rgues its case from within, rather than as an outsider. The minimal emonstration of commitment is early EMS entry, which has been put off far oo long. This is needed to bring UK inflation down, and the Chancellor's udget strategy is positioned on ERM entry to prevent a slide in sterling. arly ERM entry should now be an easy step.

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Savings, Independent Taxation and the 1990 Budget

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I. INTRODUCTION

For most of the 1980s the focus of attention at Budget time has been on tax reform and micro-economic changes. By contrast most of the interest in the 1990 Budget was in its overall fiscal stance and its possible effect on the macro-economy. This was a natural reflection of the current state of the economy both because of the importance of getting the fiscal stance right to avoid recession on the one hand and inflation on the other, and because of the consequent lack of room for manœuvre in cutting or reforming taxes. Nevertheless it is important not to lose sight of the micro-economic measures that were announced.

In this article we shall look at the impact of the changes to excise duties and income tax that were announced, as well as the move to independent taxation of husband and wife. This latter change, although announced two years ago, will come into effect this April and will be the most important change to the income tax system in 1990. It is, furthermore, of importance both in looking at the overall impact of this year's tax changes on revenue raised and in understanding the abolition of the composite rate of tax and the introduction of Tax-Exempt Special Savings Accounts (TESSAs). We shall look at these changes to the taxation of savings before going on to discuss the introduction of tax relief for the value of workplace nursery provision in the final section.

II. THE BUDGET

As the basic and higher rates of income tax were, as expected, left unchanged and personal allowances were indexed in line with inflation, the only real[1]

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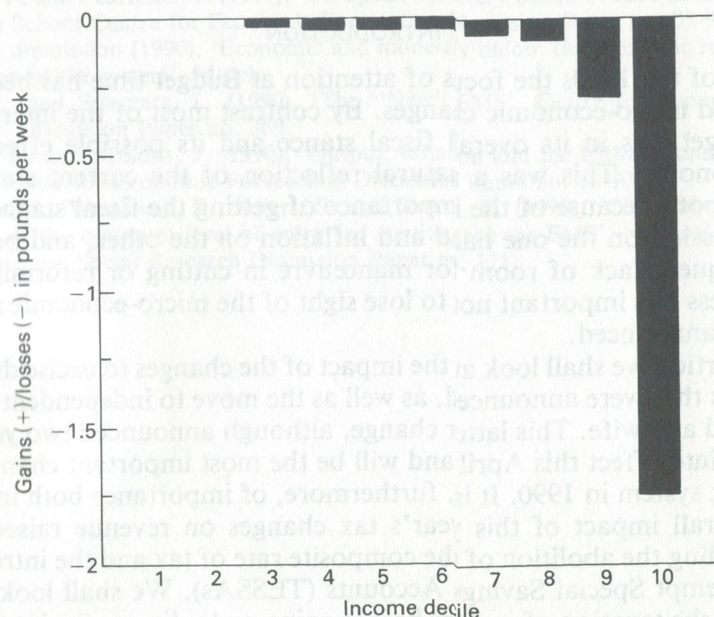
[1] Real in this context implies changes other than those which simply account for inflation over the preceding year.

changes to the income tax system announced in the Budget were the non-indexation of the higher rate threshold in line with inflation and the increase in the scale charges for company cars (the scale charge is the imputed value of the car on which tax is charged). Both of these changes are progressive in that they result in higher tax payments in real terms by those with relatively high incomes, and these changes explain the losses for the highest income groups shown in Figure 1.[2] The very small losses for other income groups result from the slight over-indexation of excise duties on tobacco, petrol and alcohol, particularly spirits.

FIGURE 1
Distributional Effect of the Budget

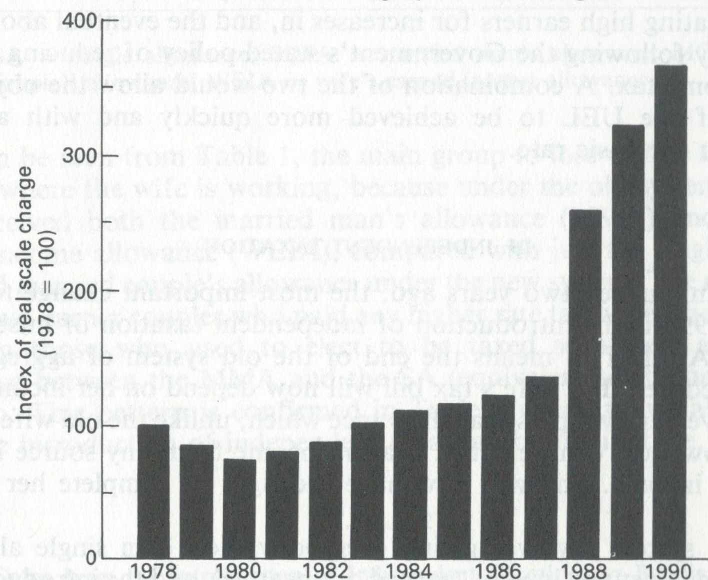


The increase in company car scale charges by 20 per cent maintains the consistent policy followed by this government of limiting the relative attractiveness of payment by benefits in kind, of which the company car is the most important. Scale charges are now almost five times as high in real terms as they were in 1980/81 and much more nearly reflect the true value of the benefit. Figure 2 illustrates these increases with particularly dramatic growth since 1988 when Nigel Lawson doubled scale charges. In that year he noted in his Budget Speech that independent studies had found that 'a typical

[2] This and other tables and charts in this article are based on analysis using the IFS tax and benefit model. For details of the model see Johnson, Stark and Webb (1990).

company car may be taxed on only a quarter of its true value'. This figure might suggest that even now company cars are taxed on a little less than their true value. However, the more important distortion relates to National Insurance contributions (NICs). Neither employees nor employers are liable for NICs on company cars, as on most other benefits in kind, and thus the direct tax system still provides a substantial incentive to employers to use benefits in kind such as company cars as a method of payment. Indeed, Ashworth and Dilnot (1987) calculated that, even before the recent large increases in scale charges, it was the failure to charge NICs on company cars which was the more important of the two tax privileges. This more important privilege remains in its entirety to be dealt with in a future Budget.

FIGURE 2
Real Value of Company Car Scale Charges



One might also look at the failure to index the basic rate income tax threshold in the light of problems associated with the National Insurance system. One of its most important problems is that above the upper earnings limit (UEL), now set at £350 per week, no more contributions are payable. This means that the marginal rate of tax on earned income faced by basic rate taxpayers with incomes above the UEL is lower than that for those with incomes below the UEL. Since the UEL is fixed at a certain proportion of the basic state pension, which is uprated in line with prices, it is itself effectively uprated in line with prices each year. Because earnings tend to increase faster than prices, the number of people with earnings above the UEL will continue increasing until, within a very few years, the UEL and average earnings will

be coincident, at which time we shall face a situation in which many of those with below average incomes will face a higher marginal tax rate than many of those with above average income. This cannot be sustainable.

The relevance of this to the non-indexation of the basic rate threshold lies in the fact that this brings the UEL and the threshold closer together. The closer the UEL and the threshold, the fewer people would lose if the abolition of the UEL were combined with a reduction in the higher rate of tax. At present any such move would impose considerable losses on all those with earnings above £18,200 p.a. as they would lose 9 per cent of any earnings between this and their basic rate threshold. To continue a policy of not indexing the basic rate threshold would, however, bring more people into the higher rate band, effectively increasing their marginal tax rate, and this obviously flies in the face of recent government policy. Nevertheless, this strategy could be combined with that, outlined by Dilnot and Webb (1988), of compensating high earners for increases in, and the eventual abolition of, the UEL, by following the Government's stated policy of reducing the basic rate of income tax. A combination of the two would allow the objective of abolition of the UEL to be achieved more quickly and with a smaller reduction in the basic rate.

III. INDEPENDENT TAXATION

Although announced two years ago, the most important change to the tax system in 1990 is the introduction of independent taxation of husband and wife from April. This means the end of the old system of aggregation of couples' incomes. The wife's tax bill will now depend on her income alone. She will have her own personal allowance which, unlike the old wife's earned income allowance, can be offset against income from any source including investment income. She will now have the right to complete her own tax returns.

The new system involves giving everybody their own single allowance, offsettable against any income, earned or unearned, and the introduction of a married couple's allowance (MCA). The MCA goes in the first instance to the husband, but if he is unable to use it because he does not earn enough then it can be transferred to his wife. The new system was designed to remove the sexism inherent in the old system of joint taxation, with as little change as possible to people's actual tax payments, and the system introduced in April will achieve this to a large extent. As can be seen from Table 1, the vast majority of families will receive the same allowances as under the old system with the only major changes being for single-earner couples where the wife is working, and for two-earner couples who used to choose to elect separately under the old system in order to reduce the amount of tax paid at the higher rate.

TABLE 1

The Impact of Independent Taxation

Family type	*Old system* Allowances received	Index (SA = 1)	*New system* Allowances received	Index (SA = 1)
Single person	SA	1	SA	1
Single-earner couple (husband working)	MMA	1.6	SA + MCA	1.6
Single-earner couple (wife working)	MMA + WEIA	2.6	SA + MCA	1.6
Two-earner couple	MMA + WEIA	2.6	2 × SA + MCA	2.6
Two-earner couple (separately elected)	SA + WEIA	2	2 × SA + MCA	2.6

Note: SA = single allowance; MMA = married man's allowance; MCA = married couple's allowance; WEIA = wife's earned income allowance.

As can be seen from Table 1, the main group to lose will be single-earner couples where the wife is working, because under the old system she would have received both the married man's allowance (MMA) and the wife's earned income allowance (WEIA), compared with just the single allowance (SA) and married couple's allowance under the new system. The main gainers will be two-earner couples who paid any higher rate tax under the old system, including those who used to elect to be taxed separately and lost the difference between the MMA and the SA (equivalent to the new MCA) in doing so. This pattern is confirmed in Table 2 which shows average gains from the introduction of independent taxation, by family type.[3]

TABLE 2

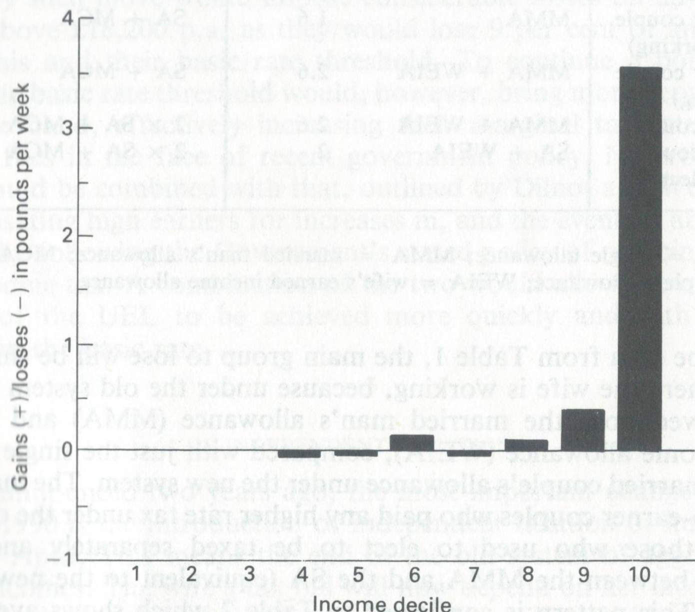
Gains from the Introduction of Independent Taxation, by Family Type

Family type	*Average gain (£ per week)*
Single-earner couple	0.14
Two-earner couple	1.27
Unemployed couple	0.09
Pensioner couple	1.46

[3] No account is taken here of the transitional protection arrangements which will prevent families where the wife is the only earner from losing in *nominal* terms.

Single-earner couples are gaining on average, because the wife's unearned income can now be offset against her own single allowance, which it could not be against the old WEIA; this outweighs the losses among the few bread-winner wives. The large gains for pensioner couples arise for the same reason. The pattern of gains by income range is shown in Figure 3.

FIGURE 3
Distributional Effect of Independent Taxation



Large gains are concentrated at high incomes, partly because of the gains among the high income two-earner couples and partly because the largest amounts of investment income, particularly investment income not taxed at source, are concentrated at high incomes. Those on lower incomes are affected little on average. Indeed it is important to stress that the huge majority of taxpayers are not affected by the introduction of independent taxation; the gains and losses shown here are concentrated among a small group of people.

The introduction of independent taxation has two other important effects. The first relates to the Government's overall fiscal stance. The latest estimate of its cost provided by the Government is £0.5 billion in 1990/91 and £1.3 billion in 1991/92. If this is taken into account then there will actually be a small decrease in taxation in 1990/91 of some £70 million, not an increase of £430 million as a result of the Budget changes only. Secondly, the fact that women can now offset investment income against their own personal allowance means that a million women have been taken out of the income tax

system altogether. This has important implications for the tax treatment of savings, to which we now turn.

IV. THE COMPOSITE RATE

In the Budget the Chancellor announced that the composite rate of tax would be abolished from April 1991. The composite rate is a fixed rate of tax charged on interest paid to individuals by building societies, banks and some other institutions. The same rate is paid by taxpayers and non-taxpayers alike and the rate is set at a level such that the same revenue is raised as would have been raised if taxpayers had paid income tax on the interest at the basic rate and non-taxpayers had paid none. Thus the level at which the composite rate is set is a function of the basic rate of income tax and the relative proportions of total interest received by taxpayers and non-taxpayers.

This was a bad system. It penalised non-taxpayers, mainly pensioners and children, and redistributed towards taxpayers, mainly workers. However, it is the introduction of independent taxation which has led to its abolition; independent taxation creates a whole new class of non-taxpayers. Under the old system, any investment income of a wife was treated as her husband's income, and therefore typically taxed. Under the new system, the wife can receive investment income in her own right, and thus if she is not working, investment income to the value of the allowance should not be taxed. Two things would have followed had the composite rate remained. First, the rate would have fallen substantially to take account of this whole new class of non-taxpayers with interest-bearing accounts, and second, millions more non-taxpayers would have been taxed on small amounts of investment income. This would have created incentives for reallocating savings to other assets entirely, or the creation of such things as offshore accounts by banks and building societies.

TABLE 3

Gains and Losses from the Abolition of the Composite Rate, by Family Type

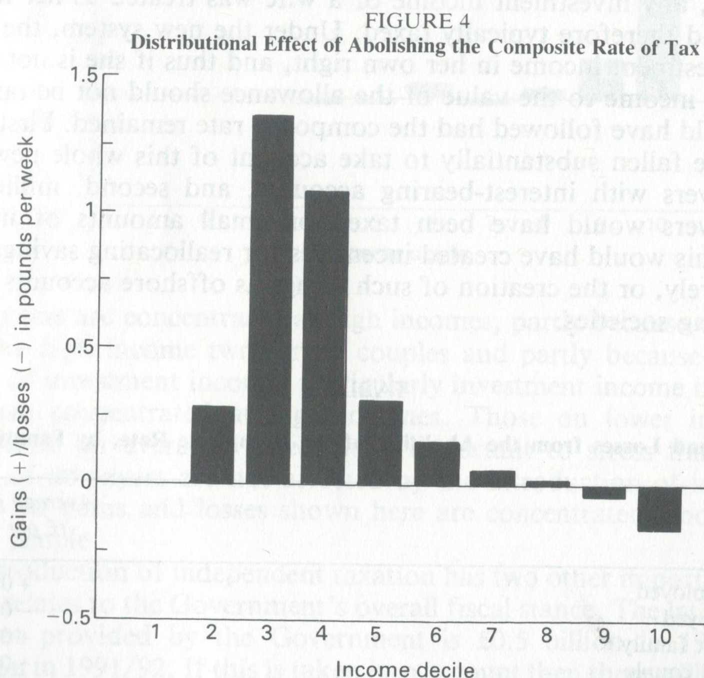
Family type	*Average gain/loss (£ per week)*
Single unemployed	+0.16
Single employed	−0.12
Single-parent family	+0.14
Unemployed couple	+0.55
Single-earner couple	+0.53
Two-earner couple	−0.13
Single pensioner	+0.07
Pensioner couple	+2.02

The response to these problems has been to abolish the composite rate and treat interest income from banks and building societies in the same way as any other income. That is, non-taxpayers will pay no tax on it and taxpayers will pay tax at their marginal rate, with the result that taxpayers will lose from the change and non-taxpayers will gain. The pattern of gains and losses by family type is shown in Table 3.

The biggest gains are for couple pensioners, many of whom are non-taxpayers with significant savings in banks and building societies. The single employed and two-earner couples lose because they are taxpayers, while the typically non-taxpaying unemployed gain. Single-earner couples gain significantly because the wife can now use her allowance against investment income.

Figure 4 shows the distribution of gains and losses by income decile and, just as one would expect, gains are concentrated among those on fairly low incomes with losses increasing with income. This again reflects the fact that non-taxpayers with some savings gain from the change and taxpayers lose. The very richest lose most because they tend to have higher income from investments.

FIGURE 4
Distributional Effect of Abolishing the Composite Rate of Tax



In general, the average gains and losses are small, and significant changes are again concentrated among a very few. Only 12 per cent of people have their incomes affected by more than 1 per cent, and only 2½ per cent by more

than 5 per cent. This change will, however, impose some losses on a large number of taxpayers, and in the next section we look at a scheme introduced by the Chancellor which may have been intended to offset the losses to some extent.

V. TESSAs

Mr Major claimed that his Budget was a Budget for savers and the creation, from next January, of Tax-Exempt Special Savings Accounts (TESSAs) appears to be one of his main reasons for making this claim. In effect a TESSA will allow taxpayers to receive interest on building society and bank deposits tax-free, but only subject to stringent conditions. A maximum of £9,000 can be deposited over a five-year period, with a maximum of £3,000 in the first year and £1,800 a year up to the overall limit in subsequent years. The interest will be exempt from tax so long as no capital is withdrawn during the five years. If any capital is withdrawn early, all the interest will be subject to tax.

The importance of the scheme will depend crucially on what happens to it in subsequent Budgets. If it is left in its present form, it is likely to be of little importance and will become just another small anomalous aspect of the taxation of savings. If, on the other hand, it is expanded significantly, with the investment limit and minimum period abolished or made much more generous, it may become an extremely important aspect of savings in Britain and a step down the path towards a more rational treatment of the taxation of savings.

As they stand, TESSAs are unlikely to have a wide appeal. They will be advantageous only to taxpayers who are willing and able to commit themselves to tying up their savings for a period of five years, and who are sufficiently risk-averse or financially unsophisticated not to want to invest their money in other ways, such as in unit trusts, perhaps through a Personal Equity Plan, which might well have a higher yield. On the other hand, the vast majority of people in Britain with small amounts of savings save in banks and building societies. Since TESSAs should be readily available and cost little to enter, many may make use of them in the hope that they will not need to use their capital for five years. If there is no cost to being in a TESSA then uncertainty about the need to retrieve capital before the five-year limit need not prevent one from opening such an account. If, however, there is a cost to opening a TESSA, either in terms of a lower interest rate or an entry fee, only those reasonably confident of not needing their capital for five years would have an incentive to enter the scheme. In either case it is highly unlikely that TESSAs will result in much new saving as most investment will simply be switched from elsewhere.

As conceived at present, then, TESSAs are unlikely to be of importance. However, they do embody an important principle which is that income from

interest-bearing accounts should be tax-free. The present regime of savings taxation penalises interest-bearing accounts in banks and building societies in comparison with the other main forms of savings — owner-occupied housing, pensions, life assurance and Personal Equity Plans (PEPs). In each of these cases assets are bought out of taxed income and profits are received free of tax. In the case of banks and building societies, however, income after tax is deposited and tax is then due on interest from this income. Saunders and Webb (1988) show that building society deposits have the lowest 'degree of fiscal privilege' of all the major assets, and it is in the interest both of efficiency and of equity that this 'degree of fiscal privilege' should be equalised with that on other forms of saving. Over 80 per cent of the financial savings of the bottom 75 per cent of wealth holders are held in this form.

It is to be hoped, then, that TESSAs will be extended significantly in future years to make them more attractive, bringing a greater rationality to the taxation of savings and a system which no longer penalises the commonest form of savings. TESSAs work in a similar manner to PEPs in allowing income to be received tax-free; it is to be hoped that they will be treated similarly to PEPs which have gradually been extended and made more attractive since their introduction in 1986. If such extensions are made, the combination of PEPs and TESSAs will move further towards the 'EXPEP' scheme advocated by the Capital Taxes Group (1989).

VI. WORKPLACE NURSERIES

In the run-up to the Budget a great deal of attention was focused on the tax treatment of childcare costs. Prior to the Budget, any childcare provided by employers was treated as any other benefit in kind, and subject to income tax.[4] Correspondingly, privately incurred childcare costs were not tax-deductible. From April 1990, employer-provided childcare is no longer to be treated as a taxable benefit in kind. Before this change, employer-provided childcare was already tax-privileged, since no NI contributions were due. This tax privilege has now been considerably extended. The tax treatment of privately incurred childcare costs has not changed.

Why was this reform introduced? Mr Major's Budget Speech seems confused. He said: 'Before I leave income tax, I have a supply side measure to announce, which will help the labour market work better. We have always made it clear that it is not for the Government to encourage or discourage women to go out to work. That is rightly a decision for them to take and one in which the Government would be wise not to interfere'. He then went on to announce just such an example of government interference, namely the removal of the value of workplace nursery provision from tax. It is hard to see how a government that believes in freeing markets from state-induced distortions could see this change as one which will help the labour market work better. If there is a coming shortage of labour because of the fall in the number of school-leavers, the free market solution is for excess demand to drive up the price of labour. It seems that Mr Major intended to do precisely what he said he did not want to do: affect the decision of women to go out to work.

So there is a serious question mark over the basic motivation of the change. But given the apparent or presumed objective of encouraging women with children back into the labour market, will it work? Providing tax relief for employer-provided childcare will reduce the costs of working for those actually or potentially employed by employers with such facilities. For those already receiving employer-provided childcare, the reform will be a pure income effect, encouraging them to reduce hours of work rather than increase them. For those not working, the financial gain from working will rise, encouraging greater participation. This latter effect might not hold if the husband of a non-working wife could, or did, gain from employer-provided childcare. The couple would gain extra income from the tax relief, providing an income effect discouraging work, but the costs of working in terms of providing childcare would have fallen for the wife, encouraging participation. The overall effect of the change is hard to gauge, and will obviously be affected by the number of employers offering such schemes.

It is worth noting that a wide range of alternative ways of spending government money to encourage labour force participation by parents might have been considered. First, some limit might have been set on the amount of tax-free childcare per child, to avoid large revenue losses from a small number of expensive schemes. Second, the relief might have been restricted to the basic rate of tax, for similar reasons. Third, and slightly more radical, consideration might have been given to lump-sum subsidies to employers for each place provided. Fourth, the Government might have issued vouchers, redeemable at workplace or other approved nurseries. Finally, the possibility of increasing expenditure on free state nursery places, or on post-school-day and holiday care, seems an option worth pursuing.

The change to the taxation of workplace nurseries flies in the face of other government action on benefits in kind and attempts to distort the labour market, despite claims to the contrary. As significant, even if one accepts that action to encourage caring parents back into the labour market is required, this change is not obviously the best. Further research is needed, and further thought should have been given before action was taken.

[4] Only for directors and employees earning more than £8,500 p.a.

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The Impossibility of Perfect Neutrality: Fundamental Issues in Tax Reform

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I. INTRODUCTION

The tax treatment of saving in the UK is far from uniform. Saving can take many different forms and there are almost as many different tax regimes. This mosaic of different regimes is not the result of a coherent policy toward saving, but rather the lasting by-product of a wide variety of *ad hoc* responses to changing circumstances over the years. That the Chancellor called this year's Budget a 'Budget for savers' testifies to the importance accorded to this area of tax policy. The introduction of four separate measures — the establishment of 'Tax-Exempt Special Savings Accounts', the abolition of the composite rate tax, the large increase in the maximum investment for Personal Equity Plans, and the abolition of stamp duty on shares transactions — illustrates, however, its continuing complexity.

Of course, the tax system makes many distinctions, and one might reasonably ask why those relating to savings should be a particular cause for concern. The reason is straightforward: the differential tax treatment of saving has distorted financial decisions. Tax incentives have joined — and in some cases replaced — economic incentives in determining the allocation of savings in the economy.

The pervasiveness of these distortions has led to concern about the 'neutrality' of the tax system. While there is general agreement that neutrality is an important objective, the precise meaning of neutrality and its implications for tax reform have rarely been spelled out.

The purpose of this paper is to examine neutrality and its implications for tax policy. Section II discusses the importance of neutrality with respect to

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