

The Tax Threshold: Policy, Principles, and Poverty*

Abstract

In the absence of an independent poverty standard, postwar British governments have tended to use current, politically determined social security scales (from Unemployment Assistance in the 1930s to Income Support today) as their definition of minimally adequate income levels, commonly known as an 'official poverty line'. A basic principle of taxation since the days of Adam Smith, however, has been that incomes below the minimum income required for socially defined necessities should be free of tax. The personal tax allowance which determines the income tax-paying threshold thus also provides a practical definition of such an official poverty line. Royal Commissions and official committees since the nineteenth century have endorsed Smith's principle, but it only acquired major political significance after the Second World War when income tax began to affect low earners, particularly after the 1960s when poverty was 'rediscovered' in the UK. In spite of this potential coincidence of purpose, a review of evidence and interviews with officials shows that there has been no co-ordination of policy between the Treasury and Inland Revenue responsible for determining the level of the tax allowances, and the Social Security ministries responsible for the minimum benefit scales. The tax threshold has consequently continued to be determined by considerations of political economy and administration and not by the alleviation of poverty.

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Introduction

The subjects of every State ought to contribute towards the support of the Government as nearly as possible in proportion to their respective abilities, that is, in proportion to the revenue which they respectively enjoy under the protection of the state.¹

When Sir Josiah Stamp quoted this maxim of Adam Smith's in his Newmarch Lectures for 1919, speaking about 'The Fundamental Principles of Taxation in the Light of Modern Developments', it was in the context of an exposition of his views on the first of Smith's four canons of the principles of taxation, namely Equality or Ability.² This paper reviews the history of a regrettable aspect of British personal tax policy in the twentieth century: the failure to base the tax threshold on a conception of people's ability to pay taxes without detriment to meeting their needs. One might naively assume that policy-makers would have ensured that the threshold was based on some principle such as taxable capacity, but the evidence suggests that no British government has ever done so during the century or so in which this could have been an issue.

Early this century, when the issue was first questioned by policy-makers, the Royal Commission on the Income Tax stated in 1920 that 'the truth is that the exemption limit has never been based on a figure consciously related to any kind of minimum of subsistence'.³ This view was reiterated by the 1954 Royal Commission on the Taxation of Profits and Incomes. The reasons were not sinister: they reflect an approach concerned solely with political and economic salience which was either not conscious of the burden on the poor or otherwise discounted it. Adam Smith's long-standing principle that taxation should not be levied on poverty incomes has thus been vitiated in practice: since the Second World War, the poor have been increasingly taxed. Little has been written about this conflict: indeed, some histories of taxation, such as Sabine's, wholly ignore it.⁴

Why does this matter? First, from the viewpoint of social policy, it is perverse to tax people on incomes insufficient to meet prior needs when there are principled reasons for not doing so. Second, it is important to review the available historical evidence, written and oral, which offers some explanation of how this perverse situation has come about and which

¹ Adam Smith, *An Enquiry into the Nature and Causes of the Wealth of Nations* (1776: London, 1961) bk. 5, ch. 2, pt.

² The other three were Certainty, Convenience, and Economy in administration; Josiah Stamp, *The Fundamental Principles of Taxation in the light of modern developments (The Newmarch Lectures for 1919)* (London, 1921), p. 4.

³ Royal Commission on Income Tax (RCIT), *Second Report*, Cmd. 615 (HMSO, 1920), p. 55, quoted by F. Shehab, *Progressive Taxation: a study in the development of the progressive principle in the British Income Tax* (Oxford, 1953), p. 262.

⁴ B. E. V. Sabine, *A History of Income Tax* (London, 1966).

counters the naive assumption that there must always be good, even if unrevealed, reasons for tacit policy. The paper sets out the evidence and then discusses it in the context of Richard Titmuss's concept of 'fiscal welfare' and the principles that historically have been held to apply to fiscal treatment of the lowest incomes.

Setting the Tax Threshold in the Twentieth Century

'To him that hath shall be given' has the warrant of the Scriptures but doesn't make sense in the assessment of needs.⁵

So much for the expression of the principle by an anonymous civil servant. What has been the practice in British policy-making? Study of contemporary primary sources, including interviews with retired senior officials and the examination of departmental files, has revealed that until the period after the Second World War the subject was treated as academic since it had no consequences for deprivation. Before the First World War the Chancellor would set the limits at what he thought he could afford⁶ and between the wars tax allowances continued to be high in relation to average earnings. Sir Norman Price, a former chairman of the Board of Inland Revenue, confirmed that the relationship with social security benefits did not form any part of government thinking at this time.⁷

By the late 1940s, however, the level of personal allowances had fallen considerably. Piachaud suggested that the issue of the overlap between the income tax system and the social security system (whose benefit levels carry an implied official view of need) was:

largely the result of the post-war extension of the income tax system to large numbers of manual and clerical workers who were previously exempt together with the extension of cash benefits (normally subject to a means test) to those with low employment incomes.⁸

The 'extension' of tax coverage was not a positive act; it resulted from the erosion of the value of the personal allowances. However, under the high employment conditions of the time the issue was not perceived as anything more than a matter of a relatively few hidden anomalies, such as the level of some untaxed benefits being higher than taxed earnings of the same level. For example, far more married women were employed and receiving

⁵ Anonymous civil servant, 9 December 1944, PRO:AST 7/735.

⁶ Shehab, *Taxation*, p. 262.

⁷ Sir Norman Price, personal letter 2 March 1988. Price worked for the Inland Revenue from 1939 to 1976; he was a member of the Board from 1965 onwards, Deputy Chairman 1968–73 and Chairman 1973–6.

⁸ D. Piachaud, 'Taxation and Social Security', in C. Sandford, C. Pond, and R. Walker (eds.), *Taxation and Social Policy* (London, 1980), pp. 68–9.

the tax allowance for a working wife. This had been introduced in 1944 as part of Pay As You Earn (PAYE) (before 1941, income tax was collected half yearly and had to be saved up) and was intended to ease the calculation of PAYE rather than to further a women-back-to-work policy.⁹ Child tax allowances also disguised the erosion of the individual's tax allowance, so that in general any incipient poverty trap was confined to the single person on low wages. The departmental view in this period was recalled by Price:

The fact that the anomaly was small allied itself with the difficulty of finding the resources to increase personal allowances substantially, so as to make irrelevant in Budget terms the association [between assistance scales and personal tax allowances]. It tended to become a question of Chancellors saying 'By how much can we afford to put up personal allowances this year?' without regard to social security levels. Recollections of the relationships pre-war between earnings and personal allowances persisted for, I should say, ten or twelve years after the war, and consciously or not there was a tendency to try to get back to them. The vast increase in the number of taxpayers (and of the Inland Revenue staff) was thought to be wrong. Gradually Ministers accustomed themselves to what was inevitable. Most earners were going to be liable to pay tax and the urgency to exempt a high proportion began to fade. Other considerations could take priority in determining tax allowance levels. Benefits in the social security scheme were one such—and people began to discover the poverty trap.¹⁰

From the middle 1950s onwards there began to be an increasing political interest in correcting the anomaly that some untaxed social security benefit payments were higher than taxed earnings. The tax threshold for a two-child family was then approximately the same as average male earnings, but a decade later it had fallen to only around 70 per cent of average earnings and already within the limits then described as being on the margins of poverty.¹¹ At the beginning of the 1970s the tax threshold was tending to fall below the Supplementary Benefit (SB) scales and burden the poor.¹² By the end of the decade, as Piachaud noted:

it had fallen to less than half average earnings . . . For many households, the tax threshold lies at an income below the supplementary benefit level (including housing costs) for that household. It is not surprising that there has been increasing concern over the decline in tax thresholds.¹³

⁹ Price, personal letter 2 March 1988.

¹⁰ *Ibid.*

¹¹ Piachaud 'Taxation' p. 69. B. Abel-Smith and P. Townsend, *The Poor and the Poorest* (London, 1965) used 140 per cent of the NA scale rate as being 'on the margins of poverty', an approximation of the official poverty standard as applied to claimants whose disregarded income and additional payments raised them above the 100 per cent scale level.

¹² D. Piachaud, 'Poverty and Taxation', in B. Crick and W. Robson (eds.), *Taxation Policy* (Harmondsworth, 1973), p. 75.

¹³ Piachaud 'Taxation', p. 69.

Piachaud's concern was the anomaly of taxing poverty incomes, but the Inland Revenue's concern was the anomaly of untaxed social security benefits. While in the 1950s the Inland Revenue made no attempt to relate the level of the tax allowances to untaxed benefit levels, Price reported that:

there was one close relationship [which] did affect tax allowances and that was their level as compared with the basic retirement pension. This was taxable and its level affected the work load thrown on the PAYE machinery. If the single tax allowance were less than the basic retirement pension, it would be necessary to make a tax assessment on every pensioner. This would have been an enormous administrative burden and while it was feasible allowances were kept just ahead of pensions to avoid it. Although I cannot recall that I heard any Minister actually say so in so many words, I cannot help feeling that this factor might have inhibited some potential pension increases. Not only did the money for the increased pension have to be found, but so also, in an even greater amount, did it have to be found for increased tax allowances.¹⁴

By the middle of the 1960s only about half of all the six million retirement pensioners were required to complete income tax returns, and most completed returns only every third year. The remaining pensioners were exempt from income tax because their incomes were below the thresholds for old people.¹⁵

Administrative issues rather than principles of needs were thus the main preoccupation of those concerned with tax allowance policy during this period. As a result, when from the mid-1960s political interest in income guarantee and tax credit proposals to combat the newly 'rediscovered' poverty, especially among older people, developed to the stage of government enquiries and Green Paper,¹⁶

the fact that tax allowances and social security benefits had each developed their own momentum and got out of line with each other certainly plagued everybody; the cost of ensuring that people would not be worse off on the introduction of Income Guarantee got so high as to become virtually un-supportable.¹⁷

The impression that the issue of adequacy was never addressed in the departmental discussions of the level of personal tax allowances is similarly conveyed by the recollections of Sir Kenneth Stowe.¹⁸ He was then a

¹⁴ Price, personal letter, 2 March 1988.

¹⁵ 'Briefing on Income Guarantee for Cabinet Social Services Committee', para 6, 26 May 1965, PRO:MP308/1 [now PRO:BN72/152 or /153].

¹⁶ Chancellor of the Exchequer and Secretary of State for Social Services, *Proposals for a Tax-Credit System*, Cmnd. 5116 (HMSO, London, 1972).

¹⁷ Price, personal letter, 2 March 1988.

¹⁸ Sir Kenneth Stowe, civil servant 1951–87; NAB 1951–66; MSS 1966–8; DHSS 1968–73; 1973–9 Cabinet Office (Principal Private Secretary 1975–9); Chief Secretary Northern Ireland Office 1979–81; Permanent Secretary DHSS 1981–7.

National Assistance Board official who had been engaged in the first and only in-house study of the adequacy of NA benefit levels¹⁹ and who was later involved closely in negotiation with the Inland Revenue. During the interdepartmental discussions on the Income Guarantee in 1965, he was amazed to hear a senior official in the Ministry of Pensions and National Insurance casually telling him that:

he had always assumed that the Inland Revenue, in fixing their allowances, had some regard to the level of benefits. What it demonstrated to me was that they were two completely different departments operating two completely different systems. The adequacy of their thresholds was their problem, and the adequacy of our benefit levels was our problem.²⁰

As Stowe experienced it, the Inland Revenue attitude to the adequacy issue was 'stop befogging us with silly questions' about a matter no one had thought worthy of rational enquiry. This was also the impression of Dr J. Leonard Nicholson, who had been Chief Economic Adviser to the Department of Health and Social Security (1968–76) and was involved in the question of minima from the point of view of a statistician modelling the combined effects of taxes and benefits. He recalled that the Inland Revenue 'never explicitly said to themselves, what would be a sensible level at which to start taxing people?'²¹ In both Stowe's and Nicholson's views, the critical moments at which the issue of a minimum taxable income was even conceptualized in the Civil Service were during the reviews of the Labour government's income guarantee proposals in 1965–6 and the Conservative government's tax credit proposals in 1972. However, the crucial point is that their conceptualizations were in terms of formal economic models of the existing social security rates and the poverty trap problem, and not in terms of the social adequacy of the rates themselves, that is, what income was necessary to support a given minimum level of living. That question was never addressed.

Academic observers of this period of policy-making had a similar impression. Professor Della Nevitt of the London School of Economics was one of the earliest academics to calculate the effects of the poverty trap, and her recollections were expressed in provocatively strong terms:

I can assure you that during the period up to the mid 1960s it was almost impossible to talk rationally to the Inland Revenue. They would not, for example, accept that the abolition of Schedule A²² had created a direct and important

¹⁹ J. Veit-Wilson, 'The National Assistance Board and the "Rediscovery" of Poverty', in H. Fawcett and R. Lowe (eds.), *Welfare Policy in Britain: The Road from 1945* (London, 1999).

²⁰ Stowe, recorded interview, 23 February 1988.

²¹ Nicholson, interview, 23 February 1988.

²² Schedule A of the PAYE personal income tax scheme taxed the imputed value of housing owned and occupied. It was abolished in the budget of 1963.

subsidy to those who bought their house with a mortgage. They flatly refused to use the term 'subsidy' which is now very generally accepted and used. . . . I doubt very much whether there was any real philosophy or logic. Everything was a matter of expediency, and of course a matter of the general economic policy decisions of attempting to control inflation by restricting the purchasing power of the people. And as far as the Inland Revenue were concerned, it didn't really matter whether people were rich or poor, so long as they had a fairly simple system they could operate. I believe that the removal of the lowest tax band, for example, was only introduced because relatively few people remained on that low level as wage levels increased, so that they put even the lowest paid workers into the standard rate of tax levels.²³

It is noteworthy that the standard 1966 work on income tax by Basil Sabine,²⁴ a former official in the Inland Revenue, makes no reference to the issue of the basis or adequacy of the tax threshold.

Professor James Meade was another academic (though he had also worked in the Treasury) who recalled that the social security scales were the limit of the Inland Revenue and Treasury conception of poverty and needs in this period.²⁵ He later chaired the Institute of Fiscal Studies' Committee on The Structure and Reform of Direct Taxation. One might imagine that this subject would deal with the individual's ability to pay, but the only reference to the topic in the report is brief and late:

The criterion of minimum needs is normally taken as being that which is set by what Parliament considers to be the appropriate level for Supplementary Benefit (previously National Assistance). This concept of minimum needs can change and is clearly a relative one.²⁶

Some academic analysts found this approach justified by political reality if not scholarship: as Field, Meacher, and Pond put it, 'Since we are concerned about the administration of the tax system by the government, it is appropriate to use a governmental definition of poverty.'²⁷ But the social security scales are not an independent analytical criterion of adequacy.

Thus there was little pressure for a different point of view. Price concluded that 'those academics who have said that the Revenue did not pay a great deal of heed to the "fiscal welfare" dimensions of the level of allowances are right. The Department approached this level in a different way from that in which it approached other problems.'²⁸ The reasons for

²³ Nevitt, recorded personal communication, March 1988.

²⁴ Sabine, *History*.

²⁵ Meade, interview, 21 November 1987. Meade had been a member of the Economic Section of the Cabinet Office from 1940 to 1947 and Director of it for 1946-7; he became an internationally respected authority on taxation matters.

²⁶ J. E. Meade, *The Structure and Reform of Direct Taxation* (London, 1978), p. 276.

²⁷ F. Field, M. Meacher, and C. Pond, *To Him that Hath* (Harmondsworth, 1977), p. 52.

²⁸ Price, personal letter, 12 March 1988.

this were partly administrative. The responsibility for tax policy-making lay in the last analysis with the Treasury; the methods of administering taxation were matters for the Inland Revenue. It is commonplace that method crucially affects policy, and the Inland Revenue was therefore concerned with advising the Treasury about problems to be avoided, such as the pensions problem mentioned above.

[The Revenue's] interest in personal allowances tended to be confined to management and not philosophical issues. We were concerned at the effect that the ever-increasing gap between average wage levels and the income tax threshold was having on staff numbers and our capacity to run the system at all. As a generalisation, given that there was money to be given away in any budget and that the Chancellor of the day had decided to apply some or all of it to direct tax, we would urge, for management reasons, that it be devoted to an increase in allowances rather than to a rate reduction. In pressing for increases in allowances, it may well have been that the Revenue's minutes would draw the Chancellor's attention to contemporary levels in social security benefits, particularly if variations in the latter were throwing up nonsenses and making the poverty trap more vicious. But I think that such arguments, persuasive though they might be, were used to bolster the case for any increase in allowances to reduce the number of taxpayers rather than *causa causans*. I do not think it would be any truer to say now than it was, say, thirty years ago, that the Revenue has a 'philosophic' view about where the level of tax allowances ought to be.²⁹

There may have been changes in approach subsequently. The increasing co-ordination of government policies in the past thirty years has led to the Inland Revenue being represented on joint departmental planning committees which earlier might not have been considered part of its traditional role. In 1971, for instance, it was a member of the Treasury-chaired Steering Group for Family Poverty Review, set up by order of the Conservative government's Cabinet Social Services Committee. The group was required to take the SB scale rates as its official poverty standard, but within that constraint the following extracts show that officials had become much more aware of the 'philosophical' tax issues than previously, even if the issues do not seem to have worked through to policy implementation.

The Tax Threshold: The gap between the Supplementary Benefit level and the tax threshold has narrowed substantially over recent years. The 1971 budget has improved the relationship, but nevertheless from September 1971 the Supplementary Benefit level will be above the tax threshold for single people, married couples without children and married couples with fewer than three children. We think that the tax threshold should always be above the Supplementary Benefit level for everyone. It would seem extremely difficult to justify

²⁹ Ibid.

the payment of tax by someone who is below the Supplementary Benefit level, though we fully recognise the difficulties in the way of preventing this situation from arising. . . . The level at which tax begins to be payable carried with it the assumption, implied if not explicit, that a man [sic] at that level can afford to pay some of his income to the State, and if the SB level is regarded as the poverty line it seems to us very difficult to justify imposing tax liability anywhere below it. In our view the tax threshold should always be above the SB level. Indeed, unless the view is taken that as soon as a person reaches the minimum tolerable level it is not unreasonable to require him to pay 30 per cent of his additional earnings to the State, there is a very strong case for saying that there should be a substantial distance between the SB level and the tax threshold.³⁰

Underlying this issue is the widely ignored similarity between the tax threshold, the income level below which an individual is not liable to pay direct tax, and government minimum income maintenance provisions such as means-tested Income Support. The latter are sometimes erroneously called 'official poverty lines', though Conservative ministers explicitly rejected the validity of any measure of adequacy or poverty in the UK, while Labour ministers simply disregarded them.³¹ This highlights the conceptual confusion between poverty measures, which are the findings of empirical research into correlations between income levels and complex socially defined deprivations, and Governmental Minimum Income Standards which are mere *political* prescriptions, often unrelated to such evidence.³² What the subject needs is a paradigm which embraces these various concepts and the measures which governments may take to respond to the issues raised by income maintenance. That paradigm was offered by Richard Titmuss in the 1950s; he termed its relevant aspect 'fiscal welfare'.

By 'fiscal welfare' Titmuss meant the various tax allowances which relate to recognized needs and determine an individual's tax threshold and burden. At any one time, he argued, the personal income tax allowances in particular could be said to represent an official view of the minimum income an individual or couple should receive, free of tax on it. He also emphasized that the tax revenue foregone by government was no less a form of public expenditure on those minimum personal needs than were more traditional welfare benefits explicitly focused on needs. Titmuss argued that underlying the expansion of fiscal welfare had been:

³⁰ SBC, Family Poverty Review, 1971, paras 27 and 115, PRO: departmental reference SBC:POF 21.

³¹ See for instance Department of Social Security, 'Benefit Levels and a Minimum Income', in: House of Commons Social Services Committee, *Minimum Income: Memoranda laid before the Committee*, HoC Paper 579 (HMSO, 1989), pp. 3–5; Department of Social Security, *New Ambitions for our Country: a new contract for welfare*, Cm 3805 (TSO, 1998).

³² J. Veit-Wilson, *Setting Adequacy Standards: how governments define minimum incomes* (Bristol, 1998).

a continuous search for a reasonable 'subsistence minimum' for income tax payers. It was needed as a basis for the various benefits, for fixing exemption limits and for determining the extent to which a taxpayer's kinship relationships and particular states of need should be recognised.³³

Titmuss then added the rider that:

Not the least remarkable aspect of this search is the complete absence of any reference in the relevant reports to the simultaneous search for a 'subsistence minimum' as a basis for social welfare policies from 1920 to the Beveridge Report and subsequently.³⁴

What he precisely meant by the search for a *fiscal* subsistence level is unclear because, as shown above, officials within government showed scant interest in it. They equated subsistence crudely with the level of means-tested benefits in their various forms from Unemployment Assistance in 1934, Assistance (1940), National Assistance (1948), Supplementary Benefit (1966), to Income Support in 1988. This was not an accidental equation, since from 1934 the Assistance scales were founded on a basis similar to that used by Rowntree in 1899 for his minimum subsistence primary poverty measure.³⁵ While there has been a long-running academic debate about the basis and adequacy of those benefits either for participation in society or only for physical but not social needs, there has been little evidence of official interest in the issue, except perhaps for an isolated episode in the early 1960s.³⁶

Since Titmuss's time, however, governments considering issues such as income guarantees or negative income tax, or the problems of the poverty trap, have become increasingly aware of the similarity of the issues raised by tax allowances and cash benefits. The recognition has grown that people with low incomes may suffer deprivations as much if their tax-free incomes as their benefits are too low. Even British governments have started to use the term 'tax expenditures' familiar in other countries for over forty years.³⁷ The historical issue is, then, what were the broad principles on which the level of the tax allowances should be based, which were largely ignored even though they have been in the public domain since the time of Adam Smith? We therefore have to go back to Adam Smith to review how these principles have been expressed in the intervening period.

³³ R. M. Titmuss, 'The Social Division of Welfare', in *Essays on 'the Welfare State'* (London, 1958), p. 49.

³⁴ Titmuss, *Essays*, referring to Royal Commission on Income Tax (1920), p. 50 and to Shehab, *Taxation*, pp. 260–6.

³⁵ J. Veit-Wilson, 'Muddle or Mendacity? The Beveridge Committee and the Poverty Line', *Journal of Social Policy*, 21/3 (1992), 269–301.

³⁶ Veit-Wilson, 'The National Assistance Board and the "Rediscovery" of Poverty'.

³⁷ J. Kvist and A. Sinfield, *Comparing Tax Routes to Welfare in Denmark and the United Kingdom* (Danish National Institute of Social Research, Copenhagen, 1996), pp. 12–14.

The Underlying Principle of Taxation: Progressivity in Wealth and Poverty

The actual term used by Smith in the quotation at the beginning of this article was 'proportional' and not 'progressive', but, as both Shehab³⁸ and Silverman³⁹ have agreed, he meant what we now term progressivity—Silverman quoting Smith's further remark that it 'is not very unreasonable that the rich should contribute to the public expense not only in proportion to the revenues, but something more than in proportion'.⁴⁰ Smith considered indirect taxation in his time to be a substitute for an ideal tax distributing burdens according to ability,⁴¹ and maintained that inequality should be reduced 'as much as possible by relieving the poor and burdening the rich'.⁴²

While many justifications for progressive taxation had been expressed in these terms of equity, Stamp's lecture went on to explain⁴³ that the justification for progressivity in economists' terms was that of the diminishing marginal value of income: an additional pound of tax paid meant less proportionate consumption foregone for a better-off than a worse-off person. The key issue was not just how people perceived that extra pound of tax in abstract terms, but what difference it made to their life-styles. The marginal utility of income itself depended on the cultural expectations of the people in question; it would vary according to the value systems of the different social groups and strata as well as by their varying income levels. One could not assume that one knew what that marginal utility was—that was an empirical question—but one could assume that, other things being equal, it would diminish as income rose.⁴⁴ There might thus be a level of income at which the utility in maintaining necessary living standards was so high that none of the marginal pound would be available for any other purpose, such as paying income tax.

Acceptance of the principle of progressivity on whatever criterion thus implied the possibility (though not the necessity) that there might be people with incomes so low that if they were to pay tax on them, they would be left with too little for their own (and their dependants') minimum needs, whatever those might be. Stamp located the first complete English exposition of the principle of progressivity in Paley's expression in 1830, 'we should tax what can be spared' and described 'the Dutch

³⁸ Shehab, *Taxation*.

³⁹ H. A. Silverman, *Taxation—its Incidence and Effects* (London, 1931).

⁴⁰ Silverman, *Taxation*, pp. 75–6; Smith, *Wealth*, as above.

⁴¹ Shehab, *Taxation*, p. 32.

⁴² Quoted by L. Eisenstein, *The Ideologies of Taxation* (New York, 1961), p. 29.

⁴³ Stamp, *Principles*, p. 40.

⁴⁴ If the additional pound gave access to a different higher life-style than before, one might hypothesize an increased marginal utility for a band of increased income.

writers proceeding from the exemption of the subsistence income'.⁴⁵ But how could that minimum be calculated? Adam Smith's views on the relativity of the concept of minimum needs (the linen shirt but not necessarily the shoes) are well known; they were based on a firmly social conception of needs.⁴⁶ But even if one prefers a materialist perspective, if the 'reproduction of labour power' requires a certain minimum level of expenditure, then it is dysfunctional to diminish it by taxation, especially if the taxes then have to be spent in combating the consequences of the economic and social damage. Thus at the time when the direct tax on income was first introduced in 1799, Friend wrote justifying the principle of exempting some income from tax on these grounds. In quoting Friend, Shehab added a gloss to his statement:

'There must be a certain income, which will exactly keep a man, his wife and two children; and if from that income anything is taken away, the family is deprived of necessities' [Friend] without which industry and general welfare would be injured.⁴⁷

The theoretical views quoted above may have borne little weight with policy-makers, but past governments did sometimes seek outside ideas. In 1852, the Parliamentary Select Committee on the Income and Property Tax heard many witnesses argue for the retention of a subsistence exemption from income tax, though the argument was less about the concept of subsistence than about where to draw the boundary between necessities and luxuries.⁴⁸ John Stuart Mill defended the exemption before the Select Committee on the ground that taxing the income needed for minimum subsistence would be too injurious, and equality of sacrifice between taxpayers could not be established without security of that income required for necessities.⁴⁹ The progressivity principle thus necessitated adequate exemption. As the Royal Commission on the Taxation of Profits and Incomes put it in 1954,

The conceptions of progressive taxation raise the question [of subsistence] in its most obvious form, for, as compared with other taxpayers enjoying more substantial incomes, the capacity to pay of a person with an income insufficient to provide the means of subsistence is non-existent.⁵⁰

⁴⁵ Stamp, *Principles*, p. 40.

⁴⁶ Smith, *Wealth*, as above.

⁴⁷ Shehab, *Taxation*, p. 50, quoting W. Friend (1799), *Principles of Taxation* (no page reference given).

⁴⁸ Shehab, *Taxation*, pp. 101; 111.

⁴⁹ Shehab, *Taxation*, p. 2.

⁵⁰ Royal Commission on Taxation of Profits and Income (RCTPI), *Second Report*, Cmd. 9105 (HMSO, 1954), para 158.

Once again the key question is, what are the components of that subsistence minimum which should be exempted from direct taxation? A Royal Commission on Income Tax answered this in 1920 by suggesting three different ways of understanding 'subsistence'.⁵¹ The first was an income sufficient only for 'bare subsistence'. This was clearly not a level of living on which anyone could be expected to live for more than a short time, because the second definition was an income 'large enough to equip and sustain a healthy and efficient citizen, not merely to keep him alive'. The third definition was an income above the second to the extent that it would in addition provide conventional comforts and luxuries usually enjoyed by the 'working classes'. The first definition roughly corresponded with what was understood at the time as Rowntree's primary poverty line; the second with his recently published prescriptive Human Needs of Labour poverty measure⁵²; and the third with the sort of poverty revealed by present-day empirical 'deprivation indicator' methods.⁵³ Obviously the first definition was inadequate since an income tax exemption had to apply to all citizens over time without damaging them. Thus the 1951–5 Royal Commission on the Taxation of Profits and Income, quoting these 1920 definitions as an acceptable source of ideas about the basis of the subsistence exemption which it was considering, concluded that:

We have not found it necessary . . . to be precise in outlining what we have in mind by 'subsistence'. Undoubtedly it requires an income larger than the first suggestion. On the other hand we think that an income of the third kind is well within the range of taxable capacity at a time when a very heavy body of direct taxation is being laid upon the whole body of taxpayers. Therefore what we are thinking of is something that corresponds to the second suggestion.⁵⁴

The Royal Commission was the most recent official body to report publicly (in 1954) on the matter in the UK, and it came to no more firm a conclusion than this. It did believe that any exemption limit ought to be expressed in terms of 'a certain minimum of real income' which should 'pay regard to subsistence considerations'.⁵⁵ However, it claimed that it could not find any principles on which to base the size of the tax allowances for households of varying composition, since they were not meant to act as estimators of minimum subsistence but as gradators or differentiators of

⁵¹ Cmd. 615, para 242, 1920, quoted in RCTPI 1954, para 163.

⁵² B. S. Rowntree, *The Human Needs of Labour* (London, 1918).

⁵³ See for instance D. Gordon and C. Pantazis (eds.), *Breadline Britain in the 1990s* (Aldershot, 1997).

⁵⁴ RCTPI, para 163. Note that the 'first suggestion' of primary poverty which the Commission rejected as inadequate was nevertheless the basis of Beveridge's social security benefits: see Veit-Wilson 'Muddle or Mendacity?'.

⁵⁵ RCTPI, para 172.

the burdens of taxation to produce some equity between taxpayers.⁵⁶ The trouble was (and continues to be) that tax allowances are meant to provide not only vertical equity but also horizontal equity between taxpayers with similar incomes 'and there are serious disadvantages in using the same instrument for this double task'.⁵⁷

However, the important point is that the Royal Commission raised the issue and made an important statement of principle which, in the absence of any other, must still stand as the clearest official statement of the matter in the UK. Noting that income tax was not generally progressive until 1907, it rejected the 'least sacrifice' principle but suggested nevertheless that 'the application of any principle must be controlled by the general sense of fairness'. Naturally what 'fairness' is taken to mean may vary over time, but it quoted Adam Smith's maxim about progressivity not proportionality.⁵⁸ The principle which it finally enunciated deserves quotation at length:

An Exemption Limit: Any scheme of taxing incomes has to provide an answer to the question whether all incomes are to be taxed, however small; and, if not all incomes, what is to be the standard by which the exemption of the smallest incomes is to be determined We feel no doubt that the answer should be *there should be no income tax levied upon any income which is insufficient to provide its owner with what he requires for subsistence.*⁵⁹

What the Royal Commission actually found in the early 1950s was that in practice 'the starting point for liability is lower than it could reasonably be expected to be if the needs for subsistence are borne in mind'.⁶⁰ Significantly, the political aspects of the anomaly did not become a public issue until (as outlined above) the poverty lobby exposed the poverty trap problem over a decade later, and it still remains the case that, as the Royal Commission argued, 'none of the personal allowances is now fixed with any deliberate reference to a standard of subsistence'.⁶¹

In addition, the Royal Commission commented that, while the tax-free allowance should not be below subsistence, there was no reason why it should not be higher. However, instead of treating this as a realistic recommendation, it quoted a common objection to doing so which was itself based on a misunderstanding of the policy options open to governments: that increases in tax allowances benefit all taxpayers at their highest marginal rates.⁶² While the *aggregate* costs of raising the tax threshold for all

⁵⁶ RCTPI, para 209.

⁵⁷ RCTPI, para 160.

⁵⁸ RCTPI, para 108.

⁵⁹ RCTPI, para 158; emphasis added.

⁶⁰ RCTPI, para 161.

⁶¹ RCTPI, para 160.

⁶² RCTPI, paras 160–1.

taxpayers in order to benefit only the poorest among them may be high and is often seen as perverse, there is no inevitable need for the benefit to remain with *individual* higher rate taxpayers; it could be removed by the simple expedient of lowering the threshold of the next tax bands appropriately. Presumably the Royal Commission was concerned about aggregate costs and omitted the policy corollary because of its apparent irrelevance to their purpose *at that point*. But the important point must not be presented as if it were incontrovertible, without the qualification that the unwanted consequence for individuals can be avoided, though at a political price which may be unacceptable.

The problem of indirect taxation. Besides direct taxes on incomes, residents of a country also pay indirect taxes in their consumption of goods and services, including housing. How were these indirect taxes to be covered by the progressivity principle?

In their evidence to the Royal Commission on Income Tax in 1919, many witnesses wanted the threshold for direct taxation lifted, although they could not agree on how much. The lowest proposal came from the National Chamber of Trade, but even its representatives agreed that some allowance was justifiable because 'a man with so small an income was already sufficiently taxed through indirect taxes'.⁶³ Writing between the wars, Silverman quoted the common idea that 'everybody, whatever his income, ought to pay something in taxation', but then added that the minimum subsistence qualification must include indirect taxes as well as income tax. This was because in his view they could not be levied in proportion to ability to pay, and so if there were a minimum it would mean either that there was no margin out of which to pay indirect taxes without damage, or that the minimum must be large enough to cover the indirect taxes as well. This would involve the government in paying larger benefits to the poor so that the poor could pay taxes, an observation he justified by explaining that 'the present old age pensions are admittedly slender; yet if the taxes on food did not exist, it is conceivable that the payments would be even smaller'.⁶⁴ Nor did the postwar Royal Commission avoid the issue. Its view quoted above about using a real level of living as the guide to the tax threshold would have implicitly accommodated the indirect tax question, because if these taxes were to vary, the tax allowance would have had to vary in order to preserve the real value of the net allowance.

However, one of the members of the Royal Commission, the economist J. H. (later Sir John) Hicks, expressed a formal reservation. He did not accept the notion of minimum subsistence, which would be high in the UK

⁶³ Cmd. 288, quoted by Shehab, *Taxation*, p. 260.

⁶⁴ Silverman, *Taxation*, p. 75.

by comparison with subsistence costs in other countries, and therefore he could not support the Commission's explicit proposal for exemption based on it. He would have preferred the whole burden of tax on the individual to be taken together, direct and indirect, and believed that, since the burden of public expenditure on the social services fell mainly on lower income recipients, it would be better to base this on explicitly progressive income tax than on covert, regressive indirect taxes or flat rate NI contributions.⁶⁵ This view that the concept of a tax-free minimum might not be desirable has also been held in much more recent years by those who see it as socially divisive. Citizenship is widely held to involve responsibilities as well as rights, and paying taxes according to ability is among the responsibilities. To deprive a person of the ability to discharge responsibilities is thus a psychological deprivation which hits at the duty of reciprocity and diminishes the sense of community membership. As an OECD Report on Personal Income Tax systems put it in 1986:

It is considered desirable by the Scandinavian countries to have relatively low thresholds, so that even the lower paid can feel that they are contributing towards the benefits they largely receive.⁶⁶

From this point of view, it is essential not only that a person has enough income to be able to pay indirect taxes without deprivation, but also to meet social obligations and individual psychological needs by paying direct taxes, such as social security contributions or income tax.⁶⁷ The view goes beyond any quoted above which want earnings to be free of income tax at the poverty line, to assert instead that the tax threshold for income tax should be placed at such a level that the net income *after paying all taxes* is at or above the poverty line. The difference is not so much arithmetical as evaluative. One view expects that some incomes will be below the poverty line and therefore exempt from tax; the other demands the right for all citizens to receive incomes sufficient for them to pay taxes, demonstrating full social participation, and still remain at or above the poverty line. This latter view clearly rejects a situation where all citizens pay taxes, but some do so detrimentally on inadequate incomes below the poverty line.

Conclusion

The question of what was a minimum adequate level for the tax threshold

⁶⁵ RCTPI, p. 90.

⁶⁶ Organisation for Economic Cooperation and Development, *Personal Income Tax Systems Under Changing Economic Conditions: Report of the Committee on Fiscal Affairs* (OECD, Paris, 1986), p. 62.

⁶⁷ I am indebted to David Donnison and Tony Lynes for their succinct expressions of this view to me.

does not seem to have arisen seriously in official circles until the 1960s. Before that, the Adam Smith principle, re-enunciated by the 1954 Royal Commission, was held to be applicable in theory if untested in practice. In retrospect, it seems likely that had there been an independent poverty standard higher than the NA scales, Smith's principle would have been breached, and Atkinson and his colleagues have in fact shown that the postwar NA scales were well below Rowntree's sparse Human Needs of Labour poverty standard used in his third survey of York in 1950.⁶⁸ However, in the event the level of tax allowances was not perceived as problematic. Income tax was seen as an 'above the poverty line' matter and the responsibility of a different government department from that of Assistance, which was for those at or below the line.

Whatever the precipitating factors—the increasing sophistication of the new poverty lobby or the introduction of Family Income Supplement (FIS) in 1970 and the consequent academic calculations of the poverty trap on earners—controversy over tax allowances was exacerbated by the abolition of the reduced rates of tax mentioned above. What was noticed was that effective tax rates of combined income tax at standard rates plus benefit withdrawal were very high and even confiscatory at some points—although what was not so often remarked upon was that the combined effect of income tax and FIS in effect created a kind of concealed reduced band of income tax for those who claimed FIS. Even during this period, however, the *adequacy* of the tax-free income in the personal tax allowances did not arise as an official issue. Insofar as needs were ever taken into account by Treasury or other departments' deliberations in tax thresholds, the criterion used was no more specific than the levels of social security scales, and even this did not prevent the tax threshold falling below them.

What the evidence therefore suggests is that the Adam Smith principle—although recognized in official circles—still awaits implementation, and that this cannot be fully achieved until the UK government makes the effort to adopt minimally adequate income standards, a step recommended to all European Union member states by the European Commission in 1992.⁶⁹

⁶⁸ A. B. Atkinson, J. Corlyon, A. K. Maynard, H. Sutherland, and C. Trinder, 'Poverty in York: A Reanalysis of Rowntree's 1950 Survey', *Bulletin of Economic Research*, 33 (1981), p. 67; B. S. Rowntree and G. R. Lavers, *Poverty and the Welfare State* (London, 1951).

⁶⁹ European Commission, 'Council Recommendation of 24 June 1992 on common criteria concerning sufficient resources and social assistance in social protection systems' (92/441/EEC). *Official Journal of the European Communities*, L(245 26 August 1992), pp. 46–8.