CHAPTER 3

THE INCOME TAX TREATMENT OF MARRIED COUPLES

The personal tax system is an area where the structure of policy clearly reflects basic assumptions about the patterns of financial responsibility and resource-sharing within households. Over the course of recent years, as views have changed, the existing treatment of married couples by the personal tax system has begun to look increasingly anachronistic. In this chapter we set out the evolution of the system, and the way in which pressure for change has accumulated. We describe the way in which the new system of independent taxation introduced this year has changed the tax treatment of married couples, and try to evaluate the extent to which it represents a solution to the various problems that had been identified.

3.1 Evolution of the System

The view of the economic relationship between husband and wife embodied in the income tax system at the start of the last decade dates right back to the introduction of income tax during the Napoleonic Wars. At that time, only the very rich were subject to the income tax. The system aggregated incomes of both partners from all sources, and made the husband liable for all tax affairs, including tax payments.

Subsequently, two further important features were added to the system: married men received an additional tax allowance, and child tax allowances were introduced. The effect of these changes was to differentiate the amount of untaxed income according to family size: for a given level of family income, a family with more members would have a lower level of taxable income, and hence of tax.[1]

By the start of the 20th century, objections to the lack of individual privacy involved in the system had led to the introduction of a system of 'separate election', under which married women could choose to be sent their own tax returns. This system involved no change, however, in the tax liability of married couples, and merely introduced a superficial element of privacy in the income declarations made by married women. Because the tax liability of married couples was still a function of their joint incomes, it would

in fact normally have been possible for an inquisitive husband to deduce his wife's income from his own tax bill.

Most of the remaining components of the system in operation during the 1970s and 1980s had come into place before the end of the Second World War. Falling tax allowances relative to wages had meant that the scope of income tax was greatly extended. Not only did this greatly increase the administrative burden of operating the income tax, but it also brought the system into contact with a new set of issues, involving the relationships between income tax, labour supply and poverty.

Married women were given their own tax allowance, the wife's earned income allowance (WEIA), in 1920. In order to encourage women to enter paid employment during the war, and to ease administration by taking those women with small earnings out of the system, the value of the WEIA was increased to the level of the single person's allowance in 1942. Unlike the other principal allowances, only earnings could be offset against the WEIA. Any excess of earned income above the allowance, and all investment income, were still added to the husband's taxable income.

The introduction of the wife's earned income allowance illustrates one of the main trade-offs in this area. By reducing the marginal rate of tax on small amounts of earned income, it may encourage greater labour force participation by married women; but, by offering a tax allowance only to women who are working, it will tend to reduce the tax burden of two-earner couples relative to single-earner couples, despite the fact that two-earner couples may, in general, be more prosperous. The WEIA has a further, more curious, consequence. A single-earner couple will have a higher net income if it is the wife who works rather than the husband: because her earnings above the WEIA are still charged to her husband, who can offset the married man's allowance against them, they receive both allowances even though only she is earning.

Alongside these changes, the Pay-As-You-Earn (PAYE) administrative system was introduced in 1944. PAYE enabled the tax authorities to collect income tax through direct deductions from pay in such a way that no tax return need be sent to the majority of taxpayers.

A restricted form of independent taxation was introduced in 1971, the 'wife's earnings election'. Under this arrangement the husband could elect to give up the married man's allowance, and his wife had her earnings taxed separately. For couples whose joint incomes pushed them into high tax brackets, the wife's earnings election could reduce their joint tax bill, if the reduced tax paid at higher rates was enough to compensate for the fall in allowances.

The tax system which resulted from this long process of evolution was thus one in which the main features were those of a joint tax system. Except for the small minority of couples who had chosen the wife's earnings election, all incomes were aggregated, and the husband was liable for any tax due. Also, as in a pure joint taxation system, the husband received a larger tax allowance than a single person.

Nevertheless, there were aspects of the system which made its operation and effects similar in some respects to systems of independent taxation. In particular, because of the long basic rate band, dictated by the practical requirements of PAYE, the practice of aggregating husband's and wife's earnings had no effect on the marginal tax rate which most couples faced. Also, the presence of the wife's earned income allowance meant that, as with a system of independent taxation, two-earner couples benefited from greater tax allowances than a single-earner couple with the same gross income.

Pressure for change accumulated during the 1960s and 1970s, as the assumptions underlying the system came to seem increasingly out of place in the modern world. The first attempt at a wholesale reform of the taxation of husband and wife was by the 1974–79 Labour Government. Part of its package, the replacement of child tax allowances by child benefit, was brought in between 1977 and 1979, and work on a Green Paper on the reform of personal taxation itself was underway at the time of the 1979 election.

The incoming Conservative Government published its own Green Paper in 1980.[2] This made no strong recommendations, concluding that the existing system was broadly acceptable.

The Green Paper prompted a large number of submissions, and it was at this point that the lines of the present debates become clear. Few of the respondents felt that the present system was defensible. As Kay and Sandler (1982) describe, the debate over the Green

Paper involved almost complete agreement that the married man's allowance should be abolished. The key question was how the resources released by the abolition of the married man's allowance should be used. On the one hand, there were those who favoured the retention of some form of family-based tax unit, in the form of a fully — or partially — transferable tax allowance. On the other hand, there were those who favoured an entirely individual system of taxing earnings, accompanied by increased cash benefits for those with children and other dependants. These two positions, noted Kay and Sandler, represented alternative ways of resolving an 'underlying tension between two widely-accepted but conflicting aims: the principle of equal treatment of all individuals regardless of sex and marital status on the one hand, and on the other the practical necessity of taking into account a household's overall financial circumstances when taxing husband and wife' (Kay and Sandler, 1982, p. 174).

3.2 The 1986 Green Paper

Matters rested here until 1986, when the Government published its second Green Paper on the subject, *The Reform of Personal Taxation*. This proposed a system of independent taxation with fully transferable allowances. Husbands and wives would be taxed separately and each would be given their own, equal, allowance, which would initially be set half-way between the single person's and married man's allowance. If one spouse was unable to use his or her full allowance, then the excess could be used by the partner.

Such a system of transferable allowances, in the view of Kay and Sandler (1982), is one in which husband and wife are taxed as a unit, with allowances in common, and in which the financial relationships between them are explicitly recognised. It is clear that it is not a system which is neutral to marriage (one of the criteria occasionally suggested for an acceptable tax system for married couples).

In terms of its redistributive effects, the reform proposed in the Green Paper would, in practice, have been a relatively egalitarian tax reform. Most couples with two earners would have found the total tax allowances available to them unaffected by the change, whilst couples with one earner (and, other things being equal, lower incomes) would have the same allowances as two-earner couples, since the unused allowances of the non-working member could be transferred to the working spouse.

From the Government's point of view, there were three main advantages of the scheme. Firstly, (although this was not explicitly stated) it was appealing since it was possible to set the new allowance so that there would be few losers from the change. This would be costly, costing around £4½ billion per annum, but revenue from other sources was buoyant and seemed set to remain so. Secondly, it would remove sex discrimination, since each partner would have an equal allowance and would be responsible for his or her own income. Thirdly, large tax cuts for single-earner couples would remove some low-paid families from income tax altogether and hence would alleviate one aspect of the poverty trap.

Most respondents to the Green Paper welcomed the ending of the aggregation of incomes, but the response to transferability was less enthusiastic. Three main objections were raised. Firstly, the scheme was held to discourage married women from working, especially part-time, because they would have to reclaim allowances from their husbands.[3] Secondly, and related to this, the scheme would have been administratively complex, because more tax offices than at present would have had to know about the incomes of both spouses and because the PAYE system is not well suited to making mid-year corrections to the amount of allowances a taxpayer is due. Thirdly, it was argued that the revenue forgone could have been better targeted. One popular counter-proposal was therefore for the new allowance to be made non-transferable and for any available revenue to be spent on benefit increases, particularly child benefit (Morris and Stark, 1986).

3.3 Independent Taxation

Following the rebuff the Government received to its proposals for transferable allowances, a new set of proposals were announced in the 1988 Budget. These retained the provisions for the independent taxation of incomes, but the proposals for allowances were less ambitious. The scheme was introduced in the 1990/91 tax year.

Under the new arrangements, couples' incomes are no longer aggregated. 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 3.1, 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 elect to be taxed separately under the old system in order to reduce the amount of tax paid at the higher rate.

TABLE 3.1

The Impact of Independent Taxation

Family type	Old system		New system	
	Allowances received	Index (SA = 1)	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 3.1, 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 3.2, which shows average gains

TABLE 3.2

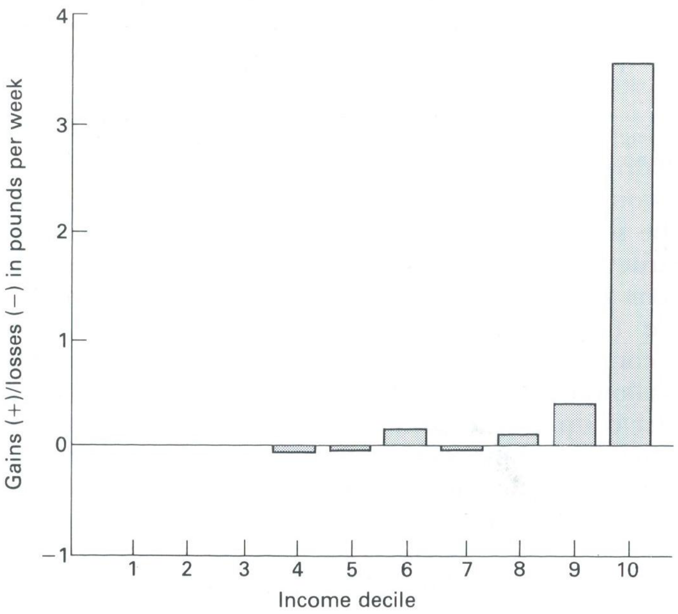
Gains from the Introduction of Independent Taxation, by Family Type

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

from the introduction of independent taxation, by family type. 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 3.1. 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

FIGURE 3.1
Distributional Effect of Independent Taxation



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 practical consequences. One is for government revenues. The Government's latest estimates of the cost of the new system is £0.5 billion in 1990/91 and £1.3 billion in 1991/92. Secondly, the fact that married women can now offset investment income against their own personal allowance means that more than a million women have been taken out of the income tax system altogether. This in turn has stimulated the Government to abolish the 'composite rate' system of taking bank and building society interest (under which non-taxpayers had ended up paying tax because these institutions were required to pay interest net of tax, regardless of the tax status of the investor).

NOTES TO CHAPTER 3

1. Note that the benefit conferred by tax allowances will vary depending on the marginal tax rate the family faces. Only where all families face the same tax rate will the benefit of equal allowances be the same to all taxpayers. Tax allowances of any form are, as negative income tax schemes recognise, of no value to non-taxpayers.
2. HM Treasury (1980). See Kay and Sandler (1982) for a discussion.
3. Whose tax liability would, in turn, have risen. In effect, as Symons and Walker (1986) demonstrate, the system would have made most married women subject to their husband's marginal rate of income tax on their first pound of income.