

PO-CH/NL/0106

PART A

CONFIDENTIAL

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PO -CH /NL/0106



PART A

1987-88 BUDGET
REPRESENTATIONS

25 years NAZIS 10-8-95

2.2.87

PO -CH /NL/0106

PART A

PART A

CLOSED

CONTINUED ON:-

PART

B

Gen Mangham Paltmar
486-4831

29871186



Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

Major General W D Mangham CB
The Brewers' Society
42 Portman Square
LONDON
W1H 0BB

6 January 1987

CH/EX
To
MAJ. GEN
MANGHAM
6/1

Gen General Mangham

Thank you for your letter of 15 December which enclosed your representations for the forthcoming Budget.

I would be delighted to meet with you again this year. I have asked my office to be in touch with the details.

Nigel Lawson

NIGEL LAWSON



FROM: CATHY RYDING
DATE: 6 January 1987

PS/MINISTER OF STATE

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Mr Scholar
Miss Sinclair
PS/Customs & Excise

VAT: TAX AVOIDANCE (STARTER NO.6)

The Chancellor has seen your note of a meeting on 4 December with the Brewers Society.

2. The Chancellor would be grateful for the Minister of State's views on the way through this.

CR

CATHY RYDING



CR
To
PS/MST
6/1



Inland Revenue

Policy Division
Somerset House

FROM: J P BATTERSBY
DATE: 7 JANUARY 1987

1. MR HOUGHTON *see copy 20th Jan 87*
2. CHANCELLOR OF THE EXCHEQUER

INHERITANCE TAX RATES AND BANDS

1. This note responds to requests for further information about the effects of current options on yield, and winners and losers. (Mr Kuczys' minutes of 31 December and 6 January.)

Effect on yield

2. You asked what would be the reduction in yield of the current two options - your scale, termed "Arithmetic 82" and Mr Houghton's Scale 4, "Geometric 82".

3. The inheritance tax (IHT) yield is rising to reflect share and house prices. Estimated accruals in respect of transfers in the year - the full year yield - have increased from around £1100m in 1986/87 to around £1270m in 1987/88. Table A below shows the eventual effect of these options on IHT accruals in respect of transfers in 1987/88.

Table A IHT accruals 1987/88

	£m	% reduction
1987/8 Accruals with statutory indexation	1270	-
" " " Arithmetic 82	1070	15.7
" " " Geometric 82	1020	19.7

-
- | | | |
|----|---------------------|---------------|
| cc | Chief Secretary | Mr Battishill |
| | Financial Secretary | Mr Isaac |
| | Economic Secretary | Mr Beighton |
| | Minister of State | Mr Calder |
| | Sir P Middleton | Mr Houghton |
| | Sir T Burns | Mr Spencer |
| | Mr Cassell | Mr Battersby |
| | Mr Scholar | Mr Brown |
| | Mr Cropper | Mrs Evans |
| | | PS/IR |

4. IHT arising from deaths in a year is received over a number of years, because tax on some assets can be paid by instalments, and large cases take time to settle. Roughly a third of the tax is received by the end of the year in question, and about three quarters by the end of the following year. This is reflected in the figures shown for these options in scorecards, which are the effects on the estimated receipts in that year.

Gainers and losers

5. IHT liability arises on only around 6 per cent of estates. Table B below analyses the 40,000 taxpaying estates expected in 1987/88 with statutory indexation. Both current options, with an £82,000 threshold, give 32,000 such estates, and a similar analysis is available.

Table B

IHT accruals in 1987/88 by size of estate

Size of Estate £000	Number of Estates	Taxpayers	Tax Liability £m	Effective % Rate
0-60	595,000	0	0	0
60-80	21,900	5,480	5	0
80-100	13,400	11,800	51	4
100-200	20,400	15,500	308	11
20-300	4,740	3,330	212	18
300-400	2,070	1,450	155	22
400-500	930	690	104	25
500-1000	1,240	943	221	27
1000-2000	306	252	126	31
Over 2000	87	70	86	28
	<hr/>	<hr/>	<hr/>	
	660,073	39,515	1,268	

6. Although marginal rates of tax payable range from 30 to 60 per cent, the effective rates are much lower: these rates rise more steeply up to around £300,000, and then decline for the small number of estates over £2 million, which contain more property qualifying for business and agricultural relief, and also heritage exemption.

7. The exemption for property left to the surviving spouse means that the majority of taxpayers are widows or single women. It is estimated that in 1987/88 56 per cent of taxpaying estates will be in this category, and will produce around 60 per cent of the tax.

8. There are no outright losers under either option, as both increase thresholds by more than the increase in the RPI which forms the basis for statutory indexation. The main gainers in percentage terms under both options are those with estates of up to £100,000, who gain both from the increase in the starting point and from the widening of the 30 per cent band. Arithmetic 82 gives smaller gains in percentage terms as the size of estate rises, and the same cash reduction in tax to all estates above £400,000. Geometric 82 is more generous to estates above around £250,000, and gives its greatest reduction to estates in the range of £300,000 to £500,000. The Annex shows the effect of both options on various sizes of estate.

9. In the time available we have not been able to analyse in detail such estates, but the following broad points emerge:

- a. From Table B, there are estimated to be only around 3,400 taxpaying estates of above £300,000 - 10 per cent of taxpaying estates - in 1987/88.
- b. In general, the larger the estate, the smaller the proportion of its assets contained in housing. The percentage declines from around 55 per cent of the total assets in estates of £90 - 100,000 to around 22 per cent at £500,000.
- c. In line with b, the larger estates contain a greater proportion of liquid assets (cash, securities, quoted shares) than the smaller. The figures (the aggregate of all relevant estates) are 62 per cent for estates between £300,000 and

£500,000, and 46 per cent for taxpaying estates up to £100,000.

- d. Only 17 per cent of taxpaying estates contain assets qualifying for business or agricultural relief, but these must be the larger estates (we have not done a detailed analysis) as they are estimated to contribute around 35 per cent of the yield. If so, then in general their liquid assets are more than sufficient to meet the tax. Tax represents 7 per cent of liquid assets at the lowest level of taxpaying estates, and a maximum of 59 per cent for estates over £2 million - but these are also aggregate figures, and individual cases may show significant differences.

Conclusion

10. There are no potential losers. The "typical" IHT taxpaying estate is that of a widow. Both options give the largest percentage reductions to estates below £100,000, which consist almost entirely of houses and liquid assets. Estates above that level are relatively few, and in this range Geometric 82 is most generous to estates between £300,000 and £500,000. Such estates are likely to have about a quarter of their total assets in housing, and most of the rest in liquid assets.

J P Battersby

J P BATTERSBY

REDUCTIONS IN TAX COMPARED WITH STATUTORY INDEXATION

Estate Size in £000s	Tax Under Statutory Indexation	82 Arithmetic	82 Geometric
100 reduction %	7,900 -	5,400 2,500 32	5,400 2,500 32
200 reduction %	47,800 -	39,000 8,800 18	39,000 8,800 18
300 reduction %	98,900 -	84,400 14,500 15	79,000 19,900 20
400 reduction %	157,550 -	141,600 15,950 10	126,200 31,350 20
500 reduction %	217,550 -	201,600 15,950 7	176,200 41,350 19
1000 reduction %	517,550 -	501,600 15,950 3	460,600 56,950 11
2000 reduction %	1,117,550 -	1,101,600 15,950 1	1,060,600 56,950 5

20/11

MC-KENZIE
→
LESTER
9/1

FROM: G MCKENZIE
DATE: 8 January 1987

The attached has been agreed with Customs and HE division as appropriate.
[Signature]
9/1/87.

- 1. MR WALTERS
- 2. MISS SINCLAIR
- 3. **MRS LESTER**

- cc PS/Chief Secretary
- PS/Financial Secretary
- PS/Economic Secretary
- PS/Minister of State
- Sir P Middleton
- Mr Cassell
- Mr Scholar
- Miss Sinclair
- Mr Romanski
- Mr Walters
- PS/Inland Revenue
- PS/Customs & Excise

Last year you did this on a one-to-one basis. I have lined up FST + HST as you requested; 2 officials will also be on hand. Do you want a memo to stand down anyone?

BUDGET DEPUTATION: AA

D
12/11

There is only one person from the AA and it's may look a little "top-sided"
CR 12/1

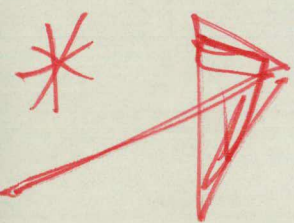
I attach briefing for the Chancellor's meeting with the AA on Tuesday 13 January at 4.00 pm.

2. Mr Boardman (C&E) and Mr Romanski (FP) will provide official support.

[Handwritten in red and blue ink]
FST stand down
Mr Boardman
Done
DL
13/11

[Handwritten signature]
G MCKENZIE

G MCKENZIE



OTORING TAXATION: STRUCTURE

A. AA's VIEWS

The AA have traditionally been strongly against abolishing Vehicle Excise Duty (VED) and transferring the tax to the price of petrol. The AA believe that abolition would create more injustices than exist at present and would unduly punish both high mileage and large car drivers. It is the AA's view that it would be far better to impose substantial penalties under the existing system for evasion of VED. The AA would favour abolition of Car Tax, but do not regard it as a matter of the first importance, and have not raised the point this year.

B. BACKGROUND

1. VED

One of the conclusions of the PAC report on VED evasion and enforcement, published on 17 November 1986 was:

(viii) We note the absence of information on the calculations or considerations on which all of the possible alternatives to VED have again been rejected. We have ourselves identified a number of factors which indicate some continuing possibilities. We are therefore glad to note that the position on alternatives to VED has not been permanently settled.

The Government's position remains as the then Financial Secretary stated, in the debate on an earlier PAC report on 24 October 1985, that "possible alternative forms of taxation have been examined, but none has been found to be preferable to the form that we have, even with its acknowledged disadvantage. I put that clearly on record".

The latest survey of evasion showed that it probably amounted to between some 3.5 and 5% of the total VED revenue, or about £80 million to £120 million in 1985/86. This is less than previously thought.

Abolition of VED would mean additional tax of about 38p on each gallon of petrol to recoup the lost revenue.

STRUC
TURE

Car Tax

Abolition of Car Tax is strongly advocated by bodies such as the Society of Motor Manufacturers and Traders and favoured by the AA. The revenue at stake is likely to be approaching £1 billion in 1986-7. Abolition of Car Tax would represent a significant revenue loss which would have to be recouped from other sources.

C. LINE TO TAKE

Although the possibility of shifting taxation from VED to petrol duty is kept under regular review, the Government have no immediate plans to abolish VED. They would only do so if the benefits of such a move were clearly greater than the disadvantages.

[If the issue is raised] - The arguments about Car Tax on both sides are understood; the Government does not see a pressing case for immediate abolition.

MOTURING TAXATION: RATES

A. AA's VIEWS

The AA express appreciation of the treatment of 'motoring taxation' generally in the 1986 Budget, and accept that recent increases in petrol duty have been 'modest'. They stress the importance of cars to individuals and to the economy, and ask for a standstill or even a reduction in rates of tax. In connection with petrol duty, they suggest that demand for petrol is relatively price-elastic, and point out that duty increases contribute to inflationary pressures. No comment has been offered on the planned help for unleaded petrol. Although the AA consider that Vehicle Excise Duty is less unpopular than petrol duty, they appear to be pleased that it has been kept to a round £100, as urged by Lord Erroll last year.

B. BACKGROUND

In the 1985 Budget VED for cars and light vans was raised from £90 to £100 (an increase of 11.1%, more than twice the rate of inflation). In the 1986 Budget it was left unchanged. Petrol duty was exactly revalorised in 1985, but in 1986 it was over-indexed: the 8% increase, combined with the VED standstill, achieved overall revalorisation for motoring taxes. The duty differential in favour of unleaded petrol to take account of the higher production costs, which was announced in the 1986 Budget, is to be introduced in the 1987 Budget.

C. LINE TO TAKE

The Government is not anti-motorist. Taking both VED and petrol duty together, the increase in motoring taxes in the 1986 Budget was equal to the rate of inflation. Comparisons with motoring taxation in other countries are complex and of debatable relevance; the Government does not consider that the UK motorist currently faces an unacceptable burden.

[If the point is raised] - Preparations for giving unleaded petrol some fiscal assistance are proceeding.

BRIEF
RATES

BACKGROUND BRIEFING FOR CHANCELLOR'S MEETING WITH THE AA ON TUESDAY 16 DECEMBER

86

(i) National traffic growth forecasts are periodically updated and used in deciding priorities for the National Roads Programme.

(ii) Both Scotland and Wales devote resources to the provision of roads that will relieve communities from the effects of heavy traffic.

(iii) Government gives roads a high priority; since 1978/79 capital spending on motorways and trunk roads in England has increased by almost 30 per cent in real terms.

(iv) Taxes are not hypothecated because:

(a) taxpayers do not generally receive benefits directly proportionate to their contribution to the Budget: all tax entails some redistribution

(b) flexibility in both planning public expenditure and raising tax revenue would be reduced.

BACK
GROW



Inland Revenue

Policy Division
Somerset House

FROM: B T HOUGHTON

8 JANUARY 1987

CHANCELLOR OF THE EXCHEQUER

INHERITANCE TAX RATES AND BANDS: GAINERS AND LOSERS

1. Mr Battersby's analysis in his minute of 7 January (below) responds to your request for further information about the impact of the possible changes in the IHT rate schedule in terms of gainers and losers. But the analysis is done in terms of death estates and this raises the question how the impact of IHT changes is perceived by the living.

2. The perception of the impact falls into two main categories: the first is the living, contemplating the impact of the tax on their death and the second are the beneficiaries whose take is reduced by the tax. As regards the first category, many people want to see as much of their estates pass to their beneficiaries and not to the state as possible. Reductions in the tax rates will be generally welcomed on this account. They will be of even greater importance to those who want to keep assets as intact as possible because of their utility to the future generations (businesses, farms and agricultural estates) and want to leave sufficient liquid assets to secure this. But many estates finish up in the hands of an elderly widow (often being cared for) who has only a limited capacity for concern about the reduction which the tax will cause in the dispositions she is making - often to fairly remote relatives. As regards the beneficiaries themselves of course their interest lies in anything which minimises the cut which the tax takes from their inheritances and their interests may not be the same as the testator's.

cc	Chief Secretary	Mr Battishill
	Financial Secretary	Mr Isaac
	Economic Secretary	Mr Beighton
	Minister of State	Mr Calder
	Sir P Middleton	Mr Houghton
	Sir T Burns	Mr Spencer
	Mr Cassell	Mr Battersby
	Mr Scholar	Mr Brown
	Mr Cropper	Mrs Evans
		PS/IR

NO. 10/10/87
to
CH/2/87
8/1

3. You also asked whether we could comment on the interaction of the CGT/IT changes and the IHT options. Although we hope to be able as a result of the recently completed survey to say more about the relation between CGT and IT payers* we cannot provide an analysis bringing in IHT as well. The difficulty is that death is not an occasion of charge for CGT purposes. The information we have about the contents of death estates cannot be linked with data about gains or income during lifetime.

*see separate folder
CGT/IT
9/1*

W

B T HOUGHTON

CONFIDENTIAL

FROM: P J CROPPER
DATE: 9 January 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Mr Scholar
Mr Ross Goobey
Mr Tyrie

*WT March 82
@ "Cherish 82"
"Anti-anti-82"
address my proxy
to X.M.*

CONSERVATIVE LAWYERS: INTERITANCE TAX AND TRUSTS

The second half of the Conservative Lawyers' submission has just come in. Theo Wallace adds: "I am also sending these to Leon Brittan who is now chairman of the Society of Conservative Lawyers".

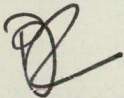
2. In their first submission the Conservative Lawyers' pressed the case on IHT treatment of Trusts with Interest in Possession. Mr Battishill, to whom we referred the question, has sent a note (also attached). He adds in an accompanying letter:

"The settled property point is the important one. It is old ground, and the Society has nothing new to say. The issue is whether the Chancellor wants to move from the firm position he took last year and embark on a long and possibly controversial consultation exercise."

3. The tax man at the Country Landowners tells me that Peter Rees has advised the CLA tax committee: "Your best chance of getting a change in the IHT treatment of Trusts with Interest in Possession is to line up with other representative bodies and all push together."

4. The CLA think the Revenue is greatly over-playing the difficulty of devising anti avoidance measures to deal with the "widows loophole".

5. As a useful reminder, I attach a copy of the relevant "note on clauses" from last year's Finance Bill.



P J CROPPER

CONQUEROR



1987 BUDGET PROPOSALS

RATES OF INCOME TAX AND CAPITAL TRANSFER TAX

In May 1986 we submitted a short paper on the rates of inheritance tax with a Table comparing the burden of capital tax on estates of the same real value in 1949, 1974 and 1986. We take this opportunity to re-submit the table with some further comments together with some observations on the rates of income tax.

It seems to us that, although the burden of income tax and inheritance tax has been substantially alleviated at both the lowest and the highest ends of the scale, the burden in the middle remains excessive.

When the rates for the new unified income tax were originally announced in the March 1972 Budget the threshold for the 40 per cent band was set at a total income of £5,000. Between that date and December 1985 (the basis month for indexation of thresholds for 1986/87) retail prices increased by more than 350 per cent. If thresholds had been increased in line with inflation since March 1972, the threshold for the 40 per cent band for 1986/87 would be £22,650 against an actual figure of £17,200. The annexed Table shows the

rates for 1973/74 and 1986/87 together with the rates which would apply in 1986/87 if fully indexed from March 1972. The contrast is even more marked at the 45 per cent threshold. It should be remembered that at these middle incomes the impact of the limit of £30,000 for mortgage interest relief is at its greatest due to the high price of property; those with high incomes are better able to fund the excess interest not qualifying for tax relief.

We would urge that consideration be given to introducing a smoother progression of higher rate tax with a lower band at 35 per cent and with wider bands thereafter. We share the concern of Ministers at the impact of the higher rates of tax particularly when compared with those now obtaining in the USA; we would however suggest that as an alternative to abolishing the higher rate bands consideration be given to retaining a high band for the present but with a much increased threshold.

X | We wish to emphasise our concern at the impact of inheritance tax on estates between £71,000 and £317,000.

At these levels the smaller the estate, the larger the proportion accounted for by private residences; in our experience, it is not unusual to find the sole

substantial asset of an estate to be a residence worth some £100,000. It is of course true that spouse relief is most valuable; however, it is our experience that many widows with families are gravely worried by the prospective burden of capital transfer tax on their death. With the passage of time since the introduction of full spouse relief in November 1974, an increasing number of surviving spouses are dying with inheritance tax being levied at a high rate on the combined estates. It does seem to us that it should be possible for a person to own a residence and a modest amount of free capital in order to provide for old age without the prospect of a high rate of inheritance tax on death: that is not the case at present.

At a time when the Government is seeking to promote a capital-owning democracy we find it strange that such high rates of inheritance tax have been retained on estates of medium size.

While persons with large estates can take advantage of the P.E.T. regime to make lifetime gifts, this is more hazardous for those whose main asset is their house. Indeed the impact of the reserved benefit rules is greater on persons with medium sized estates than on wealthier persons who can afford to make outright gifts. Furthermore, many widows only hold limited interests in the estates of their husbands and are thus

unable to avail themselves of the reliefs for
potentially exempt transfers.

P.W.E. Taylor (chairman)

Theodore Wallace (secretary)

Society of Conservative Lawyers
Taxation Sub-Committee.

[A] Comparison of effective rates of tax payable on death on 1974 Estates with 1949 and 1986 equivalents using R.P.I. The heaviest are circled.

July 1949 Equivalent Estate	£3,948	£5,264	£6,580	£7,896	£13,160	£26,320	£65,800	£131,600	£197,400	£263,200
1949 Estate Duty	2%	3%	3%	4%	8%	18%	40%	50%	55%	66%
August 1974 Estate	£15,000	£20,000	£25,000	£30,000	£50,000	£100,000	£250,000	£500,000	£750,000	£1,000,000
1974 CTT rates	NIL	2.5%	5%	7.5%	15.5%	28.2%	45.9%	52.9%	55.3%	59%
December 1986 equivalent estate	£51,750	£69,000	£86,250	£103,500	£172,500	£345,000	£862,500	£1,725,000	£2,587,500	£3,450,000
1986 Inheritance Tax	NIL	NIL	5.3%	9.8%	21.4%	36.9%	50.8%	55.4%	56.9%	57.7%

RPI August 1974 = 109.8 and December 1985 378.9 ; July 1949 equivalent 28.9

[B] Comparison of 1974 CTT rate bands with 1986 marginal rates at equivalent values

1974 Rate and band	1986 equivalent Marginal rate
10% from £15,000	NIL
15% £20,000	NIL
20% £25,000	30%
25% £30,000	35%
30% £40,000	40%
40% £60,000	50%
50% £100,000	60%
60% £150,000	60%
65% £500,000	60%
70% £1 million	60%
75% £2 million	60%

Thresholds for Higher Rates of Income Tax

A comparison between the actual thresholds for 1973/74 and 1986/87 with those which would apply for 1986/87 assuming full indexation from March 1972 when the 1973/74 rates were announced to December 1985, the relevant date under Finance Act 1980, s. 24(4).

Threshold	1973/74	1986/87 Actual	1986/87 Indexed
40%	£5000	17200	22700
45%	£6000	20200	27200
50%	£7000	25400	31800
55%	£8000	33300	36300
60%	£10000	41200	45400

I.R. Comments
on earlier reps

Society of Conservative Lawyers

Inheritance Tax on Settled Property

Point at issue

1. The Society want settled property brought into the new regime for lifetime gifts. Outright gifts between individuals are exempt from inheritance tax if the donor survives for 7 years. Gifts into a trust are not.

Comment

2. This is the now familiar complaint that the CTT concept of parity between trust giving and outright gifts has been abandoned. That has been defended on the grounds that

- Chancellor wished to encourage outright, unfettered giving, and trust giving is by nature unfettered;
- the parity concept has lost relevance and the departure from it was deliberate.

A change now would look like a U-turn.

3. Exemption of all gifts into and out of trusts would undermine the structure of the IHT regime. This is because the system pre-supposes that some transfers will be taxable when made and would not be appropriate if all lifetime transfers were exempt. Creation of a new structure would need a major consultation exercise lasting at least two years. The outcome so far as discretionary trust charges are concerned is likely to be controversial. These are the periodic charges that are imposed on discretionary trusts as the price of sheltering assets from the death charge. They are barely adequate alongside a charge on

transfers into trust, and would need to be increased if the transfer charge were abolished.

4. Some critics have suggested exempting transfers to and from interest in possession trusts but leaving discretionary trusts alone. Limited action of this sort would expose the weaknesses in the discretionary regime and might precipitate a major review. Even if it did not, it would not be so easy as its proponents suppose. To be complete, it would involve measures to defeat exploitation of the spouse exemption at both the entry and the exit from the IIP trust.

5. There is no obviously right form of anti-avoidance measure even at the entry point, which Sir Brandon Rhys Williams tried to tackle at the Report Stage of the 1986 Bill. There are problems about finding a fair system, since almost any system would be perceived as bearing too harshly where there is no avoidance motive. There are further problems at the exit stage, where action might have to be by direct and controversial restriction of the general exemption for inter-spouse gifts.

6. Given the need to work up proposals and to consult, limited legislation could not be ready before the 1988 Finance Bill - and possibly not then if wider issues were pressed.

Society of Conservative Lawyers

Inheritance Tax - Reserved Benefits

Point at Issue

Clarification of the application of the Gift with Reservation (GWR) rules when a share in a house is given to children, who then occupy it as their family home with the donor - each owner bearing his share of the running costs. Ministerial statement during passage of Finance Bill was based on unsound view of the law. Clarification should be by legislation, a considered statement of practice or an extra statutory concession.

Comment

The GWR rules are admittedly complex. They deal with complex situations. Some uncertainty is inevitable but the case law on similar estate duty legislation provides useful guidance on matters of interpretation.

We do not agree that the Ministerial statement on the specific point mentioned by the Society was ill founded. It rests on a respectable interpretation of the law. The point is one of several we are considering for the issue of further guidance. We are not yet certain whether the guidance needs the status of a formal Statement of Practice. But we do not believe it requires either legislation or an extra-statutory concession.

BOARD OF INLAND REVENUE

BACKGROUND NOTE

5. We assume the proposal uses the term life interest in the colloquial sense of an interest in possession [which need not necessarily be for the whole of life].

6. Immediate charge on gifts out of interest in possession trusts is necessary to prevent the avoidance of the charge on death by the channelling of property through a surviving spouse. Because of the certainty which a trust provides it would be both simple and attractive to get round the pre-death protective period by leaving property to a spouse for a fixed term with remainder to the children.

7. For example, A - with only a few months to live - puts property into trust to pay income to his wife for 1 year (or until A's death if it is earlier) with remainder to his son absolutely. There is no entry charge on property going into trust as the spouse exemption applies. Under the amendment, there would be no exit charge when the trust property passed to the son on A's death. If A had given the property directly to his son, the gift would have been taxable on the donor's death.

FOR
MINIS-
TERS
USE
ONLY

8. More detailed notes on Trusts in paragraphs 21, 22 and 47 to 50 of the General Note on Clauses 79-83 and Schedules 18 and 19. Any change in the trust regime would have serious repercussions on the rest of the IHT provisions and might wreck the whole scheme.

*Thank. I agree
that we should
do as suggested, as
no more on this
contract of
Export duties
will*

*Papers
p2e*



FROM: Minister of State

DATE: 9 January 1987

CHANCELLOR OF THE EXCHEQUER

- c Chief Secretary
- Financial Secretary
- Economic Secretary
- Mr Scholar
- Miss Sinclair
- Mr Cropper
- PS/Customs & Excise

*MST
To
CH/EX
9/1*

VAT: TAX AVOIDANCE (STARTER No 6): THE BREWING TRADE

I have seen the note of 6 January from your Private Secretary to mine. I discussed this with Customs yesterday - the note of the meeting gives further details.

When the Brewers' Society came to see me on 4 December they thought that the change we have proposed would cost them about £70 million. Customs will be issuing draft regulations in about a month, and thereafter they expect to have detailed discussions with the trade, with the aim of agreeing a special method of assessment for them. Customs expect that this would reduce the loss to the trade to about £25 million, costing us £45 million in lost revenue.

To avoid any loss to the brewers, we would have to withdraw the proposals we announced before Christmas, and start again. We could easily lose all of the £300 million benefit from closing this loophole. I hope you agree that we should not consider this further. But the £25 million of extra VAT paid by the brewers and the licensed trade could be offset by adjustments to drink duties - especially on beer and spirits. The under-indexation package in Mr Knox's submission of yesterday implies, in score-card terms, a loss of revenue from drinks duty of about £40 million, of which sales through licensed premises account for about £25 million. Of course one cannot assume that all taxes and duties are passed completely to the final consumer, but nevertheless a package of this kind would leave the overall

*on covering
Folder -
tax issues*

tax burden on this area broadly unchanged, compared with a standard revalorisation and no reform of VAT.

One final point is that, as Mr Jefferson Smith's submission of yesterday makes clear, a package on these lines would not cause any problems with the wine duty restructuring that I agreed at the end of December.

P.B.

PETER BROOKE

CONFIDENTIAL



FROM: S P Judge

DATE: 12 January 1987

*Bif with
advice*

MR BAZLEY - C+E

cc PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Mr Scholar
Miss Sinclair
PS/Customs & Excise

PS/MST
To
BAZLEY
C+E
12/1

VAT: TAX AVOIDANCE (STARTER No 6): LEGAL ADVICE

At the meeting on 4 December between the Minister of State and the Brewers' Society, there was some discussion about whether Customs' proposal was lawful. As you explained to me on the telephone on Friday, you have slightly amended the details of your proposal, in order to make it clear that you are using the powers in Article 17 of the Sixth VAT Directive. This will be made clear when you issue your draft regulations early next month, for consultation with the trade.

Notwithstanding this, the Minister of State thinks that it would still be prudent to ask the Law Officers to confirm that all is well. I hope that this should be reasonably straightforward. The Minister has asked me to reassure you that he is not doubting the accuracy of your legal advice, but simply taking all possible precautions.

I would be grateful if you could set this in hand, and (as soon as possible) give me an idea of the likely timescale.

A handwritten signature in dark ink, appearing to be "S P Judge".

S P JUDGE
Private Secretary



MINUTES OF A MEETING HELD AT 4.00PM ON TUESDAY 13 JANUARY
IN NO.11 DOWNING STREET

Those present: Chancellor
Sir Ralph Carr-Ellison-AA

BUDGET DEPUTATION: AA

Sir Ralph Carr-Ellison said that the Association were very appreciative of the stance that the Government had taken towards motoring taxation. The Association consisted of over 6 million members representing 12 to 15 million motorists. They had contact with motorists through their members, through their break down services and via their regular monthly survey of 1,000 motorists. The car was no longer a luxury, but was a necessity in rural areas, for business, and represented a large part of people's budgets.

Petrol duty

2. Sir Ralph said that he hoped that it would be possible for the Government to leave petrol duty at its present level, or to limit any increase to inflation. Recent increases in petrol prices would benefit government revenue, to an extent which he hoped would satisfy the Government's needs.

VED

3. Sir Ralph said that he understood that the Government had decided against abolishing VED, and raising an equivalent amount from petrol duty. Abolishing VED and increasing petrol duties would increase substantially the cost to rural motorists, smaller motorists, and those in the most disadvantaged parts of the country. Furthermore, it would still be necessary to register vehicles and so there was bound to be some charge which was unlikely to be less than £5. The Chancellor said that petrol tax was a much fairer tax than VED because it related taxation to the use being made of roads. This was why a complete switch



had been considered, but he noted that Sir Ralph would be against it. Sir Ralph said that he would expand on these points in a formal submission that he would be sending the Chancellor shortly.

Unleaded petrol

4. Sir Ralph said that he understood that the Chancellor was thinking in terms of tax equalisation so that unleaded petrol would be no more expensive than leaded petrol. He asked that this should not come about from increasing the tax on leaded petrol, as this would penalise those with older cars who were less well off. There was a strong case for the nation as a whole paying their proportion.

5. On the tax side generally, the Chancellor said that he noted what had been said about leaded and unleaded petrol and the non-abolition of VED. However, as Sir Geoffrey Howe had said, it was a sensible presumption that each year indirect taxes should be adjusted in line with inflation. He did not think that the yield from North Sea oil tax affected the equation in the slightest. Indeed, if there was a link, then it would have been very uncomfortable for the motorist over the last year! Motoring taxes were a very big revenue raiser, and the money was needed. However, on the whole the Government had been reasonable and he would hope they would continue to be so.

Roads

Local Authority expenditure

6. Sir Ralph said that he welcomed the commitment to maintain funding to Local Authorities for roads expenditure, but he would like to see this expenditure safeguarded. He was prepared to give evidence of examples where Local Authorities were not using this money as they should be. The Chancellor said that there was a major problem with the Local Authorities, which had come



to a head now over education. It was an area which would have to be considered, but probably not this side of the Election.

Traffic forecasts

7. Sir Ralph said that he believed that the forecasts for car users in the 1990s and beyond were not realistic. He hoped there could be some discussion and adjustment of targets for the future.

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9. Concluding, Sir Ralph said that he would submit a formal submission.

C RYDING

MST'S MEETING
WITH BREWERS'
SOCIETY

ED

Ref
CR
To
PS/MST
13/1



FROM: CATHY RYDING
DATE: 13 January 1987

PS/MINISTER OF STATE

cc Chief Secretary
Financial Secretary
Economic Secretary
Mr Scholar
Miss Sinclair
Mr Cropper
PS/C&E

VAT: TAX AVOIDANCE (STARTER NO. 6): THE BREWING TRADE

The Chancellor was grateful for the Minister of State's minute of 9 January.

2. The Chancellor agrees that we should reduce the Brewers' loss to £25 million as suggested, and then consider the remaining £25 million - whether or not to offset - in the context of other decisions on excise duties at the next Overview meeting.

CATHY RYDING



Mr Ropmanski

At Tuesday's meeting,
Sir Ralph asked for a
copy of the minutes of the
meeting. I attach a draft
+ would be grateful if you
would look through them.

I propose to send them to
Sir Ralph under cover
of a letter from me. Are
you content with this?

Cathy Ryding

Mrs Ryding

16/1

a couple of suggestions on the first
page. MST and I were also present.
I am content that you should
write as you propose. W/16:



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C RYDING

LICENSED VICTUALLERS

From: Michael Colvin, M.P.



HOUSE OF COMMONS
LONDON SW1A 0AA

(Copied to
other Mins
& Ads) *AK*
15/1

Ref AW

Debbie

14 January 1987

Re arrange

CR 17/1

4
Lindsay
Regrets?

Rt Hon Nigel Lawson MP
HM Treasury
Treasury Chambers
Parliament Street
London
SW1P 3AG

Myers.

D
15/1

1
will meet - says -
will
MSI, @
consult home
& later.

My dear Nigel -

The National Union of Licensed Victuallers are holding a meeting on Wednesday, 4 February 1987, here at the House of Commons and wondered if it would be possible to meet you sometime in the afternoon that day for about an hour - or half an hour?

Last year they talked to Peter Brooke, but as this maybe an election year and licensing law is on the agenda I think it would be a good public relations exercise for them this time to meet yourself.

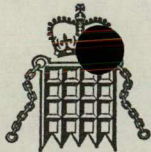
If you do agree to meet the four members and the 4 February is not convenient I should be grateful if you would let me have a suitable date.

Yours
Michael

HM CUSTOMS AND EXCISE

With Compliments

of
David Boardman



FAO. Mr Dight.

Customs and Excise.

As discussed, we had no notice of the equivalent meeting of Labour MPs with the Chancellor, were not asked to brief, and have no record of any discussion.

King's Beam House
39-41 Mark Lane
London EC3R 7HE

Tel: 01 626 1515 ext.

01 382 ext. 5103.

The EST (then PPST Chancellor) recalled the meeting (? in the Chancellor's room in the House) at the meeting with C & E 763A Imperial on 12/4/87. JS.



NEWSPAPER PRINTING UNIT

1-1-20-1518

Please Dial my Extension Direct:
Use Code (01)-382 followed by
Extension Number 5...101...

FROM: W F McGUIGAN

DATE: 15 January 1987

Minister of State

cc PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Mr Scholar
Miss Sinclair
Mr Romanski
Mr D Walters
Mr McKenzie
Mr Cropper

TOBACCO PRODUCTS DUTY : BUDGET REPRESENTATIONS

I attach briefing, in the standard format, for your meeting with MPs on 22 January at 10.30 am.

The MPs expected to attend include John Lester, Broxtowe (Notts), Martin Brandon-Bravo, Nottingham South and Malcolm Thornton, Crosby. All their constituencies have Imperial Tobacco interests. You may recollect you saw a similar delegation before the 1986 Budget.

Mr Boardman and I shall provide official support at the meeting.

W F McGuigan

Internal circ: CPS, Mr Knox, Mr Jefferson Smith, Mr Wilmott, Mr Boardman

IMPERIAL TOBACCO LIMITED

Now part of the Hanson Trust empire, the Imperial Group has interests in brewing, leisure and food; but its tobacco interests, controlled by Imperial Tobacco Limited, remain the mainstay of the Group, contributing over 50% of turnover and almost 50% of profits. The main tobacco branches are Wills (centred at Bristol), Players (at Nottingham) and Ogdens (at Liverpool). Their leading brands are John Player and Embassy cigarettes and cigars and Golden Virginia hand-rolling tobacco. St Bruno is their main pipe tobacco. The company's export trade is small, but until comparatively recently it commanded about 66% of the total UK home market. In the past decade this dominant position has been seriously eroded, and Imperial's share has now dropped to below 45%. While it remains the largest UK manufacturer, its two main competitors (Gallahers and Rothmans) now together command a similar share.

Over the past decade the UK tobacco market as a whole has shrunk by more than a quarter, and there has been a more than corresponding reduction in employment in the industry. The Imperial workforce has fallen in recent years to about 10,500, and late in 1985 further job losses over the next few years were announced, including closure of a factory at Newcastle, which will bring the number below 9,000. However, employment has fallen at a faster rate than the fall in production, reflecting benefits from stream-lining and investment in new machinery. Imperial feel somewhat beleaguered and react strongly to anything seen as a threat to their future.

OBJECT OF MEETING

2. The MPs in this delegation all share constituency interests connected with Imperial Tobacco Ltd. The Tobacco Advisory Council, of which ITL is a member, has mounted an intensive campaign against further increases in cigarette taxation and the threat to the UK industry and jobs from high taxes and cheap imports. The delegation can be expected to lend their support to this campaign.

WRITTEN REPRESENTATIONS

3. No formal written representations have been made for this meeting. In common with the rest of the tobacco industry ITL is engaged in a intensive lobbying campaign to secure 'a year off for tobacco' in the 1987 Budget (see paragraph 4.2 below). This includes

literature prepared and distributed to MPs invited to a dinner to discuss the problems of the tobacco industry.

POINTS LIKELY TO BE RAISED

UK Taxation.

- 4 1 The UK tobacco industry is deeply concerned about increases in duty, the effect on cigarette consumption, and the fact that health arguments are now being deployed to justify repeated real increases in duty levels. The heavy increases in 1981 (adding 17p to the price of a packet of 20), 1984 (adding 10p), and 1986 (adding 11p) caused consternation and were bitterly attacked as excessive (several times the amount required to revalorise) and discriminatory (some other excise duties were increased proportionately less or not at all). The industry welcomed, however, the continuation in 1986 of the standstill on cigars and pipe tobacco.
- 4 2 The tobacco industry are inveterate lobbyists, and are concerned that their representations are not yet having the desired effect on Treasury Ministers. This year they are making a special effort to secure a 'year off for tobacco' in the 1987 Budget, through a freeze on all tobacco duties, by analogy with the freeze on alcoholic drinks duties in the 1986 Budget. As Imperial have a substantial share of the cigar and pipe tobacco markets, they may be expected to press for the standstill on those products to be continued, irrespective of the decision on cigarette duty.
- 4 3 Cigarette consumption has fallen by about 20 per cent from 1980 to 1985. This may well have been caused in part by duty increases, but also reflects a long term trend against smoking, which began considerably earlier.

IMPORTS

- 4 4 Imperials along with the other UK manufacturers claim that increases in taxation, although superficially neutral, worsen the position of UK manufacturers against cheap imported brands. Until recently imported cigarettes were of little concern to UK manufacturers but they have now captured about 10% of the market and the proportion is increasing. The imports come mainly from W Germany, principally Berlin where manufacturers are claimed to receive assistance because of the special position of the city. They are made mainly for sale under supermarket "own labels" and are cheaper than UK products. Imperials argue that UK firms cannot compete because of subsidised and

marginal cost production in Berlin. They also claim that smokers are no longer loyal to particular brands and that when there are major increases in cigarette taxation, they turn to cheaper imported brands. However, competition with imports has to be seen in the context of the unwillingness of UK tobacco majors to compete in the "own label" market. The recent weakness of the £ against the W German mark may be of greater help to the UK industry than a duty standstill. Very recently Imperial have announced a cut of 5p in the price of John Player Specials. At this time of year they are normally seeking an increase in price. The cut is probably to fight for UK market share generally, rather than as a direct counter to imports.

EC HARMONISATION

4.5 Imperial and the tobacco industry as a whole are concerned about the impact of further EC cigarette tax harmonisation. The present second stage of harmonisation, recently extended indefinitely, requires that cigarettes bear, in addition to VAT, an excise duty which is partly specific and partly ad valorem; and that the specific element should be not less than 5% nor more than 55% of the total tax burden including VAT. The present specific proportion in the UK is close to the maximum, and the whole UK industry feels strongly that final harmonisation at a much lower figure would greatly damage its interests by putting a premium on cheapness. The UK government has consistently supported the industry case in Brussels. The present impasse over cigarettes is quite acceptable to the UK industry, and Commission proposals, informal as yet, for a harmonised ad valorem duty structure for minor products such as cigars, smoking and chewing tobacco, which the industry dislike, are unlikely to make any progress until it is resolved. The industry fear however that the Government will come under increasing pressure to give ground in the wider context of tax approximation and completing the internal market. Very recently there have been proposals by health interests within the Commission to unify cigarette tax rates at the highest Community rate (Denmark) rather than at an average rate. The exact status of the proposal is not clear but the industry has been alarmed by it.

4.6 Government support for the industry, particularly in relation to the structure of the duty, could be pointed out, but on approximation of duty rates, UK government interests may differ from those of the industry.

PRE BUDGET RESTRICTIONS ON DELIVERIES

- 47 Customs, with Ministerial agreement, announced on 2 October 1986 their intention of imposing restrictions on the delivery of cigarettes and hand-rolling tobacco before the 1987 Budget to limit the scale of forestalling, which had reached unacceptable levels. The permitted allocation will be 1.5 times average deliveries, in a restriction period from 1 February 1987 to 2 days after Budget day, when any duty changes would take effect. The reaction of the UK industry was that, given the almost inevitability of restrictions, the arrangements are fair. They have sought some minor variations to enable them to plan their production schedules more firmly and we have agreed to most of their proposals. If the subject is raised the point might be made that the restrictions are modest in the shortness of the period and generous in the amount of uplift allowed over normal deliveries. Their operation will be closely monitored to ensure they are not abused.

POINTS TO RAISE

5. None. The delegation will not expect detailed comment in advance of the Budget Judgement.

PSI Chancellor
PSI C&E
PSI F&E
PSI EST
Mr Schlar
Miss Sinclair
Mr Romanski
Mr D Watters

Mr Inckenzie
Mr Cropper
PSI C&E

Mr Boardman } C&E
29/1/87



NOTE OF A MEETING HELD IN ROOM 50/2, HM TREASURY ON 22 JANUARY 1987 WITH MPs

Present: Minister of State
Mr McGuigan - C&E
Mr Boardman - C&E
Mr Romanski

MPs

Jim Lester (Broxtowe)
Martin Brandon-Bravo (Nottingham South)
Richard Ottaway (Nottingham North)
Michael Fallon (Darlington)
Michael Knowles (Nottingham East)

TOBACCO PRODUCTS DUTY: BUDGET REPRESENTATIONS

The Minister of State welcomed the deputation and explained that he would remain, necessarily, impassive throughout the meeting.

Mr Lester said that he thought the principle of taxing products on health grounds was wrong. He accepted that the duty on tobacco products would be increased in the Budget but felt that this increase should be kept in line with the rate of inflation. Mr Knowles added that the Chancellor should quantify the health risks and health costs; otherwise the annual increases on tobacco would be open-ended and the Chancellor would meet more political argument.

Mr Lester said that he was also concerned about EC tax harmonisation on tobacco: he could see no point in encouraging own brand imports from West Germany.

Mr Fallon spoke of the effect duty increases had had on the tobacco industry. There had been a number of factory closures in his area and now only Imperial Tobacco remained in Darlington. Any further closures would devastate either his constituency or Anthony Blair's (Sedgefield). He could see no excuse for not devising

a fairer system of taxation for all products subject to excise duty.

Mr Ottaway was concerned by the number of corner shops, often reliant on tobacco sales, which were going out of business. He considered serious the loss of the social focus which such shops provided. Mr Ottaway verified that the ad valorem element of tobacco duty was linked to the final selling price and invited Customs and Excise to look at the fact that this resulted in cheap imported tobacco products being subject to less tax than home produced goods. The Minister of State pointed out that under EC harmonisation the specific element of tobacco duty was restricted from 5 per cent to 55 per cent of the total tax burden. The UK was already very close to the 55 per cent maximum. He agreed with Mr Ottaway insofar as there could be a small absolute advantage but in relative terms the factor cost was less important.

As an aside, in his capacity as a politician, Mr Ottaway added that the tobacco factories which risked closure were all in marginal seats.

Mr Brandon-Bravo said that the tobacco industry just needed a breathing space because there was a limit to the duty increases that it could absorb. He spoke about the large numbers of jobs lost within the industry in Nottingham. Imperial Tobacco realised that it could not only rely on politicians and was trying to help itself: it had recently announced a price cut. However, according to Mr Brandon-Bravo, Imperial knew that if it took on a marginal cost battle with the German own brands, the tax structure was such that Imperial stood to lose.

The Minister of State understood the request for a year off but felt that, like the argument to increase duty on health grounds, the request could be made each year. Mr Lester said that the industry only needed a year off in order to slow down the rate of factory closures. Mr Ottaway quoted from the Tobacco Advisory Council's representations on the need for a standstill.

Mr Fallon asked the Minister whether he could say anything about the pattern of annual fiscal reform. The Minister of State said that the general principle was revalorisation, although this did not preclude some fine tuning which allowed the UK to conform to its EC obligations although 1992 was the target for EC harmonisation.

Mr McGuigan said that the recent weakness of the £ against the German mark might cause suppliers of own brands to look to home manufacturers. Mr Lester thought that ideally factories should take turns to go into the own brand market.

Mr Fallon said that if cigarette consumption tended to drop, political perception would show that the Government had made the situation worse. Mr Knowles suggested that the tobacco manufacturers did not push marketing enough. He feared that the domestic market would end up comprising only of imported products. Mr Brandon-Bravo added that as 16 million people continued to smoke, there was clearly still a market for UK manufacturers to target. He repeated his argument that it was too easy for cheaper cigarettes to be imported from Germany. Mr Boardman pointed out that West Germany had turned to the export market when its domestic consumption had fallen.

The deputation thanked the Minister of State for the opportunity to express its concern about the UK tobacco industry.

Deborah Francis:

MISS D L FRANCIS
Assistant Private Secretary



FROM: FINANCIAL SECRETARY
DATE: 16 January 1986

CHANCELLOR

cc PS/Chief Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Mr Wilson
Mr Cassell
Mr Scholar
Mrs Lomax
Mr Ilett
Ms Sinclair
Mr Cropper
Mr Haigh
Mr Graham OPC
PS/IR

1 agree

**STARTER 157B: FSA CONSEQUENTIALS:
DEFINITION OF STOCK EXCHANGE**

1. I have authorised the preparation of legislation on this Starter as a contingency basis (my Private Secretary's response of 5 January to Mr Spence's 19 December note). But my discussion of the issue with officials has made me uneasy about the extent of the proposed Regulation making powers.

2. I see no difficulty in legislating for Regulations that will enable securities quoted on new Recognised Investment Exchanges to get the same tax treatment as the Stock Exchange gets now. It is possible that no new RIE will be adversely affected by the existing rules. In that event no legislation will be needed. We cannot decide this until we know more about the proposed RIE for international bond dealers (AIBD). I hope officials will be able to clear this up fairly soon. But I am clear that if the AIBD RIE would be at a disadvantage if the rules are left unchanged, then action is necessary to ensure that new RIE and the SE get the same treatment. Regulatory powers to allow for this will be straightforward and uncontroversial.

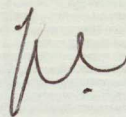
CONFIDENTIAL

3. The difficulty is that the Regulation making powers the Revenue propose would go wider than lining up new RIEs with the existing rules for the Stock Exchange. They would also cover the making of new rules for the Stock Exchange. There is a case for this. The existing dividing line between the fully-listed SE market and the USM produces some odd results. It would be sensible to provide a means of adjusting them, particularly where the appearance of a new RIE produces changes in the Stock Exchange markets.

4. The problem is that if the regulatory powers extend to the Stock Exchange, they could be used to make fairly major changes which are too substantial for secondary legislation. They could, for example, be used to remove the small business reliefs attached to USM securities, such as the purchase of own shares relief, interest relief and IHT business reliefs.

5. We could make a statement that we would not use the Regulations to make changes which ought to be made - if at all - by primary legislation. But this would not satisfy the critics. They would say - rightly, I think - that the scope of the Regulation making powers should be properly confined from the start.

My conclusion is that if we have to legislate, the Regulation making powers should only apply to new RIEs, and should not extend to the Stock Exchange. If we get to the point where changes are necessary for USM and/or TTM securities on the Stock Exchange, then we will have to introduce primary legislation.



FINANCIAL SECRETARY



PHD

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

19 January 1987

Sir Ralph Carr-Ellison
The Automobile Association
Fanum House
Basingstoke
Hampshire
RG21 2EA

Dear Sir Ralph,

... As you requested, I attach a note of your meeting with the
Chancellor last Tuesday.

Yours sincerely,

Cathy Ryding

CATHY RYDING
Assistant Private Secretary



MINUTES OF A MEETING HELD AT 4.00PM ON TUESDAY 13 JANUARY
IN NO.11 DOWNING STREET

Those present: Chancellor
Minister of State
Mr Romanski
Sir Ralph Carr-Ellison - AA

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9. Concluding, Sir Ralph said that he would submit a formal submission.

Circulation

Those present
PS/CST
PS/FST
PS/EST
Sir P Middleton
Mr Cassell
Mr Scholar
Miss Sinclair
Mr Walters
Mr McKenzie
PS/IR
PS/C&E

CR

C RYDING

pub



Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

From: P Jefferson Smith

Date: 20 January 1987

MINISTER OF STATE

Handwritten notes in red ink:
A-2 →
Miss @
Pratt → ✓

cc Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Mr Scholar
Miss Sinclair

VAT : TAX AVOIDANCE (STARTER NO. 6) : LEGAL ADVICE

1. Your Private Secretary's minute of 12 January asked that we should seek confirmation from the Law Officers that the revised partial exemption Regulations will comply with Article 17 of the Sixth Directive.

JEFFERSON
SMITH
To
MST
20/1

2. We now have a first draft of the Regulations: our aim is to finalise them this week and then get the draft out to the trade by the end of the month. Consulting the Law Officers would add probably two to three weeks depending on what other pressures were on them. We would be reluctant to add this to the timetable; we are trying to set up our next round of talks with the brewers, who are understood to be seeking to see you in mid-February. The brewers are showing themselves willing to negotiate but might become less so if there appeared to be any delay in producing the text.

3. The other factor is that it is normal to avoid adding to the workload of the Law Officers unless the Department's Solicitor advises that the question of law is unclear or admits of more than one answer; the advice of the Law Officers will then be sought as to which interpretation or course of action should be adopted. They would not expect to be consulted on a matter on which the

Internal circulation:

CPS	Solicitor	Mr Bazley	Mr Michie
Mr Knox	Mr Butt	Mr Nissen	

25/1/87

Departmental lawyers were clear in their advice. In this case, our lawyers have been instructed to draft in a way that so closely reflects the Sixth Directive as to be beyond challenge. It would be normal to see whether there was such a challenge, and we think the Law Officers would expect this, before we took up their time with a request for advice.

4. We would therefore seek your agreement to publishing the draft Regulations by the target of the end of the month, without consulting the Law Officers.

PH 5

P Jefferson Smith

EXTRACT FROM NLVA REP. BRUSE

VAT input tax changes

9. The NLVA support the brewers' protest against the application of these changes to tied house rentals. The brewers argue that implementation of the changes in the rules for input tax deduction will cost them about £70 million - equivalent, they say, to about 2p a pint on beer sold through tied houses. I met the Brewers' Society on 29 January and offered a method which would reduce the impact of the changes to about £10 million a year. Briefly, they would restrict their input tax deduction in relation to income from tied houses in ratio that rentals or property expenditure bore to total income; a global figure of 15% is suggested. They have gone away to consider; and it was made clear on our side that the proposal is ad

referendum to you. You are seeing a further deputation from them on 10 February.

10. While the NLVA cannot be given any hope of exemption for tied houses, they can be assured that talks are underway with the Brewers' Society aimed at agreeing a suitable method of input tax calculation which, while consistent with the new rules, does take account of the quantifiable and unique features of tied house rental agreements.

EXTRACT
FROM NLVA
BRIEF
VAT INPUT
TAX
CHANGES

FROM: D N WALTERS

DATE: 20 January 1987

1. MISS SINCLAIR

2. CHANCELLOR OF THE EXCHEQUER

cc PS/Chief Secretary
 PS/Financial Secretary
 PS/Economic Secretary
 PS/Minister of State
 Sir P Middleton
 Sir T Burns
 Mr F E R Butler
 Mr A Wilson
 Mr Monck
 Mr Cassell
 Mr Scholar
 Mr Culpin
 Miss O'Mara
 Mr Haigh
 Mr Romanski
 Mr McKenzie
 Miss Wallis
 Mr Cropper
 Mr Ross Goobey
 Mr Tyrie
 PS/IR
 PS/C&E
 Mr Bone C&E

attached at A
Thanks.
Per letter in a copy
of last year's matrix,
I compare with this.
I am to receive
it was all ok
how clear.

Thanks.

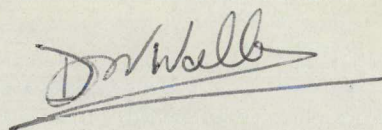
1987 BUDGET: MAIN REPRESENTATIONS

attached
 Miss Wallis' minute of 16 December enclosed a summary of the main Budget representations received to the end of October. I now attach a summary of those representations received between the beginning of November and Christmas. Also enclosed is an update to the matrix table attached to Miss Wallis' minute.

2. The detail provided for each organisation is not intended to be fully comprehensive. It simply points out those areas which seem to provide the main thrust of each approach. Should you wish to see any of the representations in full, copies can, of course, be provided.

3. Finally, for completeness, I should record one error in the summaries attached to Miss Wallis' note of 16 December. These

recorded that the International Chamber of Commerce supported the
✓ OECD/Council of Europe draft multilateral convention on mutual
administrative assistance in tax matters. This should have read
that they oppose the convention.

A handwritten signature in dark ink, appearing to read "D N Walters", is written over a horizontal line.

D N WALTERS

BR(87)2

Budget 1987 Representations - Second Edition

Managerial, Professional and Staff Liaison Group - 30-10-86
The Institute of Taxation - 31-10-86
The Automobile Association - 4-11-86 and 4-12-86
The Institute of Chartered Accountants of Scotland - 6-11-86
The Scotch Whisky Association - 19-11-86
The Jockey Club - 25-11-86
British Venture Capital Association - 28-11-86
General Council of British Shipping - 1-12-86
TUC Technical Representation - 2-12-86 ✓
CBI - 5-12-86
The Unquoted Companies Group - 12-12-86
The Brewers Society - 15-12-86

Managerial, Professional and Staff Liaison Group

Generally favour a shift from direct to indirect taxation. Hence:

Income Tax

- reduce basic rate to 27 per cent;
- fully index all allowances;
- increase tax allowance for married couple to £4670 (2 single allowances) and reduce wife's earned income allowance to £1320.

Duty Rates

- increase duty on tobacco by 50 per cent;
- increase duty on beer by 4 pence per pint, wine by 20 pence per bottle and spirits by 200 pence per bottle.

VAT

Increase rate from 15 to 30 per cent on specified luxury goods; impose additional VAT charge of 15 per cent on all advertising on TV and in public places.

Gaming

institute an additional tax of 30 per cent on all forms of gaming and gambling.

Privatisation Proceeds

should be used to improve the nation's infrastructure, not for consumer spending, and a Royal Commission should be appointed to make recommendations on how proceeds should be best utilized.

Other

- private provision for retirement should be encouraged;
- increase the mortgage interest relief threshold to £60,000;
- increase exemption level for stamp duty on house purchase to £50,000 with eventual abolition.

The Institute of Taxation

Major concern is "the way in which so much detailed technical legislation has been introduced with little if any real opportunity for comment". Review required of the methods by which taxation

laws are enacted. Concern about "the increasing use of delegated legislation".

Other representations on individual taxes are detailed and technical. These cover income tax and corporation tax, capital gains tax (principally concern about undue restriction of retirement relief to family companies), stamp duty (consolidation award provisions relating to stamp and capital duties sought), inheritance tax and VAT.

The Automobile Association

General concern that level of taxation on motorist should not be increased.

Petrol Duty

should be held at its present level

Vehicle Excise Duty

against incorporation of VED into petrol duty.

Infrastructure

higher proportion of revenue received from motorists should be hypothecated to investment in road infrastructure.

The Institute of Chartered Accountants of Scotland

Main concern is increasing complexity of tax legislation. Other major concerns are:

Mining Restoration Costs;

provisions for warranty and damages (lack of uniformity of treatment);

Time Limits: Standardisation at 6 years for claiming all types of reliefs;

Loss Relief;

(i) Surplus capital allowances should be relievable against future profits of a new company's trade.

(ii) S172 ICTA should be amended to allow surplus capital allowances to be used to create or augment a qualifying loss.

Forming Losses

section 180 ICTA 1970 is unnecessarily restrictive;

Inheritance Tax

potential double charges and also effects on associated operations;

Other Concerns ^{below ground} (mainly subject headings only):

- entertaining expenditure (parity of treatment between a company and an unincorporated business);
- dependent relative reliefs (current legislation discriminates unfairly against male parents);
- widows bereavement allowance;
- disincorporation;
- recovery of CGT from trustees;
- tax treatment of interest;
- ACT change of rate;
- method of charging non-residents (amend s78 TMA 1970 to avoid discouragement of use of UK resident investment managers by certain offshore funds);
- patent purchase from an associated company;
- sterling commercial paper (introduce legislation or a statement of practice re tax relief availability on the interest element in the issue of sterling commercial paper).

Scotch Whisky Association

General concern that Scotch Whisky Industry:

- experiences a much higher effective rate of corporation tax than all other industrial and commercial enterprises;
- faces excise duty almost twice the rate of beer and wine on a per degree of alcohol basis; and
- contends with a system of duty deferralment which penalises the industry and is not consistent with practice in other member states of the European Community.

Recommend:

Statutory Maturation Allowance

for all stocks of maturing scotch whisky distilled in the previous 3 years, thus reflecting the statutory requirement to mature scotch whisky for that minimum period;

Drink Duty

more rapid movement toward system of drinks taxation with the same rate of tax per degree of alcoholic strength in line with principle of a fiscal neutrality;

as interim measure, to reduce anomalies in present system of drinks taxation of mixed drinks, introduce new band for all mixed drinks below 15 per cent alcohol volume.

Duty Deferrment

increase period from 4 to 8 weeks.

The Jockey Club

Abolition of the 4 per cent on-course general betting duty.

British Venture Capital Association

Two main concerns:

the need to establish a fiscally effective framework for on-shore venture capital funds; and

the importance of providing appropriate incentives to experienced executives to leave established companies to develop small businesses.

On entrepreneur incentives, propose that legislation should be enacted to allow full-time managers of small private businesses to invest upto £40,000 in their own company without such investment being subject to capital gains tax provided they hold their investment for at least 5 years. These gains should also be specifically exempted from the application of income tax under section 79.

General Council of British Shipping

Main requirement is creation of conditions for investment in ships, new or secondhand.

Investment Allowances

A 50 per cent ship allowance for new and secondhand ships; specific provision for a rollover relief for balancing charges.

Seafarers Tax

Loosen conditions under which seafarers serving on ships trading predominantly outside the UK are eligible for exemption from liability for UK tax.

Business Expansion Scheme

a British ship should be considered as part of UK for purposes of BES.

TUC Technical Representation

Five proposals:

Tax Thresholds

- (i) increase tax exemption limits for trade union provident benefits;
- (ii) increase threshold for benefits in kind to £10,000 with subsequent upratings in line with RPI.

Childcare Facilities

reinstatement of tax exemption for employers' contributions.

Overseas Earnings

1984 Budget measure withdrawing tax relief on overseas personal earnings should be reversed.

Pension Fund Surpluses

maximum surplus limit of 5 per cent should be increased to 10 per cent.

CBI

Three main strands:

- a package of measures to encourage enterprise;
- additional spending on the nation's infrastructure;
- a 5 per cent real increase in tax allowances.

Detailed Points:

Enterprise

expansion of initiatives to encourage research and development and marketing by small firms;

provision of 100 per cent capital allowances to benefit small firms and unincorporated businesses;

tax relief to "connected persons" under BES;

exclusion of business assets from inheritance tax;

a more flexible system of VAT penalties and easier recovery of VAT on bad debts.

Business Costs

- continue to exert downward pressure on local authority rate increases;
- reduce the rate burden on business when legislation is introduced on local authority finance;
- ensure that tighter financing constraints for nationalised industries do not represent hidden tax burden on business through higher energy and water prices;
- avoid any upward pressure on labour costs through changes in national insurance contributions.

The Unquoted Companies Group

Mainly concerned with Inheritance Tax, which though welcomed, is not considered an adequate solution to the problem of transfer taxation on family firms.

Inheritance Tax:

- business property relief - increase to 100 per cent and reduce minimum holding period for qualification for such relief to 28 days;
- reduce period of aggregation to not more than 3 years or, if this is not acceptable, re-establish the principle that the tax chargeable does not exceed 50 per cent of the death rate if the donor survives the gift by at least 3 years;
- the top rate should be reduced as quickly as possible to 30 per cent
- Other points raised on accumulation and maintenance trusts and settlements with interest in possession.

Capital Gains Tax

- exempt gains after a holding period of not more than 5 years;
- reduce rate to not more than 20 per cent;
- any unused portion of annual exemption should be eligible for carry forward to grant relief on the disposal of assets held over the period concerned;
- taxpayer should be entitled to carry his losses back against his gains during the previous 6 years.

Employee Share Schemes

- remove restriction on parent close companies from setting up schemes using shares of subsidiary companies;
- replace section 79 FA 1972 with provisions specifically designed to counter avoidance or abusive transactions;
- introduce a new Revenue approval code for "share equivalent" schemes.

The Brewers Society

No increase in beer duty.

Managerial ProfessionalA.A.S.W.A

PERSONAL TAX

- (i) Reduce basic rate to 27 per cent
- (ii) Fully index all allowances
- (iii) Increase tax allowance for married couple to £4670 and reduce wifes earned income allowance to £1320

BENEFITS IN KIND

STAMP DUTY

Increase exemption level on house purchase to £50,000 with eventual abolition

CGT

IT (Inheritance Tax)

CT

Concern that whisky industry experiences a much higher rate than all other industrial and commercial enterprises

ACT

CAPITAL ALLOWANCES

BES

SHARE INCENTIVES

VAT

- (i) increase VAT to 30 per cent on specified luxury goods
- (ii) impose additional VAT charge (15%) on all advertising on TV and in public places

VED

Against incorporation of VED into petrol duty

EXCISE DUTY

- (i) increase duty on tobacco by 50 per cent
- (ii) increase duty on beer by 4p/pint, wine by 20p/pint and spirits 200p/bottle

Petrol duty should be held at present level

(i) Whisky faces excise duty twice as much as beer and wine

(ii) more rapid movement toward system of drinks taxation with the same rate of tax per degree of alcoholic strength

(iii) increase period of duty deferment from 4 to 8 weeks

BETTING AND GAMING

Institute an additional tax of 30 per cent on all forms of gaming and gambling

General Council for
British Shipping

TUC
(Technical)

CBI

PERSONAL TAX

Reverse 1984 measure
withdrawing relief on
overseas personal
earnings

5 per cent real increase in tax
allowance

BENEFITS IN KIND

(i) Increase thresholds
for benefits in kind
to £10,000 with
subsequent upratings
in line with RPI
(ii) Increase exemption
limits for TU provident
benefits

CGT

IT (Inheritance
Tax)

exclusion of business assets from IT

CT

ACT

CAPITAL ALLOWANCES

50% allowance for
new and secondhand
ships

100 per cent capital allowances to
benefit small firms

BES

British ship should be
part of UK for purposes
of BES

Tax relief to "connected persons" under
BES

SHARE INCENTIVES

VAT

A more flexible system of VAT penalties
and easier recovery of VAT on bad debts

CAR TAX

EXCISE DUTY

BETTING AND GAMING

PENSION FUNDS

Increase surplus
limit to 10%

Unquoted Companies
GroupBrewers SocietyBritish Venture
Capital Association

PERSONAL TAX

BENEFITS IN KIND

STAMP DUTY

CGT

- (i) exempt gains after holding period of not more than 5 years
- (ii) reduce rate to not more than 20 per cent

Measures to encourage small businesses particularly entrepreneur incentives

IT (Inheritance Tax)

- (i) business property relief increase to 100 per cent
- (ii) reduce period of aggregation to not more than 3 years
- (iii) reduce top rate to 30 per cent as quickly as possible

CT

ACT

CAPITAL ALLOWANCES

BES

SHARE INCENTIVES

- (i) remove restriction on parent close companies from setting up schemes using shares of subsidiary companies
- (ii) replace S79FA 1972 with provision specifically designed to counter avoidance of abusive transactions
- (iii) introduce a new Revenue approved code for share equivalent schemes

VAT

CAR TAX

EXCISE DUTY

No increase in beer duty

BETTING AND GAMING

JOCKEY CLUB

PERSONAL TAX

BENEFITS IN KIND

STAMP DUTY

CGT

IT (Inheritance
Tax)

CT

ACT

CAPITAL ALLOWANCES

BES

SHARE INCENTIVES

VAT

CAR TAX

EXCISE DUTY

BETTING AND GAMING

Abolition of on-course
betting duty

FROM: MRS T C BURNHAMS
 DATE: 21 JANUARY 1988

ppp

- 21/1*
1. MISS SINCLAIR
 2. CHANCELLOR OF THE EXCHEQUER

cc **Principal Private Secretary**
 Chief Secretary (2)
 Financial Secretary (2)
 Paymaster General (2)
 Economic Secretary (2)
 Sir Peter Middleton
 Sir Terence Burns
 Sir Geoffrey Littler
 Mr Anson
 Sir Anthony Wilson
 Mr Scholar
 Mr Culpin
 Mr Sedgwick
 Mr Odling-Smee
 Mr Riley
 Miss Evans
 Mr Hudson
 Mr Cropper
 Mr Tyrie
 Mr Call
 Mr Battishill - IR
 Mr Isaac - IR
 Mr Painter - IR
 Mr Unwin - C&E
 Mr Knox - C&E

MINISTERIAL REPRESENTATIONS

Monday's overview meeting is to run through the main representations you have received from Ministers in other Departments. We suggest you might take them in the following order:-

Secretary of State for Trade and Industry

Lord Young wrote to you on 7 December. Briefing on his proposals is attached at Annex A. You are having a bilateral meeting with Lord Young on 29 January.

Secretary of State for Employment

Mr Fowler wrote to you on 22 December and briefing was provided under cover of my minute of 8 January. A copy is attached at Annex B.

Secretary of State for Northern Ireland

Mr King wrote to you on 25 November about tobacco duty and asked you to consider restricting any increase to the level of inflation.

Secretary of State for Social Services

Mr Moore wrote to you on 14 January supporting a substantial increase in tobacco duty. His view is shared by Mr Rifkind.

Secretary of State for Transport

Mr Channon wrote to you on 9 December about motoring taxation. He favours a freeze on VED in favour of increased fuel duty. You agreed at the Overview meeting on 18 January that VED should be left unchanged and that duty should be increased on leaded petrol and derv.

In addition Mr Bottomley wrote to the Economic Secretary about a number of minor VED Starters and these are still under consideration.

Secretary of State for the Environment**Secretary of State for Energy****Minister for Roads and Traffic**

Mr Ridley wrote to you on 15 December and again on 11 January supporting an increase in the duty differential between leaded and unleaded petrol. This view was endorsed by Mr Parkinson in his letter of 22 December and also by Mr Rifkind, but opposed by Mr Bottomley in his letter of 24 December. You are considering increasing the differential from 5p to 10p.

Secretary of State for Scotland

Mr Rifkind's Private Secretary wrote on 18 January with his Secretary of State's proposals for the Budget. Apart from duty on unleaded petrol and tobacco which are mentioned above he suggested the following:-

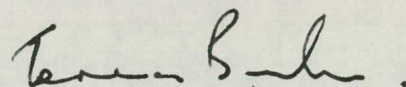
- no increase in duty on Scotch Whisky
- CGT to be replaced by a tax on short-term gains
- greater flexibility over carry forward of losses for income tax
- changes in the treatment of pre-trading accounts

A note on the present treatment of pre-trading accounts is attached at Annex C.

Minister of Agriculture, Fisheries and Food

Mr MacGregor wrote to you on 31 December suggesting certain easements connected with CGT, IHT and Capital Allowances which would be of benefit to farmers and landowners. He drew attention to the particular problem of indexation from only 1982 and "lumpy assets" but made no specific proposals on CGT apart from an increase on the limit for deferral of CGT on part disposal of land. On Inheritance Tax he suggested increasing the threshold and widening the bands. He proposed an easing of the concession given in the 1984 Finance Act on holiday letting, which would reduce the number of days of letting necessary to qualify. He also suggested a minor change on Capital Allowances which would allow farm buildings no longer used for their original purpose to be deemed to have a negligible value.

2. Finally, you are to have a meeting with the Home Secretary, the Secretary of State for Social Services and the Lord President of the Council on 9 February to discuss the duty on alcohol.



MRS T C BURNHAMS

BRIEFING: LORD YOUNG'S BUDGET PROPOSALS1. Higher Rates of Income Tax

Proposal: Reduce and simplify the higher rates of income tax as a first priority.

Lord Young points out that:

- The present structure has remained unchanged since 1979.
- The thresholds for the highest rates have not increased as fast as inflation.
- The gap between the basic rate and the first higher rate is now 13 points.
- The top 60 per cent rate compares unfavourably with the USA.

Line to Take: You will be sympathetic to this proposal

2. Basic Rate of Income Tax

Proposal: Reduce the basic rate to 25p and cut the small companies' CT rate by a corresponding amount.

Line to Take: A 25p basic rate is your publicly declared aim.

3. National Insurance Contributions

Proposal: Alleviate the discouraging effect on employment of people at pay just above each NIC step.

DTI officials are apparently working up a scheme of their own. Lord Young wishes to see improvements introduced in the next Autumn Statement, if not earlier.

Comment: Lord Young makes it clear that he wishes to see the NIC steps reduced in size, at least for employers. The current option at the lower end of the NIC structure

would not achieve this particular objective, though it would of course help many low paid employees between the steps. It seems unlikely that the DTI have come up with anything radically different to the options on NICs which have been explored at length in recent months.

Line to Take: We suggest that you ask Lord Young to communicate his ideas to your officials as soon as possible so that we can see if they have any merit.

4. Companies' purchase of own shares

Proposal: ACT should not be payable when a company buys its own shares in the market.

Comment: This proposal was examined in Mr Ilett's minute to the Chancellor of 23 December.

You commented that the key question is whether or not there is any compelling case, either in principle or in terms of the potential loss of tax revenue, in maintaining the ACT requirement.

You asked the Financial Secretary to look into this; he concluded in his minute of 20 January that no legislation should be made this year but that the matter should be kept under review.

Line to Take: You could tell Lord Young that the subject is under active review together with the related issue of whether companies should have to cancel shares which have been bought in. You could also say that, even if this is not a 1988 starter, we propose to continue to discuss it with interested parties as occasions arise in the coming year.

5. Local Enterprise Companies (LECs)

Proposal: BES style relief for investment by individuals and companies (subject to some limit) in LECs. An LEC would be a Government approved company investing amounts up to £100,000 or £150,000 in small businesses within a predetermined local area. Overall, at least half of the amount invested would have to be in the form of equity but this would not apply to each investment. A loan could therefore be made to an unincorporated business. There are various other aspects to the proposal,

including Government grants to LECs to help cover their appraisal costs in the early years.

Lord Young says that it is difficult to raise small amounts of capital, and that the minimum size of investment by venture capital companies is increasing. LECs are meant to fill this gap. He suggests that initially they should be confined to DTI assisted areas. He also suggests that DTI and Revenue officials should start work urgently to translate this concept into a workable tax measure.

Comment:

The proposal seems very similar to ideas for SFICs that have been exhaustively examined in the past. The main differences are:

- (i) The limitation that investments must be within a specified local area and in amounts under, say, £100,000.
- (ii) Government assistance should be given to LECs to help finance initial appraisal costs.

The main arguments against such a proposal would be:

- (i) It may be that Lord Young is correct in saying that it is difficult to raise small amounts of capital. However, **many small businesses will not wish to part with equity and the Loan Guarantee Scheme is available to help with loan finance.** If they do want to raise equity capital, the BES is already available. And the introduction of a ceiling on the amount a company can raise using BES should make it easier for them to raise small amounts of BES finance.
- (ii) There would be a **loss of a direct link between investors and the businesses they were supporting** which would significantly lessen the risks for investors, calling into question the generosity of the BES-type reliefs.
- (iii) There would be **substantial deadweight**, ie investment that would in any case have gone ahead would be subsidised.

- (iv) Like BES, LECs would require **elaborate anti-avoidance provisions**, particularly because finance could take the form of a loan (which can be made more secure than equity) and that loans could be made to unincorporated businesses. Allowing companies to obtain tax relief would also complicate the scheme, given the need to deny relief to insiders.
- (v) The case for subsidising appraisal costs is weak. **Appraisal costs are real and should be taken into account by potential investors** - if subsidised by the Government there would be a risk that finance would be raised in uneconomic ways. A venture capital fund with a mix of small and larger clients can in any case effectively cross-subsidise to surmount this problem.

Line to Take: We recommend that no further work be done on this proposal.

6. **VAT Registration Threshold**

Proposal: To allow a trader the option of a VAT-free allowance equal to the registration threshold on condition that he agrees to forgo all input VAT.

Lord Young claims that the present £21,300 threshold acts as a strong disincentive for small businesses to expand since, in the extreme case, when a business whose taxable turnover passes the threshold has to register it can become liable for VAT of £3,000, which has often to be paid out of profits.

Comment: The case made is partly true (and would be true for any level of threshold) but only for certain types of business, typically those with very few overheads for whom registration involves large VAT payments but little VAT to reclaim. These are businesses in the service sector, often trading from home, eg electricians, plumbers, decorators.

The proposal (and others to tackle the same problem) is already being examined by Customs with a view to establishing the probable resource and revenue costs. It is already clear, however, that there may be better solutions than Lord Young's proposal. Whatever the outcome, it is unlikely that his scheme or a variant would be permitted by EC law. It would therefore require a derogation which, in present circumstances (ie our recent derogation for cash accounting and ongoing discussions on the Small and Medium Size Enterprise draft directive to harmonise special schemes for small businesses), is unlikely to be granted.

Line to Take: You could express your concern at the problem, but point out that it is not as widespread as is sometimes assumed. You could say that the EC difficulty rules out action in 1988 but that Customs are reviewing the options for 1989 and later years.

7. **Research and Development**

Proposal: Tax relief should be extended to expenditure on R&D incurred before a company starts to trade.

The intention would be to encourage companies to hive off high risk R&D into a consortium company which would be funded by financial institutions. The effects of the relief would be to give these institutions immediate tax relief for the funding they provide.

Comment: This proposal was included in the DTI's Budget reps in 1986 and 1987. The Revenue did some work with DTI last year on the shape of a possible relief but Treasury Ministers decided against its introduction. The relevant points are:

(i) **R&D is already favoured by the tax system** and Ministers were not convinced of the case for yet more favourable treatment.

- (ii) The relief would run completely counter to the spirit of the 1984 CT reforms which were designed to remove the distortions which special reliefs introduce.
- (iii) There is little evidence that the relief would encourage new R&D as opposed to subsidising R&D which would have taken place anyway.
- (iv) The restrictions which would be needed to ensure that the relief was correctly targetted would inevitably fuel complaints that this was an inadequate response to the general concern about the UK's R&D performance.
- (v) The international survey of tax reliefs for R&D, published by the Revenue in 1987, suggests that special fiscal incentives for R&D are not very cost-effective.

Line to Take: We see no reason why you should alter your opinion last year of this proposal and recommend that it is not pursued further.

8. *bizarre* VAT on Gifts to Educational Establishments *service vs equipment EC driven. not worth low.*

Proposal: To extend more favourable VAT treatment of gifts of equipment to educational establishments.

Lord Young states that in West Germany no VAT is payable on such gifts whereas in the UK VAT is payable at the standard rate.

Comment: In Customs' view it is unclear how the German practice can be justified under EC law although, as Lord Young points out, the practice has not yet been challenged.

Line to Take: Most of the pressure for a concession of this kind comes from computer companies whose gifts to universities and colleges commonly have strings attached; ie they are not really gifts at all. You should therefore resist this

proposal even if we were satisfied (which we are not) that it would be permissible under EC law.

9.

Professional Training Expenses

Proposal:

Expenditure by members of professional institutions on their continuing professional training should be tax-allowable and expenditure on full-time courses of management education should be allowable against future income.

Comment:

This proposal (also made by Kenneth Baker) was examined in Miss Rhodes' minute to the Financial Secretary of 6 January.

The existing tax concession on employee-borne training expenses applies only where the course is job-related and where either the employer reimburses the employee or allows the employee time off on full pay to attend the course. The argument against extending it is that it **would be very difficult to restrict tax relief to only those expenses incurred on training courses which had a direct and positive job or professional application**, as distinct from those which may have only incidental relevance or purely recreational value.

Quite apart from this objection in principle, there would be a **very substantial staff cost** for the Revenue and a revenue cost of £50 million annually, of which a significant proportion would be deadweight.

It also seems **doubtful whether a tax incentive of this kind would be the most effective way of encouraging people to undertake vocational training**. It must surely be more desirable to persuade employers to recognise the value of and pay for the continued training of their professional staff. The existing tax incentive encourages them to do so.

Line to Take: We recommend that you resist this proposal.

*What other
Committee
do.
PMG or no
imminence entth.*

Pressure from both sides. Ch not been

Chance of a Lifetime

Good name -

Proposal:

An exemption from income tax in the most deprived inner city areas for the first two years of a new business to be available once in a businessman's life.

This is a repeat of a proposal made last year, then to be nationwide. Lord Young sees this more limited proposal as particularly relevant to the needs of the inner cities and "as an alternative to remaining in the black economy".

Comment:

The Revenue see the following objections:

(i)

Cost. Lord Young suggests it would be "within manageable proportions" but without a clearer idea of exactly which areas he has in mind it is impossible to be more specific. Last year, Lord Young estimated the nationwide cost at perhaps £1 billion a year. A significant proportion of any cost would be deadweight because a lot of the people benefiting from the scheme would have started up in business anyway.

(ii)

Likely effectiveness. Is a tax holiday the best way of encouraging people to start out in business? A potential entrepreneur is surely more likely to be deterred from setting up in business because of fears of lack of ready cash in his first two years, when he is getting established and unlikely to be making anything much in the way of profits - certainly not profit which would be liable to tax. He is far less likely to be deterred by the thought that if he does well enough to make good profits in his first two years he will subsequently have some tax to pay on them. This suggests that the (apparently very successful) Enterprise Allowance approach is a far more effective way of giving a financial incentives to new businesses.

(iii)

Equity vis-a-vis employees. Employees would think this scheme very unfair. The unfairness would be particularly apparent, and hard to justify, in circumstances where self-employed and employees work side by side - eg in the building trade. Why should "labour only subcontractors"

- the "lump" - enjoy two years' tax exemption, but not building employees?

(iv) **Pressures on employment - self employment boundary.** There would clearly be more pressure in this difficult area.

(v) **Limited scheme.** This would be open to abuse - for example, it would be easy for someone whose real home, and work, was outside the particular inner city area to arrange for a postal address - or temporary digs - there.

Line to Take: We recommend that you resist this proposal.

11. **BES Investment in Inner Cities**

Proposal: Relax BES conditions for investment in deprived inner city areas.

*Can we
look at*
Lord Young suggests that property in these areas should be disregarded when applying the land and buildings' restriction, having the effect that all of a company's assets could take the form of inner city property. He also suggests raising the annual limit on an individual's BES investment from £40,000 to £100,000 where at least £60,000 is invested in inner city areas.

Comment: Looked at simply in terms of the BES relief there is no strong case for either relaxation.

Property in deprived inner city areas may be worth less than equivalent property in other areas but there is no reason to believe that it provides a less secure investment.

There seems no reason for assuming that allowing an additional £60,000 of BES investment for companies trading in inner city areas would be more effective than allowing it for investment elsewhere; it might simply displace investment that would have taken place anyway, either in inner cities or outside those areas. The cost of an additional £60,000 limit would be up to £35 million.

Line to Take: If there is a good case for these relaxations it would have to be based on the policy for helping deprived inner city areas. But tax reliefs are usually less cost-effective in this respect than direct expenditure or grants since they are non-discretionary and therefore inevitably less well targetted. We recommend that you resist this proposal.

12. **Technical Representations**

Proposal:

- (i) Extend the proposed relaxation of S79 FA 1972 to cases where managers' equity is acquired at a discount.
- (ii) Relax dispensation requirements for PLLD forms.
- (iii) Relax eligibility rules for tax exemption certificates in construction industry.
- (iv) Give earlier tax repayments for insured pension schemes.
- (v) Take into account solvency and EC considerations in the dispute with insurers over discounting for future claims.
- (vi) Changes to SRF could adversely affect Lloyds' competitive position.

Comment: We have assumed that neither you nor Lord Young will wish to discuss these points in detail, but briefing is available should you require it.

Line to Take: You will want to thank Lord Young for these points and say that you have passed them to the Revenue for their consideration. You may also want to tell him that you plan no changes to Lloyds SRF. Lord Young is unlikely to object; his main concern was at possible abolition.

FROM: MRS T C BURNHAMS
DATE: 8 January 1988

1. MISS SINCLAIR^{5/1}
2. CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Anson
Mr Monck
Mr Scholar
Mr Burgner
Mr Culpin
Mr MacAuslan
Mr Waller
Mr Cropper
Mr Tyrie
Mr Call

PS/IR
PS/C&E

BUDGET REPRESENTATION FROM SECRETARY OF STATE FOR EMPLOYMENT

You asked for early advice on the Secretary of State for Employment's letter of 22 December and I attach our assessment of the specific proposals he makes in the annex to his letter. This has been agreed with IAE, Inland Revenue and Customs.

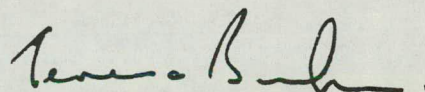
2. Mr Fowler's major proposals are aimed at small businesses and the problems of raising finance for new projects or expansion. He also puts forward a number of suggestions by representative organisations to simplify taxation or remove anomalies. An assessment of each of the proposals is attached. A number of the proposals have been considered before and rejected but the suggestion to increase the ceiling of the Loan Guarantee Scheme does appear reasonable and we have no reason to question the estimated cost of £2.25 million in 1989-90 quoted in the letter.

3. Apart from the specific proposals set out in the annex to his letter Mr Fowler endorses Lord Young's proposal for "Local Enterprise Companies". Separate briefing on Lord Young's Budget representation will be provided next week in time for the Chancellor's meeting on 20 January.

4. Mr Fowler also comments on the effect the withdrawal of initial capital allowances has had on small firms and asks for further examination of the problem.

5. Finally he expresses concern that any Budget measures are assessed for their effect on employment and incentives to work. He mentions particularly national insurance contributions and highlights the "cliff edge" start to payments and the uneven marginal tax steps resulting from the lack of integration between tax and national insurance although acknowledging the problem of the contributory principle in an integrated system. He suggests the aim of any changes should be to reduce the burden on the low paid and "to bring the tax and national insurance system more into line". He proposes that officials from both Departments should discuss any changes under consideration but I assume you would not wish to take up such an offer.

6. Unless you wish to discuss any of the proposals with Mr Fowler I recommend a standard reply should be sent and this is attached.



MRS T C BURNHAMS

Item 1 Business Expansion Scheme

- A. Mr Fowler's proposal would allow relief to a paid employee previously unconnected with the company.

At present, BES relief is not available to an employee of the company. Mr Fowler proposes that this should apply only to people who were employees before making their investment. His idea is to attract experienced businessmen (who may have retired or been made redundant from another job) to invest and take an active part in the running of the company.

A similar scheme, for part-time directors, was considered in the run-up to the 1986 Budget. Although the Chancellor was sympathetic to the proposal, because it would encourage a "hands-on" approach by investors, he decided against it because of the difficulty of holding the line against allowing in other "insiders". Apart from this consideration, there would be a deadweight cost, particularly where someone was investing in a new business (and so by definition could not have been employed in it before). And there would be some danger of "round-tripping": the company pays out a high level of remuneration (or dividends) to reimburse the investor for at least part of the cost of his investment; the BES relief cancels any extra income tax liability, but the company gets a corporation tax deduction for the payments. While it would be possible to devise rules to restrict the deadweight cost and the danger of round-tripping there is still the question of whether the line could be held at new employees.

- B. He also proposes relief on preference shares in co-operatives.

BES relief is available only in respect of ordinary shares, not preference shares. The reason for this is that preference shares can be more secure investments. Mr Fowler says that

co-operatives often have a very small amount of ordinary share capital and use preference shares to raise the bulk of their capital. In this case the preference shares could be very little more secure than the ordinary shares. So he suggested that where the authorised ordinary share capital of a co-operative does not exceed £500 BES relief should be available on non-voting preference shares.

It is not clear why non-voting ordinary shares, which would be eligible for BES relief, could not be issued instead of preference shares. It is also not clear why co-operatives should be treated more favourably than other companies. In principle, it would be possible to allow BES relief for preference shares generally, subject to restrictions to prevent the investment being too secure, but this would be an added complication which does not seem necessary.

Item 2 Corporate Venturing

The Secretary of State proposes a modified form of an idea put forward in a Bow Paper to provide an incentive for firms to undertake corporate venturing. This amounts to BES style relief for investment by companies. He suggests a 10 per cent relief from Corporation Tax on profits invested in qualifying companies with a maximum of £10 million and a limit of £250,000 for investment in any one company. It is estimated that the revenue cost would be £35 million.

BES relief is only available to individuals. This is because the relief was aimed at individual outsiders, who would otherwise be unlikely to make equity investments in unquoted trading companies, rather than organisations (like banks and venture capital funds) which make such investments anyway. His aim is to encourage corporate venturing.

The main objection to this proposal is the deadweight cost where the company would anyway have invested. But it would also be necessary to elaborate on the BES anti-avoidance rules to prevent them being got round by the interposition

of a company (which might be controlled by an individual who was a director or employee of the target company).

Item 3 Loan Guarantee Scheme

- A. The proposal to raise the ceiling from £75,000 to £100,000 does not seem unreasonable, as it has not been raised since the scheme was introduced in 1981. DE themselves estimate the gross cost of this measure at £2.25 million in 1989-90, £4.5 million in 1990-91 and £6.75 million in 1991-92. This compares with gross costs of £21.7 million in 1989-90 and £22.3 million in 1990-91 on current plans. The assumptions on which these figures are based seem reasonable, and if anything may overstate the cost. Take-up of LGS is currently running at only around 100 a month, and the failure rate is below 10 per cent. However, although we would not rule out this measure, DE officials have told us in the past that there seems to be little demand to raise the ceiling.
- B. He also proposes that banks should be allowed discretion to decide whether they require personal assets to be put forward as security.

This proposal is more far-reaching. Actual evidence suggests that having to put up one's own home, for example, as security is a major disincentive to taking out a loan. Much hinges on the attitudes of individual bank managers, and DE believe that they would not "be over-generous to borrowers in applying their discretion", so there would only be a slight effect on lending. But the banks only bear 30 per cent of the risk of LGS loans, and so may be tempted to be less stringent. At the very least, costs are highly dubious. Nor would it seem desirable to encourage banks to be more lax on the terms of which they make LGS loans.

It should be noted that the present LGS scheme is due to expire at the end of March 1989. Making any changes to the scheme in the 1988 Budget would be odd unless it was expected that the scheme would continue. If you agreed to raise the

ceiling you should be prepared to announce a continuation of the scheme, or concede it, if asked. IAE therefore think it might be sensible if you agree to raising the ceiling to also put down a marker than DE and HMT should in due course review the small firms' provision across the board. This has grown up in a piecemeal fashion, and we need to know whether it really fits together, particularly given the initiative taken by DTI to be announced in their White Paper next week.

Item 4 Inheritance Tax - 100 per cent Business Property Relief

Mr Fowler claims the present rules bear heavily on unquoted companies and is a disincentive to employee share ownership. The cost of the proposal is estimated to be a revenue loss of about £20 million.

The case for settling the choice of successors to key positions in businesses as well as taking steps to mitigate the adverse effect of an untimely death applies equally to all businesses and is not therefore a peculiar consequence of the IHT regime.

100 per cent business property relief has been resisted in the past because even in those cases where a tax charge arises due to the premature death of the transferor within 7 years, the existing business property relief and interest free instalment facility are generous.

Item 5 Sub-Contractor's Tax Certificate

Mr Fowler supports a familiar suggestion from Department of Employment - that the conditions for getting a certificate exempting a subcontractor in the construction industry from deduction at source should be relaxed.

The exemption scheme and its associated paperwork are costly for both the Revenue and the industry to run. So there are resource arguments for reducing the number of certificates in issue. There is a balance to be struck between the limited

validity of the 'licence to work' arguments (and some much stronger cash flow arguments largely unidentified by the Department of Employment) on the one hand, and security of the scheme against evasion on the other. The scheme will be the subject of an Efficiency Scrutiny, with terms of reference allowing recommendations needing legislative changes.

Item 6 Relief for Business Expenses and incidental costs of raising capital

The rules allow for tax deductibility only if revenue expenses are incurred wholly and exclusively for the purposes of trade. Some business expenses cannot meet this test as they are capital in nature but no capital allowances are available.

The present distinction between the tax treatment of the incidental costs of raising equity finance and those incurred in raising for the purpose of a trade, and interest - the cost of servicing equity - are treated as a distribution of profits after tax and are not an allowable expense. The possibility of legislating to make the costs of raising equity finance deductible was considered in 1985 and 1987 but was ruled out mainly on cost grounds.

If relief were allowed for costs incurred on all abortive capital projects it would be given in circumstances where the project, if completed, would not have attracted capital allowances (eg the construction of a commercial building).

Item 7 National Insurance Contributions

Mr Fowler supports the same allowance for Class 2 payments that was introduced for Class 4 payments.

A major argument for granting tax relief on Class 4 National Insurance Contributions was that they earned no benefit entitlement. This is not the case for Class 2 Contributions which are tied to benefits.

CONFIDENTIAL

In contrast to Class 4, Class 2 Contributions are a fixed weekly payment and if there were arguments for reducing payments either on the grounds of the contributory principle or for other policy reasons it would be more logical to alter the rates rather than introduce a relatively complicated tax relief that would not benefit all payers.

Giving tax relief for Class 2 payments would be administratively difficult as unlike Class 4 Contributions the Revenue has no record of who pays Class 2. This would require a much wider exchange of information between the Revenue and the DHSS and would breach present rules on confidentiality.

Item 8 P11D

Mr Fowler urges that any changes introduced as a result of the Revenue review of "dispensations" should be announced in the Budget.

As part of the Government's initiative to reduce compliance costs on employers, Ministers agreed that greater publicity should be given to encouraging employers to apply for "dispensations" relieving them from the requirement to record expenses payments on P11D forms.

Following a press announcement in February last year, a leaflet (IR69) explaining the circumstances in which "dispensations" may be granted was issued to employers along with P11D forms.

Results so far are encouraging showing a large take up by employers, the vast majority of which Inspectors have allowed. We are continuing to monitor the position and will be minuting Ministers in more detail later. The results of the review to date do not suggest that any major changes will be necessary. If the proposal in starter 104 goes ahead, the form P11D will disappear. It may be however that some form of dispensation system should be retained to deal with eg expenses payments for business purposes.

Item 9 VAT Registration

Mr Fowler supports the extension of the registration period to 60 days.

An extension from 10 to 30 days was introduced in the 1987 Finance Act. Many small businesses register on the basis of past taxable supplies made in a quarter and with a 30 day registration period they effectively have 4 months in which to establish their need to register. A further extension would involve a significant loss of revenue.

Item 10 Cash Accounting

Mr Fowler supports a relaxation of the rules to allow firms into the scheme for a trial period (a year) during which time they could get their payments up to date. This concession would be aimed at small firms saving cash flow problems through late payment by customers.

Cash accounting, whereby the tax is accounted for on the basis of cash paid and received, assists the cash flow of businesses in this important sector where they are required to offer extended periods of credit to customers and, or, have a high incidence of bad debts. These advantages have, though, to be balanced against revenue collection considerations. The scheme does increase the scope for manipulation and fraud and consequently a number of conditions are necessary before Customs will authorise businesses to adopt the scheme. One of these conditions is that traders have a good compliance record and are up to date with their payments, however Customs are being flexible in this area; applications are being allowed where only small amounts are outstanding and, where amounts outstanding relate solely to the last tax period, the application is not refused until an extended period has elapsed.

The scheme, together with its legal framework and public notice, which has the force of law, was the subject of

extensive consultation with trade and professional bodies. Customs will embark on further consultations when they undertake a thorough review of cash accounting in the Autumn of 1988, following a full year's practical operation.

Item 11 Approved Share Option Schemes

- i. a. Mr Fowler supports a proposal to tie executive scheme relief to the introduction of all employee schemes.

This has been considered, and rejected, on a number of occasions since the FA 1984 approved share option scheme legislation was first enacted. The purpose of the schemes is different. The all-employee schemes under FA 1978 and 1980 aim at improving the employee's perception of the interest they share with their employer in their enterprise's prosperity as well as contributing to the general widening of share ownership. The discretionary FA 1984 scheme also aims at attracting key personnel by prospects of high rewards in future rather than large salaries now.

Adoption of the proposal could discourage companies from introducing discretionary schemes and thereby reduce the effectiveness of the FA 1984 legislation. The requirement would have to be not only that an all-employee scheme should be in existence but also that it should be operated - to some stipulated extent, and with some required frequency. A requirement of this kind would run counter to the voluntary nature of the share scheme legislation.

- b. He also advocates raising maximum limits for all employee schemes.

There is little evidence that the present limits are a constraint.

Both schemes continue to be popular. In no year have average annual appropriations under the FA 1978 scheme exceeded £350 (the present limit is £1,250 per annum or, if greater,

10 per cent of salary, subject to an overall maximum of £5,000).

ii Tax Relief for Share Purchase

Mr Fowler suggests that tax relief should be provided on amounts employees invest to buy ordinary shares in their company through a savings contract.

This, in effect, would amount to a form of share incentive scheme, with the employee obtaining his shares at the outset and being allowed tax relief on the money used to purchase them. Individuals who obtain shares under approved schemes already receive favourable tax treatment in that there is no charge to income tax on the benefit that accrues when they buy their shares at less than the prevailing market price. It is not clear that a further relief of the kind proposed is necessary.

iii Employee Share Trusts

- a. Mr Fowler supports the proposal that there should be incentives for taking out loans to buy substantial shareholdings for employee share trusts (by means of tax relief for companies' payments to trusts reimbursing latter's loan financing costs).

Some of the objects of this proposal can already be achieved under existing law, for instance, using a secondary 'warehousing' trust. Even under the proposal put forward here, some two-thirds of the net cost of the shareholding being acquired would be met by the company itself.

While there is no overriding objection in principle to this particular proposal, in isolation it would be unlikely to have any substantial effect.

- b. He also suggests removing the restriction making gifts of shares to trusts which hold less than 50 per cent of a firm's equity liable to IHT, and give IHT relief for requests to

employee share trusts.

The difficulty with the former would be to devise a workable solution that would eliminate the need for a share valuation and contain adequate safeguards against avoidance while remaining attractive.

On the second point there are a number of exemptions and reliefs already available. There is little evidence that the existing rules are deterring owners of businesses who genuinely wish to pass the ownership of them to their employees.

iv Profit Related Pay (PRP)

He proposes allowing separate small scale profit dependent organisations within the public sector to apply for PRP relief.

Ministers gave very careful thought to the inclusion of public sector businesses before the PRP legislation was drawn up. It was decided to exclude the public sector for the following reasons:

- the greater part of public employers are not engaged in trading with the aim to make a profit.
- areas that do trade still have major differences in culture and many trade for only part of their workload.
- public sector businesses are inevitably subject to certain conditions and constraints.
- the benefit of PRP is strongest for businesses operating fully in the disciplines of the market economy.

The problem - as the Secretary of State for Employment recognises - is that the public sector is a price setter. His prescription contemplates wide Revenue discretion which would raise its own difficulties.

TREATMENT OF PRE-TRADING ACCOUNTS

Mr Rifkind suggests that there is some inconsistency between the treatment of pre-trading income and pre-trading expenditure on the basis that whereas pre-trading expenditure can only be relieved once a trade starts, pre-trading income is taxed when it arises. He is particularly concerned that this might reduce the value of Regional Selective Assistance grants received prior to the commencement of a trade.

It looks as if there may be some misunderstanding here. There are two points:

- (i) If a company incurs expenditure within three years of the time at which it starts to trade, that expenditure can, under a special relief introduced in 1980, be carried forward and set against the income of the first year's trading.
- (ii) If during a similar pre-trading period a company gets Regional Selective Assistance grants, those grants are not - as Mr Rifkind suggests - taxed at the time the company gets them. But they may reduce the expenditure which it can carry forward to the first year of trading - (i) above. That is in accordance with the general principle that a company only gets tax relief on what it has actually spent out of its own pocket.

Ref



H.M. CUSTOMS AND EXCISE
KING'S BEAM HOUSE, MARK LANE
LONDON EC3R 7HE
01-626 1515

FROM: W D WHITMORE

DATE: 22 January 1987

- 1. Mr Jefferson ~~Smith~~ *Smith*
- 2. Chancellor of the Exchequer

- cc PS/Chief Secretary
- PS/Financial Secretary
- PS/Economic Secretary
- PS/Minister of State
- Mr Scholar
- Miss Sinclair
- Mr Cropper
- Mr McKenzie

WHITMORE
TO
CH/EX
22/1
BRIEF

PRE-BUDGET MEETING WITH THE BREWERS' SOCIETY : TUESDAY 27 JANUARY

- 1. You are due to meet the Brewers' Society at 10.30 am on Tuesday 27 January. I attach a brief.
- 2. **Customs support** at the meeting will be provided by **Mr Jefferson Smith** and **Mr Tullberg**.

W D WHITMORE

Internal circ: CPS, Mr Knox, Mr Wilmott, Mr Bazley, Mr Tullberg, Mr Cain, Mr Hankins

PRE-BUDGET MEETING WITH THE BREWERS' SOCIETY : TUESDAY 27 JANUARY

Organisation.

1. The Brewers' Society represents about 80 large and medium sized UK brewing companies which together account for over 95% of UK beer production. The smaller brewers have their own separate association.
2. On this occasion, the Society will be represented by its current Chairman, Mr A G F Fuller and Major General W D Mangham CB. Mr Fuller is Chairman and Managing Director of Fuller, Smith and Turner, a medium sized Chiswick based brewing company paying some £5 million duty a year, with about 140 managed or tied pubs. Major General Mangham has been Director of the Society since 1980.

Object of the meeting.

3. The Society is one of the organisations whose representatives normally meet the Chancellor to make pre-Budget representations.

Written representations.

4. The Society contrasts the performance, over the 12 months ending August 1986, of beer (plus 0.2%) with wine (plus 2.5%) and spirits (plus 2.4%). They claim that the marginal upturn in the beer market as compared with the same period a year ago can be attributed to the effect of the weather (the summer in 1985 was particularly bad whereas the summer of 1986 was approaching average). The Society say that this is disappointing against the background of no duty increase and believes that the underlying market trend is still slightly downwards. It hopes that the duty will remain at its present level for a further year.

5. The main points made by the Society are those made before:-

due to economic changes the traditional beer market has declined;

beer is facing increasing competition from wine and spirits which have had more favourable duty treatment; and

pubs and clubs have been harder hit than the take home market.

Points which the Society may make.

6. It is likely that, as on previous occasions, the Society's representatives will highlight points in their paper.

Beer duty

7. **Static beer market.** In the 30 years up to 1979 the market grew steadily. Consumption then fell in the following 3 years, since then it has been broadly static, and independent forecasts predict that the market is unlikely to increase significantly during the next few years. Home production seems to have been losing some ground to imports in recent years. While the change is not in itself large, imports rising from 3.6% in 1981/82 to 5.1% in 1985/86 (and to 5.2% in the first 5 months of 1986/87), it does nevertheless represent a noticeable loss of share in a stagnating market.

8. **Duty has contributed significantly to beer's decline.** In real terms, the duty is still lower than in the late 60s and early 70s when consumption was increasing. However, there is little doubt that the real price increase in recent years, attributable in part to duty and VAT increases, have contributed to the decline in beer drinking. Although the tax element has risen faster than the RPI since 1979, so have other components in the price of beer. Brewers have not been slow to put up their prices and have therefore contributed to any consequential reduction in demand. The brewing industry generally has remained profitable despite the volume reduction.

9. Whilst price increases have contributed to the drop in beer consumption there have been other factors, notably economic decline in beer's traditionally strong markets (eg the North and heavy industry); a shift in consumer preference in favour of other drinks; and competition from other leisure activities.

10. **Wine and spirits have been treated favourably compared with beer.** The ratios between beer duty and those for wines and spirits have moved to the disadvantage of beer. Duty on table wine is constrained by the European Court judgement in the beer/wine case. The relatively favourable treatment of spirits in recent years reflects a recognition of the plight of the Scotch whisky industry and of the importance of its exports. There is no "correct" beer/spirits duty ratio.

11. **The weather.** In our opinion the sensitivity of beer consumption to the weather is unproven. The 3 months, June to August, have accounted for about 27% of annual beer consumption in recent years. The constancy of this percentage over both warm and dry and cold and wet summers suggests that the weather may not have a significant effect on the beer market.

Other matters.

12. **VAT input tax changes.** The brewers protest against the application of these changes to their tied house rentals and argue that implementation of the changes in the rules for input tax deduction will cost them about £70 million, - equivalent, they say, to about 2p on the beer sold through the tied houses. While the brewers cannot be given any hope of a special relief for tied houses, nevertheless the Minister of State has indicated that there should be talks with Customs aimed at agreeing a suitable method of input for calculation which, while consistent with the new rules, does take account of any quantifiable and unique features of tied house rental agreements. The Society are due to meet Mr Jefferson Smith on 29 January and the Minister of State is due to meet a deputation led by Sir Dudley Smith MP on 10 February. While the Society may refer to the matter, therefore, it is unlikely that they will expect more than an acknowledgement that you are well aware of it.

extract of briefing from NLSA making behind on outcome of meeting

POINTS YOU MAY WISH TO RAISE

13. The Society's December 1986 paper reiterates familiar points. As a result of the annual meetings which focus on the relatively narrow issue of beer duty, and other contacts, the trade's views are well understood. In essence, brewing is an important domestic industry whose market is static for a number of reasons; but it is also an important source of revenue, bringing in about £2 billion a year at current duty rates.

C/ The best we could
do on the Brewers'
Price increase

CJZ 6/2

1986

Price of a pint of bitter in pence

March	78.42
June	78.81
Sept.	80.29
Dec.	81.54

Price increase from March to December is 4% compared with RPI increase of 3%.

The Licence Victuallers are prone to exaggeration. The brewers will claim for example that new materials are now up 6 per cent, above inflation rate rises etc. On the other hand brewery profits are generally healthy eg according to a press report in December Regional brewers average profits were up 17 per cent.

Suggested line Ask the Brewers Society to explain the reasons for price rises of about 3p to 4p a pint despite the fact that there was no increase in beer duty in last year's Budget.



Treasury Chambers, Parliament Street. SW1P 3AG
01-270 3000

R Jackson Esq
Press and Parliamentary Officer
The National Federation of Self Employed
and Small Businesses Ltd
140 Lower Marsh
Westminster Bridge
LONDON SE1 7AE

26 January 1987

R Jackson

Thank you for your letter of 15 December enclosing a copy of your Budget representations and requesting a meeting to discuss them. You also sent copies to John MacGregor, Norman Lamont and Peter Brooke.

As you will appreciate, at this time of the year Treasury Ministers get many requests to discuss Budget representations. Unfortunately, it is not possible for all organisations to be seen. I understand that you and other small business bodies have already met with David Trippier, the Minister at the Department of Employment who is directly responsible for small businesses. He will be letting me have a report of the outcome. Consequently, in all the circumstances, I am afraid that I must decline your request for a meeting. Nevertheless, I can assure you that your representations will be given most careful consideration in the run-up to the Budget.

I would be grateful if you would take this as a reply to the letters which you also sent to other Treasury Ministers.

Nigel Lawson

NIGEL LAWSON

Brewers Soc 6/2
Budget Rep

CONFIDENTIAL



FROM: S P Judge

DATE: 23 January 1987

meeting with Brewed

28/1

MR JEFFERSON SMITH - C&E

cc PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Mr Scholar
Miss Sinclair
PS/Customs & Excise

VAT: TAX AVOIDANCE (STARTER No 6): LEGAL ADVICE

The Minister of State discussed your submission of 20 January with Mr Knox and you this morning.

You explained that you were planning that:

- i. you send draft Regulations to the Brewers' Society today;
- ii. they come to see you next Thursday, 29 January;
- iii. the Brewers come to see the Minister on 10 February.

The Minister asked how likely the Brewers would be to drop their threat of legal challenge if, as a result of these meetings, they agreed to do a deal. You pointed out that the Brewers' Society could not stop all their members from taking the Government to court, but thought it was very unlikely that anyone would do so, especially as they would have to take it all the way to the European Court for a final ruling.

You explained that the change to using Article 17 of the Sixth VAT Directive was not challenged, and that your redrafted regulations follows the wording therein as closely as possible. Customs lawyers were confident that they had shot the Brewers' fox.

You thought it was unlikely that the Brewers would settle on 29 January, and that the final position would not be clear until 10 February. If we failed to shoot their fox, you agreed that

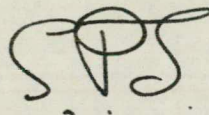
BACKGROUND

PS/INSTR TO JEFFERSON SMITH 23/1

there will be no time to re-load the gun before the Budget.

You added that the Brewers were making their normal Budget representations to the Chancellor next Tuesday. Of course Treasury Ministers could not allude to the present plans on alcohol duties. If the Brewers raised the VAT issue next Tuesday, you hoped the Chancellor would refer to the separate meetings about this.

On this basis, the Minister of State was content for you to send drafts of the relevant parts of the Regulations to the Brewers today.

A handwritten signature in black ink, consisting of the letters 'S', 'P', and 'J' intertwined in a cursive style.

S P JUDGE
Private Secretary

BRIEF
26/1

FROM: G MCKENZIE
DATE: 26 January 1987

- 1. MR. HAIGH
- 2. MISS SINCLAIR
- 3. CHANCELLOR

MS 21/1
 This is mostly familiar stuff, though a little more realistic than last summer's "Direction of Tax Reform" exercise
JLH
26/1

- CST
- FST
- MST
- EST
- Sir P Middleton
- Mr Cassell
- Mr Monck
- Mr Scholar
- Mr Turnbull
- Mr Odling Smee
- Mr Culpin
- Mr Kelly
- Mr Halligan
- Mrs Dunn
- Mr Guy
- Miss Evans
- Mr Walters
- Mr May
- PS/C&E
- Mr J Bone C&E
- PS/IR
- Mr A Walker IR

BUDGET DEPUTATION: INSTITUTE OF DIRECTORS

You are to meet a delegation from the IOD on 29 January at 4.00pm to discuss their Budget representations.

2. We have received two sets of representations from the IOD, their general representations (Annex A) and their technical representations (Annex B). The IOD have already discussed their technical representations with Inland Revenue Officials on 10 December. We assume therefore, that they would not wish to discuss these at this meeting. The main representations are likely to form the basis for discussion.

3. At the outset you may wish to confirm that both sets of representations will be carefully considered in the run-up to the Budget.

Handwritten notes at the bottom of the page, mostly illegible.

The IOD proposals

4. The IOD have provided a helpful summary of their main recommendations (pages 2-4 of their Main Paper). Their representations reiterate proposals which are familiar from previous years' submissions. Their proposals breakdown into 5 main groups:

(i) Macro Economic Points:

Fiscal and Monetary Policy

IOD policy priorities are first to bring down government spending (paragraph 40) and second to cut taxes (paragraph 42). Main points on Macro Economic policy in paragraphs 1-48 are covered in the briefing at Annex C.

(ii) Deregulation The IOD support Government policy on deregulation. They call for the deregulation of rent controls and the abolition of Wages Council. Briefing on these points and a general note on deregulation is attached at Annex D.

(iii) Privatisation The IOD call for the extension of Private Health Care and further privatisation in the educational services. There is a possibility that the IOD may also bring up their claim that the ECHR judgement on compensation for ship builders will provide a precedent for any future British Government wishing to expropriate the industries privatised by the present Government and to pay little or no compensation. Briefing covering all these points is attached at Annex E.

(iv) The Direction of Tax Reform Covered in paragraph 3 of the Main Paper, sets out their long term programme for the reduction and reform of taxation. We have already had sight of this back in June. I attach a commentary of these proposals with a line to take Annex F.

(v) Tax - Detailed proposals Paragraphs 46-100 cover the IOD's extensive range of tax proposals. Page 4 of their summary to the Main Paper sets out the first year's costs of these measures. The tax proposals include:

- 3p off basic rate
- 7p off higher rates
- reduction in small companies rate of corporation tax by 3p
- increase VAT threshold to £50,000

Annexes G and H provide briefing on the IOD's tax proposals. The IOD's recommendation to align the National Insurance contributions system with that of income tax in the short run and reduced and privatised in the long run. Annex I covers this proposal.

Handling

5. As on all of these occasions, you will want to leave the IOD to do most of the talking. However, you may care to make the following particular points:

- Welcome IOD's support for MTFs and ultimate objective of zero inflation;
- Thank the IOD for bringing their Direction of Tax Reform paper to Ministers' attention. Share objective of bringing burden of tax down;
- Further progress on tax cuts will only be achieved provided it is prudent and safe to do so consistent with keeping inflation low.

6. Official Support will be provided by Mr Beighton (IR), Mr Kelly (MPL) and Mr Haigh from FP.

G McKenzie
PP G MCKENZIE

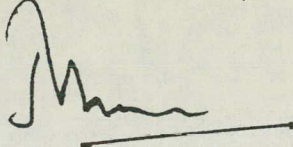
Rt Hon Nigel Lawson, MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
London SW1P 3AG

9 January, 1987

Dear Nigel,

I enclose the Institute's representations for the 1987 Budget and look forward to discussing them with you at 4 pm on 20 January. I will be accompanied by:

Mr Bruce Sutherland	- Chairman, Taxation Committee
Dr Barry Bracewell-Milnes	- Economic Adviser
Mrs Judith Chaplin	- Head of the Policy Unit
Mr Sandy Anson	- Secretary, Taxation Committee
Mr Peter Anderson	- Parliamentary Affairs Officer

Yours ever,


John Hoskyns

	09 JAN 1987
	Mr G McKenzie FP
TO	CST, EST, EST, MST
	Sir P Middleton
	Mr Scholar, Mr Walters,
	Mr Komanski,

Mr Cropper, Mr Tynie,
Mr Ross Goobey,
PS/IR PS C+E
Mr Fisher C+E

enc.

CUT TAXES
AND COMPETE

SUBMISSION TO THE CHANCELLOR OF THE EXCHEQUER FOR THE
1987 BUDGET

Policy Unit
Institute of Directors
116 Pall Mall
London SW1Y 5ED.

£2.95
January 1987

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SUMMARY OF MAIN RECOMMENDATIONS

Paragraphs

- 3
MP In "The Direction of Tax Reform" (June 1986) the IOD set out a long term programme for the reduction and reform of taxation which was a central element of the general programme for privatising and deregulating the economy set out in "The Business Leaders' Manifesto" (October 1986).
- In this submission the IOD sets out the steps it believes the Government should take towards fulfilling those programmes in the 1987 Budget. It calls on the Government to:
- 10
GEP * treat the increase in spending in the Autumn Statement as a temporary election year aberration
- 14, 40-41
MP * restore the reduction of government spending as the top priority and establish a Long Term Spending Strategy to reduce the 44.5% of GDP absorbed by the State first to the US level of 37.1% and then to the Japanese level of 32.6%
- 13, 15, 46 * increase the power of the Chief Secretary and make other institutional reforms necessary to the implementation of that strategy
- 15, 17 * improve the health and educational services by more privatisation and giving more power to parents and patients
- 23, 25
JAE
Bill 944 * put more emphasis on tax cuts and on deregulation (e.g. abolition of Wages Councils, abolition of rent controls) rather than spending initiatives as cures for unemployment

- 26 * replace regional grants and subsidies with business rates relief in the qualifying areas
- 28 * publish figures for employment and self employment at the same time as for unemployment
- 29-35 * maintain its commitment to zero inflation and to this end re-establish the money supply (perhaps measured by a weighted composite indicator) as an important determinant of policy
- 37-38 * place less emphasis on the total PSBR and more on its component parts by restoring "the line" between items on capital and current account
- 42-45 * make tax cuts the next priority after spending reduction to enable Britain to compete effectively with the US, Japan etc
- 46, 100 * give tax cuts higher priority than the PSBR which is already excessively austere and could be relaxed by £1½ billion
- 47-48 * make tax cuts with a total first year net cost of £2 billion (this figure allows for secondary and supply-side effects and is equivalent to a first year cost on the government's ultra-conservative conventions of £4 billion)
- Appendix
- 52 * continue abolishing a tax a year, inheritance tax first, then capital gains tax
- 53-57 * take into account the overall economic impact of proposed technical changes in taxation not just the technical considerations (many of our technical points are of wider economic significance and many Revenue-initiated changes have had adverse economic effects)

- 52, 60-61 * abolish inheritance tax, or failing that
- 62 * restore parity between assets held in trust and assets held absolutely
- 63 * exempt business and agricultural assets
- 64 * cut the rates by at least 5p for each 1p off basic rate income tax
- 52, 65-66 * abolish taxation of capital gains (except at the boundary with income), or failing that
- 67 * exempt pre-1982 (or preferably all) assets held for ten years
- 68 * restore the 1965 differential between capital gains tax rate and income tax basic rate, ie CGT rate of 21% if basic rate 29%
- 71 * give worthwhile tax relief for profit-related pay
- 70, 72-74 * give income tax relief for all personal investment in new equity and correct technical anomalies in share option and incentive rules
- 75-79 * cut income tax basic rate by 3p and higher rates by 10p
- 80 * introduce transferable income rather than transferable allowances for spouses
- 81 * make permanent health insurance premiums deductible
- 82-84 * in long term replace national insurance contributions with privatised genuine insurance and meanwhile align NIC with tax and benefit systems
- 85 * in long term reduce corporation tax rate to income tax basic rate and meanwhile
- * keep small companies rate same as basic rate, ie cut by 3%

- 57, 86 * correct major technical defects concerning change of ownership, losses, ACT, exchange rate fluctuations, commercial buildings and other "nothings"
- 89 * enact a right to be self-employed for workers who relinquish the benefits and safeguards of employment
- 90-91 * make no increase in the rate or coverage of VAT
- 92 * maintain pressure on EC to raise VAT threshold to £50,000
- 93-94 * make partial not full "revalorisation" of excise duties
- 100 Our proposals are by our own criteria too fiscally conservative in order to provide a substantial margin for contingencies. Their cost in 1987-88 is as follows:
- Appendix

	£ Million
Reduce income tax basic & higher rates by 3p	3,495
Reduce higher rates by further 7p	455
Reduce small companies' rate by 3p	60
Reclassification to self-employment	45
Reduce inheritance tax rates	70
Exempt business and agricultural assets	20
Increase VAT threshold to £50,000	150
Abate revalorisation of excise duties	150
Allowance for unquantifiable items	160
Allowance for overlapping cost	-40
	<u>4,565</u>
Less: VAT threshold first stage only	-133
Supply-side effects (inheritance tax and income tax higher rates only)	-432
	<u>4,000</u>
Recommendations with little or no first year cost	
Capital gains tax changes	-
Child tax allowance	-
Capital allowance for commercial buildings	-
Loi Monory investment relief	-
1987-88 DIRECT COST OF IOD RECOMMENDATIONS	<u>4,000</u>
Less: Secondary effects including further £500m supply-side effects	<u>-2,000</u>
1987-88 NET COST OF IOD RECOMMENDATIONS	<u>2,000</u>
	=====

Using the Government's ultra-conservative conventions, the first-year cost is £4,000 million and full-year cost is £6,700 million.

INTRODUCTION

1. The Institute of Directors' technical representations for the Budget and Finance Bill 1987 were submitted to the Inland Revenue in October. The present submission contains our general representations; and we refer here to some of our technical representations that have a more general significance as well.
2. Our Budget representations have for many years been based on the implicit assumptions, first, that our annual recommendations were integral elements of a long-term programme of tax reduction and reform and, second, that our tax proposals were integral elements of a general programme for privatising and deregulating the economy.
3. During the last year we have published two papers that make these implicit assumptions explicit. "The Direction of Tax Reform: Controlling the Urge to Change the System" (June 1986) argues that tax reform and tax reduction are complementary parts of the same process, and we are glad that the Chancellor has stated his agreement with this proposition. If government spending can be cut, or at least prevented from rising, dramatic reductions in tax rates are attainable over a period as short as ten years; and these reductions in the tax burden serve to resolve most of the problems of tax reform which are insoluble as long as taxes remain at anywhere near present levels. "The Business Leaders' Manifesto" (October 1986) shows how these proposals for tax reduction and reform are at the centre of a programme for reforming and liberalising the economy in general.
4. The present submission first shows how our immediate proposals form part of a long-term tax strategy. Under the heading "Fiscal and monetary policy" it discusses alternatives to the levying of taxes for the achievement of financial policy aims and under "Policy priorities and the scope for tax cuts" it considers the implications of these arguments for possible tax reduction in the next Budget. "Tax reduction and structural reform" shows the pattern of tax reduction we recommend as doing most to reform the tax structure in parallel with a reduction in its burden.

ANNEX
B

A LONG-TERM STRATEGY

5. In "The Direction of Tax Reform" we showed how *income tax and value added tax could be cut to 10 per cent each over the next decade and most other taxes could be substantially reduced or abolished if the growth of the economy was larger by some 2.6 per cent a year simple than that of government spending*. We recommended a cut of this amount in government spending and took no credit for any growth in the economy; but the same result can be achieved conformably with the Government's previous intention to hold the "planning total in real terms" steady provided that the economy grows by some 2.6 per cent a year - a rate attained or exceeded for substantial periods since the war.
6. Although radical tax reduction is compatible with a wide range of growth rates for the economy, its achievement requires a firm control over government spending, by privatisation or otherwise. It is very sensitive to variations in government spending, and it is not compatible with levels of government spending that absorb an increasing share of output and economic growth, as has happened during most of the last twenty-five years. At present the line is not being held, and the control of government spending remains as elusive as at any time since 1979.
7. We strongly support the Government's policy of reducing the basic rate of income tax to 25p and regard this as the first stage of a programme involving much more radical reductions. These more radical reductions should be at the centre of the Government's longer-term plans for the reform of the economy and the improvement of its international competitiveness.
8. *On grounds of international competitiveness, large reductions in the British rates of tax on income and capital are more urgently required than ever before*. In the United States, the 1981 and now the 1986 tax reforms have reduced the highest rate of income tax to 28 per cent (or 33 per cent for certain categories of higher incomes), as compared with the 29 per cent lowest or basic rate of income tax in this country. A number of other industrialised countries have been reducing their tax rates or planning to do

so or already have lower tax rates than Britain: for example, Canada, France, Germany, Japan and New Zealand. At a time when international transport and communications have never been easier, Britain will not be able to retain her most able wealth creators unless British tax rates become competitive. British tax policy should not try to move against the international current. Britain should seek to overtake and surpass American achievements in tax reduction. The long-term aim of policy should be to make Britain a low tax country or tax haven like Switzerland or Hong Kong; and this aim is desirable as well as attainable.

9. Among the principles underlying our annual representations and long-term programme, the following deserve mention because they are contentious in certain quarters. First, *the replacement of government spending with a tax relief is doubly beneficial*, because government spending and taxation are both reduced at no net cost to the government; an example is our proposal to replace child benefit with a child tax allowance (subject to the right of the mother to continue to be paid child benefit as at present, as explained in our earlier submission on this subject). Second, *indirect taxes should be reduced*, not increased; the only form of switch from direct to indirect taxation that is acceptable to us is to reduce direct taxes more rapidly than indirect. Third, *there is no place for taxes on capital in an efficient tax system* and they should be abolished as soon as possible. Fourth, *tax-deductibility of mortgage interest, as of other interest outgoings, is correct on grounds of principle* (and excessively restricted at present). The Government are right to resist the pressure in certain quarters to remove or reduce this relief; its value to the taxpayer and cost to the Exchequer will fall as tax rates are cut.

FISCAL AND MONETARY POLICY

Government spending: the continuing problem

10. The statement of the Government's expenditure plans on 6 November was a grave disappointment but not a surprise. It confirmed our long-standing assessment that there is still no effective counterpoise to the institutional pressures for increased spending. The

Government's spending projections have proved yet again to have been too low, not least because of the rise in public sector pay rates; and there is little reason for confidence that the Government will be any more successful in containing its expenditure at the new higher levels than it has been in the past. The damage done to the economy will be substantial. The incontinent government spending of the early 1960s combined with the lack of a rigorous monetary policy initiated nearly twenty years of inflation and economic decline from which the country is still painfully recovering. It is particularly unfortunate that the present Government should have no consistent policy on public spending at a time when it has no coherent monetary policy either. (Paragraphs 29 and following, below). We hope that the increase in government spending announced on 6 November will be seen in retrospect as a temporary aberration owing more to electoral tactics than to economic strategy. The endeavour to control government spending should not be relaxed but intensified.

11. The inefficiency inherent in government spending is not primarily at the level criticised by the Rayner Scrutiny Programmes, although the potential savings uncovered by these programmes are substantial; nor is it at the level criticised by the Comptroller and Auditor General, who found the DHSS unable to break down the total spent on each of more than thirty social security benefits. *It is inefficiency at the deeper level of the government's doing for the citizen, at vast expense of administration and coercion, what he could do more cheaply and effectively for himself with his own money.* Spending requirements are most economically identified by the individual, and not by the government on his behalf. Both theory and the evidence indicate that welfare spending would increase considerably if it were privatised; and if the peripheral activities of government were privatised, more money might be available for its essential functions.
12. The privatisation of welfare spending is a long-term process, although progress need not have been as slow as it has been in recent years. In the short term, it is important to keep up the momentum through subsidiary forms of privatisation such as

contracting out (the scope for which extends to all Departments in national and local government and not merely those concerned with welfare spending). We congratulate the Treasury on the report "Using Private Enterprise in Government" (HMSO, October 1986) with its frank comments on the resistance to contracting out from Ministers and civil servants in other Departments.

13. Under present arrangements, increasing government spending on education, health and housing could do more harm than good, as was argued by Mr Geoffrey Pattie, Information Technology Minister at the DTI, in a speech on 16 June. The problem goes beyond changes of policy to embrace institutional reform as well. All Departments other than the Treasury gain more than they lose by increasing their expenditure. Since 1979 there has been the important innovation of cash limits, but no other major institutional reform. Too much responsibility and too little power are accorded to the Chief Secretary to the Treasury, who represents the general public interest, as opposed to the sectional interests of the various Departments of State and their client lobbies. In particular, although the funding of increased spending in higher-priority areas from reduced spending in lower-priority areas has much to commend it as a way of preventing total spending from escalating out of control, there is little evidence so far that this is an effective means of constraining government expenditure even within Government Departments, still less between them.

14. *The Government should establish a Long Term Spending Strategy designed to reduce the present 44.5 per cent of GDP absorbed by the State, first to the United States level of 37.1 per cent and then to the Japanese level of 32.6 per cent.* This would release exactly the volume of resources that would be required to implement our long-term tax programme even if there were no growth in GDP over the next ten years. Even the Government's aim in the 1986 Budget to keep the public expenditure planning total broadly constant in "real" terms over the period to 1988-89 was not sufficiently ambitious, especially given the pressures to increase spending above this level. Absolute reductions are required, first in the "real" terms of money adjusted for inflation and ultimately in nominal terms as well. Companies that have to economise do not do

so in "real" terms or relatively to GDP; they do so at current prices and absolutely. British Governments have in the past made absolute reductions in their spending at current prices; but this has been a lost art in the Governments of recent years.

15. In previous Budget Representations and elsewhere, we have made a number of proposals for institutional reform to further genuine economy in government spending, in particular zero-base budgeting, across-the-board cuts in Departmental budgets, incentives for senior civil servants to economise and above all the determination of spending policy by tax policy rather than vice versa. *We do not foresee any solution to the problem of long-term government overspending without major institutional reform and a large extension of privatisation into spending on welfare;* in default of these reforms, government spending will still be crowding out tax reductions at the turn of the century and beyond.
16. We congratulate the Chancellor on reducing the basic rate of income tax in the 1986 Budget despite widespread opposition beforehand. Little or nothing was heard of these criticisms once the decision was announced. This shows the importance of fiscal leadership, and we hope to see similar leadership this year as well. Tax cuts are popular because taxpayers have a natural and healthy preference for disposing of their own money and generally being in charge of their own destinies. Despite widespread support for collective spending among the great and the good and the media of communication, there is not enough collective guilt, middle class or otherwise, among the voters in general to outweigh and reverse this natural preference. Howard Jarvis with his proposition 13 in California showed how voter resistance to taxation could be successfully mobilised against a hostile political and bureaucratic establishment. Similarly for proposition 2½ in East-Coast-liberal Massachusetts.
17. The reason why opinion polls sometimes appear to show a preference for higher taxes and higher government spending over lower taxes and lower government spending is because the wrong questions are asked. The deficiencies of the educational system and the National Health Service are undeniable and serious; but they are caused by the present financial structure of provision and cannot be cured by

additional provision within this structure. Other countries spend less per head than Britain and achieve better results. But if a respondent to a poll knows that there are grave faults in the provision of health and educational services and is invited to choose between tax cuts and the correction of these faults through increased expenditure, he may prefer the increased expenditure to the tax cuts, because he is not being offered the real choice. The problem is that state provision is unsatisfactory just because it is monopolistic provision by the State and not competitive provision by private suppliers. The answer to the understandable worries of the electorate is not more state provision but more privatisation. *There is no real alternative to parent power and patient power for improvement of the health and educational services: parent and patient power in terms of the purse and not the more or less illusory alternative of elections and committees.*

18. We support tax cuts because we believe them to be right economically and socially. We also believe them to be popular. But, if we are wrong on the last point, this need not be a good reason for not cutting taxes in the 1987 Budget. British governments have not infrequently enhanced their reputation by introducing stern and unpalatable measures to correct weaknesses in the economic system; if tax cuts are as unpopular as is sometimes alleged, a government that introduced them just before an Election in the teeth of popular disapproval could at least hardly be accused of vote-catching.

19. In areas of policy like trade union reform, privatisation of nationalised industries and reduction of the basic rate of income tax (in so far as this has happened), the Government has scored because the message has been both popular and clear: policies have been most successful where they have been most radical. By contrast, the control of government expenditure has not been equally effective or popular because the message is unclear. In particular, if the Government fails to contain its spending within its own guidelines, is this a matter for regret or rejoicing? Since the Government's own response to this question is fork-tongued, it is hardly surprising if the electorate is confused. The Government's response to this question is ambivalent because it still insists on fighting on the collectivist terrain where its opponents have all the

high ground: if most health and educational provision is assumed by the Government to be State provision, then it is impossible for Ministers to outbid political competitors of an even more collectivist persuasion. The only way to win the argument is to admit the dimension of privatisation, which both theory and empirical evidence show to be an attractive option.

20. Similarly for infrastructural spending. *We do not regard spending on the infrastructure as constituting a specially virtuous category of government spending, even though infrastructural spending might with advantage be increased if its financing were privatised.* The argument from unsatisfactory provision at present is an argument for more and earlier privatisation rather than more government spending. Where a government initiative is nevertheless considered necessary the aim should generally be to engage a large proportion of private capital (± 90 per cent) to complement a small proportion of government capital (± 10 per cent). Where capital spending yields a commercial return, government financing is a second-best; privatisation of commercially self-supporting activities is more efficient, and it also removes the financial limits that are inevitable as long as these activities remain within the government sector. Non-commercial capital spending, on the other hand, may have to remain within the government sector because it would not be financially self-supporting outside; but capital spending of this kind frequently requires additional current spending for its servicing in future years.

21. We congratulate the Government on the continuing success of its privatisation of the nationalised industries and we welcome the increase in the target for the annual sale of government assets from £4.75 billion to £5 billion. These funds may properly be used to finance tax cuts; but they should not be used to fund additional government spending, as is happening currently more than ever before. We warmly welcome the recent initiative of the Environment Secretary in asking the Property Services Agency to conduct a review of the properties it owns to see if some would not be better looked after in the private sector. (Speech to the Royal Society of Arts, 15 October). In his recent report to Parliament (August 1986) the Comptroller and Auditor General said that his office had

"found it difficult to establish with any precision the value of central Government's holding of assets and of all the resources used by Government Departments"; the best it could do was to accept an estimate from the Central Statistical Office that the Government's assets were worth about £60 billion. The imprecision and probable understatement in this figure suggest that a large proportion of these assets would be put to better use in private hands. A principal argument for privatisation is that the government is less efficient than the private sector in managing its own assets as well as being more efficient in regulating the activities of the private sector than in regulating its own.

22. We regret the Government's recent victory over the shipbuilding plaintiffs in the European Court of Human Rights. This is the sort of victory the taxpayer could do without. The Government should never have defended this case. Apart from the injustice done to the shipbuilders, the judgment and the Government's decision to fight the case provide a notable precedent for any future British Government wishing to expropriate the industries privatised by the present Government and to pay little or no compensation.

Unemployment, taxation and deregulation

23. Deregulation is the right solution to the problem of unemployment: it attacks the cause, namely malfunction of the labour market. Government spending, by contrast, does not attack the cause of unemployment and generally has undesirable side-effects: it may well make unemployment worse, because the additional taxation required to finance the spending destroys more jobs than the spending creates. *More emphasis should therefore be put on deregulation as a cure for unemployment and less on policy alternatives involving additional government expenditure.*
- Deregulation is a popular cause; but it has not yet achieved enough, or sufficiently important, successes to make much impact either on the unemployment figures or on the public consciousness. *The abolition of the remaining Wages Councils and the easement or abolition of residential rent controls are examples of deregulatory measures that would have a direct impact on unemployment.*

24. Incomes policies are the antithesis of deregulation; the Government are right to reject all forms of incomes policy as means of reducing unemployment, including the allegedly more foolproof variants being peddled currently.
25. *The belief in some quarters that tax cuts are in competition with measures to create jobs through government spending is the opposite of the truth. Jobs are destroyed by government spending and the additional taxation it requires, whereas tax cuts are the most effective way of creating jobs that are financially self-supporting in the long term. In the United States, about 10 million new jobs have been created since the tax reductions of the Economic Recovery Act 1981.*
26. In our submission of May 1984 on the Government's White Paper on regional policy "Regional Industrial Development" (Cmnd 9111) we argued that the *money at present spent on regional grants and subsidies should be used instead to fund reductions in local rates for businesses in the qualifying areas. This would serve to reduce both taxation and government spending and unemployment without imposing any additional cost on the government. We urge that our proposal be reconsidered in the context of current plans for the reform of local taxation.*
27. Another example of a measure with the triple merit of reducing government spending and taxation and unemployment is the policy recently instituted by the Department of Employment of summoning the long-term unemployed for interview. In response to this summons nearly one in ten of the first batch of respondents stopped claiming benefit. This is the type of measure that should be extended and intensified: there is a strong case for campaigns against people who claim unemployment/supplementary benefit while working in the black economy.
28. *The unemployment figures would be put in a clearer perspective if more emphasis were placed on the figures for employment and self-employment: in recent years the unemployment, employment and self-employment figures have been rising simultaneously.*

Admittedly, accurate and up-to-date figures are not available for employment and self-employment; but neither are they available for unemployment - the number of those on the unemployment register is a function of the social security provisions with little significance of its own, and it is a seriously misleading indicator of economically significant variables such as the number of those actively seeking work. The Department of Employment has made a number of improvements in the unemployment figures; but these improvements do not go nearly far enough. In the early post-war years the figures for the balance of visible trade (which were often unfavourable) attracted attention and sometimes caused alarm because they were available in full every month; the corresponding figures for invisible trade (which were invariably favourable) were available less fully and after a longer interval. Now that an estimate of the invisible balance is issued simultaneously with each month's visible figures, comment about the latter is much more relaxed. Similarly for the employment figures: the Department of Employment should accompany the latest unemployment figures with the best available estimates of employment and self-employment for the same period. This would serve to reduce the importance of the unemployment figures as an influence on economic policy in general and budgetary policy in particular.

Monetary policy and the control of inflation

29. *We share the Government's commitment to zero inflation.* Stability in the general level of prices is a mark of an orderly economy and a just society.

30. The achievement of this aim is being made unnecessarily difficult by the Government's retreat from its earlier reliance on the quantity of money as an indicator of policy and an instrument of control. £M3 has been steadily downgraded in recent pronouncements and may be retired from active service. Its place has been taken by a number of indicators that have little to do with the money supply - the exchange rate, the PSBR, interest rates, even money GDP.

31. We have explained elsewhere our misgivings over this process. (Business Leaders' Manifesto, page 35). Present monetary policy is too subjective. It relies on a number of different indicators, most of them more important in contexts other than the control of inflation, without giving any indication of their numerical relationship with the inflation rate or of what should be done when they move at different speeds or even in different directions.
32. *The importance of the quantity of money in the determination of policy should be re-established.* There is nothing wrong with the performance of the money supply indicators in recent years. The problem has been the excessive reliance on £M3, the behaviour of which has been much affected by financial innovation. Indicators of narrower money have performed better and should have been relied on more.
33. A *weighted indicator* of money supply, such as we have recommended, embodies the commonsense principle that some forms of money are more important than others in generating inflation (and it would have performed better in recent years than the indicators used by the Government). The principle of weighting is implicit in the Government's use of both M0 and £M3 (since the components of M0 are also components of £M3); but it should be made more explicit and given more emphasis in the determination of policy. In any case, it should be the Bank of England's business to devise and monitor the most useful and up-to-date indicators of the money supply instead of merely explaining why those employed hitherto have not performed well.
34. Nothing in the Loughborough lecture of the Governor of the Bank of England (22 October) alters our belief that the quantity of money should be a major determinant of monetary policy and that valid and up-to-date indicators of the money supply exist or can be devised. This is not an illusory search for simple truths in a difficult and complex world. On the contrary, it is possible to make things seem more difficult than they really are. The technical expertise of the Bank of England did not succeed in preventing the British rate of inflation from rising to well over 20 per cent, nor had it much to

contribute to the subsequent return towards stable money. What reversed the rise in inflation was the work of a few economists, mostly foreign, confirming the importance of changes in the money supply as a determinant of inflation. The Government is in danger of presiding over a return to the intellectual climate of the first thirty or so years after the War when the quantity theory of money was out of fashion and the ground was prepared for the accelerating inflation of the nineteen-seventies. We urge the Government not to repeat this mistake: the quantity of money should be restored to the centre of monetary policy.

35. Indicators of money supply are important for policy in the short term as well as the long. If the emphasis of monetary policy is shifted from the quantity of money to other indicators including the PSBR, the scope for tax reduction is unnecessarily constrained and the economy as a whole is the loser.

Public sector borrowing requirement

36. Our policy on the PSBR is set out in the paper "The Public Sector Borrowing Requirement" of July 1985. We accept that a low or zero PSBR is generally preferable to a higher PSBR used to finance additional government spending on current account. A lower or zero PSBR may not be a desirable aim of policy, however, if it is achieved at the expense of tax cuts forgone.
37. For similar reasons, we regret the abolition of "the line" in 1965. Although the difference between items "above the line" and items "below the line" did not correspond as closely as was generally believed to the difference between items on current account and items on capital account, the distinction was a valuable one. In particular, an increase in the PSBR to fund expenditure on an income-generating capital asset is a very different matter from an increase to pay for additional current spending. Similarly, an increase in the PSBR to fund reductions in taxes on capital is a very different matter from an increase to pay for cuts in value added tax or in the basic rate of income tax. The abolition of "the line" has served to obliterate these important distinctions. *If there were technical deficiencies in the concept of "the line", it should have been amended and improved, not abolished.*

38. *Too much emphasis has been put on the crude total of the PSBR in recent years, partly because too little has been put on alternative indicators including better constructed indicators of the money supply. As a result, opportunities for tax cuts have been forgone, and tax reductions have been less than they might have even at existing levels of government spending and within prudential constraints on the relationship between government debt and other relevant magnitudes such as GDP. A transfer of emphasis from the PSBR to the control of the money supply could provide scope for additional tax cuts of several billion pounds a year consistently with further progress towards zero inflation.*
39. The Government is right to emphasise the PSBR at the expense of the Public Sector Financial Deficit (PSFD). The main difference between the two is that the former allows for the deduction of the proceeds of asset sales, whereas the latter does not. It is right that these proceeds should be omitted from an indicator of the increase in government debt: the cost of nationalisation is a genuine ingredient of government spending, and the proceeds of privatisation are a deduction from government spending, by the same argument, which is reflected in the definition of the PSBR.

POLICY PRIORITIES AND THE SCOPE FOR TAX CUTS

40. The real burden of government activity is public spending. Taxation and public borrowing are merely means of supporting this burden. Outside a small range of essential functions, we do not regard government spending as something desirable but restricted in supply through financial stringency: it is a costly and inefficient way of providing services that could be provided more economically and on a larger scale by competitive private suppliers. *Our first policy priority is to bring government spending down.*
41. General government expenditure as a proportion of national output is projected to be 44.5 per cent in 1986 compared with 41.7 per cent in 1979. The 6 November statement increased the projected expenditure/national output ratio for 1987-88 and 1988-89 by about 1 1/4 percentage points above the previous projections for these years and absorbed financial resources that could otherwise have been used to cut the basic rate of income tax by 4p to 25p.

42. *Our second priority is to cut taxes, especially the taxes on income and capital. Taxation has risen from 32.9 per cent of GDP in 1979 to 38.6 per cent in 1985. At tax levels like these, Britain will never be able to compete effectively with Japan, the United States and other less heavily taxed international competitors. The reduction of inflation is also an important aim of policy; but it is not in conflict with tax-cutting provided that the growth of the money supply is kept under control.*
43. The elimination of inflation and of the growth of government spending would make it easier to reduce real interest rates from their present high levels, with the advantage this implies for industrial borrowers. In the present situation, however, the reduction of interest rates has a lower priority than our other policy aims. Since the private sector is a net creditor of the government, a rise in interest rates is substantially equivalent on income account to a reduction in taxation; in this sense, it is something to be welcomed. Even as a component of industrial costs, interest rates are for most firms a small proportion of labour costs; and the latter, which are more under the control of firms than most other industrial costs, have recently been rising much faster than inflation and much faster than productivity. *We should not wish to forgo a possible tax cut merely in order to bring down interest rates.*
44. The gradual devaluation of the money supply as a leading element of the Medium Term Financial Strategy means that the Public Sector Borrowing Requirement is now the only objective indicator of financial rectitude still actively used by the Government; and the laxity of control over government spending increases the pressure on the Government to retain the appearance of rigour in monetary policy. The unfortunate consequence is that what remains of government determination in these matters is directed almost entirely at the PSBR, a variable of exaggerated significance which has been seriously overworked for years in terms of the policy responsibilities it has been obliged to bear. The PSBR is now some 1.75 per cent of GDP, and this percentage has fallen by two-thirds from some 5½ per cent in 1980. It serves no useful purpose to

concentrate on the PSBR merely because the Government find it closer to hand and easier to control than the more important policy variables of government spending and the money supply.

45. The contrast between United States and United Kingdom policy in recent years is instructive. In both countries government spending has been substantially out of control. In the United States the emphasis has been on tax cutting, and the deficit has been left to take the strain. In the United Kingdom the emphasis has been on reducing the deficit (or PSBR), and the tax burden has risen by nearly 6 percentage points from 32.9 per cent of GDP in 1979 to 38.6 per cent in 1985. In the United States, revenue lost from tax cuts has been largely recouped through increased activity (and more than fully recouped at the top of the scale). In the United States this additional activity has generated some 10 million new jobs and has significantly reduced unemployment. In the United Kingdom, the number of new jobs was inadequate for this purpose and (at least until autumn 1986) unemployment continued to rise. Nor has the emphasis on reducing the PSBR resulted in a superior counterinflationary performance in Britain by comparison with the United States. Despite all the differences between the two countries, these contrasting results are not a matter of chance. *Britain has paid a heavy price in jobs lost and tax cuts forgone for the fiscal conservatism that has dominated policy.*
46. An important element of the United States experience is that tax cuts have been used to restrain government spending: concern over the deficit has taken the edge off the appetite for further expenditure. In Britain the domination of fiscal conservatism has removed even this weapon from Treasury Ministers. Every victory of the spending Departments over Treasury spending limits has been accommodated by additional taxation or tax cuts forgone and has thus been allowed to serve as a springboard for further assaults on the soft target represented by the new, higher spending limits. Under the curious conventions that have governed these affairs in recent years, the Treasury never seeks to mount an effective counterattack, and the level of government expenditure is steadily ratcheted upwards. These conventions and their underlying institutions, which could make tax reductions

permanently unattainable, have done too much damage for too long and should be changed. In particular, *it is far more important that taxes should be cut in the 1987 Budget than that the PSBR should be held at a level which is already excessively austere* and thus disproportionately damaging to the economy relatively to any minor and transient benefits which it may confer.

47. The Appendix starts with an updating of the fiscal adjustment (or scope for tax reduction) for 1987-88 given at the time of the 1986 Budget. *This updating, which applies conventional concepts and assumptions to the new information in the 6 November Statement, indicates that the fiscal adjustment of £2 billion in a full year should now be increased to £4 billion; the figure in the first year would be less.* This estimate of the fiscal adjustment is consistent with an unchanged PSBR of £7 billion and is also fiscally conservative in other ways: in particular, it takes no credit for the United States "supply-side" evidence that tax revenues as well as economic activity and employment are soon increased when high rates of tax are cut.

48. We regard a full-year fiscal adjustment of £4 billion in the 1987 Budget as too low. First, as has been argued earlier in this submission, it is more important to cut taxes than to keep the PSBR at its present level. Second, a low PSBR encourages the overshooting and raising of spending targets, as recent events have shown; an increase in the PSBR helps to strengthen resistance to further government spending. Third, taxation should lead and government spending should follow: tax revenue should determine spending, and not the other way round. *We therefore believe that the £4 billion fiscal adjustment should be treated as a first-year rather than a full-year figure, with an increase to about £6.7 billion in a full year and an increase of about £1.5 billion in the PSBR for 1987-88 from £7 billion to £8.5 billion (and more if the price of oil falls).* We recognise that this increase would be contrary to an undertaking in the 6 November statement; but the increases in government spending announced in that statement were not prevented by the reaffirmation in a major speech only a few weeks earlier of the Government's commitment to hold its spending steady in real terms. Controlling government spending is far more important than keeping up appearances with a low PSBR.

TAX REDUCTION AND STRUCTURAL REFORM

49. In *"The Direction of Tax Reform"* we reaffirmed our long-standing policy that tax reform should be a component and indeed a subsidiary part of tax reduction: reform should consist of cutting the worst taxes fastest. The main fault of the tax system is not that its structure or pattern is ill-chosen (although this is true) but that its aggregate burden is excessive. *We are opposed to revenue-neutral tax reforms* in which the gains of the gainers are paid for by the losses of the losers. *Since the general problem is one of excessive taxation, the starting point for reform is that no tax should be increased in rates or extended in coverage.*
50. The tax system after a decade of tax-cutting in "The Direction of Tax Reform" would consist essentially of income tax, corporation tax and value added tax, each at a maximum rate of 10 per cent. Excise duties on drink and tobacco would still be levied, but at lower rates than at present; they might be abolished eventually. The future of the excise duty on petrol and the car tax would fall to be decided within the context of transport policy. The minor excise duties and the taxes on capital would be abolished.
51. There is a continuum between policy in the short term, the medium and the long. Every budget should in our view constitute a step in the direction of the ideal system that we have indicated. And because tax reform is important as well as tax reduction, it is a serious failure not to make radical reforms in the course of a tax-cutting budget: there should be no repetition of the 1979 budget, in which income tax rates were cut drastically and the rates of capital transfer tax were left unchanged.
52. The Chancellor is to be congratulated on abolishing a tax a year since the start of his tenure of office; and we hope that he will keep up this success rate. *Our top candidate for abolition is inheritance tax, which does more damage to the British market economy than any other major tax per pound of revenue raised.* If the Chancellor is reluctant to abolish a tax which he introduced only last year, we have other candidates to propose. Of these, the first

is the abolition of capital gains tax on all assets held for more than, say, ten years: this would simplify the tax system, remove within a short period the injustice of taxing pre-1982 inflationary gains and take away the "locking-in effect" restricting the redeployment of assets after the qualifying period; capital gains tax would become a tax on gains in the medium term instead of the long. Another possibility, short of the abolition of capital gains tax, is to restrict its ambit to corporate gains and to relieve from tax gains in the hands of individuals and trusts; there are foreign precedents for taxing corporate gains, and it is the taxation of personal gains that causes the more serious problems. For inheritance tax, the priorities are reversed: inheritance tax on business and agricultural property may make it impossible to transmit a family firm or farm to the next generation. The abolition of inheritance tax on business and agricultural property through the extension of business and agricultural property relief to 100 per cent would be extremely cheap at about £60 million a year or less than a twentieth of a penny on the basic rate of income tax.

General and technical

53. The tax system should reflect the principles underlying the Government's philosophical position, and in some of the main lines of policy it has been doing so: for example, the investment income surcharge, development land tax and the tax on lifetime gifts have been abolished; capital gains tax and capital transfer tax/inheritance tax have been indexed for inflation; and the top rates of capital transfer tax/inheritance tax and income tax have been reduced to 60 per cent. In these matters, Treasury Ministers have clearly been in charge. We believe that the free-market principles informing the main lines of the Government's tax policy should penetrate through to the interstices of the tax system. But this has not happened. *A change of character affects British tax policy when it moves from the general to the technical. The free-market principles that inform policy at the general level are rigorously excluded from the minutiae.* Although all matters of tax policy are of course decided by Ministers, the uninstructed observer might be led to infer that policy at the technical level is in fact determined by the Inland Revenue.

54. In addition to the failure to carry through the principles underlying general tax policy, policy at the technical level has the following weaknesses. *First*, it is obsessed by avoidance and the blocking of loopholes, often to the exclusion of more important considerations such as the effect of a measure on the level and pattern of economic activity. *Second*, the effect of avoidance is assessed by the narrowest and least enlightening criterion, namely the immediate or first-round effect on the yield of the tax concerned; very different answers can be obtained by looking at the effect of a measure on the tax system as a whole, since the second-round effects are generally opposite in direction to those in the first round. *Third*, although the Revenue are keenly aware of the administrative costs imposed by new legislation on themselves, they appear to take little interest in the compliance costs imposed on the taxpayer. The Business Impact Statements which we have proposed as a normal preliminary to the introduction of new legislation would be nowhere more useful than in technical legislation on taxation.
55. The two most notorious examples of recent legislation in which the campaign against avoidance or alleged avoidance was allowed to drive out other and more important considerations of policy are Chapter VI on controlled foreign companies and Chapter VII on offshore funds in the Finance Act 1984. There is no real or identifiable benefit to the country or even to the revenue from either of these pieces of legislation. It appears that a genuine attempt is being made at present to correct the worst features of Chapter VII; but the defects of Chapter VI go too deep to offer much prospect of adequate reform.
56. As a result of the institutional differences between the handling of general and of technical tax changes, some of the areas of reform that are cheapest, most beneficial to the economy and politically least controversial have been neglected. *The following are our technical representations which we particularly urge Ministers to assess, not merely as technical tax proposals, but in the context of general economic policy:-*

- treatment of exchange rate fluctuations
- capital allowances for commercial buildings and other "nothings"
- liberalisation of the rules restricting the use of losses (Technical Representations, pages 20-22)
- liberalisation of the rules restricting the use of advance corporation tax (a) within groups (b) to avoid the double taxation of corporate capital gains (c) to eliminate the bias against the distribution of dividends out of overseas income
- application of the 29 per cent small companies or small profits rate of corporation tax to the first £100,000 of profits of all companies or groups
- premiums for permanent health insurance to be made tax-deductible
- restoration of the original differential between the (higher) standard/basic rate of income tax and the (lower) rate of capital gains tax
- exemption of pre-April 1982 assets held for over, say, ten years
- an annual capital gains tax exemption for companies
- a general right for individuals and trusts to carry forward any unused annual capital gains tax exemption without time limit
- capital losses to be eligible for carry-back over two years
- gifts to settlements where there is an immediate interest in possession and termination of such interests to be treated as potentially exempt transfers in the same way as gifts by and to individuals
- inheritance tax chargeable to be no more than 50 per cent of the death rate if the donor survives the gift by three years
- replacement of present incentives for new investment in trading companies by a straightforward income tax deduction for investment in new equity.

57. A clear example of technical provisions requiring amendment on general grounds of economic policy is *section 483 ICTA 1970 and section 101 FA 1972*, which restrict the carry forward of unutilised

losses and advance corporation tax respectively where there is a major change in the nature or conduct of a business within three years of a change of ownership. There can be few businesses nowadays which can survive, let alone prosper, without making one or more changes in their customers, products, markets or suppliers over a six-year period, any one of which could bring section 483 into play if there is a change of ownership.

The market economy and the personal ownership of capital

58. It has been a major success of the present Government to extend the concept of a property-owning democracy from owner-occupied homes to company shares; more has been achieved since 1979 than during the previous twenty years of talking. The personal ownership of capital is important not only politically and socially but also economically: *a capitalist system cannot be expected to function to maximum efficiency without widespread personal ownership of capital, some of it in substantial holdings.* Institutional ownership is not an adequate substitute for personal ownership and should not have tax advantages over personal ownership, as it has at present through inheritance tax, in particular, and the legislation on offshore funds in Chapter VII FA 1984.
59. The Government has successfully exploited the extension of personal ownership through the privatisation of nationalised industries. This privatisation programme should be complemented by substantially more favourable tax treatment of share incentive and share option schemes; by the extension of the Business Expansion Scheme to cover all new investment in United Kingdom trading companies; and by the reduction or preferably abolition of inheritance tax. We return to these topics below.

Inheritance tax

60. We warmly welcome the abolition of tax on gifts between individuals made more than seven years before the death of the donor. We have never regarded the taxation of lifetime gifts as a necessary or

desirable extension of a tax on death. We have argued for years that the case for taxing lifetime gifts is even weaker than the case for taxing bequests. The Government has now accepted that there are good social arguments for abolishing the tax on lifetime gifts. But there are also good social arguments for abolishing the tax on bequests: positively, the personal ownership of not only trading assets but also portfolio assets and the transmission of these assets to the next generation are essential to the efficient working of a market economy in which individuals are not subject to tax-subsidised competition from financial institutions and the State; negatively, *inheritance taxation generates a one-generation lifestyle which is undesirable both economically and socially*, with its incentive to the successful entrepreneur to emigrate to a more fiscally hospitable climate and its incentive, among those who remain, to engage in conspicuous consumption, up to 60 per cent of the cost of which would otherwise be paid to the Treasury in inheritance tax.

61. All forms of inheritance taxation are objectionable in principle. No such tax is acceptable as a permanent part of the British fiscal scene. Death tax has been abolished in Canada and also in Australia, where the present Labour Administration has no plans to bring it back; it has been abolished or drastically reduced in nearly all the other former British territories in Asia and the Pacific. In so far as Treasury Ministers of the present Government seek to justify a tax on death, the arguments would seem to be that some such tax has been around for a number of years and that their political opponents would complain if it were abolished. It would hardly be possible to damn a tax with fainter praise, especially when the Treasury Ministers pride themselves on their reforming zeal. As our contribution to the Chancellor's campaign to abolish a tax a year, *inheritance tax is top candidate for abolition*.
62. Inheritance tax is an uneasy mixture of estate duty and capital transfer tax. Our Technical Representations propose a number of changes to correct the resulting defects. In particular, *it is wrong and harmful that assets held in trust should now be taxed more heavily than assets held absolutely*. The "principle of parity"

should still be followed. Gifts to settlements where there is an immediate interest in possession and termination of such interests should be treated as potentially exempt transfers in the same way as gifts by and to individuals and to accumulation and maintenance trusts and trusts for the disabled.

63. It is just as important under inheritance tax as it was under capital transfer tax that *business and agricultural property relief should be increased to 100 per cent for both controlling and minority interests.* The case for taxing business and agricultural assets is even weaker than the case for taxing assets held passively as investments.
64. Our Technical Representations show that *estates between £80,013 and £2,887,769 (the vast majority of estates subject to inheritance tax) are now more heavily taxed than they would be if the original capital transfer tax scale had been uprated for inflation;* in parts of the range the burden is over 50 per cent heavier in 1986 than it was in 1974. Moreover, the top rate of 60 per cent starts at £317,000, which is in no sense a large fortune; in London and the South East a great part of this sum may be represented by the value of a family home. The schedule of tax rates should be less steeply graduated; but we do not recommend that this should be done by starting the existing tax rates at higher levels of estate, since the problem is the excessive rates of tax themselves and not just the low levels of estate on which they are charged. Tax reduction should follow the admirable precedent of 1984 and work from the top down. *Each cut of 1p in the basic rate of income tax should be complemented by a cut of not less than 5p in the top rate of inheritance tax, with corresponding changes lower down the scale.*

Capital gains tax

65. Although the United States tax reform of 1986 includes a number of elements that deserve imitation elsewhere, the confusion of capital gains with income is not one of them. The boundary problem between income and capital gains should be kept at the level of a

border dispute and should not be permitted to determine broader policy. The rationale of integrating the tax treatment of capital gains with that of income is the curious modern fallacy that all saving is for future consumption - an example of the way in which economic theory can fly in the face of common sense. If assets are being held for the long term or in perpetuity, an increase in their value provides no additional taxable capacity; any rise in income associated with this increase is already subject to income tax.

66. Although we welcome the indexation of post-1982 gains as an alleviation of the burden of capital gains tax, we are not among those who consider that a perfectly indexed capital gains tax would be an acceptable tax. For the reasons just indicated *we do not believe that capital gains are a suitable base for taxation at all, except at the boundary with income.* As indexation reduces the yield of capital gains tax and increases its complexity, the case for its abolition becomes stronger; and this is a development we welcome.
67. In our Technical Representations we argue for *the exemption of pre-1982 assets held for more than, say, ten years.* This would be the technically simplest means of dealing with the problem of pre-1982 inflation. About half the yield of capital gains tax still comes from pre-1982 inflationary gains, and the long period of ten years takes account of the Government's reluctance to part with this unjustifiable source of revenue. Moving from the technical to the general, we should like to see a cut-off introduced for all assets, and not merely pre-1982 assets, after a holding period of ten years. The case for taxing long-term capital gains is even weaker than the case for taxing those held for a shorter period.
68. The rate of capital gains tax at 30 per cent is a survivor from the era of very high tax rates. When capital gains tax was introduced in 1965 the standard rate of income tax was 41.25 per cent and the top rate of income tax was 91.25 per cent. The basic rate of income tax is now 29 per cent and the top rate is 60 per cent; but the rate of capital gains tax has remained at 30 per cent for the last twenty-one years and is now for the first time higher than the basic rate of income tax. We believe that capital gains should be taxed less heavily than income (and preferably not at all) and

certainly not more heavily; the present situation is indefensible. The restoration of the 1965 proportional difference would require *the reduction of the rate of capital gains tax to 21 per cent.*

Share incentive and share option schemes

69. Share schemes have two purposes, to give the whole management and workforce a financial interest in the prosperity of the firm and to encourage the senior management team to give their best possible performance. The two approaches are not mutually exclusive and are often combined in complementary schemes.

70. Each type of scheme is valuable, economically and socially. The Government are seized of the arguments, as is shown by Ministerial statements such as the address by Mr John Moore, then Financial Secretary to the Treasury, to the National Association of Pension Funds on 10 May. But when the principles come to be legislated, they are subordinated to the dominant motive of anti-avoidance. The schemes are narrowly circumscribed and a large part of their potential is lost. Our Technical Representations (pages 44 and following) contain proposals for *correcting the worst of the anomalies in present legislation*: we urge that these proposals should be considered by Ministers at the level of policy and not merely countered with anti-avoidance reflexes.

71. Even where anti-avoidance is not the dominant consideration, the Government's attitude is in our view insufficiently ambitious. *We support the proposals on profit-related pay* for reasons set out in the Green Paper and the Chancellor's speech to a CBI conference on 15 September. *But the tax concessions proposed are excessively modest* and even so do not represent a Government commitment; without an improvement in the tax treatment of profit-related pay there is unlikely to be any significant change in the present situation.

Business Expansion Scheme and Loi Monory/Loi Delors

72. We warmly welcome the establishment of the Business Expansion Scheme as a permanent institution by section 40 FA 1986. This institution should not be eroded over the years by anti-avoidance legislation; its coverage should be extended.
73. The extension we propose is that the tax reliefs for the Business Expansion Scheme should be subsumed in a more general tax relief (on the lines of the French Loi Monory/Loi Delors and other foreign precedents) for subscriptions to new equity capital of UK trading companies or of holding companies of trading groups. We have explained our proposals in detail in this year's Technical Representations (page 43) and last year's General Representations (page 51).
74. Our new proposal is additional and not alternative to the Business Expansion Scheme. Where the coverage of the latter is wider than that of the former, it should not be curtailed. It is also additional to the Personal Equity Plans announced in the 1986 Budget; the incentive to the investor provided by PEPs is in our assessment too modest to produce any large increase in personal share ownership.

Income tax

75. We congratulate the Chancellor on reducing the basic rate of income tax to 29p in 1986; this reduction, the first for seven years, was long overdue. We also welcome the reaffirmation of the Government's commitment to reducing the basic rate to 25p; as we have explained, a basic rate of 25p should be a stage on the road to much lower rates.
76. For reasons explained in previous years' representations and elsewhere, *a further reduction in the basic rate of income tax in 1987 is our top priority proposal among items of major revenue cost.* Cuts in the basic rate of income tax are the flagship of tax reduction and must be at the centre of any serious tax-cutting programme. The basic rate determines the principal marginal rate

of tax for the majority of taxpayers and thus has more effect on incentives than any other rate of tax. We propose *a reduction of 3p in the basic rate*; the arithmetic in the Appendix shows this to be *within the bounds of financial prudence*.

77. Financial resources that could be used to reduce the basic rate of income tax should not be dissipated in increasing thresholds by more than indexation for price rises or in introducing a new, lower rate of income tax for the first tranche of taxable income. These measures can be expensive in tax revenue without substantially improving incentives. Recent Government policy in these matters should be maintained.

78. As we have explained in "The Direction of Tax Reform", the higher rates of income tax should be abolished. Income tax should become a proportional tax again, as it was when first introduced. It is no longer sufficient to argue that the top rate of income tax in Britain is in line with the average top rate in continental Europe; Britain must now look to the United States. Above all, there should be no repetition of the mistake made last year when the basic rate of income tax was cut and the higher rates were left unchanged. *Each cut in the basic rate of income tax should be carried through to the effective higher rates of income tax, as would have happened automatically before the change of income tax system in 1972. In addition the top rate should be cut by a further 7p. So, the top rate would fall from 60p to 50p. This reduction should be carried through to the other higher rates, so that the next rate above the basic rate would be 30p instead of the present 40p.*

79. Evidence both from the United States and from Britain suggests that these tax cuts would pay for themselves: when tax rates at these levels are cut, tax revenue rises rather than falls. Egalitarian opposition to cuts in high rates of tax is thus mistaken even on its own assumptions. It was an error not to cut the higher rates of income tax last year and not to raise the higher-rate thresholds (by more than the rise in the basic-rate tranche):

the rest of the taxpaying population lost rather than gained from this exercise in soaking the rich. The higher-rate thresholds should be fully indexed for inflation this year. But if for any reason the Chancellor is unpersuaded by this argument and wishes to restrict tax remission at the higher end of the scale, it is in our view more important to cut higher rates of tax as we have recommended than to increase higher-rate thresholds for inflation.

80. In our response in October to the Green Paper on Personal Taxation (Cmnd 9756) we argued for transferable income in preference to the Government's proposal of transferable allowances between spouses. Although only independent taxation can remove the high marginal tax rates on very low incomes that are inherent in a system of voluntary transfers, these adverse effects on the incentive of the second spouse to take employment are intensified by the Government's proposal and mitigated by ours. In addition, the transferability of income without limit serves to lessen or remove the present tax penalty on marriage for spouses with incomes taxed above the basic rate of income tax but below the highest rate.
81. Our Technical Representations (page 31) reaffirm our long-standing proposal that *premiums for permanent health insurance should, within reasonable limits, be deductible for income tax for all taxpayers*. At present, premiums are non-deductible and proceeds (after an initial tax-free period of between 12 and 24 months) are liable to income tax. This departure from fiscal neutrality is unjustifiable. At the level of the taxpayer, permanent health insurance is essentially about permanent disability: many policies disallow a lengthy initial period from benefit of claim. The individual who pays PHI premiums is motivated solely by the wish to retain an element of financial independence in the event of a remote but disastrous contingency. The whole operation is self-policing without government involvement: the insurance companies are at risk from the "moral hazard" of excessive or fraudulent claims, whereas the government is at no such risk, and the "reasonable limits" referred to above will be prescribed by the companies

concerned in accordance with their assessment of each individual case. At the level of the government, an individual who makes his own provision for catastrophic illness reduces or even eliminates his call on state provision should disaster strike; since even the tax-deductibility of premiums leaves most taxpayers bearing much the larger part of the cost themselves, it might be thought that the Government would be willing to offer at least a fiscally neutral regime for this form of private provision, especially as in their speeches Treasury Ministers are among the foremost advocates of self-help and privatisation. But in practice the proposal has met with continued resistance over a number of years. In practice there is much more resistance to a small and financially self-supporting increase in tax relief than there is to a corresponding increase in welfare benefits many times as large. This is a good example of our argument that the principles that are supposed to inform the main lines of tax policy often fail to reach the subsidiary branches; we ask Ministers to think again.

National insurance contributions

82. The integration of national insurance contributions with income tax has attracted interest across the range of political opinions.
83. Employers responding to IOD surveys have consistently indicated that the integration of the income tax on earnings with national insurance contributions would have major advantages in easing administration of the complex Pay As You Earn and National Insurance Contributions systems.
84. Integration of the tax and national insurance systems can be achieved in two different ways, through alignment or merging. National insurance contributions are for many purposes equivalent to an additional tax on earnings, and in the short term the two forms of taxation on earned income should be aligned in order to reduce anomalies and the compliance costs of employers; the speed of alignment is constrained, however, by the no-loser principle that no employer or employee should be worse off as a result of

alignment and no rate of tax should go up. But, while we favour the integration through alignment of the income tax on earnings and national insurance contributions, we oppose their integration through merging, at least in the context of present institutions. In the long term, we believe that *national insurance contributions should gradually be reduced and eventually abolished through the privatisation of this "insurance"*, which under the present system is not genuine insurance at all; in particular, the present Government dealt a devastating blow to the contributory principle by abolishing the ceiling on employers' contributions, whereas we consider that the contributory principle was correct and should be reinstated. This process of privatisation will inevitably be a lengthy one; but large sums of money and important questions of principle are involved, and the achievement of the right objective should not be jeopardised by wrong decisions on the important but essentially short term question of the reduction of anomalies and employers' compliance costs under the existing regime.

Corporation Tax

85. *Our long-term policy for the rate of corporation tax is that it should be reduced to the basic rate of income tax. The tax regime for companies should revert to what it was until 1937. If it is thought appropriate to levy a separate tax on companies, this should take the form of a standard charge per company. Not only is this right on general grounds of economic principle: its realisation would confer a large competitive advantage on the United Kingdom relatively to other industrialised countries.*

86. In the 1987 Budget we give priority to reductions in personal income tax and the taxation of capital over reductions in the rate of corporation tax. But, if Treasury Ministers believe that corporation tax reform is now complete and little more needs to be done, at least for the time, this is not a belief we share. On the contrary, there is a wide range of reforms, complex enough to be regarded as technical but important enough to be treated as matters of general tax policy, *which are indispensable for streamlining the*

present obsolete and uneconomic structure of corporation tax. These reforms are the subject of our Technical Representations, pages 20-27; here we would mention in particular the liberalisation of the rules restricting the *use of losses* and the liberalisation of the rules restricting the *use of advance corporation tax* (including the granting of full imputation for corporation tax on companies' chargeable gains, which are now more heavily taxed than corporate income in the hands of the shareholders). In addition, the *tax treatment of exchange rate fluctuations* and the provision of *tax relief for investment in commercial buildings* and other "nothings" (or non-deductible items of business expenditure) are matters of interest primarily to corporations, although they affect other taxpayers as well. These are the kind of question that ought to be engaging the attention of Ministers anxious to remove fiscal obstacles to employment and economic growth; but there is little sign that they have done so up till now. We urge that these matters should receive the attention they deserve and be treated as questions of general and not merely technical tax policy.

87. On the realisation of our proposal to align the rate of corporation tax with the basic rate of income tax, there would be no place in the system for a small companies (or small profits) rate of tax. Meanwhile, the problem of the high rate of corporation tax over the range where the benefit of the small companies rate is withdrawn is growing in importance as the basic rate of income tax is cut and the rate of corporation tax remains unchanged. We urge that *the 29 per cent small companies rate of corporation tax be extended to the first £100,000 of profits of every company or group.*

Unincorporated businesses and self-employment

88. Unincorporated businesses liable to the higher rates of income tax lost substantially from the reform of corporation tax in 1984. No attempt has been made to offset these losses; on the contrary, the higher rates of income tax were maintained at their previous levels when the basic rate was cut in 1986. The loss of accelerated depreciation allowances by unincorporated businesses is yet another

argument for reducing the higher rates of income tax, at least on business income. In addition, our Technical Representations (page 28) make specific recommendations for offsetting the losses incurred by unincorporated businesses as a result of the reform of corporation tax.

89. The enactment of a right to be self-employed on the lines proposed by the IOD would much increase the flexibility of working arrangements throughout the economy; we believe that it would make a major contribution to increasing activity and reducing unemployment. Our proposal makes provision for the Revenue to challenge any particular arrangement which they regard as abusive. But we see little incentive or even scope for abuse. An individual who moves from employment to self-employment relinquishes a broad range of benefits and safeguards and thus pays a high price for whatever advantages the status of self-employment may confer. He is also helping to improve the working of the labour market (and thus to increase employment) by easing the distortions and rigidities imposed on it through employment protection and similar legislation: *unemployment would be lower if the ratio of self-employment to employment were higher.* Moves from employment to self-employment deserve Ministerial encouragement, not resistance. This is another area where the broad lines of policy should prevail over technical objections (objections which we do not in any case consider to be well founded).

Value added tax

90. *Our long term policy is that the rate of value added tax should be reduced to 10 per cent.* This process could have started in 1987, with a consequent reduction in the rate of inflation and the cost of living, if £4.7 billion had not been pre-empted for additional spending in 1987-88.
91. *We oppose any increase in the coverage of value added tax and support the Government's resistance to the European Commission's proposal to extend the tax to new building work.*

92. We have for several years been arguing for a large increase in the value added tax registration threshold. It seems that the merits of the case are accepted by Ministers and that the obstacle lies in the need to secure the agreement of Britain's European Community partners. The period of Britain's Presidency of the Community has been used to promote a significant advance in this area of policy: the draft 22nd Directive has proposed a higher optional threshold of 35,000 ECU's, currently about £24,100. This is a welcome development and one which *we hope will presage further progress towards a threshold of £50,000.*

Excise duties

93. We congratulate the Chancellor on not "revalorising" (increasing) the duties on drink in the 1986 Budget and not "revalorising" the duties on cigars and pipe tobacco in the Budgets of 1986 and 1985. These are welcome moves in the direction of tax neutrality between different forms of consumer spending which we hope will be repeated in 1987. There is similarly a case for not "revalorising" the other excise duties, including the duty on cigarettes, or for "revalorising" them only in part. The social case for levying excise duties on drink and tobacco is unpersuasive: most of the burden falls on the moderate smoker and drinker, while the addict is unlikely to be deterred by the tax. The discouragement of immoderate smoking and drinking is not an essential function of government and should in any case be pursued through non-fiscal measures.
94. We also recognise the merits of the Chancellor's decision not to raise the excise duty on petrol to offset the fall in the price of oil. *We wish to see all forms of taxation reduced, indirect as well as direct, excise duties as well as value added tax.* Excise duties are among the most discriminatory elements in the tax system, and their reduction not only reduces the rate of inflation and the cost of living but also serves to restore to the consumer the control of his own spending.

CONCLUSION

95. The increase in government spending in 1987-88 and thereafter by an amount that would have paid for a reduction of some four pence in the basic rate of income tax is a major battle lost; but the war goes on. The size of the increase and the disregard of a commitment made only a few weeks earlier to avoid any such increase confirm our assessment that far too much of the nation's spending power is in the hands of Ministers and that the institutional constraints on government spending are out-of-date and grossly inadequate. The case against government spending at anywhere near present levels is strengthened, not weakened, by the change of direction announced on 6 November.
96. The problems due to the ambivalence of the Government's policy towards its own spending are aggravated by the recent decline in the coherence of its monetary policy: money-supply targets that had at least the objective merit of falsifiability have been replaced by a set of alternatives whose interpretation is inherently unquantifiable and subjective. In particular, a disproportionate weight has been brought to bear on the Public Sector Borrowing Requirement, the one monetary indicator whose performance in recent years has by any standard been consistently good.
97. In order to re-establish control over events, the two essentials are, first, to impose effective constraints on government spending and, second, to revert to the use of indicators of the money supply as the main instrument of monetary policy. The 6 November statement represented a major defeat in the campaign to control government spending, and this reverse will not be corrected for some time; but a reversion to the quantity of money as the main determinant of monetary policy could be instituted and restore confidence quickly, and would relieve the present pressure on the PSBR and thus increase the scope for tax cuts.
98. *Tax cuts are a necessity, not a luxury, if the British economy is to regain its former international competitiveness. The luxuries are excessive government spending and a subjective and incoherent monetary policy.*

99. We have therefore proposed a set of tax cuts for the 1987 Budget concentrated on income and capital taxes but embracing indirect taxes as well. *This is a first stage in the programme of tax reduction and reform which would realise our ideal system.*
100. *Our proposals for the 1987 Budget are by our own criteria too fiscally conservative: they allow for an increase of only £1.5 billion in the Public Sector Borrowing Requirement, which in comparison with other financial magnitudes is at present much too low. We have done this deliberately, in order to provide a margin for contingencies. If the assumptions underlying our arithmetic are challenged, or if the budgetary situation deteriorates as a result of a fall in the oil price or otherwise, the difference should be made good in the short term by an increase in the Public Sector Borrowing Requirement and not by a reduction in the tax reductions we have proposed: these tax reductions are indispensable, both internationally, for the strengthening of the British economy relatively to competition from abroad, and also domestically, for the increase of activity and the reduction of unemployment.*

REVENUE IMPLICATIONS OF THE INSTITUTE'S PROPOSALS

1. The changes in the forecasts for 1986-87 announced in the 6 November statement relatively to the forecasts in the Financial Statement and Budget Report March 1986 are as follows:-

	1986-87 £ billion
Increase in VAT, corporation tax and other non-oil revenues	2.0
Reductions in oil revenues as a result of the oil price having fallen below the Budget estimate of \$15	- 1.0
Reduction in oil revenues as a result of the acceleration in the repayment of Advance Petroleum Revenue Tax	- 0.3
Net overrun (-) in government expenditure	<u>- 0.5</u>
Increase in government revenue net of increase in expenditure	0.2 =====

2. The changes in the expenditure plans for 1987-88 and 1988-89 relatively to March 1986 are as follows:-

	1987-88	1988-89
	£ million	
Increase in government expenditure planning total	4,700	5,500
Of which reduction in the contingency reserve	<u>2,580</u>	<u>2,370</u>
Financed otherwise	2,120 =====	3,130 =====

3. The FSBR 1986-87 (page 16) put the annual fiscal adjustment at £2 billion in 1987-88 and £4 billion in 1988-89. In 1987-88 the charge on government financing of the additional spending announced on 6 November is £2,120 million (paragraph 2, above). The tax recoupment from the £4,700 million increase in the government expenditure planning total, much of which represents pay and has a

large income tax component, would be of the order of £1.5 billion, although this recouplement would lag the increase in the government expenditure planning total by an average of several months. In addition, if the problem of excessive pay rises is as serious as Treasury Ministers have been implying, a substantial increase in income tax payments above the March 1986 forecasts for 1987-88 may reasonably be expected, and in this case no time lag is involved; for this and other reasons the £2 billion increase in non-oil revenue above the Budget 1986 forecasts for 1986-87 may be taken to continue in 1987-88. Further, the reduction of £1 billion in oil revenues for 1986-87 was due to a fall in the oil price below \$15; the price has since recovered to \$15 and most recently to \$18. The forecast yield of North Sea tax in the FSBR 1986-87 (page 15) was £6 billion in 1986-87 but only £4 billion in 1987-88; this latter figure now looks low rather than high, even if the current OPEC efforts to increase the oil price to \$18 do not continue to be as successful as they have been to date. There is also the £250 million increase in asset sales.

4. The *"annual fiscal adjustment"* for 1987-88 given in the FSBR 1986-87 (page 15) may thus be updated as follows:

	1987-88 £ billion
Annual fiscal adjustment, FSBR 1986-87	2.0
Increase (-) in government expenditure planning total	- 2.12
Tax content of £4,700 million increase in government expenditure planning total	1.5
Increase over forecast in non-oil revenue	2.0
Increase in asset sales	0.25
Increase in oil revenue, say	<u>0.37</u>
Fiscal adjustment 1987-88, revised November 1986	4.00 ====

5. *The conventional concept of the fiscal adjustment is a full-year figure; the first-year cost of tax cuts is significantly less.* Of the components of the £4 billion 1987-88 fiscal adjustment in paragraph 4 above, the original fiscal adjustment of £2 billion and the £1.5 billion tax content of additional spending are full-year costs; the first-year equivalents are significantly less. For the other four components the first-year and full-year costs are the same. The total of £4 billion is thus a full-year rather than a first-year figure.

6. *We regard a full-year fiscal adjustment of £4 billion in the 1987 Budget as too low and are treating this as a first-year rather than a full-year figure, with a consequent increase in the full-year figure to about £6.7 billion.* The difference of about £1.5 billion represented by treating the £4 billion in 1987-88 as a first-year rather than a full-year figure (so that the whole cost of the £4 billion would be incurred in 1987-88) can be accommodated by an increase in the PSBR from £7 billion to £8.5 billion in 1987-88. For the reasons explained in the text (paragraphs 44, 48, 100), this is not a policy of fiscal laxity but rather the opposite, particularly as too much emphasis has been put on the PSBR in recent years and not enough on the more important variables of government spending and the money supply.

7. We are not putting forward a traditional, finely judged assessment of what the economy can afford; we are seeking changes in the institutions and assumptions determining policy. *But even by conventional standards, there are further reasons for believing that a first-year tax cut of £4 billion would be well within the bounds of financial prudence.* First, the unemployment figures started to improve in the autumn, and the October figures were the best for fifteen years. If this trend is confirmed, there will be a double benefit, from higher tax revenue and lower government expenditure. *Second*, £4 billion of tax cuts in 1987-88 would be £700 million less than the increase in government spending in 1987-88 announced on 6 November. It is here that the real problem lies: fiscal laxity is an attribute of increases in government spending rather than reductions in rates of tax. *Third*, although the full-year cost at £6.7 billion is some £2.7 billion more than the first year cost, this full-year cost will not be felt until later

years, which will be the subject of later Budgets; the £2.7 billion increase from the first year to a full year is about 1½ per cent of government spending, and economies of this order should be within the reach of an economising government. *Fourth*, reductions in capital taxes should not be considered as adding to the PSBR in the same way as reductions in taxes on current account (text, paragraph 37); they are better regarded as the fiscal dimension of privatisation, especially when the PSBR is as low as it is at present. *Fifth*, our arithmetic for particular tax cuts is based on the conventions and assumptions underlying the Treasury's figures, which we regard as ultra-conservative to the point of being seriously misleading.

8. The Treasury's basis of computation is explained in the Financial Statement and Budget Report 1986-87, page 48. "For Inland Revenue taxes (and VED) the difference in yield for each tax is generally calculated by applying the pre and post-Budget tax regimes to the same tax base. This base is the post-Budget base - that is the levels of income, profits etc forecast for future years on the assumption that all the measures proposed in the Budget take effect The estimates shown in Table 4.1 do not reflect changes in the tax base arising from changes in money incomes and in the general level of prices and other economic variables which may result from the proposed tax change. These secondary effects are, of course, taken into account in estimating the impact of the tax change on the PSBR. The base for the post-Budget forecast of each tax (given in Table 6.B.3) takes account of the effects, direct and secondary, of all the measures announced in the Budget." (Table 4.1 gives "Direct effects of changes in taxation"). But what is interesting and significant for policy is not so much the "direct effects of changes in taxation" in Table 4.1 but the "effects, direct and secondary". The secondary effects must be computed by the Treasury because they are "of course taken into account in estimating the impact of the tax change on the PSBR" and "the base for the post-Budget forecast for each tax"; but the figures for the secondary effects are not published. Since the supply-side

argument is precisely about the expansion of the tax base when tax rates are cut, *the publication of figures only for direct effects systematically inflates the perceived cost of tax reduction* and obstructs useful public discussion of the policy alternatives. The direct effects are admittedly easier to compute accurately than the secondary effects; but we would rather be approximately right than precisely wrong.

9. As influences on policy decisions, the figures of direct effects of tax changes have two major defects. *First*, except for components of consumer spending, the computations generally take no account of the effect of a change in one tax on the yields of other taxes; and even the total of consumer spending is assumed to remain unchanged. For Inland Revenue taxes the calculation is on the post-Budget base; but this misses the effects of each tax change on the whole system. For example, if income tax is cut some of the increase in disposable income will be spent on goods and services attracting value added tax; if value added tax is cut, some of the difference will be spent on goods subject to excise duties and some will enure to traders in the form of additional income subject to income tax and corporation tax; and so on throughout the tax system. Where tax revenue amounts as in 1984 and 1985 to some 38.60 per cent of gross domestic product at market prices, it may be assumed as a first approximation that 38.60 per cent of any tax cut will return to the Exchequer in a full year through increases in the yields of other taxes. *Second*, any beneficial incentive effects are separate and additional; they are also very substantial, where rates of tax are high. United States experience (of which we understand that the Inland Revenue are aware), demonstrated by Internal Revenue statistics, makes it clear that the reduction in the top rate of income tax from 70 to 50 per cent under the 1981 Act resulted in more revenue, not less, being collected from top bracket taxpayers - more both in absolute terms and as a proportion of total tax collections. This result confirms what is obvious *a priori*, that the tax base shrinks drastically when high rates of tax are increased and expands correspondingly when they are reduced. It is also notable, since "behavioural changes" (responses of economic agents to improved incentives) have been a major purpose of this Government's policies since 1979, that Treasury arithmetic still fails

to accommodate them in its published assessments of the effects of tax changes, even though this failure often means that the published figures are not only seriously wrong in magnitude but even wrong in direction.

10. At present the Government takes some of these secondary effects into account in estimating the PSBR but not in published estimates of the cost of individual tax changes. This means that the Government's figures of the PSBR are better founded than those for the cost of individual tax changes: individual tax changes are computed on a basis which exaggerates their real cost to the Revenue. Since the PSBR is in principle unaffected by these proceedings and since we consider the present and projected level of the PSBR to be too low in terms both of prudential constraints and of tax remissions forgone, it follows that the scope for tax remissions can be doubly increased, first, to allow for a release of the PSBR from present excessive restrictions and, second, to allow for secondary effects of tax reductions, which are already included in the Government's published figures for the PSBR but not in those for the particular tax remissions themselves.

11. We have for the first time incorporated these arguments in our explicit budgetary arithmetic. First, *we have abated the cost of our proposed reductions in inheritance tax and the higher rates of income tax by £432 million, or 60 per cent of their nominal cost; this abatement is very modest, and United States experience suggests that an abatement of well over 100 per cent would be nearer the mark - in other words, revenue would in fact be increased, not reduced, by the tax cuts we are proposing; and an interesting feature of United States experience is that much of the political pressure for reductions in the highest rates of tax came from taxpayers who were not subject to them currently but hoped to have incomes within this range in later years. We have also allowed £500 million for remaining supply-side effects; the total of £932 million or some 23 per cent of the direct cost of our proposals is modest given their enterprise-orientation. Second, we have allowed for the fact that reductions in the rates of any one tax tend to increase the yields of all other taxes. At a 38.6 per cent*

- 48 -
COST OF TAX CHANGES 1987-88

£ million

Statutory indexation (3 1/4%)

Income tax allowances and thresholds	
Main personal allowances	600
Basic rate limit	70
Further higher rate thresholds	40
	710
Inheritance tax thresholds and bands	18
Capital gains tax exempt amounts	-
	728

Revalorisation of indirect taxes

Full revalorisation (3 1/4%)			- 475
Abatements:	beer	+ 55)	
	wine	+ 20)	
	spirits	+ 25)	+ 150
	cigarettes etc	+ 25)	
	cigars etc	+ 7)	
	other	+ 18)	
		- 325	- 325

COST OF INDEXATION NET OF PARTIAL REVALORISATION 403
====

Institute of Directors' recommendations for tax changes

Reduce the basic and higher rates of income tax by 3p	3,495
Reduce higher rates of income tax by a further 7p	455
Reduce small companies' rate of corporation tax by 3p	60
Reclassification from employment to self-employment	45
Reduce all rates of inheritance tax by a quarter and round down	70
Business and agricultural property relief from IHT to 100%	20
Increase value added tax threshold to £50,000	150
Abate revalorisation of excise duties (as above)	150
Allowance for unquantifiable items	160
Allowance for overlapping cost	-40
	4,565
Abatements	
Increase in VAT threshold: allow for first stage only	-133
Supply-side effects: inheritance tax and higher rates of income tax	-432
	4,000
Recommendations with little or no first-year cost	
Capital gains tax changes	-
Child tax allowance (funded by savings on child benefit)	-
Capital allowances for new commercial buildings	-
Introduce reliefs based on Loi Monory/Loi Delors	-
1987-88 DIRECT COST OF IOD RECOMMENDATIONS	4,000

Allowance for secondary effects of recommendations (including £500 million supply-side effects other than those quantified above) -2,000

1987-88 NET COST OF IOD RECOMMENDATIONS 2,000
=====

ratio of tax revenue to gross domestic product (in 1984 and 1985), the recoupment from other taxes of a £4 billion first-year cost of tax reduction would (as a first approximation) become £1.5 billion in a full year, which, together with the £500 million of unspecified supply-side effects, amounts to a deduction of £2 billion from the £4 billion direct cost of our proposals. The sale of the remaining BP shares is another possible source of funds to finance tax cuts; since our arithmetic makes no call on it, it constitutes a reserve of some £3 billion in the first year. We have also made no call on the £300m increase in the yield of value added tax in 1987-88 that would result from the implementation of the Government's proposals on input tax announced on 19 December. Thus our proposals err on the side of caution. The scope for reducing taxation is substantially increased, if due allowance is made for the overstatement of the real cost of specific tax cuts in the Treasury figures of their "direct cost" and, above all, if the convention that taxation follows government spending instead of leading it is reversed: fiscal stringency or laxity is a characteristic of government spending rather than of taxation. Furthermore, the Government should reassert its authority over its own policies: as a result of a firmer control over the money supply and other changes we have proposed, the shape of a Budget and the scope for tax remissions should never again be substantially determined by movements in the oil price and the exchange rate in the preceding month or two.

12. Thus, the table below gives the cost of our proposals in the first year 1987-88. The cost in a full year would be higher by about £2.7 billion as is explained below. *The detailed costings are based on the Treasury's figures and thus on the ultra-conservative financial assumptions underlying the Treasury's budgetary arithmetic. These figures are then adjusted to take account, first, of supply-side effects and, second, of secondary (or second-round) effects on the yields of other taxes.*

13. Apart from the reductions in the rates of inheritance tax and the higher rates of income tax, we believe that our proposals with the highest potential (per million pounds of direct revenue yield) for invigorating the economy and thus indirectly increasing tax revenue are those for increasing the value added tax threshold, permitting the voluntary adoption of self-employed status, and increasing business and agricultural property relief from inheritance tax to 100 per cent. If allowance is made for the increase of economic activity resulting from these tax cuts, their cost to the revenue may well be negligible or substantially negative. This argument does not extend to reductions in the basic rate of income tax, which are likely to impose significant costs on the revenue. Nevertheless, supply-side effects are to be expected from all our proposals; the total of these effects, at £932 million, is a conservative figure, given that a number of the items are likely to be "tax-elastic", the amount of the activity being highly sensitive to variations in the tax regime.

14. The cost of our proposals is additional to the Government's figures for the cost of statutory indexation net of the full "revalorisation" of excise duties. The Treasury figure for this is £253 million (£728 m - £465 m). Our figure of £403 million exceeds the Treasury figure by an abatement of £150 million from full "revalorisation". Of this £150 million, £100 million is the "cost" of not increasing the duties on drink (following the precedent of 1986) and £7 million is the "cost" of not increasing the duty on cigars and pipe tobacco (following the precedents of 1986 and 1985). £25 million is the "cost" of "revalorising" the duty on cigarettes by only two-thirds of the Treasury figure of £75 million for full "revalorisation". The remaining £18 million allows for less than full "revalorisation" of the other duties. We reject as defeatist the assumption that excise duties should be fully indexed for inflation and we welcome the evidence of the last two Budgets that the Chancellor is sympathetic to this point of view. Although the "costs" imposed by not "revalorising" are opportunity costs rather than conventional accounting costs, we have included the £150 million in the costings of IOD recommendations: opportunity costs are real costs for the revenue and the economy, as we emphasise in particular in our references to supply-side effects. In this one matter, our procedures are more fiscally conservative than those of the Treasury.

15. The cost of increasing the value added tax threshold to £50,000 is abated to the first stage of this increase, the increase to £24,100 provided for in the European Commission's draft 22nd Directive and included in the Customs & Excise consultative document of October 1986.
16. The 1986 Budget was right to cut the basic rate of income tax rather than increase tax thresholds. We have allowed nothing for tax thresholds this year beyond statutory indexation.
17. We have included an allowance of £160 million for small or unquantified items from our general and especially our technical representations. Most of the latter would have their main or entire revenue effect after the first year. The cost of extending the 29 per cent small companies rate of corporation tax to the first £100,000 of profits of every company or group would be £30 million in a full year. Rates of corporation tax are announced at Budget time with retrospective effect; we have allowed for the cost in 1987-88 of the 3p reduction we have proposed in the basic rate of income tax, on the assumption that this would be carried through to the small companies rate of corporation tax.
18. In our assessment, the only satisfactory solution to the problems created by inheritance tax and capital gains tax is the abolition of these taxes; the abolition of inheritance tax has the higher priority. In case our proposals to abolish these taxes are not acceptable this year, we have specified reforms within the present system as less satisfactory alternatives. All capital gains tax liabilities are assessed a year in arrears, so that the first year cost of any reduction in the tax charge is zero. The first-year cost of inheritance tax reductions is about a third of the full-year cost; our costings include only a reduction of the rates by a quarter (and an increase in business and agricultural property relief to 100 per cent), and if the Government decided to abolish the tax, the additional cost in the first year would be only about £200 million.

19. One of the disadvantages of decimalisation is that the division of the pound into 100 units of legal tender instead of 240 has increased by 140 per cent the cost of a one penny reduction in the basic rate of income tax. There is a danger that the basic rate will be reduced less than it should be over the years as a result of always rounding reductions down to the nearest whole penny. *We see no reason why the basic rate should not include a halfpenny* and several good reasons why it should. First, the extra halfpenny would be of real value to the economy. Second, the fact that the basic rate had not been rounded down to the next whole penny might paradoxically do more to strengthen confidence in sterling and government policy than if the basic rate had been rounded up. Third, the fact that a fractional basic rate would be an innovation might appeal to a reforming Chancellor.
20. The cost of our proposal for legislation on the lines of the Loi Monory/Loi Delors would depend on the take-up. Perhaps the best guide is the cost of the Business Expansion Scheme. Inland Revenue Statistics 1985 gives the cost for 1984-85 as £55 million on the basis of accruals in 1983-84.

Full-Year Cost

21. A number of items would impose further costs in a full year. The 3p reduction in the basic rate of income tax would cost a further £1,050 million in a full year and the total reduction of 10p in the higher rates a further £850 million. The reduction of 3p in the small companies rate of corporation tax would cost a further £60 million. The reduction of inheritance tax rates by a quarter would cost a further £150 million and the increase in business and agricultural property relief to 100 per cent a further £40 million. The abatement of the revalorisation of excise duties would cost a further £15 million. The total of these items is £2,165 million.
22. In addition, provision should be made for the full-year cost of tax reductions with little or no first-year cost. The most important of these is the reduction and eventual abolition of capital gains tax. The most recent estimate of the yield from CGT on individuals and

trustees in 1986-87 is £1,050 million; the figure for companies is £800 million, so that the total is £1,850 million. Cuts of not less than £500 million in the yield for 1988-89 should be made in the 1987 Budget; since capital gains tax is collected in arrears over several years, this allows for a proportionately larger reduction in the full-year cost. We also include £100 million for the cost of the Loi Monory/Loi Delors legislation (paragraph 20, above) and £50 million for the cost of capital allowances for commercial buildings (the full-year cost of which is not incurred for many years). Our proposal to abolish the £8,500 threshold for the taxation of employees' benefits would save up to £100 million in a full year.

The £550 million total of these items added to the £2,165 million total in paragraph 21 gives £2,715 million, say £2.7 billion, and takes the £4 billion first-year cost of our proposals to a full-year cost of £6.7 billion.

23. *This £2.7 billion excess of the full-year cost of our proposals over their cost in the first year should be funded from three sources. The first is economies in government spending, whether at the level of policy or of administration. £1.5 billion is about 1 per cent of government expenditure, and retrenchment of 1 per cent a year is by commercial standards a very modest exercise in economy (indeed, excessively modest, as we have argued earlier). Second, by the same argument as in paragraph 11 above, the additional £2.7 billion of revenue cost in a full year itself generates a further £1 billion of revenue through secondary effects. (38.6 per cent of £2.7 billion is £1,042 million, round to £1 billion). The balance of some £200 million would be covered more than three times by the full-year supply-side effects of the reductions in the rates of inheritance tax and the higher rates of income tax.*

24. The excess of the nominal full-year cost over the first year cost of the tax cuts in 1987 need not therefore constitute a limitation on tax cuts in 1988 and thereafter. We are proposing the first stage in a long term programme of tax reduction. The pace of tax reduction should be maintained or accelerated in the years after 1987.

IOD SUBMISSION FOR 1987 BUDGETMACRO ECONOMIC POINTS: FISCAL AND MONETARY POLICY

IOD policy priorities are first to bring down government spending (para 40), and second to cut taxes (para 42). Main points on macroeconomic policy in paras 1-48 are:

(a) Dramatic reductions in tax rates attainable over 10 years if government spending can be cut, or at least reduced (paras 3, 5). Government should aim to reduce general government expenditure (GGE) as a percentage of GDP from present 44 per cent, first to US level of 37 per cent and then to Japanese level of 33 per cent in 10 years; absolute reduction in spending required (para 14). Government does not have spending under control (paras 6,10).

Lines to take

- Government spending firmly under control:
Since 1982-83 GGE as a percentage of GDP has fallen steadily from $46\frac{3}{4}$ per cent to an estimated $43\frac{1}{4}$ per cent in 1986-87 (47 per cent to $44\frac{1}{2}$ per cent excluding privatisation proceeds). Latest public expenditure plans indicate percentage back to levels of early 1970s by 1989-90, with or without privatisation proceeds ($41\frac{1}{4}$ per cent and $42\frac{1}{4}$ per cent respectively).
Allowing for inflation, projected average annual growth of GGE excluding privatisation proceeds for 1986-87 to 1989-90 is about 1 per cent - compared with nearly 3 per cent in decade to 1978-79, around $2\frac{1}{4}$ per cent in 4 years to 1982-83, and about $1\frac{3}{4}$ per cent in 4 years to 1986-87.
- Absolute reduction in government spending not necessary to produce substantial fall in GGE as percentage of GDP in 10 years. To illustrate: 3 per cent annual growth in real GDP (close to the average for past 5 years) and 1 per cent annual real growth in GGE excluding privatisation receipts would reduce 1986-87 ratio of $44\frac{1}{2}$ per cent to under 37 per cent by 1996-97.

- In contrast to UK decline in GGE as a percentage of GDP in recent years, US ratio has tended to increase, and Japanese ratio has been relatively constant.

(b) No solution to problem of government overspending without large extension of privatisation (para 15). Privatisation proceeds may properly be used to finance tax cuts, but should not be used to fund additional government spending, as is happening increasingly (para 21).

Lines to take

- Government has rolling programme of privatisation, and continually seeking to transfer functions from public to private sector where practical to do so. Considerable progress already made on state owned industries (nearly $\frac{1}{3}$ privatised to date, $\frac{2}{5}$ by end of 1987).
- Proceeds from privatisation have enabled government borrowing to be reduced below what it otherwise would have been. Level of PSBR (and consequent scope for tax cuts) set taking privatisation proceeds into account. Cannot use proceeds to cut taxes by same amount on a sustainable basis.
- Proceeds not being used to fund additional government spending. General government expenditure excluding privatisation proceeds as a percentage of GDP on steady downward trend since 1982-83. Continuation of downward trend indicated by latest public expenditure plans.

(c) More emphasis should be put on deregulation as cure for unemployment and less on policy alternatives involving additional government expenditure (para 23).

Line to take

- Apart from expenditure on employment measures designed to improve operation of labour market eg training, the government has never seen additional public expenditure as a cure for unemployment. Solution lies in more flexible labour markets, and moderation in wage settlements. The Government believes it is the role of macroeconomic policy to reduce inflation, and of microeconomic policy to improve the functioning of markets. Together these policies create conditions for sustained growth and genuine reductions in unemployment.

(d) Achievement of zero inflation made unnecessarily difficult by downgrading of quantity of money supply as indicator of policy and instrument of control, and substitution by indicators that have little to do with money supply - exchange rate, PSBR, interest rates, even money GDP (paras 30,35). No coherent monetary policy (para 10), too subjective (para 31). Quantity of money should be restored to centre of monetary policy and should have relied more on narrower measures of money because £M3 affected by financial innovation (para 32, 34).

Lines to take

- Government remains committed to firm monetary policy that keeps steady downward pressure on inflation. Has targets for both M0 and £M3. More weight given to M0 because £M3 increasingly erratic indicator (as submission acknowledges, para 31). M0 has behaved more predictably and is better suited to targetting. But need to weigh developments very carefully against other evidence; monetary growth monitored closely alongside other indicators of monetary conditions.

- Target aggregates have special status, but mechanical rules cannot substitute for intelligent assessment taking all available evidence into account. Visible benefit from firm adherence to monetary discipline - inflation under 4 per cent and economy now well into sixth successive year of steady growth.
- Wrong to argue that interest rates, exchange rate and money GDP have little to do with monetary conditions. Short-term interest rates are the essential instrument of monetary policy; will be held at level consistent with inflation objectives. No exchange rate target, but favour level which will exert degree of financial discipline; sharp falls in exchange rate can add to inflationary pressures and expectations. Control over money GDP is essential to control of inflation; can be interpreted as velocity adjusted money supply. Excessive growth of money GDP would clearly indicate lax monetary conditions and accommodation of inflation.

(e) Lower or zero PSBR not desirable if achieved at expense of tax cuts (para 36). Too much emphasis on PSBR in recent years (para 38), significance exaggerated (para 44). Switch to looser fiscal policy and tighter monetary policy could allow tax cuts consistent with further progress towards zero inflation (para 38). Tax cuts should not be forgone merely to reduce interest rates (para 43). Far more important to cut taxes than to hold PSBR at level which is already excessively austere (para 46).

Lines to take

- Government not aiming at zero PSBR, but Chancellor already made clear there will be no relaxation of MTFs path for PSBR published at Budget time (1 $\frac{3}{4}$ per cent of GDP for 1987-88). Fiscal stance not excessively austere - OECD estimates of general government financial balance as a percentage of GDP show only US with larger deficit among G5 countries and UK just above G5 average.

- Essential that fiscal policy supports monetary policy with a PSBR that can be financed in non-inflationary way. The Government remains committed to reducing tax burden, but only when prudent to do so and not via fiscal relaxation that might prove unsustainable. The MTFSS is intended to promote balanced non-inflationary growth and this objective will not be put at risk by fiscal laxity.

Deregulation (general)Line to Take

It is recognised that regulations divert the time and resources of business away from the primary task of wealth creation and consequently the creation of employment. Thus the Government's policy is to remove regulations which are unnecessary or impose burdens out of proportion to their benefits and to simplify those which are unduly complex. The Government agrees that better regulation is part of the process that will enable jobs to multiply.

The White Paper "Lifting The Burden" (published July 1985) built on the progress made in tackling regulations since 1979 by proposing 80 proposals for further deregulation. Considerable progress has been made on these and a further White Paper "Building Businesses ... Not Barriers" (published May 1986) described 80 more proposals.

PROFIT RELATED PAYBackground

The Institute supports the PRP proposals but argues that the tax concessions envisaged in the Green Paper are excessively modest. As you are aware the proposed level of relief will be higher than suggested in the Green Paper.

Line to Take

Your representations on this point will be considered.

Wages Councils

The IOD paper claims that if the remaining Wages Councils were abolished there would be a significant impact on employment.

Line to Take

If this is raised you should say that the Government has reformed the system of Wages Councils provided for in the 1979 Wages Act and replaced it with a new system giving Councils reduced and simpler powers; removed from the Secretary of State for Employment the power to establish councils, and introduced simpler procedures for abolishing and amending the scope of Councils - the Government favoured reform rather than outright abolition because simplification of the system has removed many of the detailed inflexibilities which existed previously; reduced the bureaucratic burdens on employers and helped to promote job opportunities, particularly for the young.

Further Points

Reform rather than outright abolition accepted by Ministers because political costs of abolition too high. The majority of responses to consultation opposed outright abolition (including the Bow Group, the Tory Reform Group and Centre Forward). The right balance had to be struck therefore between the desire to promote greater flexibility in the labour market and meeting the needs of employers and employees. There is a greater political cost involved in abolition - far greater than that resulting in accusations that the Government is not committed to do anything about unemployment by freeing up the labour market. Something had to be done but to go much further would probably achieve little.

PARA 23 : DEREGULATION OF RENT CONTROLS : BRIEFING

FACTUAL

RECENT MEASURES TO STIMULATE PRIVATE RENTED SECTOR:-

Extension of Assured Tenancy Scheme: under this scheme reputable landlords, who have to be approved by the Secretary of State, can let dwellings at market rents to tenants who have similar security of tenure to that enjoyed by business tenants. Until now only new dwellings could be let as assured tenancies, but from the beginning of this year it has been possible to let renovated dwellings. These must satisfy basic fitness standards, and at least £4000 (£5000 in London) must have been spent on each dwelling.

End of phased rent increases: an Order currently before Parliament will, if approved, end the requirement that when a rent officer approves an increase in fair rent the increase must be phased in over two years. In future the increase can come into effect immediately. This should slightly improve the return to landlords.

No requirement to register fair rent on shorthold: another Order now before Parliament will end the requirement that fair rents must be registered on shorthold leases in London. Shortholds are leases of between one and five years where the land has certainty of repossession at the end. There are many more shortholds outside London, where there is no requirement to register a fair rent, than in London. It is hoped that this change will increase the use of shorthold in London and reduce the number of empty dwellings in the area of greatest housing shortage.

Financial help for renting: assured tenancy schemes run by housing associations are eligible to apply for 30% Housing Association Grant on their capital costs. The balance of the finance comes from the private sector. This makes the economics for investors much more attractive when combined with market rents. In inner city areas UDG may be available for some assured tenancy schemes

to a wider range of developers.

Shared ownership made easier: where someone part buys, part rents his home, buying extra shares when he can afford it. It will be made easier for the private sector to run such schemes when, in the spring, the renting element is freed from Rent Act control and from the provisions of the Leasehold Reform Act, provided the landlord is constituted as a Housing Association.

POSITIVE

The Government is committed to stimulating the private rented sector. This issue will be addressed in a new Parliament. It has already taken a number of steps to stimulate the sector (see Factual).

DEFENSIVE

Increased mobility advantages to combating particularly if accommodation more freely available in areas where labour demand greatest. Limited impact however as the areas are mostly in areas of high house prices (eg SE). High renting costs act as disincentive. Market rents will seldom give landlords a sufficient return in capital to stimulate significant expansion. House purchase becomes a favoured option for most tenants at rent levels below those sufficient for landlords to expand. Various options for altering this balance have not been fully explored but would have an adverse effect on public expenditure.

(i) **EDUCATION**

There are two positive themes which the Chancellor can take up with the Institute: increased choice in education through the establishment of City Technology Colleges (CTCs) and the greater role which the Government sees for parents in the education system. This last point in particular echoes the Institute's comments (paragraph 17 of their paper) that, "there is no real alternative to parent power ... for improvement of ... educational services".

CTCs. The Institute will be aware of the Government's initiative to establish up to 20 CTCs in urban areas. They will be for 11-18 year olds; will be independent but provide free education with a bias towards science and technology, and will be run by charitable trusts. It is intended that CTCs' promoters will meet all or a substantial part of their capital costs. Grants from DES for running costs will be determined on the basis that they should cover what might reasonably be spent on LEA maintained schools serving similar localities. CTCs will address the urgent need better to equip young people for adult and working life. They will provide an alternative to the existing LEA monopoly.

Parent power. The Government recognises the importance of greater involvement of, and say for, parents. That was one of the three key issues for the future of education highlighted by Kenneth Baker in his speech on 9 January to the North of England Education Conference. As he explained then, the Education Act 1986 will extend parental representation on school governing bodies. It will for the first time require that members of the local business community should have a place on most governing bodies. The Act also requires LEAs to delegate some direction over spending to governing bodies - the power of the purse to which the Institute referred. LEAs will be required to give such discretion at least in respect of books, equipment and stationery. The Government aims to move as quickly as possible to extend that list of items on which delegation is obligatory.

Education Vouchers

Although not mentioned in terms in the Institute's paper, they may raise education vouchers. DES' advice is that, if vouchers are raised, the Chancellor should say no more than that they are no longer on the political agenda.

(ii) PRIVATE HEALTH CARE

Line to Take

(i) The Government wants to see a continuing expansion of private health care.

(ii) Since 1979 there have been increases in -

- the number of people with private health insurance (from 2½ to 5 million).

- the total amount of private health insurance premiums (from £100m to £400m).

- the number of private hospitals (from 150 to 200).

- the number of private hospital beds (from 6,500 to 10,000).

(iii) Pleased to hear of any specific suggestions the Institute has for altering the balance of public and private health care.

(iv) (If pressed on tax relief for insurance). Private health insurance has grown considerably under our administration. We helped that by giving tax relief to individuals earning under £8.500 who are insured in group schemes. Do the Institute have any ideas for fiscal changes in this area?

[NB Any wider extension of tax relief for private health insurance would have an initial deadweight cost of about £100 million to the Exchequer in respect of existing insured people].

(iii) ECHR JUDGMENT ON COMPENSATION FOR SHIPBUILDERS

Background

Sir William Lithgow was one of seven applicants to the European Court who claimed that the compensation paid under the Aircraft and Shipbuilding Industries Act 1977 was inadequate and was contrary to the European Convention of Human Rights. The applicants took the case to the European Commission of Human Rights after the Government's refusal announced by Sir Keith Joseph on 7 August 1980 to amend the compensation terms payable under the Nationalisation Act. The Government maintained that while the system of compensation laid down by the Nationalisation Act could rightly be criticised, and had been strongly criticised during its passage through Parliament, it was not contrary to the Convention of Human Rights. The European Commission of Human Rights supported the Government's view but referred the cases because of their importance to the European Court in 1984. The Court in 1986 also found in favour of the Government taking the view that a legislature nationalising the property of its nationals has a wide measure of discretion, and the Court should not intervene unless the compensation were manifestly without reasonable foundation.

Line to Take

The IOD claim that the case provides a precedent for any future British Government wishing to expropriate the industries privatised by the present Government and to pay little or no compensation. The Court's stated reluctance to intervene unless compensation were manifestly without reasonable foundation does in fact leave the situation unchanged. This judgement gives no comfort to those who might consider legislating for nationalisation with little or no compensation.

The success of subsequent privatisations shows that private investors do not share IOD fears at this point. It is the policy of this Government that there should be fair compensation for any appropriation of private assets by the state. (But as the

then S of S for Industry said in August 1980 (PQ attached) there was no satisfactory way to alter the 1977 compensations terms to the former owner of the aircraft and shipbuilding companies).

INDUSTRY

Shipbuilding and Ship Repairing

Mr. Buck asked the Secretary of State for Industry whether he intends to introduce legislation to enable the nationalised shipbuilding and ship repairing companies to be offered back to private enterprise; and if he will make a statement.

Sir Keith Joseph: The Government have been considering whether to introduce private sector capital into shipbuilding and ship repair. This review was begun when there were some signs of recovery in the market and there was still a reasonable expectation that British Shipbuilders would be able to keep within its financial limits this year without the need for substantial corrective action. As the Minister of State told the House last week, these

hopes have not been realised and the industry faces a period of continuing uncertainty about its future shape and viability. We have accordingly decided to defer proceeding at this stage. I know that this decision will be a disappointment to many, including all those who think that private enterprise offers a better hope for jobs and prosperity in the industry than public ownership. We intend to introduce private capital into the industry as soon as appropriate.

We recognise that some previous owners and many members of this House and of the public believe that the terms of compensation imposed by the 1977 Act were grossly unfair to some of the companies and we share this view. We have explored every possibility to right the injustice done by the previous Government, but to our very great regret we have concluded that amending legislation to establish new compensation terms retrospectively would be unjust to the many people who sold shares on the basis of the previous terms.

We had to recognise, moreover, that had we wanted as an alternative to offer the companies back to the former owners legislation would have been required. This would inevitably create a long period of uncertainty for the industry during the passage of legislation, the preparation of the detailed offer to the former owners and the consideration of the terms. Moreover we cannot return to the former owners that which was taken from them because the assets and liabilities of the companies concerned have changed. In the case of the aircraft industry the changes are quite clearly irreversible. We have there-

INSTITUTE OF DIRECTORS' REPORT:

"THE DIRECTION OF TAX REFORM": COMMENTARY

Introduction

1. This note outlines the principles and assumptions underlying the IOD's proposals, and summarises the proposed tax reforms. Comments on the proposals follow with a suggested line to take at the end.

Principles

2. The IOD claim that their proposals are based on 10 "principles", described on pages 5-8 of their report. These can effectively be boiled down to four assertions:

i) a low tax, low public spending economy (with functions such as health and education perhaps transferred to the private sector) is inherently better than the opposite;

ii) capital is the "motive force of capitalism", and so taxing its ownership and transfer (particularly within the family) is especially pernicious;

iii) the tax system should include the minimum necessary number of taxes, which should be at a low rate. The IOD quite specifically say they "are generally opposed to broadening the tax base" (para 19); and

iv) tax cuts for one group benefit everyone, so explicitly aiming for equity is unnecessary.

Assumptions

3. The Institute assume that tax cuts are financed by equal cuts in public expenditure. Appendix E of their paper (pages 41-48) includes a reference to a programme of unspecified reductions in public expenditure of £8½ billion a year for the next 3 years, with a further £24 billion cut spread over the following 7 years. The total reduction is £49½ billion by 1996-97, or about 30% of planned 1987-88 public expenditure.

4. The IOD's figures assume a static economy: they say they take no account of any increase in tax Revenues which might result from the supply-side effects of cutting taxes, nor do they allow for any economic growth, or other changes.

Proposals

5. The table at page 46 of the report sets out the proposed tax cuts and reforms up to 1996-97. Briefly, these include:

i) the abolition of all capital taxes - first inheritance tax, then CGT, and finally stamp duties; possibly also income tax on investment income.

ii) the progressive reduction of income tax, corporation tax and VAT rates to a single rate of just 10% (or,

alternatively, a 20% tax rate on either incomes and profits, or expenditure with no tax on the other);

iii) the VAT threshold increased by stages (up to £100,000);

iv) new tax reliefs for overseas investment, private education and health; and

v) reduced duties on alcohol and tobacco.

The IOD also suggest, for the long term without including in their costings, first abolishing all tax on investment income, and, second, abolishing car tax and all excise duties, (although perhaps replacing motoring duties by a "congestion tax".)

Comment

6. The Institute's assumptions are also suspect. The total annual cost of their proposals, at almost £50 billion by 1996, represents substantially more than the present social security budget, or more than 2½ times the present defence budget. Such a scale of savings cannot be regarded as feasible within anything remotely resembling present policies. While it is true that their figuring excludes the increase in tax revenues to be expected from economic growth, it also excludes the likelihood of demands for increased standards of public services to match increasing living standards generally; their calculations also completely ignore the effects of declining oil revenues.

7. These proposals are essentially a longer-term development of ideas which the IOD have put forward before - notably in

this and earlier years' Budget representations. They are probably intended more to provoke and extend the debate on the potential scope for tax cuts and reforms, than as a serious blueprint for reform.

8. The IOD's basic argument for a simple tax structure, with low-rate taxes, are sensible, standard tax theory points, though the majority of commentators would argue for a wider tax base whereas the IOD say they are "generally opposed to broadening the tax base." And their case for a low-tax, low public spending economy is one this Government would no doubt want to support in principle. However it is difficult to support their argument that capital taxation is inherently objectionable. Penal capital taxes could obviously have a damaging effect on wealth-creation, just as penal income taxes can have a damaging effect on incentives to work. But it is hard to see why more modest levels of tax should be unreasonable on capital while reasonable on income. In fact every single OECD country has some form of tax on death or inheritance.

9. In particular, realised capital gains are very similar to income in the command they give over resources and it is hard to see the mass of people who pay tax on their earnings finding it acceptable to see investment income or capital gains escaping tax altogether. The IOD's asserting that gains (ie tax cuts) for one section of the population (ie the rich) benefit everyone might be true in absolute terms - though this would be difficult to prove - but cannot disguise the fact that the relative gains would be much larger for the wealthy.

10. Finally, it is worth noting that there could be significant distortions to behaviour from the IOD proposals to narrow the tax base by removing capital transfers and gains from the tax base entirely, to leave the VAT base unchanged, and creating major new income/corporation tax reliefs for overseas investment, private education, etc. It is the unrealistic nature of their assumptions on Public expenditure which allows the IOD to think that they would have money for these reliefs.

Suggested line to take

11. Share objective of reducing burden of tax. But there is no evidence that there is scope for cuts on the scale envisaged by IOD. Their proposals reject equity as a proper objective of the tax system, and, by including complete abolition of all capital taxation, would favour the rich.

**MINUTES OF A MEETING AT SOMERSET HOUSE AT 2.45 PM ON WEDNESDAY
10 DECEMBER 1986 TO DISCUSS THE INSTITUTE OF DIRECTORS' BUDGET
REPRESENTATIONS**

<u>Those present</u>	Mr Isaac	Mr Sutherland
	Mr Painter	Mr Anson
	Mr Walker	Mr Davies
	Mr Kent	Mr Chown

1. The meeting had before them the Institute of Directors' Technical Representations for the 1987 Budget and Finance Bill.

GENERAL

Quality of Fiscal Legislation

2. The Revenue noted the IOD's comments on the technical standard of the 1986 Finance Act.

Structure of the Taxes Acts

3. The IOD suggested that the opportunity provided by the forthcoming consolidation of ICTA should be taken to change to the United States system, grouping related provisions together in a block with spare section numbers for future additions.

4. The Revenue said that they had discussed such an approach with the Solicitor and Counsel. It would require a major revision of the statutes and insofar as it affected the personal style of legislation drafting it would involve the responsibility of the Lord Chancellor. The current consolidation would necessarily be in the present style.

Amendment of the Taxes Acts

5. The Revenue noted the IOD's view that provisions should be amended by the wholesale replacement of the old sections rather than by reference.

6. As for the IOD's suggestion that full revised texts of provisions to be amended by a Finance Bill should be published at the same time, the Revenue said that to undertake this across the board in present circumstances raised difficulties of resources and money 'cleansing' schedules were published where appropriate and possible. However, the Parliamentary draftsman did not have a full amended text of the Taxes Acts (eg on word processor), and to publish this when the Finance Act was published would represent a considerable additional task. Amendments during the passage of the Bill would complicate the position. The question was chiefly for Counsel, HMSO and, of course, Parliament. The Revenue noted Mr Sutherland's suggestion that the operation should be privatised.

Sections and Schedules

7. On the IOD's suggestion that two or more changes of substance should not be combined in a single section or schedule, the Revenue pointed out that this was largely a matter between Ministers and Parliament.

Delegated Legislation

8. The IOD felt that minimum use should be made of delegated legislation, and that where delegated legislation was used for reasons of urgency the provisions should be incorporated in the primary legislation in the following Finance Bill. They mentioned in particular the IHT provisions on double charges, where the regulations were still to come even though a number of occasions of charge within the provisions had already occurred.

9. The Revenue said that they had no doubt that it would be possible to find a practical solution to any such cases. The tax could not have been pre-announced, and in all the circumstances it had been inevitable that some of the detailed regulations had to follow later. More generally, the use of delegated legislation was a matter for Ministers and Parliament. The increase in recent years brought the Revenue closer to the practice for other Departments' legislation (including Customs and Excise). Many of the regulations arising from the 1986 Bill were in categories which the IOD regarded as suitable for secondary legislation; and in some cases the use of regulations allowed opportunity for consultation.

Consultation and Publication of Draft Clauses

10. The Revenue noted the IOD's view that consultation could improve the technical quality of legislation, and agreed that goodwill was important on both sides. On the IOD's suggestion that more consultation, perhaps on a strictly confidential basis, would have helped in 1986, they said that this was a matter for Ministers, who had to bear in mind that there were both political and market constraints in some areas, and an approach could sometimes put a consultee in an impossible position. They did, however, welcome consultation where possible, for example the recently published draft clauses on dual resident companies.

Furniss v Dawson

11. On the IOD's point that any changed interpretation of the law should be made public, the Revenue said it was their normal practice to do this. In some cases, where it had been suggested that there had been a "change of practice", there had in fact been no change of practice but the application of Revenue's existing understanding of the law to different circumstances and new issues.

12. Mr Sutherland added that the Revenue should give early notice of intention to appeal in important cases. Several people had entered into Dawson-type arrangements which they might not have done if they had known the Revenue would contest the case in the Lords. The Revenue noted the view, but said that the Ramsay principle had by then already been established, and Dawson was only a particular application of that approach.

Technical Division

13. The Revenue disputed the IOD's claim that the technical quality of legislation was the cause of reduced access to TD for practitioners. They said that TD had to deal with enquiries from Ministers and their policy advisers, districts and (mainly London-based) practitioners. A shortage of resources had forced a cut, and it had had to fall on enquiries from practitioners. But it was still open to them to approach TD direct on issues arising on new legislation or changes of practice. The normal line of approach for practitioners was, of course, the District Inspector who continued to consult TD as necessary. The IOD accepted that some practitioners had used TD as a cheap alternative to Counsel.

SCHEDULE D

Exchange Rate Fluctuations

14. The IOD considered a revised tax treatment of foreign currency gains and losses to be a top priority. Gains should be taxed, and losses should get tax relief. Legislation was required.

15. The Revenue noted that the earlier provisional Statement of Practice had not led to a consensus. The question of exchange fluctuation had been given high priority since the Finance Bill. The essential purpose of the revised draft Statement of Practice was to provide the - necessary - basis for settling existing cases. It was hoped that Ministers would feel able to say something about their attitude to the possibility of legislation when the Statement of Practice was published. There were clearly formidable problems under a root and branch approach, not least the uncertainty which could be created for the Exchequer. Meanwhile the IOD would be joining in the confidential discussions of the revised draft Statement with P4.

Costs of Equity Finance

16. The Revenue noted the IOD's proposal that S.38 FA 1980 should be extended to cover equity finance. 'Nothings' generally were kept under review. But it was arguable that there was a valid distinction in principle between the cost of raising equity capital which determined the ownership of a company and other finance. As a practical matter relief of the type sought would be likely to be costly if extended to the costs of all equity finance and complex if more closely focussed on new equity.

Abortive Capital Projects Post-trading Expenditure

17. The Revenue noted the IOD's proposals, but saw serious difficulties which a proposal to allow such a deduction for capital expenditure. The IOD were asked for their view of the scale of the problem on post-trading expenditure.

Capital Allowances - Commercial Buildings

18. The IOD said that there was no justification for excluding capital expenditure on commercial buildings from relief. They felt that arguments based on cost were unacceptable: cost was no ground for maintaining injustice. The Revenue said that the debate was not on principle (though it needed to be recognised that many commercial buildings in fact appreciated over a significant part of their lives). But cost to the Exchequer had to be recognised as a relevant factor: even if costs were reduced by limiting relief to new expenditure, the annual revenue loss could rise over time to well over £1 billion. The proposal was of course a budgetary matter for Ministers, rather than a technical issue.

Capital Allowances - Industrial Buildings

19. The Revenue noted the IOD's proposal to move the 25% limit from an expenditure to an area basis.

20. The IOD felt strongly that the basis of relief for expenditure on second hand buildings was unjustifiably asymmetrical in favour of the Revenue, particularly where the original costs predated a period of high inflation. Administrative complexity was not a convincing argument to a businessman who paid many times the original cost. The Revenue said the writing-down regime for industrial buildings in general was generous and the original cost basis provided an objective yardstick of qualifying expenditure and avoided a need for apportionment of purchase price between land and buildings. The existing basis was well understood and the proposal would, clearly, be a move towards greater complexity.

Capital Allowances - cars

21. The IOD proposed an end to the restriction on allowances for cars costing over £8,000. They saw no logic in the distinction, which created extra work for the Revenue and for taxpayers. Since relief was given by way of a balancing adjustment the distinction served no purpose and helped no-one but the tax-planning business. The Revenue noted the comment: the matter was one for Ministers.

CORPORATION TAX

Change of Ownership

22. The IOD said that S.483 ICTA prevented desirable ownership changes from occurring. They could not give examples because

abortive plans often went no further than the board of a company and its in-house tax adviser. Some rescue operations had been frustrated solely because the trading losses were ineligible for relief. Their view was that "major change" was interpreted too narrowly. They gave the example of a change from retail to wholesale trading as one which should not be caught.

23. The Revenue said that unfortunately work on a revised draft Statement of Practice had had to be put to one side because of Finance Bill and other commitments. If an acceptable SP could be produced it would be easier to see the strength of the case for amending the legislation.

Trading Losses

24. The IOD's view was that brought-forward trading losses should be capable of offset against the profits of another trade within the same company or another group company. The Revenue said this would introduce a significant difference of treatment between groups and other traders, and could lead to cross-subsidy of unprofitable activities simply by virtue of the tax relief. There were other considerations: the proposed change could be costly and complex.

Group Relief

25. The Revenue noted the IOD's representations. On the question of time limits, this was an issue to which they could return after implementation of some of the Keith Committee's proposals.

ACT - Group Relief

26. The IOD suggested that ACT should be freely transferable within a group: they thought there were potential problems in the case of a non-wholly-owned subsidiary. The Revenue questioned the need for change. Profits paid out by subsidiaries as distributions to minority shareholders were profits of the subsidiary itself and there was no reason why ACT on those dividends should be capable of offset against CT on the profits of other companies within the group.

ACT - Capital Gains Imputation

27. The IOD felt that it was a major anomaly that ACT could not be set off against capital gains.

28. The Revenue recalled that when the imputation system was introduced in 1972, there had been strong representations from industry that companies did not normally distribute capital gains. The IOD felt this was still probably true, but there were occasions - eg on the sale of Reuters - where gains had been distributed. In earlier years with an effective 51% tax rate, the treatment had seemed unreasonable, but the reduction in CT rates had now accentuated the issue. Those caught in the

trap were on the whole small businessmen who had not been alert to the trick of owning their premises as an individual and leasing them to the company. The double CGT on selling their business would create bitterness at an unfair system. The Revenue noted their views.

ACT - Overseas Income

29. The Revenue explained that the IOD proposal to allow DTR for credit against ACT would be a fundamental breach of the imputation system: shareholders would be receiving the benefit of tax credits while the ACT underlying the credit might not have reached or stayed with the UK Exchequer.

S.506 ICTA 1970

30. The Revenue said Ministers were aware of the IOD's view that relief should be given for underlying tax where dividends were paid out of pre-merger profits after the merger of overseas subsidiaries.

Controlled Foreign Companies

31. On the IOD's concern that the Revenue were showing excessive zeal in applying CFC legislation the Revenue explained that they were well aware of the need to use information powers responsibly. The legislation was operated and controlled by a special unit in Head Office. No notices under S.90 FA 1984 had yet been made.

32. The Revenue said they had not yet been able to define acceptable mixing or averaging. But one would expect a mixer company to pass the acceptable distribution test. The Revenue asked what function a mixer company could serve other than the exploitation of DTR (which would justifiably fall within the CFC charge). Mr Chown undertook to send Mr Painter a note outlining what he saw as the commercial problem.

S.482 ICTA 1970

33. On the IOD's suggestion that S.482 should be abolished the Revenue pointed out that Ministers had said they intended to keep S.482 but to review the general consents. The Revenue were awaiting the IOD's response on consents.

Small Companies Rate of CT

34. The Revenue noted the IOD's representation.

Close Companies Apportionment

35. The Revenue said they could not usefully add anything to what Mr Green had said in his letter of 15 February 1984. In view of the administrative complexity involved in deciding what part of dividends related to trading profits Ministers would need hard evidence of the seriousness of the problem before considering changes.

UNINCORPORATED BUSINESSES

Disincorporation

36. The Revenue noted the IOD's suggestion that the higher rates of income tax on business profits should be reduced or that unincorporated businesses should be able to opt for company tax treatment. There were problems of ring-fencing the trading activities of an individual; and a balance had to be kept between the relative tax treatment of incorporated and unincorporated businesses. This sort of question highlighted the continuing need for distinguishing between different types of income - issues which could become more acute if the schedular system was abandoned as some suggested.

37. Mr Isaac added that, in connection with the deregulation exercise, they were committed to look at these issues. The options were to adopt an early legislative approach, or to consult first (with implications for timing of any legislation). The IOD preferred the latter course.

INCOME TAX

Benefits in kind - £8,500 threshold

38. Nothing new was said on this matter.

Benefits in kind - Cars and Fuel

39. The IOD said that a further rise in the scale could create pressure for a return to taxation on an actual basis, as well as penalising not the rich but the middle manager. The Revenue said that the correct measure of the benefit was, arguably, the availability of the car, rather than its precise private mileage. In any event, it was a question of judgement how close the scale charge came to the value of the benefit. One view was that it was still a long way short.

40. The Revenue said Ministers were aware of the IOD's point of view on the fuel scale and petrol prices.

Permanent Health Insurance

41. The Revenue noted the IOD's view that PHI premiums should be deductible for income tax. They added that PHI was not an acceptable feature of a retirement annuity contract as the IOD asserted.

CAPITAL GAINS TAX

Rate of Tax

42. This was a matter for Ministers.

Pre-1982 Inflation

43. The Revenue explained that Ministers had decided not to extend inflation relief to the 1965-82 period partly on grounds of cost. Subject to the behavioural effects, it could cost up to 70% of present CGT revenue. A 10-year cut-off would allow real as well as inflationary gains to escape taxation. The proposal would also reintroduce the complexity of the 1982 arrangements making share pooling impossible. Moreover for periods before 1982 or after 1985, (when share pooling was possible), not all the necessary information was available. The IOD asked why claims could not be checked against income tax records. The Revenue said that not all taxpayers returned tax returns or, by and large, records were not kept for long enough.

Annual Exemption

44. The IOD suggested that small companies could be helped by an annual exempt amount. The Revenue said that the exemption for individuals and trusts was primarily a de minimis provision to relieve both taxpayer and tax office from the need to undertake complex calculations for small amounts of tax. The same consideration did not apply to companies, who were not in any event on all fours with individuals in that they had the advantage of being able to set trading losses against gains.

45. Turning to the question of carry-forward of unused annual exemption, the Revenue pointed out that this would frustrate the whole point of the exemption in giving de minimis relief in a given year. People would need to undertake a whole new bureaucratic burden of calculating and recording very small disposals each year, in order to arrive at the unused amount to be carried forward.

Losses

46. The Revenue noted the IOD's proposal for carry-back of capital losses but said it was inconsistent with the tax treatment of losses generally.

Roll-over Relief

47. The Revenue noted the IOD's suggestion for extending roll-over relief to shares in certain circumstances. But this would be a major change in principle and could be seen as a precedent for giving roll-over relief on portfolio reinvestment. In general shares were not within the intended scope of roll-over relief.

48. As for the IOD's view that, in the case of pre-1965 assets, the whole of the trade use should be taken into account even if a proportion of it fell before 6 April 1965, they explained that since it was only gains from 1965 which were brought into charge, the law looked only at the use of an asset since that date. It was illogical to argue for a pre-1965 numerator and a post-1965 denominator.

S.278 ICTA 1970

49. On (a) the Revenue asked for clarification whether the IOD meant the time limit for making the claim or the time limit to which claim should relate. The IOD said they meant the former. The Revenue pointed out that allowing S.177(2) to run back could create substantial administrative work and uncertainty with regard to previously settled assessments. The IOD said they would provide examples of the problem, if possible.

50. As for (b), the Revenue said that this would defeat the purpose of S.278 which was that gains should crystallise at that time.

Transfer of Subsidiaries

51. The Revenue agreed that the decision in the Westcott v Wollcombers Ltd case appeared to create an anomaly. Their understanding was that the Court of Appeal was to consider the case in May.

INHERITANCE TAXS.104 Finance Act 1986

52. The IOD felt that the provisions of the regulations should be incorporated into primary legislation in the 1987 Finance Bill. They also asked about consultation, and when the regulations would be laid. The Revenue said regulations were being drafted and would be laid in the new year. They were not certain whether, in this case, outside bodies would see the regulations in draft.* The Solicitor had had a heavy burden of drafting.

Potentially Exempt Transfers

53. The Revenue noted the IOD's view on the "parity" question. The Revenue said that the "loss of parity" was not only an avoidance-driven measure. Ministers had taken a policy decision to exempt outright giving between individuals, but not into trust. The only exceptions were where the circumstances created special problems in the way of an outright gift (ie to infants or the disabled), hence the admittance of A&M trusts and trusts for the disabled.

Businesses and Agricultural Property Relief

54. The Revenue disputed the IOD's case for giving relief if the property qualified at the date of the gift. Their comparison with the situation under CTT was not valid. The purpose of the relief was to allow for the situation where the business asset was not liquid and incapable of generating funds to meet the tax. IHT had changed the situation in that no charge was now made on a lifetime gift of a business asset to an individual. If the tax was payable only on the death of the donor. If at that time the asset had been sold, there was no

case for relief. The IOD mentioned some special cases (eg on winding up); but the Revenue said that these did not detract from the general argument.

Burden of the Tax

55. The Revenue noted the IOD's calculations: it would be naive to think that Ministers were not aware of the comparisons. The burden of the tax was a matter for Ministers to decide in the light of what they could afford.

Gifts within five years of death

56. The Revenue noted the IOD's views and said this was a matter for Ministers.

SHARE INCENTIVES AND INVESTMENT

New Investment in Trading Companies (Loi Monory)

57. The Revenue pointed out that, despite the IOD's strictures, PEPs were to be widely marketed, including by the High Street banks. The Loi Monory/Delors approach suffered from complexity (because of the need to police the front-end loading) and it also necessarily acted through intermediaries. Its future was currently under review in France.

Approved Share Option Schemes

58. The Revenue noted the IOD's view that the ceiling in para 5 schedule 10 FA 1984 should be removed.

59. The IOD claimed the Revenue were applying the 10% "material interest" test incorrectly. The Revenue said they were consulting the Solicitor on this point.

60. On the IOD's proposal that the 3-year minimum period between grant and exercise of approved options be abolished, the Revenue said Ministers had been concerned that the beneficial tax arrangements might be discredited if options were "annualised" and seen as an avoidance device.

61. On takeovers and mergers the Revenue said that Ministers had taken a conscious decision to allow early exercise of an option in such circumstances, but without the income tax benefit. They had heard of no severe practical difficulties in this area.

Section 79 FA 1972

62. The IOD would write with suggestions for reform of S.79 1972, which they felt could impose a penalty on bona fide arrangements and deter companies who were unsure of their ground. They asked what type of avoidance the provisions were aimed at. The Revenue said that, in broad terms, the two main kinds of avoidance prevented by S.79 were the manipulation of

value of "clogged" shares and the use of shares of unquoted subsidiaries of unquoted parents where value could be fed in from above. They would welcome helpful suggestions for reform.

Employee Controlled Companies

63. On the IOD's suggestion that the interest relief under FA 1983 for employees borrowing to buy shares in an ECC should be for an unlimited period, the Revenue said that the purpose of the relief was to facilitate the event of the employee-buyout itself and not to give a continuing subsidy. The IOD said employees who subsequently joined the company should also be encouraged to buy shares.

64. On the IOD's concern at the withdrawal of relief where employee control was lost, the Revenue said the provisions were already generous in allowing for temporary loss of control.

Pension Scheme Surplus

65. The IOD said that some older occupational pension schemes were prevented by their trust deeds from making refunds to the employer, and this had led to schemes being over-funded. The Revenue suggested that the 1986 Social Security Act - which gave the Occupational Pensions Board the power to authorise modifications of pensions trust deeds - should meet the problem. The relevant DHSS regulations were likely to be available in about April 1987.

cc Those present on IR side

Mr Pollard	Miss Rhodes
Mr Beighton	Mr Munro
Mr Lewis	Mr Battersby
Mr Corlett	Mr Thompson
Mr Houghton	Mr Cayley
Mr McGivern	Mr Reed
Mr Taylor Thompson	Mr Driscoll
Mr Johns	Mr Elliott
Mr Prescott	Mr Bryce

IOD 1987 BUDGET REPRESENTATIONS

Paragraph 89

IOD want a statutory right for workers to be able to choose to be self-employed - at present self-employed status depends on an objective test (are you in business on your own account?)

Background

The IOD have been pressing for some time proposals for a statutory right to choose to be self-employed. Their proposals have been raised in the House on a number of occasions by Mr Michael Forsyth MP. Essentially they propose that employers and workers should be free to agree self-employed status between them.

Line to take

Main objections are that the proposals would

- actually reduce the incentive to become genuinely self-employed (ie to launch out on your own). If the tax advantages of self-employment were available to people who were effectively employees, there would be no incentive to risk taking. This would frustrate Government policy rather than help it.
- involve a significant and immediate loss of revenue both in cash flow terms and in actual receipts.

(IR/DHSS/DE currently working on proposals which would make it considerably easier for employers and workers to obtain a definitive decision on individuals' employment status).

INSTITUTE OF DIRECTORS: 1987 BUDGET REPRESENTATIONS ON INDIRECT TAXATION

Factual

1. The Institute's representations (paragraph 90-94) are made up of four basic proposals:

- a) gradual reduction in the rate of VAT to 10%;
- b) do not extend the current coverage of VAT;
- c) increase the VAT registration threshold to £50,000; and
- d) reduce excise duties (IOD question philosophy of revalorisation).

2. These proposals are ^{very} ~~essentially~~ similar to those made in the Institute's June 1986 paper "The Direction of Tax Reform". In that paper, however, the Institute was pressing for a VAT registration threshold of £100,000.

Positive

1. Government shares general objective of reducing the burden of tax.
2. Chancellor made clear in 1985 Budget statement that he did not intend to make any further extension of the VAT base during the lifetime of this Parliament unless required to do so by EC law.
3. As explained in the White Paper "Lifting the Burden", the Government is seeking changes in EC rules to allow Member States more flexibility in fixing threshold levels.

Defensive

These proposals for

1. *L* Reductions in rates of indirect taxation cannot be considered in isolation. They need to be viewed in the context of the Institute's proposals generally.
2. Reduction in duty and tax revenues would need to be financed by cuts in public expenditure or increased borrowing.
3. Present VAT threshold (£20,500) represents maximum permissible within EC rules. As the Institute records, the recent UK Presidency saw some advance towards a higher optional threshold (c £24,000). Further discussions planned during Belgian Presidency.
4. Revalorisation of ~~excise~~^{excise} duties means no more, and no less, than maintaining real value of their revenue: other side of coin is maintaining real value of income tax allowances.

PARAGRAPH 82-84: NATIONAL INSURANCE CONTRIBUTIONS**PROPOSAL**

1. That the national insurance contribution system be aligned with that of income tax in the short run and reduced and privatised in the long run.

BACKGROUND

2. The IOD do not specify how alignment would take place but, given the proposal is designed to ease employers' administration, it would presumably involve introducing allowances and thresholds along the lines of income tax. Nor do the IOD specify how a private insurance system would work but it seems likely that premia would reflect the risk the individual represented, in terms of industry, status, health etc.

COMMENT

3. The IOD's proposal on alignment would undermine the contributory principle. Many part-time and low paid employees would cease to pay contributions, while if the proposal was to be revenue neutral the contribution rate for those earning above their allowance would have to be raised. If the upper earnings limit was maintained, a steep rise in the NIC rate would be necessary, while if the UEL was abolished, many high earners would have to pay large sums of NICs, which would bear no relation to the potential benefits. In either case, incentives would be badly affected.

4. Few would dispute the desirability of reducing NIC rates, but this can only be achieved as fast as the National Insurance Fund permits. Subsidising national insurance benefits out of general taxation undermines the contributory principle.

5. The Government has not been averse to privatising parts of the national insurance system. The introduction of personal pensions and incentives to set up occupational pension schemes, as well as the modification of SERPs, will reduce the number of those dependent on the state for the additional component of

their state pension. However, complete privatisation might present problems. With the basic retirement pension, the double burden on the current working generation of paying the previous generation's pension as well as funding its own pension might prove unacceptable. Myopia might result in people making insufficient provision for retirement with the result that the savings on retirement pension would be partially offset by increased supplementary pension expenditure. With unemployment and invalidity benefit, there would be insurance problems. Those most likely to become unemployed or disabled would have to pay high, possibly unaffordable, premia. Firms in financial difficulties would have to pay the highest premia, and it is likely that economic cycles and regional disparities would be exacerbated. In the long run many of the unemployed and disabled will still end up on social security, because the insurance companies will only be prepared to pay benefits for a limited period.

INHERITANCE TAX RATES AND BANDSPoint at issue

IoD urge -

- a. Abolition of IHT
- b. Reduction of rates by 5 pence in line with every penny off basic rate of income tax.

Background

IoD warmly welcome abolition of lifetime charge, but see IHT as next tax to be abolished. They attach importance to transmission of all assets to next generation, and regard IHT as generating "one-generation lifestyle" to detriment of economy. Failing abolition, IoD favour restoring 1975 levels of taxation by reductions in rates of IHT rather than increases in thresholds, and would make a 5 per cent reduction in IHT rates for every 1 per cent off basic rate of income tax. They argue that nominal cost would be abated by at least 60 per cent by supply side effects.

Line to take

- i. Costs of IHT changes significant. 1987/88 yield £1100m.
- ii. Major structural change last year allows unlimited tax-free transfers to next generation. This, and other changes make comparisons with 1975 less illuminating.
- iii. Substantial progress in reducing IHT burden since 1979
 - 7 year instead of whole life cumulation
 - threshold up from £25,000 to £71,000, now with statutory indexation
 - top rates down from 75 per cent (death and lifetime) to 60 per cent death and 30 per cent lifetime.
- iv. If resources available for IHT reductions, need to consider raising thresholds to reduce number of taxpaying estates as well as improving rate schedule.

INHERITANCE TAX: BUSINESS AND AGRICULTURAL RELIEFS

Point at issue

IoD want 100 per cent relief for all business and agricultural property, including minority shareholdings.

Background

Present reliefs reduce IHT value of property by -

- 50 per cent for interests in unincorporated businesses, controlling shareholdings (quoted or unquoted) and agricultural land farmed by owner.
- 30 per cent for minority shareholdings in unquoted companies, assets (land, buildings, plant and machinery) owned by partner or controlling shareholder and used in business, and agricultural land farmed by a tenant.

Line to take

- i. Increases in selective reliefs reduce resources for general reductions in rates.
- ii. No evidence that lack of 100 per cent relief has damaged businesses. Present level may be right balance between assistance for businesses and distortion of investment decisions for tax reasons, particularly with full tax shelter.
- iii. Full relief for unquoted companies has anomalous results. Minority shareholder (any size holding) in unquoted company (includes here USM) has full relief, but shareholder in quoted nil relief. And disincentive to full listing.

INHERITANCE TAX: SETTLED PROPERTY

Point at issue

IoD urge that interests in possession should be treated in the same way as gifts between individuals.

Background

Last year's change gave exemption to outright gifts between individuals (and by individuals into accumulation and maintenance trusts and trusts for the disabled) if made more than 7 years before death. Other transfers, including gifts into settlement, continue to be chargeable when made. IoD argue that parity between assets held on trust and held absolutely should be restored by giving the same exemption where a gift is made to a settlement with an immediate interest in possession, and where such an interest is terminated.

Line to take

- i. Change last year to encourage outright and unfettered giving.
- ii. Trust giving no worse off than before because of last year's change, but deliberately not given same advantage as outright gifts.
- iii. Need to look at link with discretionary trust regime - a complex area.
- iv. But recognise that the IoD proposal is widely suggested.

CAPITAL GAINS TAX

Proposal

Abolish CGT or, if this is not possible, restrict the scope of the tax to corporate gains.

Comment

There are two main objections to abolition. First, it would be extremely expensive - the total estimated yield for 1986-87 including the chargeable gains of companies is £1.85 billion. Secondly, the behavioural responses which could reasonably be expected as a result of taking all capital gains out of charge completely could have significant implications for the other taxes. Legislative action has already had to be taken against the more blatant forms of income conversion (eg accrued income scheme in 1985, offshore funds in 1984).

The alternative proposition, to tax only corporate gains and not those of individuals and trusts, would carry a full year cost of over £1 billion. It would also create distortions between the corporate and non-corporate sectors, and would make the incorporation of businesses unattractive.

Line to take

Government fully recognise the burden imposed by CGT and since coming to office have taken a number of steps to make the tax fairer and less oppressive. Abolition ruled out on grounds of cost and effect on other taxes.

CAPITAL GAINS TAX

Proposal

If abolition not possible, exempt gains on assets acquired before 31 March 1982 and held for more than 10 years.

Comment

This is a familiar point and a regular feature of the IOD and other representations.

The object of the proposal is to provide relief for pre-1982 inflationary gains: such relief ruled out in 1985 on grounds of cost. However, the proposal would also exempt real gains as well. This could have rather capricious effects; in particular, landowners would benefit to a far greater extent than investors in shares.

Schemes involving cut-offs have been examined in recent years (and as part of the review of CGT in 1984) but have been found to suffer from several drawbacks. First, considerable problems arise from the need to determine acquisition dates, especially in the case of pooled assets such as shares. Secondly, the schemes are costly since (as noted above) real as well as inflationary gains are exempted. A 10 year cut-off would result in the loss of a substantial proportion of the yield - possibly as much as seven-tenths.

Line to take

- Recognise impact of the tax on accrued inflation content of pre-1982 gains.
- Cut-off schemes expensive, complex and would cause market distortions.

CAPITAL GAINS TAX

Proposal

To reduce the rate of capital gains tax to 21% in order to create a differential between the rates of CGT and income tax.

Comment

A reduction in the rate of CGT would encourage income conversion, against which action has already had to be taken in recent years (eg accrued income scheme in 1985, offshore funds in 1984).

The proposal would also reduce the yield of the tax (estimated at £1.85 billion for 1986/87, including companies' gains), excluding behavioural changes, by perhaps £m600.

Line to take

- Government have taken a number of steps to reduce the burden of the tax.
- Any substantial reduction in the rate would carry a large revenue cost.

IOD Budget Representations

Employee Share Schemes: paragraphs 69 and 70

Claimed that the potential of the employee share scheme legislation is excessively constrained by its anti-avoidance provisions. Stated that proposals to meet anomalies are contained in IOD Technical Representations. Briefing on these follows:

Finance Act 1984 approved (discretionary) share option schemes

1. Point at issue. It is proposed that the overall ceiling on approved options should be abolished - suggested any limit will tend to be regarded as "norm" and many companies will not be able to afford to grant large portions.

Background. 1984 legislation restricts size of options that may be held at any one time by an individual to greater of 4 times remuneration and £100,000.

Line to take. Ministers regard present limit as generous, no plans to increase it. No evidence in applications for approval or early returns as to scheme operation that limit is in practice regarded as norm; but in remote possibility that this did happen, still no reason for removing limit - might only create even greater 'upward pressure'. [In relation to quoted companies, the Investment Protection Committees would not normally allow an individual to be granted options in excess of 4 times remuneration.]

2. Point at issue. It is suggested the Revenue have not applied the 10% 'material interest' test correctly.

Background. Individuals with a 10% material interest in a close company are not permitted to participate in an approved 1984 share option scheme. The Revenue's practice in determining whether an individual has a material interest for approved scheme purposes has always been to take account of shares over which he has an option.

Line to take. The Revenue are taking legal advice on this point. If the advice is that the effect of the law is not as we have always understood it to be, Ministers will no doubt wish to consider the position. The IOD will probably be aware of the recent Press Release announcing a number of minor technical changes to the present rules which will be enacted in the next Finance Bill.

3. Point at issue. The proposal is that the rule which requires a 3 year interval between tax-relieved option exercises should be abolished.

Background. To qualify for favourable CGT treatment, options granted under an approved scheme must not be exercised within 3 years of the last such option exercise which qualified for tax relief.

Line to take. Ministers' views on this remain unchanged. The condition is designed, as the IOD are aware, to counter the risk that options may otherwise be treated as a tax-efficient substitute for or addition to normal salary - companies could achieve this by enabling senior executives to receive annual options which, after allowing for the annual exempt threshold for CGT, would produce gains taxable at only 30% CGT compared with up to 60% IT for a comparable rise in annual salary. It is of course possible for employees to exercise options more frequently than at 3 yearly intervals but subject to IT liability on the gain.

4. Point at issue. It is proposed that tax relief should be provided on early exercise of FA 1984 options in the event of a takeover or merger.

Background. An option under an approved scheme may be exercised with the benefit of tax relief providing it has been held for at least 3, and not more than 10, years (and subject also to the '3 year interval' rule). Schemes may provide for options to be exercisable before the 3 year point but the gain would then be subject to IT.

Line to take. The prescribed conditions in the legislation are designed to secure some real association between the interests of the option holder and his employing company over a worthwhile period. That is why Ministers decided there should be a 3 year minimum period before options would qualify for relief. There is no question of removing this condition entirely and there would be difficulties in providing a special easement purely for takeovers/mergers. For example, earlier access to the reliefs in defined circumstances could open the door to possible abuse of the conditions in the legislation. Ministers have concluded that this sort of change would not be appropriate. They will however be looking at the issue again in future years.

Section 79 Finance Act 1972 should be reformed

Point at issue. It is claimed that the section is targeted too widely and can impose tax penalties on bona fide commercial arrangements - IOD promise to write separately with detailed suggestions for reform.

Background. Section 79 contains anti-avoidance provisions designed to prevent companies passing additional remuneration to employees in the guise of capital and therefore free of income tax.

Line to take. The IOD's detailed suggestions for the reform will of course be examined carefully when received. The legislation contains exemptions so that no 'growth in value' income tax charge arises where employees acquire 'normal' shares on normal terms. It is not therefore true to say that it is an 'in terrorem measure' to force companies granting shares/options to do so through approved schemes. The Revenue have always been willing, resources permitting, to look in advance at companies' proposed arrangements and advise on potential Section 79 consequences. No doubt largely for that reason very few Section 79 charges are in practice raised. It remains the case that Ministers are willing to look at detailed suggestions for amending or simplifying Section 79 which would not weaken its important anti-avoidance function.

IOD BUDGET REPRESENTATIONS

Paragraph 71 - PRP

Point at issue : IOD support proposals in July 1986 Green Paper on PRP but describe tax concessions proposed as "extremely modest". Improved tax treatment needed.

Background: Green Paper commended PRP, but in indicating that a tax relief might assist its adoption by employers made no commitment. It suggested relief for one quarter of PRP up to 5 per cent of employee's pay.

Line to take: Grateful for support for PRP concept. Decisions on whether to introduce a tax relief, and if so on its size, are for the Budget.

Point at issue

The IOD suggest that a new scheme should be introduced similar to the French Loi Monory/Delors which would give more tax relief for any investment in new quoted or unquoted equity of UK trading companies (or holding companies of trading groups) subject to a clawback of relief if the shares are disposed of within five years.

Line to take

The possibility of introducing a Loi Monory type scheme has already been carefully considered and rejected. It was concluded that the most effective way of stimulating more direct personal invest is to reduce taxation generally, and so increase the attraction of equity rather than introduce new distortions. There is, however, a recognised need for a fiscal incentive to encourage investment in small unquoted companies.

Background

The case for introducing a UK equivalent to the Loi Monory was considered in the period preceding the introduction of the business start-up scheme. Proposals for such a scheme were examined and discussed in detail by the working group on taxation and savings. The group found little enthusiasm for such a scheme because of its high cost, limited effectiveness and administrative complexity. Overall, it was concluded that the gains from such a scheme were unclear and unquantifiable, whilst the costs were likely to be substantial. There was considered to be a stronger case for a relief confined to investment in smaller unquoted companies.

IOD RESPONSE TO THE GREEN PAPER : THE REFORM OF PERSONAL TAXATION

IOD say there is a strong case for a purely cosmetic reform of the taxation of husband and wife designed to eliminate the remaining overt elements of sex discrimination in the system. If the objective is a radical reform the IOD favour a system of independent taxation with transferable income. There would be no limit to the amount of income which could be transferred and transfer would be by election, not covenant. Income transferred would be treated as paid *after* deduction of basic rate tax.

2. IOD claim the system would have similar effect to transferable allowances but in addition would

a. provide complete privacy to husband and wife

and b. eliminate the disincentive to work for married women which it is claimed will arise under transferable allowances.

Comment

3. a. Privacy In principle under a system of transferable incomes a wife need not disclose her own income to her husband for him to transfer income to her. In practice for a partner to decide whether there is any advantage in making a transfer it would probably be necessary for him to know something about the other's level of earnings. While there would be full privacy for couples under transferable allowances when both have incomes above the tax threshold, under transferable incomes partners would need to disclose full details of their income to each other to benefit fully from the provisions (see 4.a. below).

b. Disincentive to work To get the benefit of personal allowances against income transferred from one spouse to another the receiving partner would need to claim back from the Revenue the tax notionally deducted by the transferring partner. But a wife who used up the allowance in this way would then have nothing to set against any earnings when she began work. So disincentive effects would remain. A similar problem arises at present with student covenants.

4. Other points

a. Benefits to Higher Rate Taxpayers There would be large gains for this group under transferable incomes. They would be able to minimise their tax liability by 'income-splitting' - equalising incomes between partners to take advantage of lower tax rates as well as both personal allowances.

b. Cost. System would be very costly. Widespread income-splitting of both earned and investment income means there would be a substantial additional cost over and above the cost of introducing transferable allowances.

c. Administration. Would be much more complex to administer than transferable allowances. For example, repayments would have to be made to several million married women receiving transferred income in order to give them the benefit of their personal allowances. Under transferable allowances the benefit of both spouses' allowances can be given to one of them through PAYE.

d. Complexity. The system seems unlikely to be as easily understood by many taxpayers.

IOD BUDGET REPRESENTATIONS

Income Tax

Point at issue

1. IOD say they
 - support commitment to reduce basic rate to 25p;
 - welcome cut in basic rate to 29p in 1986;
 - criticise under-indexation of higher-rate thresholds in 1986;
 - prefer further reductions in basic rate to increases in allowances;
 - support further reductions in top rates of tax in line with US and plans in other countries; in longer term say higher rates should be abolished.
2. Proposals for 1987
 - Cut basic rate by 3p
 - Reduce all higher rates by 10p
 - IOD say they prefer reduction in higher rates to indexation of higher rate thresholds if Chancellor considers tax cuts to higher rate taxpayers should be restricted. Paragraph 19 of Appendix to submission mentions possibility of having a basic rate involving a $\frac{1}{2}$ p if Budget arithmetic does not permit reduction of a full point.

Background

1. IOD Budget recommendations consistent with their previous proposals for major reduction in burden of taxation over longer term (in particular in "The Direction of Tax Reform". Ministers will be familiar with arguments put forward for reducing top rates of tax by comparison with changes in US. Fractional basic rate a practical option if Chancellor wishes to take it.
2. 3p cut in basic rate costs £3.3 billion in 1987-88, £4.3 billion in 1988-89 on top of indexation.
3. 10p cut in all higher rates costs £650 million in 1987-88, £1,500 million in 1988-89 on top of indexation.

4. IOD allow £2 billion for secondary and supply side effects reducing direct revenue costs of all their tax proposals.

Line to take

5. Welcome IOD support for reductions in taxation and commitment to reduce basic rate to 25%. Prospects for tax cuts in Budget will depend on spending and revenue forecasts. But already made clear that extra spending in Autumn Statement reduces potential scope for tax cuts.
6. Reduction in US tax rates at all levels emphasises need for further reductions generally here, as circumstances permit. Chancellor referred to potential need for further reductions in top rates in FT interview on 5 January.

IOD BUDGET REPRESENTATIONS

Transferable Incomes

IOD repeat their support for system of transferable incomes instead of transferable allowances.

Background

See attached note.

Line to take

Government still considering way forward on Green Paper in light of responses received. Encouraged that IOD views are broadly in line with own thinking. But have reservations about claims made for advantages of transferable incomes.

Issue

1. IOD want the rules restricting the set-off of losses relaxed so that:

- a. trading losses brought forward from the past can be set against future profits from another trade in the same company or group (provided the loss-making trade continues and remains in the same group); and similarly they want relief given for unrelieved management expenses brought forward from the past.
- b. more use can be made of losses in groups by, for example
 - taxing groups on a consolidated basis (so that all profits and all losses from whatever source are aggregated and one profit taxed or one loss carried forward);
 - or allowing trading losses to be relieved against profits elsewhere in the group in the previous year;
 - or extending the time limit for claims to group relief from two to six years;
 - or allowing non-trading (Case VI) losses to be relieved elsewhere in the group (at present relief is only possible in the company incurring the loss).

Line to take

2. Extending relief for trading losses or management expenses might distort behaviour because it would allow cross-subsidisation of loss making activities with profitable

ones. Doubtful if this is consistent with overall strategy. Existing rules already provide generous relief on a current basis. Anyway, any extension of relief would cause a loss of tax which would have to be made up elsewhere - what tax do the IOD think should be increased?

3. As far as group relief is concerned these issues were considered only a couple of years ago in the groups review and it was thought that these changes could not be justified. The proposals would put groups at an advantage over other companies and taxpayers and would further complicate the legislation and administration of group relief.

Background

4. The existing tax rules allow current trading losses to be set against other profits (including capital gains) of a company in the same year or the previous year. These losses can also be set against other profits arising elsewhere in the group on a current year basis. The idea is that a current loss is funded from other current sources in a company but that it is difficult to say that it is funded by future income or gains. So future relief for the trading losses is restricted to future income from the same trade.

5. The IOD suggest that groups should be taxed on a consolidated basis because it would be simpler and more flexible but they have not suggested in any detail how it would work. However, a system which did this would involve almost totally recasting the way groups are taxed and would put them at an advantage over other taxpayers (because the distinctions between different types of income and loss would be ignored).

6. Their proposals allowing trading losses to be set against the previous year's losses elsewhere in the group, or giving group relief for Case VI losses are designed to give groups the same reliefs that would be available to companies organised in divisions. There is logic in this, but the rules allowing losses to be carried back one year in a company arose from historic

circumstances rather than current needs, and might not be justified now. Moreover, extending this relief to groups would be costly.

7. On time limits there is at present a structure of two or six year limits which arose from the work of a 1955 Royal Commission. Two year limits apply where there is a "choice of route" how the relief might be taken. Although there might now be grounds for an extension this should not be considered aside from other time limits and it does not seem appropriate to do this until the Keith legislation has been settled.

Issue: Disallowance of trading losses on change in ownership

A trading loss may be carried forward indefinitely for use against profits from that trade. This applies even when ownership of the company carrying on the trade changes. But in order to prevent loss-buying, Section 483, ICTA prevents the losses going forward where there is a change in the ownership of the company and a major change in the nature of its trade within a three year period. Similar provisions in Section 101, FA 1972 restrict the carry forward of surplus ACT.

The IOD consider that Section 483 (and Section 101) are drawn so widely that they could catch many "innocent" take-overs and reorganisations, and thereby deter legitimate and necessary commercial changes, not least through uncertainty. They would like the Sections to be made less restrictive, either by a change in legislation or by publication of a Statement of Practice.

Background:

In July 1984, in response to representations from the IOD and others, the Revenue produced a draft SP which gave some guidance on how they interpret "a major change in the nature or conduct of a trade" (Section 483(1)(a)). They invited selected representative bodies, including the IOD, to comment on whether they felt such a SP would be helpful. The IOD made a useful response.

Because of the amount of work on the Finance Bill this year further consideration of the possibility of an SP was put into abeyance but the Revenue are now giving careful consideration to all the representations made and hope to produce a revised draft soon.

Line to Take:

The IOD views about the effect on the development of businesses are noted but this issue cannot be considered in isolation from the problem of tax avoidance through loss selling.

Unfortunately, Finance Bill commitments this year delayed the Revenue's further consideration of the possibility of a Statement of Practice on Section 483 and (Section 101). But they are now giving the matter urgent attention and hope to produce a revised draft Statement of Practice soon. If they can produce an acceptable Statement of Practice it will then be easier to see the strength of the case for amending the legislation.

LIBERALISATION OF RULES RESTRICTING USE OF ADVANCE CORPORATION
TAX (Page 25)

Point at issue

1. The IOD want the rules relaxed so that:

- ACT can be freely transferred in a group (and any transfers revoked within the original time limit)
- ACT can be set against corporation tax on a company's capital gains
- Double taxation relief unused because of insufficient profits can be set against a company's surplus ACT (so that the ACT liability is reduced).

Line to take

2. On transferability the existing rules already provide sufficient flexibility and further changes would either put groups at an advantage over single companies or complicate administration.

3. Recognise that there may now be no good reason not to allow ACT to be set against CT on capital gains, but would welcome evidence of extent to which companies distribute the proceeds of capital disposals.

4. Allowing overseas tax to be set against ACT would breach the imputation system and would amount to a UK subsidy for overseas governments (who would receive the tax against which a credit was given to the shareholder here).

Background

5. The group income rules mean that in most cases only a parent need pay ACT which can then surrender this down to its subsidiaries. This provides plenty of flexibility. If a

subsidiary pays ACT it is likely to be its own (in respect of minority shareholders) so there is no reason why the group as a whole should get relief for it as the IOD want.

6. ACT cannot be set against CT on capital gains because in 1972 companies argued that gains were not distributed and that the (then) new higher rate of corporation tax was wrong. So gains were only charged to CT at an effective rate of 30 per cent but ACT could not be offset.

7. Companies with substantial overseas income complain that they are discriminated against because ACT can only be set against corporation tax after double taxation relief has been allowed which means that often the ACT credit cannot be enjoyed. But the position was worse before 1984 because ACT was set off first and it was the DTR which remained unrelieved, and unlike ACT this cannot be carried forward (indefinitely) or back (up to 6 years for relief against CT in another year.)

Point at issue

1. The IOD want priority given to devising clearer and more acceptable tax rules.

Line to take

2. The Revenue have been consulting confidentially about a revised Statement of Practice with a view to issuing this before too long. That will help taxpayers settle their liabilities within the law as it stands. Given the uncertainties that exist about present law this has had to be immediate priority.

3. But understand criticisms of present system and do not rule out possibility of legislation. However, any solution would have to have general support and be capable of implementation at acceptable cost to Exchequer. Hope that industry will be able to put forward proposals that can be considered by Revenue. Do not favour joint working party as this could be misunderstood as commitment to a particular course of action.

Background

4. The Revenue have with Ministerial approval been consulting on a confidential basis (including the IOD) about a revised Statement of Practice. This will be a general statement on the tax treatment of exchange rate fluctuations under current law.

5. Hope to make a submission to Ministers shortly seeking authorisation to publish the revised draft (which has been amended to take account of comments). Hope that Ministers will then be able to make some public announcement of where they stand on the possibility of legislation. This is likely to be that:

- legislation is not ruled out; but

- in view of absence of consensus on a possible solution would invite representative bodies to submit detailed proposals for reform which could be considered by Revenue on a "without commitment" basis. Would then be able to judge whether a solution can be found which meets both industry and government's needs.

BUDGET REPRESENTATIONS 1987

INSTITUTE OF DIRECTORS

Capital Allowances - Commercial buildings - paragraph 86

Proposal

An allowance for new expenditure on commercial buildings.

Background

Present position

The only commercial buildings whose construction costs currently attract capital allowances are

- (a) business buildings within enterprise zones
(100 per cent initial allowance)
- (b) qualifying hotels ie hotels which meet certain minimum standards as to the available of accommodation and services offered (4 per cent straight line).

Cost (Page 48) (all figures approximate).

An allowance for expenditure on commercial buildings incurred on or after 1 April 1987 at 4 per cent per annum (ie a 25 year write-off period as for industrial buildings) would cost:-
1987/88 neg, 1988/89 £m30, 1989/90 £m90, 1990/91 £m150. At 1987 prices, the estimated cost would ultimately rise to a plateau of £1.5 (over 25 years).

1984 Budget changes

Staged reduction of initial allowances for industrial buildings (and assured tenancy properties) from 75 per cent as follows:-

to 50 per cent for expenditure incurred on or after 14 March 1984

to 25 per cent for expenditure incurred on or after 1 April 1985

to Nil for expenditure incurred on or after 1 April 1986

Initial allowance (20 per cent) for qualifying hotels reduced to nil for expenditure incurred on or after 1 April 1986.

Writing down allowance of 4 per cent per annum continues for those categories of building.

Line to take

Right in principle there should be a tax allowance for all capital consumed in earning the profits of a business. This was acknowledged in 1982 CT Green Paper. Main problem of extending capital allowance system to include all commercial buildings continues to be that of cost. But important to bear in mind that commercial buildings tend to depreciate very slowly - and frequently they appreciate rather than depreciate at least during earlier part of lifespan.

RATE OF CORPORATION TAX (Page 25 and Page 35)

Point at issue

IOD wants all companies to enjoy a CT rate band of 29% on first £100,000 before reaching main CT rate.

Background

IOD's proposal is the simplest possible version of a graduated system and avoids many of the difficulties with some of the other suggestions we have seen. For example, most proposals have included rate bands below the basic rate of income tax, a suggestion which causes grave difficulties for the imputation system. But would still not be easy to administer.

Line to take

In the context of the present corporation tax rates, understand intention behind suggestion. But proposal raises the rather wider issue of whether corporation tax should be a flat rate tax or a progressive one. Moreover change would not be as simple as the IOD suggest, for example in the treatment of groups eg companies joining or leaving a group.

Cost, at £30 million, is not as insignificant as the IOD suggest.

'Nothings' (Paragraph 86)

Point at issue

The IOD suggest that tax relief should be available for those items of business expenditure for which no relief is available under the present tax system. These are generally known as "nothings".

Background

The basic rule on business expenditure is that only revenue expenses incurred wholly and exclusively for the purposes of the trade or profession are allowable as deductions in computing business profits. "Nothings" fail to meet this test, often because the expenditure is capital in nature, e.g. costs of abortive capital projects, but no capital allowances are available, or because the expenditure is incurred outside the trade. There was a comprehensive internal review of nothings at the end of the 1970s, and after this some were legislated for, e.g. incidental costs of obtaining loan finance and relief for pre-trading expenditure. The remainder are kept under review and occasionally considered as possible Budget starters, e.g. costs of equity finance in 1985.

In their technical representations the IOD singled out three "nothings" for potential legislation; costs of raising equity finance, expenditure on abortive capital projects, and expenditure incurred after a trade ceases.

Line to take

1. All remaining "nothings" are kept under review and individual items are legislated for from time to time; but it tends to be difficult to find Finance Bill space for what may be minor, if deserving, items.
2. There are objections of principle to allowing deductions for items of expenditure which are capital in nature. To allow them blurs the capital/revenue divide.
3. Some of the larger items would involve a substantial cost. Examples are: costs of raising equity finance; and abortive capital expenditure (especially at a time when a large number of takeover bids are being made, some unsuccessful).

Unincorporated businesses and self-employment

(Paragraph 88)

Point at issue

The IDD argue that unincorporated businesses, which have to pay tax on their profits at rates of up to 60%, lost substantially from the 1984 business tax reforms. They suggest that this sector could be compensated by a reduction in the higher rates of income tax, at least on business income. In their technical representations, the IDD made the additional point that serious injustices can arise where particular professions are barred from incorporating either by statute or by professional rules. If these bars are not removed they say that in addition to a reduction in the higher rates of income tax further consideration should be given to allowing unincorporated businesses to elect to be taxed as companies.

(Restrictions on incorporation are not of course a matter for the Revenue or Treasury.)

Background

Following the 1984 Budget there has been criticism to the effect that unincorporated businesses have lost stock relief and incentive capital allowances without the compensating reductions in tax rates which companies enjoyed. However, the impact of higher rates of income tax on unincorporated businesses has been exaggerated, for only a small minority (about 10%) of self-employed people are higher rate taxpayers. The vast majority pay basic rate income tax only - the same rate of tax as the small companies rate of corporation tax (29%). Reducing higher rate income tax for business profits only would mean treating self-employed people very advantageously in comparison with employees.

In their technical representations the IDD proposed that unincorporated businesses should be able to elect to be taxed as companies. We assume that the idea behind this proposal is to have profits retained in the business taxed at CT rates and profits withdrawn for the proprietors' personal use at income tax rates. The problem with a scheme of this kind is that whereas companies and their directors/shareholders are separate legal entities, no such distinction exists between the self-employed and their businesses. That distinction would have to be created artificially. Whatever form such a scheme took it would inevitably impose additional accounting requirements on the self-employed. Such a scheme would be expensive to administer since there would have to be some check that monies retained in the business and taxed at lower rates were actually used in the business. The IDD themselves accept that there would be technical problems.

Line to take

1. The balance of advantage between the incorporated and unincorporated sectors is continually shifting. The 1984 reforms did work in favour of incorporation. However, since 1979 the unincorporated sector has benefitted from reductions in both basic and higher rates of tax and the substantial increase in real terms in the value of personal allowances. Also, Class 2 National Insurance contributions have been cut and tax relief introduced on one half of Class 4 contributions.
2. Tax rates are a budgetary matter; but any reduction involves substantial costs. Any preferential treatment for the self-employed would be difficult to justify.
3. Only a minority of the self-employed would benefit from the IOD proposals - the 10% who pay higher rate tax.
4. Any scheme which creates an artificial distinction between the self-employed and their businesses raises practical difficulties for both the Revenue and the taxpayer.



Chancellor.

I think Par Stoker was
privately appalled that
his lead been released to
the Times before being sent
to you. It has just arrived
his minute.

Very good.
FST is I take
strong Emma
shakes.
18.30
Monday.



Conservative Women's National Committee

32 Smith Square Westminster London SW1P 3HH
Tel. 01-222 9000 Telex 8814563 Fax. 01-222 1135

26th January 1987

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
11 Downing Street
LONDON
SW1

Dear Mr Lawson

The CWNC have asked me to forward the attached proposals for your consideration when preparing the Budget for 1987.

They feel very strongly that there should be no Taxation on Work Place Nurseries and Women's Products and that the Inheritance Tax should be reconsidered.

Yours sincerely

Patricia Stocken

Patricia Stocken
Assistant Director - CWNC



Conservative Women's National Committee

32 Smith Square Westminster London SW1P 3HH
Tel. 01-222 9000 Telex 8814563 Fax. 01-222 1135

PROPOSALS SUBMITTED TO THE RT. HON. NIGEL LAWSON, MP

CHANCELLOR OF THE EXECHEQUER, FOR THE 1987 BUDGET

BY THE CONSERVATIVE WOMEN'S NATIONAL COMMITTEE

In our Budget Submissions this year, we urge the Chancellor of the Exchequer to look at three matters which we feel need his urgent attention.

1. Work Place Nurseries
2. VAT on Women's Products
3. Inheritance Tax

1. Work Place Nurseries

The CWNC asks the Chancellor to reconsider the confirmation that a place for one's child in a work place nursery is a tax assessable benefit.

Whilst not wishing to encourage mothers to work outside the home whilst their children are too small, the CWNC stresses that some women need to work ----- single parents, those whose special skills are needed by employers and those who wish to maintain skills, perhaps by working part-time. The fact that employers are prepared to provide work-place nurseries, often at considerable expense, shows the value they place on the work of these women.

The work place nursery is clearly an excellent form of provision existing in line with the required working hours and giving the child access to the parent whenever necessary, it therefore, seems strange not to give encouragement for such a provision, especially since there is a shortage of high quality nursery provision in the country.

By taxing a parent on the cost of a place the total cost is put out of reach of many women. The resulting danger is that those who need to work will put their children in less good provision, some will be prevented from working and may have to rely on state benefits and some whose skills would be of real value to the economy will be discouraged from working at all. To maintain that some women should not have a provision which is not available to all is not usually an argument put forward by the Conservative Party.

2. VAT On Women's Products

The CWNC asks the Chancellor to consider exempting from VAT the product required for Women's monthly cycle. Most necessities are exempt from VAT and it is unfair that these products which women cannot avoid using should have a higher cost due to Value Added Tax.

3. Inheritance Tax

The CWNC welcomes the abolition of Capital Transfer Tax on lifetime gifts between individuals. However, it is concerned that, due to the relatively low threshold of Capital Transfer Tax on death, the present system penalises those with low or modest incomes more than wealthier families. A wealthier family may have sufficient money to be able to pass on considerable wealth to their children or others during lifetime. Others, owning their house and a small sum of money, are unable to pass on anything during life for fear of impoverishing themselves. They are then heavily taxed by Inheritance Tax.

The CWNC therefore, asks the Chancellor to raise the threshold and to reduce the starting rate of Inheritance Tax,

.....



RWF

The Automobile Association

Head Office: Fanum House, Basingstoke, Hampshire RG21 2EA

Basingstoke (0256) 20123 Extn.

Direct Line: Basingstoke (0256)

Telex 858538 AABAS G

Director General O. F. LAMBERT CBE

Please quote our reference:

┌ Mrs Cathy Ryding
Assistant Private Secretary
Treasury Chambers
Parliament Street
SW1P 3AG

PP/JTC/bt

27th January 1987

Dear Mrs Ryding,

Sir Ralph has asked me to acknowledge and thank you for your letter of 9th January enclosing notes of his private meeting with the Chancellor of the Exchequer.

Yours sincerely,

J T Carr
Executive Manager, Public Policy

AWP



FROM: A P HUDSON
DATE: 27 January 1987

MR CROPPER

cc: PS/Financial Secretary

**BUDGET REPRESENTATIONS FROM CONSERVATIVE WOMEN'S
NATIONAL COMMITTEE**

The Chancellor has seen the letter from Miss Stocken, attached to your note of yesterday. He has commented "Very bad".

2. He assumes that the Financial Secretary will be seeing Emma Nicholson.

AH

A P HUDSON

6/2

cc

PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Mr Scholar
Miss Sinclair
PS/C&E



Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

DL
To
MAD. GEN.
MANGHAM
28/1

28 January 1987

Major General W D Mangham CB
The Brewers' Society
42 Portman Square
LONDON
W1H 0BB

Dear General Mangham,

As I think you know, the Chancellor had to postpone his meeting with you on Tuesday, 27 January at short notice and he has asked me to convey to you his sincere apologies for any inconvenience which this may have caused.

It has now been re-arranged for Friday, 6 February at 10.30 am in HM Treasury. I understand you will be accompanied by Mr Anthony Fuller.

Please do not hesitate to contact me if you require any further information.

Yours sincerely,

Debbie Lester

MRS D C LESTER
Diary Secretary



✓

**NOTE OF A MEETING IN FINANCIAL SECRETARY'S ROOM HM TREASURY ON
WEDNESDAY 28 JANUARY WITH THE CONSERVATIVE SMALL FIRM COMMITTEE
TO DISCUSS THEIR BUDGET REPRESENTATIONS**

Those present: John Browne MP
Bill Cash MP
Peter Thurnham MP
John Townend MP
John Hustler

Mr Haigh HMT
Mr Michael IR
Mr Walker IR

1. Mr Browne said, by way of background, that although the SFC in general terms wanted to see tax breaks squeezed out of the system, they were in favour of selective temporary tax incentives directed at small businesses. The country had to make up for decades of inactivity in this area when small businesses and venture capitalism had been all but destroyed. The Committee proceeded to speak to the proposals contained in their Budget submission.

Capital Gains Tax

2. The proposal to exempt shares in unlisted or unquoted companies from CGT and applying to shares held for at least 3 years (as opposed to the current 5 year requirement for BES purposes) would, said Mr Browne, encourage more forms of new investment. A reduction of this kind would encourage a proportionately much greater amount of investment.

The Financial Secretary queried whether a further relaxation could be justified and indeed whether it would be appropriate. He asked what evidence there was of difficulties in raising the second or third stage finance that this proposal seemed to be aimed at.

Interest

3. Mr Cash said that the Committee very much supported the Government's achievements in the field of employee share ownership and management buy-outs. More needed to be done, however, and

one method of doing this would be by allowing employees tax relief loans they took out to buy company shares. Mr Cash said that his remarks were directed specifically at close companies and he referred to a paper which was currently being produced which illustrated the difficulties in this area. The Financial Secretary said that we wanted to do as much as possible to encourage share ownership and management buy-outs and he was conscious of there being impediments to this both generally and more particularly in the unquoted companies area. He said that he would be interested to read the Committee's paper.

BES

4. Mr Browne said that we had to encourage people to make more investments in BES companies. The people most likely to do this were those who knew the entrepreneur ie connected persons. Mr Browne thought that making them eligible for BES relief on a temporary three or five year basis would produce much new investment. He added that we had to offer greater potential reward to get people to take greater risks. The complexity of the BES legislation was another hindrance to getting more investors involved.

The Financial Secretary said that our general approach over the last few years had been the right one, namely that while we have tax breaks within the system, we should make use of them specifically to direct help towards small companies. We wanted additionality in the BES, however, and this proposal would not seem to be particularly helpful from that angle.

Mr Thurnham said that BES relief should be restricted to £500,000 of share capital in any one company thereby extending the availability of funds at the lower end of the market and Mr Hustler added that anything which was a good proposition requiring over £1m would in any event raise the necessary capital.

Corporation Tax

5. Provided it was not distributed the Committee proposed making the first £10,000 of profits of all small companies tax-free. This would be a once and for all measure and would be seen as a helpful gesture which would compensate the unincorporated sector who had not received the benefit of the cuts in the rate of corporation tax. Mr Townend said that there was a strong feeling that the unincorporated sector had not received their due rewards.

PLD's

6. Mr Thurnham thought that raising the £8,500 threshold would be a measure that would have a relatively small net cost and he wanted to see it raised to £20,000. In response to the Financial Secretary's comment that if anything there were stronger arguments for abolishing it altogether and that we should not allow untaxed benefits in kind. Mr Townend said that any step in that direction would be politically damaging. He would like to see a £10,000/£12,000 threshold including cars.

Mr Thurnham turned to the burden for the employer of actually completing the P11D. The Financial Secretary reminded the Committee of the dispensations procedure and Mr Haigh referred to the abolition last year of the P11D(A). Mr Thurnham agreed that both of these routes were moves in the right direction.

Loan Guarantee Scheme

7. The Committee put forward the proposal to exclude the family residence from the personal asset test.

VAT Threshold

8. Mr Townend said that it was much easier to remain below the VAT threshold when one was selling services as opposed to goods. He wondered if anything could be done to take account of this. He also referred to the SFC proposal that home improvement work should be liable to VAT at a rate of only 7½%.

Enterprise Bonds

9. Mr Browne said that the Government would gain here from the cash flow injection it would receive when the bonds were sold. (The idea did seem to be that put forward in previous years whereby the cost of the bond was deductible from the company's taxable profits and then was added to its taxable profits on redemption.) Mr Hustler said that the bonds could either carry a low rate of interest or possibly be non-interest bearing, in essence something similar to National Savings certificates.

Capital Gains Tax

10. Mr Browne saw this measure (the extension of CGT relief to give relief against income for a capital loss incurred as a result of a guarantee given to secure a bank loan to a small unquoted company) as a simple and attractive measure which, introduced on a temporary basis, could add to the venture capital money that was available.

In response Mr Michael said that this proposal breached the general principle of not allowing capital losses to be set off against income tax liability. Making a guarantee of this kind was more in the nature of a passive investment compared with the up front investment involved in the actual share buying.

Other Proposals

11. The Financial Secretary asked for general thoughts on the forthcoming Budget. Mr Browne urged a 'prudent' approach, but in the short-term, an extension of indexation back from 1982.

Mr Thurnham wanted to see a lower PSBR figure. He said that women should immediately be given the same tax treatment as men in respect of unearned income. He urged scrapping CGT indexation and having lower rates instead. Mr Browne agreed.

Conclusion

12. Mr Browne reiterated his introductory remarks to the effect that the SFC were generally against tax breaks but in the areas they had identified, specifically designed to help the small firms sector, there was a case for being generous at the outset by introducing incentives of a temporary nature and then tightening up quickly on abuse where necessary.

Nigel Williams

NIGEL WILLIAMS
3.2.1987

cc **PS/Chancellor**
PS/Chief Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Mr Monck
Mr Scholar
Miss Sinclair
Mr Haigh
Mr Walters IR
PS/IR
PS/C&E

PWP

X pt.



FROM: N WILLIAMS
DATE: 29 January 1987

MR P CROPPER

cc Mr Hudson

BUDGET REPRESENTATIONS FROM CONSERVATIVE WOMEN'S NATIONAL COMMITTEE

- 1. Mr Hudson's minute of 27 January refers.
- 2. The Financial Secretary will be having lunch with Emma Nicholson on 9 February ie prior to his meeting with the Committee on 12 February.

N WILLIAMS

C.

Do you want to talk to the FS7 before he meets Emma N.? Or discuss at Prayers?

discuss ✓

UNCLASSIFIED



the Government has sensibly established a presumption that excise duty rates would be increased each year in the Budget and it was only right to smooth out the flow of clearances: the alternative would be to increase the levels of duty still more. But he said he would look into the procedures for the limits applied to growing businesses.

Credit

5. Several members asked whether the continuing large increases in credit was a matter of concern or a fact of life. The Chancellor said they were both: they were a fact of life, but they did make the running of monetary policy more difficult, and there were worries that individuals were not always conscious of the burdens they were taking on. The Retail Consortium were, not surprisingly, concerned to ensure that there were no arbitrary restrictions placed on consumer credit.

Other points

6. The Consortium raised for the record their representations on the need for more favourable treatment of capital investment by retailers (with a 4 per cent writing down allowance for all retail stores and a 25 per cent one for plant and machinery). They also urged a further look at the BES rules so as to allow investment by directly connected persons.

Distribution

PS/Financial Secretary
PS/Minister of State
Sir P Middleton
Mr Scholar
Mrs Lomax
Mr Walters

PS/IR
PS/C&E

ACSA

A C S ALLAN
2 February 1987



purp

NOTE FOR THE RECORD:

CHANCELLOR'S LUNCH WITH RETAIL CONSORTIUM, 30 JANUARY

Most of the discussion during lunch at the Retail Consortium was about general issues such as the need to get British manufacturers to supply the right goods at the right price, and a general worry that the retail sector seemed to be getting a bad name because of opposition to the "consumer boom". Among the more specific points raised were:

VAT: Small Business Review

2. As they had warned, the representative of the Mail Order Traders Association raised the issue of the withdrawal of the standard method of accounting for gross takings in retail schemes. The Chancellor said the Government was still considering the representations it had received and would take full account of the concern of retailers.

VAT approximation

3. The MOTA were again very concerned about moves towards harmonisation of rates within the EC. The Chancellor drew a distinction between the Commission proceedings arguing that some of our zero rates were illegal (eg on new buildings), where we were fighting the case in the European Court; and the initiative on VAT approximation, where all countries saw problems and progress was likely to be slow.

Customs pre-Budget restrictions on withdrawals from bond

4. Mr Noble attacked Customs restrictions on taking goods out of bond in the run-up to the Budget. He presented this as one aspect of civil servants obeying the letter but not the spirit of the law, and imposing arbitrary limits - particularly on small businesses which were expanding. The Chancellor replied robustly, saying that



BUDGET CONFIDENTIAL

FROM: J P BATTERSBY

DATE: 2 FEBRUARY 1987

- 1. MR HOUGHTON
- 2. CHANCELLOR OF THE EXCHEQUER

Handwritten red signature

INHERITANCE TAX RATES AND BANDS: BS104

1. Mr Kuczys note of 2 February records that you favour Smooth Four Point 90 from the scales in my minute of 30 January, but would like some comparison with the original Capital Transfer Tax (CTT) scales of 1975.

2. Smooth Four Point 90 costs £215m in a full year, and is:

<u>£000s</u>	<u>Tax Rate %</u>
0 - 90	NIL
90 - 140	30
140 - 220	40
220 - 330	50
Over 330	60

1975 scales

3. CTT replaced estate duty for deaths on or after 13 March 1975. The rates then applicable to transfers on death were:

-
- | | | |
|----|-----------------------|---------------|
| cc | Chief Secretary | Mr Battishill |
| | Financial Secretary | Mr Isaac |
| | Economic Secretary | Mr Painter |
| | Minister of State | Mr Beighton |
| | Sir P Middleton | Mr Calder |
| | Sir Terence Burns | Mr Houghton |
| | Sir Geoffrey Littler | Mr Spencer |
| | Mr F E R Butler | Mr Battersby |
| | Mr Cassell | Mr Gonzalez |
| | Mr Monck | Mr Boyce |
| | Mr Scholar | Mr Brown |
| | Mr Sedgwick | Mrs Evans |
| | Mr Olding-Smee | PS/IR |
| | Miss Evans | |
| | Mr Cropper | |
| | Mr Tyrie | |
| | Mr Ross Goobey | |
| | Sir Angus Fraser) C&E | |
| | Mr Knox) | |

Handwritten notes on a red sticky note: "BATTERSBY to C&E 4/2"

<u>£000S</u>	<u>Tax Rate %</u>
0 - 15	NIL
15 - 20	10
20 - 25	15
25 - 30	20
30 - 40	25
40 - 50	30
50 - 60	35
60 - 80	40
80 - 100	45
100 - 120	50
120 - 150	55
150 - 500	60
500 - 1000	65
1000 - 2000	70
Above 2000	75

Lifetime rates were half death rates up to £100,000, but then increased to be the same as death rates at £500,000. The starting point for each band was increased by £10,000 from 27 October 1977.

4. Since 1980, the following changes have been made:

- a. the starting point for tax was made £50,000 at 30 per cent, and the lower rates abolished;
- b. the threshold has been increased from £25,000 to £71,000, and is now statutorily indexed;
- c. the top rates of tax have been reduced from 75 to 60 per cent on death, [and to 30 per cent for other transfers, since the lifetime rates are now half the death rates throughout the scale.] and the lifetime charge abolished.

Comparison with present scales

5. The 1975 scales revalorised in line with the RPI, and the scales for 1987/88 under statutory indexation are:

<u>1975 revalorised</u>		<u>Statutory indexation</u>	
<u>£000s</u>	<u>Tax Rate %</u>	<u>£000s</u>	<u>Tax rate %</u>
0 - 52	NIL	0 - 74	NIL
52 - 69	10	74 - 99	30
69 - 87	15	99 - 134	35
87 - 104	20	134 - 171	40
104 - 139	25	171 - 214	45
139 - 173	30	214 - 267	50
173 - 208	35	267 - 329	55
208 - 277	40	Above 329	60
277 - 347	45		
347 - 416	50		
416 - 520	55		
520 - 1734	60		
1734 - 3468	65		
3468 - 6937	70		
Above 6937	75		

6. The present threshold of £71,000, and that of £74,000 with statutory indexation are thus higher in real terms than the starting point for paying CTT in 1975. But the changes in structure mean that the better comparison is in terms of effective rates on various sizes of estates.

7. As the Annex shows, the greatest losers in comparison with the 1975 scales are estates of between £200,000 and £500,000. The changes at the bottom of the scale mean that estates of up to £92,000 face lower effective rates with statutory indexation than under the 1975 scales revalorised; and the larger estates have gained from the abolition of the top 3 rates. However, these comparisons take no account of other improvements since 1975, such as the reduction in cumulation from whole life to 7 years, and the abolition of the immediate lifetime charge; nor do they allow for reliefs often found in larger estates such as business relief, which are now much more generous than in 1975.

8. It costs £300m in a full year to ensure that no estate faces a higher effective rate of tax than on the revalorised 1975 scales. This requires a scale with a threshold of at least £85,000, and wider bands leading up to a 60 per cent rate starting at around £470,000 with a 7-point scale like that for statutory indexation. The costs of Smooth Four Point 90 are too low to restore the position for all estates, and there is thus inevitably a choice between concentrating resources on the

smallest taxpaying estates, and on those larger estates who have lost most since 1975. Smooth Four Point 90 is weighted towards the smaller estates, but raises from £92,000 to around £158,000 the level at which effective rates of tax are below those of the revalorised 1975 scales. It also brings larger estates closer to the 1975 position than statutory indexation.

Presentation

9. If Smooth Four Point 90 is the final choice, the main lines of presentation could be:

- a. Simplification of scale and worthwhile improvements at all levels - cost £215m in full year.
- b. Last year's changes likely to be of greatest value to larger estates. So greatest percentage reduction this year to smaller estates.
- c. Substantial increase in threshold to take out of tax 12,000 estates compared with statutory indexation. No tax now on £90,000 estate, compared with tax of £5,000 on revalorised 1975 scales.

10. For defensive briefing on help for estates between £200,000 and £500,000 the line would be that those estates had worthwhile reductions this year, and had the opportunity for even greater savings from other improvements, notably the abolition of the lifetime charge last year.

J P Battersby

J P BATTERSBY

IHT REDUCTIONS

Estate Size £000s	Tax (£) with Indexed scale	1975 Revalorised	Smooth Four Point 90	Arithmetic 85
100	7,850	7,000	3,000	4,500
reduction	-	850	4,850	3,350
%	-	11	62	43
200	47,600	36,200	39,000	37,500
reduction	-	11,400	8,600	10,100
%	-	24	18	21
300	98,550	76,950	87,000	82,000
reduction	-	21,600	11,550	16,550
%	-	22	12	17
400	157,100	124,600	144,000	138,000
reduction	-	32,500	13,100	19,100
%	-	21	3	12
500	217,100	178,800	204,000	198,000
reduction	-	38,300	13,100	19,100
%	-	18	6	9
1000	517,100	477,800	504,000	498,000
reduction	-	39,300	13,100	19,100
%	-	8	3	4
2000	1,117,100	1,091,100	1,104,000	1,098,000
reduction	-	26,000	13,100	19,100
%	-	2	1	2



C (wrongly)
 CSE assumed that you
 would leave this to
 the MST.
 P Jefferson Smith the
 MST will attend your
 meeting tomorrow at
 4.30 pm.

MINISTER OF STATE

Board Room
 H.M. Customs and Excise
 King's Beam House
 Mark Lane London EC3R 7HE

From: P Jefferson Smith

Date: 2 February 1987

cc PS/Chancellor
 PS/Chief Secretary
 PS/Financial Secretary
 PS/Economic Secretary
 Mr Scholar
 Miss Sinclair
 Mr Romanski
 Mr Cropper

D
 3/2

**PRE-BUDGET MEETING WITH THE NATIONAL LICENSED VICTUALLERS'
 ASSOCIATION (NLVA) : WEDNESDAY 4 FEBRUARY**

1. You are due to meet the NLVA, who will be accompanied by their Parliamentary adviser, Mr Michael Colvin MP, at 4.30 pm on Wednesday 4 February. It is not yet clear whether the Chancellor will be involved. I attach a brief.
2. As I am accompanying you to the immediately preceding meeting with Lord Young, I will also attend the meeting with the NLVA.
3. You will see from paragraph 9 that we have made some progress on tied houses and have evolved a proposal which would cut the burden on the brewers to even less than the £25 million I previously forecast as minimum. I hope this matter will be cleared up at your meeting with the Brewers on 10 February.

P Jefferson Smith

Internal circulation:

CPS	Mr Whitmore	Mr Wilmott	Mr Tullberg	Mr Hankins
Mr Knox	Mr McGuigan	Mr Bazley	Mr Cain	

17/2/87

**PRE-BUDGET MEETING WITH THE NATIONAL LICENSED VICTUALLERS'
ASSOCIATION (NLVA): WEDNESDAY 4 FEBRUARY**

Organisation

1. The NLVA is the national body to which local Licensed Victuallers' Associations (LVAs) are normally affiliated. It represents the publicans, including tenants, who form the membership of the LVAs. Managers of brewery-owned houses are represented by a separate organisation (the National Association of Licensed House Managers). The NLVA is closely associated with the trade's daily newspaper, the "Morning Advertiser".

2. The NLVA delegation accompanying Mr Michael Colvin MP, their Parliamentary adviser, will consist of:

Mr K Metcalfe - President

Mr R Jones - Senior Vice President

Mr A Edwards - Chairman, Parliamentary Committee

Mr J C Overton - Chief Executive

Mr Metcalfe and Mr Overton were in the delegation you met last year on 19 February.

Object of the meeting

3. It has been customary in recent years for representatives of the NLVA to meet a Treasury Minister in order to make an oral submission on the Budget.

Written representations

4. The NLVA make three requests in their submission: no increase in duty on alcoholic drinks; no increase in the rates of VAT and licence duty on gaming machines; and exemption of tied houses from the proposed VAT input tax changes.

POINTS WHICH NLVA MAY MAKE.

Duty on alcoholic drinks

5. The NLVA's main point is expected to be a plea for no increase in the alcoholic drinks duties. In particular they are likely to single out beer, which publicans regard as critical to their business, and point to the effect on beer sales of the substantial real increase in duty prior to last year's standstill. They may also refer to other factors which have had an adverse affect on pubs, such as rising costs and the shift in drinking habits in favour at drinking at home.

6. The beer market grew steadily in the 30 years up to 1979 but consumption then fell in the following 3 years, since when it has been broadly static. Independent forecasts predict that the market is unlikely to increase significantly during the next few years. The reasons for the static market include:

An increase in the price of beer in real terms. This is partly attributable to duty and tax increases but the brewers have not been slow to put up their prices. During the last year licensed victuallers have protested to brewers about price increases, making the point the Chancellor had not put up beer duty in the last Budget.

Economic decline in beer's traditionally strong markets (eg the North and heavy industry).

Social change and competition for the "leisure pound", eg a switch in drinking habits, more home entertainment, and the spread of leisure facilities.

Increasing public awareness of the health and drink driving dangers.

Gaming machine licence duty

7. The NLVA will argue against any increase in the licence duty on gaming machines. The annual rates of licence duty for amusement with prizes (AWP) machines used in public houses are:

5p AWP machines - £120

10p AWP machines - £300

These rates were fixed in 1982 after a full-scale review.

Revalorisation would mean an increase of about 25%.

The number of machines has remained fairly constant over the past few years and the revenue yield reflects this. Over the last 3 years the total gaming machine licence duty has averaged about £65 million. AWP machines contribute about £44 million and the large brewing companies control some 60% of all AWP machines yielding about £26 million duty.

8. Few representations about duty rates have been made in recent years with the trade concentrating its efforts on improving prizes. Increases in prize limits were approved by the Home Office from 1 January when the AWP machine limit rose from £3.00 to £4.00. The NLVA deputation is likely to argue that although machine income has risen in recent years profitability has decreased due to spiralling costs of operation. They have, however, consistently failed to produce evidence in support of this.

VAT input tax changes

9. The NLVA support the brewers' protest against the application of these changes to tied house rentals. The brewers argue that implementation of the changes in the rules for input tax deduction will cost them about £70 million - equivalent, they say, to about 2p a pint on beer sold through tied houses. I met the Brewers' Society on 29 January and offered a method which would reduce the impact of the changes to about £10 million a year. Briefly, they would restrict their input tax deduction in relation to income from tied houses in ratio that rentals or property expenditure bore to total income; a global figure of 15% is suggested. They have gone away to consider; and it was made clear on our side that the proposal is ad

referendum to you. You are seeing a further deputation from them on 10 February.

10. While the NLVA cannot be given any hope of exemption for tied houses, they can be assured that talks are underway with the Brewers' Society aimed at agreeing a suitable method of input tax calculation which, while consistent with the new rules, does take account of the quantifiable and unique features of tied house rental agreements.

Points you may wish to raise

11. You may wish to invite the deputation's views on the prospects for the coming year, particularly in the light of the significant investment in refurbishing pubs now under way. You might ask whether the increased prize limits will make AWP machines more attractive to the public and hence increase income.