount of Income Tax paid by a household earning £70,000 annually varies from £9,000 to £15,000 depending on the composition of household earnings, with an effective average income tax rate of 12.9-22.1%.
- The amount of Income Tax paid by a household earning £140,000 annually varies from £31,000 to £48,500 depending on the composition of household earnings, with an effective average income tax rate of 22.1-34.6%.

In other words, the income tax system places single-earner families in an unfavourable tax position regardless of income level: they are consistently paying the highest ATRs, often higher by a significant margin. If we take the approximate median household annual income of £30,000, we can see (as shown in the examples), that a single-earner family will have a disposable income of £2,500 less as a result of their higher tax bill compared with a household where both spouses are earners. This would require the single-earner household to earn an additional £3,125 in order to have the same disposable income as the dual-earner household.

The situation becomes more dramatic as we move up the earnings scale. We should remember that couples higher up the income scale relative to median earnings should not necessarily be regarded as well off, especially if they live in areas with high housing costs. The median household income is much higher for couples who are of the age where most people have children, when decisions about which parents go out to work have to be taken, but resources are also often tighter.[24] The aggregate median income is based on the distribution of incomes across society as a whole, including those of younger and older ages who would be expected to have less income, on average, than families with earners in their late 30 and 40s.

At a family income level of £70,000, a single-earner family will pay £6,000 more in tax than a dual-earner family with an equal split of earnings (i.e., £35,000 per annum each). The single-earner family will have to earn an additional £10,000 to have the same disposable income as the dual-earner family – that is, the single-earner family requires earnings that are 14% higher.

At a family income level of £140,000, a single-earner family will pay £17,500 more in tax than the dual-earner family who earn £70,000 each. The single-earner family needs to earn an additional £29,000 to have the same disposable income as the dual-earner family: in other words 20% more.

It should be noted that these are conservative estimates as they ignore national insurance contributions and the withdrawal of child benefit the impact of which are examined in later sections.

3.2 Income Tax and Marriage Allowance

The impact of the Marriage Allowance (MA) on household finances is largely insignificant. Regardless of the level of total income, the maximum tax saving a family can claim using the MA is £250 per annum. It is no surprise, therefore, that the resulting reduction in household ATR is also negligible.

The following examples illustrate the point:

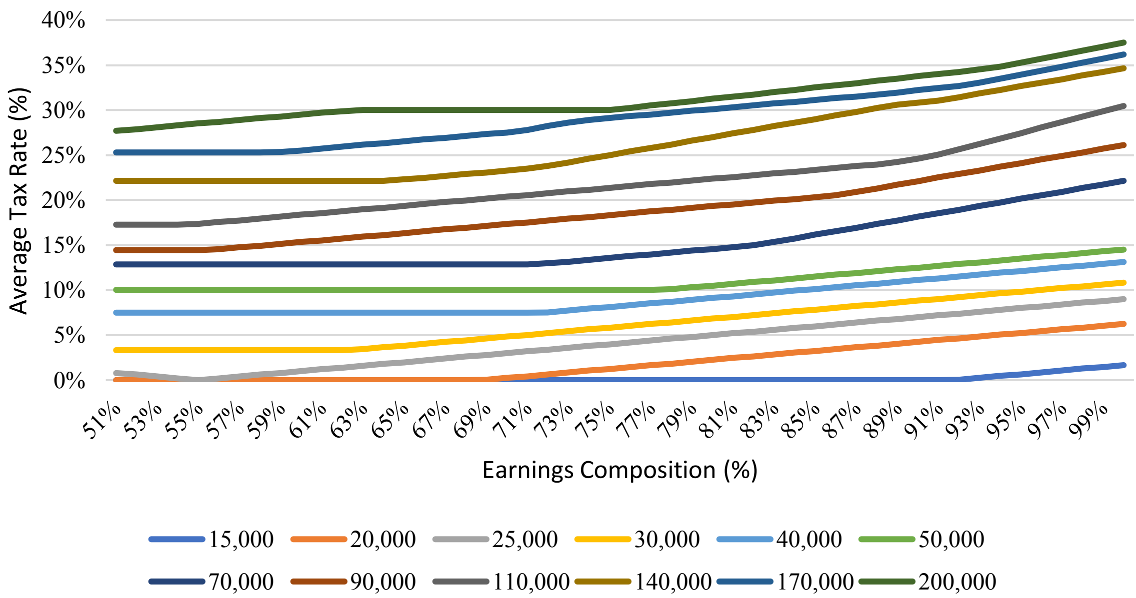
- The MA reduces the effective average income tax rate from 7.5% to 6.3% for a single-earner couple on £20,000 per annum. The dual-earner couple with a 50-50 income split will stay pay no income tax at all and so has an ATR of zero.

[24] Median weekly pay, for example, is 27 per cent higher for people in their 40s as compared with people in their 20s. See: "Average earnings by age and region", *House of Commons*, https://commonslibrary.parliament.uk/research-briefings/cbp-8456/

- For a single-earner couple earning £30,000, the MA reduces the effective average income tax rate by just 0.9% from 11.7% to 10.8%. The effective ATR for the dual-earner earner with a 50-50 split remains at just 3.3%.

Figure 2 illustrates the ATR of households when the MA is taken into consideration. As noted above, the reduction in ATR resulting from the marriage allowance is tiny, even when its effect is at its greatest. The reduction in ATR from the MA continues to decrease in percentage terms as the household income increases. It is notable from this figure that, even after allowing for the MA, a single-earner couple earning £50,000 a year faces approximately the same average tax rate as a dual-earner couple earning £90,000.

Figure 2: Average Tax Rate (ATR) with Marriage Allowance (MA) at various income levels and earning compositions



3.3 Income Tax, Marriage Allowance and Child Benefit Tax Charge

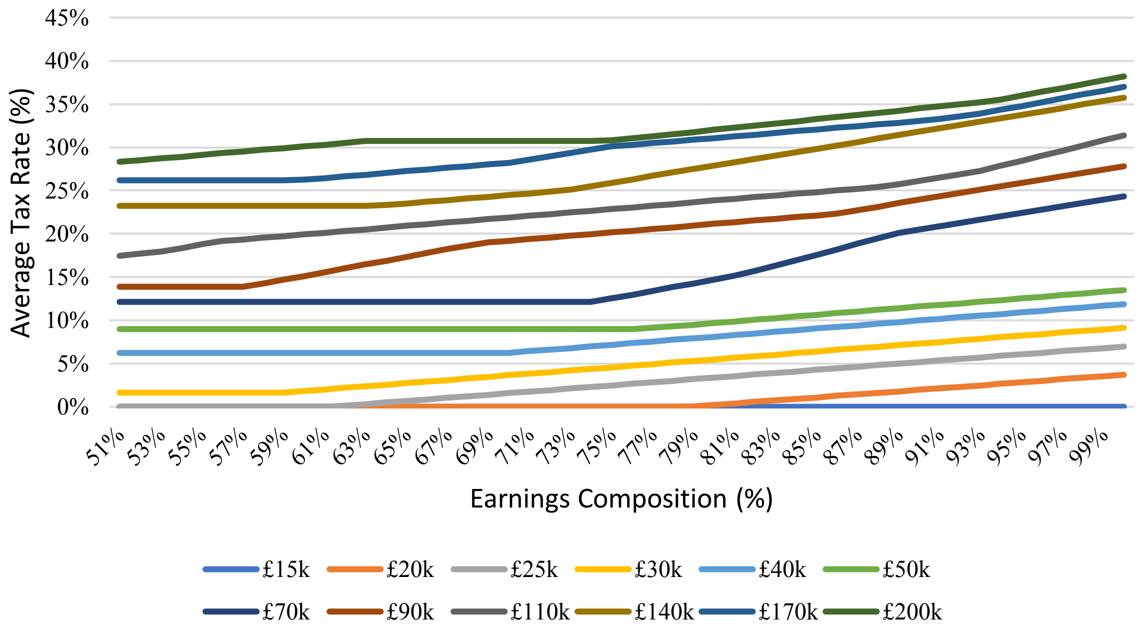
The Child Benefit Tax Charge (CBTC), also known as the 'High Income Child Benefit Tax Charge' is a tax charge placed on incomes above £50,000 per annum for households in particular circumstances. The tax charge arises from the desire by the government to withdraw child benefit from those on higher incomes: though, as we have noted, a single-earner family earning £50,000 a year in an area of high housing costs should not necessarily be regarded as "high income".

Its operation seems to have been designed to impose a discriminatory burden on single-earner families. If any earner within a family earns more than £50,000 per annum, the child benefit is withdrawn, even if the child benefit was paid to a non-earner (for example, the mother). The withdrawal takes place over the following £10,000 of income until all the child benefit has been withdrawn once the individual is earning £60,000. The cost of this depends on the number of children, but it can be enormous and can add substantially to both the marginal and average tax rate of a household that has one or more individuals earning over £50,000 per annum. For example, a family with three children with one member of the household earning £60,000 will lose their £2,556 child benefit as their earnings progress from £50,000 to £60,000.

There is no principle of taxation that can justify this policy. A dual-income household with an income of £100,000 evenly split between two earners will not be affected at all by the charge, whereas a single-earner family with an income of £60,000 and three children would lose a total of £2,566. This would amount to 4.3% of gross income and 5.9% of net income.

Figure 3 shows the ATR, taking into account both the MA and CBTC, of households with different earnings' structures, at different levels of total income. We have added child benefit

Figure 3: Average Tax Rate (ATR) with Marriage Allowance (MA) and Child Benefit Tax Charge (CBTC) at various income levels and earning compositions



for a family with three children to the gross income. We then adjust the figures for household taxation for the CBTC and also taking account of the marriage allowance.

Some key results are:

- The amount of Income Tax paid by a household earning £70,000 annually varies from £8,491 to £17,027 depending on the household earnings' composition. The effective average rate of Income Tax rate on the household varies from 12–24%. This means that a single-earner household will pay an additional £8,536 in tax compared with a household where there is an equal split of earnings between the couple. Because the single-earner household is paying higher-rates of tax, the earner will have to earn an additional £14,700 of gross income to be in the same position as the dual-earner family. In other words, a single-earner household would have to earn £84,700 per annum to have the same net income as a dual-earner household with an income of £70,000 per annum.
- The amount of income tax paid by a household with an annual income of £140,000 will vary between £50,027 and £32,527 depending on the household earnings' composition. The effective average tax rate varies between 36% (for a single-earner family) and 23% (for a dual-earner family with a 50:50 split of income). The single-earner family will pay an additional £17,500 in tax as compared with the family with a 50:50 split of incomes. The single-earner family would have to earn over £30,000 more than the dual-earner family to have the same net income.

One of the reasons for this huge difference in tax paid by the single- and dual-earner family at high income levels is the existence of a further complexity in the UK tax system. Although, at this level of income, both couples will pay the CBTC, when earnings are above £100,000, the personal allowance is withdrawn. This creates an effective marginal income tax rate of 60% on the next £25,000 of earnings. Again, this affects single-earner families disproportionately. A single-earner family with a household income of £110,000, for example, will have paid a 40% income tax rate on £50,000 of earnings, followed by a 60% income tax rate on £10,000 of earnings. On the other hand, a dual-earner family with the same household income will have paid 40% tax on only £10,000 of earnings and does not pay the 60% rate at all. This has a significant effect on the difference between average tax rates where household incomes are above £100,000.

3.4 Income Tax, Marriage Allowance, Child Benefit Tax Charge, and National Insurance Contributions

So far, we have focused on the income tax system and ignored National Insurance Contributions (NICs). The situation with regard to national insurance is more complex conceptually because a contribution record provides an entitlement to benefits – most importantly a state pension in retirement.

If the benefit received from the payment of NICs were proportional to the amount of NICs paid, we might not be worried about the differences in the incidence of the national insurance system on different households: if more contributions were paid, the benefit received would also be greater. However, in the UK system, national insurance is, from the financial perspective, more like a standard tax. Individuals become eligible for accrual of the full state pension as soon as they enter the national insurance system[25]. NICs are then paid, with no entitlement to further benefits, until earnings reach approximately £50,000. They then reduce dramatically for the employee. This leads to a particular additional problem of discrimination against single-earner households. A single-earner household with earnings of £50,000 per annum, for example, will pay more national insurance than a dual-earner household where two adults each earn £25,000. In total, they will pay about £800 more. However, whereas the dual-earner household will receive entitlement to two state pensions, the single-earner household will be entitled to only one. So, the dual-earner family pays less in NICs and receives twice as much in terms of state pension entitlement. This is mitigated somewhat by the fact that, in some circumstances, can receive state pension entitlement when they have caring responsibilities.

[25] Like many aspects of the UK tax system, there are unnecessary complexities. There is a small income band in which workers earn benefits without paying contributions.

In the calculations below, we have only included employee national insurance contributions. We have ignored employer NICs, the whole or part of the burden of which is likely to be borne by employees. The figures presented therefore understate the discrimination against single-earner families.

Figure 4: Average Tax Rate (ATR) and National Insurance Contributions Rate (NICs), taking into account Marriage Allowance (MA) and Child Benefit Tax Charge (CBTC) at various income levels and earning compositions

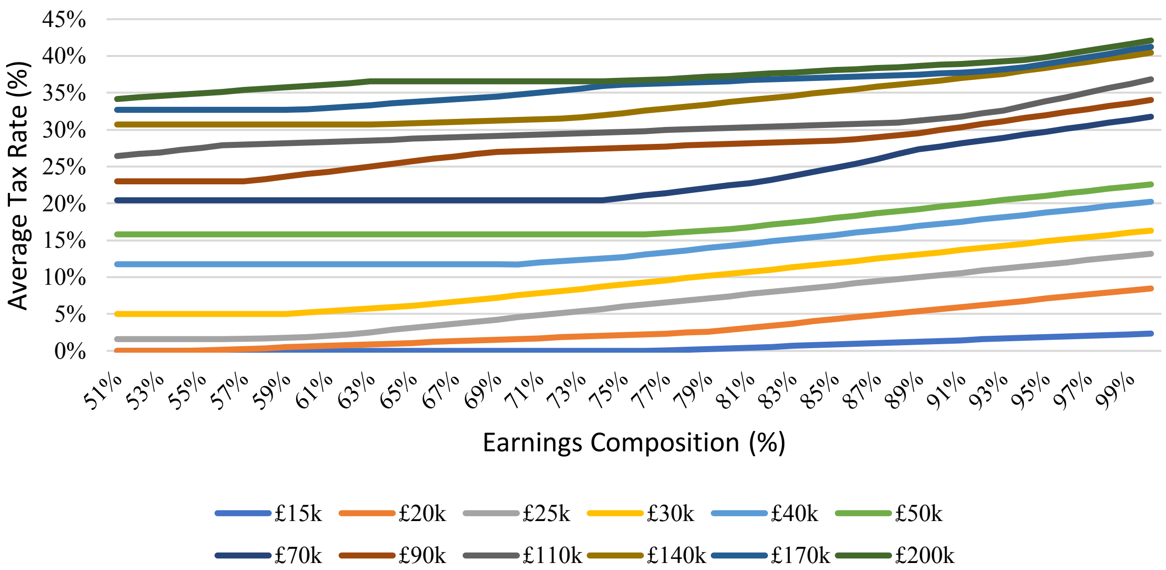


Figure 4 shows the ATR taking into account income tax and national insurance as well as the Marriage Allowance and Child Benefit Tax Charge for households with different earnings' structures and at different levels of total earnings.

- The amount of the Income Tax and National Insurance Contributions paid by a household earning £30,000 varies from £1,502 to £4,894 depending on the household earnings' composition, with an effective average tax rate varying between 5% and 16%. A single-earner household pays £3,392 more in tax than a dual-earner household on the same level of income. The single-earner family would have to earn an additional £4,988 per annum to have the same disposable income as the dual-earner family with a 50-50 split of incomes.
- The amount of the Income Tax and National Insurance Contributions paid by a household earning £70,000 varies from £14,302 to £22,237 depending on the household earnings' composition, with an effective average tax rate varying between

20%–32%. This would result in the single-earner family paying £7,935 more in tax compared with the dual-earner household on the same level of income. The single-earner family would have to earn an additional £13,681 to have the same disposable income as the dual-earner family with a 50-50 split of incomes. In other words, the single-earner family would have to earn 20% more to have the same disposable income as the family with an equal split of earnings.

- The amount of the Income Tax and National Insurance Contributions paid by a household earning £140,000 varies from £42,997 to £56,637 depending on the household earnings' composition, with an effective average tax rate varying between 31% and 40%. This would result in the single-earner family paying £13,640 more in tax compared to dual-earner household on the same level of income. The single-earner family would have to earn about £23,500 more to have the same disposable income as the dual-earner family with a 50-50 income split.

It should be remembered that, in all these cases, the dual-earner family is more likely to accrue two state pensions than the single-earner family. However, it should also be noted that, at very high levels of earnings, the dual-earner family will pay more in National Insurance Contributions in total than the single-earner family.

3.5 Conclusion

The analysis so far has shown how the tax system in the UK systematically discriminates against families where there is an uneven split of earnings between the two members of a couple. This discrimination is difficult to justify and is a consequence of a tax system that focuses obsessively on the individual rather than the household. This is despite the fact that government inequality measures and policies are focused at the household level.

It should be noted that an unequal split of earnings between the members of a couple can arise for a variety of reasons. It could arise as a result of unimpeded choice whereby the couple decides that one of its members will not work or only work part-time in order to take on caring responsibilities. Such choices can, of course, be strongly influenced by family circumstances in which one member of the couple may have little choice but to take on caring responsibilities. Differences between earnings within a couple could also arise because of accident or illness. Or they could arise because of differences in skills levels, training or experience between the two members of a couple. Our contention is that, whatever the cause, two households with the same income should face approximately the same tax bill. We emphasise "approximately" because there might be a desire to make some allowance for the difference in costs per person of running a multi-member household. The starting position, however, should be one of treating households with the same income equally as happens in countries such as Germany and France.

This conclusion is reinforced when we consider how the tax system interacts with the benefit system. We then see that our individualised tax system, in combination with our benefits system, discriminates not just against single-earner families but against family formation itself.

Section 4: The Interrelationship between Household Composition and Universal Credit

Chapter two briefly discussed the incoherence of assessing income tax on an individual basis whilst measuring inequality and assessing benefits on a household basis. The interaction of the tax and welfare systems in the UK creates a range of problems. Because Universal Credit (the basic welfare benefit in the UK) is based on household and not individual income, single people can be financially better off by remaining single. If the wage-earner forms a household with a non-wage-earner (especially with children), then the non-wage-earner is likely to lose their welfare benefits whilst the wage earner would pay exactly the same amount of tax (with a small saving if they are eligible for the marriage allowance). This leads to a benefits system that disincentivises couples living together or marrying - or, at least declaring that they are living together. This is especially so if they have children. Even if it is thought that financial incentives do not affect behaviour, this situation raises questions about fairness and the impact of our fiscal system on culture.

The range of potential scenarios for benefit entitlements and tax obligations is enormous given that the systems interact with each other. Furthermore, welfare benefits are dependent upon expenses faced by households. We have therefore chosen a few examples to illustrate the problems. They are unlikely illustrate the most egregious situations.

Table 1 shows how much a couple stand to lose financially under Universal Credit (UC) if they decide to live together rather than separately. It should be noted that the complexities go beyond the variation of benefits with household situation. Each household is assessed on a case-by-case basis with the amount of UC that each claimant will get being based on an 'assessment period'. This represents a rolling one-month period that starts on the day that the first claim for UC is made.[26] Therefore, there will be practical variations in relation to the timing of receipts when a family's situation changes. The calculations are thus representative as an illustrative average.

Table 1 assumes an hourly minimum wage rate of £8.91 and a full-time and part-time working week of 37h and 18.5h respectively. Our household assumes two parents and two children

[26] https://www.turn2us.org.uk/Jargon-buster/Assessment-Period#:~:text=An%20Assessment%20Period%20is%20a,21%20November%20to%2020%20December.

under the age of 5. The person receiving UC and holding childcare responsibilities in each case is "Partner A". The financial data was generated using a UK government recommended benefits calculator.[27] Tax and national insurance was applied to earnings and couples were assumed to benefit from the Married Couples Allowance where this was available to them.

Table 1: Single vs Couple Total Income (after Tax/ incl. UC)					
Partner A income	**Partner B income**	**Monthly Income when living:**		**Loss in Total Income (%) if living together, rather than separately**	**Loss in Total Universal Credit (%) if living together, rather than separately**
		Together	**Separately**		
£0	£330/week (full time work at the minimum wage, £8.91*37h)	£1,707.53	£2,000.98	-14.66%	-37.0%
£0	£0 (unemployed and looking for work)	£984.06	£1,123.81	-12.4%	-12.4%
£165/week (part-time work at the minimum wage, £8.91*18.5h)	£330/week (full time work at the minimum wage, £8.91*37h)	£1,915.86	£2,535.79	-24.44%	-92.1%
£165/week (part-time work at the minimum wage, £8.91*18.5h)	£0	£1518.09	£1657.84	-8.4%	-14.0%

Table 1 presents four scenarios:

1) Partner A without income, living together with and living separately from partner B who works full time earning a minimum wage.
2) Partner A without income, living together with and living separately from partner B who is unemployed.

[27] Turn2us - https://www.gov.uk/benefits-calculators. Figures representative as of 15th Oct. 2021.

3) Partner A working part time, living together with and living separately from partner B who works full time earning a minimum wage.
4) Partner A working part time, living together with and living separately from partner B who is unemployed.

If an individual who has no income choses to form a household with a partner who works on the minimum wage, between them they will both see a reduction in their total income of nearly 15%. The worst-case scenario in this illustration arises where one partner works part time and the other full time. This arises because they lose a significant amount of universal credit whilst paying a significant amount of tax as a result of the uneven split of earnings between the partners.

In one sense, the basic problem here is simple. However, as the discussion of Nick Clegg's position highlights, the explanation is subtle and seems, therefore, to be misunderstood even by Deputy Prime Ministers. The welfare system works on the basis that families exist to share resources. It therefore provides resources to families that have insufficient resources. The welfare system does not provide resources to individuals who have no income within well-off families. It therefore takes away resources when somebody with no income forms a household with a partner who has an income. These kinds of incentives are natural in any welfare system. However, in our individualised tax system, tax is not charged according to family resources but according to the incomes of individuals. This means that if you put an earner into a household with a non-earner, the earner is taxed as if he continues not to share his income with the non-earner and any children – but they do not receive any welfare benefits.

A report published by The Health Foundation found that in July-August 2020 over 200,000 people were ineligible for UC solely due to their partner's earnings and a further 200,000 were ineligible due to their own savings.[28] The report concluded that this placed additional financial pressure and difficulty on those choosing to live together:

> "…there is significant financial strain among those who were ineligible for benefits (UC and new style Job Seekers Allowance): much more than among the general public. […] This financial strain was particularly acute amongst those ineligible for UC due to partner earnings, and amongst those experiencing income shocks who were

[28] Geiger, BB; Scullion, L; Summers, K; Martin, P; Lawler, C; Edmiston, D; Gibbons, A; Ingold, I; Karagiannaki, E; Robertshaw, R and de Vries, R (2020), "Should social security reach further? A study of those not claiming benefits at the start of the COVID-19 pandemic", *Welfare at a (Social) Distance Project Report*.

> ineligible for UC and contributory benefits. Many (though not all) felt that it was unfair that they were not eligible."[29]

It is reasonable, of course, for the state to only assist households who have no income. The welfare system should not be designed to provide support for individuals who have not income who live in households who are earning above subsistence levels. In this sense, a welfare system is always likely to penalise household formation at least to some extent. However, if the necessity for welfare payments is determined by household income, how can it be argued that the ability to pay taxes is not also determined by household income?

One solution to achieving some sense of financial parity between couples and individuals requires structural change in the criteria under which UC is paid out to claimants. The Institute for Fiscal Studies (IFS) suggested 2010 that "Existing couple penalties could be reduced, and some couple premiums created, by increasing benefits and tax credits for couples or cutting them for single adults."[30] Regardless of whether couple benefits are increased or single benefits are decreased, the current discrepancy between couples contributes to the bias against family formation.

[29] *Ibid.* p. 28

[30] Institute for Fiscal Studies, (2010), "Press Release: Couple 'penalties' in tax and benefit system are widespread, but almost impossible to eliminate", https://ifs.org.uk/pr/couple_penalty0410.pdf

Section 5: Fiscal policy and fairness, the example of Germany and France

As we have discussed earlier, our analysis does not imply trying to design a tax system that is based on some 1950s vision of the typical family. The modern reality is that people live form households and different adults in the household contribute differently in terms of paid and unpaid work. Our tax system recognised this reality until recently and the tax system of many European countries still does today. Before discussion those alternatives to our current tax system, we will look briefly at a proposal made by a former Treasury minister and Cabinet minister in the Labour government led by Tony Blair.

5.1 Fiscal family and fairness - reforming welfare

One way of addressing the problems discussed in Chapter 4 was proposed by Rt Hon Ruth Kelly, in a pamphlet for the Fawcett Society in 2000, published not long before she became Economic Secretary to the Treasury in the Blair Government[31].

Recognising the financial penalties from marriage and household formation, Kelly suggested that, when an individual in receipt of welfare benefits forms a household with an earner, the partners incomes are added together and divided by two. They are then treated as individuals as far as the calculation of welfare benefits are concerned. To illustrate the points at the extremes, suppose an individual with earnings of £100,000 married an individual with no earnings. The welfare benefits of both parties would be based on an income of £50,000. Therefore, neither would receive any benefits. On the other hand, if an individual earning the minimum wage (£17,160 in our example above) married an individual with no income, they would both apply for welfare benefits based on the assumption that they were both single-person households earning £8,580).

This proposal would have the merit of removing some of the disincentives towards family formation that exist in the UK fiscal system. It would also work within the existing framework and perhaps be more palatable to politicians. However, it has a serious drawback. It would increase the total amount of money spent on welfare and increase welfare churn by which

[31] See: https://www.theguardian.com/business/2000/mar/13/6

families simultaneously pay taxes and receive welfare payments. Our main proposal therefore involves a radical change to the tax system to leave resources in the hands of families.

5.2 Fiscal policy and fairness – the examples of Germany and France

The German tax system makes provisions for families by a principle of 'income splitting'. Under this principle the tax of a married couple is determined by taxing half of their combined incomes and then doubling the amount to result in the total tax payable. Given the German progressive system of taxation, this method would result in a lower amount of total tax for the couple than if they were taxed individually.[32] This system means that households with the same income pay approximately the same amount of tax regardless of the split of income between individuals within a household.

In addition, there are also special provisions for children such as child tax free allowances. Though it is beyond the subject of this paper, this would be a useful evolution of the system we propose here. If cash benefits for children were replaced with additional tax allowances, it would reduce "churning" by which families both pay tax and receive welfare benefits for their children. The German system has rather extensive measures in place to financially help and promote family formation.

Table 1 shows how much income tax households would pay if the German principle of income splitting were applied in the UK. A single-earner household on a yearly income of £30,000 would pay £1,000 in annual tax given these assumptions. Under the current UK system, that same family pays £3,250 in income tax.

At an annual income of £70,000, a single-earner household would pay £15,500 in tax under the current UK system compared with £9,000 if the principles underlying the German system were applied. This means that the family pays 172% more tax than it would under the German

[32] Viktor Steiner, Katharina Wrohlich, (2004), "Household Taxation, Income Splitting and Labour Supply Incentives - A Microsimulation Study for Germany", *German Institute of Economic Research, DIW Discussion Papers No. 421*.

system. The ATR consequently jumps from 13% under the German system to 22% under the current UK system.

Table 1: Applying the German Tax System to the UK							
		100/0 income split example					
Income w/o CBTC (£)		Tax under current UK system (£)	ATR(%)	Tax under German system (£)	ATR	Difference (£)	UK tax / DE tax (in %)
15,000		250	2%	0	0%	250	
20,000		1,250	6%	0	0%	1,250	
25,000		2,250	9%	0	0%	2,250	
30,000		3,250	11%	1,000	3%	2,250	325%
40,000		5,250	13%	3,000	8%	2,250	175%
50,000		7,500	15%	5,000	10%	2,500	150%
70,000		15,500	22%	9,000	13%	6,500	172%
90,000		23,500	26%	13,000	14%	10,500	181%
110,000		33,500	30%	19,000	17%	14,500	176%
140,000		48,500	35%	31,000	22%	17,500	156%
170,000		61,500	36%	43,000	25%	18,500	143%
200,000		75,000	38%	55,000	28%	20,000	136%

Table 2 shows households with a 75/25% income composition. A household with an annual income of £30,000 currently pays £1,750 in tax with an ATR of 6%. Under the German principle of income splitting, that same household would pay £1,000 in tax with an ATR of 3%.

At £90,000 per annum, a household with a 75/25% income composition currently pays £16,500 in income tax with an ATR of 18%. Under the German system the total tax owed would be £13,000 with an ATR of 14%.

Table 2: Applying the German Tax System to the UK						
	75/25 income split example					
Income w/o CBTC (£)	Tax under current UK system (£)	ATR	Tax under German system (£)	ATR	Difference (£)	UK tax / DE tax (in %)
15,000	0	0%	0	0%	0	
20,000	250	1%	0	0%	250	
25,000	1,000	4%	0	0%	1,000	
30,000	1,750	6%	1,000	3%	750	175%
40,000	3,250	8%	3,000	8%	250	108%
50,000	5,000	10%	5,000	10%	0	100%
70,000	9,500	14%	9,000	13%	500	106%
90,000	16,500	18%	13,000	14%	3,500	127%
110,000	23,500	21%	19,000	17%	4,500	124%
140,000	35,000	25%	31,000	22%	4,000	113%
170,000	49,500	29%	43,000	25%	6,500	115%
200,000	60,000	30%	55,000	28%	5,000	109%

The French system is slightly more complex than the German approach. In France family taxation is based on a "quota", or number of adults and children within the household. The term in French is "quotient familial". It considers the entire composition of the household to determine the number of dependants, and thus the total amount of tax payable.[33]

In a nutshell, each adult is the equivalent of one unit or 'share'. The first two child dependants are counted as half a unit each, whilst the third (or subsequent) children are counted as 1 unit each. The total household income is then divided by the household 'quota' number which, for instance, in a four-person family with two adults and two children would be three. The amount of tax is then calculated based on the tax bracket that the divided sum falls into, and total is multiplied by the household quota (which in this case would be three). The result is a lower overall tax bill for the household that is primarily driven and determined by the number of dependants - not just the number of earners and split of earnings between them.

Once again, we would favour an approach recognising the cost of raising children that, where possible, cut tax bills rather than involved government spending. However, that is a separate issue not considered further here. As far as the adults are concerned, the basic principle is clear: the total amount of tax paid is not affected by the split of earnings between the adults in the family.

Table 3 and Table 4 illustrate how much tax would be paid by UK households if the French principle of *quotient familial* were applied (but not using French tax rates or bands). Once again, we do not take into account national insurance contributions or the child benefit tax charge. We do, however, assume that the family has two children.

Table 3 illustrates the situation of single earner households with a quota number of three (i.e., four individuals: two parents, two children), at various levels of income. Here we can see how, at an annual income of £30,000, a UK household currently pays £3,250 in tax with an ATR of 11%. Under the French principle of *quotient familial*, that same household would pay no tax (an ATR of 0%).

[33] French-Property.com, (2021), "Guide to French Income Tax" https://www.french-property.com/guides/france/finance-taxation/taxation/calculation-tax-liability/

At £40,000, a UK household currently pays £5,250 in annual tax with an ATR of 13%. Under the French system, that household would pay £500 in income tax and have an ATR of 1% - resulting in a significant tax reduction of £4,750.

Table 3: Applying the French "Quotient Familial" principle to UK Income Tax							
Quota: 3	100/0 income split						
w/o CBTC		UK system (£)	ATR	FR system (£)	ATR	Difference (£)	UK tax / FR tax (in %)
Household income	Household income/quota						
15,000	5,000	250	2%	0	0%	250	
20,000	6,667	1,250	6%	0	0%	1,250	
25,000	8,333	2,250	9%	0	0%	2,250	
30,000	10,000	3,250	11%	0	0%	3,250	
40,000	13,333	5,250	13%	500	1%	4,750	1050%
50,000	16,667	7,500	15%	2,500	5%	5,000	300%
70,000	23,333	15,500	22%	6,500	9%	9,000	238%
90,000	30,000	23,500	26%	10,500	12%	13,000	224%
110,000	36,667	33,500	30%	14,500	13%	19,000	231%
140,000	46,667	48,500	35%	20,500	15%	28,000	237%
170,000	56,667	61,500	36%	30,500	18%	31,000	202%
200,000	66,667	75,000	38%	42,500	21%	32,500	176%

A UK household earning £70,000 currently pays £15,500 in annual tax with an ATR of 22%. Under the French system, that household would pay £6,500 in income tax and have an ATR of 9% - resulting in a tax saving of £9,000.

A household earnings composition of 75/25% also reveals significant tax savings under the French system compared with the current UK system for a family of four. In Table 4 we see how a family earning £30,000 per annum would pay no income tax under the *quotient familial* principle compared with £1,750 under the current UK system.

Table 4: Applying the French "Quotient Familial" principle to UK Income Tax						
Quota: 3	75/25 income split					
w/o CBTC	UK system (£)	ATR	Tax in FR system(£)	ATR	Difference (£)	UK tax / FR tax (in %)
Household income (£)						
15,000	0	0%	0	0%	0	
20,000	250	1%	0	0%	250	
25,000	1,000	4%	0	0%	1,000	
30,000	1,750	6%	0	0%	1,750	
40,000	3,250	8%	500	1%	2,750	650%
50,000	5,000	10%	2,500	5%	2,500	200%
70,000	9,500	14%	6,500	9%	3,000	146%
90,000	16,500	18%	10,500	12%	6,000	157%
110,000	23,500	21%	14,500	13%	9,000	162%
140,000	35,000	25%	20,500	15%	14,500	171%
170,000	49,500	29%	30,500	18%	19,000	162%
200,000	60,000	30%	42,500	21%	17,500	141%

At an income of £50,000 per annum the tax bill would be halved from £5,000 to £2,500 by adopting the French system. Even at comparatively higher levels of income the tax saving for the household remains notable. At £90,000 the tax bill would be reduced from £16,500 to £10,500 – saving the family a total of £6,000 per annum.

It is important to note that these calculations are illustrative. If the tax system were changed in the way we are proposing, it is likely that revenue would be reduced so that, for a given level of government spending and if other taxes remained the same, income tax rates or thresholds would have to be adjusted in a way which would increase the burden on some families and single people and offset some of the savings we have indicated families may benefit from. However, the following should also be noted:

- Tax rates would not need to increase and thresholds reduced to German and French levels as these are also higher because the government spends more in those countries.
- There would almost certainly be behavioral changes arising from reduced fiscal costs of family formation which are likely to reduce welfare costs and increase tax revenues. Modelling this is beyond the scope of this paper and, indeed, likely to be beyond the capability of Treasury models.
- In both the French and German systems (though it is more explicit in the French system), the tax burden is reduced for families with children. If this were to be adopted in the UK (which is not our main proposal), there would be a number of benefits. The tax burden on families with children would be reduced and there could therefore be a corresponding a reduction in welfare payments to families with children who are also paying tax. Indeed, the tax and welfare systems could be integrated for such families so that, if the income of a family was below the level of tax-free income after taking into account the allowance in respect of both adults and children, a cash benefit would be paid which would be withdrawn as income rose. This would, in effect, involve some integration of the tax and universal credit system.

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