PO-CH/NL/0107
PART A

CONFIDENTIAL

(Circulate under cover and
notify REGISTRY of movement)

PO -CH /NL/0107

PART A

1988 BUDGET DAY
PAMPHLETS

DD's 25 years NA 2/3 11/8/95.

15.2.88

1988

PO -CH /NL/0107

PART A

mjd 4/40An

BUDGET CONFIDENTIAL

150

FROM: A P HUDSON

DATE: 26 January 1988

MR MACE - IR

cc Mr Scholar
Mr Culpin
Miss Sinclair
Mr Riley
Mr A C S Allan
Mr Cropper
Mr Tyrie
Mr Isaac IR
Mr Dyall IR

PAMPHLET ON INDEPENDENT TAXATION: FIRST DRAFT

I attach a first draft of the pamphlet ~~on~~ for Budget Day.

2. Once you and others have had time to think about this, I should be glad of the chance to discuss it.

- The first question is, who are we aiming at? Journalists? MPs? The man in the street? Practitioners?
- If we cannot satisfy all these in one go, what should we do about the rest? For example, is it worth publishing more detailed notes when the Finance Bill is published?
- How far should the Budget Day pamphlet be a sales pitch, and how far simply an explanation of what the new system will look like?
- What format will it be in?

3. Looking forward to the Budget Brief, and other presentational exercises, it may help to record the questions I found most difficult in drafting the pamphlet.

   a. Why is the married couple's allowance always given first to the husband?

b. Given that it is going to be income-limited, why does withdrawal start at such an astronomic income?

c. Can the reform be described as a simplification?

4. One other thing we might consider is what information to publish, and in what format, on distributional effects.

5. I am quite happy to do some more work on the pamphlet once I have your comments and those of copy recipients.

APH

A P HUDSON

PAMPHLET ON INDEPENDENT TAXATION: FIRST DRAFT

MAIN POINTS

1. The Government is introducing a new system of Independent Taxation for married couples, starting in April 1990.

- A husband and wife will be taxed as separate individuals.
- Each will have their own tax allowance and set of tax rate bands.
- Each will fill in their own tax return.
- The married man's allowance and the wife's earned income allowance will be abolished.
- There will be a new married couple's allowance, normally given to the husband, which brings his total allowances up to the level of the old married man's allowance.

2. This sweeps away a system which lasted for 180 years.

- For the first time, married women will have privacy and independence in their tax affairs.
- The present tax penalties on marriage will be abolished.
- Many couples will pay less tax than they do now. None will pay more in cash terms.

THE CASE FOR CHANGE

3. The present system for taxing married couples is based on treating husband and wife as one taxpayer, with

the husband legally responsible for filling in tax returns and paying the couple's tax.

4. This principle dates back to the introduction of income tax in 1805. Not surprisingly, it produces results which are completely unacceptable in today's world.

5. First, a wife cannot have privacy or independence in her tax affairs. Her husband is legally obliged to fill in the couple's tax return, so she has to give him details of all her income - whether earnings, interest on a nest-egg, or even the profits of her own business. This is absurd, in an age when two out of three married women are in paid work, and millions more have savings of their own.

6. Second, the system means couples can actually have to pay more tax simply because they are married. Although couples can elect for the wife's earnings to be taxed separately, her investment income has to be added to her husband's for tax purposes. So if he pays tax at a higher rate than her - including, of course, if she would otherwise not have to pay tax at all - the couple will have to pay more than if they were living together as two single people.

7. Many pensioner couples suffer from this problem, because the wife has either savings, or a pension based on her husband's national insurance contributions, or both.

8. Tax penalties on marriage can occur for various other reasons, mostly arising out of the rule that a married couple's income is taxed as one. The most important case is mortgage interest relief, where a married couple are entitled to relief on up to £30,000, whereas a cohabiting couple can have up to £30,000 each.

9. It is clearly unacceptable that marriage should be penalised in this way.

10. The Government has therefore decided on a major reform, to make the system fairer, simpler to understand, and up to date.

THE NEW SYSTEM

11. The basic principle of the new system is that husband and wife will be taxed independently on the whole of their incomes: earnings, savings, pensions, and anything else. Their incomes will no longer be added together, and each will pay their own tax, independent of the income of the other. Income from joint accounts will generally be split equally between the two for tax purposes.

11A. Each will fill in their own tax return, and handle their own tax affairs.

12. The married man's allowance and wife's earned income allowance will be abolished. All taxpayers, male or female, married or single, will start with the single allowance (in 1987-88, £2425).

13. Married couples will also receive a new married couple's allowance. The married couple's allowance and the single allowance together will be worth the same as the present married man's allowance. So, in 1987-88 terms, the married couple's allowance would be £1,370 (the difference between the married man's allowance of £3,795 and the single allowance of £2,425).

14. The new married couple's allowance can be used by either husband or wife. But for simplicity's sake, it will be given first to the husband, as a general rule.

Example 1 - husband and wife both earning

Take a typical couple where the husband earns £10,000 and the wife £5,000.

Present system

Husband:	10000	Wife:	5000
less married man's allowance	3795	less wife's earned income allowance	2425
so pays tax on	6205	so pays tax on	2575
so tax bill is	1675.35	so tax bill is	695.25

Independent Taxation

Husband:	10000	Wife:	5000
less single allowance	2425	less single allowance	2425
less married couple's allowance	1370		
so pays tax on	6205	so pays tax on	2575
so tax bill is	1675.35	so tax bill is	695.25

The couple's tax bill is unchanged.

Example 2 - husband earning, wife with investment income

Take a couple where, again, the husband earns £10,000; the wife has no earnings, but has £500 investment income, in dividends on shares inherited from her parents.

Present system

Husband earns	10000	Wife's income is taxed with husband's
plus wife's investment income	500	
so total income	10500	
less married man's allowance	3795	
so pays tax on	6705	
so tax bill is	1810.35	

Independent Taxation

Husband earns	10000	Wife's income	500
less single allowance	2425	less single allowance	(2425)
less married couple's allowance	1370		
so pays tax on	6205	so tax bill is	0
so tax bill is	1675.35		

The couple's tax bill is £135 lower.

COUPLES IN PARTICULAR CIRCUMSTANCES

"Breadwinner Wives"

15. In some cases, the husband has little or no income, and the wife is the main family breadwinner.

16. At present, because all the couple's income is treated, for tax purposes, as the husband's, the wife is able to claim both the married man's allowance and the wife's earned income allowance against her earnings.

17. This means that the couple where the only breadwinner is the wife pay a lot less tax than the couple where the only breadwinner is the husband. There is no justification for this.

18. Under Independent Taxation, both couples will be treated in the same way. If the husband has no income, the wife gets the married couple's allowance, so her total tax allowance will be the same as a husband whose wife has no income. If the husband has a small income, but not enough to make full use of the married couple's allowance, his wife can use the balance.

19. In other words, under Independent Taxation, a couple's total tax allowances will be the same, whether their income comes from husband or wife, or both, or from earnings or savings, or a mixture of the two.

20. If these rules were introduced straight away, some 'breadwinner wives' would see a reduction in the value of their tax allowance. The Government has therefore decided on transitional arrangements to make sure that they do not lose out in cash terms.

Example 3 - "breadwinner wife"

Husband has no income; wife earns £10,000.

Present System

Wife earns	10000
less wife's earned income allowance	2425
less married man's allowance	3795
so pays tax on	3780
so tax bill is	1020.60

Independent Taxation, with transitional allowance

Wife earns	10000
less single allowance	2425
less married couple's allowance	1370
less transitional allowance	2425
so pays tax on	3780
so tax bill is	1020.60

The value of the transitional allowance will fall over the years, as the other allowances are increased, and it will disappear when the combined value of the single allowance and the married couple's allowance reaches the present allowance for a "breadwinner wife".

Taxpayers over 65

21. Pensioner taxpayers will be among the main gainers from Independent Taxation.

22. As now, taxpayers over 65 will get a higher tax allowance (and those over 80 a higher allowance still). Married women will qualify in their own right for this allowance, rather than the wife's earned income allowance which they currently get, and this could save them nearly £150 tax. On top of that, they will be able to set this allowance against income of any kind, including investment income and pensions based on their husband's contributions, which do not qualify for the wife's earned income allowance.

23. There will be a higher rate of married couple's allowance for couples whether one or both is over 65, and a higher rate still if either partner is over 80.

24. As now, all the age allowances will be subject to an income limit. They will be withdrawn by £2 for every £3 of income above the limit, until they reach the level of the ordinary allowances. But under Independent Taxation, husband and wife will each have their own income limit, whereas at present a single limit applies to their combined income. So some A per cent more people will qualify for the extra allowance.

Example 4

Take a couple who are both over 65 where the husband has an occupational pension and the State pension, and the wife has a pension based on her husband's contributions. [Please could Inland Revenue devise suitable figures.]

Couples on Higher Incomes

25. At present, couples on high incomes, where the wife earns more than a certain amount, generally elect to have the wife's earnings taxed separately, because their combined income would put them in a higher tax bracket.

26. Under Independent Taxation, their incomes will be taxed separately, so the Wife's Earnings Election will disappear. The husband will normally get the married couple's allowance. However, where the husband's income is above [£40,000] a year, the married couple's allowance will be reduced progressively, until it reaches the level of the single allowance. The same arises if the married couple's allowance is claimed by a wife with a very high income.

Couples who marry during the tax year

27. In the year a couple marry, the married couple's allowance will be apportioned, so that, for example, where the marriage takes place half way through the tax year, half of the allowance is available.

Couples where one partner dies during the year

28. In the year in which a married woman is widowed, and the following tax year, she will be entitled, as now, to the widow's bereavement allowance. There will be more flexibility under Independent Taxation: the allowance will be available against any of her income in the year of bereavement, not just against income which arises after the husband's death, as at present.

ENDING THE TAX PENALTY ON MARRIAGE

29. The introduction of Independent Taxation eliminates the main tax penalty on marriage: the taxation of the wife's investment income at her husband's top rate of tax. The Government is taking parallel measures to eliminate the other tax penalties.

Mortgage Interest Relief

30. At present, mortgage interest relief is available on a loan of up to £30,000 for the purchase of a home. But the structure of the legislation means that two single people sharing a home can get £30,000 each, and thus gain a tax advantage over married couples. This creates a widely resented tax penalty on marriage.

31. In future, the limit on relief will apply to the house or flat, irrespective of whether there are one or two borrowers, married or single. This puts cohabiting couples on the same footing as married couples, and eliminates the tax penalty on marriage.

Capital Gains Tax

32. At present, a married couple share one annual exempt amount for capital gains tax, whereas single people have one each, and the husband normally has to deal with the couple's CGT affairs.

33. Under Independent Taxation, husband and wife will each have their own annual exempt amount and will each look after their own affairs.

Additional Personal Allowance

34. At present, couples who live together outside marriage can each claim the Additional Personal Allowance (designed for single parents), if they have two or more children. Thus between them, they get the equivalent of two married allowances.

35. In future, this will be specifically prohibited by the legislation.

Maintenance and Covenants

36. A few unmarried couples exploit the present tax reliefs for maintenance and covenanted payments to gain a tax advantage not available to married couples. The major reform of this area, which the Government is undertaking for wider reasons, will eliminate this tax penalty for the future.

Other limits

37. In a number of cases, the amount of spending that qualifies for tax relief is subject to a limit, and under the present system, a married couple have to share the limit between them. The most common example is [life assurance or the BES?]

38. Under Independent Taxation, a husband and wife will each have a separate ration of relief.

OTHER CONSEQUENCES

39. Transfers of assets between husband and wife will remain exempt from CGT and Inheritance Tax.

40. At present, a husband and wife can set certain tax reliefs against their joint income - the most common example is [whatever it is]. Under Independent Taxation, these reliefs will be available only against the income of the spouse who actually made the payment.

TIMETABLE FOR CHANGE

41. Independent Taxation will come into operation from April 1990.

42. During the previous tax year [can we be more precise?], local tax offices will be getting in touch with taxpayers to establish the information they need to run the new system. That will involve, in particular, setting up records for married women as taxpayers in their own right, and transferring information onto these records from their husbands' tax records.

mjd 4/44An

BUDGET CONFIDENTIAL

FROM: A P HUDSON
DATE: 29 January 1988

MR CORLETT - IR

cc Mr Scholar
Mr Culpin
Miss Sinclair
Mr Burr
Mr J Heywood
Mr Cropper
Mr Tyrie
Mr Isaac IR
Mr Mace IR

MAINTENANCE AND COVENANTS: BUDGET DAY PAMPHLET

... I attach a first draft of the Budget Day Pamphlet on Maintenance and Covenants.

2. We had a word about what presentational material would be required, and agreed that this pamphlet should be aimed at the man in the street, and that you would start work on a more detailed press release, explaining the new system for practitioners.

3. Before we go very much further with this pamphlet, or the other one which we are working on, I think we need to get a clear steer from the Chancellor on exactly what format they should take, and who they should be aimed at. I should like to do that in the course of next week. So please could I have comments by, say, close on Tuesday, not with the aim of perfecting the drafting by then, but simply to sort out any horrible mistakes before showing the text to Ministers as very much work in progress. I do not think it is worth spending a lot of time poring over the details until we know what exactly what we are aiming at.

APH

A P HUDSON

MAINTENANCE AND COVENANTS

FIRST DRAFT OF BUDGET DAY PAMPHLET ETC.

Introduction

1. The Government is introducing a major reform of the tax treatment of maintenance payments and covenants, which will make the system fairer and simpler.

2. This pamphlet explains why the changes are being made and how the new system will work.

Summary of the changes

3. The new system will apply to new maintenance payments and deeds of covenant. Existing arrangements will not be affected. And tax relief will still be given for all covenants to charities.

4. For new maintenance payments, starting from [date]:

- the person receiving the payments, normally a divorced wife, will not have to pay tax on them;
- a man maintaining his ex-wife will get tax relief on the payments he makes, up to a limit of [£2,500];
- there will be no tax relief for maintenance payments.

5. For new covenants:

- payments made under a deed of covenant will be tax-free;
- no tax relief will be given for people making covenants;

- parents of students, who are the main users of covenants, will benefit from a reduction in the parental contribution to the student grant.

The Case for Change

6. The Government wants to simplify the tax system as far as possible. That makes life easier for taxpayers, accountants and solicitors, and the Inland Revenue, alike.

7. The tax arrangements for maintenance payments and deeds of covenant reflect the technical legal consequences of a transfer of income from one person to another under a legal agreement. That was viable in the days when only a small number of relatively well-off and well advised taxpayers were affected. But it is simply not appropriate now that one in [twelve?] of the population are affected, in what are straightforward, everyday situations.

8. The vast majority of maintenance payments are made by divorced or separated men to their ex-wives. This is, in effect, housekeeping money, and there is no reason why the ex-wives should pay tax on it. Similarly, there is no logical reason for giving the man tax relief simply because the payments are made under a particular kind of legal agreement. What should be recognised is the expense of helping to maintain two households. [Dangerous?]

x 9. The present system for people who are separated or divorced, is extremely complicated.

- Most maintenance payments are paid gross, and the ex-husband has to claim tax relief separately. And if the wife is above the tax threshold, she has to pay tax on the money. This makes work for the taxpayer and the Inland

Revenue alike. And overall, no tax is raised in many cases, because the wife's tax bill is cancellled out exactly by the husband's tax relief. The system is also a disincentive for the wife who wants to go out to work.

- A further complication is that some maintenance payments are paid with tax already deducted. In that case, where the ex-wife is not liable to tax, she has to get a repayment from the Revenue. This makes more work for all, and delays the time when the wife or child gets the full amount of the money.

10. The system can also penalise marriage itself. A few couples, generally well-off and well advised, have gained extra tax relief by remaining unmarried. They take out maintenance orders against each other for the cost of raising their children, and get tax relief on the payments, which married couples are unable to do.

11. The recent Sherdley case has opened the way to further unfairness, by allowing a divorced parent tax relief for the cost of educating his children who are living with him. If that were to become common, the only parents who would not get tax relief for the cost of maintaining their children would be those who got married and stayed married!

12. The same unnecessary complexity arises with <u>covenants</u>. Apart from those to charity, where the system works well, most covenants are made by parents' supporting their student children.

13. Covenants to students have become popular since the age of majority came down to 18, and parents were able to get tax relief. But it is difficult to imagine a more convoluted way of getting State support into the hands of students.

14. The parent will usually already have gone through a means-test for the student's grant. He then has to go through the legal rigmarole of making a covenant, and supplying evidence of payment. The Revenue then have to means-test the student and repay him or her the relief. And as covenant income is taxable, many students are discouraged from taking holiday jobs and paying tax on their earnings.

The New System

15. The Government has therefore decided on a radical reform. In essence, this involves taking maintenance payments and covenants out of the tax system, and giving support, where appropriate, in other ways.

Maintenance Payments

16. People receiving maintenance payments will no longer have to pay tax on them. Nor will they have to put them on their tax return. [True?] This will simplify the tax affairs of some A million people.

17. A man maintaining his ex-wife will get tax relief on the payments he makes, up to a limit of [£2500], equal to the single person's allowance. This recognises the cost of helping to maintain a second household. If there were no limit, a few well off taxpayers could get large amounts of relief, far in excess of that available to the married man who is still married. The limit of [£2,500] would cover [over 90 per cent] of existing maintenance payments.

18. No relief will be available for other maintenance payments. [Why?]

Covenants

19. With the exception of covenants to charities, new covenants will be taken out of the tax system altogether. The payers will not get tax relief, and the recipients will not have to pay tax on the money they get.

20. To give broad compensation to students, the student grant for new students will be increased by B per cent from [date]. [Do we have to put this in terms of the parental contribution being reduced?] Thus State support for students will be given solely through grants.

21. Other covenants are, in effect, a gift from one person to another, often from grandparents to grandchildren. There is no reason why these gifts should get tax relief simply because they are made under a legal agreement. This relief is therefore being abolished, as part of the Government's policy of removing special tax reliefs, where posssible, and using the revenue saved to reduce the general burden of taxation.

Conclusion

22. These changes will bring a radical simplification of the tax system for ordinary people, sweeping away three different systems of taxing maintenance payments, the unintelligible legal mumbo-jumbo surrounding covenants, and the inevitable bureaucracy that follows both.

- The whole system will be easier to understand.
- All those receiving payments will find their tax affairs easier to handle.
- Student support will be rationalised.
- The Revenue will save C staff.

BUDGET DAY PAMPHLETS

RH13.

BUDGET CONFIDENTIAL

PMP

FROM: A P HUDSON

DATE: 4 February 1988

CHANCELLOR

cc Financial Secretary
Mr Scholar — Sir P. Middleton
Mr Culpin Sir T. Burns
Miss Sinclair
Mr Riley
Mr A C S Allan
Mr Cropper
Mr Tyrie
Mr Isaac - IR
Mr Corlett - IR
Mr Mace - IR
PS/IR

BUDGET DAY PAMPHLETS

... I attach a shot at the Budget Day Pamphlets on Independent Taxation and Maintenance and Covenants. These incorporate initial comments from FP and the Revenue.

2. These are almost certainly too long and detailed to be published as pamphlets. But before any more work is done on the drafting, it would be helpful to have a word about the intended audience and the scope of the pamphlets.

- Are we aiming at journalists? MPs? The man in the street? Or tax practitioners?

- If we cannot satisfy all these in one go, should we aim for a short pamphlet, plus a more detailed press release or note?

- What balance should be struck between arguing the case for the proposals, and simply explaining how the new system will work?

Not ws pd publicity rules!

- What format should the pamphlets take, and how widely should they be distributed? Mr Walker's note (attached) sets out the options here.

...

3. The answers to these questions may, of course, be different for Independent Taxation and Maintenance and Covenants.

- On Independent Taxation, it may be worth putting out a short pamphlet, selling the proposal, and a longer and basically factual press release setting out the consequences in more detail.

- On Maintenance and Covenants, Mr Corlett has already prepared detailed press releases and a Question-and-Answer leaflet designed for the person actually involved in the system (attached, top copy only).

...

APH

A P HUDSON

INDEPENDENT TAXATION

mjd 4/38An

BUDGET CONFIDENTIAL

PAMPHLET ON INDEPENDENT TAXATION: SECOND DRAFT

MAIN POINTS

What is Independent Taxation?

1. From April 1990, there will be a new system for taxing married couples.

- Independent taxation for husbands and wives.
- Complete privacy and independence for married women.
- An end to the tax penalties on marriage.
- Lower tax bills for many people.

2. The Government's reform sweeps away the system of taxing husband and wife as a unit, which lasted for 180 years.

3. Under the new system:

- A husband and wife will be taxed as separate individuals.
- Each will have their own tax allowance and set of tax rate bands.
- The wife will be able to fill in her own tax return,
- The married man's allowance and the wife's earned income allowance will be replaced by a new married couple's allowance. For simplicity, this will normally be given to the husband, bringing his total allowances up to the level of the old married man's allowance, but if he does not have enough income to use it, his wife can do so.

THE CASE FOR CHANGE

4. The present system for taxing married couples is based on treating husband and wife as one taxpayer, with the husband legally responsible for filling in tax returns and paying the couple's tax. For income tax purposes, a married woman's income is deemed to be her husband's.

5. This principle dates back to the introduction of income tax in 1805. Not surprisingly, it produces results which are unacceptable in today's world.

6. First, a wife cannot have privacy or independence in her tax affairs. Her husband is responsible, in law for filling in the couple's tax return, so she has to give him details of all her income - whether earnings, interest on her savings, or even the profits of her own business. This is absurd, in an age when two out of three married women are in paid work, and millions more have savings of their own.

7. Second, the system means couples can actually have to pay more tax simply because they are married. This affects, in particular, couples where the wife has a certain amount of savings income, but would not have to pay tax if she had her own tax allowance against this.

8. Tax penalties on marriage can occur for various other reasons. The most important of these is mortgage interest relief: a married couple are entitled to mortgage interest relief on loans up to £30,000, whereas an unmarried couple can have relief on up to £30,000 each.

9. It is clearly unacceptable that the tax system should penalise marriage.

10. The Government has therefore decided on a major reform, to make the system fairer, simpler to understand, and up to date.

THE NEW SYSTEM: INDEPENDENT TAXATION

11. The basic principle of the new system is that husband and wife will be taxed completely independently - on earnings, savings, pensions, and any other income. Their incomes will no longer be added together, and each partner will pay their own tax, independent of the other.

Is not compulsory!

12. The wife will be able to fill in her own tax return, and handle her own tax affairs.

13. The married man's allowance and wife's earned income allowance will be abolished. All taxpayers, male or female, married or single, will have a personal allowance (in 1987-88 terms, £2425, for people under 65).

14. Married couples will also receive a new married couple's allowance. The married couple's allowance and the personal allowance together will be worth the same as the present married man's allowance. So, in 1987-88 terms, the married couple's allowance would be £1,370 (the difference between the present married man's allowance of £3,795 and the single allowance of £2,425).

15. The new married couple's allowance will go in the first instance to the husband, so he will see no reduction in his tax threshold as a result of the change to the new system. But if he has insufficient income to make use of the allowance he will be able to transfer it to his wife.

16. Examples 1 and 2, in Annex 1, show how the new system will work.

COUPLES IN PARTICULAR CIRCUMSTANCES

Taxpayers over 65

17. Pensioner taxpayers will see a number of benefits from Independent Taxation.

18. As now, taxpayers over 65 will get a higher tax allowance (and those over 80 a higher allowance still). Married women will qualify in their own right for this allowance, rather than the wife's earned income allowance. They will be able to set this allowance against income of any kind, including investment income and pensions based on their husband's contributions, where the wife's earned income allowance is not available.

19. There will be a higher rate of married couple's allowance for couples where one or both is over 65, and a higher rate still if either partner is over 80.

20. As now, all the age allowances will be subject to an income limit. They will be withdrawn by £2 for every £3 of income above the limit, until they reach the level of the ordinary allowances. Under Independent Taxation, husband and wife will each have their own income limit, whereas at present a single limit applies to their combined income.

Couples on Higher Incomes

21. At present, couples on high incomes, where the wife earns more than a certain amount, generally elect to have the wife's earnings taxed separately, because their combined income would put them in a higher tax bracket.

22. Under Independent Taxation, their incomes will be taxed separately, so the Wife's Earnings Election will

disappear. The husband will normally get the married couple's allowance. However, where the husband's income is above [£40,000] a year, the married couple's allowance will be reduced progressively, until it ~~reaches the level of the single allowance~~. The same arises if the married couple's allowance is claimed by a wife with a very high income.

is phased out altogether

"Breadwinner Wives"

23. At present, because all the couple's income is treated, for tax purposes, as the husband's, the wife is able to set the married man's allowance as well as the wife's earned income allowance against her earnings, if her husband cannot use his allowance. This means that the couple where the only breadwinner is the wife pay a lot less tax than the couple where the only breadwinner is the husband.

24. Under Independent Taxation, both couples will be treated in the same way. If the husband has no income, the wife gets the married couple's allowance, so her total tax allowance will be the same as a husband whose wife has no income. If the husband has a small income, but not enough to make full use of the married couple's allowance, his wife can use the balance.

25. If these rules were introduced straight away, some 'breadwinner wives' would see a reduction in the value of their tax allowance. The Government has therefore decided on transitional arrangements to make sure that they do not lose out.

ENDING THE TAX PENALTY ON MARRIAGE

26. The introduction of Independent Taxation eliminates automatically the most common tax penalty on marriage: the taxation of the wife's investment income at her

husband's top rate of tax. The Government is also taking steps to eliminate other tax penalties. Some of those changes will come into effect before the main change to Independent Taxation in 1990.

Mortgage Interest Relief

Discuss Chancellor

27. At present, mortgage interest relief is available on a loan of up to £30,000 for the purchase of a home. But two single people sharing a home can get relief on loans up to £30,000 each, whereas a married couple share a single ration of relief. This creates a widely resented tax penalty on marriage.

28. [From August 1988], the limit on relief will apply to the house or flat, irrespective of whether there are one or more borrowers, married or single, living there. This puts unmarried couples on the same footing as married couples, and eliminates the tax penalty on marriage.

Apply only to new mortgages

Capital Taxes

29. The problems of the absence of privacy for married women and the tax penalty on marriage arise for capital gains tax in the same way as for income tax. A married couple share one annual exemption for capital gains tax, whereas single people have one each, and the husband has to deal with the couple's CGT affairs.

30. From April 1990, under Independent Taxation, husband and wife will each have their own annual exemption, and partners will be responsible for their own affairs.

31. Transfers of assets between husband and wife will remain exempt from CGT and Inheritance Tax.

Additional Personal Allowance

32. At present, married couples can each claim the Additional Personal Allowance if they have two or more children living with them. This means that between them, they get more allowances than a married couple.

33. [From April 1989], the rules for the Additional Personal Allowances will be changed so that an unmarried couple can get no more allowances in total than a married couple.

Maintenance and Covenants

34. A few unmarried couples exploit the present tax reliefs for maintenance and covenanted payments to gain a tax advantage not available to married couples. The Government is introducing a major reform of this area. For new maintenance arrangements and covenants (except to charities), the person receiving payments will not have to pay tax on them, and tax relief – up to a specified limit – will be given only to men maintaining their ex-wives. This will eliminate the tax penalty in this area. (A separate pamphlet/press release gives further details.)

TIMETABLE FOR CHANGE

35. Independent Taxation will come into operation from April 1990.

36. During the previous tax year, local tax offices will need to get in touch with some taxpayers to ask for the information they need to run the new system. That will involve, in particular, setting up records for married women as taxpayers in their own right, and transferring information onto these records from their husbands' tax records.

ANNEX

MV ✓ happy with examples

Example 1 - husband and wife both earning

Take a couple where the husband earns £10,000 and the wife £5,000.

Present system

Husband:	10000	Wife:	5000
less married man's allowance	3795	less wife's earned income allowance	2425
so pays tax on	6205	so pays tax on	2575
so tax bill is	1675.35	so tax bill is	695.25

Independent Taxation

Husband:	10000	Wife:	5000
less single allowance	2425	less single allowance	2425
less married couple's allowance	1370		
so pays tax on	6205	so pays tax on	2575
so tax bill is	1675.35	so tax bill is	695.25

The couple's tax bill is unchanged.

Example 2 - husband earning, wife with investment income

Take a couple where, again, the husband earns £10,000; the wife has no earnings, but has £500 investment income, in dividends on shares inherited from her parents.

Present system

Husband earns	10000	Wife's income is taxed with husband's
plus wife's investment income	500	
so total income	10500	
less married man's allowance	3795	
so pays tax on	6705	
so tax bill is	1810.35	

Independent Taxation

Husband earns	10000	Wife's income	500
less single allowance	2425	less single allowance	(2425)
less married couple's allowance	1370		
so pays tax on	6205	so tax bill is	0
so tax bill is	1675.35		

The couple's tax bill is £135 lower.

Example 3 - "breadwinner wife"

Husband has no income; wife earns £10,000.

Present System

Wife earns	10000
less wife's earned income allowance	2425
less married man's allowance	3795
so pays tax on	3780
so tax bill is	1020.60

Independent Taxation, with transitional allowance

Wife earns	10000
less single allowance	2425
less married couple's allowance	1370
less transitional allowance	2425
so pays tax on	3780
so tax bill is	1020.60

The value of the transitional allowance will fall over the years, as the other allowances are increased, and it will disappear when the combined value of the single allowance and the married couple's allowance reaches the present allowance for a "breadwinner wife".

Example 4 - Pensioner Couple

Take a couple who are both over 65 where the husband has an occupational pension and the State pension, and the wife has a pension based on her husband's contributions.

Pensioner Couple

(Both over 65 under 80)

Now:

Husband:	£	Wife:	£
Occupational Pension	3000		NIL
NIRP (including Cat B for wife)	3427*		
	6427		
Age Allowance	4675		
	1752		
Tax	£ 473.04	Tax	NIL

Independent Taxation

Husband	£	Wife	£
Occupational Pension	3000	NIRP Cat B	1287*
Own MIRP	2140*	Age Allowance	2960
	5140		NIL
Age Allowance	4675		
	465	Tax	NIL
Tax	£ 125.55		*1988-89 Levels.

So couple pay £347.49 less.

MAINTENANCE AND COVENANTS

mjd 4/43An

BUDGET CONFIDENTIAL

MAINTENANCE AND COVENANTS

THIRD DRAFT OF BUDGET DAY PAMPHLET ETC.

INTRODUCTION

1. The tax system for maintenance payments and covenants has become far too complicated, and produces anomalies and distortions in the way people organise their private finances. It also makes unnecessary work for taxpayers and the Inland Revenue alike. The Government has therefore decided to introduce a reform of the system, bringing a major simplification by taking most arrangements out of the tax system altogether.

2. This pamphlet explains why the changes are being made and how the new system will work.

SUMMARY OF THE CHANGES

3. The new system will apply to new maintenance payments and deeds of covenant. Existing arrangements will not be affected. The people making the payments will continue to get tax relief on them, and the recipients will pay tax on the money they receive, in the same way as now, for as long as the payments continue. And tax relief will still be given for all covenants to charities.

4. For new maintenance payments under Court Orders or agreements made on or after 15 March:

- the person receiving the payments will not have to pay tax on them;
- a man maintaining his ex-wife (or a woman maintaining her ex-husband) will get tax relief on the payments made, up to a limit of [£2,500];

Single allowance

- there will be no tax relief for any other maintenance payments.

5. <u>For payments made under new deeds of covenant</u>, other than to charities:

- the person who receives the covenanted payments will not have to pay tax on them;
- no tax relief will be given to the person making the covenant;
- parents of students starting new courses will stand tobenefit from a reduction in the parental contribution to the student grant, to balance the fact that tax relief will no longer be available on covenants made after Budget Day.

<u>THE CASE FOR CHANGE</u>

6. The present system, for both maintenance payments and covenants, is too complicated, produces anomalies and unfairness, and can penalise people who want to work.

<u>Maintenance Payments</u>

7. One in [twelve?] of the population now either makes or receives maintenance payments. The vast majority are made by divorced or separated men to their ex-wives.

8. There is no reason for the tax system to be involved simply because the payments are made under a particular kind of legal agreement. What should be recognised is the expense arising from the breakdown of a marriage, and hence of the need to maintain two households.

9. The system should be as simple and straightforward as possible. In fact, it is extremely <u>complicated</u>.

- Most maintenance payments are paid gross, and the ex-husband has to claim tax relief separately. And if the wife is above the tax threshold, she has to pay tax on the payments she receives. This makes work for the taxpayer and the Inland Revenue alike. And overall, no tax is raised in many cases, because the wife's tax bill is cancelled out exactly by the husband's tax relief.
- A further complication is that some maintenance payments are paid with tax already deducted. In that case, where the wife's income is below the tax threshold, she has to get a repayment from the Revenue. This makes more work for all, and delays the time when the wife or child gets the full amount of the money.

10. The system <u>can also penalise marriage</u> itself. A few couples, generally well-off and well advised, have gained extra tax relief by remaining unmarried. They take out maintenance orders against each other for the cost of raising their children, and get tax relief on the payments, which married couples are unable to do.

11. [The Courts have recently established that a divorced parent can get a Court Order against him or herself for the cost of educating his children who are living with him, and get tax relief for it. Given the tax advantages mentioned above that are open to unmarried couples with children, that could mean that the only parents who would not get tax relief for the cost of maintaining their children would be those who got married and stayed married!]

12. The system can also be a <u>disincentive</u> for the ex-wife (or ex-husband) who wants to go out to work.

Because the maintenance payments are taxable, she may find she has to pay tax on the first £1 that she earns.

Covenants

13. Similar problems arise from the present tax treatment of covenants.

14. Apart from those to charity, most covenants are made by parents' supporting their student children. But it is difficult to imagine a more convoluted way of getting State support into the hands of students.

15. The parent has to go through the legal rigmarole of making a covenant, and supplying evidence of payment. The Revenue then have to check the student's income, and repay him or her the tax that had been paid.

16. As covenant income itself is taxable, many students are discouraged from taking holiday jobs, because they will have to pay tax on the first £1 of their earnings. This is scarcely the best way of introducing young people to the tax system. — or to paid work

17. Covenants can also be used by unmarried couples to gain a tax advantage that is not available to married couples, by covenanting money to their own children and getting tax relief for that.

THE NEW SYSTEM

18. The Government has therefore decided on a radical reform. In essence, this involves taking new maintenance payments and non-charitable covenants largely out of the tax system, and giving support, where appropriate, in other ways.

Maintenance Payments

19. People receiving maintenance payments under new Court Orders or agreements will not have to pay tax on them. Nor will they have to put them on their tax return. [IR checking.] This will simplify the tax affairs of some A million people.

20. A man maintaining his ex-wife will get tax relief on the payments he makes, up to a limit of [£2500], equal to the single person's allowance. This recognises the cost of helping to maintain a second household. If there were no limit, a few well off taxpayers could get large amounts of relief, far in excess of that available to the ordinary married man.

21. No relief will be available for other maintenance payments.

[illegible]

22. Thus the treatment of maintenance payments will be more generous than it is now, in the vast majority of cases. The husband will get the same relief as he does now, and the wife will not have to pay tax on the payments she receives.

23. The system will be

- <u>simpler</u>, with one claim for relief;
- <u>fairer</u>, with no tax penalty on marriage;
- and <u>better for incentives</u>, with the wife able to earn up to the single allowance without having to pay tax.

Covenants

24. With the exception of covenants to charities, new covenants (made on or after Budget Day) will be taken out of the tax system altogether. The payers will not get

tax relief, and the recipients will not have to pay tax on the money they get.

25. The main beneficiaries from the existing system have been parents of students. They will be given broad compensation through a reduction in the parental contribution to the student grant. Thus support for students will be concentrated in the grant system.

26. Students will be able to earn up to the tax threshold without paying tax.

27. Other covenants are, in effect, a gift from one person to another, often from grandparents to grandchildren. There is no reason why these gifts should get tax relief simply because they are made under a legal agreement. This relief is therefore being abolished, as part of the Government's policy of removing special tax reliefs, where posssible, and using the revenue saved to reduce the general burden of taxation.

Conclusion

28. These changes will bring a radical simplification of the tax system for ordinary people, sweeping away two different systems of taxing maintenance payments, the unintelligible legal mumbo-jumbo surrounding covenants, and the inevitable bureaucracy that follows both.

- The whole system will be easier to understand.
- All those receiving payments will find their tax affairs easier to handle.
- Student support will be simplified.
- There will be less work for the Revenue in running the system.

Transfers on marriage

MR WALKER: MECHANICS

FROM: A.J. WALKER
DATE: 4 February 1988

BUDGET CONFIDENTIAL

OPTIONS FOR PRODUCING BUDGET DAY PAMPHLETS: NOTE BY THE INLAND REVENUE

1. This note considers the possibilities open for the production of Budget Day material over and above press notices etc. In particular, it examines options for producing two additional leaflets or booklets on

- maintenance and covenants, and
- independent taxation

No consultative document on Res. until after the Budget rush.

Background

2. The Revenue's in-house printing team produce Budget Day press notices to a very tight deadline, but have always delivered on time. This is achieved by working overtime, in the week preceding the Budget and all weekend (including nights). Last year they printed and collated 13,000 sets of Revenue press notices, each set running to 108 pages. These go into the Budget packs for the media and MPs, and also to tax practitioners and the technical press. They also have to cope with other Budget printing requirements (copying of the Brief, etc, and Instructions to tax offices). We are confident that, provided there are no major operating difficulties, they could produce a similar amount of material this year if necessary; but there is little margin for flexibility, particularly over the pre-Budget weekend.

These pamphlets are much more important than residence etc.

3. If it was decided to produce any other documents for issue on or soon after Budget Day - for example, a consultative document on residence - scope for the production of additional leaflets or booklets would be further constrained.

Options

4. Bearing this in mind, the main options are:

i. Use a secure outside printer to print a few thousand copies for distribution with press notices. Printing would take about three days if the Revenue provided copy in final form (including finished artwork). The best estimate of overall production time, including setting up, is four to five days. In addition, some time would be needed for putting the leaflets in Budget packs etc. This points to the final text being agreed by Tuesday or Wednesday in the week preceding the Budget (i.e 8 or 9 March). This option would be more costly than printing in-house (in the region of £3,000 to £4,000 for 13,000 copies of each leaflet) but has the advantage that the leaflets could go into the Budget packs, and thus be available to journalists for reproduction in the press the following day. This would be particularly helpful on maintenance and covenants, where those affected will want details as quickly as possible.

ii. Print the pamphlets in Somerset House well before the pre-Budget weekend. Printing would need to be completed by the Wednesday before the Budget in order not to jeopardise the printing timetable for Press Releases. The final text would need to be settled by the preceding Friday (4 March).

iii. Issue the text of the pamphlets on Budget Day as press notices and subsequently print the same material so that it appears in pamphlet form two or three days after the Budget. In this case the final text would be agreed to the same timetable as other press releases. It would be necessary to decide the audience at which the pamphlet was aimed and how to get it to them.

Each of options i. to iii. involves a print-run of only a few thousand copies aimed at the media, MPs, representative bodies, and perhaps tax practitioners. A format along the lines of the attached booklets might be adequate (the text itself could be produced to look more "professional", and the page size could probably be altered if necessary).

5. There is a further option which would get leaflets into the hands of a wider audience:

iv. Use a secure outside printer to print a more popular leaflet for the general public. If the text were short enough a format similar to some of the Revenue's explanatory leaflets could be adopted (see attached example). The print run needed for such a leaflet would be longer and more complex than the Revenue could handle in-house. To be available to the press and MPs on Budget Day, and to the public through tax offices by say the Thursday of Budget week, would be a major and ambitious operation, but should be achievable if final texts were agreed by Tuesday 8 or Wednesday 9 March. The cost would be considerable - probably well in excess of £20,000. To keep this option open, we would need to start detailed planning (including lining up a secure printer with capacity for such a job) immediately.

See also HMT leaflet on PEPs.

6. We think it is too ambitious to plan for final texts of these pamphlets by 4 March, in which case option ii. is unrealistic. As between options i, iii. and iv. the choice is essentially between aiming at the public directly (option iv), or indirectly through the media, MPs and practitioners (options i. and iii.). As between i. and iii., i. has the advantage of having the leaflets available on Budget Day but costs more.

Chancellor (i) & (iv)

Issued by the Inland Revenue

Produced by the Communications Group

July 1987

DEPARTMENTAL STATEMENT 1987

A STATEMENT OF DEPARTMENTAL AIMS AND OBJECTIVES, PRIORITIES AND TARGETS.

INLAND REVENUE

VALUER NUMBERS

Target	1987/8 (target)
a. Revaluation	
Increase in Senior Valuers	15
Increase in Valuers (Main Grade)	15
Increase in Regional Building Surveyors	6
b. Recruitment of professional staff	150

DEPARTMENTAL STATEMENT 1987

A. OVERALL AIMS AND OBJECTIVES

The Department's overall aims are to

- advise Ministers on policies on the direct taxes and stamp duties and the provision of valuation services;
- implement its responsibilities for the management, assessment, and collection of the direct taxes and stamp duties in accordance with Government policy, and legislation approved by Parliament;
- provide valuation and rating services to local authorities, other Government Departments, and for tax purposes;
- carry out these functions as efficiently and effectively as possible within the Department's financial and manpower targets.

B. MAIN CRITERIA RELEVANT TO CARRYING OUT DEPARTMENTAL AIMS AND OBJECTIVES

- In meeting the Department's policy responsibilities, to give responsible, effective and timely advice, taking account (inter alia) of;
  - Exchequer cost/yield;
  - economic and social effect;
  - effect on perceived fairness and acceptability of the tax system;
  - administrative implications, including public expenditure and manpower costs/savings;
  - compliance burden on taxpayers and employers.
- In carrying out the Department's statutory and operational responsibilities for the direct taxes and for the valuation and rating services to;
  - assess and collect the tax properly due as efficiently and economically as possible;
  - value property to proper professional standards.

- In carrying out its management responsibilities (involving almost 70,000 staff and a budget of over £1 billion) to;
    - use its resources (both manpower and money) efficiently and effectively, including maximum effective use of new technology;
    - strengthen the accountability, together with the freedom of action, of line managers at all levels on the basis of delegated budgeting and improved management information;
    - operate effective personnel policies in regard to the recruitment, retention, training, development, motivation and well being of its staff, and seek improvements in all their application.
- In its relations with the public, in accordance with the Taxpayer's Charter to;
    - deal with the taxpayer's affairs fairly, impartially and with strict regard for confidentiality;
    - carry out its duties courteously, promptly and as helpfully as possible;
    - have regard to the impact of its activities on individuals, business, and the economy.

C. MAIN PRIORITIES AS AT APRIL 1987

To;

- meet new Ministerial decisions involving major operational changes - most notably the revaluation of non-domestic property;
- implement the computerisation of PAYE (COP), Schedule D assessing (CODA) and the new Collection and accounting system for tax (BROCS) on schedule;
- maintain the improvements in clerical workstate and reduction of arrears successfully achieved in 1986/87 by WIN in Taxes and Collection offices, and secure further improvements (particularly in reducing the number of open Schedule E cases and outstanding local action notices in collection);
- complete implementation of line management budgeting;
- complete network office reorganisation.

LINE MANAGEMENT BUDGETING

Objective: To secure, through delegated budgeting, better value for money, and better results, with the overall resources allocated to the department.

Target: In 1987/88 to extend line management budgeting to remaining 25% of the department involving a further 400 budgetholders. (In 1986/87 line management budgeting was extended to 75% of the department, involving 1,100 budgetholders).

NETWORK OFFICE RATIONALISATION

Objective: To reduce the size of the tax, collection and valuation networks to create offices of a size consistent with maximum operational efficiency.

Target:	End of March 1988 (target)	End of March 1987 (actual)	End of March 1986 (actual)
Tax Offices	634	639	662
Collection Offices	136	149	154
Valuation Offices (E&W)	135	141	160

INSPECTOR NUMBERS

Objective: To:

- ensure a continuing supply for the fully trained and non-fully trained Inspectorate;
- reduce shortfalls in required Inspector numbers.

Target:	1988 (target)	1987 (target)	1986 (outturn)	1986 (target)
FT Inspectors				
Graduate recruits taking up duty	120*	120*	128*	90*
Internal Selections (TO(HG) and Inspector)	100	100	90	47
NFT Inspectors				
Selection for Accounts Investigation Course	500	500	580	475
Inspector (O) promotions	60	60	118	160

*These figures are to 30 September each year (others are for calendar years).

APPROVAL AND SUPERVISION OF PENSION SCHEMES

Objective: To:

- reduce the arrears of work in the Superannuation Funds Office;
- improve the speed at which scheme approvals are given.

Target:	1987/88 (target ø)	1986/87 (outturn)	1986/87 (target)	1985/86 (outturn)
Average monthly arrears: Clerical (AA)		4203	4000	5401
Examination (AO and above)		6277	5600	5725
Arrears over 3 months		164	170	335
Ratio of approvals to applications		79%	82%	80%

COLLECTION OF STAMP DUTY

Objective: To:

- continue to collect stamp duty as inexpensively as possible;
- maintain so far as possible the substantial efficiency gains achieved in recent years.

Targets:	1987/88 *	1986/87 (outturn)	1986/87 (target)	1985/86 (outturn)
Document processed target (million)	8.4	7.1	5.2	6.3
Cost of processing target (each document (£))	0.9	0.94	1.0	1.15
Duty Collected (£m) estimate (not a target)	2460	1860	N/A	1230
Cost/yield percentage estimate	0.27%	0.36%	N/A	0.59%

ø Management initiative launched recently. Targets still under discussion.

* Subject to receipt of final data.

D. SPECIFIC DEPARTMENTAL TARGETS

FINANCIAL

To ensure that departmental expenditure is kept within the overall costs limit, and that running costs are kept within the running costs target, as required by Ministers.

	Cash Limit	Running Costs Target
1986/87	£m963.3 (net of receipts)	£m923.86
1987/88	£m1013.8 (net of receipts)	£m980.4

MANPOWER

To ensure that manpower numbers are within the manpower targets agreed by Ministers.

	Manpower Target
as at 1 April 1987	68,250
1 April 1988	67,974

COP/CODA

To complete the implementation of COP/CODA (including COP enhancements) on schedule, including realisation of resulting manpower savings (if financial and manpower targets are to be met).

Milestones:

by April 1987	COP operational in 9 regions
by April 1988	COP operational in all regions (except Centre 1)
	CODA fully operational in 2 pilot regions
by April 1989	Centre 1 operating COP
	CODA fully operational in all regions (except Centre 1)
By December 1989	Centre 1 operating CODA.

Staffing savings by April 1989 (COP and CODA) - 5800.

TAXATION: CLERICAL WORK

a. Post over 14 days

Objective: To hold the good position achieved at April 1987, and to reduce arrears further so far as possible.

Target:	April 1988 (provisional target)	April 1987 (actual)	April 1987 (original target)	April 1986 (actual)
	100,000-150,000 ∅	136,000	192,000	1,295,000

b. Open Schedule E cases

Objective: To reduce so far as possible cases at April 1988.

Target:	April 1988 (provisional target)	April 1987 (actual)	April 1987 (original target)	April 1986 (actual)
Current year	2,750,000 ∅	4,258,000	2,196,000	3,544,000
Earlier years	500,000 ∅	789,000	516,000	837,000

c. Schedule E returns examination

Objective: To complete the bulk of the programme by October 1987.

Target: 95% of returns examined by October 1987. (In 1986/7 93% were examined by October 1986).

d. Schedule E employers' end of year returns

Objective: To transmit (on form P228) to DHSS by October 1987 over 98% of schemes received.

Target: Ditto

e. Schedule D principal assessing programme

Objective: To make and issue 100% assessments by November 1987.

Target: Ditto

∅ Provisional target set at April 1987. The provisional target for April 1988, and other quarterly targets, are to be reviewed on a rolling basis, and if necessary revised, in the light of changing circumstances.

TAXATION : INVESTIGATION

Objective: Within existing resource constraints to

- examine a sufficient percentage of cases in detail
- verify, and as appropriate correct, the level of profits shown in accounts submitted
- act as a deterrent against fraud.

Target:	1987/88 (target)	1986/87 (outturn)	1986/87 (target)
Company Accounts	1%	1.11%	1%
Schedule D Accounts	2.25%	2.23%	2.4%

COLLECTION

Objective: To:

- check the growth in, and so far as possible reduce, the collectible balance outstanding;
- hold, and if possible, reduce the over 14 day post arrears;
- collect at least 90% of taxes (other than tax under appeal) assessed in the first 9 months of 1987/8.

VALUATION :PROFESSIONAL STAFF OUTPUT

Objective: To:

- give proper professional advice to the other divisions of the Inland Revenue, other Government Departments and local authorities concerning the valuation, acquisition and disposal of property;
- maintain the rating valuation lists.

Target: 265 average weighted work-units per annum per professional valuer, maintaining the level achieved in 1986/87.

NON-DOMESTIC REVALUATION

Objective: To complete tasks by end 1989 in time for introduction of the new valuation list on 1 April 1990 in accordance with Valuation Office's phased timetable throughout the period of the revaluation.

Issued by the Inland Revenue

STATEMENTS OF PRACTICE

INDEX OF

INLAND REVENUE STATEMENTS OF PRACTICE

VALID AT 30 JUNE 1987

STATEMENTS OF PRACTICE

STATEMENTS OF PRACTICE

STATEMENTS OF PRACTICE

STATEMENTS OF PRACTICE

STATEMENTS OF PRACTICE

STATEMENTS OF PRACTICE

Price 80p

F. MISCELLANEOUS

Construction Industry Tax Deduction Scheme - Carpet Fitting	SP12/81
Development Land Tax - negotiations on liability	SP 2/79
- Double Taxation Conventions	SP 4/84
Estate Duty - calculation of clawback charge on heritage objects previously granted conditional exemption ...	*SP11/84
- acceptance of property in lieu - waiver of on tax satisfied (also applies to IHT - see section E)	**SP 6/87
Limitations on Inland Revenue advice to taxpayers	F1
Securities dealt in on the Stock Exchange Unlisted Securities Market - Status and valuation for tax purposes (see also Section B)	SP18/80
Stamp Duty - convertible loan stock	SP 3/84
- treatment of securities dealt in on the Stock Exchange Unlisted Securities Market..........	SP 9/84

Deletions since last index issued

F2 - superseded by ESC C14 (s67 FA 1982 applicable from 1 April 1982)
F3 - superseded by ESC D12

---

* This number allocated retrospectively. Practice announced in Inland Revenue Press Release of 3 May 1984.
** This number allocated retrospectively. Practice announced in Inland Revenue Press Release of 8 April 1987.

INDEX OF INLAND REVENUE STATEMENTS OF PRACTICE WHICH REMAIN VALID AT 30 JUNE 1987

This index lists Statements of Practice issued up to 30 June 1987 which were valid on that date. It replaces the cumulative index published on 16 May 1983, and shows deletions made in the interim. Further copies of this index are available from the Reference Room, New Wing, Somerset House, Strand, London, WC2R 1LB, price 80p post-free.

Statements of Practice issued since 18 July 1978 are in numbered annual series having the prefix "SP". Copies of individual SP series Statements of Practice are available from the Public Enquiry Room, West Wing, Somerset House, Strand, London, WC2R 1LB. A large SAE should be enclosed with written applications.

Other references are to earlier statements, which were publicised in various ways and first brought together in a list published on 18 June 1979, since updated. The latest edition of that list, containing those pre-1978 statements still valid at 30 June 1987, is now available from the Reference Room, New Wing, Somerset House, Strand, London, WC2R 1LB, price £1.20 post-free.

The statements are grouped under the following general subject headings:

A. Statements applicable to individuals (Income Tax and interest on tax).

B. Statements applicable to individuals and companies (Income Tax and Corporation Tax).

C. Statements applicable to companies etc (Corporation Tax and Income Tax).

D. Statements relating to tax on Capital Gains (individuals and companies).

E. Inheritance Tax (also applicable where tax charged is Capital Transfer Tax).

F. Miscellaneous.

Inland Revenue Statements of Practice have no binding force and do not affect a taxpayer's right of appeal on points concerning his liability to tax.

Somerset House, JULY 1987

INDEX

A. STATEMENTS APPLICABLE TO INDIVIDUALS
(INCOME TAX AND INTEREST ON TAX)

Abroad, earnings for work done A17

Accountancy expenses A28

Accounts on a cash basis A27

Administration period, income received during - claims to repayment of tax (see also SP 3/86) ... SP 7/80

Airline pilots - residence - incidental duties A10

Assessing tolerance A12

Attorneys, completion of returns by A13

Barristers - the cash basis A3

Benefits in kind - cheap loans - advances for expenses ... SP 7/79

- VAT A7

Capital allowances on machinery and plant - amendment of claim by individual trader A26

Cash basis, accounts on a A27

- barristers A3

Charities - deeds of covenant in favour of - income tax repayment procedure ... A5

- covenanted and other income in favour of - income tax repayment procedure SP 3/87

Completion of return forms by attorneys A13

Deceased persons' estates - income received during the administration period - claims to repayment of tax (See also SP 3/86) .... SP 7/80

Deeds of covenant - general.............................. A1

Settled property - Miscellaneous

- Employee trusts E11

- Excluded property E9

- Leases for life E10

- Power for trustees to allow a beneficiary to occupy a dwelling house SP10/79

Superannuation, life assurance and accident schemes

- Associated operations E4

- Death benefits *SP10/86

- Superannuation schemes E3

* This number allocated retrospectively. Practice announced in Inland Revenue Press Release of 9 July 1986.

** This number allocated retrospectively. Practice announced in Inland Revenue Press Release of 8 April 1987.

E. INHERITANCE TAX (Also applicable where tax charged is Capital Transfer Tax)

Acceptance of property in lieu - waiver of interest on tax satisfied (also applies to Estate Duty - see section F) .... **SP 6/87

Accumulation and maintenance settlements: Section 71, IHTA 1984

- Examples E2a
- Powers of advancement E2
- Powers of appointment E1
- Treatment of income .... SP 8/86

Death benefits under superannuation arrangements SP10/86

IHT and Scots law

- Missives of sale E16
- Partial disclaimers of residue E18

Interests in possession

- Age of majority E8
- Close companies E5
- Power to augment income E6
- Protective trusts E7

Legal Entitlement and Administrative Practices (see also Section A) .... SP 1/80

Non-settled property

- Business relief - "buy and sell " agreements SP12/80
- Charities E13
- Close companies - group transfers E15
- Orders in matrimonial proceedings E12
- Pools etc syndicates E14

Deeds of covenant - in favour of charities - income tax repayment procedure A5

Delay in rendering tax returns - interest charge and penalties A14

Disability resulting in cessation of employment, payments on account of ... SP10/81

Double taxation relief - payments to a non-resident from UK discretionary trusts or UK estates during the administration period (see also SP 7/80) .... SP 3/86

Earnings for work done abroad A17

Employees resident but not ordinarily resident in the United Kingdom - liability under Cases II and III of Schedule E .... SP 5/84

End of year adjustments, informal A11

Furnished lettings - wear and tear allowance A19

Goods taken by traders for personal consumption A32

Incentive awards - calculation of the amount assessable .. SP 6/85

Individuals coming to the United Kingdom - ordinary residence .... SP 3/81

Informal end-of-year adjustments A11

Insurance Policies - non-residents' liability under Chapter III of Part XIV ICTA 1970 (chargeable event provisions) SP11/80

Interest - solicitors' deposit A22

- relief - mortgage - year of marriage SP10/80
  - loans applied in acquiring an interest in a partnership A33
  - loans used to purchase or improve land A34
  - loans used to buy land occupied for partnership etc business purposes (see also section D) .... SP 4/85

Investigation settlements - retirement annuity relief .... SP 9/80

Investigation settlements - inclusion of interest clause (cont) in letters of offer	SP 6/86
Legal entitlement and administrative practices (see also Section E) .	SP 1/80
Life assurance premium relief - children's policies	SP 4/79 & SP11/79
- premiums on which commission is payable to the policyholder (see also Section B) ..	SP 3/79
Living expenses abroad - Schedule D Cases I and II	A16
Lorry drivers - relief for expenditure on meals	SP16/80
Maintenance payments - under court orders - retrospective dating ..	SP 6/81
- payment of school fees	SP15/80
Mortgage interest relief - year of marriage	SP10/80
Non-statutory redundancy payments	SP 1/81
Offshore funds - Chapter VII Part II FA 1984	SP 2/86
Partnerships - change in membership	A4
- mergers and demergers	SP 9/86
- retirement annuity relief	A18
Payments on account of disability resulting in cessation of employment ..	SP10/81
Payments to redundant steel workers	SP 2/84
Payments to a non-resident from UK discretionary trusts or UK estates during the administration period - Double taxation relief....(see also SP 7/80)..	SP 3/86
Penalties and interest charge for delay in rendering returns ...	A14
Redundancy - non-statutory payments	SP 1/81
- steelworkers	SP 2/84

Treatment of VAT	D7
Unquoted shares or securities held on 6 April 1965 - Application of para 14 Sch 5 CGTA 1979 para 27 Sch 6 FA 1965)	SP14/79
Value shifting S43 FA 1977 (S26 and Para 11 Sch 6 CGTA 1979)	D18
VAT, treatment of	D7

<u>Deletions since last index issued</u>

D14 - superseded by SP 5/85
D15 - superseded by SP14/80
D20 - obsolete
SP9/81 - superseded by SP7/84

Partnerships - assets owned by a partner D11
(cont)
- assets owned by individuals - retirement .. D5

Release or partial release of life interest in settled property (FA 1971 Schedule 12 para 7, (Section 5(1), CGTA 1979)) D10

Relief for interest payments - loans used to buy land occupied for partnership etc. business purposes (see also Section A) SP 4/85

Relief for losses on loans to traders - time limit for claims .... SP 3/83

Relief for owner occupiers SP14/80

Repairs to property, initial (IRPR 11/6/70) D24

Replacement of business assets - Employees and office-holders SP 5/86

Replacement of business assets in groups of companies D19

Replacement of business assets - time limit D6

Residence - non-resident company (IRPR 11/6/70) D23

Retirement relief - partnerships - assets owned by individuals D5

Rollover relief for replacement of business assets: trades carried on successively .... SP 8/81

Settled property - exercise of power of appointment over SP 7/84

- release or partial release of life interest - Sch 12 para 7 FA 1971 & s 5(1) CGTA 1979 .... D10

Short delay by owner occupier in taking up residence S29 FA 1965 (ss 101-105 (CGT 1979)) D4

Superannuation funds - tax on Capital Gains D2

Time limit - claim that asset is of negligible value D13

- company leaving a group - election for 6/4/65 valuation under Sch 6 para 25 FA 1965 - s278 ICTA 1970 (IRPR 10/9/71) D21

- losses on loans to traders - claim to relief SP 3/83

Reimbursement of taxpayers' expenses A31

Relief for interest payments - loans applied in acquiring an interest in a partnership A33

Relief for interest payments - loans for purchase or improvement of land A34

Relief for interest payments - loans used to buy land occupied for partnership etc. business purposes (see also section D).. SP 4/85

Reliefs for non-residents - s27 ICTA 1970 - treatment of wife's income........ SP 7/85

Relocated employees, treatment of certain payments to .... SP 1/85

Repayment - procedure, income tax - deeds of covenant in favour of charities A5

- covenanted and other income in favour of charities SP 3/87

- supplement -Schedule E assessments A9

Residence - airline pilots - incidental duties A10

- employees resident but not ordinarily resident in the UK - liability under Cases II and III of Schedule E .... SP 5/84

- ordinary residence of individuals coming to the UK .. SP 3/81

- treatment of income of wife of non-resident under s27 ICTA 1970 . SP 7/85

Retirement annuity relief - investigation settlements .... SP 9/80

- partnerships A18

Returns - delay in rendering - interest and penalties A14

- personal - use of schedules SP 5/83

- completion by attorneys A13

Schedule E - VAT A6

- assessments - repayment supplement A9

Scholarship & apprenticeship schemes for employees........ SP 4/86

Settlements - benefits to settlor's future spouse A30

- interaction of income tax and IHT/CTT on assets put into settlements ... SP 1/82

- Part XVI ICTA 1970 .... A2

Solicitor's deposit interest A22

Stock Dividends - Para 1(3) Sch 8 F(No 2)A 1975 .... A8

Temporary workers engaged through foreign agencies........ A21

Trusts - payments to a non-resident from UK discretionary trusts or UK estates during the administration period - double taxation relief (see also SP 7/80) SP 3/86

Use of schedules in making personal tax returns........... SP 5/83

VAT - Schedule E A6

- benefits in kind A7

Wife's earnings election - S23 FA 1971 - extension of time limits... A25

<u>Deletions since last index issued</u>

A29 - See ESC A37 in booklet IR1 (1985)
SP 2/80 - See ESC B25 in booklet IR1 (1985)
SP 4/83 - Overtaken by section 25 FA 1986

D. STATEMENTS RELATING TO TAX ON CAPITAL GAINS (INDIVIDUALS AND COMPANIES)

Accommodation let by owner-occupier SP14/80

Allowable expenditure - expenses incurred by personal representatives .. SP 7/81

Asset of negligible value - time limit for claims D13

Capital Gains Tax - Time Limit for an Election for valuation on 6 April 1965 under Sch 6 para 25 FA 1965 - company leaving a group - s278 ICTA 1970 (IRPR 10/9/71) D21

Capital Gains Tax - Transfer of Business to a Company - FA 1969, Sch 19, para 15 [IRPR 10/9/71]... D22

Capital Gains Tax - non-resident company [IRPR 11/6/70] .. D23

Capital Gains Tax - initial repairs to property [IRPR 11/6/70]... D24

Company liquidations - shareholders' CGT D3

Division of a company on a share for share basis .... SP 5/85

Exercise of power of appointment over settled property ... SP 7/84

Foreign bank accounts SP10/84

Indexation - identification of securities - time apportionment for assets acquired before 6/4/65 - Disposal of assets on No Gain/No Loss basis ...... SP 3/82

Offshore Funds - Chapter VII Part II FA 1984 SP 2/86

Owner-occupiers - absence from only or main residence SP14/80

- accommodation let by SP14/80

- short delay in taking up residence (s29 FA 1965 - ss101-105 CGTA 1979) .. D4

Part disposals of land D1

Partnerships - general D12

- annuities and lump sums (extension of D12) SP 1/79

Non-resident lessors - Section 38 FA 1973.................	SP 6/84
Purchase of own shares by company - s53 & Sch 9 FA 1982 ..	SP 2/82
Redundancy payments, additional	SP11/81
Residence - company	SP 6/83
- non-resident lessors - s38 FA 1973	SP 6/84
Section 464 ICTA 1970 - cancellation of tax advantages from certain transactions in securities: procedure for clearance in advance	SP 3/80
Subsidiaries of UK companies - taxation of profits	C8
Trade Unions - provident benefits - legal and administrative expenses ...	SP 1/84
Valuation fees for compliance with s16 (1)(a) Companies Act 1967 - deduction not allowable	C10

B. STATEMENTS APPLICABLE TO INDIVIDUALS AND COMPANIES (INCOME TAX AND CORPORATION TAX)

Accountancy Expenses (see also Section A)	A28
Business Expansion Scheme - overseas activities	SP 4/87
Capital allowances - film production expenditure etc	SP 9/79
....	SP 2/83
....	SP 2/85
- industrial buildings allowance - industrial workshops constructed for separate letting to small businesses	SP 4/80
- Section 75 FA Act 1980 .... (small workshops allowance)	SP 6/80
- machinery and plant - short-life assets..........................	SP 1/86
- mining - expenditure on planning permission applications	SP 4/78
Compensation for acquisition of property under compulsory powers ..	SP 8/79
Contributions to retirement benefit schemes on termination of employment ..	SP 2/81
Eurobonds, interest on quoted - s35 FA 1984	SP 8/84
Exchange rate fluctuations - consequences of for trading concerns	SP 1/87
Goods sold subject to reservation of title	B6
Life assurance - premiums on which commission is payable to the policyholder (see also Section A)	SP 3/79
Retirement benefit schemes, contributions to - on termination of employment	SP 2/81
Securities dealt in on the Stock Exchange Unlisted Securities Market - status and valuation for tax purposes (see also Section F)	SP18/80
Section 35 FA 1984 - interest on quoted Eurobonds	SP 8/84

Stock relief - building licences granted under the Community Land Act 1975 .. SP 8/78

- recovery charges when level of trading is negligible .... SP 4/81

Stocks and work in progress - changes in accountancy practice (SSAP 9) B5

- changes in the basis of long term contract work in progress................... B4

Tax consequences of exchange rate fluctuations for trading concerns ... SP 1/78

Treatment of value added tax B1

USM - Status and valuation for tax purposes of securities dealt in on the Stock Exchange Unlisted Securities Market (see also Section F).. SP18/80

Deletions since last index issued

SP 8/78 - obsolete
SP 8/80 - obsolete
SP 7/83 - superseded by SP 7/86
SP 3/85 - superseded by SP 1/87
SP 7/86 - superseded by SP 4/87
B2)
B3) obsolete
B4)
B7)

C. STATEMENTS APPLICABLE TO COMPANIES ETC
(CORPORATION TAX AND INCOME TAX)

Additional redundancy payments SP11/81

Claims to loss relief under Section 177(1) ICTA 1970 ..... C11

Close Companies - general statement C4

- income tax relief for interest on loans applied in acquiring an interest in a close company .... SP 3/78

- para 10(1)(a) Schedule 16 FA 1972 'reasonable time' C3

- apportionment - guidance to Inspectors of Taxes on the exercise of their discretion within Paragraphs 1 and 3, Sch 16 FA 1972 SP 2/87

Company's purchase of own shares - s53 and Sch 9 FA 1982 . SP 2/82

Company residence .... SP 6/83

Company taxation - interest paid in foreign currency C9

Country - risk debts .... SP 1/83

Demergers - Schedule 18 FA 1980 .... SP13/80

General rules as to deductions not allowable - valuation fees for compliance with Companies Act 1967, S 16(1)(a) . C10

Group relief - consortia - Section 28(3) FA 1973 .... C6

- para 10(1)(c) Schedule 10 FA 1967 (S264(1)(c) ICTA 1970) C2

- Section 29 FA 1973 .... C7 & SP 5/80

Interest - on loans applied in acquiring an interest in a close company .. SP 3/78

- paid in foreign currency C9

- paid to a bank in the United Kingdom on a loan made in foreign currency .. C5

Loss relief under s177(1) ICTA 1970 .... C11

Lotteries and football pools C1

MR CORLETT
PRESS RELEASES/
Q + A LEAFLET

CONFIDENTIAL

DRAFT PRESS RELEASE

DEEDS OF COVENANT

In his Budget the Chancellor proposes changes in the tax treatment of deeds of covenant [and similar transfers of income] made by individuals. These do not affect covenants made in favour of charities.

Summary

The proposals are that

- Covenants (other than ones to charity) made by individuals on or after today (15 March 1988) will not be "effective" for tax purposes. That is, the payer will not get tax relief on them, and the recipient will not pay tax or be able to claim a tax repayment on them.

- The present rules will continue to apply to

  - all covenants in favour of charities
  - other covenants made by individuals before 15 March, provided they are sent to the Inspector to arrive by 30 June 1988.

Present tax position

The tax advantage normally associated with deeds of covenant arises when one person

CONFIDENTIAL

covenants [or in Scotland binds himself] to make a series of payments to another person who is not liable to pay tax. On making each payment the payer is entitled to deduct and retain basic rate tax. So each covenanted payment of, say, £100 costs him only [£73] when the basic rate of tax is [27 per cent].

Since the recipient is not liable to tax he can claim the £27 tax deducted from his payment back from the Inland Revenue. This, with the £73 he has received from the payer, makes up his income of £100.

Existing deeds

The present tax rules will continue for payments made under legally valid and effective deeds executed before today (15 March 1988) provided that such deeds are already in the hands of the Inland Revenue or are submitted to the Inspector before 1 July 1988.

New deeds

Deeds made from today onwards, and deeds made before today which are not received by the Inspector by 1 July 1988, will have no effect for tax purposes. This means that a person making payments under such a deed will not be entitled to deduct tax from the payments; and a person receiving payments under such a deed will not be entitled to claim a tax refund.

CONFIDENTIAL

DRAFT PRESS RELEASE

MAINTENANCE PAYMENTS

In his Budget the Chancellor proposes major changes in the tax treatment of maintenance payments to make the rules simpler and fairer.

Summary

Under the proposed new rules for new Court Orders and maintenance agreements made on or after today (15 March 1988):

- payments will qualify for tax relief only if they are made by a divorced or separated husband to his wife (or vice versa) and only up to a maximum of [£2425] a year;

- there will be no tax relief for other new maintenance or alimony payments;

- payments will be made gross (without deduction of tax) and the recipient will not be liable to tax on them.

The present rules will, however, continue to apply to existing maintenance payments - that is, payments made:

- under a Court Order or maintenance agreement which was made before 15 March 1988 and (in the case of agreement) is sent to the Inspector of Taxes to arrive by 30 June 1988; or

CONFIDENTIAL

- under a Court Order made no later than 30 June 1988, provided the application for the Order was made to the Court before 15 March 1988.

Where the new rules are more favourable, taxpayers with Orders or agreements made before 15 March 1988 will be able to elect to switch to the new rules.

Present rules

At present, a divorced or separated person, can get tax relief for maintenance payments to his or her spouse. Tax relief is also available for maintenance payments under a Court Order to children.

The recipient of maintenance payments is liable to tax on them. Tax may or may not have to be deducted at source, depending on the nature and amount of the payments.

The present rules are set out in more detail in the annex.

These arrangements contrast with the position of a married couple living together, who get no tax relief for payments they make to each other, eg for housekeeping purposes. Nor is there any general tax allowance for children.

Proposals

Under the Chancellor's proposals, tax relief will continue to be available at basic and higher rates for payments by a divorced or separated

CONFIDENTIAL

husband/wife to his/her spouse or ex-spouse, but only up to a limit of [ ]. Payments in excess of that amount will not quality for relief. The payments will be made gross and the recipient will not have to pay tax on them.

All other payments of maintenance, including payments made direct to children, will not affect tax liabilities. That is, the payer will not get tax relief for them, but neither will the recipient be taxable on them.

Transitional Arrangements

The present tax rules will continue to apply to

- Court Orders and agreements made before 15 March 1988, (provided, in the case of agreements, that they are received by the Inspector of Taxes before 1 July 1988);

- Scottish agreements presented for registration in the Books of Council and Session before 15 March 1988;

- Court Orders made [before 1 July 1988] for which application was made to the Court before today.

That means that all payments under such Orders and agreements will continue to qualify for relief, and the recipients will be taxable on them.

The new tax rules will apply to

- all Court Orders made after 30 June 1988;

- Court Orders made before 1 July 1988 for which application is made to the Courts on or between 15 March and 30 June 1988;

- all other agreements made or or after today;

- existing Court Orders which are replaced or varied [? or revived];

- [supplementary agreement or Court Order];

[To be amended when final decision taken on variations etc]

[Formula payments]

Right to elect for new rules

Some people with existing arrangements will find that they would be better off under the new rules. This will happen, for instance, where the recipient currently pays tax on his/her maintenance. It will be possible to elect (once and for all) to switch to the new rules provided

- all parties to the arrangement elect to do so; and

- the election is made in writing to the Inspector by the end of the first tax year to which it is to apply;

- the election takes effect from the beginning of the tax year in which it is made.

Payments which will continue to qualify for relief

As stated above, relief will be available, up to £2425, for payments between divorced [or separated] couples. All payments made under a legally binding agreement or UK Court Order will count towards the limit. Thus not only cash payments, but payment of pecuniary liabilities, eg rates etc, will qualify. [Mortgage interest]

Payments which will not count will include:

- voluntary payments - that is payments which are not made under a legal obligation;

- payments under a foreign Court Order or agreement

- payments made to or caused to be made by DHSS to support a dependent relative].

Multiple divorces

A payer of maintenance with more than one ex-wife or husband will be limited to relief of up to [ ].

Interaction with Married Persons Allowance

A married man will not be allowed to claim married allowance and tax relief for maintenance payments for the same period in respect of the same wife or ex-wife.

In the year of separation [or divorce] married allowance is given for the whole tax year and is not apportioned. A husband will continue to get the married allowance for that year and will not get maintenance relief for the part of the year during which he is separated [or divorced]. However he will have the right to elect instead for single allowance plus maintenance relief for payments made from the date of separation up to the yearly limit of [ ].

If a divorced husband re-marries he will be able to claim married allowance in respect of his new wife and maintenance relief in respect of payments to his ex-wife.

If a divorced husband re-marries the same wife, maintenance relief will be allowed for the part of the year before re-marriage or reconciliation provided that overall the husband's personal allowances and maintenance relief do not exceed twice the single allowance.

Retrospection

SP 6/81 explains the Inland Revenue's practice where a Court Order provides for payments for a period prior to the date of the Order. The Revenue accepts that such payments can be taken into account for tax purposes provided

a. the payments do not relate to a period before the date of application for the Order;

b. the parties agree; and

c. there has been no undue delay by the parties in pressing the application.

This practice will continue to apply to Court Orders dealt with under the old rules.

CONFIDENTIAL

For other Orders where a Court orders payments retrospectively only payments made on or after the date of the Court Order will qualify for tax relief and will count towards the limit on which relief is available in that year [£ for 1988-89]

Publicity

The Inland Revenue will be publicising [shortly] further information for taxpayers [and for professional advisers] on the details of the new system.

CONFIDENTIAL

ANNEX

Present tax arrangements

At present tax relief is generally available for payments made under a United Kingdom Court Order

a. by a divorced or separated husband or wife to his/her spouse or ex-spouse for his/her own benefit or for the maintenance of a child of the marriage

b. by a parent direct to a child of the marriage

following a marriage breakdown, and

c. by a father to the mother of his child

d. by a father [or mother] direct to his [or her] child

where the parents are not married to each other.

Payments within a. and c. which are made under a separation agreement or some other legally binding arrangement, which is not a Court Order, can also qualify for tax relief. (Payments under b. and d. do not qualify because of special provisions in the Taxes Acts, known as the settlements legislation, which treat the payments as the parent's income). The recipient is taxable on the payments.

"Small maintenance payments" (that is United Kingdom Court Order payments which do not exceed £48 a week or £208 a month) must be paid gross. All other payments, including Court Order payments which exceed these limits, are paid under

CONFIDENTIAL

deduction of tax. Where the recipient is not liable to pay tax he/she can claim a refund from the Inland Revenue of all or part of the tax deducted.

[3 February 1988]

DRAFT LEAFLET

TAXATION OF MAINTENANCE PAYMENTS

Proposals in the 1988 Budget

This leaflet explains the new proposals announced in the Budget for tax relief for maintenance payments which were introduced from Budget Day, (15 March 1988).

"Maintenance payments" are payments made between spouses following the breakdown of a marriage.

Under the proposed new rules for new Court Orders and maintenance agreements made on or after today (15 March 1988):

- payments will qualify for tax relief only if they are made by a divorced or separated husband to his wife (or vice versa) and only up to a maximum of [£2425] a year;

- there will be no tax relief for other new maintenance or alimony payments;

- payments will be made gross (without deduction of tax) and the recipient will not be liable to tax on them.

Who is affected

(a) I am already divorced or separated and paying maintenance and/or alimony under a Court Order as legally binding agreement. What do I do?

CONFIDENTIAL

Nothing - except that if you have not already done so, you should send your agreement to the Inspector by 30 June 1988. The existing rules will continue to apply to you. (The existing rules are set out in the back of this leaflet.)

(b) I am in the process of divorce etc. Am I affected?

Yes - unless your Court Order is made before 1 July 1988.

<u>What arrangements do the new rules apply to?</u>

- All Court Orders made after 30 June 1988

- Court Orders made before 1 July 1988 for which application is made to the Courts on or between 15 March and 30 June 1988

- All other arrangements made on or after 15 March 1988

IF YOU ARE PAYING MAINTENANCE PAYMENTS

<u>Will I get relief?</u>

Yes - if you are a divorced or separated man or woman making payments under a Court Order or other legally binding arrangement which is subject to the jurisdiction of the United Kingdom Courts. But the payments must be made to your separated wife or ex-wife, or to your separated husband or ex-husband.

<u>What payments will count?</u>

All cash payments and any bills you pay (eg rates) on behalf of your separated wife or husband,

CONFIDENTIAL

ex-wife or ex-husband (provided that the payments are due under a legally binding agreement or Court Order).

Are there any payments which will not count?

Yes - you cannot get relief for

- voluntary payments (that is payments which are not made under a legal obligation)
- payments made under a foreign Court Order or agreement
- payments made to DHSS to support a dependent relative.

What about payments to children?

The proposal is that these will not qualify for tax relief in future.

Will payments to a third party for the benefit or support of a child be allowed?

No.

How much tax relief will I get?

Under the proposals you will get relief at basic and higher rates of tax on payments up to the equivalent amount of the single person's allowance [£ for 1988-89].

Can I pay more?

Yes - but you will not get tax relief for anything above the single person's allowance.

CONFIDENTIAL

Will I be able to claim for payments to more than one ex-wife or husband?

Yes - but the total amount of relief you get in any one year is still the same, however many people you pay.

Should I deduct tax from my payments?

No - you pay over the full amount ordered or agreed.

WHAT YOU NEED TO DO

How do I get my tax relief?

Tell your tax office about your separation or divorce and send them a copy of your Court Order or separation agreement. At the end of the year show the total amount of your payments in your tax return.

The tax office will give you your tax relief, usually through your PAYE code or your tax assessment.

My Court Order/agreement was made before Budget Day

So long as you continue to make payments they will be treated under the existing tax rules provided, if you have an agreement, it has already been sent to the Inspector of Taxes or is sent there before 1 July 1988.

I applied for a Court Order before Budget Day but it was not made until after then

Provided your application was with the Courts before Budget Day and the Court Order is made before 1 July 1988, the existing rules will apply.

I have an agreement in Scotland, but it was not registered before Budget Day

If, in Scotland, an agreement was presented for registration and execution in the Books of Council and Session or sheriff court books before Budget Day, and is registered before 1 July 1988, the existing rules will apply.

CHANGES IN YOUR PERSONAL ARRANGEMENTS

What if my pre-Budget arrangements are altered?

Changes which do not affect the maintenance payments, for instance arrangements for access to children, do not alter the tax treatment. So the existing tax rules continue to apply.

[But changes which do affect the maintenance payments will immediately cause the new rules to apply. These changes include a pre-Budget Order or agreement

- which is replaced by a new one

- which is varied in a way which increases or reduces any of the maintenance payments to any recipient, or extends the period for which they are payable

- which has expired or been suspended and is subsequently revived.]

I have a pre-Budget arrangement, which provides for my payments to increase automatically. Will I get relief on the increase?

[If your payments are not stated amounts but are based on a formula, for instance the single person's tax allowance or involve payment of bills such as rates which increase each year, tax relief will continue to be given under the existing rules even though the payments increase after the Budget].

I qualify for relief under the old rules. Will I be able to choose the new rules if they benefit me more

Only if you have an "old rule" arrangement and want to switch to the new rules. You can elect to do this provided the election

- is signed by all parties to the arrangement

- is made in writing to the Inspector of Taxes no later than 3 months after the end of the first tax year to which it is to apply

- takes effect from the beginning of the tax year [in or for which it is made].

Does the new maintenance relief start as soon as I am separated/divorces?

Not necessarily. In the year of separation or divorce a married man continues to get the married allowance until the end of the tax year, 5 April. In these circumstances no relief will be given for maintenance payments.]

However you can elect to have instead single persons' allowance for the whole of that year plus maintenance relief for payments made [? apportioned or whole year's allowance].

What if I re-marry?

You can claim married allowance for your new wife and maintenance relief for payments to your ex-wife.

What if I am reconciled with my wife?

You can claim maintenance relief for the part of the year before reconciliation and married allowance thereafter, provided that your total personal allowances and maintenance relief do not exceed twice the single allowance for the year.

The same applies to a divorced man who re-marries his ex-wife.

[I made some payments while I was waiting for the Court Order/agreement to be made. Do these count?

No.

OTHER POINTS

The Court ordered me to make payments for a period before the Order. Do these count?

Only if they are paid on or after the date of the Court Order and are not for a period before you applied to the Court for the Order.]

If you are receiving maintenance payments. Must I pay tax on it?

No, it is tax free.

Will I have to claim a tax refund?

No - the full amount is paid to you without tax being deducted.

CONFIDENTIAL

For payers and recipients of maintenance

The information in this leaflet is generally about arrangements made after Budget Day 1988. For information about earlier arrangements, or post Budget Day arrangements to which the previous tax rules apply, ask your tax office for a copy of leaflet IR30, Income Tax Separation and Divorce.

INSTITUTE OF DIRECTORS

POLICY UNIT

116 PALL MALL LONDON SW1Y 5ED
TELEPHONE 01-839 1233
TELEX 21614

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

CONTENTS

	Page
SUMMARY OF MAIN RECOMMENDATIONS	1
INTRODUCTION	5
A LONG-TERM TAX STRATEGY	6
FISCAL AND MONETARY POLICY	7
Government spending: the continuing problem	7
Unemployment, taxation and deregulation	13
Monetary policy and the control of inflation	15
Public sector borrowing requirement	17
POLICY PRIORITIES AND THE SCOPE FOR TAX CUTS	18
TAX REDUCTION AND STRUCTURAL REFORM	22
General and technical	23
The market economy and the personal ownership of capital	26
Inheritance tax	26
Capital gains tax	28
Share incentive and share option schemes	30
Business Expansion Scheme and Loi Monory/Loi Delors	31
Income tax	31
National insurance contributions	34
Corporation tax	35
Unincorporated businesses and self-employment	36
Value added tax	37
Excise duties	38
CONCLUSION	39
APPENDIX Revenue implications of the Institute's proposals	41

SUMMARY OF MAIN RECOMMENDATIONS

Paragraphs

3 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 * treat the increase in spending in the Autumn Statement as a temporary election year aberration

14, 40-41 * 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 * 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 Appendix * 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)

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 <u>worthwhile</u> tax relief for profit-related pay

70, 72-74 * give income tax relief for <u>all</u> personal investment in <u>new</u> equity and correct technical anomalies in share option and incentive rules

75-79 * <u>cut income tax basic rate by 3p and higher rates by 10p</u>

80 * introduce transferable <u>income</u> rather than transferable <u>allowances</u> 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
Appendix
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:

	£ 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
	4,565
Less: VAT threshold first stage only	-133
Supply-side effects (inheritance tax and income tax higher rates only)	-432
	4,000
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	4,000
Less: Secondary effects including further £500m supply-side effects	-2,000
1987-88 NET COST OF IOD RECOMMENDATIONS	2,000
	=====

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.

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.

<u>Public sector borrowing requirement</u>

36. Our policy on the PSBR is set out in the paper <u>"The Public Sector Borrowing Requirement"</u> 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 it 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.

APPENDIX

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	- 0.5
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	2,580	2,370
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 recoupment 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	0.37
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

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.*

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
				======

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.

FROM: A P HUDSON
DATE: 15 February 1988

MR CORLETT - IR
MR MACE - IR

cc Financial Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Odling-Smee
Miss Sinclair
Mr Riley
Mr R I G Allen
Mr Pickford
Mr Cropper
Mr Tyrie
Mr Isaac - IR
Mr Walker - IR
PS/IR

BUDGET DAY PAMPHLETS

I have now had a chance to discuss with the Chancellor the questions in my 4 February minute, and the attached drafts.

2. He has decided on the following publications.

(a) On <u>Independent Taxation</u>,

(i) a well produced Treasury Press Notice explaining the case for change, based on my present draft;

(ii) an Inland Revenue Press Notice, setting out the details for the technical press;

(iii) - at a later date, yet to be decided - a short Question-and-Answer leaflet for issue in tax offices.

This last leaflet is for issue quite a bit later, so we do not need to worry about it now.

(b) On <u>Maintenance and Covenants</u>,

(i) a Treasury Press Release based on my own draft;

(ii) separate Inland Revenue Press Releases, setting out the details, along the lines of Mr Corlett's drafts;

(iii) a Question-and-Answer leaflet, again along the lines of Mr Corlett's draft.

This leaflet would need to be available on Budget Day, or as soon as practicable afterwards.

We shall obviously have to take care, in both cases, to make sure that the presentation is all in line, that duplication is kept to a minimum, and that the various products cross-refer to one another.

3. The Chancellor had the following specific comments on my draft on Independent Taxation.

(a) The section on the Case for Change should probably come before Main Points.

(b) Somewhere, the pamphlet should explain why the system could not come in immediately.

(c) We should explain that the vast majority of the population will still not need to fill in tax returns, and not frighten married women into thinking that they will not be able to hand theirs to their husband, if that is what they want to do.

(d) There was a case for not mentioning the mortgage interest relief change at all. If we do, we should make absolutely clear first that the change comes in ahead of 1990, and second that it applies only to new mortgages.

(e) One important point was the disappearance of the Wife's Earnings Election, and Separate Assessment, which were now redundant.

(f) Paragraph 10 took the wrong line. It would be better to say that the reform would put right the problems identified, giving married women complete privacy and independence, and ending the tax penalties on marriage. We could add that this would be achieved several years sooner than it would have been under transferable allowance.

(g) The pamphlet should make clear that nobody needed to take any action - the Revenue would initiate the change to the new system.

(h) The Chancellor was not happy with the examples, which focussed too much on who gained and who lost. The text could make clear that no couple would pay more tax, and many would pay less. The aim in the examples should be to show how the system would work, and how the wife stood to benefit. I shall incorporate the example he suggests in a revised draft.

4. The Chancellor had the following comments on the draft of Maintenance and Covenants.

(a) A possible introduction to the pamphlet could be that the majority of transfers occur within marriage, for example a husband giving an allowance to a non-working wife. These did not involve tax at all. This was clearly the most simple approach, and should be extended as far as possible. But the tax arrangements for other transfers were in fact immensely complicated, and should be simplified.

(b) This reform should be presented primarily as a simplification. So there should not be too much stress on, for example, removing penalties on marriage.

(c) All the pamphlets, press releases, etc. should start with the fact that payments would in future be tax-free, and not with the ending of relief.

(d) All the publications should stress very early on that existing arrangements would be unaffected.

5. I shall circulate a revised draft of my two pamphlets as soon as I can. You will no doubt now take forward your own, in the light of the Chancellor's comments.

APH

A P HUDSON