The 1981 Budget.
Review of Corporation Tax and Stock Relief.

ECONOMIC POLICY

PART 4.

Part 1 : May 1979
Part 4 : October 1980

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~3.11.80~~							
~~5.11.80~~							
~~7.11.80~~							
~~10.11.80~~							
~~1.12.81~~							
~~2.1.81~~							
~~Feb 81~~							
~~9.2.81~~							
~~16.2.81~~							
~~20.2.81~~							
17-2-81							
— ENDS —							

PREM 19/438

Sir Jeremy Moore see
Econ Pol, PM's ~~mtgs~~ lunches with
Clearing Bankers. Oct 79.

PART 4 ends:-

TL to PM of 17/2/81

PART 5 begins:-

TL to HMT of 18/2/81.

2

Econ Pol

PRIME MINISTER

Next Tuesday's Cabinet

Mr. Whitelaw and Mr. Edwards will be absent from Cabinet. Lord Carrington will be back.

Attached is a letter from Mr. Heseltine to the Chancellor giving his views on the Budget. He suggests we should do the maximum for industry by not raising the tax allowances at all and thus bringing down the PSBR and reducing interest rates.

N.P.G. Mitchell
Duty Clerk
(For TPL)

17 February 1981

BUDGET SECRET

cc Mr. Walters
Mr. Wolfson
Mr. Hoskyns
Sir Robert Armstrong

14

SUBJECT.

NOTE FOR THE RECORD

The Prime Minister and the Chancellor had a further discussion about the Budget this afternoon. The following points came up:

I The Chancellor said he was having doubts about the shape of the Budget. It had been pointed out to him that, if personal allowances were raised by only 7½%, people on below average earnings would be hit disproportionately. By contrast, if the basic rate were to be raised by 1%, the extra burden would be shared more equally. Provided the Prime Minister was prepared to contemplate it, he was thinking of the possibility of raising the basic rate by 1% and personal allowances by about 10%. This would not only be a fairer arrangement, but it would raise additional revenue which - with the present arithmetic for the PSBR coming out at about £11¼ billion - would be very useful. The Prime Minister said that provided it was additional to less than full indexation of the threshold, she was prepared to contemplate a basic rate increase. She was veering towards the view that a PSBR of less than £11 billion was essential.

II The Chancellor said that he was going ahead with the bank levy; he had yet to decide on the rate of the levy, though it would be pointless to do it for less than £300 million.

III Capital taxes. The Chancellor said he would minute the Prime Minister with details of what he proposed. Despite the criticisms that any further improvements would be helping the rich, it was essential - in his view - to make some minor changes as part of the

/enterprise

BUDGET SECRET

enterprise package and to fulfil the Government's election promises. The Prime Minister said she agreed.

IV Benefits in kind. The Chancellor referred to his minute of 3 February. The Prime Minister commented that she had doubts about one of the proposals contained therein: namely, the proposal that in future the value of season tickets provided by employers and of goods and services purchased with company credit cards should be taxed for all ~~the~~ employees - not just the better paid employees. The Prime Minister said she doubted whether it would be wise to bring the value of season tickets into tax when commuter fares were going up fast. It might not be possible to carry this through the House.

17 February 1981

CONFIDENTIAL

Mr Duguid
Mr Walters
Mr Wolfson

2 MARSHAM STREET
LONDON SW1P 3EB

My ref:

Your ref:

16 February 1981

Dear Geoffrey

1981 BUDGET

I have thought further about the letters you have received from Keith Joseph. Jim has reinforced for me even more strongly how critical it is that your forthcoming Budget should be - and be seen to be - designed to advance our long-term objective of a vigorously growing private sector, generating new investment and jobs that have a commercial future. And yet it must not conflict with the need to keep up the attack on inflation and on easy money. But all our gains on that crucial front will be lost if by the time of the election it cannot be seen that the positive growth policies have been working.

Our industrial base is desperately weak. Not only is this an economic problem but far more serious are the social and political consequences. Here down in the South we are partly shielded from the grim truth - although even here in Inner London and still more in the Black Country, the evidence is there in decaying manufacturing, its associated infrastructure and the disappearing jobs.

After 2 years, you can rightly claim that our hard message about the link between inflation and monetary laxness is getting home. Inflation is falling and wage settlements in private industry and public service are becoming more responsible. But not surprisingly the link between that and rebuilding our industrial base is neither understood nor credible at a time when the main indicator of industrial performance - the output of manufacturing industry - has fallen nearly 10% in one year - and the profits to invest in new growth have evaporated.

As we pull out of the present recession, profits will recover, probably in 1982. But the recovery of investment will be slower - on past performance we cannot expect any significant upsurge in manufacturing investment much before 1983, for investment will only be widely undertaken (on any past analysis of which I am aware) if and after prospects for sales and profits are good. Is it right that we should wait that long? Is there in fact any need to do so?

The public is rightly concerned about the annual £4 billion tax receipts from North Sea Oil. I share the general view that we ought to have been using them to invest in the future. But the truth is that they have been used to shield private consumption and the public services from economic reality. Between 1977 and 1979 our predecessors' decisions allowed post-tax incomes to rise

by 14% while output rose by less than 5% - as well as leaving us with plans for larger public programmes and the Clegg time-bomb. Somehow we must reverse these priorities - and start using our North Sea revenue for rebuilding our industrial base.

I have no doubts about public expenditure. It is still much more than we can afford. But what distrubs me most is the way the distribution of our cuts has hurt the private sector so disproportionately. We all know this. We know the damage that is taking place and I believe we have got to find a means of changing the balance now. It is not sufficient to believe that the balance will be restored simply by us holding down public expenditure as the recovery proceeds. That is too slow.

Capital expenditure - in spite of our condemnation of our predecessors for just that fault - has been cut much harder than current - with especial damage to the private construction industry. And even in current expenditure, preference has in practice gone to preserving jobs and real pay levels in the service with purchases from outside suffering.

I fully realise that you have virtually no scope for general relaxation (especially as that could, by keeping interest rates and the exchange rate up, damage industry even more). But any switch to help industry and investment can come only by curbing consumption, public and private. The increase in employees' national insurance contributions has pointed the way. But I would urge you now to go further to achieve the positive response from industry whose absence could so easily undermine our strategy for beating inflation. I believe that we should ask those in work to contribute more by suspending entirely for one year (at a revenue gain of over £2 billion) the Rooker-Wise provisions for the indexation of tax allowances. I would also look wider for similar contributions from other inflation-protected groups not at the bottom of the income scale. There will be protest. But, if the burden is spread fairly from top to bottom, and is seen as a genuine attempt to shift resources to the underlying problems of rebuilding our industry base, I believe that there is very widespread support available both from a political as well as an economic standpoint.

I do not believe we should use such money to give across-the-board budgetary relief to industry and commerce's current costs (whether by reducing the NIS or non-domestic rates). The relief you can bring by creating the monetary conditions in which interest rates can fall is more valuable. Such unselective help will not capture the imagination of the public as an adequate response to industry's recovery needs nor offer reason enough to forego their personal living standards. Nor would it stimulate industry to whom it would be very much a case of too little too late. But certainly a determined programme of incentives to the successful companies could be devised and existing programmes with the right ingredients expanded.

It is much more a question for Keith than me to advise how the money could be spent to secure increasing investment. Within my own sphere of responsibilities I can see several areas where added investment, some in industry, some in the infrastructure, would help to create the climate for successful new business especially in the industrial and economically deprived areas where the inherited environment is such a drag on the spirit of enterprise.

Much of the industrial area of Britain looks derelict. At the heart is the despoiled land which is not going to be cleared up and used because it is cheaper to use new unspoiled land. We should act to remove this negative value of this derelict land on an increased scale. It is right in every way and particularly as it is job creating in areas of high unemployment.

We could act to restore and convert declining industrial buildings into premises for new small businesses on a large scale.

Schemes exist on the continent to provide grants for companies improving their effluent discharge. The companies get modern equipment, the community gets cleaner air, less noise or fresher water.

We have a range of ideas for cheap starter homes either fully owned or partly owned that could be advanced, where for each pound of public expenditure 3 or 4 times as much private finance could be forthcoming with direct benefit not only to the construction industry, but to both the building materials and home fitments and furnishings industries also.

I am not aiming to press my Departmental ideas at the expense of other colleagues. They too will have good candidates for consideration once one has decided that a drive of this kind will take priority over more regular types of public expenditure and that we will not flinch from the sacrifices needed to provide the funds without resorting to extra public borrowing. Presentationally, the sort of programmes you could offer would be most exciting - and could galvanise the private sector into action. And you would have the political initiative back firmly in our hands. Is it worth considering?

I have mentioned to you the next step that I think follows from what I have said. Jim makes it clear that we are facing the prospect of sustained unemployment of 2½ to 3 million. I know what your personal attitude will be to this. And just as these appalling figures are emerging we shall be anguishing over the cash limits for the next pay round.

May I ask you to consider a package that deals with the central set of problems we face? I set it out only in its most basic form. In essence you should present for the next pay round a challenge incorporating the items I have outlined above. You set a near nil pay factor for cash limits. You say that for the next year extra North Sea Oil revenue will also be set aside for investing in the future. And you put on the table investment programmes, some private, some public, that you would be prepared to back in return for such a manifestation of national sanity. It would not mean no wage increases - but only increases that genuinely arose from efficiency and productivity. We all know they are available if the will is there.

I am copying this as before.

Yours ever

MICHAEL HESELTINE

Rt Hon Sir Geoffrey Howe MP

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

16th February 1981

T.P. Lankester Esq.
Private Secretary
No. 10 Downing Street
LONDON
SW1

Dear Tim,

We owe Sir Jeremy Morse a reply to his letter of 2nd February to the Prime Minister, which he copied to the Chancellor on 3rd February.

We think it would be best if the Chancellor were to reply and he has now approved the attached draft. Before signing the reply, however, he wanted to be sure that the Prime Minister was content with this approach. I should be grateful if you would confirm that this is so.

Yours ever,

Richard Tolkien

R.I. TOLKIEN
Private Secretary

Prime Minister
I agree with the Treasury that it would be best for the Chancellor to reply to Jeremy Morse. ~~If not, the letter with (If you write, the draft will have to be~~ Are you content?

(The draft could be improved; but the Chancellor can worry about that).

TL 16/2

Agree - but don't like the last sentence.

PERSONAL AND IN CONFIDENCE

LETTER FROM THE CHANCELLOR OF THE EXCHEQUER TO:

Sir Jeremy Morse KCMG
Chairman of the Committee of London Clearing Bankers
10 Lombard Street
London EC2V 9AP

Thank you for your letter of 3 February, with which you sent me a copy of your letter to the Prime Minister and its enclosures. I have discussed what you say with her and she has asked me to reply.

We have, of course, already discussed your argument that a tax would have a damaging effect on your pay negotiations, and I am afraid that I continue to find it unconvincing. It can hardly be suggested that the unions concerned are unaware either of the level of banks' profits or of the bargaining value of that fact. Public recognition that you have high profits would surely not signal anything new to the unions. By contrast it could well be said that a tax or other form of contribution would give an added argument for standing firm in negotiations, on the grounds that it decreased ability to pay.

I note what you say about retransfer of export credit at present refinanced by the Government. As you know, neither we nor the previous Government have excluded such retransfers. However, the acquisition by the banks of what is really a form of gilt-edged security carrying interest at 1¼ per cent over LIBOR can hardly be seen as a major benefit to public funds or an important sacrifice by the banks. I am afraid the interest charge fully offsets what you say about a discounted cash flow advantage. These retransfers do not meet the need for a real contribution.

In all the circumstances, I must express my very real disappointment that you and your colleagues have not felt able to respond more positively to the proposals for cost-sharing which Nigel Lawson put to you at the end of January. ~~But, given this reaction, there is, I am sad to say, no point in discussing the matter further.~~

GEOFFREY HOWE

CONFIDENTIAL

PRIME MINISTER

Meeting with the Chancellor

You have more or less agreed the strategy for the Budget, but not yet a number of details. I suggest that you go over with the Chancellor his proposals for:

(i) Capital tax changes (Flag A), and see also David Wolfson's comments at Flag B);

(ii) Taxation of fringe benefits (Flag C);

(iii) Indirect tax increases: you have agreed that the Chancellor should raise approximately £1b., in addition to revalorisation, and that the maximum addition to the RPI should be 2%. A note should be coming in later tonight with detailed proposals (Flag D). From an RPI point of view, we ought to do more on beer than on tobacco and spirits, but the political and health arguments probably go the other way. The Chancellor will no doubt also propose increasing petrol tax and VED: these are relatively effective revenue raisers for a given RPI effect, but there are the obvious political difficulties and the adverse impact on industrial costs.

Table being submitted by Chanc Ex at meeting

You also want to have a word with the Chancellor about his proposed paper to Cabinet on the 1981 public expenditure survey (Flag E).

S J Pike
Duty Clerk
pp TPL

16 February 1981

CONFIDENTIAL

FILE

VLB

16 February 1981

Price Basis of 1981 Public Expenditure Survey

Thank you for your letter of 12 February which I have shown the Prime Minister. She has read the draft paper which you enclosed with it, and would like to discuss it with the Chancellor when they meet tomorrow afternoon.

T P LANKESTER

P. S. Jenkins, Esq.,
H.M. Treasury.

Copy no 16 of 16 copy no 2 of 2

13a

cc MOS[1]
Mr Lamont[2]
Mr Moore[3]
PUS[4]
Mr T Jones[5]
Mr D Jones[6]
Mr Tucker[7]
Mr Spain[8]
Mr Priddle[9]
Mr Morphet[10]
Mr Agrell[11]
Mr Herzig[12]
Mr Price[13]
Mr Houston[14]
Mr Davis[15]
Mr Guinness[16]

01-211-6402

Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
Treasury Chambers
Parliament Street
London SW1

13 February 1981

Dear Chancellor,

BUDGET MEASURES AFFECTING ENERGY PRICES

I have been thinking further about the issues we discussed on 12 February.

I know how tight are the constraints on your budget judgement. I will certainly support measures on North Sea taxation and petrol duty, which are politically contentious. But it would be wrong to alter the North Sea tax regime in ways which threaten to undermine North Sea development and so your tax receipts.

I have so far, with your help, been able to hold the line on the economic pricing of energy despite the very great pressures from Parliament and industry for major and costly concessions. But the figures now being agreed in the NEDO Task Force between the electricity and gas industries and their major consumers are showing that there now are some significant disparities between pricing in the UK and on the Continent. For example, the difference in electricity prices charged in Britain and France to comparable bulk chemical manufacturers is over 35%. For steel the disparities are even greater. BGC's firm renewal prices for all industrial users (29.3p) are above those in France (19-26p/therm) and right at the top end of those in Germany (19-31p/therm). On present policies disparities are likely to remain even if the gap is narrowed in the coming months. There are, of course, good explanations for some of these disparities - for example the strengthening of sterling and the availability of low cost electricity in France from their large nuclear and hydro programme. I will do all I can to get these explanations across. But I am sure - and I know you agree - that we need to make some concessions if we are to head off an explosion which could force a major departure from economic pricing with all that would mean for both economic and energy policy.

I think any package to be effective needs to consist of four elements - action on gas and electricity prices for large users, a substantial reduction in the HFO duty and a short term scheme to encourage the replacement of oil-fired boilers by coal-fired ones. I am still working on some of the details but my present ideas are:

(a) Electricity
Work in the NEDO Task Force is confirming that the major problem is with bulk intensive users at high load factors in such industries as paper and board, chemicals and steel. The esi have already been able to find measures which will have the effect of reducing electricity costs to a limited number of such users by 3-4½% without adding to their EFLs. The esi would be able to provide a further 4-5% of help to a limited number of such users at a cost of raising their EFL by £45m pa. I recommend that we accept this proposal. It will still leave a big gap between UK and French and German prices to these users: but to go further would be contrary to the esi's statutory obligations.

(b) Gas
You will recall that when Denis Rooke agreed to work towards a -£400m EFL to help your revenue needs he pointed out that in the time available it would almost inevitably lead to our prices being out of line with those in Europe and to the possible failure of some firms. Our firm gas renewal prices have recently moved out of line with both those in Germany and even more so with France. Prices on the Continent should rise in the next few months to reflect increased fuel oil prices. But on present policies BGC's prices will also rise - BGC's firm gas price is due to go up 1p per therm early next month and 1p/therm a quarter thereafter. In addition as more and more companies renew their contracts at the current levels (29.3p) average UK firm renewal prices will almost certainly be above those on the Continent. The strengthening of sterling and the cumulative effect of BGC's price increases means that in the past month or two our prices have ceased to be broadly in line with those on the Continent.

I have just received the proposals from BGC which I asked for after our meeting with the Prime Minister on 13 January. We shall need to discuss them with the Corporation. For example, BGC propose to hold their interruptible price at about 22-24p until April despite the recent rise in the HFO price. To continue to hold it at this level for a further period would cost £25m for each 6 months and primarily help bulk users. If we wish to go further, BGC suggest keeping firm gas renewal prices at their current levels for 6 months, which might be presented as help particularly to high load process users. The cost

would be up to £40m p.a. While we shall have to undertake intensive work on the various alternatives in the next 10 days, I think we shall have to agree to relax BGC's EFL by up to some £65m depending upon the detailed arrangements made.

(c) Boiler Substitution Scheme
This will be particularly helpful to large energy users such as ICI and Courtaulds who have good schemes to invest in coal boilers but are not prepared to invest in present conditions of capital rationing. Indeed Boots has actually cancelled its agreed investment plan. The scheme would also help the NCB's difficult financial position. NCB have committeed themselves to a major programme of closing uneconomic pits. Until that course brings the supply of and demand for their coal into balance, they will still be faced with the problem of over-production and of rising stocks which, as a last resort, will have to be financed by an increase in their EFL. (It goes without saying that the Board will have to seek all possible cash savings before we increase EFL). It must make more sense for us to spend £25m to encourage conversion to coal-fired boilers, which, on our rough estimates, should lead reasonably soon to an additional 1mt a year of continuing coal sales to the industrial sector than to add over £30m to the NCB's EFL to stock 1mt of surplus coal with no wider and continuing benefit to the economy. Quite apart from these savings, it would also reduce potential Social Security benefits to unemployed boiler-makers and construction workers mainly in areas particularly badly hit by the recession. The announcement of a scheme could also have great psychological value. I do therefore urge you to find at least £25-35m over a 2 year period (with less in the first year than in the second) even if you cannot find the full £50m.

(d) HFO Duty
The strongest pressure from industry on both of us has been for abolition or at least reduction of the HFO duty. This pressure will increase now that HFO prices in the UK are again ahead of those on the Continent. I agree, of course, that this measure is cost-ineffective, but I am sure that action here is politically essential. To be sure of achieving our political objective I think a reduction of at least 50% is called for. But if it would help you to find the funds for the other three sectors of this package I would be ready - most reluctantly - to accept a reduction of 25%. While I doubt whether the early renegotiation of Frigg is practicable I am having a final urgent look at this.

I realise that the cost of this package will not be easy to meet. But industry has concentrated much of its opposition to the Government's strategy on energy prices and it is in this area where we should be prepared to help industry a little. If we do not respond to the Task Force's findings with an acceptable package we shall have to make much more costly concessions at a later date. If it would help you provide funds for this total package I would be ready to support an increase in petrol duty by an extra 2p which with VAT should bring you in an extra £100m.

Yours sincerely,

B. D. W.

pp D A R HOWELL
(Approved by the Secretary of State and signed in his absence).

FILE COPY

MR WHITMORE (FIRST)

CONFIDENTIAL

SUBJECT.

13

cc. Master set.

R H

SECRET

B/C: Sir R Armstrong
Mr Wolfson
Mr Hoskyns
Mr Walters

10 DOWNING STREET

From the Private Secretary

13 February, 1981

BUDGET

Dear John.

I enclose my note of the meeting the Prime Minister held this afternoon to discuss the Budget.

Yours ever

Tim Lankester.

A J Wiggins, Esq
HM Treasury

SECRET

NOTE FOR THE RECORD

The Prime Minister held a further meeting this afternoon with the Chancellor of the Exchequer, Sir Douglas Wass, Mr. Burns, Mr. Wolfson, Mr. Walters and Mr. Hoskyns to discuss the Budget strategy.

The Chancellor said that the PSBR forecast for 1981/82 had now risen to £13½-13¾ billion. His latest thinking on how this might be reduced was as follows:-

I He had in mind twice revalorization of the specific duties. This would raise £1 billion. It would mean a 2% addition to the RPI, but it should still enable the published forecast for November to November to be 10% - which would in turn mean social security uprating of 9%.

II He envisaged raising thresholds by 7½%, rather than 15% which would be necessary to fulfil Rooker-Wise. This would yield about £1 billion. A 6½% uprating would be the absolute minimum if a substantial number of people - for example, widows - were not to be brought into tax; he had chosen a slightly higher figure of 7½% largely for presentational reasons - because it was half the 15% implied by Rooker-Wise.

III He had decided firmly on the proposed bank levy.

These measures would reduce the PSBR to £11¼-11½ billion. He very much wanted to find room for a package of measures to help industry. He had concluded that nothing was possible on the National Insurance Surcharge. But he was minded to provide some relief on electricity and gas prices to bulk users, possibly the suspension of Development Land Tax and an increase in the first year allowance on industrial buildings from 50% to 75%, and an enterprise package aimed at small businesses which would cost less than £100 million in the first year rising to £300 million in a full year. The enterprise package might include some or all of the following: an Aunt Agatha scheme

/(which

(which would be renamed enterprise investment), a loan guarantee scheme, an extension of the venture capital scheme, relaxation of the Investment Income Surcharge, raising the threshold of small company corporation tax, and some minor capital tax concessions.

The Chancellor said that, ideally, it might be desirable to reduce the PSBR below £11 billion. But he did not believe this was politically possible. In his view, an increase in basic tax rates had to be ruled out; 2% was the maximum that could be borne on the RPI; and he did not believe that colleagues would agree to a further round of public spending cuts.

Mr. Walters said that, in his view, the markets would be disappointed by a PSBR of £11 billion (after the Budget measures), and consequently there was a strong likelihood that the Chancellor's proposals would be insufficient. Given the possibility that the PSBR might in any case overshoot the forecast, he feared a funding crisis either in the summer or the autumn. A PSBR of, say, £10 billion would be no more deflationary than one of £11 billion - because the latter would be worse for expectations and for interest rates. It would be worth paying a premium now in terms of a tougher Budget, in order to avoid having to introduce supplementary measures later in the year. Serious consideration should be given to raising the basic rates of income tax by one or two per cent.

The Chancellor said that he was well aware of the risks. But he did not believe it would be politically possible to adopt a more stringent approach than he had outlined. It was going to be difficult enough as it was to introduce what would be represented as a deflationary Budget at a time of the deepest recession since the 1930s; to include an increase in basic rates would be impossible. If it turned out that the Budget measures were inadequate, then further action would have to be taken during the year. The need for such action would arise against a background of rising interest rates and a faster than planned

/ expansion

expansion of the money supply; and therefore it would be easier in political terms than tougher measures in the Budget itself.

The Prime Minister indicated that the measures outlined by the Chancellor on indirect taxes and on income tax were, in her view, the most that were politically sustainable. She also did not dissent from the proposed bank levy.

In further discussion, the following points were made:

(i) The Prime Minister questioned the possibility of raising additional revenue by reducing the relief on life insurance premia. This seemed particularly apposite when the insurance companies were reported to be making a substantial pay settlement. The Chancellor said that this would not be an appropriate measure for the forthcoming Budget, but it was a possibility that the Treasury were looking at for some future Budget.

(ii) The Prime Minister pressed the case for abolishing the Postponed Accounting Service for VAT on imports. The extra £600 million which this would yield in 1981/82 would be very useful, and she did not believe that it would place as big a burden on the corporate sector as had been suggested - since to some extent, the earlier payment of VAT would be financed by suppliers overseas. Moreover, the corporate sector could be protected by restricting the change to the import of finished goods only. The Chancellor, referring to his minute of today's date, said that he had come down strongly against the change. The extra burden on the corporate sector would outweigh all the measures he hoped to introduce to help the corporate sector in the Budget. To the extent that it would tilt demand in favour of UK manufacturing

/ cuts

cuts, he would bear it in mind for a future Budget; but it would be wrong to make the change now. The Prime Minister said that the Chancellor should at least keep the option open a little longer in case he needed the revenue.

(iii) The Chancellor said that three choices had been put to him for the uprating of child benefit - 50p, which would reflect the November to November RPI forecast; 75p, which would be in line with Rooker-Wise; and 95p, which would return child benefit to its real value in 1979. Following discussions with Conservative backbenchers, he had concluded that child benefit should be uprated in line with the Social Security uprating - i.e. by 9 per cent or 45p. The Prime Minister said she agreed.

TL

13 February, 1981

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

P.
13/2

13 February 1981

T. Lankester, Esq.,
No.10, Downing Street

Dear Tim,

PRICE BASIS OF THE PUBLIC EXPENDITURE SURVEY

I mentioned in my letter of 12 February that we would be forwarding a short passage on the proposal contained in the Chief Secretary's minute of 11 February to go over to a cash-planned contingency reserve for 1981-82. I attach this draft; the most appropriate place to insert it in the Cabinet Paper would be after paragraph 12 (i.e. just before the Conclusion) with a separate heading "Contingency Reserve". This will require an extra conclusion, (b), which would read: "To endorse the proposal in paragraphs 13 - 15 on the Contingency Reserve".

Yours ever,

Peter

P.S. JENKINS

DRAFT PASSAGE FOR CABINET PAPER

CONTINGENCY RESERVE

13 There is a related change which I propose we should make now, affecting expenditure in 1981-82.

14 The contingency reserve has operated in the past as a control on decisions to add to the volume of expenditure. As part of the move towards a greater emphasis on cash spend, I propose that any decision we take to increase a cash limit should be a charge on the reserve, regardless of whether the change is technically classified as volume or pay or price.

15 For expenditure not subject to cash limits, the reserve in 1981-82 would continue to be confined to decisions we take to add to volume. For 1982-83 we will need to look again at this area in the light of our decisions on the cash basis of the survey.

SECRET - BUDGET

Econ Pol 12

PRIME MINISTER

Meeting on the Budget

You already have a note from the Policy Unit.

Douglas Wass has telephoned to suggest that the meeting should cover the following topics (and I think this fits in with the approach suggested by the Policy Unit):-

(i) What PSBR should we be aiming for in 1981/82? The Treasury's latest estimate on the conventional forecasting assumptions (i.e., revalorisation on indirect taxes and of direct tax thresholds) is for a PSBR of £13¾ b. The forecast has now deteriorated by nearly £3 b. in the course of the last three weeks. You will want to ask what grounds we have for believing that it won't deteriorate further. (But there have been some years in which the Treasury have over-estimated the PSBR - usually, I think, when the economy has been coming out of recession. This happened in 1977/78: when the IMF came in November 1976, we were expecting a PSBR of about £10 b.: we took £1½ b. off the PSBR, and the final outcome was nearer £5 b.) Then discuss what PSBR would be desirable. To decide this, we really need to know what monetary target we are going for. The Treasury are not yet ready to go firm on this because of the unresolved question of how (i.e., M3 and/or other measures) the target should be expressed. But assuming the Treasury are still on 6-10% for M3, I judge that that would require a PSBR of no more than £10 b. as a maximum if there can be any confidence of interest rates falling. On the other hand, taking as much as £4 b. out of the economy may not be politically possible; and pace the Policy Unit, even if it is possible, the short term effect may arguably

SECRET / be

be too deflationary. We need to consider carefully the trade-off between the deflation caused by interest rates not falling, and the deflation which would come from what the Policy Unit call "overkill". From a political point of view, getting the PSBR down from £8¾ b. to £10 b. may simply not be possible - which brings us on to the main revenue options.

(ii) What is the maximim RPI effect we can stomach?
Revalorisation on the specific duties, which is already built into the forecast, adds 1% to the RPI. Twice revalorisation would add a further 1% to the RPI, and yield about £1 b. (The increases can of course be varied as between beer, tobacco, etc.: you get a good deal more revenue from beer for a given RPI impact than from tobacco or spirits. Thus, 1p on a pint of beer adds 0.1% to the RPI and yields £105 m. in a full year; 1p on a pack of cigarettes also adds 0.1% to the RPI, but yields only £40 m.) Your own feeling earlier this week was that a full 2% addition to the RPI was untenable politically; and, of course, the more we add to the RPI, the more difficult it is to achieve a given monetary target.

(iii) How much do we do on thresholds?
Rooker-Wise require 15%. The Treasury thinking is that we can't do less than 7½%; otherwise, quite apart from the disincentive effect, large numbers of additional people are brought into tax; and this means extra staff numbers. By raising thresholds by only 7½%, we save about £1 b. on the PSBR.

(iv) Bank Levy
The Chancellor's proposal would reduce the PSBR by £450 m.; he wants your endorsement of it, though I am

told that the Governor wants to make his own representations before a final decision is taken. One point we need to be clear on is what will be the monetary effect of the levy: I have been told that, while it reduces the PSBR, it will not have a beneficial effect on the money supply.

(v) VAT on imports

The Chancellor has sent in a minute (Flag A) arguing very strongly against: he argues that it would have a negligible effect on switching spending to domestic manufacturers, while at the same time it would be a substantial drain on corporate liquidity. A decision is needed today. If we were to do this, it would save £600 m. on the PSBR.

(vi) Industry Package

The Treasury have in mind some measures to help all of industry, in addition to the enterprise package (costing £200 m.) which is designed specifically for small businesses. They have in mind some minor measures such as helping on energy prices, which might cost about £250 m. But in view of the arithmetic set out above, and if we are to get the PSBR down even near £11 b., it seems doubtful whether we will be able to afford this. (There is one other revenue measure which the Treasury have up their sleeve: £250 m. from smoothing the receipts from VAT. In other words, they hope to be able to bring forward some of the VAT receipts from large traders from 1982/83.)

R

13 February, 1981.

cc Mr Walters
Mr Duguid

cc Mr Wright (CO)

Prime Minister 2
This is the Treasury's draft paper with plans for a further move towards cash planning in PESC. I suggest you have a word with the Chancellor about it on Tuesday.
T 13/2

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

12 February 1981

T. Lankester, Esq.,
No.10, Downing Street

Agreed MT

Dear Tim,

PRICE BASIS OF THE PUBLIC EXPENDITURE

As you know, we have thought long and hard since the spring of last year about the best way of moving from the present volume price basis of the survey to a system which brings home the importance of cash availability, particularly the movement of costs through the various stages of planning and execution of programmes. Following the discussion at the luncheon on 28 January, the Prime Minister made some very helpful comments on this subject in her minute of 30 January, in particular supporting the idea of a radical move to planning in cash.

At that stage we were still considering two possible approaches, but we now have a clear preference for a single scheme, described in the attached paper which the Chancellor has approved. He thinks, subject to the Prime Minister's agreement, it would be a useful focus for a discussion on this subject at Cabinet. We have yet to add a short passage on the Chief Secretary's proposal to go over to a cash-planned contingency reserve for 1981-82 (his minute of 11 February refers). This will be forwarded shortly. On timing, he thinks it essential for him to be in a position to announce changes in the Budget; this in turn means a discussion in Cabinet not later than 24 February. The meeting fixed between the Chancellor and the Prime Minister on Tuesday at 3.45 on the Budget would provide an opportunity for them to talk about the paper.

Flag A

Yours ever,
Peter
P.S. JENKINS

CONFIDENTIAL

CABINET PAPER

1981 PUBLIC EXPENDITURE SURVEY

Note by the Chancellor of the Exchequer

I propose, and would like to announce in general terms in my Budget Speech, changes in the way in which we conduct the annual Public Expenditure Survey, beginning this year. They are designed in part directly to strengthen control and pressure for economy and efficiency, but mainly to enable all of us in Cabinet to see more clearly the prospective cash costs of expenditure as events develop and decisions are taken. I believe this will contribute to more effective overall management of public expenditure.

2. Our record so far on this is disappointing. Many of our supporters are highly critical. The effects on the outlook for even the most economically desirable tax cuts, for the Public Sector Borrowing Requirement and so for interest rates are widely resented.

3. When the full planned and forecast costs of expenditure for next year are published shortly, it will be seen that total cash expenditure is projected to have risen from £77 billion in 1979-80, to £94 billion in 1980-81 and £104 billion in 1981-82. Over the 2-year period the increase is 35 per cent. This is more than the rate of inflation over the same period. And there has been a sharp rise in the proportion of GDP we have taken for public expenditure.

4. This has happened in spite of considerable and repeated efforts to hold and reduce expenditures. Some of the explanation lies in commitments inherited from the previous Government, especially on public service pay. A major factor

has of course been the recession. It would be foolish to blame the system and to expect changes in the system to solve anything like all our problems or to make difficult decisions unnecessary. But I am convinced that the system under which we have planned expenditure has played an important and damaging role in preventing us all from being as fully and promptly aware of what was happening as we should be.

5. This weakness turns particularly on the traditional and out of date "constant prices" basis of the survey. This basis was part of the medium-term planning system which Plowden introduced some 20 years ago and which at the time had much to commend it. But inflation is very different now from what it was then. The much higher, and highly variable, rates of inflation of recent years have made the system more and more misleading - indeed I understand that Plowden himself now doubts whether his original system is workable. It prevents us from focusing on, or even knowing clearly, the cash implications of our decisions and the likely development of overall cash costs, as we go along. And these cash developments can falsify our intentions. A striking illustration is that, after the Cabinet decisions taken last November, it was still not possible for me to know their implications for actual cash expenditure in 1981-82 until a couple of weeks ago, and the eventual figures could - and did - contain some unwelcome surprises.

6. I attach a specification of the arrangements I propose for adoption for the 1981 survey, about to begin. It has been discussed inter-departmentally among officials. In essence, it provides for all plans and discussions, at least for the principal target year of 1982-83, to be conducted from the outset in terms of the kinds of cash values which will apply in that year. The focus throughout will be on ultimate cash cost. This is essentially the way in which any family (and almost every business) considers its budget for the year ahead.

7. The arrangements will give rise to some technical and management problems and no doubt some difficult (although possibly more helpful) discussions in Cabinet. It was considerations of this kind which led an inter-departmental group of officials to reject a number of similar proposals last year. The particular scheme I am proposing does not - no scheme can - overcome all the difficulties. Colleagues may find it helpful if I briefly highlight one or two of them.

8. First, it will be necessary for Cabinet to adopt for a period ahead - initially as long as 18 months or so - provisional figures for the likely course of inflation, and to decide whether to distinguish between the likely general rate of inflation and the increases the Government is prepared to see in its own costs, both for public service pay and for other prices. We cannot in a highly uncertain world hope for close accuracy of prediction. This is bound to mean an occasional need to review our assumptions, perhaps to make adjustments, but with the considerable advantage of doing so in terms which will show us at once the overall cash expenditure implications.

9. Secondly, my proposals will give greater weight to the constraints on cash costs compared with the traditional sense of "entitlement" to some particular volume or level of service. But there will be scope for review of both general and particular movement of costs, and adjustments of cash provision to meet them. The presumption will be, as I believe it should be, that increased provision will be made only if thoroughly justified, and not as at present largely automatically. In some areas of expenditure, particularly those which we have not found it possible to subject to cash limits, the main problem will be that of prediction, rather than direct control. Even so, we shall arm ourselves better to consider these areas of expenditure, as well as their impact on the total, if we are constantly aware of their prospective development in actual cash cost.

10. Thirdly, colleagues concerned with cash-limited expenditures will note that the form of revaluation proposed at the outset of the survey builds from year to year, including the effect of cash limits set previously. The practical result is that any squeeze or slack which may have emerged for spending managers in handling expenditure within cash limits in one year would normally be carried forward into the next year. This contrasts with the curious feature of the present system (reflecting the traditional commitment to a particular volume of expenditure irrespective of cost) that a part of the revaluation process each year has been to restore cash provision to accommodate price changes in the previous year, whatever effect the cash limits for that previous year may have had.

11. It must be right to carry forward effects of economy and efficiency in this way. I recognise, however, that there must be limits, and that a cumulative series of squeezes year after year could rapidly reach unrealistic levels. My proposals allow colleagues responsible for cash-limited programmes to seek special adjustments where they believe their actual experience of price movements in those programmes, and inability to absorb them without intolerable reductions in levels of service, justify increased cash provision. Again, it is right that the presumption should be that continuing efforts are made to operate within cash constraints, and without special adjustments, but this can be no more than a presumption.

12. Finally, the specifications of the scheme leave open the question how far we should attempt to carry detailed planning beyond the focal year of each survey and how far, if at all, we should deal with later years on the basis of cash valuation. This question could be considered further on the occasion when, shortly after my forthcoming Budget, I present colleagues with actual proposed figures, the detailed ground rules for launching the 1981 survey on which I shall need their agreement.

Conclusion

13. I invite colleages:-

(a) To agree broadly on changes in the 1981 survey, on the lines of the attached specifications.

(b) To agree that I should give some general indication of intentions in my Budget speech which might be on the lines of the very provisional draft also attached.

(c) To note that, immediately following the Budget, I shall be bringing to Cabinet proposals for the provisional inflation assumptions to be built into the construction of 1982-83 prices for the survey and indicating further assumptions which would, if desired, make possible the presentation of 1983-84 figures in terms provisionally appropriate for that year.

H.M. TREASURY
12 February 1981

PROPOSED CHANGES IN PUBLIC EXPENDITURE SURVEY

The following is a specification of the proposed changes, with some comment on their immediate implications.

1981 Survey: The Target Year 1982-83

2. The starting-point will be the provisional planning figures agreed for 1982-83 as a result of the 1980 survey. These will be published in the Public Expenditure White Paper next month in "1980 survey prices" (broadly the prices of 1979-80 or around autumn 1979).

3. The first objective will be to lay the basis for discussion of 1982-83 plans in the course of the 1981 survey in terms of the cash or approximate prices of 1982-83 in which money in that year will actually be spent. This requires a form of revaluation covering a span of three years. It is intended to carry through the whole revaluation at the outset, but there will be two stages in the process, and each needs to be specified:-

(a) Departments will be invited to revalue their 1981-82 and 1982-83 plans, first by the normal "survey to survey" revaluation from autumn 1979 to autumn 1980 (or from average 1979-80 prices to estimated average 1980-81 prices), and then by the cash limits factors agreed for 1981-82. This work has already been done for cash limits for 1981-82, but should be extended to non-cash-limited expenditure in that year and to all expenditure in 1982-83. The figures for 1981-82 should accord closely with the cash figures being included in the Public Expenditure White Paper this year for the first time.

(b) A further adjustment to the 1982-83 figures will then be made by the Treasury to reflect provisional assumptions about inflation between 1981-82 and 1982-83. These assumptions (covering public service pay and prices) will be considered by Cabinet on the basis of proposals by the Chancellor.

4. From this process, there will emerge base-line figures for 1982-83 which will provisionally be the cash forecasts and cash limit figures for the various programmes, in terms of the actual cash expenditure planned for 1982-83.

Normal Adjustments, Bids and Options

5. Starting from the base-line just described, survey discussion about 1982-83 will be conducted on traditional lines in respect of adjustments to reflect current decisions, bids for new or amended expenditures, and any options for reducing expenditures. Throughout, however, the discussion will be in terms of cash.

6. Where a decision is taken to adjust a cash limit for the current year (1981-82), this will normally be carried into the figures for 1981-82. A simultaneous decision will be taken whether to carry a corresponding or some other adjustment into the figures for 1982-83. Similarly, where estimating changes are made (for example in demographic or economic assumptions), their cash implications will be presented for consideration, as a basis for deciding whether to make provision for them or seek some fresh decision.

Keeping Inflation Prospects Under Review

7. As part of the arrangements, it will be particularly important for Departments to keep under review the current and prospective evolution of pay and prices affecting individual programmes. Where these diverge from the average, Departments may propose some compensating adjustment to the cash provision. More generally, it may be necessary in the light of developments to make at some point a general adjustment to the 1982-83 prospective cash figures, to reflect a more optimistic or pessimistic outlook for pay and prices. The presumption, however, should be against changes unless they are significant and likely to be matched by corresponding trends in revenue.

8. It will be desirable to come close to final agreement around November 1981. Some later adjustments may be possible, until January, although those responsible for managing Estimates and other plans within Departments, and particularly those concerned with instructing outside agencies (local authorities, health authorities, etc.) will be very conscious of the need to reach finality in order to give timely instructions to managers and print Estimates for Parliament.

9. Although there will have been a process early in 1981 analogous to that by which cash limits pay and price factors have been set in the past, and that process may remain identifiable, particularly if adjustments are made late in the survey cycle, the basic discussions

in Cabinet about expenditure plans, being conducted in cash, will not make the same distinction between volume changes and price adjustments as has been made in the past. Much of the discussion will of course be concerned with levels of service and their prospective cost, but the arithmetic will be geared to the final cash numbers, rather than to their precise composition. The initial arithmetic of pay increases may well have become overlaid by a variety of adjustments to cash totals which in some areas may effectively mask it, and this could be helpful. Of course individual managers and negotiators will need to make their own calculations of the amount of money available to finance pay increases, but they may in some areas be able to achieve a degree of freedom of negotiation within their own cash target figure, without the inhibition that the basis of their calculations is officially and publicly announced.

<u>1983-84</u>

10. It is for consideration whether the principle of cash planning should be carried further forward, at the outset of the 1981 survey, by adding provisional inflation assumptions for the year 1983-84. The process would be similar to that already described for 1982-83. The uncertainty one year further into the future would of course be greater, and the figures might well have to be reviewed later at the opening of the 1982 survey. But if provisional assumptions can be agreed there would be some advantage in making this complete move to cash planning for the future. The alternative would be to handle the plans for 1983-84 at this stage in the same sort of prices as 1982-83.

<u>Longer-term comparisons</u>

11. There would be a continuing demand for analysis of the traditional kind on a "constant price basis" extending into both past and future. Probably the simplest and most convenient response for the time bring will be to retain 1979-80 (1980 survey prices) as the base year and express other years in 1979-80 prices, with relative price effects (i.e. in "cost terms"). Departments would be able to comment, in the relevant chapters in Part 2 of the White Paper, on the evolution of levels of service within individual programmes, by reference to this series or any other usefully illustrative measurement they may develop.

Public Presentation

12. The annual Public Expenditure White Paper, beginning in 1982, would reflect the new basis of the survey system. 1982-83 figures would automatically be expressed in terms of the cash numbers which had been agreed by Cabinet. The treatment of subsequent years would depend on the decision taken for handling 1983-84: there would be either a "constant price series" showing the provisionally planned volume changes from 1982-83 onwards, or a provisional view of prospective cash expenditures for each subsequent year.

DL/JS

DEPARTMENT OF HEALTH & SOCIAL SECURITY

Alexander Fleming House, Elephant & Castle, London SE1 6BY

Telephone 01-407 5522

From the Secretary of State for Social Services

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
Parliament Street
London
SW1

12th February 1981

Dear Geoffrey,

I wrote to you at this time last year with my views on the attitude we should adopt towards taxation of tobacco and alcohol. This letter brings my views up to date in relation to tobacco. I have written to you separately about tax on alcohol.

There have been several important developments since your last Budget. We have reached an agreement with the tobacco industry which, though the best that we could achieve at the time, has been widely criticised outside Parliament, and by both Government and Opposition Members within it, for being too soft on the tobacco interests. Second, the UK is unlikely to be able to resist pressure from other European Community members to abandon the surcharge on cigarettes with a high tar content during the next financial year. Third, evidence is beginning to emerge that, in addition to the well known risks that smokers themselves run, there are hazards to those around them from 'passive smoking'. Finally, the tobacco companies have been able to contain their prices below the level of inflation and cigarettes have become relatively cheaper than they were after last year's Budget.

As you know, I have recently circulated to our colleagues the draft of a handbook of health policies and priorities for health and social services authorities. The draft emphasises (as does George Younger's foreword to the recent report by the Scottish Health Service Planning Council) the importance of preventing ill-health. Smoking is, of course, the greatest single preventable cause of disease, accounting as it does for some 50,000 premature deaths each year, an estimated 30 per cent of all deaths from cancers, and loss of 50 million working days annually. No Government can be convincing about its commitment to prevention unless it is seen to be prepared to tackle the problem of smoking with all the means at its disposal.

E.R.

The medical profession, our own Select Committee and more recently the European Commission, have noted the failure of successive UK Governments to maintain the real level of tobacco taxation and contrasted this with those same Governments' professed concern about smoking and health. Last year you were able to raise the price of tobacco in real terms to about the level prevailing after the June 1979 Budget, but it still remains considerably below the levels of 1970, let alone those prevailing in the 1960s when the danger of smoking became established. A PQ answered by Peter Rees on 12 January showed that in November 1980 a duty increase of 33 per cent would be needed to maintain the 1977 real cost of cigarettes. The table attached (which updates that which accompanied my letter of 8 February last year) shows that, even after the recent increase in manufacturers' prices, a typical packet which now costs 75p would cost £1.08p if its price had done no more than keep pace with inflation since 1965. The Central Office confidential survey last May shows that we may have underestimated public acceptance of increases in duty on tobacco, particularly amongst our own supporters.

In the survey respondents were asked what measures should or should not have been in the budget.

The relevant figures are as follows:

The Budget should have:-

	ALL	Con	Lab	Lib %
Increased taxes on wines and spirits	67	84	57	66
Increased tax on beer	63	76	51	64
Increased taxes on tobacco and cigarettes	67	82	57	67

As will be seen, two-thirds thought the budget should have increased taxes on wines and spirits (marginally fewer on beer) and on tobacco and cigarettes. This is a very high figure and quite staggeringly high among Conservative voters. In other words, it looks as if there would be reasonable public acceptance of excise duty increases in this area and that our own supporters would strongly back this approach.

The battle against inflation must, of course, be our first priority, but price is the major determinant of tobacco consumption, and I think there is a strong case for a substantial increase in tobacco taxation which, as well as going some way to recovering lost ground on prices, would discharge the industry from spending on other forms of promotion the £6 million which will be diverted from poster advertising following our November agreement. It would also be desirable to mop up the £0.6 million which will accrue to the industry as a result of abandonment of the high tar surcharge. George Young has already conveyed to Peter Rees our view that increasing the ad valorem element in tobacco taxation is desirable both on health and revenue grounds.

Finally, I would hope that in the context of the Budget changes you would feel it right to make express reference to the health aspect.

I am copying this letter to our Cabinet colleagues, and Sir Robert Armstrong.

Yours ever

Patrick

11

PRIME MINISTER

BUDGET STRATEGY

1. THE POSITION WE START FROM

1.1 We have had a very severe monetary squeeze. This has had beneficial effects on efficiency and attitudes in the private sector, but industry can't stand the present exchange rate and MLR much longer.

1.2 Public expenditure has risen as a result of the lower activity caused by the squeeze. Every time we look at projected spending and PSBR, they get worse. We MUST assume there is worse to come, and budget accordingly. But we can not do much to cut spending further during 1981-2.

2. THE BUDGET'S STRATEGIC OBJECTIVES

2.1 This Budget will set the stage for the next Election. We can avert massive short-term damage to industry, and get, given a 2-year lead time, the main indicators (output, unemployment) moving in the right direction by late 1983. This is good management, not panic vote-buying.

2.2 The key is to get MLR down with the exchange rate hopefully following it down. How can we ensure that this is possible?

3. CHOICE OF BUDGET STRATEGY

3.1 The choice is between a Budget which takes the latest PSBR forecasts at face value (we call this optimism) and a Budget which assumes that PSBR projections will get worse (realism).

3.2 The penalties for erring too far on the side of optimism will be fatal, economically and electorally. Those from erring on the side of realism are, by comparison, trivial.

3.3 If we pursue an optimistic policy it is likely that we will face a mid-summer funding crisis, with a desperate attempt at further cuts, splits in Cabinet, trivial savings to show for it, and finally a further rise in MLR and then the exchange rate. This will lead to yet lower activity, higher unemployment and PSBR, which will no

/longer

longer be reversible before the Election. The credibility of MTFS and Geoffrey himself will be destroyed and your own position undermined. It will be claimed "you have used your strategy and failed: let us now reflate".

3.4 This reflationary alternative would be to let money supply finance the gap. This would exacerbate inflation just as we run up to the next Election.

3.5 The choice between realism and optimism is like the choice about where to cut a firebreak to stop a forest fire. Do you do it 5 miles back, sacrificing 5 miles of forest to be sure that you save the nearby town? Or do you cut it 1 mile back, hoping only to sacrifice 1 mile of forest, but recognising that if you have misjudged the fire speed, you've lost the town? You choose the strategy which makes the worst outcome least likely. WE HAVE NO CHOICE BUT TO GO FOR REALISM.

4. RECOMMENDED STRATEGY

4.1 We should plot on a piece of paper, over time, the recent series of public expenditure and PSBR forecasts. We should then project their own "growth trend line". (This is standard business practice.) This will then quantify our experience over the recent past.

4.2 We should then design a Budget to reduce this realistic PSBR to a level compatible with declining MLR. The Budget itself has to deliver a certain revenue against a given expenditure. Let us decide the amount of that revenue. Then let us determine the best way of collecting it. The consequences of not collecting enough revenue would be so damaging that we ought to consider even the most unpalatable measures (eg increases in direct taxes).

4.3 The costs of our realistic budget giving rise to overkill are relatively small, and in any case they could be quickly offset by reductions in interest rates.

4.4 We do not believe that a realistic Budget would be hard to sell. We have a number of ideas about how to do it.

/5. CONCLUSION

SECRET

5. CONCLUSION

All the evidence and past Policy Unit papers show a familiar Treasury pattern: underkill; too little and too late; hoping things won't get worse, despite all the evidence; and resulting failure to get ahead of the problem. This is the story of the 1979 Budget and the 1980 Budget. The 1981 Budget is absolutely the last chance for realism to take over from wishful thinking.

AAW
JH
DW

12 February 1981

SECRET

S E C R E T

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

PRIME MINISTER

VAT ON IMPORTS

At our meeting on 10 February I promised to send you a copy of the report by officials on the possibility of abolishing the Postponed Accounting System for VAT on imports. This is attached. As I see it, the main considerations are as follows.

2. The proposed change was originally conceived in the context of a review of non-tariff barriers. It was then suggested that the present VAT accounting arrangements gave a financial advantage to imports over home produced goods which should be reviewed. The detailed examination which has since been under-taken suggests, however, that the practical effects of the present arrangements make little difference as between imports and home-produced goods. The change would be seen as a positive discrimination against imports, and in favour of domestic manufacturers. But the effect would be very tiny; and the best estimate is that imports might be reduced by £100 million a year at most.

3. Against this background the main results of the change would be a once-and-for-all revenue and PSBR gain of about £600 million (plus or minus £200 million allowing for the many uncertainties involved), but this would mean a corresponding reduction (on average) in business liquidity. These are very large figures compared with the very small continuing effects of the change. In present difficult circumstances this is the way we could expect industry to perceive it.

S E C R E T

Effects on industry

4. The effects on business liquidity are likely therefore to be crucial. Unless UK importers were able to pass any of the effect back to their foreign suppliers, their own business liquidity could be reduced by up to £600 million in the long run. And in the initial months after the change this figure could be as high as £800 million. Almost half of the effect would fall on UK manufacturers who would not be able to pass all of it on in higher prices. Any manufacturers who stood to lose particularly would complain that they were being penalised by the change.

Effects on traders' accounting the Customs and Excise

5. There would be a significant price to pay in terms of the costs of VAT. The change would involve both Customs and Excise and traders in processing an additional 4,500,000 documents a year, a burden which would remain long after the main revenue gain had been dissipated. The new system would be much less economical than the present one and would go against the drive for greater efficiency and cost-consciousness in the Civil Service which we are pursuing through our policies on manpower and the Rayner exercises. Indeed, it would require a substantial addition to Customs and Excise staff at a time when efforts are being made to reduce numbers as much as possible.

Conclusion

6. When this was first raised, it had an immediate superficial attraction. But now that I have seen the likely implications, I feel that the balance of argument is firmly against making the change. This is particularly so in the context of a Budget in which I shall be seeking, within very limited room for manoeuvre, to provide immediate assistance to the company sector without appearing unduly to add to its burdens. I doubt whether it could be presented convincingly. I hope you will agree that it should not be pursued further this year.

7. I have no reason to think that Keith Joseph or John Biffen are particularly attracted to this, but if you did wish to take the matter further, you would no doubt wish me to consult them.

G.H.

(G.H)

12 February 1981

conqueror

1/8/80

CONFIDENTIAL

SUMMARY

A. THE ISSUE

Traders are not required to account to Customs and Excise for VAT on imported goods until they make their normal quarterly return. It was suggested that this could provide a financial advantage compared with the purchase of domestically produced goods and services on which VAT is paid when the supplier s account is settled. We were asked to examine the implications of a change in these arrangements.

B. REASON FOR CHANGE

This proposal originated from an examination of possible non-tariff barriers by the Industrial Policy Group of officials. It was commended to Ministers on the grounds that it would bring the VAT arrangements for imports more into line with those for domestically produced goods. On further examination, however, we believe that the practical effects of the present arrangements may be little different as between imports and home produced goods. Nevertheless, it remains true that some of our main competitors in Europe require VAT to be paid on imports at the time of importation, and that a move in that direction would not be incompatible with our EEC obligations.

C. WITHDRAWAL OF THE POSTPONED ACCOUNTING SYSTEM

Our report therefore considers the effects of replacing the present Postponed Accounting System with an arrangement whereby VAT would be required to be paid on imports either at the time of delivery or by direct debit on the 15th of the month following.

D. EFFECTS OF THE CHANGE

1. Revenue and PSBR

(a) Withdrawal of the Postponed Accounting Arrangements would accelerate the payment of VAT on imports by, on average, 6-8 weeks.

(b) This would provide a once-for-all revenue gain of about £600 million (plus or minus £200m) with a corresponding benefit to the PSBR. For the full effect to be felt in the first financial year the change would need to be implemented not later than 1 December. Later introduction would mean that a proportion of this gain would come through in the following year.

(c) Once the change had been fully absorbed, the gain(or loss) to the PSBR in succeeding years would mainly depend on the size of the increase (decrease) in the value of UK imports.

2. Monetary

Despite the large initial gain to the PSBR, the effect on companies' cash flow means that the benefit to the money supply would be likely to be small.

3. Trade

(a) The cost of financing earlier payment of VAT would be equivalent, at most, to an increase in import prices of 0.3%. This would have negligible effects on the volume of imports, amounting at most to a reduction of about £100 million a year.

(b) In practice this reduction might be smaller to the exte that the current strength of sterling permitted UK manufacturers to pass more of the resulting cost increase back to overseas suppliers.

4. Effects on industry

(a) There would be a once-for-all adverse effect from the change in the cash flow of importers (or their foreign suppliers) corresponding to the gain to the revenue.

(b) In the early months this could fleetingly reach something of the order of £800 million at the peak, but should settle within a matter of months to around £600 million.

(c) £600 million represents an average figure equivalent to 6-8 weeks of revenue. The aggregate financing burden on traders would fluctuate within any one month, quarter, or financial year.

(d) Individual traders would require additional finance varying each quarter up to a peak of a full quarters VAT on their imports. The transitional cost would be greatest for traders who opt to pay on entry rather than by later direct debit covered by bank guarantee.

(e) The cost to traders of financing these payments (at current interest rates) would be up to £100 million a year, of which almost a half would fall on manufac turers.

(f) The effects would vary significantly between different sectors and between different firms within a particular industry.

(g) In general, the financial consequences for the manufacturing sector are likely to be more significa than for services and the distributive trades which are generally more profitable and for the most part not subject to foreign competiton.

(h) Within the manufacturing sector, the impact of the change would be likely to be greatest for the oil, motor vehicle, electrical goods, metal manufacturing, alcohol, air transport, tobacco, chemical and paper industries.

(i) Within each industry, the effects on company liquidit and competitiveness would vary significantly betwee individual companies depending on variations in their pattern of trading. On the limited informati available we have not been able to identify any major UK manufacturer who would be critically affected; but we are not able to rule out the possibility of serious effects on some individual companies.

(j) The implications for traders would need to be considered against the background of the poor outlook for corporate liquidity.

5. Administration and manpower

(a) It would still be necessary to retain the PAS for certain postal imports and some services where there is no "point of entry".

(b) Withdrawal of PAS for other imports would require a continuing addition of 85 Customs and Excise staff, plus a temporary need for a further 15 staff until computerisation in mid-1982.

(c) In addition, overtime would be necessary in the transitional stage, and on a continuing basis in smaller VAT offices.

(d) The change would be a move away from the direction of simplifying procedures and reducing administrativ burdens on traders.

(e) There would be increased compliance costs for business especially customs agents and warehousekeepers, as a result of the new procedures.

6. Legislative requirements

The change could be implemented by Statutory Instrument subject to negative resolution.

7. Implementation

The change would require a minimum of three months to implementonce a decision to proceed was taken. Implementation reasonably quickly following an announcement in the Budget Speech would bring the full benefit to the PSBR in 1981/82. Implementation in time to have a substantial effect on this year's PSBR would require early decision For the full effects to come through in 1980/81 the change would need to operate from 1 December: this requires a decision by the beginning of September.

VAT ON IMPORTS

A preliminary report by officials examining a change in accounting arrangements for imports designed to accelerate the payment of VAT on them went to the Chancellor of the Exchequer on 14 March. The proposal was intended as a means of discouraging imports.

2. The present report represents the fuller evaluation which the Prime Minister asked the Chancellor to undertake on 25 March in conjunction with the Secretaries of State for Trade and Industry. It also follows the Ministerial discussion in 'E' Committee on 25 June, in the course of which the Committee expressed general support for bringing the arrangements for payment of VAT on imports into line with those for domestically produced goods as soon as possible, but agreed that account had to be taken of the effect on company liquidity. Like our preliminary report this report has been produced by officials of the Departments of Trade and Industry, Customs and Excise and the Treasury. It is being submitted concurrently to the Chancellor and the Secretaries of State for Trade and Industry.

3. Our earlier report provisionally concluded that accelerating the payment of VAT on imports would:-

(i) remedy the situation whereby imported products appear to be more favourably treated than those produced in the home market;

(ii) result in a small reduction in imports; and

(iii) produce a once-for-all revenue gain in the first year (and a much smaller benefit to the money supply).

But that on the other hand, the measure would:-

(i) adversely effect corporate liquidity, in a way which could not be mitigated by discriminating between sectors;

(ii) involve serious administrative problems, requiring permanent additions to Customs and Excise staff, and adding to the compliance costs of traders.

The present position

4. Purchases of domestic goods

A trader buying goods on the home market has to pay VAT on them when he pays his supplier; this is termed "input tax". He can take credit for this VAT against the "output tax" due to Customs and Excise on his sales, at the time he makes his next return to them.

The majority of traders are normally liable to account for more "output tax" than "input tax". They are classified as "payment" traders. Such traders are normally required to make returns of VAT and pay over the balance to Customs and Excise at quarterly intervals, one month after the end of the quarter to which the return relates. But a proportion of traders are regularly entitled to take credit on their returns for more "input tax" than their liability for "output tax". This situation can arise because, for example, a high proportion of the trader's sales are zero-rated (e.g as exports). Traders in this position are termed "repayment" traders. They may choose to submit returns either on the same quarterly basis as other traders; or at monthly intervals, as soon as possible after the end of the month to which they relate so as to obtain early repayment of the VAT they have suffered.

5. For any trader making quarterly returns, the average time between his receipt of goods bought on the home market and the due date for making his return, to Customs and Excise, and accounting for VAT, is therefore, 2½ months. The actual period for which a particular trader has to finance the payment of input tax will depend on the date when he actually pays his supplier for the goods in question (raw materials, equipment etc), and may vary considerably according to the period of credit he is extended.

6. Purchases of imported goods

Because there is no VAT in the supplier's price of imported goods, a trader who purchases imports is liable to pay VAT direct to the Customs and Excise on them. But provided he is registered for VAT the trader is not required at present to finance such input tax on the goods he imports for any period at all. This is because under an arrangement known as the Postponed Accounting System (PAS), he is allowed to defer the VAT payable at the time of importation and instead offset it against the corresponding credit he would take for input tax on his next VAT return. In other words, his purchases are in effect VAT-free until he renders his next return to Customs and Excise. He must, of course, charge output VAT in the normal way on any subsequent sales. This arrangement was introduced after consultation with industry during the planning of VAT.

The Proposal

7. The proposal we have considered is that the PAS should be withdrawn. If that were done traders would be required in future to pay the VAT due on their imports either at the place and time of entry, or by direct debit (covered by banker's guarantee) on the 15th of the following month (that is, on average one month after the goods have come in to the

country).[1] The VAT would be reclaimed on the next quarterly return, ie on average 2½ months after the time of import and importers who took advantage of the one month deferment would be required to finance the VAT payments for 1½ months on average.

8. We looked at this proposal in our earlier report. Our provisional conclusions are summarised in paragraph 3 above. The following paragraphs look at them in more detail.

Relative treatment of imports and home-produced goods

9. The proposed change was originally conceived in the context of a review of non-tariff barriers. It was suggested that the present VAT accounting arrangements gave a financial advantage to imports over home produced goods which should be reviewed. This was the assumption underlying the conclusions of our earlier work. On further examination, however, we believe that the practical effects of the present arrangements make little difference as between imports and home-produced goods. In these circumstances, withdrawal of the PAS would tend to place importers at a relative disadvantage compared with those who use domestically produced inputs.

10. As explained in paragraph 5, in practice, the period for which a purchaser of goods on the home market has to finance the VAT depends on the terms on which trade credit is extended. If he pays his supplier at the time he receives the goods, he must finance the VAT for, on average, 2½ months. In fact there is evidence to suggest that the average period of trade credit in manufacturing industry is currently around 2½ months, (although there are wide variations around this average). This means that on average purchasers on the home market are able to defer payment to their suppliers for about the same period as elapses before they may reclaim the corresponding input tax on their purchases. The position of individual traders may, of course, vary widely. But it would appear that in the aggregate purchasers on the home market do not have to finance the VAT payments on their purchases any more than the purchasers of imported goods. The difference is that in the case of imports tax can be accounted for and reclaimed by the same trader on the same return; for suppliers on the home market one trader pays another reclaims. In respect of any one transaction the timing of payment and refund may not coincide but in aggregate they balance out. On the home market any financing cost to the purchaser is balanced by an equal advantage to the supplier - and vice versa.

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[1] Under EEC rules the UK is required to allow importers to defer payment of tax on imports for this length of time. In effect the arrangements would correspond to the position for customs duties (which however are levied on only about 25 per cent of imports).

Effects on the revenue

11. It is estimated that VAT on imports of goods in 1980-81 may be around £5250m - rather lower than we assumed in our earlier report - or on average about £1,300 a quarter. The proposal would bring forward the date when receipt of this revenue is due by on average, 1½ months. In principle, assuming that the flow of payments was spread evenly through the year, this would give a once-for-all revenue gain in the year of introduction of about £600 million. There would be a corresponding potential cash flow disadvantage for traders (see paragraph 24 below).

12. The effect in practice would depend on a number of factors. These would include features in the operation of the tax, and for example the level of imports in the last four months of the year in which the change was introduced. They give rise to a wide margin of uncertainty. In our first report we expected that once these factors had fully worked their way through the system, they would be likely overall to reduce the final amount of revenue brought forward to about £400-500m. Further analysis suggests that in the long run their effects might come closer to offsetting each other:-

a. On the one hand, our earlier report identified a number of ways in which traders could escape the full effects of the change. The most important of these is that as a consequence of requiring VAT on imports to be paid separately from the return on which the corresponding credit is claimed a fair proportion of traders would become entitled to net repayment of VAT when they rendered their normal returns, and would thus become eligible to receive monthly repayments (see paragraph 4). Further analysis suggests that the opportunities for traders to use this to do more than mitigate the effects of the change might be more limited than we initially concluded. But Customs and Excise estimate that once traders had become aware of the opportunities, up to £1250m a year of the total VAT due on imports might have to be repaid monthly to such traders. The amount of VAT that would be subject to accelerated payment, eventually, therefore might be of the order of £4000m a year (about £1000m a quarter).

b. On the other hand, VAT on imports would in future be paid at the time of entry or by direct debit and this would ensure prompt receipt of the revenue by Customs. This contrasts with the present delays in quarterly returns. VAT outstanding at 31 January 1980 was equivalent to 34 days average payments (compared with 25 days a year previously). Customs and Excise are endeavouring to get these arrears down again, but it would be over-optimistic to hope that they would be eliminated. In practice, therefore withdrawal of the PAS would require traders as a whole to finance the VAT on imports for longer than the 1½ months assumed earlier. It is difficult to assess the effect of these factors, but we think that, as indicated above, they would roughly cancel out the effect of traders becoming eligible for monthly repayments.

13. Once these changes had fully worked through, therefore, we would expect that on average, some £600m would be accelerated. But we have had to recognise that because of the many uncertainties involved this estimate of the average revenue flow is subject to a margin of up to £200 million in either direction. The figure would in any case fluctuate because of differences in the value of imports attributable to the three groups of traders who account for VAT at different dates in the year.[2] They would also vary with the seasonal pattern of trade.

14. The effects on revenue (and the cash flow of business) in the first few months would be likely to vary significantly from the position once the changes have fully worked their way through. We estimate that in the early months after the change, and before traders had had an opportunity to minimise the impact on their finance, the revenue effect could reach something in the order of £800m at the outside. As the position then unwound, this might be expected to fall back towards £600m.

15. The actual revenue gain in the year of introduction would depend upon the date of introduction. This is discussed further in paragraph 46 below.

16. There is one possible further qualification to this figure. In line with the general one-month deferment of VAT payments on imported goods (paragraph 7 above) traders would have to be allowed to defer VAT on goods delivered from warehouse to the middle of the month following delivery. This, in turn, could increase the existing pressure for deferment of excise duties. Deferment of the excise duties on the same basis would involve an estimated once-for-all cost of about £450 million - some £140 million for wines and spirits and £300 million for hydrocarbon oils. We assume that duty deferment would continue to be resisted and we have made no allowance for it.

Economic Effects

(a) PSBR Effects

17. The PSBR effect of advancing VAT payment is unlikely to be very different from the direct revenue effect - that is a once for all gain of around £600m. Whilst there would be some changes in economic activity and interest rates resulting from the measure, we think that any difference would be relatively small in the first year. In the longer term the continuing PSBR effects, like the continuing revenue effect, would be likely to be small.

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[2] VAT returns are made quarterly but for administrative reasons a proportion of all traders have an accounting date ending in any particular month. The numbers of traders in each of these 'stagger' groups are not equal. This can affect the monthly pattern of VAT payments on imports in any quarter or financial year.

(b) Monetary Effects

18. The monetary effects would be much less than the reduction in the PSBR since companies who are now in a very tight liquidity position, may well be unable to finance the additional VAT payments by running down their bank balances. Some of the finance would come from external sources but much would probably come from increased bank borrowing. This would offset much of the effect of the reduced PSBR on £M3 and the net monetary effects would therefore be likely to be small.

(c) Effects on Imports

19. We have looked again at the likely effects of the proposal on imports. The cost to traders of financing the full accelerated payment of VAT on imports would be roughly equivalent to an on-going cost increase of about 0.3 per cent of import prices. (This might be increased marginally for those traders who opt to defer their VAT payments for one month by the costs associated with obtaining a bank guarantee). In terms of a corresponding tariff barrier the effects of a change of this size would normally be regarded as negligible.

20. The normal assumption in the Treasury model would be that manufacturers would not be able to pass back to foreign suppliers any of the increase in the cost of new materials and semi-manufactures but that there might be scope for passing back to suppliers about a third of the additional cost of finished manufacturers. On these assumptions we would expect a reduction in imports of around £100 million.

21. In current circumstances, these effects could be smaller in practice, because over the last two years the prices of imports of manufactures and semi-manufactures have not fully reflected the strength of sterling. They have risen by 10% more than world prices, with a corresponding widening of importers' margins. This trend suggests that UK firms may be better placed at present than they would normally be to pass the costs back to their overseas suppliers.

(d) Effects on Industry

22. It would not be practicable to try to impose the change selectively on, for example, distributors or profitable firms, but not on manufacturers or companies with liquidity problems.

23. The available data suggests that:

(a) in all some 45,000 traders would be directly affected by a change in the VAT arrangements for imports;

(b) within this total nearly 50% of the VAT due on imports is paid by 76 large traders and some 90% by a total of 4,500 major traders;

(c) about 45% of the VAT due is attributable to imports by UK manufacturers, and the remainder to imports by the distributing trades and imports of services;

(d) something in the order of one-third of the imports which would be affected are subsequently re-exported in one form or another.

24. As explained in paragraphs 11 to 15 above, once the effects of the change had fully worked through, the overall once-for-all revenue gain would be in the order of £600m. Importers as a whole would suffer a corresponding, continuing loss of liquidity unless they were able to pass any of the additional costs back to their suppliers or forward to their customers. Rather less than half of this would fall on manufacturers. The cost to traders of financing these payments, at current interest rates, would be about £100m a year.

25. In assessing the effects on business cash flow it also has to be borne in mind that:

(a) as indicated in paragraph 14 above, in the early months, and before traders have been able to minimise the effect on their finances, the adverse impact on business cash flow could reach something in the order of £800m.

(b) the once-for-all revenue gain of £600m represents an <u>average</u> of 1½ month's VAT. Individual traders, however, would require additional finance varying each quarter up to a peak of a <u>full</u> quarter's VAT on their imports. This could place many of them in difficulties, and it seems likely that a significant number would be unable to obtain the bank guarantees needed to enable them to take advantage of the facilities for one month's deferment described in paragraph 7 above.

(c) these estimates make no allowance for the possibility that the existing strength of sterling may allow importers of manufacturers and semi-manufacturers to pass back more of the increased costs to their overseas suppliers than would normally be the case.

26. In general, the financial consequences would be likely to be more important for the manufacturing sector than for the non-manufacturing (including service trades; distribution and retailing). This is because the manufacturing sector is generally less profitable, less able to pass back increased costs to overseas suppliers and in most cases more subject to foreign competition. Nevertheless, within the non-manufacturing sector, the measure could be expected to cause particular difficulties for the mail order trade, since their fixed price system of trading is vulnerable to sudden increases in costs.

27. Annex A indicates the distribution of the VAT accounted for on UK imports in 1979-80 between trade groups. Within the manufacturing sector those most affected by the change would include the oil, motor vehicle, diamond, electrical and mechanical engineering, metal manufacturing, alcohol, air transport, tobacco, chemicals and paper industries. As Annex B illustrates, the ability of individual industries to meet the effects on cash flow would also vary considerably.

28. Moreover, within each industry, the effect on company liquidity and competitiveness could vary considerably between individual companies, depending on:

(a) their relative dependence on imports of raw materials, semi-finished or finished manufactures. (For example, within the electrical goods industry, while many firms would welcome any move that made imports from Italy relatively more expensive, there would be some cost increases for UK firms such as Hoover which both manufacture in this country and import);

(b) whether in total they pay more VAT then they may reclaim (when both the VAT due on imports and on their sales are taken into account);

(c) whether, where the option was available, they chose to make quarterly or monthly repayment claims; and

(d) how promptly they rendered their VAT returns.

Some illustrative examples of the effect are shown at Annex C.

29. We have looked at a number of the largest importers in order to assess how they would be affected by the measure. On the basis of the limited information available, we have not been able to identify any major UK manufacturers for whom the impact of the change would be obviously critical. We cannot, however, rule out the possibility that it would have serious adverse effects on some companies. Nor, given that the effects would vary greatly according to the particular circumstances of individual companies, do we think that the uncertainties would be resolved by consultations with representative trade bodies.

30. The implications for business cash flow take on an added importance against the present background of severe and growing pressure on corporate liquidity. Liquidity ratios in the main sectors of manufacturing industry are at their lowest since mid-1975 (only just above the bottom of the 1974/75 liquidity crisis). It is possible that the company sector financial deficit in 1980 may be worse in real terms than in 1974 and the squeeze is likely to continue into 1981; the outcome will depend on how fast stocks and investment are cut back. Liquidations are nearing historically peak levels and are rising at a rapid rate. To withdraw the PAS in present circumstances, unless accompanied by other off-setting

benefits to corporate liquidity, would significantly increase the burden currently being borne by industry as a result of the present economic conjuncture.

EC Implications

31. The European Community rules provide no obstacle to our abandoning the PAS, so long as this was not done on a selective basis to mitigate the effects on particular industries.

32. The table at Annex D summarises the more recent information we have been able to obtain about the arrangement operating in other Member States. Although there are wide variations of detail, all Member States operate a system which is broadly on the lines either of the UK's existing practice or of the arrangements described above. The precise arrangements in some Member States are not entirely clear, but the change to the system proposed could, we think, be represented as bringing us more closely into line with our major competitors in the community.

Administration and Manpower

33. Our original report recognised that the proposal would involve more administrative work and complication for Customs and Excise and for business; would require more Customs staff to operate; and would move away from the direction of simplifying procedures and reducing compliance burdens of VAT for businesses. These broad conclusions remain, though we have revised downwards the figure of additional staff required.

34. In assessing the administrative effects we have assumed that any new system would conform with our Community obligation to allow importers to defer payment of the tax due on imports by an average of one month. Importers would continue to be able to take credit for the VAT due on imports on their next VAT return. But, as we have noted, they would be required to pay the tax either at the time and place of entry; or (if they chose) furnish a bank guarantee for their liability, and make payment by direct debit on the 15th of the month following importation. For the reasons stated in paragraph 25 we think that many smaller importers would be unable to take advantage of this latter facility and the majority of them would choose to pay VAT at the time of entry of their goods. But a fair proportion of the 45,000 would defer resulting in an increase in the number of bank guarantees required for tax on imports from 3,000 to perhaps 12,000.

35. We have concluded that it would be necessary, in any event, to retain the present postponed accounting system in being to provide facilities for postal imports of below £1,000 in value (the VAT on which would involve disproportionate staff and effort for

Customs and Excise and the Post Office to collect at entry), and for some imported services for which there is no "point of entry".

36. In the light of these considerations, Customs and Excise's best estimates of the staffing implications of changing the present arrangements are as follows:

(a) they would have a continuing need for about 85 additional staff to operate the new system (rather than the 150-200 contained in our original report);

(b) in addition they would have a temporary need (to mid-1982) for a further 15 staff to operate a manual system of recording, pending computerisation;

(c) overtime would be required to cope with the continuing commitment at smaller units; and

(d) there would be a considerable further transitional burden during the initial months before the system bedded down, which would also have to be met by overtime.

These additional requirements would have to compete both with the existing demands for collecting the revenue and helping to maintain law and order and with pressures for some tightening of customs controls in selected areas eg textile quotas.

37. There is another consideration which should be mentioned. As a result of our membership of the EC, customs procedures on importation have been and are being simplified, and our controls have much relaxed. The assessment and collection of VAT on imports would reverse this process and any consequent staff economies, and would result in the up-grading of much of this work which is in the course of being down-graded. More generally, a change of this type could be seen to be out of step with the efforts which Customs and Excise and the Department of Trade have been making to persuade other countries to simplify their complex and sometimes obstructive customs procedures in the interest of UK exporters.

38. There is also the effect on importers to consider. Most of the additional work in the commercial field would fall on customs agents and warehouse keepers. They would be bound to face increased compliance costs, in addition to the direct costs involved in providing bank guarantees and financing the initial loss of liquidity. The more detail that is required from traders, the more chance there is of error and queries, all of which tend to cause delays. Speed of clearance, always a bone of contention in the customs field, would be reduced, resulting in complaints from traders, trade associations and in Parliament.

Statutory requirements

39. Withdrawal of the PAS would not require primary legislation. It would be necessary to amend the existing Regulations governing payment of VAT. This would require a Statutory Instrument subject to Negative Resolution.

CONSULTATION

40. In the absence of consultations with trade representatives, we have been unable to provide conclusive indications of the effects of either scheme on individual industries or firms or of the extent of any increase in industry's compliance costs (for example, in reprogramming computers).

41. We have concluded that consultations on the administrative arrangements for the change would be essential before implementation. It remains a matter for political judgement whether industry should be consulted before a decision was taken in principle to change the present arrangements. Criticism could be expected, from trade representatives who were consulted before the present system was adopted, if a decision were taken to alter it without opportunity or representations to be heard. On the other hand, it seems likely that such consultations would produce loud and sustained protest rather than clear factual analysis of the effects on individual sectors. We have concluded that, on balance, little would be gained by embarking on consultations before a decision to proceed had been announced.

IMPLEMENTATION

42. The change would need to take effect on the first day of a calendar month. On the assumption that Ministers did not wish to authorise consultation before taking a decision, a minimum period of three months would be required from the date of decision to the date on which the new system for imports first took effect. The first two months would be devoted to confidential planning by Customs and Excise. There would then be a public announcement following which officials would engage in discussions with representative bodies about implementation. Customs and Excise consider that a period of one month should be sufficient for such discussions and for the majority of traders to make the necessary arrangements.

43. The effect on the revenue, and on companies' cash flow, would also be relevant to the timing of a change. This is because, as noted in paragraph 7 above, the essence of the change would be to alter the pattern of VAT credits and payments within the normal quarterly accounting period. Allowing for the one month period of grace for payment, this

means that the process of acceleration would be completed within four months from the date the change first took effect. (Though the true net effect of the scheme could take a little longer if traders were slow in appreciating the implications for monthly repayment in certain cases).

44. As noted above, withdrawing the postponed accounting system would require an amendment to be made to the VAT regulations. The necessary Statutory Instrument could be laid at the time an announcement was made.

45. There are, therefore, the following possibilities:-

(a) Budget announcement. The change could be announced in the 1981 Budget Speech to take effect in the course of 1981-82. Provided that implementation took place by 1 December 1981 the PSBR could be expected to benefit in 1981-82 by the full £600 million (plus or minus £200 million either way);

(b) Implementation this year. Implementation in time to have a substantial effect on this year's PSBR would require an early decision. For the full effects to come through in 1980-81 the change would need to operate from 1 December 1980: this would require a decision by the beginning of September and an announcement not later than 1 November. Later introduction would mean that a proportion of the gain would come through in 1981-82.

Summary and Conclusions

46. We have looked again at the possible effects of withdrawing the postponed accounting system for VAT on imports. The case for this proposal is that it would:-

(a) bring us broadly into line with the requirements placed on importers by some of our main competitors in Europe, in a way which would not be incompatible with our EC obligations;

(b) provide a discouragement to imports, to the extent perhaps of reducing imports by at most £100 million a year;

(c) produce a once-for-all revenue gain of about £600 million (plus or minus £200 million) (with similar effect on the PSBR, but a much smaller reduction in the money supply).

47. On the other hand, the measure would:-

(d) reduce corporate liquidity in the initial months by upto £800 million and in the long run by about £600 million (plus or minus £200 million), of which manufacturing would bear almost one-half, in a way which could not be mitigated by discriminating between sectors, and at a time when the general outlook for corporate liquidity is already poor;

(e) involve more work for Customs and Excise requiring permanent additions of 85 and temporary additions of 15 staff; and

(f) as the counterpart of (b) add to the compliance costs of traders importing raw materials, or semi-finished or finished goods.

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1 August 1980

ANNEX A

ANALYSIS OF VAT DUE ON IMPORTS BY TRADE CATEGORY IN 1979-80

TRADE GROUP	TOTAL TAX DUE (£ million)	INDIVIDUAL INDUSTRIES WITH MORE THAN £10 MILLION DUE	AMOUNT DUE (£ million)
PRIMARY INDUSTRIES			
Agriculture, Forestry, Fishing	2.1		—
Mining & Quarrying	15.3	Petroleum & Natural Gas	14.1
MANUFACTURING INDUSTRIES			
Food, Drink & Tobacco	125.2	Brewing & Malting	20.8
		Spirit Distilling	36.4
		Tobacco	44.1
Coal & Petroleum Products	205.6	Mineral Oil Refining	205.1
Chemicals & Mixed Industries	261.0	General Chemicals	113.1
		Pharmaceuticals	41.5
		Synthetic Resins	18.2
		Dyestuffs & Pigments	15.6
Metal Manufacture	157.4	Iron & Steel	51.3
		Aluminium	31.7
		Copper, Brass, etc	22.1
Mechanical Engineering	127.1	Pumps, Valves, etc	13.8
		Constructions & Earth Movers	24.4
Instrument Engineering	34.1	Scientific & Industrial	29.7
Electrical Engineering	226.3	Electrical Machinery	22.2
		Insultated Wires & Cable	18.8
		Radio & Electronic Components	37.7
		Electronic Computers	77.1
		Electric Appliances	23.3
Shipbuilding & Marine Engineering	4.9		
Vehicles	250.4	Motor Vehicle Manufacturing	176.8
		Aerospace Equipment Manufacturing	54.2
Metal Goods	103.6	Precious Metals	51.2
Textiles	98.6	Production of Manmade Fibres	25.0
		Wollen & Worsted	15.6
Leather, Leather Goods & Fur	17.0		
Clothing & Footwear	38.2		
Bricks, Ceramics, Glass, Cement, etc	17.7		
Timber, Furniture, etc	92.6	Timber	70.7
Paper, Printing & Publishing	89.7	Paper & Board	34.4
		Packaging	30.0
Other Manufacturing Industries	69.3	Rubber	29.3

(An[illegible]s (cont'd) - year ended 31.3.80)

TRADE GROUP	TOTAL TAX DUE (£ million)	INDIVIDUAL INDUSTRIES WITH MORE THAN £10 MILLION DUE	AMOUNT DUE (£ million)
CONSTRUCTION			
Construction Industries	14.8		
UTILITIES			
Gas, Electricity & Water	0.8		
TRANSPORT & COMMUNICATION			
Transport & Communication	28.2	Air Transport	22.3
DISTRIBUTIVE TRADES			
Wholesale Distribution	1799.6	Alcoholic Drink	109.8
		Petroleum Products	581.7
		Clothing	60.0
		Textiles	49.4
		Footwear	21.3
		Electrical Goods	62.6
		Radios, TVs, Tape Recorders	66.4
		Jewellery	14.6
		Photographic Goods	32.3
		Furniture & Flooring	20.5
		China, Glassware & Hardware	18.7
		Paper & Board Products	77.8
Retail Distribution	102.0	Women's & Girls' Wear	15.9
Dealers	290.7	Industrial Material	183.7
		Industrial & Agricultural Machinery	76.6
SERVICES			
Insurance, Banking & Financial	100.4		
Professional & Scientific	12.4		
Miscellaneous	320.5	Distribution, Repair & Service of Motor Vehicles	255.3
Public Administration	nil		

NATIONAL TOTAL 4606.3

ANNEX B

ANALYSIS CONTAINED IN OUR PROVISIONAL REPORT OF THE IMPLICATIONS OF WITHDRAWAL OF THE P.A.S. FOR THOSE INDIVIDUAL SECTORS AND SUB-SECTORS ON WHICH THE GREATEST IMPACT CAN BE EXPECTED.

Sector/Sub-Sector	Possible Implications for UK Industry of Tax Change.
Spirit distilling	Profitable industry - unlikely to pose problem.
Tobacco	- ditto -
Chemicals - whole industry	Facing increasing international competition and declining profitability. Unhelpful.
Pharmaceuticals	Very profitable. Main customer is NHS, which under agreed pricing regime would foot large part of extra cost.
Dyestuffs and pigments	Generally in a bad state - ICI thinking of closing down much of their business. Unhelpful.
Instrument engineering	
Scientific and industrial instruments	
Electrical engineering	
Radio and electronic components	One-sixth of industries output is merchanted goods (almost certainly imported finished goods). Discouragement of imports would be welcome but any deterioration of UK-based companies finances would weaken efforts to strenghten domesti manufacturing capability, especially TV sets.
Electronic computers	Multinationals could bear cost easily but position of ICL and especially others small UK-owned manufacturers much less robust.
Vehicles	/BL's import content is low.7 No problem for Ford, but Talbot and Vauxhall in poor financial shape.

Leather, leather goods and fur	Footwear is a separate industry. There would probably be no great problem for this sector.
Timber, furniture etc.	Furniture industry is in the doldrums.

EFFECTS OF WITHDRAWING THE POSTPONED ACCOUNTING SYSTEM ON SAMPLE TRADERS

Note: It is assumed throughout that the payment traders render their returns on the due date (i.e. one month after the end of the period) and repayment traders as soon as possible after the end of the period.

A. PAYMENT TRADER WHO REMAINS A PAYMENT TRADER

A chemical manufacturer (whose purchases are 20% imports) who at present pays £25.6 million on his quarterly return,would pay £2.4 million at import each month and £18.4 million on his quarterly return.

Overall he would be required to pay £7.2 million on average 6 weeks earlier. I.E. CASH FLOW DETERIORATION.

B PAYMENT TRADERS WHO OPT TO MOVE TO MONTHLY VAT RETURNS AS A REPAYMENT VAT TRADER

Company 1

A computer manufacturer (whose purchases are 66% imports) who at present pays £9.6 million on his quarterly return would pay £4.6 million at import each month, and receive repayments of £1.4 million on each monthly return.

Overall he would be required to pay £9.6 million tax on imports, on average, 6 weeks earlier. i.e.MITIGATED CASH FLOW DETERIORATION.

Company 2

A diamond company (whose purchases are virtually all imports, and whose sales are virtually all zero-rated exports) who at present pays £0.7 million at import each month, and receive repayments of £18.3 million on each monthly return.

Overall he would be required to pay £0.7 million , on average, 6 weeks earlier i.e. MARGINAL IMPACT ONLY

C REPAYMENT TRADER MAKING MONTHLY RETURNS

An airline (whose purchases are 33% imports) who at present receives repayments of £1.6 million from his monthly return, would pay £0.9 million monthly at import, and at about the same time receive increased repayments of £2.5 million.

Overall MARGINAL IMPACT ONLY

D REPAYMENT TRADER ON QUARTERLY RETURNS WHO DOES NOT OPT TO TRANSFER TO MONTHLY RETURNS

A small clothing manufacturer (whose purchases are 10% imports, and whose sales are 40% zero-rated) who at present receives repayments of £1000 from his quarterly return would pay £333 each month at import, and receive increased repayments of £2000 from his quarterly return.

Overall he would be required to pay £1000 on average 6 weeks earlier i.e. CASH FLOW DETERIORATION

ANNEX D

VAT ACCOUNTING PERIODS

MEMBER STATE	Domestic	Imports	Source of information
BELGIUM	If turnover is above 15 million BF (c £227,000) p.a., returns are monthly. If annual turnover is not over 15m. BF returns are quarterly but VAT is still paid monthly, the first 2 months of each quarter being advanced payments equal to $\frac{1}{3}$ of the VAT due in the preceding 3-month declaration. All traders must also file an annual return.	VAT payable at importation except by: - taxpayers obtaining special authorisation - taxpayers receiving goods from the Netherlands or Luxembourg. These traders may account for the VAT in their normal returns (i.e. within 20 days of the following month or quarter)	Belgian Embassy
DENMARK	The standard tax period is the calendar quarter. Exceptionally, returns may be made weekly, monthly or six-monthly.	VAT payable at importation except for registered traders who may defer payment until the end of the following month.	Danish Embassy
FEDERAL REPUBLIC OF GERMANY	Assessment period is one calendar year but preliminary returns are filed each month. Returns are made quarterly if tax liability in preceding year was less than DM2400 (under £600) and the annual return alone is filed if tax due was less than DM600 (under £150).	Complex system but essentially registered traders normally have up to the 15th of the month following importation to pay the VAT due. Regular importers, some of whom may need special authorisation or security, may account for the VAT on an average 'forfait' system in their normal VAT returns.	German Chamber of Commerce
IRISH REPUBLIC	Two-monthly	Registered importers account for VAT in their normal VAT returns.	Public Notice issued by the Revenue Commissioners at Dublin Castle
ITALY	Traders with a turnover of more than 360 million lire (£185,000) p.a. make monthly payments, and traders with a turnover of under 360 million lire make quarterly payments. All traders must also submit an annual return.	VAT is payable at importation: there is no deferred accounting period.	Study visit of December 1978

MEMBER STATE	VAT ACCOUNTING PERIODS		Source of Information
	Domestic	Imports	
LUXEMBOURG	If turnover is over 3½ million LF (£53,000) p.a., traders make monthly payments. If annual turnover does not exceed 3½m. LF quarterly payments are made. If turnover is not above 250,000 LF (under £4000) payments are made annually. All traders also make an annual declaration.	VAT registered importers may account for VAT in their periodic tax returns. Otherwise, VAT payable at the moment of importation.	VAT Law (1.1.80) Articles 63, 64.
NETHERLANDS	Standard tax period is the calendar quarter. Those traders paying more than 6,000 G (£1310) per quarter and some 'bad risk' traders are on monthly returns; and those paying less than 1,000 G (£218) a year may furnish annual returns.	Postponed accounting system similar to UK, but importers must obtain prior approval. If approval is refused tax must be paid at the frontier.	Embassy (confirming 1978 visit)
U.K.	The standard tax period is three months. Repayment traders can ask for monthly tax periods.	Registered taxable persons may account for VAT due on imports in their normal tax returns.	H.M. Customs and Excise Notice No. 700 and 702.
FRANCE	Monthly. Quarterly if tax due is less than 500 F per month. Exceptionally, annually.	VAT payable at the frontier. However, specially authorised clearing agents, with banker's guarantees etc, can pay a lump sum at regular intervals. Interest is charged on this credit facility.	Embassy (visit 5 June 198

P.a. R. 18/2 9

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr Ridley

THE BUDGET

You are holding a small meeting tomorrow to discuss the general Budget strategy in the light of the revised forecast and the talk with the Prime Minister.

2. I have not attempted any detailed new packaging. The grounds are still too shifting. But I thought a few crude sums might help you to focus on the kind of problems we now seem to face.

3. Assuming an "existing policies" PSBR starting point for next year o some £13½ bn (Mr Evans will be confirming the figure tomorrow), the following PSBR reducing packages for next year could be contemplated.

PSBR £bn 1981-82

Treasury Budget		Prime Minister's Budget	
Starting PSBR	13.50	Starting PSBR	13.50
PSBR Reductions		PSBR Reductions	
6½% Rooker-Wise	-1.10	6½% Rooker-Wise	-1.10
2 x revalorisation specific duties (no VAT blocking)	-1.00	X VAT on imports	-0.60
PSBR smoothing	-0.25	PSBR smoothing	-0.25
'Bonus' from bank levy of £450m (say)	-0.25	'Bonus' from bank levy of £450m	-0.25
		X 1% NIC(E) from November (say)	-0.35
Resultant PSBR (say)	10.90	Resultant PSBR (say)	10.95
Industry Package		Industry Package	
[Combination of measures] (say)	0.25	[Combination of measures] (say)	0.25
Final PSBR	11.15	Final PSBR	11.20

4. This is all very rough and ready, but it suggests that, if you were prepared to publish a PSBR of £11 to 11¼ bn, you could still, on either basis, fit in a small package to industry (or alternatively go for the lower PSBR). But in the "Treasury Budget", persons and

consumers would be pretty severely hit (taking the already decided NIC(E) into account). And in the Prime Minister's Budget, although the further effect on prices would be moderated, the further NIC(E) increase would effectively raise marginal tax rates, and VAT on imports would significantly worsen industry's cash flow.

5. Many variations on either package are possible (eg a larger NIC(E) increase). For PSBR reducing purposes VAT blocking could also be restored (reducing the PSBR by some £0.23 bn but worsening company income by £0.27 bn direct). But to the extent that changes were designed to reduce the PSBR further, they would add to the burden on persons or businesses and add to a Budget whose overall effect is likely to be substantially deflationary. Of the two possibilities above the overall effect of the Prime Minister's budget would, in conventional terms, probably be less deflationary since the effect of double revalorisation of the specific duties is greater than that of VAT on imports (mainly a financial transaction).

JBU

J B UNWIN
11 February 1981

Prime Minister (through [illegible])

Mr Jenkin presses the case for increasing duties on alcohol.

MP 11/2.

cc Mr Walters Mr Wolfson

DEPARTMENT OF HEALTH & SOCIAL SECURITY
Alexander Fleming House, Elephant & Castle, London SE1 6BY
Telephone 01-407 5522
From the Secretary of State for Social Services

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
Parliament Street
London S W 1

10 February 1981

Dear Geoffrey,

TAXATION OF ALCOHOLIC DRINKS

In your letters to me of 21 November and 11 December last year, you agreed on the need to take into account in your preparations for the coming Budget the health implications of changes in tax on alcoholic drinks.

Since then, officials from my Department and other interested Departments have met officials from the Board of Customs and Excise (as they also did last year) to discuss in more detail the effects of possible changes in taxation on alcohol generally and in relative duty rates on beer, wines and spirits.

It may help if I summarise the arguments as I see them, for proposing that in the Budget, the overall level of taxation on alcohol is raised to match the rate of inflation over the last year. I know that these views are shared by my colleagues in the other UK Health Departments.

First, the evidence that the problems of alcohol misuse are increasing is, I believe, indisputable. I also believe that, while there is controversy about the nature of the link between growth in the levels of misuse and growth in overall consumption, present evidence alone is sufficiently strong to justify action to prevent the real value of duties on alcoholic drinks, and so their price, from falling further.

Secondly, as you know, the problems of alcohol misuse have now been discussed at length by 'H' Committee at the meeting on 13 January 1981. It was agreed then, in principle, that to focus attention on the preventive role Government and other agencies could play, a consultative document should be issued by the Health Departments. It was accepted that such a document should not be published until after the Budget, but the point was made that, in the meantime, the Government should not take any action which might appear to prejudge the outcome of discussions on alcohol misuse which we would hope to promote.

E.R.

It would therefore fit in with this strategy if any changes in duties on alcoholic drinks could be expressed in a way which showed that they were intended to restore the real value of duties over whatever period seemed to be appropriate. More generally, there is a case for raising duties on alcoholic drinks more frequently and in smaller steps, rather than less frequently and in large steps.

While on health grounds we would not wish to distinguish between different kinds of alcohol, if on other grounds it seems desirable to vary the duties, I would favour a real increase in beer duty (since the OPCS Survey into drinking habits suggest that beer is most heavily implicated in heavy drinking and associated problems), preferably without a reduction in the real value of duties on wines.

I am copying this letter to Cabinet colleagues and Sir Robert Armstrong.

Yours ever
Patrick

SECRET

PRIME MINISTER

The Budget, etc.

1. When we are buffetted around by massive shifts in the target variables as we saw in this morning's (Tuesday's) meeting, the strategic planning of the budget is extremely difficult. The most important elements, the PSBR, with the £M_3 equation and interest rates, emerge with lurches of frightening magnitude. It is very difficult to create stable conditions in such an environment. We cannot make nice adjustments in any meaningful way. But we ought to plan on the basis of our past experience.

2. The trend of the forecasts of PSBR is upwards - and, by the nature of the extrapolative forecasts, they are unlikely to undershoot unless there is a marked turn around in the economy. True there will be attempts to cut spending, but it would be unwise to be sanguine about the result of such attempts. We are likely therefore to budget for too low a reduction in PSBR (as we did in 1980/81).

3. This will lead either to an additional late summer or autumn budget (which is to be avoided) or to putting great strains on funding. This last resort <u>may</u> lead to a funding crisis, but it will certainly lead to high interest rates, retaining high exchange rates and yet another squeeze on the private sector. This outcome must be avoided - it would be a quite impossible scenario for the approach to an election.

4. Painful decisions now, properly packaged as being due to the costs of last wage round and NI Losses, and put forward as an employment budget, might get things right in time for an election. But there is little time even to make the decisions, let alone package and sell them to Colleagues who must be <u>persuaded</u> that we have got it right.

5. I have discussed this with David Wolfson and John Hoskyns.

<u>10 February, 1981</u>

SECRET

SECRET

Original returned to 7 A. Walters

PRIME MINISTER

BUDGET AND MONETARY POLICY

1. What are our objectives in budget?

Mainly

i. "to re-establish credibility in our monetary and public expenditure objectives" (Chancellor memo 5 February).

ii. "persevering with a tight fiscal and monetary policy". (Chancellor memo 5 February).

Given the high public expenditure, however, the Chancellor's memo implies increased taxes to give a £1 to £1½Bn net reduction in PSBR (down to about £9½ to £10Bn.

2. What will be the reaction of this tough budget on consumer spending, investment and, cet par, the level of activity and unemployment?

Is it reasonable to assume that most of the increased tax on disposable personal income (of the order of 2 to 3 percent, say) will be paid out of the present high savings so that the level of activity will be roughly the same? What are our expectations?

3. What will be the effect on interest rates and the funding problem?

A decrease in the expected PSBR may be needed to prevent a funding crisis - but does this mean that interest rates will be lower as PSBR decreases and so the exchange rate will be subject to downward pressure?

Note: The Chancellor expects exchange rate to stay at a "high level" p.3 of memo of 5 February.

4. The exchange rate is crucial in both budget and monetary strategies. The effects of the rapid appreciation in the real effective exchange over the latter part of 1979 and 1980 have still to work through the economic system There was an 11% increase in sterling real effective exchange rate from January 1980 to January 1981 This would imply, inter alia, at least a 9 to 14 percent decrease in manufactured exports and corresponding reductions in import substitutions spread over 1981-82.

SECRET

/ As a rough rule a 10% decrease in the exchange rate will add 8% to 13% to exports of manufacture with an average lag of 1 year 3 months./

The effect of the high exchange rate in increasing unemployment and public spending needs to be seen in both a budgetary and monetary context. The present planning for unemployment benefits uses the government actuary's estimate of unemployed - but this may be far too low in view of sterling's rise in late 1979-1980.

5. In terms of our £M3 criteria and performance, a reduction of MLR (which is very desirable) should be interpreted as a relaxation of monetary policy. There is an apparent contradiction in the movements in our fiscal and monetary stance. In my view this is sensible since monetary policy has been very tight while the PSBR has been too loose. The combination of a downward path for MLR and a decrease in PSBR seems right, but it needs a better rationalisation than the £M3 figures provide.

6. What is our monetary policy and how do we exercise control to ensure that it is consistent with the budgetary policy?

We know that the relationship between MLR and £M3 is not tractable or even perverse. How are we to keep some control on £M3 when we cannot control the extension of bank credit to the private sector? The financial community know this and are looking for some well articulated alternative such as MBC - would it not be best to announce that the objective is MBC so that institutions can adjust?

There is an urgent problem to ensure that the recent rapid expansion of interest-bearing liabilities in £M3 does not become monetised by the Bank of England.

/ Gordon Pepper is also concerned about this./

This could be prevented by a suitable form of monetary control, but it needs to be put into place very soon.

AAW

10 February 1981

FILE

6

BUDGET SECRET

MHJ

cc Mr. Wolfson
Mr. Walters
D Wright

10 DOWNING STREET

From the Private Secretary

10 February 1981

Dear John,

As I told you, no decisions were taken at the Prime Minister's meeting with the Chancellor and others this morning. However, you may still like to have a copy of my note of the meeting. This is enclosed.

Yours ever,

Tim Lankester.

A. J. Wiggins, Esq.,
H.M. Treasury.

BUDGET SECRET

SUBJECT 5

SECRET

NOTE FOR THE RECORD

The Prime Minister held a meeting this morning with the Chancellor of the Exchequer, Sir Douglas Wass, Mr. Burns, Mr. Wolfson and Mr. Walters to discuss the Budget strategy.

The Chancellor said that his minute of 5 February had indicated a PSBR for 1981/82, on existing policies, in the region of £11 billion. It had suggested that the objective should be to secure a reduction of £1½ billion so as to bring the PSBR back to £9½ - 10 billion. The PSBR forecast had now been updated, and the estimate was now for a figure of £13 billion. On this basis, and assuming the right policy was to achieve a PSBR of £9½ - 10 billion, his budgetary task was going to be extremely difficult. He had ruled out raising income tax rates. Consequently, the only possibilities for raising tax were through holding back the increase in thresholds and through raising indirect taxes (though he had also ruled out raising VAT). He had hoped to raise thresholds by 10 per cent, but in view of the latest PSBR forecast, it looked as if only a 6 per cent increase would be possible. As regards indirect taxes, the Treasury were considering two main options: one would raise the RPI by 1¾ per cent, the other by 2 per cent. Again, in view of the PSBR forecast it might be necessary to go for the higher figure. Then there was the question of how much revenue should be switched to the corporate sector. He believed that an enterprise package amounting to about £250 million would be psychologically very valuable. As for a reduction in the National Insurance Surcharge, he was still undecided. The CBI were pressing strongly for this, and the first year cost of a 1 per cent reduction would be only about £300 million. On the other hand, the full year cost had to be considered, and also the fact that part of the benefit would go the banks and other service industries. In addition, industry might prefer a lower PSBR, and the improved prospect for interest rates which would follow.

/ In discussion

SECRET

SECRET

In discussion the following points were made:

(i) The Prime Minister said that the first priority must be to improve industrial activity; and in her view, this meant giving priority to a reduction in interest rates which would also have a salutary effect in getting down the exchange rate. If there were to be a choice between a reduction in the NIS and a lower PSBR, she would go for the latter.

(ii) The Prime Minister suggested that, if help was to be given to industry, a reduction in the heavy fuel oil duty should be considered. The Chancellor explained that he had considered this option, but a major drawback was the fact that - according to the Department of Energy - a good deal of the revenue would, because of the terms of the FRIGG contract, accrue to the Norwegians. He was exploring this further with Mr. Howell.

(iii) The Prime Minister suggested that, faced with the prospect of a 2 per cent addition to the RPI as a result of indirect tax increases, the Cabinet would prefer further public expenditure cuts. The Chancellor indicated that he did not believe that, at this stage, further cuts would be possible. It was going to be difficult enough to stay within the cash limits already agreed. At the same time, it was a regrettable fact that colleagues did not seem to fully understand the enormous burden of Government spending on pay. The central Government pay bill was forecast to increase by 10 per cent in 1981/82, and this was a major cause of the PSBR problem.

/ (iv)

SECRET

(iv) The Prime Minister asked about the proposal to speed up VAT payments on imports: she thought that the extra revenue from this would be very useful. The Chancellor said that a final decision on this still had to be taken. It would yield a sizeable benefit for the PSBR in year 1; on the other hand, it would impose an undesirable burden on the corporate sector at a time when the aim should be to ease industry's cash flow. He was likely to decide against.

(v) The Prime Minister suggested that a further increase in the National Insurance contribution of employees should be considered. The Chancellor said that this would require new legislation, but in any case he did not believe it was a runner coming on top of the one per cent increase already in train.

(vi) Mr. Burns said that it would be hard to defend a PSBR any higher than £10-10½ billion. This was the highest figure consistent with the PSBR projection in the MTFS after making allowance for the lower level of activity now forecast.

The meeting then turned to a discussion of monetary policy. The Chancellor said that, for the sake of the credibility of the strategy, M3 would have to continue to be the target variable for the medium term. But he would indicate in his Budget Speech that the authorities would be looking at other monetary aggregates as well in future. (Whatever the disadvantages of M3, he had concluded - following discussions his officials had had with outside experts - that it could not simply be abandoned.) He would also say that they would be moving as fast as they sensibly could in the direction of monetary base control.

/ The Prime Minister

SECRET

The Prime Minister urged the Chancellor to go further than this, and announce a concrete plan for moving to monetary base control.

Mr. Burns said that, even if there was greater focus in the coming year on the narrower aggregates, there was still a significant risk of conflict between the different policy objectives. If M3 and the narrower aggregates were to be contained within the MTFS target, there was a risk that interest rates would have to go up; and this would put upward pressure on the exchange rate. He was concerned that the authorities should maintain a tight grip on monetary policy: in the last six months there had been a significant relaxation, as evidenced by the acceleration of all the aggregates; there was a danger that, if this was not curbed, inflation would start to rise again. Mr. Walters suggested that, insofar as the growth of the monetary base had been very modest until recently, there might be a case for allowing it to grow rather more quickly in the year ahead.

Finally, there was a short discussion of the immediate prospect of an MLR cut. The Chancellor said that he had now concluded that an MLR reduction in the Budget itself would be untenable because of the relatively high PSBR forecast. If there was to be a cut, it would have to be either this Thursday or next. An early reduction could not be justified in terms of the money supply figures; it could only be on the basis of the lower rate of inflation (now expected to be just over 13 per cent for January), and the need to moderate the exchange rate. Mr. Burns added that a cut in MLR might help to reduce M3, but it would tend to push up the narrow aggregates. The Chancellor said that Treasury officials were doing further work on the possible justification of an MLR cut. The Prime Minister said that, if there were to be a cut before the Budget, in her view it would be better to do it this Thursday rather than next.

10 February 1981

SECRET

√MAP

QUEEN ANNE'S GATE LONDON SW1H 9AT

9 February 1981

Dear Geoffrey.

– will request if required

Thank you for your letter of 29 January about the 1980 fiscal concessions on donations to charities. Tim Raison and I have taken every opportunity when addressing voluntary organisations to draw attention to the concessions and emphasise that charities should work hard to obtain maximum benefit from these. Officials have done the same in their contacts with voluntary organisations. However, at the meeting on 29 January of Tim Raison's Ministerial Group, at which Peter Rees was present, it was agreed that at their next meeting consideration should be given to how the Government's policy towards the voluntary sector could be restated in as effective a manner as possible. In considering this issue, I am sure that Tim Raison's Group will have particular regard to your comments about the fiscal concessions.

I am sending copies of this letter to the Prime Minister, Michael Heseltine, Patrick Jenkin, Mark Carlisle, and to Sir Robert Armstrong.

Yours

Willie

The Rt. Hon. Sir Geoffrey Howe, QC., MP.

SECRET

cc Mr Walters
Mr Hoskyns
Mr Wolfson

Prime Minister

Mr Prior's call for, on his estimate, £1 billion of reflation in the Budget

Caxton House Tothill Street London SW1H 9NA

Telephone Direct Line 01-213 6400

Switchboard 01-213 3000

Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
Treasury
Great George Street
LONDON SW1

9 February 1981

Dear Geoffrey

THE 1981 BUDGET

I have just seen Keith Joseph's letter of 30 January to you. I was on the point of writing to you myself and I am glad to add my voice to Keith's, because I entirely share his convictions that we must now actively help industry to recover and create new jobs. I am convinced of that both for his reasons and because unemployment is developing into a problem of vital social and political importance to which we must show that we are responding.

I wonder whether colleagues have a clear picture of the scale of unemployment that promises to confront us over the next few years. It is increasingly clear that unemployment may reach 3 million or even more by the end of this year. The seasonally adjusted figure may run short of it, but there is a real danger that the total numbers will exceed that figure, perhaps quite substantially if we have setbacks, as could occur, for example, on exports. That is an overall rate of 1 in 8. The rates would be higher still for men, for young people and for racial minorities. In particular localities the position would be comparable with the 1930's or worse. The numbers remaining unemployed for 12 months or more could stand in 1982 at 6-700,000 - more even than in the 1930s.

There are reasons for thinking that unemployment on this scale will not substantially decline of its own accord, certainly not before the next Election. Even when the recovery in output comes the effect on unemployment will be delayed and probably subdued. Industry will not take back the same numbers having achieved de-manning, the numbers entering the labour force are growing and the labour effects of new technology will increasingly appear.

Sustained unemployment at these levels is quite likely to produce social problems on a scale we have not had to deal with in 40 years, particularly amongst the growing numbers of long term unemployed,

and racial problems we have not seriously had to deal with before. It is also of immense political significance. There are many signs that the issue has moved to the forefront of political debate. Public opinion polls show that, in a major shift of attitude, it has overtaken inflation as the main worry and the Press and other media coverage is responding. By so vocally and visibly condemning Labour's performance on this front, we have asked to be judged on it ourselves - and the judgement on the present outlook is unlikely to be favourable.

In drawing attention to this I am not challenging - any more than Keith - our basic economic strategy. I believe it is broadly right and, if held to, promises this nation a better prospect than it has had for a long time. I am absolutely convinced, however, that we have got to weave into it a coherent and positive strategy on unemployment - not leave this to seem to be the residual of other factors - and that we must use every possible room for manoeuvre both to promote industrial recovery and to combat unemployment.

In devising a convincing strategy it seems to me that we need to develop several strands:

(i) to assist industry to recover by lowering its costs and particularly by stimulating new and expanding businesses. I think there is a great deal in the ideas Keith has put forward and that their thrust is right in this respect. I also support his order of priority among them. We need something that is quick acting and, despite the arguments that can be brought against it, I agree with him that action on the NIS surcharge now has a very great deal to commend it, as indeed has some early action on energy prices. In particular I wish to support the loan guarantee scheme and tax relief on equity investment start ups. These measures can be represented as a Conservative approach to job creation, and have therefore a political as well as economic advantage.

(ii) to support industry expenditures on the supply side. Keith has rightly mentioned assisting R & D and I think we need to keep this objective in mind when we come to consider new proposals on training.

(iii) to promote some major capital works which could sensibly be undertaken to improve the industrial infra-structures and prepare for the upturn. We should have particular regard for areas of high unemployment like the West Midlands. Here again I agree with Keith that we should look at the nationalised industry investment programmes, but there may be other substantial capital schemes eg by local authorities, which would fall in this category and help output and employment in the engineering and construction industries. To overcome the public financing problem we really do need to find ways of getting private finance for schemes of this sort, through leasing for example.

(iv) to do more directly to help those hardest hit by unemployment. On this we shall soon have proposals from the CPRS study, but I think we should do more to extend the possibilities of early retirement. I really do wonder whether we should not begin to consider encouraging a more flexible

approach to retirement at an earlier age and start a programme for moving by stages towards it. But more immediately I think there is now a very strong case for extending JRS down to age 60 for men (an estimated extra cost of about £120m in the first year).

(v) to recognise the plight of the long term unemployed. This is an area where we are politically extremely vulnerable. We have gained considerable credit for what we have done for the young unemployed but there is growing concern at the plight of older people and the real hardship faced by those unable to find work for very long periods. We cannot readily expand our temporary work programmes for them this year, but I think there are two things we should do for them. One is to enable those aged 60 and over who have been unemployed more than 12 months to retire if they want to, under the JRS,extended as I propose. The numbers would be small and the cost not more than a few million, but it would be worth doing. Secondly, I think the time may come to make those unemployed more than 12 months eligible for the long term social security benefit rate. At present the long term unemployed qualify only for the ordinary SB rate, which means £34.60 a week for a married couple, as against the £43.45 which is paid to other long term recipients of SB. I am told that the cost might be around £100 million a year at the current level of long term unemployment, but Patrick Jenkin will best be able to say. It would be something even to extend it to those unemployed for more than two years.

How far we can go at this time in terms of resource is a difficult judgement, but on the information available to me I would have thought that the PSBR could be allowed to rise by, say, £1 billion above what it would otherwise be on present plans without departing from our financial strategy - though I recognise that this would mean a lower fall in interest rates than would otherwise be the case. If at the same time we made the switch of resource from the personal to the corporate sector that Keith is proposing by providing for something considerably less than a full indexation of personal tax allowances, this would allow a higher level of expenditure to provide us with a more positive strategy on industry and employment.

I hope that you will seriously consider these ideas along with Keith's in formulating the Budget and I look forward to discussing this with you at the meeting we are to have next week.

I am sending copies of this letter to the other recipients of Keith's letter.

bc Mr Walters
Mr Wolfson

jfh

SECRET

Econ 18

3

9 February 1981

Additional Revenue from the Banks

The Prime Minister has read the Chancellor's minute of 6 February, and has noted his view that there is now no alternative but to introduce a tax on the banks' windfall profits.

John Wiggins, Esq.,
HM Treasury.

SECRET

CONFIDENTIAL

SUBJECT.

Econ Pol

qc GB/E
Mr Walters
Top copy: Econ Pol, Lunch with Clearing Bankers Oct 79

10 DOWNING STREET

From the Private Secretary

6 February 1981

Dear John,

I am sorry that I have not written earlier about the Prime Minister's lunch with the Committee of London Clearing Bankers last Monday. - 2/2/81.

The discussion ranged widely over a number of topics, including the short-term prospects for industry, recent monetary developments, and monetary control. The Prime Minister expressed concern at the continued growth of lending to the personal sector, including lending based on credit cards. The bankers pointed out a good deal of the lending to the personal sector was in fact to small businesses, and that credit card lending represented only a small proportion of it; they also pointed out that, since November, the banks had stopped advertising credit cards. On the question of lending to the corporate sector, they denied the criticism that in too many cases overdraft facilities had been made available to enable companies to finance uneconomic pay settlements; they argued that the clearers had played a positive role in preventing the recession from causing even more bankruptcies than had taken place. On the other hand, to the extent that in some cases overdraft facilities might have been excessive, it was pointed out that the clearers faced strong competition amongst themselves and from the American banks: if increased credit facilities to a particular borrower were held back, all too often another bank would step in.

/ They also

CONFIDENTIAL

They also raised the question of a possible windfall tax on bank profits. Sir Jeremy Morse said that they were strongly opposed to such a tax. They had had discussions with the Chancellor the previous autumn with a view to helping the Government reduce the PSBR by other means - namely, that they should take back some of the export credit currently being refinanced by the Government. They had not put a figure on their proposal at that time, but they were now prepared to come back to the Chancellor with a specific proposition. In response to a question from the Prime Minister, he said that he thought they would be prepared to offer to take back £1 billion.

The Prime Minister gave no indication of how the Government would move on the windfall tax proposal. She expressed interest in the proposition put forward by Sir Jeremy on refinancing, but she made it clear that the Chancellor would have to consider it carefully before taking a view.

Sir Jeremy has now written to the Prime Minister with a copy to the Chancellor (his letter of 2 February), and I should be grateful for advice on how the Prime Minister might respond.

I am sending a copy of this letter to the office of the Governor of the Bank of England.

Tim Lankester.

A. J. Wiggins, Esq.,
H.M. Treasury.

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

PRIME MINISTER

ADDITIONAL REVENUE FROM THE BANKS

We spoke about the position on taxing the banks following your meeting with the clearers. Sir Jeremy Morse also sent me a copy of his letter to you of 2 February, in which he offered to take back £1 billion worth of fixed rate lending by the banks which is at present refinanced by the Government.

2. His proposal is not new; it was put forward by the clearing banks in November when I opened discussions with them and it has been floated in the exchanges on this subject which Nigel Lawson and I have had with them since.

3. The proposal would reduce the PSBR in 1982. And Jeremy Morse is right in saying that it would bring a greater immediate benefit to the PSBR than cost sharing or a levy. But this would be purely cosmetic and would certainly be seen as such. It is exactly the sort of device which Harold Lever used to invent for the last Government and which deceived no-one. It would not help bring down the rate of monetary growth and could even increase it. Moreover part of the PSBR reduction in 1981-82 would be achieved at the expense of increases in public expenditure in later years as future flows of receipts were transferred from the Government to the banks.

4. It is easy to see why the banks made the offer. The proposed transfer of fixed rate lending would be largely costless - even profitable for them. But equally, looked at from our point of

/view, it

view, it fails completely to meet my request for a real contribution to the Exchequer from the profits which they make as a result of their monopoly of current accounts when interest rates have been high.

5. We therefore proposed to the banks that they should contribute two-thirds of the subsidy element in the fixed rate lending on their books. This meant that they would have made a real contribution to reducing the PSBR. The banks were apprehensive about the continuing nature of such a contribution. So following the early discussions, I also explored an option under which the Government would no longer pay any subsidy on pre-1978 fixed rate business; this would have yielded about £150 million next year but would wither away over the next 3 or 4 years. This met the banks' fears that they should not be subject to a continuing arrangement.

The banks provide export credit at, say, 8%, and the Government provides a subsidy to them to bring their return up to market rates.

R.

6. I made it quite clear to the banks that the alternative to coming to some compromise agreement of this kind would be a tax on their current accounts. They responded, both orally and in writing to say that they would prefer a tax to any such arrangements. So they have put me in a position of having no alternative but to tax them because - seemingly on grounds of principle - they are unwilling to contemplate voluntary measures which would make a worthwhile contribution to reducing the PSBR.

7. Finally, Sir Jeremy's letter mentions the damaging effect he thinks a tax would have on pay negotiations. I have already taken him up on this point. His argument seems to be that public recognition that the banks have windfall profits will give banking unions a new trump card. Given the banks' record of excessively high settlements, this is a pretty astonishing claim. To suggest that the unions are unaware of the banks' present healthy profits and are not already well able to deploy these

/arguments

arguments in negotiation is very far-fetched. Indeed, if a special tax is imposed, the clearers can argue that they can only afford smaller pay increases.

(G.H.)

6 February 1981

cc Mr Walters
Mr Wolfson

Prime Minister
I believe this letter from Robin Ibbs sets out the case for a lower exchange rate pretty convincingly. You might like to talk to the Chancellor - at your next meeting with him - about the ideas in the last para for getting it down.

CABINET OFFICE
Central Policy Review Staff
70 Whitehall, London SW1A 2AS Telephone 01-233 7765

From: J. R. Ibbs

Qa 05244

Yes

6 February 1981

Dear Chancellor,

The 1981 Budget

I have seen Sir Keith Joseph's letter to you of 30 January. Of the various matters he raises the one on which I wish to comment is the exchange rate, referred to in his paragraph 12.

As you know, my view is that the strength of sterling is the most serious problem with which British industry is grappling at present. The recession is affecting many countries and low demand is affecting much of UK industry. But the exchange rate is a major additional difficulty which falls on a number of sectors which are of immediate importance in terms of economic activity and employment, and which are of longer term importance if the economy is to be strong when there is less support from oil. Reduction in the exchange rate is therefore of structural importance and would provide financial relief where it is most needed. The relief could also be on a greater scale than I believe you are likely to be able to provide through fiscal adjustments. Anything which could be done to bring about a reduction in the rate would be as beneficial, if not more so, than any other relaxation being contemplated in the Budget.

The appreciation of sterling has been of such a magnitude and has happened over so short a period (as well as being largely unpredicted) that for many companies even the maximum

The Rt Hon Sir Geoffrey Howe QC MP
HM TREASURY
S W 1

cost reductions conceivably open to them would only partially counteract it. Many have been hanging on to their export markets in the hope that the exchange rate will ease but margins are now so low (and in many cases negative) this cannot continue indefinitely. Unless the rate falls, a range of important trading activities will have to be closed down entirely or at best continue in an impoverished way that results in further diminishing competitive strength through inadequate investment and R and D.

Sir Keith Joseph suggests a depreciation of between 5 and 10 per cent. I believe the latter figure is needed. I understand that the Treasury model indicates that depreciation of 5 per cent would bring a rise in the annual value of exports of around £2 bn. with a large part of this going into profit margins. A 10 per cent depreciation would give roughly twice this. Such changes would significantly ease financial burdens where they currently press most harshly.

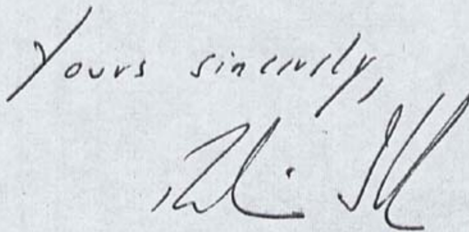
Nor is the effect confined to exports. For products made and sold in this country which are subject to international price levels the reduction in the exchange rate would bring a corresponding financial benefit. This has been well illustrated by the recent figures we have seen on British Steel. The overall benefit of a 10 per cent fall might therefore amount to several £ billions.

I appreciate that the loss of competitiveness has been in part the result of excess UK cost inflation and, moreover, that the appreciation of sterling has been a factor in bringing about the decline in the inflation rate. However, to put the suggested 5 to 10 per cent depreciation into perspective, a 5 per cent depreication would bring competitiveness back only to where it was in May 1980: a 10 per cent depreciation to the level at the beginning of 1980. Companies would still

need to make very challenging cost reductions through other means - their task would therefore have been made more feasible rather than easy. With a lower exchange rate higher import costs would have an adverse effect on the downward inflation path. But this is already well advanced compared to earlier expectations, and the penalty seems to be worth taking in relation to the great risk to important parts of the trading sector if nothing is done.

If these arguments are broadly acceptable the problem as always becomes one of finding a way to bring about the desired depreciation in a controlled manner. Reducing interest rates should help but I believe that a main task is to weaken the speculative factors which, because of so much talk of the effects of the petro-currency, have caused confidence to reach an exaggerated level. These factors would be weakened by declaring a particular exchange rate range as desirable within the broad framework of existing policies. Indeed, I understand that one specific proposal is that there might be a system of monetary targets which could be temporarily flexed to eliminate unacceptable exchange rate changes whilst still retaining confidence in the basic monetarist approach. In view of the immense importance of the problem and the need carefully to examine any potential solution, it seems to me that further exploration of this idea of 'conditional monetary targets' is worthwhile, perhaps in an interdepartmental discussion.

I am sending a copy of this letter to the Prime Minister, the Secretary of State for Industry, and to Sir Robert Armstrong.



J R Ibbs

2 1C

Original returned to Alan Walters

PRIME MINISTER

1. I agree with the broad assessment of the Chancellor. However, I would judge it wise to plan for a rather tougher figure of net reduction of £2 billion, mainly because this "tougher -than-expected" stance would further ease funding and interest rates and probably the exchange rate. The latter two effects would, of course, assist industry across the board but especially the export sector.

2. Of relief for business generally, beyond the capital tax measures, I am more keen than the Chancellor on reducing the NIS by a reduction of at least 0.5 per cent to 3.0 per cent (cost £0.6Bn). We could present it as an employment measure - a reduction in the tax on employment designed to provide more jobs. True it would not be weighted in favour of the export sector, but I would expect that the export sector suffering will best be relieved by exchange rate adjustments.

3. Generally I do not think the budget is appropriate for dealing with the distortions brought about by a high exchange rate. Tax rates will persist for the financial year - yet we may well see a dramatic change in the value of sterling (as we have seen before). And in any case such budget measures would be crude and inevitably discriminatory.

4. I am concerned about the monetary targets and, above all, the mechanism of money control. There is at present no effective control of the money supply and I am pursuing further discussions with the Chancellor, Middleton and others. I propose to report progress to you on Monday.

AW.

6 February 1981

SECRET

DOE COPY NO 1

2 MARSHAM STREET
LONDON SW1P 3EB

My ref:

Your ref:

5 February 1981

Dear Geoffrey

1981 BUDGET

As you are thinking about possible Budget measures to boost industry, I would like you to give serious consideration to what can be done to help the construction industries which, together with materials manufacture, form over one fifth of industrial production. Output in this sector is now some 10% lower than when we took office and new order figures suggest a further decline of similar magnitude in 1981.

Unemployment has risen to over 280,000 unskilled men and craftsmen. So far I understand that much of the residual manufacturing capacity has been retained; but once closed, this cannot easily be reinstated. Recent statements of business intentions concerning buildings investment suggest a halt to the steady decline since mid-1979 but this is as yet too short lived to be regarded as evidence of the beginnings of an upturn for construction.

The features of the industry which would make it an essential contributor to renewed growth in the economy are well known to you. Construction has a very small import content and labour represents the bulk of its value added. While the materials capacity remains, it can swing into action as quickly as the orders come forward. This would trigger off an upswing for other industries - construction plant heating ventilating equipment, carpet manufacture to name a few.

The most valuable fiscal stimulus which could be directed primarily to construction would be to extend 100% capital allowances to those businesses investing in industrial building, placing these allowances on a similar basis to that for plant and machinery. There would be a revenue cost of some £600 m spread over four years, though none of this would fall in the first year and in the long run there would be no loss of revenue. With my encouragement the industry is directing more attention to this particular market in the private sector; and a change in the tax arrangements now would strongly complement such efforts.

This would of course bring wider benefits to industry as a whole. Much of our efforts in Government to date have been directed to raising industrial performance. As you know, so much of our industry - even the innovative engineering sectors - is conducted in hopelessly antiquated premises which hamper efficient production and undermine the morale of management and workforce. As the

recent NEDO Study 'Construction for Industry Recovery' reported, investment in new premises has resulted in improvements and profitability for most firms on a scale which was unexpected. Efficient buildings can reduce the time and cost of production, improve delivery service, and reduce capital tied up in work in progress. A reduction in cost for a new facility of this kind would be of significant help to small and medium sized companies considering new investment.

I have thought about your suggestion that Development Land Tax should be exempted for a period. I strongly support this. It seems to me that there are powerful arguments for doing this for a short period in the first instance. Perhaps only for one year subject to review. I think we want the maximum galvanising effort.

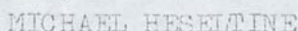
I would strongly support any change to reduce the costs of new house purchase and hence provide a stimulus to the housebuilding industry at a time when private sector output is some 30% lower than in the previous year. Given that the average price of a new house substantially exceeds the exemption limit of £20,000 there is a strong case for raising it to £25,000 or even £30,000. You might also consider the proposal for a reform of the structure of the tax so that only the top slice exceeding the limit attracts the tax rather than the whole house price.

I should also like to emphasis the concern that I expressed when I wrote to you in August about the different treatment for VAT purposes of new build and repair and maintenance. The existing rules are so blurred round the edges that they have produced endless anomalies in tax treatment and have encouraged evasion. The construction industry has expressed justifiable disquiet at the resulting growth of the black economy. It seems to me that we could argue that, in the context of EEC obligations, zero rating of repair and maintenance would not be a significant extension of the existing situation. It would also give a welcome boost to our policies of encouraging responsible home ownership and promoting the rehabilitation of older housing. Moreover this kind of building work is labour intensive and would provide welcome relief for the unemployed. If you are unable to agree to zero rating repairs generally, I hope you will consider making this relaxation for repairs to historic buildings. It would remove a major disincentive to conservation work.

I hope you will be able to accommodate some or all of these changes. I should be happy to discuss further with you.

I am copying this to the Prime Minister, and to those to whom Keith Joseph's letter of 30 January 1981 was copied.

Yours ever



-5 FEB 1981

MICHAEL HESELTINE

Rt Hon Sir Geoffrey Howe MP

SECRET

DOE COPY NO 1

1B1

2 MARSHAM STREET
LONDON SW1P 3EB

My ref:

Your ref:

5 February 1981

1981 BUDGET

I was interested to see Sir Keith Joseph's letter of 30 January. I agree very strongly with him that helping industry, even at the expense of the domestic taxpayer, must be our main priority. (I am writing to you separately today with some ideas of my own).

For me, the top priority remains the early introduction of a 'stimulus to enterprise' package, on the lines of which FASE has been working. I think your forthcoming budget is the last occasion on which something can be introduced which will make a significant contribution in this Parliament. We must be prepared to take risks here.

I hope also that you will be able to look sympathetically at Keith's suggestions for some more discretionary expenditure. Even if, as we all hope, output has reached the bottom, a quick recovery in investment will not happen without some stimulus. The proposal to cancel the deferment of RDG looks attractive as a means of helping relieve the financial pressures on the big investors.

I have thought deeply about his main suggestion that the NIS surcharge should be cut. A selective cut would be attractive - particularly if it could include the construction industry, which is also suffering badly from the heavy cut-backs to investment. But if that is not possible, my own feeling is that it would be better not to give this across-the-board relief. Similar, probably rather greater problems would apply to industrial derating. I have already mentioned to you my concern about the adequacy of building society funds to support the revival of private housebuilding, particularly as your proposals to finance more of the PSBR from domestic savings and less from the long-term capital markets could make their task harder. But I feel that both Keith and I should be wary of making proposals that relieve the current costs of industry or construction. They must make it harder for you to reduce your need to borrow and put off the time when interest rates (and the exchange rate) can fall and so help the revival of private investment, whether in industry or in housebuilding.

I would also like to offer strong support for Keith's suggestion on capital allowances for small industrial workshops. An extension of the arrangements to enable the tax advantages to

flow through to a large number of individual investors has considerable merit. If we are to get these developments off the ground successfully then we must be seeking to tap all sections of the market, not simply the Pension Funds, who initially are inclined to adopt a more cautious line.

I am copying this to the Prime Minister and to those to whom Keith Joseph's letter of 30 January was copied.

Yours ever

MICHAEL HESELTINE

-5 FEB 1981

Rt Hon Sir Geoffrey Howe MP

CH/EX. REF. NO. B(81)2
COPY NO. 1 OF 22 COPIES

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

PRIME MINISTER

THE BUDGET

I thought it would be helpful to let you have a brief account of my preliminary thoughts on how I see the Budget shaping up. I have still a good way to go before I come to my decisions, but the key problems and choices are becoming clearer.

Present problems

2. One of the most difficult tasks I face is to re-establish credibility in our monetary and public expenditure objectives. This overshadows all other considerations. As you know, the PSBR this year seems likely to come out at between £12½ and £14 billion, compared with the £8½ billion forecast in last year's Budget: and between February 1980 and January 1981 the adjusted growth of £M3 at an annual rate is likely to be just under 19 per cent, compared with a target of 9 per cent ± 2 per cent. At the same time, the public expenditure plans we shall be publishing on Budget Day are substantially higher than those we committed ourselves to last year. My Budget must be seen to be relevant to these unfavourable and unfortunate developments.

3. I believe that I can only re-establish confidence by bringing in a rather tough Budget even though there are some grounds for thinking that our policies are working well. The inflation outlook for instance continues to be encouraging, and strong pressures remain on industry to keep its costs down. We must not however relax in our fight against inflation and this means persevering with a tight fiscal and monetary policy.

4. The present forecast (which assumes indexation of the personal tax allowances and of the specific duties, and takes account of the new system of stock relief and the measures announced last November - the 1 per cent increase in employees' national insurance contribution and the new tax on North Sea income, each producing £1 billion in 1981-2) gives a PSBR next year in the region of £11 billion (nearly 4½ per cent of GDP). This compares with the implied medium term strategy figure of around £7½ billion (some 3 per cent of GDP). Taking into account the extent of the recession, the external pressure exercised by the exchange rate and the need to re-establish confidence, I judge that we should aim for a PSBR somewhat below £10 billion. This would be in the range commentators in the City and elsewhere now seem to expect. But it means looking for a net reduction in the Budget of perhaps £1 - 1½ billion compared with the outlook on present policy.

5. I should stress that the PSBR forecast could, of course, change further and the figures quoted above are necessarily subject to this.

6. To secure a reduction of £1½ billion in the PSBR I should ideally like to have a further reduction in public expenditure. I am continuing to think about the scope for this, but I am not hopeful of being able to formulate any proposals that would be acceptable to the Cabinet, given the long struggle we had last autumn to get to where we are now.

7. This means that I shall probably have to look principally to increased taxation. In addressing myself to the question where I should find the sums I need I must bear in mind an important change in the distribution of income which took place in 1980. The combination of a high exchange rate and a sharp fall in domestic demand has reduced the real income of the company sector and increased that of persons. For example, personal disposable income last year increased by over 17 per cent in money terms, whereas that of non-oil companies fell by more than

20 per cent. With the exchange rate as likely as not to remain at a high level, there is therefore a very strong case for making no net increase in the fiscal burden borne by business. Indeed there is a powerful case to be made for actually reducing the tax burden on businesses, even though this would effectively mean a pro tanto increase in personal taxation.

8. Before addressing myself to the question of what extra taxation I can impose on the personal sector, I have to bear in mind the effects of the increase in employees' national insurance contributions (NIC) which will operate from the beginning of April. This will be a most useful addition to revenue next year; but, equally, it is bound to limit my freedom of manoeuvre to increase the 'real' burden of income tax as well.

Income tax and the specific duties

9. We have ruled out an increase in the basic rate of income tax. Some abatement of the full indexation of the personal allowances seems unavoidable however. Full indexation would be just over 15 per cent (the increase in prices during 1980). The very minimum we can do, I think, is 6½ per cent, which would be sufficient to preserve "clear water" between the tax threshold and the widows' pension. This would save about £1.1 billion off the forecast PSBR. I should like, however, to do more than this if at all possible, and I am at present thinking in terms of a threshold increase of 9 or 10 per cent - which would reduce the PSBR saving to about £0.6 billion. As it is, the NIC change from April means that most people will lose more in extra contributions than they gain from any degree of revalorisation of personal allowances that I could contemplate this year. We need to keep this loss as low as we sensibly can even though in some ways it is the inevitable consequence of the excessive growth of personal sector incomes over the past year.

10. So far as the specific duties are concerned the present forecast already allows for full revalorisation which has an initial RPI impact (already allowed for in the forecasts) of about

1 per cent. Depending on how it is possible to weight the package - bearing in mind in particular the adverse effect on the cash flow of businesses arising from increases in the fuel duties - I would not want to rule out 1¾ times or even perhaps 2 times revalorisation, which would have a further RPI impact of around ¾-1 per cent and would reduce the 1981-82 PSBR by £0.75 -1 billion.

Relief for companies

11. Increases in personal taxation (direct and indirect) of this scale - with a combined PSBR reduction of about £1½ billion - would not offer any significant scope for a reduction in company taxation consistently with the objective of reducing the PSBR by £1 billion or more. I am anxious to include some further enterprise measures and to reduce the capital taxes on the lines of the minute I sent you recently. Beyond that I do not think I can provide more than about £½ billion at the most for the coming year, even if I shade down the size of the PSBR reduction I am aiming at. For planning purposes I am assuming that most of the extra revenue will have to come mainly from the personal sector, along the lines already described.

12. There is a difficult judgement also on how most effectively to give the relief to companies that we can afford. The choice of instruments is restricted, and each has its disadvantages. There is universal pressure for a reduction in the NIS. Further relief (i.e. over and above the measures on stock relief and capital taxation) of about £¼ billion for companies would just about allow a 1 per cent reduction from October (or a smaller reduction combined with other measures); a larger package of about £½ billion would permit a reduction of 2 per cent from October (or, again, a smaller NIS reduction plus other measures).

13. I am not myself greatly attracted to reducing the NIS. Although the costs this year would be modest, the full year cost is much greater (a 1 per cent reduction would add some

G. H.

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Effects – stance

1b.   2b.   2£b.

↓ Interest rates.

PSBR. – Int.   Exchange Rate   Level of Activity   Money

£0.7 billion and a 2 per cent reduction nearly £1½ billion to the PSBR in 1982-83); and the relief would be indiscriminate, with a risk that some of it might go quickly into wages. However, some reduction would undoubtedly be popular with industry, which attaches greater importance to help with costs than with profits; and it would be well received by the CBI in particular.

14. Of the other possible reliefs I have been concentrating on corporation tax and heavy fuel oil duty. Both have disadvantages. A corporation tax reduction would only benefit the one-third of companies currently paying any corporation tax. As for the heavy fuel oil duty, the terms of the British Gas Corporation's contract for buying gas from the Norwegian sector of the Frigg field are such that the price they pay rises automatically in the event of any reduction in the level of our duty. As a result the PSBR cost, and the resource loss to the UK, far outweigh the reduction in duty, and any conceivable benefit for industry. Despite its obvious attractions from some points of view, I have reluctantly concluded that we must rule it out as an option this year.

Monetary targets

15. I am still thinking about the form in which I should present my target for the monetary aggregates next year. The course charted by the MTFS would imply a £M3 target of 8 per cent. But I may want to consider targeting on other variables, at any rate for the determination of short term interest rates. I shall minute you separately about this, in the light of the discussions I am currently engaged in on monetary control.

(G.H.)
5 February 1981

E.R.

5 February 1981

Policy Unit

Chron
+ - Memo to Niehans

PRIME MINISTER

You will not have time to do more than glance at the massive Niehans report* before you see him (hopefully on Friday, 13 February - he is staying over the weekend in London).

I attach, therefore, the summaries of each of the three parts of his paper, retyped for easier reading.

*A full copy of Niehans report will go into the week-end box.

JOHN HOSKYNS

Summary of Part I

The conclusions of part I about the causes of sterling appreciation can be briefly summarized as follows:

(1) North Sea oil was probably not a major factor. To the extent it contributed to the appreciation of sterling, this was not so much through its effect on trade and capital flows than through its effect on the demand for money.

(2) The principal cause of recent sterling appreciation was the abrupt halt in monetary expansion in the spring of 1979.

(3) The effect of monetary contraction on the sterling rate was magnified by exchange-rate overshooting, which must be regarded as a normal concomitant of shifts in monetary policy.

Summary of Part II

Overall, part II led to the following conclusions about the effects of sterling appreciation:

(1) The price effects of overshooting, being only temporary, are rather an undesirable disturbance than a valuable contribution to long-run anti-inflationary policy.

(2) Overshooting, taken by itself, may have a serious, though temporary, effect on output and employment while its effects on trade are generally less clear. If overshooting is the concomitant of domestic monetary restraint, it may be conjectured that it magnifies the real effects of monetary policy.

(3) To the extent this is possible in a simple single-equation approach, empirical estimates for the United Kingdom tend to confirm a considerable influence of real exchange rates on output and also on trade.

Summary of Part III

The appreciation of sterling during the last two years is largely a monetary phenomenon. While monetary aspects of North Sea oil may have contributed, its main cause was progressive monetary restraint, culminating in a complete stop in the growth of the base money supply in the late summer of 1979. A pronounced overvaluation of the currency is a normal concomitant of such a policy.

Monetary restraint is absolutely necessary for the elimination of inflation. Some temporary recession in output and employment is the unavoidable price that has to be paid. However, if the restraint is applied abruptly and the rigidity of wages and prices is high, the recession may be intolerably severe. It is further aggravated by the overshooting of exchange rates. The empirical evidence suggests that this additional effect can be very strong.

In the present situation of the UK economy, monetary policy faces the task of effecting a transition from abrupt restraint to a sustainable path of gradual disinflation combined with a resumption of growth. The strategy proposed in this study can be briefly summarized in the following points:

(1) Money supply targets should be expressed in terms of the monetary base instead of £M_3; as the main policy instrument, the minimum lending rate should be replaced by the supply of base money.

(2) During the first half of 1981, the monetary base should be raised to the level it would have had if it had been permitted to grow at an annual rate of 5-6 per cent since the middle of 1979; from then on, the target range should be slowly lowered to a non-inflationary trend.

(3) If the normalization of the base money supply is not enough to restore competitiveness, the overshooting of the sterling

/rate

rate should be reduced to tolerable proportions (though not necessarily eliminated) by a temporary exchange-rate target to be implemented by foreign-exchange purchases, even at the cost of temporary deviations of the monetary base from its target.

The principles of British monetary policy during the last two years were sound. The resolution with which they were applied is admirable. The people understand that the price of noninflationary growth is a temporary recession and they are willing to pay the price. The early decline in inflation has justified and even exceeded their expectation.

The implementation of those principles, however, is in urgent need of improvement. If the present rigidity of monetary policy is maintained, there is a serious danger that the principles themselves may be irreparably compromised. The consequence would be a tragic relapse into inflation. The sacrifices would have been in vain.

Such improvements are proposed in this study. They grew out of the experience of central bankers and the progress of economics during a period of rapid evolution in the field of monetary policy. The proposed measures do not guarantee success; decision-making is inherently risky and there will be doubts, warnings and controversies. I believe, however, that in the present situation the risk of doing nothing would be much greater. I am also confident that the proposed measures could put the British economy on a sustainable path of declining domestic inflation and expanding output within three months. I am convinced finally that these measures, if properly explained, will command wide support.

Original returned to D. Wolfson.

10 DOWNING STREET

Feb.4, 1981.

Prime Minister.

My annual budget submission on why you should not ameliorate Capital Taxation when times are tough for the worse-off in our Society, and especially for the unemployed.

Chancellor proposes between 150 and 250 Million Pounds of Relief. Compare our approach on saving a few Million on Maternity Benefit, and other similar issues.

In detail I find the argument (Para 3) that savings in Tax Avoidance should go back to those who pay Capital Taxes totally unconvincing

Chancellor recognises the problem of Presentation in Para 7. He believes, as with the Tax Avoidance tradeoff, that he can solve it by vague reference to the Enterprise Package. Again, I find this hope quite unconvincing.

Is this the right way to approach the Budget? Like Lambeth Council, deciding what to spend first, and then looking for resources. Should we not look at revenue available first, before getting mentally committed to expenditure/revenue reductions?

David W.

MT.

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NOTE OF A MEETING HELD IN THE CHANCELLOR OF THE EXCHEQUER'S ROOM, ON TUESDAY, 3 FEBRUARY, 1981 AT 3.00 P.M.

Present:

Chancellor of the Exchequer
Chief Secretary
Financial Secretary
Mr. Burns
Sir Kenneth Couzens
Mr. Ryrie
Mr. Middleton
Mr. Britton
Mr. Monck
Mr. Unwin
Mrs. Lomax
Mr. Turnbull
Mr. Ridley

Mr. Walters - No.10

MONETARY TARGET AND MONETARY CONTROL

Consumer credit control

The Financial Secretary said that although there had been a case for some tightening of consumer credit controls, the time for this was now past. Nor would such controls fit well as part of a new system of monetary control, although the possible need for them at some future date could not be excluded. It was generally agreed that the contingency work already done was satisfactory, and that there was no need for any further work. It was noted that it would be necessary to revise the Bank's "directional guidance" to the banking system, but this was a secondary and minor issue.

Minimum Lending Rate

2. Mr. Ryrie said that he was perhaps more favourably inclined to an early move on MLR than others in the office. It seemed likely that the market had already discounted a 1 per cent fall and that the reception of a change would be favourable. 12 February

was probably the last date on which a change could be made before the Budget. In further discussion it was noted that the most convenient justification for a reduction in MLR would be the slow growth of M1 - but at the same time there would be risks in following this approach before any decisions had been taken about future arrangements for monetary targets and monetary controls. An immediate change in MLR would re-emphasise its character as an administered rate, and would not be consistent with letting the markets have a bigger say in the determination of interest rates. Meanwhile it could well be that expectations of a change in MLR were doing more to secure gilt sales and to edge down the dollar exchange rate than would be achieved by the change itself. It was agreed that the discussion should be resumed later in the week, in the light of further information about the January money figures.

Monetary control

3. Mr. Middleton said that a new question had arisen about future arrangements for monetary control, which ought in principle to be considered before any decisions were taken on future monetary targets. Since 24 November work had been proceeding on the assumption that the system of monetary control would evolve gradually in a manner consistent with an eventual move to Monetary Base Control (MBC), but without the authorities being committed to such a movement. The Bank had now produced proposals involving the abolition of the reserve assets ratio (RAR) and of lending through the discount market window. (No progress had yet been made on the suppression of the clearers' cash ratio and the future arrangements for assuring the Bank's income.) The Bank proposed in future to rely on open market operations in commercial bills, and had proposed some underpinning of the Discount Market as a means of ensuring that the functioning of the commercial bill market could be relied on. There was a close relationship between these arrangements and the arrangements for future prudential supervision of the banking system; it was important that supervision should be consistent with the requirements of monetary control. All these developments were consistent with the Chancellor's statement of 24 November and - leaving aside the cash ratio - would not require further consultation

with the banking system. However, Mr. Walters had now suggested instead a direct move to MBC during the course of 1981.

4. Mr. Walters said the Prime Minister had asked him to establish what administrative steps would be required before a quick move to MBC. He thought such a move should be possible within 9 months, given goodwill on all sides (although he expected the Bank vigorously to oppose such a move). In the absence of statistics for M2, he accepted that MBC would have to be on a non-mandatory basis; and he also agreed that a quick move to MBC would mean a different decision on the future of call money with the discount market. He envisaged that the decision to move directly to MBC might be announced in the Budget speech, with a view to completing the arrangements by the end of 1981. He noted that the Treasury were working urgently on a paper which was intended to clarify the necessary steps on the way to an early move to MBC and the difference between such an approach and the approach previously announced by the Chancellor.

5. In further discussion, it was noted that, if the approach recommended by the Bank were to be adopted, the next step would be to widen the band within which interest rates would be left to find their own level. The authorities would then be able to learn something about the banking system's demand for cash in the situation of much greater uncertainty which would thereby be created. If it were decided to shore up the Discount Market to play a key role in the financial markets under such a regime, it would be reasonable to give the resulting arrangements a run of, say, one to two years before taking decisions whether or not to make further moves to MBC; the Bank would probably be content to maintain the "interim" arrangements indefinitely.

6. It was noted that the issue of a possible quick move to MBC would have to be resolved without delay. The alternative approach foreshadowed in the Chancellor's 24 November statement would lead to changes which would desirable in their own right, whether or not there were an eventual move to MBC; an immediate move to MBC

would be a "leap in the dark". If, nonetheless, it were decided to follow this course, it was important that markets should be given sufficient time to adapt to the new situation this would create - in particular, people would have to come to terms with the disappearance of the overdraft system. The Chancellor asked that a Treasury paper on the steps required for a quick move to MBC should be circulated without delay, so as to make possible resumption of the discussion on 5 February in advance of his meeting with the Governor on 6 February.

Monetary targets

7. Mr. Ryrie suggested that there were two main questions to be considered:-

(i) should M1 be established as a supplementary or as an alternative target to £M3?

(ii) Should next year's monetary target(s) be in some way conditional on moves in the exchange rate?

The Chancellor questioned the Bank's view that the appreciation in the exchange rate had contributed to the monetary over-run; how was this consistent with the general approach which sought to minimise intervention in the foreign exchange markets because official purchases of foreign current tended to put upward pressure on the monetary aggregates? Mr. Britton said there were differences of emphasis between the analytical approaches followed by the Treasury and Bank; the Bank looked mainly at financial flows, and expected 1981 to show a pattern similar to 1980. Thus they feared a continuing monetary over-run, associated with continuing upward pressure on the exchange rate which would still further damage the trading sector of the economy. The Treasury, by contrast saw financial flows as generated by stock adjustments, although there was bound to be a substantial margin of uncertainty about measures of the stock of money in relation to GDP.

8. The Chancellor questioned how a monetary target conditional on the exchange rate would work in practice; if the exchange rate strayed outside the acceptable band, presumably it would be necessary both to adjust interest rates and to intervene in the foreign exchange markets to bring the exchange rate back within the band - but, once there, the monetary target would reassert itself, thus leading to increases in interest rates which would once again push the exchange rate outside the band. It was generally agreed that the concept of conditionality did not really enable a satisfactory reconcilation to be made between monetary targets and exchange rate objectives; when it came to the point, a monetary target conditional on the exchange rate was very little ~~difficult~~ different from an exchange rate target. An exchange rate target could be presented as an expression of the Government's commitment to an inflation objective, so short-circuiting the possible need for a monetary target as a key element in the Government's counter-inflation policy; but the Bank's approach in practice emphasised an output rather than an inflation objective.

9. In further discussion of the merits of different monetary aggregates, the following points were made:-

(i) although M1 only responded to changes in interest rates with a lag, the reponse was much quicker than that of £M3, and M1 could much more easily be hit within any given year, provided the authorities were not too worried about the mortgage rate. Mr. Walters was inclined to accept that M1 was after all more important than sterling M3, despite the experience of the early 1970s after Competition and Credit Control, which seemed to have suggested the opposite conclusion.

(ii) The Financial Secretary, however, feared that M1 had been discredited by past misuse; he was inclined to prefer M_0 - although others saw serious disadvantages with this alternative.

(iii) The Treasury were preparing a note on the possibility of a weighted average monetary measure on the lines of the German "central bank money"; it was noted, however, that the weights were inevitably arbitary, and that such a measure might be thought to be a "fiddle".

(iv) The authorities should not be too pessimistic about the possibility of controlling £M3; attention had hitherto been focused on short-term interest rates and the PSBR as the only available instruments, whereas there was now a prospect of achieving adjustments in long-term interest rates which would be a substantial help. Mr. Walters thought the Government had been too much preoccupied with movements of £M3 on a month to month basis - there was no point in trying to hit a monthly £M3 target.

(v) In view of the theoretical advantages which M2 appeared to have, it would be undesirable to change the target variable now, since it would then become much more difficult to make a further change when M2 statistics became available.

(vi) The role of the monetary target in the determination of interest rates had to be determined; some assessment would be needed of the operation of monetary base control in relation to the narrow aggregates.

10. The Chancellor, concluding the discussion, said he thought £M3 would have to remain the principle target and that it should not be subordinated in any way to the exchange rate. However, it would be reasonable to give further consideration to the arguments which could be offered against seeking to claw back the monetary over-run; the most promising seemed to be the structural shift in the demand for money, a large part of which could be

attributed to the financial imbalances within the economy (which the exchange rate appreciation had further intensified).

JW

(A.J. WIGGINS)
4 February 1981

Distribution
Those present
Sir Douglas Wass

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

PRIME MINISTER

TAXATION OF FRINGE BENEFITS

You will wish to know what I propose to do in this year's Budget about company cars and other fringe benefits.

2. First, company cars. They continue to be provided on an increasing scale, and the latest figures suggest that they are now available for some 65 per cent of higher paid employees and directors. As I pointed out last year (my minute of 12 March) the scales by which the benefit is measured for tax purposes are barely one-third of the estimated cost to a private individual of running his own car. But, as we agreed last year, there can be no significant change until we are able to make a further reduction in the income tax burden. I therefore propose, as last year, to make a 20 per cent increase in the scales, which will at least ensure that the scales are not reduced in real terms. Motoring costs have risen by broadly this amount over the last year. The change which I announced in last year's Budget comes into effect from 6 April of this year; and the 20 per cent increase which I shall be announcing in this year's Budget will take effect from April 1982. For a middle manager with a car in the 1300cc to 1800cc range, typically a Ford Cortina, this will mean only 35p a week in extra tax, assuming that he pays at the basic rate. As last year, the change would be made by Order rather than in the Finance Bill.

3. There is one other change which I propose for the users of company cars. Last year I made a change in the rules governing the benefit of company cars which have little or no business use. I proposed that, with effect from 6 April this year, cars

whose business use was less than 1,000 miles a year should be subjected to a higher level of tax (1½ x the scale figure). The 1,000 miles was generally regarded by commentators as on the low side, since it would mean that the higher charge could be avoided simply by a single business trip, say, from London to Aberdeen and back. I therefore propose to raise the mileage from 1,000 to 2,500 with effect from this April.

4. I also propose to correct an anomaly, whereby the value of season tickets provided by employers, and of goods and services purchased with company credit cards, is taxable as a benefit in the hands of higher paid employees and directors, but not of lower paid employees. There is clearly a strong case for taxing these, like other vouchers provided by the employer which are really the equivalent of cash, in the hands of all employees. The provision of season tickets, in particular, is a growing abuse, and bringing them into tax might meet some of the complaints from commuters who pay for their own travel costs and get no tax relief for it.

5. There is one measure of relief which I propose in relation to benefits in kind. The provision of medical insurance by employers for their employees was made taxable in 1975 for all employees and re-enacted in 1976. We promised in our manifesto to restore tax relief for employer/employee medical insurance. I propose therefore to relieve lower paid employees of tax on this benefit, so leaving it taxable only in the hands of the higher paid and directors, as it was before the previous Government extended it.

6. Finally, I do not propose to abolish the threshold which distinguishes higher paid and lower paid employees for this purpose. You may recall that this was the subject of a consultative document last year, and from the response of that document it is clear that abolition of the threshold would be

generally unwelcome. When we are able to reduce income tax further, it may be appropriate to review the matter again. So the threshold will remain at its present level of £8,500. Another suggestion made in that consultative document was that the method of taxing fringe benefits should be changed so that instead of being taken into account in the PAYE code employers should include the value of them in taxable pay. This would result in a staff saving to the Revenue of some 200. I propose to make this change, in relation to company cars whose benefit is readily quantifiable, with effect from April 1982.

7. I shall be informing Patrick Jenkin of my proposals on medical insurance, and Keith Joseph and Norman Fowler of my proposals on company cars and season tickets.

(G.H.)

3 February 1981

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THE COMMITTEE OF LONDON CLEARING BANKERS

10, Lombard Street, London, EC3V 9AP

TELEPHONE: 01-623 5511

2nd February, 1981

Dear Prime Minister,

We greatly enjoyed having you to lunch today, and hope that you found it worth while.

I enclose the paper we had prepared on the question of taxing bank profits. It sets out the main reasons why we think that a special tax would be both wrong and untimely. Under the latter head I would add the damaging effect that the announcement of a tax could have on our pay negotiations, as we discussed at the table. In view of the stress you laid on credit card lending, I also enclose the figures on this. You will see that the interest-bearing part of this lending increased by 24% over the past 12 months, but is still only 11% of personal, and 3% of total sterling lending.

As I have already written to the Chancellor, we recognise the problem faced by the Government in reducing the PSBR, and we would certainly like to help with it, in a way that does not impair our basic strength to the disadvantage of our customers and our shareholders. It is in this spirit that we have suggested that we might take back a substantial part of the export credit, say, £1 billion, which is at present refinanced by the Government. This would produce a considerably greater immediate benefit to the PSBR than the other proposals made to us, and although there would be a corresponding loss of benefit in later years the discounted cash-flow advantage of such an accelerated repayment would be considerable.

I am copying this letter to the Chancellor and to the Governor.

Yrs sincerely,

Jeremy Morse

The Rt.Hon.Margaret Thatcher, M.P.,
Prime Minister,
10 Downing Street,
London, SW1

SECRET

LONDON CLEARING BANKS' GROUPS

CREDIT CARD DEBT

£ millions

	31.12.79	31.12.80	Change	
1. Credit Card Debt outstanding:				
(a) Total	892	1,120	+ 228	(+ 26%)
(b) Interest-Bearing	652	810	+ 158	(+ 24%)
2. Total Sterling Advances to U.K. Residents	25,491	31,080	+5,589	(+ 22%)
3. Total Sterling Advances to Personal Sector	6,214	7,594	+1,380	(+ 22%)
4. 1(b) as % of 2	3%	3%		
1(b) as % of 3	10%	11%		

C.L.C.B. Statistical Unit
2.2.81

THE ARGUMENTS AGAINST A SPECIAL TAX ON BANK PROFITS

1. First, it may help to consider the background against which calls have been made to subject the banks to some form of excess profits tax. There is no denying that the profits of the clearing banks have increased considerably in recent years to amounts which are not only large in absolute terms but also represent a high return on capital, by comparison both with the banks' own record and with the current achievements of other industries.

2. Moreover, a substantial element of these profits represents the margin earned on the banks' current account balances at a time of high interest rates. This 'endowment' or 'windfall' element results from economic circumstances and government policy rather than from the banks' own endeavours.

3. The counter-arguments considered in this note have been divided into three groups. First are those based directly on the banks' financial record. Second are those which relate to the nature of the banks' business. And third are those concerned with the practical implications of seeking to impose an excess profits tax.

THE FINANCIAL RECORD

4. The banks' main argument against an excess profits tax is that, allowing for inflation and cyclicality, their profits do not represent an excessive return on capital employed. This, they believe, is demonstrated by the two accompanying charts, which show how the profits of the 'big four' London clearing bank groups have developed since 1973, both before and after allowing for inflation, and which measure the rate of return that the banks have earned each year. As 1973 marked the previous peak in bank profitability, the charts cover a full profits cycle.

The Effects of Inflation

5. It can be seen from the first chart that historic cost profits in 1979 were $2\frac{1}{2}$ times higher than in 1973. However, it is now fully accepted that historic cost accounts give a misleading impression of the profitability of banks, as of other industries. For prudential reasons banks necessarily hold more monetary assets than monetary liabilities: that is to say, part of their capital has to be held in the form of monetary items. Measures of real profitability must therefore allow for the fact that inflation depletes the real value of these net monetary assets. This allowance is achieved by the monetary working capital adjustment made under current cost accounting.

6. As the chart shows, even current cost profits in 1979 were 83 per cent higher than in 1973. But this does not mean that profits rose by 83% in real terms. As is now widely recognised, current cost accounting does not provide an indication of the effect of general price inflation on a business as a whole. Rather, the banks' current cost profits may be regarded as a measure - in money terms, not real terms - of the surplus available for distribution as dividends or for use in expanding the business. The chart shows that the real value, or purchasing power, of that surplus in 1979 was only three-quarters of what it had been six years previously.

Cyclicality

7. To subject the banks to an excess profits tax on the basis of their recent profits alone would be rather like taxing a West End store solely on the basis of its Christmas sales period. Bank profits are inherently cyclical and, as the first chart shows, in real terms they declined to virtually nothing in 1975 - just two years after reaching their previous peak. The main explanation is of course the cyclical movement of interest rates themselves: when rates are high bank profits are high, and vice versa.

8. The endowment effect, however, is by no means the only consequence of high interest rates for bank profits, and some of the other results are far from beneficial. For instance, the banks' gilt-edged investments tend to fall in value, the profits of their finance house and leasing subsidiaries decline and the cost of holding interest-free balances at the Bank of England rises, to the competitive advantage of those banks which suffer no such requirement.

9. Perhaps more importantly, the harmful effect of high interest rates on the banks' business customers increases the incidence of bad debts. However, as these bad debts often do not show through until subsequent years, they can have the effect of exacerbating the profits cycle, rather than dampening it. And, of course, the inflationary processes which give rise to high interest rates also cause increases in the banks' operating costs which must continue to be borne when rates are low.

10. The effects of inflation and the cyclical nature of bank profits should each become even more evident when the banks' results for 1980 are published during the course of the coming weeks. Stockbrokers' estimates are almost unanimous in expecting profits to fall even in historic cost terms, let alone after allowing for inflation.

Return on Capital

11. Even after full allowance has been made for inflation and cyclicality, it might still be argued that bank profits were excessive. This is not an issue which can be resolved by looking at the figures on their own: after all, the banks' profits are large mainly because the banks are large businesses. What is more, over recent years an increasingly large

proportion of those profits has been earned in areas which are not greatly influenced by domestic interest rates - notably international and overseas banking, and domestic lending financed by interest-earning deposits. It is therefore important that the banks' profits be judged in relation to the capital employed in earning them.

12. The banks' profits could fairly be judged excessive if - in real terms and over time - they represented a rate of return on capital that was well in excess of that of industry at large. Chart 2 suggests that this is not the case. Although changes in accounting conventions prevent accurate comparisons from year to year, two conclusions are inescapable.

13. First, the rate of return that the banks earned in 1979 was lower, both before and after tax, than in the previous peak year of 1973. And secondly, between these two peak years the rate of return fell to very much lower levels. What is more, as the banks showed in their evidence to the Wilson Committee the rates of return they were earning in the mid-1970s were consistently well below those being earned by leading companies in other sectors of the economy. The comparative figures are reproduced as Table 1: it should be noted that no adjustment has been made for inflation. There is no evidence that the banks' average rate of return over the full profits cycle has been excessive by the standards of industry at large.

14. Even in the peak year of 1979, the banks' current cost rate of return was starting to decline, and 1980 results are almost bound to show a further fall. The banks naturally hope that their real profitability will not decline as steeply this time as it did in the mid-1970s. But for cyclical reasons alone, a further fall is probable, and the average return over the present profits cycle - as over previous ones - is likely to prove very much lower than in the peak years alone.

15. In conclusion, the clearing banks' financial record and prospects do not lend support to the belief that the banks' profits represent an excessive rate of return on capital once allowance is made for inflation and cyclical effects.

THE BUSINESS OF THE BANKS

16. The banks recognise that some of the arguments for an excess profits tax relate less to their financial record as such than to the nature of the business that they do. In particular, it is argued that the banks' profits are a fortuitous, or 'non-functional', by-product of government policy, and that the banking industry is uncompetitive.

Current Accounts and Money Transmission

17. The point has already been made that the banks have diversified heavily in recent years into international and other areas of activity. As a result, only a portion of the banks' total profits arise from the so-called 'endowment' effect. It is usually a minor portion and is sometimes negative. Not only are the majority of the banks' deposits interest-earning but current account balances themselves are very far from being cost-free.

18. The Price Commission reckoned that in 1977 the unrecovered costs of the banks' money transmission services were equivalent to an interest rate of 6.8 per cent on their current accounts. By the end of 1977, and in the early months of 1978, market rates of interest were actually lower than this, and the banks were accordingly paying more for their current account balances than they could earn on them in the market place. In other words the current account/money transmission part of their business was a drag on the profitability of the business as a whole. Despite increases in bank charges since then, the banks' unrecovered money transmission costs have continued to grow faster than their current account balances, and are now probably equivalent to an interest rate on these balances of about 9 per cent.

19. At the time of writing, Minimum Lending Rate and three-month interbank rate are each 14 per cent. Thus market rates have only to fall by about five percentage points for the banks' current account/money transmission business to become unprofitable again.

20. The banks would like to insulate their position more from the effects of short-term movements in interest rates, so as to avoid the risks of political attack when rates are high and of losses when they are low. But this would require them to pay explicit interest on current accounts, which would create tax problems for their customers, and to increase their charges for money transmission services to a level which more fully recovered the costs of providing them. This would meet strong customer resistance and could generate fresh political attacks.

Competition

21. To justify an excess profits tax, it should be shown not only that the banks are making excess profits but that market imperfections such as state monopoly powers, or licensing and franchising systems prevent these profits from being competed away. No such constraints operate in the banking market.

22. The clearing banks may be thought to constitute an oligopoly, but this does not prevent them from competing aggresively with one another in both price and service. Equally important, there is no sector of the banking market in which they do not face fierce competition from other institutions: for example, the National Girobank in money transmission, the TSBs in personal banking generally, the building societies in personal savings and mortgage lending, the merchant banks in corporate finance and over 250 foreign banks in corporate lending in both sterling

and foreign currencies. As a result, competition ensures that profits overall are kept within reasonable bounds - as the banks believe they have demonstrated by the analysis of their financial record.

The Banks and Industry

23. Nowhere is competition felt more keenly than in the area of industrial lending. Many of the banks' loans are at margins over the cost of funds which barely cover the inherent risks of the business. During the present recession in particular, the banks have provided extensive support to industry over and above that which their normal commercial instincts alone would have dictated. In the case of small and medium-sized businesses, this has been very largely at the initiative of the individual banks. In the case of certain major companies in financial difficulties, the banks have taken part in syndicated support operations arranged by the Bank of England. Throughout, the banks have observed the lending guidelines imposed by the authorities. In particular, they have greatly scaled down the promotion of their personal credit facilities, despite the provocation of major marketing and advertising campaigns by some of their competitors.

Capital Adequacy

24. There is no doubt that an excess profits tax would seriously impair the banks' ability to carry on supporting industry throughout the current recession. Perhaps the main reason is that it would make it much harder for the banks' capital to grow in line with the scale and riskiness of their lending business. As the Wilson Committee observed:

> "Banks have found it difficult in recent years to generate post-tax profits from which to set aside sufficient reserves to maintain historic capital ratios. The ratio of free capital to deposits over the period would, indeed, have fallen appreciably were it not for the banks' extensive recourse to the equity market."

Indeed, the banks' capital ratios deteriorated even in 1979, and are likely to decline further in the absence of substantial capital-raising exercises. The retained profits which have been added to the banks' capital base in recent years will, on past precedent, be needed to protect the banks against the threats to their profits which lie ahead.

25. The banks' need for capital to protect depositors against the risk of loss is crucial in view of the importance of maintaining confidence in the banking system. Confidence is essential on the part not only of domestic depositors but also of the international financial community if the banks are to continue to make their important contribution to the balance of payments. The Bank of England's responsibilities for ensuring that banks are adequately capitalised have now been given statutory backing by the Banking Act, and its paper entitled The Measurement of Capital indicates the nature of the requirements now being imposed.

26. If post-tax profits are inadequate to maintain capital ratios at the appropriate levels, then further capital issues will be necessary, thus raising the cost of equity finance for industrial and commercial companies. Two further points should be noted. First, the dividend increases of recent years were largely a catching-up process after long periods of control, when dividends failed to keep pace with inflation. And secondly, much of the absolute increase in the banks' profits in recent years has been the result of acquisitions which have required their own appropriate level of capital backing.

FURTHER IMPLICATIONS OF A TAX

27. The banks have sought to show that the case for an excess profits tax has not been made. There remain some further counter-arguments which relate to the practical problems of introducing a tax, and the adverse consequences of doing so.

Defining 'Excess' Profits

28. It might be thought that the volume of excess profits could be calculated easily by applying a market rate of interest to the banks' current account balances. But for reasons which have already been mentioned, this would be inequitable. In particular, the effective cost of the banks' current account balances is about 9 per cent, not zero, while much of the endowment element has already been offset in other areas of the banks' business, notably industrial lending. The problems of arriving at an equitable statutory definition of excess profits would be immense.

The Institutions Affected

29. A closely related problem is that of defining the range of institutions to which an excess profits tax should apply. It is not only the clearing banks which benefit from interest-free funds. Most other banks have some current account funds, and in some cases - notably the Giro, the TSBs and the Bank of England - the amounts involved are considerable. A tax measure limited to the clearing banks, even if legally feasible, would be grossly discriminatory.

The Case for Subsidies

30. If Government feels it should subject the banks to an excess profits tax at times of high interest rates, the banks would argue that at the very least they should be allowed to establish tax losses at times of low interest rates.

Retrospection and Discrimination

31. The banks' profits have already passed their cyclical peak. Indeed one bank - Midland - actually reported a post-tax loss in current cost terms for the first half of 1980. Any attempt to introduce an excess profits tax would inevitably be seen as a means of clawing back some of the allegedly excessive profits of previous years. In spirit if not in letter, it would be an exercise in retrospective legislation, and objectionable for that reason.

32. It would also set a highly undesirable political precedent for selecting a particular sector of the economy for special taxation solely on the basis of short-term profitability and fiscal expediency.

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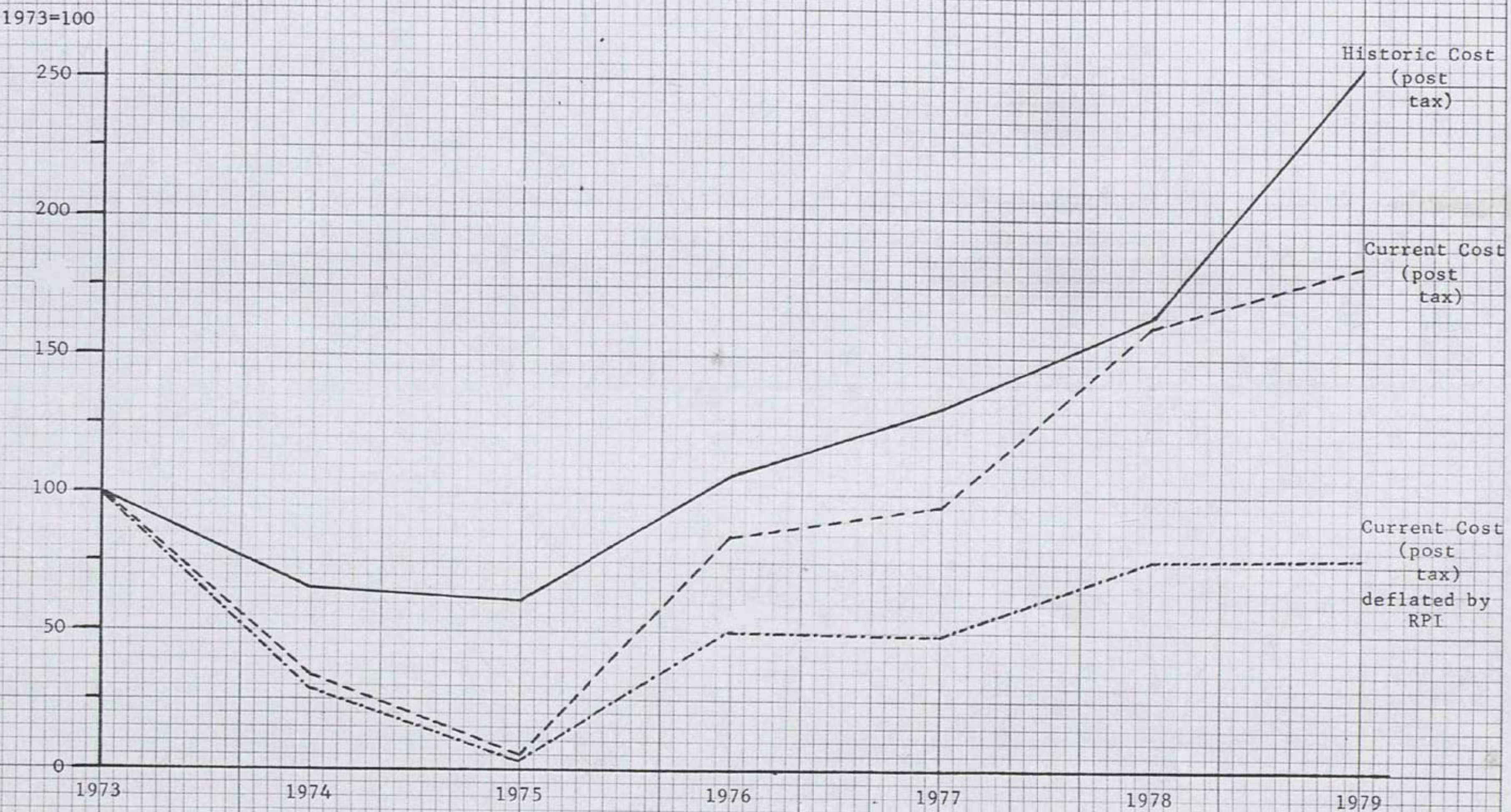
CHART I: THREE MEASURES OF BANK PROFITS
1973=100
250
200
150
100
50
0
1973
1974
1975
1976
1977
1978
1979
Historic Cost (post tax)
Current Cost (post tax)
Current Cost (post tax) deflated by RPI

CHART 2 : THE BANKS' RATE OF RETURN

Current Cost Profits as a Percentage of Capital Employed

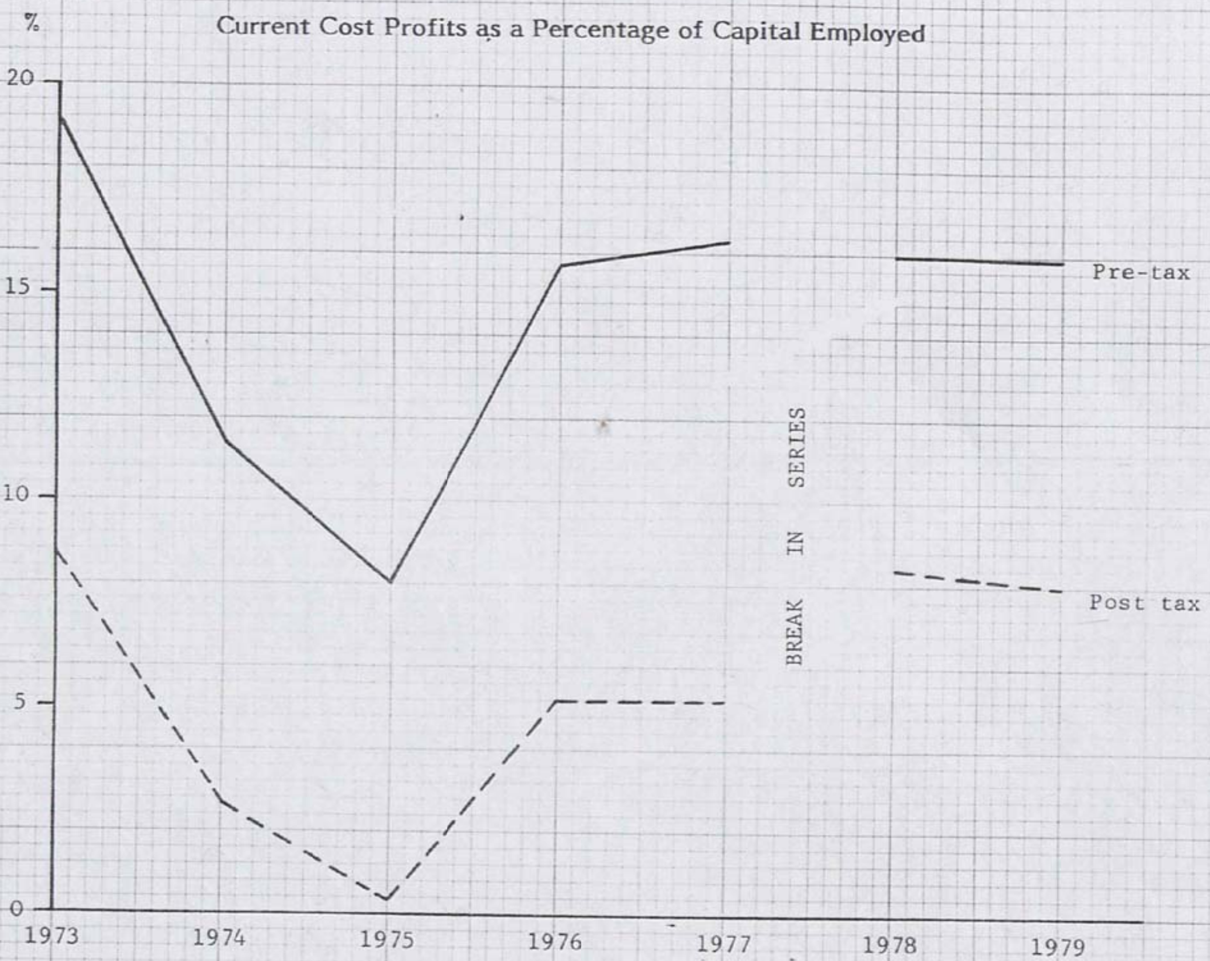

TABLE I : EXTRACT FROM LONDON CLEARING BANKS' EVIDENCE TO WILSON COMMITTEE

Profitability of other industries

Sample of four leading companies in each sector

Percentages		1969	1970	1971	1972	1973	1974	1975	1976
Profit before taxation									
Percentage of end-year shareholders' funds plus minority interests									
Average for sector sample	Breweries	16.7	19.3	23.5	26.1	21.5	17.1	18.6	21.4
	Building materials	14.1	15.6	27.6	28.9	32.7	17.0	24.2	25.7
	Chemicals	18.6	15.3	14.3	17.0	24.4	33.3	20.2	27.3
	Electricals	16.8	22.7	24.9	30.8	35.5	36.7	35.6	39.6
	Engineering	12.0	12.2	14.0	16.1	21.4	24.6	20.2	25.5
	Food manufacturing	18.5	18.2	21.2	26.2	26.4	27.7	28.1	33.5
	Other industrials	28.9	27.7	30.0	34.8	33.1	38.7	36.8	35.3
	Stores	35.5	36.1	40.2	40.9	38.4	31.0	31.5	35.3
	London clearing banks	17.2	15.6	18.2	21.1	24.1	17.2	14.9	21.3
Profit attributable to shareholders									
Percentage of end-year shareholders' funds									
Average for sector sample	Breweries	9.3	10.5	13.7	15.2	11.5	8.5	9.4	10.2
	Building materials	7.4	8.1	16.7	18.6	18.9	9.4	11.9	13.3
	Chemicals	11.1	8.9	8.6	10.1	13.4	16.8	10.5	13.9
	Electricals	10.4	13.0	14.9	18.7	20.8	18.0	17.6	19.3
	Engineering	6.0	6.6	7.9	9.6	11.1	12.4	10.1	13.7
	Food manufacturing	10.1	10.7	12.7	15.9	14.7	13.5	13.6	16.5
	Other industrials	15.8	15.0	17.0	19.9	18.7	20.4	18.9	17.8
	Stores	18.3	20.3	24.1	24.0	18.3	14.7	14.8	16.1
	London clearing banks	9.2	8.8	10.8	15.3	13.8	8.0	6.7	9.7

Companies sampled:		
	Breweries	Allied Breweries, Bass Charrington, Greenall Whitley, Arthur Guinness.
	Building materials	Associated Portland Cement Manufacturers, London Brick, Marley, Tarmac.
	Chemicals	Croda International, Fisons, Imperial Chemical Industries, Laporte Industries.
	Electricals	BICC, General Electric, Racal Electronics, Thorn Electrical Industries.
	Engineering	Babcock & Wilcox, Guest Keen & Nettlefolds, Hawker Siddeley, Tube Investments.
	Food manufacturing	Associated British Foods, Cadbury Schweppes, Ranks Hovis McDougall, United Biscuits.
	Other industrials	Beecham, Bowater, Metal Box, Reckitt & Colman.
	Stores	Boots, House of Fraser, Marks & Spencer, Mothercare.
	London clearing banks	Barclays Bank, Lloyds Bank, Midland Bank, National Westminster Bank.

THE ARGUMENTS AGAINST A SPECIAL TAX ON BANK PROFITS

Summary

* Allowing for inflation and cyclicality, the banks' profits do not represent an excessive return on capital. (Para 4)

* The banks' profits have not been enough to maintain their capital ratios - which is essential if confidence is to be maintained and the banks are to cope with future threats to their profitability. (Paras 24-26)

* The banks' profits must be judged in relation to the capital employed, taking account of their diversification into international and other areas of business. (Para 11)

* The banks earned a lower return on capital in 1979 than in 1973, and between those peak years the return fell to below those earned in other industries. The rate is now falling again. (Paras 13-15)

* The profits cycle is largely explained by the interest rate cycle, with bad debts and other costs continuing to be felt after rates have fallen. (Paras 7-9)

* Profits for 1980 are likely to show a decline even before allowing for inflation. (Para 10)

* Current cost profits have risen by very much less than historic cost profits since 1973, and the real value of the banks' distributable surplus has actually declined. (Paras 5-6)

* The banks' current accounts are far from being cost-free. Unrecovered money transmission costs mean that this part of the banks' business was loss-making for a time in 1977/78, and it would be loss-making again if interest rates fell to single figures. (Paras 17-20)

* The banks face fierce competition from one another, and from other institutions. (Paras 21-22)

* During the present recession the banks have provided exceptional support to industry and have forgone profitable opportunities in the personal lending market. (Para 23)

* The problems of arriving at an equitable definition of excess profits would be immense. (Para 28)

* To tax the clearing banks alone would ignore the interest-free funds enjoyed by other institutions. (Para 29)

* If banks are to be taxed when interest rates are high, they should at least be allowed to establish tax losses when they are low. (Para 30)

* Profits are already off their peak: indeed one bank made a current cost post-tax loss in the first half of 1980. So any tax would be retrospective, in spirit if not in letter, and would set an undesirable political precedent. (Paras 31-32)

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ENGINEERING INDUSTRIES ASSOCIATION

R

REPRESENTATIONS
TO THE
CHANCELLOR OF THE EXCHEQUER

BUDGET 1981

FEBRUARY 1981

ENGINEERING INDUSTRIES ASSOCIATION

REPRESENTATIONS TO THE CHANCELLOR OF THE EXCHEQUER.

BUDGET 1981

1. INTRODUCTION

1.1 The EIA view the present worsening economic situation with the greatest concern; it appears to be an accepted (if not acceptable!) likelihood that the number of unemployed could soon reach the three million mark, and we are warned that things could get worse before they get better.

1.2 At the end of 1980 the Association's membership stood at 4,365 engineering companies employing in excess of 300,000 workforce, having lost 154 companies (employing 16,000) during the year. Most of the membership, about 80%, consists of small and medium sized companies, of which Government in its election manifesto, and since, has endorsed and restated principal statements made by the Rt Hon Harold Lever in January 1978, excerpts of which include:

(a) 'Small firms have always been vital to our economy, but never more so than now and the years ahead......'

(b) 'Small firms mean jobs. A million small firms employ a quarter of our whole work force.......'

(c) 'We need a vigorous and confident small business sector....'

1.3 Mr J E Bolton, our President Elect, in his report of the Committee of Inquiry on Small Firms in November 1971 distinguished a number of important economic functions performed by small firms, which 'comprise their special contribution to the health of the economy' which still hold good today, for example:

- 'Many small firms act as specialist suppliers to large companies of parts, sub-assemblies or components, produced at lower cost than the large companies could achieve.'
- 'The small firm sector is the traditional breeding ground for new industries......'
- 'Perhaps most important, small firms provide the means of entry into business for new entrepreneurial talent and the seedbed from which new large companies will grow to challenge and stimulate the established leaders of industry.'

Since then, studies from the USA have highlighted the unique importance of small firms in creating new jobs (the MIT Study, by John Elliott covering 1969-1976) and in their striking leverage in the effective use of scarce innovative resources (US Science Foundation covering 1963-1973).

1.4 The EIA has carefully studied the Chancellor's statement on economic policy made to the House of Commons on 24 November 1980 and, whilst noting that the main fiscal decisions for 1981-82 must await the next budget, have the following comments to make.

1.5 Other countries, in particular Japan, Germany, France and the United States have built into their economies an adequate ploughback of profits for investment in new, competitive plant and machinery. It is essential that similar investment is stimulated in British industry, particularly in the manufacturing industry; indeed, the Bolton Report reminded Parliament that if the small firm is to be preserved, institutional finance can never take the place of capital from personal wealth and ploughed back profits. Government has a golden opportunity to finance a once-for-all 'catch up' on capital investment in industry by diverting part of North Sea oil benefits from financing the present unacceptably-high level of unemployment into urgent assistance with industrial development. The Chancellor expects to raise an extra £1 billion revenue in 1981-82, mainly from a proposed supplementary tax on income from UK oil and gas production from 1 January 1981. The highest claim for priority in benefit from this 'windfall' is revitalisation of British manufacturing competitiveness, and by reducing unemployment we believe the investment would soon become self financing in revenue terms.

1.6 The EIA fully appreciate that external factors help to push up the exchange rate, but believe that its present high rate mitigates against overseas demand for British goods, whilst actively helping overseas competitors to sell their products more cheaply here. Two immediate steps could be taken by Government to reduce the value of sterling:

(i) To bring down the Minimum Lending Rate again as quickly as possible. Whilst being a welcome move in the right direction, the reduction of 2% from 16% to 14% on 24th November 1980 is not enough. Consideration should be given to abolishing MLR altogether, leaving interest rates to float on a free market or if that is too risky the possibility of a differentially lower interest rate on small firms borrowing.

(ii) To curtail the present inflow of 'hot money' from overseas, possibly by taxing the interest on this at an especially high rate.

Paradoxically current high interest rates have undoubtedly focused attention upon - and thereby helped to improve - cash flow management in British industry, but there is a limit to this process.

2. PERSONAL TAXATION

2.1 The erosion of differentials in earnings between skilled and unskilled labour has clearly resulted in a shortage of skilled labour throughout the country. Whilst this is not so keenly felt at the present level of unemployment, the impact will come as a shock when the economy takes an upturn; the EIA believe that the average age of skilled operators in the engineering industry is 50-plus. The announcement by the Secretary of State for Employment on 21 November 1980 that the Youth Opportunities Programme will be expanded as part of an increase in providing for special employment measures is of course welcome. However, this will not take the place of providing skilled replacements for those who have retired (or emigrated to a country where skill is recognised and adequately rewarded) or will do so in the foreseeable future. The bad effect is particularly noticeable in the differentials situation for middle management. What is needed is an incentive, through the personal taxation structure, to acquire skills in industries such as engineering, which might take the form of generous tax relief for young people undergoing craft apprenticeships.

2.2 The EIA has repeatedly urged that married women should be treated as 'femmes soles' for tax purposes, with allowances being on the same basis, except that where a married woman so elects,her income and allowances should be combined with that of her hushand. In this respect EIA warmly welcomes the publication of the Green Paper 'The Taxation of Husband and Wife'. One immediate reaction is that the proposals could be detrimental to the husband and wife where both are working, as is the case in many small businesses, and it is hoped that equity prevails over administrative convenience when the possible courses are weighed.

2.3 Government has shown welcome initiative in its moves towards other reforms in the tax system, as evidenced by the Consultative Document on 'Stock Relief'; and the promise of a Green Paper on 'Reform of the Corporation Tax system.' The EIA strongly urge Government to accelerate the promised change in emphasis from direct to indirect taxation, albeit in the form of a consultative document published at the same time as, and accompanied by a statement in, the forthcoming budget speech.

2.4 The system of National Insurance contributions where a person has more than one employer, or where he not only has an employer but is also self-employed in another capacity, needs to be simplified and made more equitable. Also, the present National Insurance contributions account for a total rate of 20.45% over the range of earnings, as follows:

		%
Class 1 Employee		6.75
Employer		10.2
"	Surcharge	3.5
		20.45%

Government now propose to add a further 1% to the employee's share bringing this to 7.75% and the total to 21.45%, in order to:

* keep the fund in balance while meeting larger benefit demands (¼%)
* maintain the planned level of health services (¼%)
* throw more burden on those in work towards the whole cost of non-contributory benefits (½%).

2.5 We have already touched on the erosion of the skilled operator's take-home pay. This further turn of the screw adds to the inequitable burden thrust upon the dwindling number of those in employment, struggling to compete with foreign competition (often subsidised) whilst themselves being called upon to subsidise the ever-growing army of the unemployed. Here, too, part of the windfall revenues from oil and gas could be diverted.

2.6 If Government seriously intends the small firm to survive this inequitable burden mentioned above, urgent steps MUST be taken to reduce the burden of high energy and fuel costs on manufacturing industry, forcing up the costs of overheads in this country whilst manufacturers abroad enjoy the advantage of heavy Government subsidies.

2.7 Furthermore, British industry is far too heavily burdened with the direct and indirect costs of bureaucracy, including to no small extent inflation-proof pensions. EIA realise the difficulty Government would face attempting to abolish inflation-proof pensions altogether, but some form of sanity could be restored by:

(i) reducing the limit on inflation to a pre-determined rate, and

(ii) introducing an upper ceiling on pensions.

2.8 Following on from the last paragraph, EIA is also most seriously concerned about Government's apparent inability to curb some Local Authorities increasing rates. Government cut the Rate Support Grants, but many Local Authorities merely make cuts where they most affect the public, whilst the top-heavy bureaucracy (where the greatest cuts could be made) are not reduced at all.

2.9 Following the Barber Green Paper in 1974, it is suggested that the new PAYE computer at Cumbernauld could also deal with social security payments as tax credits, thus reducing the manpower required overall and helping the Government towards its goal of cutting expenditure in the public sector. To this end the EIA express keen disappointment that the private sector, particularly the small companies, and the skilled worker continue to be squeezed, against all Government forecasts and promises, whilst public spending continues virtually unabated.

2.10 Investment income surcharge is a disincentive to investment, and should be abolished. The Bolton Report in 1971 recommended as part of the conditions to be met if the small firm is to flourish without subsidy, 'the elimination, so far as possible, of the disincentives of the fiscal system'. Ten years is a long time to wait for effective action.

2.11 Schedule D and Schedule E expense rules, currently defined in sections 130 and 189 of the Taxes Act 1970 respectively, should be standardised.

2.12 Relief for interest payments relating to main or only residences (S72 Finance Act 1972) is still based on a maximum capital loan of £25,000. This figure is long overdue for revision and the EIA urge that it be increased to £50,000 in the next budget, with indexation thereafter.

2.13 The rules regarding retirement annuity relief for the self-employed should be brought into line with those for controlling directors of companies. The carry-forward provisions removed by Section 32 of the Finance Act 1980 should be reinstated.

3. CORPORATION TAX

3.1 The Inland Revenue have accepted the concept of taxing real profits through the introduction of stock relief and the EIA looks forward to the publication of a Green Paper reviewing the system of corporation tax, which will, hopefully, lead to the taxing of accounts on a current cost rather than an historic cost basis. There are two facets of major interest to EIA members:

(a) Stock Relief: the consultative document published on 14 November 1980 is a step in the right direction and has much to commend it, particularly the initiative taken in proposing significant changes in stock relief and the removal of the clawback provisions except for cessation or near cessation of business. However, the EIA express concern that:

(i) a single index is proposed. The whole purpose of the cost of sales adjustment (and related balance sheet stock adjustment) is to allow for the impact of price changes when determining the charge against revenue for stock consumed in the period. Table 2 in the CSO 'Price Index Numbers for Current Cost Accounting' published by HMSO gives price indices for stocks held by specific industries, and it is quite possible for one index to go down whilst another increases steeply. A single index could result in over-generosity to one taxpayer whilst penalising another.

(ii) The proposed 'de minimis' provision under which the first £2000 of stocks held by a business does not qualify for relief (the 'credit restriction') could affect many small businesses which, due to pressing cash flow problems have destocked for one reason or another (not least of all to pay their tax commitments) and could find themselves unfairly deprived of a measure of tax relief.

(b) In view of the 'wide-ranging' Green Paper to be published in due course on the reform of corporation tax, it is most unlikely that the next budget will incorporate any measures towards introducing accelerated depreciation allowances in lieu of the present 100% capital allowances. In any event, such a change would no doubt have severe adverse cash flow effects, particularly for small businesses and in the initial years of changeover.

As an immediate measure the EIA urge most strongly that Government reintroduce Investment Grants in place of capital allowances as a much-needed stimulus to plant investment.

(c) The special reliefs given to small companies in the Finance Act 1980 are welcomed, and the EIA commend the prompt action to be taken in the next Finance Act to remedy the main defect in the small workshops allowances (vendor getting too much and the purchaser too little tax relief following the sale of a small workshop for which 100% allowance has been given) as announced in an Inland Revenue Press Release dated 17 December 1980.

3.2 Industrial Buildings Allowances should be extended to include all forms of commercial and industrial buildings, as is the case in the USA.

3.3 With regard to Investment Grants, EIA accepts Sir Keith Joseph's view, following a meeting with a delegation from the EIA, that 'making these grants available outside the Special Development and Development Areas would remove the regional incentive and effectively destroy the whole basis of regional policy'. However, many of the boundaries are vague and lead to absurdities in practice; the Midlands conurbation is one particular example. The EIA believe that the whole question of Investment Grants could and should be reviewed by Government without the necessity to 'effectively destroy the whole basis of regional policy', even if this results in some form of 'weighting' heavily in favour of the Special Development areas.

3.4 The EIA believe that there should be some form of incentive through capital allowances to buy cars and other vehicles which are of British manufacture, or utilising a substantial part of British components, as a measure of support to British industry and employment.

3.5 Section 95/4 of the Finance Act 1972 which deals with relief for companies with small profits to be divided between associated companies should be amended to:

(a) exclude non-resident associated companies, and

(b) permit the group or other associated persons to determine how the relief is to be apportioned between associated companies.

3.6 The marginal rate relief band for companies with small profits is too wide, and should be narrowed. The present rates are:

	Profit	Corporation Tax	Rate
	£70,000	£28,000	40%
	130,000	67,600	52%
Marginal Band	£60,000	£39,600	66%

4. CAPITAL GAINS TAX

The Chancellor called this tax, 'a capricious and sometimes savage levy on capital itself' in his 1980 budget speech. The EIA wholeheartedly support his statement that 'the objection to capital gains tax in its present form is that most of the yield comes from paper gains arising from inflation', and urge that this tax be abolished on long-term gains by tapering the rates according to the length of time the asset has been held, along the lines of the old estate duty legislation where gifts made inter vivos within seven years of death (the old 'covenant period') became liable to estate duty but taper relief was given where more than four years had elapsed between date of gift and death. The EIA believe that rules on broadly similar lines should apply to capital gains, so that these become free of tax if held for more than a determined period after tapered rates. There should be a higher rate on short term speculative gains made within two years, possibly by bringing such gains back into taxable income.

5. CAPITAL TRANSFER TAX

5.1 The small gifts exemption should be raised to at least £500 from the present limit of £250.

5.2 Exempt gifts to charities, raised from £100,000 to £200,000 limit in the Finance Act 1980, should be taken out of the scope of this tax entirely.

5.3 Marriage gifts exemption limits, at present £5000, £2500 and £1000 under the Finance Act 1975 according to relationship between donor and donee, should be doubled.

5.4 Family transfers of business, for example from father to son, should be totally exempt from this tax if held by the transferee for at least five years after the transfer. This exemption should not extend to non-domiciled trusts.

6. VALUE ADDED TAX

6.1 The lower limit for compulsory registration should be raised to £50,000, since the costs of VAT records are disproportionate for most businesses below that size. This should take a large number of small undertakings out of charge, with a consequent reduction in civil servants required to administer the system. It is also recommended that VAT between registered traders should not be charged, thus effecting a further massive reduction in administration.

6.2 Codification of the VAT rules is now overdue.

7. STAMP DUTY

7.1 This is now an old fashioned and unnecessary tax which must cost more to administer than it produces, and its abolishment is recommended. If it is felt that this cannot be done, it is most strongly recommended that the lower limit on the purchase of private dwelling houses be raised immediately to £50,000 to help first time buyers in particular.

TLF/JB/28181/RES/jv.

SECRET

Secretary of State for Industry

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30 January 1981

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The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
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Prime Minister
Sir Keith's budget representations - see final page for summary.

Dear Chancellor

THE 1981 BUDGET

Your Budget will be a critical one for industry, and particularly for the tradeables sector. I think it will also be important for the future relationship between ourselves as a Government and industry. Until recently I have found considerable support in industry for our policies and a willingness to accept sacrifices. But there is now a growing mood of resentment that other sectors have not suffered proportionately; and growing criticism that, while our policies are reducing inflation, they are not yet providing a basis for the restoration of industrial growth and profitability.

2 You are of course familiar with the events underlying this change of attitude, and with the forecasts for the period ahead. 1980 was a very difficult year for industry, coming on top of the problems of 1979. Labour costs rose rapidly for much of the year. The exchange rate rose sharply. Output fell, particularly in manufacturing. Profitability at home was further squeezed, and our international competitiveness suffered a further deterioration.

3 The fall in output was due to a large extent to de-stocking, which should broadly come to an end this year. But great uncertainty surrounds the future trend of exports, investment, and consumer expenditure. On balance, it seems unlikely that output will rise significantly in the course of 1981 and it could well decline further. Meanwhile, the squeeze on company profitability and liquidity is expected to continue.

The Danger to Industry

4 In my letter to you of 23 December, I described the risks as I saw them then. Continued low output, combined with low profitability and cumulative financial deficits, may increasingly during 1981 lead companies to cut potentially viable capacity.

/Companies ...

SECRET

Companies will initially try to avoid closures by cutting back on discretionary expenditure - investment, R&D, product development, marketing, "seed-corn" expenditure generally. The Department's investment intentions survey, for example, is indicating a fall in 1981 for manufacturing industry of between 11 and 16%, even after taking account of the effect of leasing. We should not over-emphasise the seriousness of this - what really matters is that existing and new investment should be used efficiently and profitably - but the trend is worrying for the future ability of companies to take advantage of the improvement in demand when it comes. Our overseas rivals, less constrained than we are by low profitability and liquidity, will be in a better position to maintain their expenditure.

5 Companies which are forced to close plants are in most cases unlikely to be able to re-open them as soon as the upturn comes. Productive capacity will have been lost for a significant period, and in many cases permanently. My concern is that from now on an increasing proportion of closures are likely to be of <u>good</u> capacity; industrial "muscle" as I have previously called it.

<u>The Objective of the Budget</u>

6 Against this background I would like to suggest that the objectives of your Budget, so far as industry is concerned, might be:

a) to give relief to corporate liquidity pressures imposed by Government, both to avoid closures of potentially viable capacity and to avoid damaging reductions in discretionary expenditure;

b) to supplement this by giving positive encouragement to discretionary expenditure e.g investment; and

c) to continue to stimulate enterprise in the economy in the hope of speeding up the climb out of recession.

7 In relation to the first objective relief must be fairly quick-acting to affect decisions taken by companies in 1981 (i.e before the upturn comes when special measures would not only be too late but would possibly add to inflationary pressures); it should be on a substantial scale; and it should be directed mainly towards the tradeables sector, especially manufacturing.

8 In relation to the second objective, I would not propose new measures, but rather an increased and more vigorous use of existing instruments. The aim would be to supplement any steps to improve corporate liquidity by encouraging companies to bring forward or maintain discretionary expenditure which might otherwise be deferred or cut. This would also give a much-needed psychological boost to industry by the explicit recognition of the importance of the supply side.

/ 9 ...

9 The third objective, stimulation of enterprise, has always been fundamental to our strategy. We must continue to support it vigorously.

10 I would hope that the position on the monetary front would enable you to consider a further reduction in MLR. A reduction in interest rates would bring direct financial help to industry, and would also help indirectly by the stimulus to activity it should bring.

11 However, I believe there is a strong case for going further than this. I fully support, as you know, the maintenance of the existing Medium Term financial Strategy. But I believe we must think in terms of a switch of resources in favour of the corporate sector at the expense of the personal sector, which has done relatively well.

12 I wish I could think that, despite the arguments in your letter of 16 January, you could make it one of your budget objectives to take direct action to influence the value of sterling. We must all acknowledge that the rise in sterling has done us proud in terms of inflation. But there is no doubt that the treadeables sector has been faced with great difficulty in adjusting to the rapid and steep rise. It would be highly desirable if the average level of sterling over the year as a whole could be a shade lower - 5 to 10% would be ideal.

Measures to Improve Company Liquidity

13 I believe the principal measures should be aimed at reducing industry's costs. Certain measures are already under consideration:-

a) Energy Prices. These are being studied as a whole by NEDO. In addition, I understand that officials have concluded that my proposals for abolishing or rebating the Heavy Fuel Oil Duty would be an expensive way of providing relief to industry. If you accept this, I hope you would agree to provide an equivalent measure of relief to high load factor electricity users, whose competitive disadvantages I described in my letter to David Howell of 27 November 1980.

b) Stock Relief. Your consultative proposals would bring extra relief to industry, at least in the short term. I believe certain aspects of your proposals (particularly the credit restriction and the single index) are causing widespread concern and I hope you will consider carefully the representations you receive. Subject to this, I hope you will be able to institute a permanent scheme in place of the present temporary arrangements.

/ 14 ...

14 Important though these are, I believe we need to go further, and I should like to recommend the following for your consideration:-

a) Regional Development Grants (RDG)

The 4 month deferment of payment of RDG was introduced in your 1979 Budget. It is widely resented by industry which, while recognising the need for it in 1979, now feels that its continuation leaves the private sector bearing the cost of the Government's public expenditure savings which resulted from it. Abolition of the deferment in 1981/2 would bring forward around £100m of RDG expenditure which would otherwise fall into 1982/83. (This figure would be greater if the decision on the eligibility of the Sullom Voe project resulted in its RDG being brought forward into 1981/82). The relief would be concentrated on manufacturing industry in the areas where the recession has caused the greatest problems and it would be felt quickly.

b) The National Insurance Surcharge (NIS)

We have of course already considered and rejected a reduction of the NIS. Nevertheless, I think it right to ask you to consider the position again in the circumstances we now face. A reduction in the NIS is perhaps the most effective available way of channelling substantial relief to industry fairly rapidly (not as rapid as the RDG route, but more substantial). It would relieve industry of an impost by the Government which represents a considerable burden. A reduction would be consistent with the widely-held view that the present industrial problems are due to real wages that are too high in terms of domestic prices (i.e low profitability)and international prices/costs (i.e poor competitiveness).

A reduction would bring down labour costs and should (though this may depend on how it is financed) stimulate activity through lower prices and/or higher profits. Manufacturing should benefit more than proportionately. All companies benefit, including the tax-exhausted, which mades this option more attractive than any reduction in Corporation Tax. In international terms, a reduction in the NIS would help towards offsetting the effects of the high exchange rate on UK exporters. Having re-read your letter to me of 15 January, I am more than ever convinced that we must think in such terms if there is no way of shading down the exchange rate itself.

/In ...

In the past, I know you have thought that a reduction of the NIS would benefit too many companies who did not really need help. While this may have been true in 1979 or even 1980, I think it is a proposition that must be seriously re-examined today.

Less than 8% of the benefit of any reduction would go to oil companies, banks and financial institutions (and, so far as banks are concerned, I understand you may be considering special measures). It is true that only a third would go to manufacturing. But the construction, distribution and transport sectors are now all in serious difficulty and should I believe be seen as deserving. In any case, the benefit to prices and output should accrue whoever in the private sector is the immediate beneficiary.

I should perhaps add that I do not favour a selective reduction of the NIS (effectively a return to the Selective Employment Tax). I understand that in addition to political and analytical arguments against, it would take time to implement, and require considerable numbers of new staff.

Another previous worry about the NIS was that a reduction would feed through into wages. I believe this risk has now lessened. An announcement in the Budget could not significantly affect the 1981 pay round. In any case the labour market is so depressed, especially in manufacturing, that a NIS reduction this year should leak much less than it might have done in 1979 or 1980.

I should like to think we could abolish the NIS; it was a "crisis" tax introduced by Labour in an ill-considered way. If this is impossible, I believe we should go for a reduction of 1½ points.

c) Industrial Rates

The very substantial and rapid increases in rates that have occurred in recent years have placed a considerable and uncontrollable burden on industrial costs. I welcome your willingness to explore this area, and I am very willing that Department of Industry officials should participate in the exercise you propose in your 15 January letter.

d) Nationalised Industry Investment Programmes

The squeeze on the nationalised industry investment programmes (especially, in my own field, British Telecommunications) has caused great difficulty for private industry. It is vital that we should find

/a way ...

a way of maintaining the viable investment programmes of the nationalised industries (especially BT), on which the future of many private sector high technology companies depends. These would benefit directly from any easement.

Discretionary Expenditure

15 I turn now to ways in which we can encourage industry to maintain or increase the discretionary expenditure that is so vital to our future. I was grateful for your decision to include in your 24 November measures an "industrial support" package. However, you will remember that I wrote on 8 August last year recommending a package of some £50 million in 1981/82, £70 million in 1982/83 and £90 million in 1983/84. In the event you recommended to the Cabinet a package of some £25 million in 1981/82, £43 million in 1982/83 and £40 million in 1983/84. This is helpful but the prospects are now worse than in August. The case for additional funds is therefore even stronger than when I last wrote to you and I should now like to propose that the shortfall of approximately £100 million, between what I requested last year and what you felt able to recommend, be made good. This sum might be spread £25 million in 1981/82, £40 million in 1982/83 and £35 million in 1983/84. Although the rate at which money can actually be spent dictates this kind of spread, planning and ordering would begin to take place at once and that would be the objective. I should apply these additional funds as follows:-

a) Investment

I believe we need to make more positive use of the powers that already exist in the Industry Act. This would involve publicising our readiness to consider applications, relaxing some of the guidelines for a limited period (but keeping the main criteria intact), and announcing a specific allocation of money. If you are attracted by this idea in principle, Department of Industry officials would be ready to discuss the details with Treasury officials.

b) R&D

Large firms are now turning to Government support to enable them to carry out R&D, whereas previously they had relied on their own resources. Many smaller firms are withdrawing from R&D projects because our "normal" grant level of 25 per cent is insufficient inducement in present economic circumstances. I would like to have the flexibility to increase the level of assistance to 35 per cent of qualifying costs particularly for the development aspects of R&D and to offer 50 per cent shared

/cost ...

cost contracts more frequently. Steps are also in hand to publicise our support measures. These changes would increase our total support costs but they do appear necessary if industrial R&D is not to decline further.

c) <u>Departmental "Wedge"</u>

There are strong arguments for rebuilding our Departmental "Wedge" for future industrial needs. In earlier years this Wedge has stood at over £50 million but in 1981/82 it stands at about £5 million and in 1982/83 calls such as the Laker Airways deal have reduced the unallocated Wedge to under £3 million. Such low levels leave us with little scope to cover year-by-year fluctuations in the opportunities and imperatives which emerge.

<u>Stimulus to Enterprise</u>

16 Subject to the consultative process, I very much hope you will be able to implement a scheme on the lines of the current proposals for tax relief on equity investment in start-ups. I also hope the pilot loan guarantee scheme will be in a sufficiently advanced state of preparation for you to announce it in the Budget.

17 In addition to these, I attach importance to stimulating the growth of Small Firms Investment Clubs. I am glad to know that the FASE group are now examining the tax aspects and I look forward to seeing the result of their work well before the Budget.

18 My letter of 19 December 1980 contained a number of proposals to help new and expanding businesses. I hope you will consider all of them, but I would single out particularly my proposals on the taxation of share options. I think this would give a considerable boost to the expanding, innovative type of business where risks may be high and enterprise needs to be rewarded.

<u>Housing</u>

19 Finally, I should like to return to the theme of my letter to you on housing of 31 December. A revival of housebuilding has in the past led industry out of recession and could on this occasion also give a much needed stimulus. I hope you will consider all possible measures in this direction.

<u>Priorities</u>

20 I suggest that we should be thinking of an "industrial package" for 1981/82 totalling at least £1 billion. This would be <u>in addition to</u> the benefit to industry from any reduction in interest rates and <u>in addition to</u> the benefits of the new stock relief schemes and the measures to encourage enterprise (the Aunt Agatha and loan guarantee schemes). My order of priorities would be:

/ a ...

		Benefit to Industry 1981/82 £m approx
a)	1½ point reduction in NIS	800
b)	Assistance to maintain discretionary expenditure	25
c)	Abolition of Heavy Fuel Oil Duty or measure to give equivalent relief	85
d)	Abolition of RDG Deferment	100
		£1 billion

21 If you are unable to accept my recommendation for a significant reduction in NIS, I urge you to consider what other way can be found to improve corporate liquidity to an equal extent. One possibility might be allowances exceeding 100% for capital investment and R&D; but I consider a change in NIS far preferable.

Financing the Package

22 A switch of resources on the scale I suggest will clearly require a substantial increase in the burden on the personal sector. In deciding how to impose this burden, I hope you will bear in mind the importance of limiting the adverse effect on industry (either through the dampening of demand or through pressure for higher wage settlements, for example). I think we must consider the whole Budget this year from this point of view.

23 I am copying this letter to the Prime Minister, the Secretaries of State for Employment, the Environment, Scotland, Wales, the Social Services and Trade, and to Sir Robert Armstrong.

Yours sincerely

Ian Ellison

KEITH JOSEPH

(approved by the Secretary of State and signed in his absence)

30 JAN

Mr Walters
Mr. Wolfson

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

PRIME MINISTER

CAPITAL TAX CHANGES IN THE 1981 BUDGET

We have made little progress so far towards our manifesto aim of simplifying capital taxation and making it less oppressive. Indeed except at the bottom of the scale capital transfer tax (CTT) is now heavier in real terms than when it was introduced in 1974 or at the time of the last election. Last year we finally decided, because of the cost and balance of the Budget, to do less than we had earlier intended: next year it may still be difficult, both from a financial and political viewpoint, to make a very large reduction. Hence I think that this year we must start to reduce the burden in real terms if we are to stand much chance of achieving our aims before the next election.

Capital Gains Tax

2. The major concern of our supporters is that capital gains tax is mostly a charge on inflationary gains. We examined this very thoroughly last year and concluded that indexation - however justified in principle - would reduce the yield to about one-sixth while requiring considerable additional staff. Instead we decided on an exempt allowance of £3,000 (which will halve the number of assessments) and removed the double charge to CGT and CTT on lifetime gifts by introducing a CGT rollover; while I am looking again at the charge on inflationary gains, I doubt if we shall find any solution which eluded us last year.

/3.

3. Whilst I do not suggest changes in the rate or threshold of the tax I think this year we should extend to settled property last year's removal of the double charge (there is a good deal of pressure for this). It would have a full year cost of £50-70 million (nil in 1981-82) but would be balanced, in both financial and political terms, by tackling some large scale and widespread avoidance practices including the manufacture of wholly artificial capital losses. There is also a CGT counterpart to the proposed Vestey legislation.

Capital Transfer Tax

4. I think that the major attack this year should be on CTT. We cannot get the real burden back to anything approaching what it was when we criticised it so heavily in 1974: to do so would, for example, require increasing the top rate band, at which tax is charged at 75 per cent, from £2 million to £5 million. But we should increase all the bands by a substantial figure: we can leave the final decision until we can see the overall balance of the Budget more clearly, but our minimum aim should be an increase of 20 per cent on all points, costing £90 million in a full year (£40 million in 1981-82) and yielding an eventual staff saving of 30. We might be able to go for a 50 per cent increase all round costing £180 million and £80 million respectively and eventually saving 200 staff. Such an increase would rather more than recoup the ground lost since the Election but still leave the tax much more onerous than it was in 1974. To avoid sliding back in real terms in future, we should extend to CTT last year's provisions for indexing the higher income tax rate bands. The starting rates are far too high - last year we concentrated on increasing the starting threshold. The first rate should, I think, be reduced from 30 per cent to 20 per cent and the second from 35 per cent to 30 per cent at a full year cost of £20 million (£10 million in 1981-82).

5. More needs to be done to encourage lifetime giving. I would extend the lower rate of tax on gifts (which at present tails away above £110,000 and runs out at £310,000) all the way up the scale although not at the full half rate, at a cost between £5 million and £10 million, and increase the annual exemption from £2,000 to £3,000 at a cost of £½ million. I would certainly remove the cumulation of gifts over life, substituting 10 years instead, so that the tax no longer runs from the cradle to the grave: this is an essential element in our plan to reduce the financial and administrative burden of the tax, but would have no immediate cost.

6. We should also make a start on dealing with the problems of settled property, but more detailed consultation will be advisable before we finally tackle the technically difficult issue of discretionary trusts.

Presentation of CTT proposals

7. I think that much of this programme can be properly - and best - presented as part of our further enterprise package along with whatever emerges from our studies in FASE. As you know, the impact of capital taxation on businesses, even after business relief, much concerns many of our supporters. By concentrating on the increase in the real burden on businesses in recent years we shall be able to distinguish what we are doing here from the necessarily year by year approach taken for income tax.

Investment income surcharge

8. Apart from following any changes in the bands for the higher rates of income tax, I do not propose any changes to the investment income surcharge.

CONFIDENTIAL

Agricultural Relief

9. I am also enquiring into the progress being made by the farmers and landowners in their discussions on changes in land tenure, as this could provide an occasion for making the tax changes for let agricultural land we had originally planned last year.

Development Land Tax

10. Finally I am conducting a further review of the Development Land Tax, and will minute you if I have proposals to make.

(G.H.)

29 January 1981

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

29 January 1981

The Rt. Hon. William Whitelaw, CH MC MP
Secretary of State for the Home Department

Dear William

TAX CONCESSIONS FOR CHARITIES

As you know we introduced in last year's Finance Act a package of measures designed to help charities. The cost to the Exchequer of these measures, which are described in the attached sheet, is estimated to be some £30 billion a year.

I have the impression that we may not be making enough of the value to Charities of last year's package. My current view is that in present circumstances I shall be able to suggest very little more, if indeed anything, in this area in my forthcoming Budget. Certainly many of those who have been making representations to us - e.g. on the subject of VAT and Charities - are likely to be disappointed. This means it is all the more important that we take steps to ensure that the full benefit of last year's measures is being realised.

This is largely a matter of good and effective publicity. I know that some colleagues have taken recent opportunities to refer to the new benefits available to charities. The Prime Minister made a special point of this in her speech to the WRVS National Conference on 19 January. But there may be more that we should be doing. I wonder if this would be an appropriate matter for consideration by Timothy Raison's Group on the Voluntary Sector?

I am sending copies of this letter to the Prime Minister, Michael Heseltine, Patrick Jenkin, Mark Carlisle and to Sir Robert Armstrong.

GEOFFREY HOWE

RESTRICTED

FINANCE ACT 1980 : TAX CONCESSIONS TO CHARITIES

a. Tax relief for businesses for expenditure of a charitable nature incurred "wholly and exclusively" for the purposes of their trade.

b. Minimum period for charitable Deeds of Covenant reduced from "over six years" to "over three years".

c. Higher rate tax relief for payments under Deeds of Covenant up to a ceiling of relief on payments of £3,000 a year.

d. Increase from £100,000 to £200,000 in the capital transfer tax exemption limit for transfers to charities on or within one year of death.

e. Exemption of charities from development land tax on disposal of land.

f. Relief from the 50p stamp duty on Deeds of Covenant for unstaged or variable amounts.

Confederation of British Industry
Centre Point
103 New Oxford Street
London WC1A 1DU
Telephone 01-379 7400
Telex 21332
Telegrams Cobustry London WC1

From
Sir Raymond Pennock
President

Confidential

27th January 1981

Prime Minister
Pennock and Beckett are coming to discuss their "Recovery Plan", but I think you should be aware of their pretty unrealistic Budget representations (summary at Flag A)

Dear Prime Minister,

I have pleasure in enclosing a copy of the CBI Budget Representations, which we discussed with the Chancellor of the Exchequer on Friday.

Yours sincerely,

Ray Pennock

The Rt. Hon. Margaret Thatcher, MP,
Prime Minister,
Downing Street,
London, SW 1.

Published Papers

The following published paper(s) enclosed on this file have been removed and destroyed. Copies may be found elsewhere in The National Archives.

Budget Representations to the Chancellor,
CBI Publications, 4 February 1981

Signed OWayland Date 29 March 2011

PREM Records Team

10 DOWNING STREET

PRIME MINISTER

I thought that I should ask for some figures about the burden of taxation, and income tax in particular, following the Lawson speech and your exchange with Mr Foot last Thursday.

Here they are - and very unwelcome too.

MS
19/1

MR CORLETT
MR STUBBINGTON

cc Mr Battishill
Mr White (SS)
Mr Flaxen (IR)

BURDEN OF PERSONAL TAXATION

No 10 asked for briefing on the burden of personal taxation, in the light of the exchange between the Prime Minister and the Leader of the Opposition on 15 January (copy attached).

2. Since the Government came to power, aggregate taxation has increased as a proportion of GDP from 39.7% in 1978/79 to 44.6% this year. The figures are as follows:-

Total taxation as % of GDP

1978-79	39.7
1979-80	42.5
1980-81	44.6

3. Within the totals, the taxes paid by individuals have also risen over the past 3 years, though less rapidly than the growth in aggregate taxation. The difference is mainly accounted for by the flow of North Sea revenue. The main taxes paid by persons have moved as follows relative to GDP (expressed as a percentage) :-

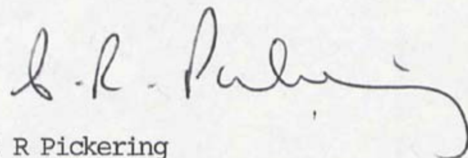
	Income Tax (1)	Taxes on Final Expenditure £ (2)	Total (1+2)
1978-9	12.9	10.7	23.6
1979-80	12.3	12.5	24.8
1980-81	12.8	13.0	25.8

4. However, the man on average manual earnings (or above) pays less in income tax now as a proportion of his earnings than he did in 1978/79. (For a single man on average manual earnings 23.5% against 23.7%; for a married man, 19.8% against 20.5%, assuming no allowances other than personal allowances.)

5. On the other hand, for persons on below average manual earnings the proportion has usually increased, following the abolition of the lower rate band; eg at three quarters average earnings, for a single man tax is now 21.3% of earnings against 20.7%, for a married man, 16.4% against 16.3%.

6. Members may mention national insurance contributions in the context of the burden of personal taxation. They have increased by ¼% since 1978/9 and are due to rise by a further 1% in April. But, as Government Ministers have frequently pointed out, these contributions are nothing to do with tax.

7. This brief has been agreed with SS (paragraph 6 only) and the Inland Revenue.



C R Pickering
16 January 1981

Cabinet / Cabinet Committee Document

The following document, which was enclosed on this file, has been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES.

Reference: CC(81) 2nd Meeting, Minute 1

Date: 15 January 1981

Signed GWayland Date 29 March 2011

PREM Records Team

HANSARD 15 JANUARY 1981 VOLUME 996 COLUMN 1529

Mr. Foot: I have had a chance to read the whole speech. Does the right hon. Lady agree with the proposition underlined in that speech — it has never before been so candidly admitted—namely that the right hon. Lady's Government has increased the real burden of taxation? Is that part of the policy that the right hon. Lady is so determined to continue?

The Prime Minister: I cannot in any way disagree with that highly intelligent speech. The person who made it is a lot more intelligent and perceptive than some of his critics. I do not disagree that the total burden of taxation, for the time being, has increased. However, it has not been increased on personal incomes. Indeed, the burden has been shifted from personal incomes to indirect taxation. That was part of our manifesto, which we intend to continue to carry out.

10 DOWNING STREET

From the Private Secretary

2 January, 1981.

Dear John,

<u>1981 Budget Arrangements</u>

The Prime Minister has considered the Chancellor of the Exchequer's minute of 30 December and is content with his proposals.

I am sending copies of this letter to Robin Birch (Chancellor of the Duchy of Lancaster's Office), Murdo Maclean (Chief Whip's Office), and Brian Shillito (Office of the First Parliamentary Counsel).

John Wiggins, Esq.,
HM Treasury.

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

PRIME MINISTER

1981 BUDGET ARRANGEMENTS

At the beginning of November we discussed the date of the 1981 Budget and you endorsed 10 March as the planning date. I have now reviewed the position in the light of subsequent developments and have concluded that 10 March should be confirmed as Budget Day and that this date should be announced during the first Business Statement after the Recess - which will I understand be Thursday, 15 January.

2. An announcement is not absolutely imperative then but it will help those wanting to put Budget representations forward and, more importantly, will also ease the task of public presentation by reassuring everyone that within a couple of months there will be a comprehensive statement about the whole economic strategy.

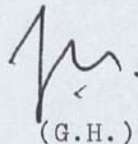
3. I take this opportunity also to respond to the suggestion, in your letter of 7 November, that we might publish the Public Expenditure White Paper on the morning of Budget day, rather as the old "Economic Survey" was handled. I have considered this carefully but do not think it would in fact be an appropriate way of responding to the complaints from the then Leader of the Opposition about the way the 1980 White Paper was published with, rather than before, the Budget. The White Paper is the vehicle for publishing the detailed public spending plans as they have emerged from Cabinet and it is essential to be able to present these in the context of the medium term strategy to be explained in the Budget Speech and documented in the Red Book. (The Red Book rather than the White Paper is of course

/where we

where we now set out general economic background material of the kind given in the old "Economic Survey".) There would be scope for considerable practical complication and confusion in presentation - leading for example to adverse newspaper headlines - if the public spending plans were to be released in isolation from the economic context.

4. Some of the complaints about the publication of the 1980 White Paper on the afternoon of Budget Day (and without the usual CFRs) probably reflected the novelty of the arrangement. I have had no representations about 1981 publication arrangements since the 24 November announcement that the White Paper will again appear at the time of the Budget. I suggest that we let the matter rest there for now, but be ready to consider providing the Leader of the Opposition with a courtesy copy of the White Paper a few hours before my Budget statement, if he asks for this. (I should add that if we were to issue CFRs of the White Paper to journalists it would be appropriate to give one to the Leader of the Opposition. In fact the balance of argument seems to be against provision of CFRs, though a final decision can be taken later.)

5. I am sending copies of this minute to the Chancellor of the Duchy, the Chief Whip, and to First Parliamentary Counsel. (Michael Jopling's people have confirmed to my officials that 10 March remains acceptable from their point of view.)



(G.H.)

30 December 1980

Arranged for Monday
22nd at 12. Noon.
No Briefing required
but b/f to M. Lankester
on 19.12.80. CS 3/12

PRIME MINISTER

The attached letter from Sir James Goldsmith asks if he could come and talk to you about Section 478 and 481 of the Income and Corporate Taxes Act 1970. He asks that his letter should be for your information only and is not passed down through official channels.

I have had a word with Tim about it and he says that it is so technical that either you should tell him that you are unable to see him or if you do see him then the Chancellor should really be present.

Which course would you like to take?

CS.

I will see him.
It must be regarded as totally

1 December,1980

Confidential.

MT.

TELEPHONE: 01-480 5676

65-68, LEADENHALL STREET,
LONDON,
EC3A 2BA.

1st December 1980

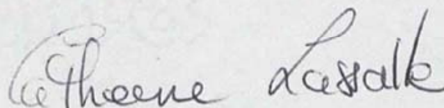
Miss Caroline Stevens,
Appointments Secretary,
10 Downing Street,
London SW1

Dear Miss Stevens,

Sir James has asked me to send you the enclosed letter for the Prime Minister's attention and he would be most grateful if you would put it before her yourself as it deals with a personal and confidential matter.

Many thanks.

Yours sincerely,



Catherine Lassalle (Miss)
Private Secretary to
Sir James Goldsmith

James GOLDSMITH

27th of November, 1980

The Right Honourable Mrs. Margaret Thatcher MP
The Prime Minister

Strictly private and confidential

Dear Prime Minister

I have asked your appointments secretary, Caroline Stevens, whether you might have quarter of an hour to spare. There is no urgency. Caroline Stevens quite properly asked me to put something on paper to describe the subject which I would like to discuss with you. I understand that your Government is presently considering revising section 478 and 481 of the Income and Corporate Taxes Act 1970. That Act concerns the transfer of assets out of the United Kingdom by UK residents so as to reduce the taxation which could be payable by them in the United Kingdom. It gives the Inland Revenue totalitarian powers of investigation which I believe some inspectors use with a political as opposed to fiscal motive.

I attach hereto an extract of this month's Accountant Magazine and I would particularly refer you to the marked paragraph which concerns the Vestey case.

See also PM Econ Oct 80 Vestey Case

I have personal experience which is also useful as an example. I am not seeking any help because I am both willing and able to fight my own battles.

I was born in France, I am domiciled in France and have my principal place of residence in France. I benefit from dual Anglo-French nationality. The domicile of both my mother and father (before his death) is in France. I was educated at Eton but spent my holidays at my home in France. I served in the British Army but returned to France for my leave. My father's estate was taxed in France.

/..

My original business was founded in France. My UK activities stem from the companies with which I have been associated in France. Funds to establish the business activities with which I have been associated in Britain were invested from France. My worldwide income is reported and heavily taxed in France (subject to appropriate bilateral tax agreements). Despite the fact that it is clear that I have never transferred assets out of the UK, certain inspectors of the Inland Revenue are using their unlimited powers under section 478 to 481 to obtain information about my personal and business affairs which I have reason to believe they might pass on to the Sunday Times as in the Vestey case. No doubt they would much like to fabricate a Vestey Mk 2 case which would be publicised in the Sunday Times with the same impeccable sense of timing as with Vestey.

I bring this to your attention because I believe that it must be wrong that inspectors of the Inland Revenue should be given totalitarian powers to wage personal ideological battles. This is the representation which I wish to make to you while your Government is considering modifications to this section of the law.

I would be most grateful if you would consider this note as being for your information only and not pass it down through official conduits.

Yours sincerely

James Goldsmith

JMG To note (Accountant's Magazine Nov. 1980) FROM KSR

goodwill therefore was not in existence *before* 6 April 1965 and the "cost" was nil.

(2) *Vibroplant Limited v Holland (Inspector of Taxes), 16 July 1980*

The Court decided that premises devoted to the repairing and refurbishing of plant which is to be let out on hire are not "industrial buildings or structures" for the purpose of section 7, Capital Allowances Act 1968 and that as a result Industrial Buildings Allowance is not available. The company submitted that the premises could fall within the definitions set out in section 7 (1) (*a*) or (*e*) but, supporting the Commissioners, the Judge held that the premises could not be described as a "factory or other similar premises" under sub-section (1) (*a*) since they were not buildings "where goods are made".

As regards sub-section (1) (*e*) the Special Commissioners had decided the case against the taxpayer company on two grounds, the first being that the trade of plant hire operators was not carried on in any of the buildings because the activities taking place in those buildings were not performed for Vibroplant's customers. The Judge was not very convinced by this argument but that did not do the taxpayer any good as he supported the Special Commissioners on their second ground, which was that the treatment provided in the buildings did not involve the subjection of the articles being treated to any "process". They said, "In the course of cleaning, maintenance and repair each item of plant was given individual attention, the precise nature of which depended on the extent of the damage suffered, by contrast with the treatment applied". The Judge agreed with this, saying that in his view, "process" connoted a substantial measure of uniformity of treatment or system of treatment and he referred to the definition of the word in the Shorter Oxford English Dictionary which is "a continuous and regular action or succession of actions, taking place or carried on in a definite manner; a continuous (natural or artificial) operation or series of operations". He went on to say that it seemed to him that an ordinary garage where cars are serviced and repaired according to their particular requirements did not involve subjecting goods or materials to any process and, similarly, the doctor's surgery where individuals are treated for their individual ailments does not involve the subjection of people to any process!

The appeal therefore failed.

(3) *Clark (Inspector of Taxes) v Oceanic Contractors Inc, 29 July 1980*

This case has decided that an overseas employer is bound to apply the PAYE procedure laid down in section 294, ICTA 1970 whenever the duties of the employment are carried out—or deemed to be carried out—in the United Kingdom. This applies whatever manner is adopted for paying the emoluments for those duties and the Judge said "an employer who comes to this country and carries on a business here must comply with domestic tax law requirements such as section 204".

In this particular case the employee concerned was employed by the North Sea Division of the employer, which was based at Antwerp, and was employed in pipe-laying from vessels which, while working out of Antwerp, operated in the part of the North Sea which is defined as a "designated area" in terms of section 38 of the Finance Act 1973. This being so, the duties of the employment are deemed to be carried out within the United Kingdom and are subject to United Kingdom tax on that basis whether or not the employee is resident in the UK or not (see sub-section (6)). Dillon, J, said that the direction in section 38 (6), FA 1973 that these emoluments are to be treated for the purpose of income tax as emoluments in respect of duties performed in the United Kingdom appeared to him to include the purposes of collection, and not merely assessment, of income tax and thus to underline that section 204, ICTA 1970 did apply to those emoluments.

He therefore allowed the appeal by the Inland Revenue against the decision by the Special Commissioners. It will be interesting to see whether the company takes the matter further—no doubt with the support of other non-resident employers in the oil industry—although one cannot help wondering how the Inland Revenue are actually going to enforce the court decision in practice.

The Vestey affair

Readers can scarcely have been unaware of the "stushie" which arose following the article in *The Sunday Times* of 5 October 1980 (the first in a series) which referred to the decision of the House of Lords in the case of *Vestey v CIR*, which was handed down as long ago as 22 November 1979. The article gave rise to considerable comment in various organs of the press—not to mention a slightly hysterical reaction by one Scottish newspaper which managed to confuse the question of the avoidance of UK tax by means of overseas trusts with the perfectly legitimate and fair group relief available to the family companies in the UK (a completely irrelevant matter which was raised in a "box" by *The Sunday Times*).

In the report on this case in *The Accountant's Magazine* of January 1980 (pp 39-40) this writer referred to the extreme likelihood that the Revenue would not take the decision completely lying down and that legislation would be introduced very shortly to negate, at least partly, the House of Lords decision for the future; no one was more surprised when the Finance Bill 1980—or rather, the "Finance No 2 Bill"—appeared without any reference to section 478, ICTA 1970. While recognising the complexity of the matter, one would have thought that someone would have been able to completely redraft the section in the space of four months or more but, at least, *The Sunday Times* article did result in a pledge by the Chancellor of the Exchequer to do something about the situation "as soon as we have the right answer". It is devoutly to be hoped that the redrafted section will not only prevent the legal avoidance of large sums of United Kingdom tax by the creation of a simple overseas trust, but will limit the present Draconian powers in the section, so that a UK resident will not be legally liable to tax on income to which he could not possibly have any actual entitlement. The courts have already indicated that a taxpayer could be held liable to UK tax on the entire income of a non-resident company (for example) even though he may have a very small stake in that company. There is no doubt that a complete revisal of this section is long overdue and the sooner the better!

However, what is really the most disturbing question of all is how it came about that *The Sunday Times* was apparently able to publish the precise wording of correspondence between the Inland Revenue and the accountant acting for the Vestey family! One has always been under the impression up to now that such correspondence is strictly confidential and one would like a statement from the Board of Inland Revenue as to what steps they are taking as a matter of urgency to trace the "mole" in this particular instance. Perhaps this is another case for Mr Bingham?

The author apologises for a mental aberration (temporary, he hopes!) when he was writing the final paragraph of the report on Prest v Bettinson in last month's Magazine. The last sentence only applies, of course, after utilising the exemptions available to the personal representatives, under paragraph 4, Schedule 1, CGTA 1979.

Solution and Notes to Crossword Puzzle No 132

ACROSS: , Dress-age; 5, Scilla (*ie*, Cilla Black); 9, Peas-ants; 10, A dag-i-o; 11, Obeys (OB + yes (anag)); 12, H-o-TT-en tot; 14, I'm-press-I-on-s(o); 18, Quicksilver; 21, In-side lip (pit rev); 23, No-o-se ("through" - "inside"); 24, Gar-ret; 25, Interval (anag); 26, Ex-pose; 27, Restored (*ie*, "store" in the red).

DOWN: 1, De-ploy; 2, Elater (2 mngs); 3, Slaps-tick; 4, Got the point; 6, Cad-G-e; 7, Legation (*ie*, allegation less al(l)); 8, Amortise; 13, Twelve pence; 15, String-ent (anag); 16, Squ(irm wr)iggle; 17, Airstrip; 19, Hoover; 20, Peel-ed; 22, Diets.

Crossword Puzzle No 132 is at page 470.

e an annual payment made,
out of a source other than
o income tax.

shall not apply where the
it deduction of tax or where
ge governing the transaction
n respect of the interest is of
deduction of tax.

he liability to tax of a jobber
the footing that any excess
erest on securities over his
payments made or receipts
for the sale or purchase of
all the purposes of the Tax
by him, then as respects that
this section shall not apply
the ordinary course of his
ker.

in the United Kingdom and
than through a broker) from
graph (*b*) of subsection (1) of
after the word " say " there
and as if for the words from
aragraph there were inserted
r of the securities or that he
es, directly or indirectly, from
he payment ".

a contract as is mentioned in
this section is not resident in
is effected through a broker,
unless the broker shows either
e payment of interest as the
or that the seller acquired the
from a person who was so
section 53(2) of this Act shall
e broker of the amount of the
payment by the broker made,
y out of such a source as is
section.

of a stock exchange in the
an a jobber,

on to any sale of securities
stock exchange in the United
London Stock Exchange, who

Copied for Goldsmith Mtg.

is recognised by the committee of his exchange as carrying on the business of a dealer and authorised by them to deal in those securities,

" jobber " means a member of the London Stock Exchange who is recognised by the committee thereof as carrying on the business of a jobber,

" securities " includes shares and stock,

and references to a periodical payment of interest include references to a dividend.

(7) Where it appears to the Board that by reason of any transaction or transactions a person may by virtue of this section have incurred any liability to tax, the Board may by notice in writing served on him require him, within such time not less than twenty-eight days as may be specified in the notice, to furnish information in his possession with respect to the transaction or any of the transactions, being information as to matters, specified in the notice, which are relevant to the question whether he has incurred such a liability as aforesaid.

CHAPTER III

TRANSFER OF ASSETS ABROAD

Provisions for preventing avoidance of income tax transactions resulting in the transfer of income to persons abroad.

478. For the purpose of preventing the avoiding by individuals ordinarily resident in the United Kingdom of liability to income tax by means of transfers of assets by virtue or in consequence whereof, either alone or in conjunction with associated operations, income becomes payable to persons resident or domiciled out of the United Kingdom, it is hereby enacted as follows: —

(1) Where by virtue or in consequence of any such transfer, either alone or in conjunction with associated operations, such an individual has, within the meaning of this section, power to enjoy, whether forthwith or in the future, any income of a person resident or domiciled out of the United Kingdom which, if it were income of that individual received by him in the United Kingdom, would be chargeable to income tax by deduction or otherwise, that income shall, whether it would or would not have been chargeable to income tax apart from the provisions of this section, be deemed to be income of that individual for all the purposes of the Income Tax Acts.

(2) Where, whether before or after any such transfer, such an individual receives or is entitled to receive any capital sum the payment whereof is in any way connected with the transfer or any associated operation, any income which, by virtue or in

PART XVII
CHAPTER III

consequence of the transfer, either alone or in conjunction with associated operations, has become the income of a person resident or domiciled out of the United Kingdom shall, whether it would or would not have been chargeable to income tax apart from the provisions of this section, be deemed to be the income of that individual for all the purposes of the Income Tax Acts.

In this subsection, " capital sum " means—

(*a*) any sum paid or payable by way of loan or repayment of a loan, and

(*b*) any other sum paid or payable otherwise than as income, being a sum which is not paid or payable for full consideration in money or money's worth.

(3) Subsections (1) and (2) of this section shall not apply if the individual shows in writing or otherwise to the satisfaction of the Board either—

(*a*) that the purpose of avoiding liability to taxation was not the purpose or one of the purposes for which the transfer or associated operations or any of them were effected ; or

(*b*) that the transfer and any associated operations were bona fide commercial transactions and were not designed for the purpose of avoiding liability to taxation.

The jurisdiction of the Special Commissioners on any appeal shall include jurisdiction to review any relevant decision taken by the Board in exercise of their functions under this subsection.

(4) For the purposes of this section, " an associated operation " means, in relation to any transfer, an operation of any kind effected by any person in relation to any of the assets transferred or any assets representing, whether directly or indirectly, any of the assets transferred, or to the income arising from any such assets, or to any assets representing, whether directly or indirectly, the accumulations of income arising from any such assets.

(5) An individual shall, for the purposes of this section, be deemed to have power to enjoy income of a person resident or domiciled out of the United Kingdom if—

(*a*) the income is in fact so dealt with by any person as to be calculated, at some point of time, and whether in the form of income or not, to enure for the benefit of the individual, or

(*b*) the receipt or accrual of the income operates to increase the value to the individual of any assets held by him or for his benefit, or

(c) the individual receives or is entitled to receive, at any time, any benefit provided or to be provided out of that income or out of moneys which are or will be available for the purpose by reason of the effect or successive effects of the associated operations on that income and on any assets which directly or indirectly represent that income, or

(d) the individual has power, by means of the exercise of any power of appointment or power of revocation or otherwise, to obtain for himself, whether with or without the consent of any other person, the beneficial enjoyment of the income, or may, in the event of the exercise of any power vested in any other person, become entitled to the beneficial enjoyment of the income, or

(e) the individual is able in any manner whatsoever, and whether directly or indirectly, to control the application of the income.

(6) In determining whether an individual has power to enjoy income within the meaning of this section, regard shall be had to the substantial result and effect of the transfer and any associated operations, and all benefits which may at any time accrue to the individual (whether or not he has rights at law or in equity in or to those benefits) as a result of the transfer and any associated operations shall be taken into account irrespective of the nature or form of the benefits.

(7) For the purposes of this section, any body corporate incorporated outside the United Kingdom shall be treated as if it were resident out of the United Kingdom whether it is so resident or not.

(8) For the purposes of this section—

(a) a reference to an individual shall be deemed to include the wife or husband of the individual,

(b) " assets " includes property or rights of any kind and " transfer ", in relation to rights, includes the creation of those rights,

(c) " benefit " includes a payment of any kind,

(d) references to income of a person resident or domiciled out of the United Kingdom shall, where the amount of the income of a company for any year or period has been apportioned under section 296 of this Act, include references to so much of the income of the company for that year or period as is equal to the amount so apportioned to that person,

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(*e*) references to assets representing any assets, income or accumulations of income include references to shares in or obligations of any company to which, or obligations of any other person to whom, those assets, that income or those accumulations are or have been transferred,

and for the purpose of applying this Chapter in relation to Case VII of Schedule D references to income in this Chapter shall apply in the case of gains accruing from the acquisition and disposal of chargeable assets as they would apply if the gains were profits from a trade of dealing in the assets, and any such gains shall be treated as payable in the first instance to the person to whom they accrue.

Persons resident in Republic of Ireland; application of Chapter III to premiums on leases, etc.

479. In relation to amounts which by virtue of any provision of section 80, 81 or 82 of this Act (taxation as income of premiums on leases, etc.) would, in the case of a person resident in the Republic of Ireland and not resident in the United Kingdom, be included in his income if he were not resident in the Republic of Ireland, this Chapter shall apply—

(*a*) as if his income included those amounts, and

(*b*) as if references to an individual included references to any person (and so that in accordance with section 250 of this Act this Chapter then applies for corporation tax as well as for income tax),

but shall so apply as if subsection (3) of section 478 above were omitted.

Supplemental provisions.

480.—(1) Income tax at the standard rate shall not be charged by virtue of the preceding provisions of this Chapter in respect of income which has borne tax at the standard rate by deduction or otherwise but, save as aforesaid, income tax chargeable at the standard rate by virtue of those provisions shall be charged under Case VI of Schedule D.

(2) In computing the liability to income tax of an individual chargeable by virtue of the said provisions of this Chapter, the same deductions and reliefs shall be allowed as would have been allowed if the income deemed to be his by virtue of those provisions had actually been received by him.

(3) Where an individual has been charged to income tax on any income deemed to be his by virtue of the said provisions of this Chapter and that income is subsequently received by him, it shall be deemed not to form part of his income again for the purposes of the Income Tax Acts.

(4) In any case where an individual has for the purposes of the said provisions of this Chapter power to enjoy income of a person abroad by reason of his receiving any such benefit as is

referred to in section 478(5)(*c*) above, then notwithstanding anything in subsection (1) of this section, the individual shall be chargeable to income tax by virtue of the said provisions of this Chapter for the year of assessment in which the benefit is received on the whole of the amount or value of that benefit except in so far as it is shown that the benefit derives directly or indirectly from income on which he has already been charged to tax for that or a previous year of assessment.

Power to obtain information.

481.—(1) The Board or, for the purpose of charging tax at the standard rate, an inspector may by notice in writing require any person to furnish them within such time as they may direct (not being less than twenty-eight days) with such particulars as they think necessary for the purposes of this Chapter.

(2) The particulars which a person must furnish under this section, if he is required by such a notice so to do, include particulars—

(*a*) as to transactions with respect to which he is or was acting on behalf of others, and

(*b*) as to transactions which in the opinion of the Board or, for the purpose of charging tax at the standard rate, an inspector it is proper that they should investigate for the purposes of this Chapter notwithstanding that, in the opinion of the person to whom the notice is given, no liability to tax arises under this Chapter, and

(*c*) as to whether the person to whom the notice is given has taken or is taking any, and if so what, part in any, and if so what, transactions of a description specified in the notice.

(3) Notwithstanding anything in subsection (2) of this section, a solicitor shall not be deemed for the purposes of paragraph (*c*) thereof to have taken part in a transaction by reason only that he has given professional advice to a client in connection with that transaction, and shall not, in relation to anything done by him on behalf of a client, be compellable under this section, except with the consent of his client, to do more than state that he is or was acting on behalf of a client, and give the name and address of his client and also—

(*a*) in the case of anything done by the solicitor in connection with the transfer of any asset by or to an individual ordinarily resident in the United Kingdom to or by any such body corporate as is hereinafter mentioned, or in connection with any associated operation in relation to any such transfer, the names and addresses of the transferor and the transferee or of the persons concerned in the associated operations, as the case may be;

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(*b*) in the case of anything done by the solicitor in connection with the formation or management of any such body corporate as is hereinafter mentioned, the name and address of the body corporate;

(*c*) in the case of anything done by the solicitor in connection with the creation, or with the execution of the trusts, of any settlement by virtue or in consequence whereof income becomes payable to a person resident or domiciled out of the United Kingdom, the names and addresses of the settlor and of that person.

The bodies corporate mentioned in the preceding provisions of this section are bodies corporate resident or incorporated outside the United Kingdom which are, or if resident in the United Kingdom would be, close companies, but not trading companies (as defined in section 292(1) of this Act).

(4) Nothing in this section shall impose on any bank the obligation to furnish any particulars of any ordinary banking transactions between the bank and a customer carried out in the ordinary course of banking business, unless the bank has acted or is acting on behalf of the customer in connection with the formation or management of any such body corporate as is mentioned in paragraph (*b*) of subsection (3) of this section or in connection with the creation, or with the execution of the trusts, of any such settlement as is mentioned in paragraph (*c*) thereof.

(5) In this section "settlement" and "settlor" have the meanings assigned thereto by section 454(3) of this Act.

CHAPTER IV

MISCELLANEOUS

Companies

Migration, etc., of companies.

482.—(1) Subject to the provisions of this section, all transactions of the following classes shall be unlawful unless carried out with the consent of the Treasury, that is to say—

(*a*) for a body corporate resident in the United Kingdom to cease to be so resident; or

(*b*) for the trade or business or any part of the trade or business of a body corporate so resident to be transferred from that body corporate to a person not so resident; or

(*c*) for a body corporate so resident to cause or permit a body corporate not so resident over which it has control to create or issue any shares or debentures; or

10 DOWNING STREET

From the Private Secretary 10 November 1980

CORPORATION TAX: THE REFORM OF STOCK RELIEF

The Prime Minister has read your letter of 7 November, and is content that the proposed consultation paper be issued provided the transfer and Lord Cockfield are content with it.

Copies of this letter go to Ian Ellison (Department of Industry), Stuart Hampson (Department of Trade), Richard Prescott (Paymaster General's Office), Robin Ibbs (Central Policy Review Staff) and David Wright (Cabinet Office).

T. P. LANKESTER

A.J. Wiggins, Esq.,
HM Treasury.

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

7 November 1980

T P Lankester Esq
Private Secretary
Prime Minister's Office
No.10 Downing Street
LONDON SW1

Dear Tim,

CORPORATION TAX: THE REFORM OF STOCK RELIEF

The Prime Minister has, as you know, agreed to the issue of a consultative paper setting out the Government's proposals for the reform of stock relief.

I now attach a copy of the draft. In general, it is in a form agreed with Lord Cockfield although he has not yet seen the whole of this particular text. Both he and the Chancellor will, however, be studying the draft over the weekend for final clearance on Monday. The Chancellor is proposing to issue the paper on Friday, 14 November and I am afraid it will, therefore, have to be with the printers by close of play on Monday.

I should perhaps add that Lord Cockfield has discussed with the Secretary of State for Trade the reservations expressed in his letter of 5 November to the Chancellor and I understand that Mr Nott is now satisfied with what is proposed.

I am copying this to the PSs to the Secretaries of State for Industry and Trade, the Paymaster General and Robin Ibbs.

Yours ever,

Richard Tolkien

R I TOLKIEN
Private Secretary

STOCK RELIEF

A CONSULTATIVE DOCUMENT

Board of Inland Revenue
14 November 1980

STOCK RELIEF - A CONSULTATIVE PAPER

"It is important that the tax system should take account of the effects of inflation on businesses, and do so in a way that is reasonably objective, equitable and simple to administer. The Government will therefore be reviewing this matter along with the accountancy profession's latest proposals for current cost accounting."

- Chancellor of the Exchequer - Budget Speech 1979
  (Official Report, 12 June 1979; col 257)

"There is criticism that the present stock relief may confer an unjustifiable advantage in certain circumstances. This is a complex matter on which detailed consultation will be needed, but my intention is to legislate next year in respect of accounts on which tax will generally be payable on 1 January 1982."

- Chancellor of the Exchequer - Budget Speech 1980
  (Official Report 26 March 1980; col 1468)

SECTION 1 - THE PROPOSED REFORM

1.1 The present stock relief was introduced as a temporary measure in 1975. It suffers from important defects which have been widely publicised. But what has added great urgency to the introduction of a new scheme on a sounder long term basis is the fact that the present recession bringing with it large reductions in stock would face manufacturing industry in particular with a very heavy burden of tax resulting from the "clawback" provisions. The new scheme removes the need for clawback (save in exceptional "terminal" conditions) and it does this by relating the relief directly to the effects of inflation on stocks thus removing from taxable profit the element which represents the appreciation in stock value due to inflation. Because the relief does not extend - as the present relief does - to increases in the physical volume of stock, the need for clawback largely disappears. At the same time an adjustment will be made for stocks financed by credit or other borrowings where the burden of inflation does not in practice fall on the business holding the stocks.

1.2 The scheme represents an important step forward in the direction of ensuring that taxation of business profits take account of the effects of inflation as stated by the Chancellor in his Budget Speech last year. The new Statement of Standard Accounting Practice on Current Cost Accounting (SSAP 16) published by the Accountancy Bodies on 31 March of this year shares the same broad objective. The scheme set out in this paper would involve a significant cost to the Exchequer and result in an equivalent benefit to industry by way of tax reductions. In present circumstances it will not be easy to find the sums required; nevertheless in the light of the financial pressures on industry the Government think it right to do so. But by the same token it is essential to keep the cost within the bounds of what the Government can afford. This means that the scheme needs to be looked at as a whole. Inevitably it entails restricting relief given hitherto where this cannot be justified. But this is the price which has to be paid to enable a more ample measure of relief to be given where it can be justified. Moreover the virtual disappearance of clawback flows from the other proposals and is integral with them. While therefore the detail of the scheme and particularly the precise rules to be followed may need modification in the light of comment and discussion, the main fabric of the scheme stands or falls as a whole. The Government firmly believe that apart from being sounder in principle, the scheme is much to the advantage of industry as a whole.

1.3 In view of the urgency of the matter comments on these proposals should be sent, in the first instance, to the Board of Inland Revenue, if at all possible by the end of December. In the light of these comments the Government intend to introduce the new scheme in the Finance Bill 1981. It will apply to all accounting periods straddling or ending on the date of publication of this document (14 November 1980), and in particular to accounting periods ending on 31 December 1980: but the credit restriction will apply only to accounting periods commencing on or <u>after</u> 14 November.

SECTION 2 - THE NATURE OF THE PROBLEM AND THE APPROACH TO THE SOLUTION

2.1 Stock relief was originally conceived as a "temporary measure" in the Finance Act 1975. It was introduced in some hurry at a time when companies were suffering from severe and urgent pressures on profits and liquidity. It was designed, very broadly, to relieve a business from tax on that part of its profits which it used to finance the higher costs of holding stocks when prices were rising.

2.2 The stock relief scheme served its original purpose. But it has now remained in (broadly) its present form for far longer than could reasonably have been foreseen in 1975. With the passage of time, certain weaknesses have become increasingly apparent: moreover the present recession has greatly exacerbated the problem of 'clawback' which faces a large number of businesses which have been compelled for reasons of financial prudence or good stock management to reduce their stocks sharply. The defects of the present scheme are explained in greater detail in the following paragraphs.

2.3 First, the present stock relief scheme extends relief, subject to certain conditions,* not only in respect of higher <u>prices</u> of stocks, but also in respect of higher <u>physical volumes</u> of stock held. The effect of this may well be that the present scheme:

a. induces businesses to build up stocks to a level higher than they would otherwise have chosen to do on a broad commercial judgment, and

b. in the more extreme cases, can offer scope for businesses to build up their stocks artificially, at the accounting year-end, for the sake of a tax advantage.

There are provisions in the tax code which seek to counter any artificial manipulation of stock levels; but it is common knowledge that these have not been particularly effective nor in the nature of things could have been.

2.4 Second, relief is given under the present scheme without regard to whether stock is being financed out of credit or other borrowings. Large amounts of relief have been available to businesses which have in practice financed their stocks by trade credit, including businesses in the retail trade which in some instances will even have sold their stocks before payment for them becomes due. In cases of this kind, businesses have been receiving relief for inflationary costs that they themselves have not had to bear.

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*See in particular the discussion on the profit restriction, paragraph 3.2 below.

2.5 Third, just as the present scheme gives relief when stock levels rise, so it withdraws relief - imposes a charge to tax (commonly known as "clawback") - when the value of stocks held falls. This follows necessarily from the form of the relief as it stands at present. However, it means that when a company wishes to reduce its stocks - perhaps in the course of a drive for greater efficiency, perhaps in order to improve its liquidity and reduce bank borrowings - it may be deterred by the prospect of the "clawback" charge. And if it nevertheless goes ahead or indeed is forced by financial pressure to go ahead something like half the cash benefit from stock reduction may be drawn off by the higher charge to tax. This clawback charge is now presenting real difficulties for businesses which in current trading conditions are having to reduce stock levels. The Government introduced provisions in the 1980 Finance Act temporarily to mitigate these damaging effects, but a permanent solution can be found only in a radical change in the basic nature of the relief.

2.6 So much for the drawbacks of the present form of stock relief. In his Budget Speech in 1979 the Chancellor said:

> "It is important that the tax system should take account of the effects of inflation on businesses, and do so in a way that is reasonably objective, equitable and simple to administer."

It is in this spirit that the Government have approached the reform of stock relief. The immediate task is to ensure that the proposals on stock are much more closely related to the effects of inflation than is the present relief. But it is equally important to ensure that the solution adopted in the case of stocks is consistent with the longer term development of the corporation tax to take account of the effects of inflation. In other words the new stock relief ought to represent a clear step forward along the path we would want to tread. This is of particular importance in view of the need to maintain stability in the taxation of business profits.

2.7 The requirements of the tax system inevitably diverge from those of accountancy. In particular it is necessary for the tax system to lay down rules which are both certain and objective and which leave little to subjective judgement. Moreover it has to pass severe tests of practical application in a wide range of very different types of case. Subject to this, the Government have taken fully into account the Statement of Standard Accounting Practice on Current Cost Accounting (SSAP 16). It is the Government's intention in due course to publish a wide-ranging Green Paper on the structure of corporation tax and the implications of possible further changes to reflect more generally the effect of inflation on the calculation of business profits. It may well be that in the context of that Green Paper and in the light of experience both within the tax system itself and of the practical operation of current cost accounting generally some

modification or refinement of the present proposals may be needed. Meantime the Government see the scheme proposed in this Consultative Document as consistent with the direction in which they would hope to see the corporation tax itself develop.

2.8 The cost of the present stock relief varies from year to year but for 1979 (tax payable generally in 1980) the cost will be about £2 billion. This compares with a yield of mainstream corporation tax for the same year of some £3 billion. Of the total relief some 45 per cent goes to manufacturing industry, the balance going to commerce, distribution, finance etc. As already explained, it is estimated that in present circumstances the new scheme will be significantly more generous than the present scheme. Manufacturing industry's share of the total relief is likely to increase from its present level of around 45 per cent to perhaps something in the region of 50 per cent. As between individual companies the relief will be distributed more appropriately: that is it will be directed primarily to the companies which have actually borne the costs imposed by inflation and in proportion to those costs.

2.9 The figures in the preceding paragraph relate to the relief which is effective. There is in addition a large amount of tax relief of all kinds - for losses and capital allowances as well as for stock - which is ineffective because the level of profits is not sufficient to absorb the full amount of the relief. The present total of these unrelieved losses etc being carried forward to set off against future profits now amounts to some £30 billion and the figure is increasing at the rate of £5 billion a year.

2.10 A detailed statistical analysis of the present yield of corporation tax, of the cost and distribution of the present stock relief, with the best available indicators of the broad effect of the proposed new relief, is included in Appendix 2.

2.11 The remainder of this paper contains first a more detailed description of the present system and then a discussion of the main aspects of the new proposals. It is arranged as follows -

Section 3 - A description of the present scheme of stock relief

Section 4 - Outline of the Government's proposals

Section 5 - The effects of inflation on stock holdings

Section 6 - Credit and other borrowings

Section 7 - Groups of companies

Section 8 - Unincorporated and smaller businesses

Section 9 - Transitional arrangements

Section 10 - Summary of proposals

SECTION 3 - THE PRESENT SCHEME OF STOCK RELIEF

Outline of the present stock relief

3.1 The present system allows relief to a business for the increase in the value of its trading stock over a period of account. No distinction is made between increases in the price of stocks and increases in the volume of stocks held; both qualify for the relief.

3.2 The amount of relief is restricted by a percentage of the businesses's profits.* This restriction was designed as a rough and ready means of excluding the effects of the normal annual average increase in stock volumes looking at the business sector as a whole. It was not intended to reflect changes in the volume of stocks held by any individual business, or indeed by the business sector as a whole in any individual year. The percentage ("profit restriction") is 15 per cent for companies and 10 per cent for others.**

3.3 For companies the relief allowable is treated as a trading expense in arriving at the trading profit or loss of the business. A trading loss is available, under the normal rules, for set-off against other income, or for allowance as group relief. Where necessary, relief can be carried forward to be allowed against the profits of the trade in a later year.

3.5 For unincorporated businesses relief is given as a deduction in charging the profits of the business. There is provision for unused relief to create or augment a loss. Again, where necessary, unused relief can be carried forward and allowed against the profits of the trade in a later year.

3.5 For periods of account ending in or after 1979/80 a business may elect to claim part rather than the whole of the relief to which it is entitled.

Clawback

3.6 Where there is a decrease in stock value over a period of account, there is in principle a recovery ("clawback") of relief previously claimed. This is subject to the recently introduced provisions for write off (3.11 below) and for the deferral of recovery charges (the "dips" scheme) (3.9 below).

3.7 Where a business ceases, the whole of any outstanding past relief is recovered by a charge.

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* After deducting capital allowances.

**See paragraph 8.2 below.

3.8 Special provisions apply to prevent a "clawback" where there is a change in the persons carrying on the trade but the trade itself continues - for example, on a company reconstruction or a partnership change.

Deferral of clawback ("dips" relief)

3.9 The 1980 Finance Act provides that, in certain circumstances, part* of any recovery charge can be deferred. This arrangement applies only to "temporary dips" in stocks (so that a recovery charge cannot be deferred when stocks have already fallen in the previous year). The arrangement is limited to one year's deferral of the charge to tax; it affects the timing, but not the amount, of the tax payable.

3.10 Where the charge to be deferred exceeds £100,000, the deferral is subject to a further restriction, to the extent that the business may be in net receipt of trade credit.

Write-off

3.11 Provision was made in the Finance (No 2) Act 1979 to write off relief for the first 2 years of the scheme (normally for periods of account ending in 1973/74 and 1974/75) so that it cannot be subject to "clawback". Subsequent years' relief will be similarly excluded and will not be recoverable in any period of account ending more than 6 years after the period to which it relates.

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*The amount to be deferred is limited to the excess over 5 per cent of opening stocks.

SECTION 4 - OUTLINE OF THE NEW PROPOSALS

Outline

4.1 The new scheme of stock relief the Government propose will provide for relief to be related much more directly to the effect of price changes.

4.2 The main differences between the new proposals and the existing scheme are:

a. Relief will be given, not by reference to increases (or decreases) in the value of stock, but by reference to the effect of price rises on stockholdings, irrespective of whether they are increasing or decreasing in value.

b. The relief will be given by reference to a measure of inflation as it affects stocks.

c. There will be no profit restriction.

d. "Clawback" will disappear save in exceptional circumstances, eg where a business is discontinued or there is a permanent and substantial reduction in the level of trading.

e. Relief will be restricted to the extent that stock is financed by borrowing where stocks exceed £m1.

Summary

4.3 The main features of the new scheme are discussed in the immediately following sections of this consultative paper. They are:

a. Relief will be given by reference to the value of stocks at the beginning of a business's period of accounts ("opening stocks"), subject to a de minimis threshold of £2,000. (Section 5)

b. The measure of relief will be by reference to movements in an index, prepared by the Government Statistical Service, of the movements in the prices of business stocks (the "all stocks" index). (Section 5)

c. Relief will not be withdrawn except where a business ceases, or when (for other than temporary reasons) total stocks are reduced and held at a level which may come close to or indeed be tantamount to cessation. (Section 5)

d. Relief will be restricted to the extent that stocks may be regarded as financed by credit or other borrowings (the "credit restriction"). This will be based on a ratio of total borrowings to total assets, directly derived from the business's balance sheet. This restriction will only apply where the value of stocks exceeds £m1. (Section 6)

e. Where a company is a member of a group, the credit restriction will be on a group basis; but the arrangements will be designed so far as possible not to disturb the present well-tried arrangements for settling company tax matters generally between the individual company and the local Inspector who normally deals with its affairs. (Section 7)

f. The arrangements for unincorporated businesses will broadly follow those for companies. (Section 8)

g. In general the new scheme will be applied to periods of account straddling or ending on 14 November. But the credit restriction will take effect only from periods of account commencing on or <u>after</u> 14 November. There will be transitional arrangements for businesses which would otherwise lose substantial amounts of relief in respect of increases in stock values which took place before 14 November. (Section 9)

4.4 Examples illustrating the operation of these proposals are given in Appendix 3.

SECTION 5 - THE EFFECTS OF INFLATION ON STOCKS

General

5.1 The present scheme broadly gives tax relief for increases in the value of stock held, and imposes a charge to tax when the value of stock held falls. The proposed new scheme is designed to reflect more directly the actual effect of price inflation on the cost of holding stock.

The basis for relief

5.2 In theory, the right way to provide inflation relief for stock might be to identify the effect of price changes on each individual item of stock between the moment it is bought and the moment it is sold.

5.3 For tax purposes that would in practical terms be impossible. It is of the essence of taxation rules that they should be capable of being applied, reasonably simply and cheaply, by businesses of all sizes, companies and unincorporated businesses alike. In this respect there is a clear distinction between taxation and accountancy practice. Accountancy practice can be tailored to the needs of the individual business. Taxation rules cannot. For tax purposes therefore it is necessary to settle for some more workable approximation, treating stocks in the aggregate.

5.4 For practical purposes, the choice appears to be between:

a. stocks measured at a single point in time - which would be taken at the beginning of the accounting year (opening stocks); or

b. an average figure for stocks during the year, in which case the simplest form would be an average of opening and closing stocks, but it could in principle be the average of quarterly, monthly or even more frequent figures.

The difference between the various systems is largely one of degree (of approximation), and to some extent of timing.

- Opening stocks

5.5 This is obviously the simplest and the most easily understood basis. The main argument against it is that it would tend to give an unrepresentative picture of stock levels in a particular year when stock levels are falling or rising.

- Average stocks

5.6 A relief based on an average would tend to give more representative figures when stock volume are changing over the year. But the advantage should not perhaps be overstated. Thus:

a. A relief based on the simple average of opening and closing stocks may not necessarily be much, if any, more accurate than a relief based on opening stocks alone, when there is an uneven rate of change or indeed there are large fluctuations within the year. (To deal with this, one would need to go to the - administratively very onerous - schemes which require stocks to be valued at quarterly, monthly or even more frequent rests.)

b. Any relief based merely on average stocks may not give an accurate result, when the rate of price increase itself is not constant.

- Practical aspects

5.7 A relief based on opening stocks would be simpler and quicker to operate.

5.8 In part, this is because an averaging approach is intrinsically more complex, as well as requiring more arithmetical steps in the computation.

5.9 A further possible advantage of basing the relief on opening stocks, is that figures for the base would be available with effect from the close of the previous accounting period. This could be particularly helpful to businesses in assessing their possible tax liabilities and administratively in operating the relief for groups of companies (see Section 7 below).

- New businesses

5.10 The use of opening stocks for the calculation of relief for the first year of a new business would in many cases be inappropriate. A simple average of opening and closing stocks could also be unsatisfactory, particularly where the business started with little or no stocks but quickly built up to its normal trading level after the first few weeks. The Government have reached no conclusion on how the relief might be calculated for new businesses but subject to views expressed in representations, they believe that the answer might be to adopt a notional value of opening stocks which would reflect, so far as possible, the normal level of stockholding through the first year.

- Conclusion

5.11 There is no single method which is both administratively practicable, and also capable of yielding an unambiguously correct measure of the effects of price changes in all situations.* In each case, it is a question of degree - on the one hand of approximation of measurement, on the other hand of complexity and subjectivity. The system used for tax purposes must be capable of being worked in practice by

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*cf The guidance Notes on SSAP 16: Current Cost Accounting, paragraph 73; published by the Accounting Standards Committee, 1980.

businesses of all types and sizes, including not only the half million active companies within the charge to corporation tax but also the 2 million or so self-employed within the charge to Schedule D income tax. The Government believe that these considerations point to a system which is as simple and easy to operate as possible. They propose therefore that, except in the case of new businesses, the relief should be based on opening stocks.

The measure of inflation

5.12 Having considered the stock figures to be used for calculating the relief, the next question is how the change in prices is to be measured. There are 3 main options:

a. Adopting for tax whatever measure of price changes individual businesses themselves use for the cost of sale adjustment (COSA), where they provide current cost accounts in accordance with the principles of SSAP 16.

b. Adopting the 90-odd official indices measuring changes in the price of stocks for particular industries which have been prepared by official sources for use by businesses for the purposes of current cost accounting (the PINCCA indices);* these would be supplemented by a general index for those industries where specific indices are not available.

c. Using a single index, measuring the general rate of inflation affecting stocks.**

- Adopting whatever figures individual companies use for purposes of current cost accounting

5.13 The general approach in SSAP 16 is to give businesses a wide measure of discretion to adopt whatever measure of price changes appears to be appropriate in their particular circumstances. Thus, they may use one or more of the official indices, or an index published by non-Government sources; they may construct their own internal index; or they may use the actual replacement cost of particular items of stock.

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* Price Index Numbers for Current Cost Accounting: published by HMSO on behalf of the Government Statistical Service.

**The term 'inflation' is commonly used to express a number of different, if related, meanings. It is used here for convenience to mean the rate of price changes over the business sector as a whole, as they affect stocks.

5.14 This would not be a practical basis for tax relief. It would introduce an unacceptable degree of subjectivity into the calculation of tax.* The application of price measurements of this kind could not in practice be monitored by tax offices. And there is, finally, the difficulty that many businesses - perhaps, in the short-term, a majority by number - will not be preparing accounts on a current cost basis.**

5.15 For practical purposes, therefore, the choice is between:

a. the industry-specific indices prepared by official sources - substituting these, where necessary, for the particular price movements used by individual businesses in their current cost accounts, and

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* cf The recognition of the need for reasonable certainty in tax matters in a consultative document on accounting standards published by the Accountancy Bodies in 1978.

"It is helpful to distinguish between users [of company accounts] objectives which are:

- legally orientated, in which certainty of calculation is the main aim: and

- those needs which are orientated more towards economic factors in which judgment may be more important than certainty ...

Where ... tax is involved, the less subjectivity the better. Figures derived for these purposes must be capable of calculation without undue difficulty, and they must readily be verifiable by audit."

(Setting Accounting Standards: a consultative document issued by the Accounting Standards Committee, 1978; paragraphs 7.3 and 7.4)

**SSAP 16 does not apply to:

a. entities which do not have any class of share of loan capital listed on the Stock Exchange and satisfy at least 2 of the following 3 criteria:

i. they have a turnover of less than £m5 per annum

ii. their balance sheet total at the commencement of the relevant accounting period is less than £m2½, as shown in the historical cost accounts, and

iii. the average number of their employees in the United Kingdom is less than 250

or to certain other specialised institutions. The Accounting Standard Committee has issued guidance notes for small and medium-sized businesses "CCA the easy way"; but for other businesses CCA is optional, not mandatory.

b. a single index, measuring the general rate of inflation affecting stocks.

- General considerations

5.16 The cost of sales adjustment (COSA) in SSAP 16 is the difference between the value to the business and the historical cost of the stock consumed in the period. It is of the essence of this approach that each individual business should have regard to the particular price changes which it itself has experienced. Thus, for example, when a manufacturing business decides a price at which it will sell its products, and the amount of its profits which it will reinvest in the business or distribute as dividends, it will have regard to the replacement cost of the materials used - rather than to a generalised index.

5.17 Nevertheless it is well established that the requirements of the tax system and of accountancy practice do differ in important respects. In a period of rising prices, most price increases reflect no more than the fall in the value of money. But other price increases reflect increases in stock value. Thus in the past decade, after allowing for inflation, the real price of oil has increased many times. The same is true of precious metals and products incorporating them; and in other areas as well. It is not self-evident that profits due to real price increases of this kind should be exempted from tax.

- Practical aspects

5.18 The practical aspects are also necessarily important, for a scheme that must be applied, in a consistent way, by up to 2½ million incorporated and unincorporated businesses.

5.19 First, it must necessarily be more complex to operate a scheme of relief employing 90 or so separate industry-specific indices, than a scheme employing a single index. The former approach would require each business to identify which index was appropriate to its particular line of operations; and in some cases a business might need to apply different indices to different categories of stock. This task would naturally be most onerous during the initial setting up of the new scheme - and in particular for less sophisticated businesses that would not necessarily be conversant with PINCCA and the rules for choosing an individual index out of the 90-odd indices available to them. Thereafter, rules would also be needed to determine the circumstances in which a business could change from one index to another. All these matters would provide areas of doubt and dispute.

5.20 There are some industries for which it has not been possible to construct any industry-specific index. For these industries, there is no escape from adopting a general index.

5.21 Second, the use of a single index could have advantages, in handling 2 particular problems which could otherwise pose practical problems:

a. Dealing profits: A business buys (say) copper, anticipating a rise in the market price, and subsequently sells that copper at a profit. It would be indefensible to apply for tax purposes the current cost index for copper to a transaction of that kind, and say that the business had made no "real" or taxable profit. This is recognised in the Statement of Standard Accountancy Practice.* In practice, however, it would often be very difficult, if not impossible, for a tax office to segregate dealing and other activities within a single business, and apply different principles or indices to each. By contrast a single index would give relief only for the general rise in prices.

b. Price reductions: Even at a time of rapid general inflation - for example, even during 1975 - it is usual to find some individual prices falling. It is entirely consistent with the principle of CCA, that the accounts of a business should calculate a "real" profit, by comparing current selling prices of stocks with the current (lower) replacement costs, even where current replacement costs are lower than historical cost. It is conceivable that this could result in a CCA profit being shown even though in historical cost terms an actual loss has resulted from the transaction. However, it is not altogether easy to see how these principles could be interpreted for the practical purposes of tax administration. A business which is having to sell stocks at less than their original purchase price, at a time when prices generally are rising rapidly, might perhaps find some difficulty in generating cash flow to pay a tax bill based on the assumption that in CCA terms it is making a "real" profit.

- Conclusion

5.22 The Government believe that the general arguments in paragraph 5.17 above and the more practical arguments in paragraphs 5.18 to 5.21 - including, in particular, the practical constraints that are inevitably involved in setting up a new scheme of this kind - point conclusively towards the use of a single index for the purposes of the new scheme to be introduced in the 1981 Finance Bill.

Choice of index

5.23 The Government do not believe that the retail price index would be a relevant or appropriate measure of inflation for the purposes of the new relief. The GDP deflator is a broader measure of inflation, but is ruled out for practical purposes by the fact that it is not available quickly and is subject to frequent revision.

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*Guidance notes on SSAP 16: Current Cost Accounting, paragraphs 78 and 79.

5.24 The Government propose to use a general index, measuring movements in the prices of business stocks, which has been prepared for this purpose by the Government Statistical Service. This is essentially derived from the PINCCA series. Further details are given in Appendix 1.

Claims for relief in respect of small holdings of stocks

5.25 One effect of the profit restriction in the present scheme of stock relief is to exclude many claims where the amount of stock at question is small in relation to the total size of the business.

5.26 At present some 300,000 companies can be entitled to stock relief. The existence of the profit restriction, coupled with the fact that in any year some companies' stocks decline in value, reduces the number who can actually claim to 200,000. With the disappearance of the restriction and the granting of relief even where stock values fall, it is necessary to incorporate some alternative test which would exclude those cases where the tax involved is relatively small. It is therefore proposed that there should be a threshold to the scheme of £2,000 of stock: where stocks exceed £2,000 relief will be given on the excess. Despite this threshold some 250,000 companies will qualify for relief compared with the present figure of about 200,000. For the self-employed, where the numbers are much greater, the substitution of the proposed threshold of £2,000 for the profit restriction will again entitle substantially more cases to relief than at present and will be proportionately more generous.

Clawback

5.27 Relief under the new scheme will be calculated on the total stock held at the beginning of the year. It will not be related to changes in the level of stocks during the year and consequently will be available whether stocks increase or decrease.

5.28 It follows that, for the normal continuing business* there will be no question of a charge to tax by way of clawback** as a result of any fall in stock levels.

5.29 However, the considerations which apply to "the maintenance of the net operating assets and thus the operating capability of the business"*** are not relevant when a business ceases, and its assets become available for distribution. Moreover, the distribution to the proprietors of a tax-free investment reserve, in circumstances of that kind, would raise

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* SSAP 16 emphasises that CCA is based on the normal "fundamental accounting concepts", including in particular the concept that the accounts of a business should be prepared on the assumption that it is a "going concern" SSAP 16, paragraph 30.

** See paragraphs 1.1 and 2.5 above.

***Guidance Notes on SSAP 16, paragraph 8.

questions of equity, as between the business proprietor and other individuals who, in the absence of any general adjustment for the effects of inflation in the tax system, cannot claim any special fiscal relief, allowing them to maintain out of their pre-tax income the real value of their capital. This problem of equity would be most obvious in the case of the short-term trading adventure, undertaken largely in the hope of capital gain, and maturing within one or two years.

5.30 The Government believe therefore that there should remain provisions for the clawback of past relief in the special situation in which a business ceases; and for practical reasons, the same rules would apply where a business which is not actually wound up falls to a very low level.

5.31 The Government propose therefore that there should be a charge to recover relief where and to the extent that the value of the closing stock of a period falls below the total relief given for that and previous periods. Relief previously recovered will be excluded from the total for this purpose, as will amounts written off (on an extension of the existing scheme which provides for write off of relief after a 6 year period where not recovered in the interim). On a cessation, the whole of the outstanding relief will be recovered. On a substantial reduction in business activity the recovery will be limited to the excess of outstanding relief over the value of the closing stock.

5.32 To ensure that a genuinely continuing business is not at risk from this residual form of clawback, merely by the fact that it experiences a very sharp fall in stock levels at a particular point in time as a result of vicissitudes of trade, there will be no recovery charge if the Inspector - or on appeal the Appeal Commissioners - are satisfied that, despite the fall in stock, there has been no permanent reduction in the scale of operations.

Cancellation of Unused Relief

5.33 To prevent a continued build-up of significant amounts of unused relief, with its implications for the future yield of tax, the Government propose to limit the carryforward of unused losses attributable to stock relief. At the six year point, when the balance of any unrecovered relief is being written off, any unused stock relief for the same period of account will be cancelled and will thus no longer be available for relief against future profits.

Periods of account shorter or longer than 12 months

5.34 For periods of account of less than 12 months, the new relief will be allowed by reference to the change in index over the relevant period. And the same basic rule will apply where the period of account exceeds 12 months, subject however to special rules for the period beyond the 12 months point.

SECTION 6 - THE CREDIT RESTRICTION

Outline

6.1 The Government propose that the new stock relief should be abated to take account of the extent to which stocks are financed by trade credit or other borrowing.*

General considerations

6.2 The new stock relief is intended to adjust the taxation of business profits so that it takes more direct account of the cost of replacing stock at a time of inflation. The Government believe that, for two reasons, this approach requires relief to be reduced where stocks are financed by trade credit or other borrowings.

6.3 First, to the extent that a business finances its stocks by trade credit or some other form of borrowing it does not itself directly bear the effects of inflation on the value of those stocks. On the contrary, it benefits from the falling real burden of its debt.

6.4 Second, there is an important link between the tax treatment of the effects of inflation on stocks (and other assets) and on interest. Under present tax rules, a business is allowed a deduction for the full cost of its interest payments, including not only the element which might be said to represent a "real" rate of interest, but also the excess which is attributable to inflation. It would be quite wrong in principle to allow the full amount of all interest as a deduction for corporation tax purposes while at the same time giving relief for the effects of inflation on stocks without any adjustment for credit or other borrowings. To do so would be to give relief twice for what in effect was the same inflationary cost.**

6.5 This link between the effects of inflation on stocks (and other assets), on borrowings and on interest is recognised in the provisions in SSAP 16 for a monetary working capital adjustment (MWCA) and a gearing adjustment.

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* This term will be used throughout the rest of this Section to include all forms of borrowing, trade and other credit obtained, bills, overdrafts, normal loans and debentures whether short or long-term and provisions to the extent that they represent estimates of known liabilities. It excludes ordinary and preference capital, deferred tax and other provisions and reserves and proposed dividends. The treatment of leasing will require special consideration.

**Broadly the same principle applies, where the interest costs are effectively reflected in the price of goods obtained on extended credit.

Form of the credit restriction

- General

6.6 The credit restriction needs to meet the following criteria:

a. It should be effective in restricting the amount of relief where stocks are wholly or partly financed by borrowing.

b. It should be certain and offer no tax advantage to a business switching from one form of borrowing to another.

c. It should be objective and therefore in a form which can readily be monitored.

d. It should, so far as possible, be simple and straightforward in order to keep the administrative costs of the scheme, for the Revenue and business alike, to the necessary minimum.

- The approach in SSAP 16

6.7 The inflation adjustment in SSAP 16 in respect of monetary liabilities is in two parts:

a. The monetary working capital adjustment (MWCA) This, in particular, operates to reduce the cost of sales adjustment in respect of stock where, broadly speaking, the business is a net recipient of trade credit. The adjustment also takes account of bank balances, cash holdings and overdrafts to the extent that these are used to finance stock and trade debtors. In other words, the effect of the MWCA is broadly to limit the inflation adjustment for stocks to the amount by which the value of stocks exceeds net trade credit received plus other net borrowings included in working capital.*

b. The gearing adjustment This further reduces all the CCA adjustments (including the COSA) by the ratio that all other net borrowings of the business, ie excluding those included in the MWCA, bear to the total net operating assets.

6.8 The approach adopted in SSAP 16 leaves businesses with a wide measure of discretion to allocate borrowings between the two monetary adjustments, in whatever form they consider appropriate to their particular circumstances. For tax purposes, however, the Government believe that a basis of this kind would be unacceptably subjective. For example, there is no objective basis on which a tax system can distinguish whether part or all of a bank overdraft is being used to finance stocks, or to finance some other asset or operation.

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*See also paragraph 6.19 below.

6.9 Even where a particular tranche of borrowings is formally linked with a particular object of expenditure - goods bought on credit, or property bought on a mortgage - the result may be, on a broader view, to release internal funds for other business purposes which otherwise would have had to be financed from bank overdraft or other general purpose borrowings. Thus any attempt to hypothecate particular items of finance to particular items of expenditure tends to be not only subjective but, in the last resort, very often artificial.

6.10 To draw a distinction of this kind between different forms of borrowing would inevitably create a fiscal incentive for businesses to channel their finances away from the less favoured form of borrowing towards the more favoured form. For example, if one sought to distinguish between the tax treatment of trade credit and bank overdraft, businesses would have an incentive either to pay off their trade creditors and increase their borrowings from the banks or (at least) to interpose a financial intermediary between themselves and their trade suppliers. In the result, not only would a credit restriction itself be ineffective, but the consequent disturbance in the normal patterns of business financing would create serious new problems of monetary management.

- The Government's proposals

6.11 The Government believe that for tax purposes the right approach is one which avoids any attempt to hypothecate particular sources of finance to particular items of expenditure. They therefore propose that for the purpose of the credit restriction total borrowings as defined should be pro-rated as between stocks and other assets. The restriction could therefore be expressed as:

$$B \times \frac{S}{A}$$

Where:

B = borrowings as defined in the footnote to paragraph 6.1 above
S = stocks
A = total assets of the business. These would generally be derived directly from the appropriate balance sheet of the business, after such adjustments as might be necessary to bring that total into line with a standard presentation. In a normal case where current cost balance sheet figures are available, these will be taken.

6.12 The credit restriction would thus proceed on the basis that the total assets of the business are financed, pro rata, from a general pool of borrowings. The Government see this as an essentially neutral approach which, whilst making no attempt to relate particular borrowings to particular assets for which they were, or were claimed to have been, incurred, provides no artificial incentive for businesses to route their finance through one channel, rather than through another.

- Practical aspects and implications for smaller businesses

6.13 The Government have framed their proposals in paragraph 6.11 above with the intention of reducing to a necessary minimum the administrative effort and cost which will be involved in operating the credit restriction, both for businesses and for the Revenue. The credit restriction will so far as possible be based on information already available in businesses' balance sheets, with a necessary minimum of special adaptation and avoiding, so far as possible, special rules for setting particular liabilities off against particular assets.

6.14 No form of credit restriction can be simple or easy to operate. The Government are concerned to reduce the administrative burden on businesses, and in particular on smaller businesses. This points to applying the restriction only in those cases where the amount of tax at issue is significant.

6.15 The Government therefore propose to apply the credit restriction only to those businesses in which the value of trading stocks exceeds a reasonably high threshold. For this purpose, the threshold might in the first instance be set at a figure of stocks of not less than £m1. The figure would need to be reviewed periodically in the light of changes in the general price level.

6.16 On this basis, the detailed rule might be that, where stocks qualifying for relief* exceed £m1, relief will be given on the value of qualifying stock as reduced by the credit restriction, or on £m1, whichever is the greater. Thus there will be no restriction of relief for smaller businesses; in the largest cases, however, the credit restriction will apply to the total value of qualifying stocks, except that relief will always be due on a minimum figure of £m1 where stocks exceed that level.

6.17 It is estimated that the threshold of £m1 will exclude virtually all unincorporated businesses from the scope of the credit restriction - with the possible exception of a few of the largest partnerships. It will also exclude a high proportion of all companies, whilst still retaining the effect of the restriction for something of the order of 90 per cent of the total amount of stock relief.

Groups of companies

6.18 Special provisions will be necessary in applying the credit restriction to companies within groups and this and the application of the scheme generally to such companies is considered in more detail in Section 7.

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*That is, the amount in excess of the "de minimis" threshold of £2,000 - see paragraph 5.26 above.

Net monetary assets

6.19 This paper does not discuss the possibility of providing a tax relief for businesses in respect of net trade debtors or for the clearing banks and other institutions holding net monetary assets. This issue raises major questions of principle and falls more properly to be considered in the wider-ranging Green Paper referred to in paragraph 2.7 above.

SECTION 7 - THE TREATMENT OF COMPANIES IN GROUPS

<u>Outline</u>

7.1 Special provisions will be necessary to determine a company's entitlement to stock relief where it is a member of a group. In particular (see 7.8 below) the credit restriction will need to be calculated by reference to the circumstances of the group as a whole.

7.2 The provisions will be designed so far as possible not to disturb the existing well-tried arrangements under which corporation tax on company profits (other than for the purposes of the new stock relief) is assessed and paid at the individual company level.

<u>Relief in respect of stock holdings</u>

7.3 It is the stocks held by each company within a group which will attract stock relief. The amount of the relief will however be subject to the operation of the credit restriction which can be determined only by reference to the group as a whole. The Government propose that, where a company is a member of a group, title to the new stock relief should formally depend on the claim being made by one company, normally the parent in a United Kingdom group, on behalf of the group as a whole. This company will formally be responsible for identifying itself and all members of its group to the local Inspector of Taxes who normally deals with its affairs, and for providing any necessary information about the total stock holdings and borrowings etc of the group.

7.4 In practice, the great majority of company groups will have total stock values of less than £m1, and will not therefore be affected by the credit restriction. In these cases it will be possible to arrange that the computations for the individual member companies should proceed independently. Thus the relief will be calculated by reference to the value of each individual company's stocks in excess of £2,000 at the beginning of the relevant period of account. Consequently, the full basic relief will be allowed and the corporation tax liability for the individual company will be settled in much the same way as at present.

7.5 In other cases - where the total value of the stocks held by the group exceeds £m1 - calculation of the net amount of relief will not be possible until the credit restriction and any other adjustments have been agreed by the Inspector dealing with the top or holding company of the group. In other respects, however, any questions relating to the relief will be dealt with directly between the individual company and the local Inspector.

7.6 Where there are inter-company sales, relief will be given by reference to the value of the stocks in the balance sheets of the individual companies, not by reference to the lower value shown in the consolidated balance sheet of the group (which will as a rule exclude the profit element in inter-company sales).

7.7 The arrangements will involve close liaison between those handling the affairs of the top or holding company and of the other members of the group. What will be required for a particular group will depend on its own circumstances. The objective will be to simplify procedures so far as possible.

The credit restriction

7.8 It is proposed that the credit restriction should be applied by reference to the borrowings of the group as a whole. This accords with the realities of a situation in which groups of companies commonly arrange their financing on a group basis - sometimes arranging for one company within the group to act as "banker" for other member companies. Any other approach would leave scope for avoidance of the credit restriction within groups of companies.

7.9 This approach is consistent with the general principle in SSAP 16 that current cost accounts should be prepared on a group basis and that the gearing adjustemnt should normally be calculated on this basis "in order to avoid anomalies which could occur where the pattern of inter-company financing does not mirror the external group financing arrangements".*

7.10 Once the credit restriction has been determined at the group level, it will then be applied to the stockholdings of the individual companies and in their tax computations.

Definition of the group

7.11 For the purposes of the new relief it will be necessary to bring within the group all subsidiary companies over which the parent exercises effective control, directly or indirectly. It is proposed therefore that the group should comprise all resident companies in which a top or holding company resident in the United Kingdom either owns more than 50 per cent of the shares or has voting control whether or not they hold stocks and whether or not they are trading companies. A group of United Kingdom companies with a non-resident parent will also be treated as a group for this purpose.

7.12 Special rules will be necessary to deal with overlapping groups. For example: company A owns 33 per cent of company B and 33 per cent of company C. Company B owns 60 per cent of company C: The groups could be AC and BC but not AB. There will need to be a rule to determine to which group company C should be attached.

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*Guidance Notes on SSAP 16: paragraph 142.

Companies joining and leaving groups

7.13 The basic rule will be that the group's credit restriction will be calculated by reference to circumstances at the beginning of the top or holding company's period of account and will not be altered by companies joining or leaving the group during the course of that period. This will mean that:

a. An "incoming" company will retain any entitlement to stock relief which it previously enjoyed, up to the beginning of the new group's next period of account. Where that date is less than 12 months from the beginning of the subsidiary's last period of account, then the subsidiary's stock relief will be calculated by the increase in the index over that shorter period.

b. The new group's credit restriction will not be recalculated until the beginning of its next period of account.

A subsidiary will normally have the same period of account as its parent; but rules may be needed to take care of the case where accounting periods do not coincide.

7.14 By the same token, where a company leaves a group, or is dissolved, after the beginning of the group's period of account, it will, for the accounting period then current, have a title to stock relief based on its own stock holding at the beginning of that period and the group's credit restriction as established at that time. The departure of the company will have no effect on the relief available to the other group members for the accounting period and the departing company will carry with it its established title for the period then current. The basis for the calculation of the relief will in general be the increase in the index from the commencement of the company's period of account until it ceases trading or starts a new period of account. Special arrangements may be required in cases where the accounting periods exceed 12 months.

Reconstructions

7.15 The general principles in the previous paragraphs will be followed where the whole or part of a trade is transferred on the reconstruction of the group. Relief will again be calculated on a time basis by reference to the growth in index over the relevant periods of account, and apportionments made where necessary.

New businesses in groups

7.16 The treatment of new businesses formed (as distinct from acquired) during the course of the parent company's period of account presents a special problem. To allow relief as for new businesses generally (paragraph 5.10) could provide scope for manipulation of stocks within the group. One approach might be to provide that the stocks held by the new business would qualify for relief only from the beginning of the group's next

period of account - leaving it to the group to decide whether it should start a new period of account at the time when the new business started. If this were not felt to be acceptable and it were considered that relief should be given on the same basis as for other new businesses, then it would be necessary to provide that relief should only be available if the stocks held by the new business were not matched by a fall in the value of stocks of other member companies. Where necessary, the group would need to provide details of stock levels in the companies throughout the group before and after the commencement of the new business.

7.17 If relief were to be given to the new business, the credit restriction to be applied would be that for the group as a whole at the beginning of the period of account in which the new business was set up.

Overseas companies

7.18 In many cases the consolidated balance sheet of a group will include entries in respect of overseas subsidiaries.

7.19 One approach might nevertheless be to base the credit restriction on the consolidated balance sheet. This approach would require a definition of the group which included non-resident companies, although of course only the qualifying stocks of group companies resident in the United Kingdom would be eligible for relief. This would have the advantage that it would require a minimum adaptation of the consolidated balance sheet for the purposes of the new relief.

7.20 The alternative approach would be to base the credit restriction on the assets and liabilities of the group as defined in paragraph 7.11 for the main stock relief provisions. However, it would require the group to compile a special consolidated balance sheet consistent with its published balance sheet but limited to the United Kingdom elements in the group and thus counting credit and other borrowings obtained from the overseas subsidiary as United Kingdom group borrowing.

Anti-avoidance provisions

7.21 There will be a general rule to deny relief in circumstances where it appears that the group structure has been manipulated to avoid or minimise the credit restriction.

Interaction between the tax affairs of the group and the individual company

7.22 The claim for the new stock relief will be made at the group level. In some cases, it will not be possible to finalise the relief to be made available to an individual company until the accounts of the group as a whole have been agreed. The scheme of relief and credit restriction envisaged does however leave entitlement to turn on the group entity, its stock holdings and its credit ratio at the commencement of

the accounting period. The underlying computations required need not therefore be left until after the accounting period ends and it should often be possible to produce and agree such figures as are necessary at group level before the individual companies are ready to move on to their own computations.

7.23 These arrangements for the new relief will be separate from the arrangements for determining the tax liability of the individual company on its conventional profits. These will continue to be determined direct between the company itself and the Inspector of Taxes with which it normally deals. For example, there will be no question of delaying the computation of the individual company's profits, or delaying payment of the tax involved, where for one reason or another there is delay in establishing the stock relief available to the group as a whole or its allocation between the various member companies within the group.

7.24 However, where it is clear that relief will be due, Inspectors of Taxes will make allowance for stock relief on a provisional basis, in determining the tax liability of an individual company. Any balance will be given by way of repayment if it cannot be determined before the tax becomes due and payable.

SECTION 8 - UNINCORPORATED AND SMALLER BUSINESSES

8.1 The arrangements for unincorporated businesses will follow those for companies. Relief will be computed by applying the percentage change in the "all stocks" index to the value of opening stocks after deducting the first £2,000. In the very few cases where this figure exceeds £m1, a credit restriction will apply, on the same broad lines as for companies. As with the present scheme, relief will be given as a deduction in charging the profits of the trade. There will be no clawback of past relief where stock values fall, except in the case where a business ceases or is reduced to a very low level.

8.2 On balance the Government's proposals will tend to provide more generous relief for the small business sector. Although the £2,000 "threshold" will have a relatively greater effect on unincorporated businesses, this will be more than outweighed by the abolition of the present profit restriction, which has weighed heavily on many smaller businesses.* Small businesses will also be untouched by the credit restriction. And, like other businesses they will benefit from the absence of clawback when the book value of stocks falls; there are some indications that small businesses have been reluctant to claim stock relief because of fears that subsequent clawback charges might pose liquidity problems.

8.3 The amount of extra relief which the proposals will give the unincorporated sector will vary from year to year. The cost to the Exchequer of the present scheme of stock relief for unincorporated businesses has risen from some £m10 in 1975/76 to some £m125 in 1980/81. At present the new relief will be worth significantly more than that.

Partnerships

8.4 The same general rules will apply to partnerships as to other businesses. The credit restriction will be based on the partnership balance sheet, with loans from individual partners (but not their capital accounts) counting as borrowing.

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*The profit restriction tends to fall more heavily on unincorporated businesses than on companies. The former have stock relief restricted by a percentage of all their profits; the latter have relief restricted by a percentage of the company's profit after taking out the proprietors' remuneration. This effect is partly - but almost certainly not wholly - mitigated by the fact that the profit restriction is set at a lower percentage (10 per cent, compared with 15 per cent) for unincorporated businesses.

SECTION 9 - COMMENCEMENT AND TRANSITIONAL ARRANGEMENTS

Summary

9.1 It is proposed that the new scheme should take effect in 2 stages:

a. For periods of account straddling or ending on 14 November - the date of publication of this document - the new scheme should come into effect, giving relief for the effects of inflation on stocks, but without a credit restriction.

b. For periods of account beginning on or after 14 November, the new scheme will have full effect, including the credit restriction.

There will be special arrangements for businesses which would otherwise be substantially worse off during the transitional period.

General considerations

9.2 In present circumstances the new system will on the whole be more favourable to businesses than the existing scheme of stock relief. In particular, it will relieve from the threat of clawback many companies which have had to reduce stock levels in response to pressures on profits and liquidity. It will also distribute the relief more fairly and put an end to the unjustified advantage which certain businesses derive from the existing arrangements.

9.3 For all these reasons, the Government believe that the new scheme should be brought in from the earliest possible date.

9.4 There would also be a formidable avoidance problem if the relief were brought into effect from a future date. Thus it would provide scope for a business to build up the volume of its stocks after the date of publication of this document and claim stock relief under the old rules in respect of that volume increase, in the knowledge that there could be no "clawback" of that relief if it subsequently ran down its stock volumes to a more normal level. In theory, it would be possible to frustrate avoidance of this kind by providing for clawback to continue under broadly the existing rules in respect of any stock relief given under those rules. But that would not only be a formidable further complication of an already complex scheme; it would also frustrate one of the Government's main objectives in introducing the new scheme. Clearly it would be much better to ensure that the transitional arrangements themselves avoid giving opportunity for abuse.

The Government's proposals

9.5 A possible approach would be to divide all periods of account which straddled the date of publication of this paper. Under this approach, relief would be given under the existing scheme for periods up to the date of publication; and under the new scheme for periods after the date of publication. However, the Government believe that the special stock-taking which businesses would be required to undertake for the purposes of this approach would present an unacceptable administrative burden. It would also leave in place the threat of "clawback" in respect of all reductions in stock that have already taken place during periods of account now current.

9.6 Another possible approach would be to apportion (on a time basis) all periods of account straddling the date of publication of this document. This would avoid the need for a special stock taking, which would be required under the approach in paragraph 9.5 above. However, it would do little if anything to relieve the problem of "clawback" in respect of reductions in stocks during the current year. And it would also be open to the same avoidance arrangements as those described in paragraph 9.4 above.

9.7 It is therefore proposed that the new relief (other than for the purposes of the credit restriction) will be brought in for the whole of the periods of account straddling or ending on 14 November - the date when this consultative document is published. The credit restriction will take effect only for periods of account beginning on or after 14 November.

Periods of account over 12 months

9.8 There will be special arrangements when an accounting period straddling 14 November exceeds 12 months.

Increases in stocks before 14 November

9.9 In general, most businesses are likely to benefit from the new arrangements. However, there will be some businesses which could be worse off under the new scheme. These will include in particular businesses which have been restoring their depleted holdings of stocks following, for example, major disruption in supplies during 1979/80.

9.10 It is therefore proposed that there should be special transitional arrangements for periods of account straddling 14 November. Under these arrangements - and subject to the provisions in paragraph 9.12 below - businesses will be able to choose for periods of account straddling 14 November whichever is the more favourable of:

a. relief calculated under the new rules, or

b. relief based on the old rules, except that no account will be taken for this purpose of any increase in the value of stocks after the date of publication.

9.11 For the reasons already explained - paragraph 9.5 above - these arrangements will not require businesses wishing to benefit from them to provide a formal audited valuation of stocks at 14 November. Where a business has such figures, the Revenue will of course accept them. In other cases, the Revenue will accept reasonable estimates, supported where necessary by such documentary evidence as may be available, for instance records of purchases and sales.

9.12 To avoid placing on either businesses or tax offices a disproportionate administrative burden where the balance of advantage between the old and the new schemes may be no more than marginal, the Government propose that the option at paragraph 9.10 above should be available only where the amount of relief due under the old rules as modified in paragraph 9.10.b. would be at least 25 per cent more than the relief due under the new scheme. The additional relief available under the option would then be limited to the amount in excess of 25 per cent of the new relief.

SECTION 10 - CONCLUSION

Summary of Proposals

10.1 It is proposed that:-

a. the present system of stock relief should be replaced by one which is confined to the effects of inflation on stocks, broadly without regard to fluctuations in stock levels (paragraphs 5.2 to 5.11);

b. the relief should be calculated on the basis of stocks at the beginning of the period of account, subject to special provisions for new businesses (paragraphs 5.2 to 5.11);

c. relief should be given by reference to percentage movements in a single index over the period of account (paragraphs 5.12 to 5.22);

d. the index used should be the "all stocks" index (paragraphs 5.23 to 5.24);

e. the first £2,000 of stocks held by a business should not qualify for relief (paragraphs 5.25 to 5.26);

f. the present profit restriction should disappear (paragraph 4.2);

g. there should be no clawback of relief when stock values fall except in cases of cessation or near-cessation (paragraphs 5.27 to 5.32);

h. the new scheme should include a credit restriction under which total borrowings (as defined) would be pro-rated between stocks and other assets (paragraphs 6.1 to 6.12);

i. the credit restriction should apply only where stocks exceed £m1, when relief would be on the greater of £m1 or stocks as reduced by the credit restriction (paragraphs 6.13 to 6.17);

j. for groups, the relief, as reduced by the credit restriction should be computed by reference to the circumstances of the group rather than the individual company (paragraphs 7.1 to 7.24);

k. the new scheme should (except for the credit restriction) apply for periods of account ending on or after 14 November 1980 - the date of publication of this document (paragraphs 9.1 to 9.7);

l. the credit restriction should apply for periods of account starting on or after 14 November - the date of publication of this document (paragraphs 9.1 and 9.7).

m. there will be special rules to ensure that businesses are not substantially disadvantaged during the transitional period (paragraphs 9.9 to 9.12).

Comments

10.2 The Government invite comments on these proposals. They should be made in writing to the Secretary, Board of Inland Revenue, Room 69, New Wing, Somerset House, London WC2R 1LB, if possible by the end of December 1980.

10.3 Further copies of this document are available on application, in person or in writing, to the Public Enquiry Room, New Wing, Somerset House, Strand, London WC2R 1LB.

THE "ALL STOCKS" INDEX

1. The Department of Industry in collaboration with the Central Statistical Office and other Departments is developing an index to reflect the price changes in stocks (of materials and fuel, work in progress and finished goods) held by all corporate and unincorporated businesses. The index is a weighted average of price indices for stocks published in "Price Index Numbers for Current Cost Accounting" (PINCCA).

2. The figures for this "all stocks" index will be published month by month with the PINCCA figures in Business Monitor MM17, "Price Index Numbers for Current Cost Accounting (Monthly Supplement)". The monthly figures will be brought together in an annual PINCCA booklet. In addition the Inland Revenue propose to issue regular press notices giving the "all stocks" index numbers.

3. Work is still proceeding on constructing the index. Publication is expected to commence in the Spring of 1981 when figures for past months will be made available in an Inland Revenue press release to provide information relevant to periods of account straddling or ending on the date of publication of the present document. Thereafter updated figures will be published monthly, within some three months of the end of the month to which they relate.

4. For illustrative purposes, some provisional values of the index are given below showing the trends over the period December 1972-79. These are based on preliminary work undertaken by the Central Statistical Office and the Department of Industry and they are subject to revision when the definitive version of the index is available in the Spring.

Price Index for Stocks held by all Corporate and Unincorporated Businesses

Provisional series for December (Average 1975 = 100)

	1972	1973	1974	1975	1976	1977	1978	1979
	61.9	73.5	89.9	106.7	128.6	142.9	155.3	179.2
% increase on previous year		18.7	22.3	18.7	20.5	11.1	8.7	15.4

5. Provisional quarterly figures for [1979] and [1980] are as follows:-

1979 1980

INCIDENCE AND YIELD OF CORPORATION TAX: EFFECT OF THE GOVERNMENT'S PROPOSALS

A. YIELD AND DISTRIBUTION OF CORPORATION TAX

Yield and distribution of corporation tax

1. The yield of corporation tax is normally dependent, above all, on the development of company profits. It has in general recently been less buoyant than (in particular) income tax collected under PAYE; but it remains a very significant source of revenue - in 1980/81 the third largest after income tax itself and VAT.

TABLE 1

Corporation tax: receipts

	1974/75	1980/81 (estimated)
		£ billion
Mainstream corporation tax (MCT)*	1.7	3.1
Advance corporation tax (ACT)**	1.2***	1.8
Total	2.9	4.9

* net of all repayments
** gross of repayments
*** including ACT addition of £m0.4

2. Consistently over this period, the manufacturing sector of industry has made the biggest single contribution to corporation tax; the revenue from distribution and the financial sector has also been important:

TABLE 2

Percentage distribution of corporation tax receipts

	Average 1974/75 to 1979/80		
	MCT	ACT	Total
	%	%	%
Manufacturing	34	39	36
Distribution	19	15	17
Other home* industrial and commercial	18	9	15
Financial	24	33**	28
Other (including North Sea)	5	4	4
	100	100	100

* other than those trading mainly overseas
** including payments by holding companies of groups in respect of dividends earned by the group as a whole.

More detailed figures are given in the tables at the end of this Appendix.

Incidence of corporation tax

3. Figures of the absolute yield of corporation tax throw little light upon whether the tax is effective or appropriate, unless they can be related to the underlying level of business profits, on which the tax is levied.

4. There are several ways in which it is, in principle, possible to approach this question of the burden of tax in relation to the level of profits - that is, the effective rate of tax. None of them is exclusively right for all uses. Different concepts are appropriate for different purposes.

5. The available estimates are related to home industrial and commercial companies. They take two alternative measures of tax on these companies' income:-

i. the total yield of tax on company income,* and

ii. the yield after deducting payments of ACT (which serve to frank the tax credit payable to the shareholders) - predominantly 'mainstream' corporation tax.

and two alternative measures of profits (each of which is itself different from the definition of gross trading profits for tax purposes):

iii. historical cost profit, as conventionally measured in company accounts, and

iv. real profits after adjustment for the effects of inflation (for the purposes of this illustrative calculation, this has been taken to be profits attributable to the shareholder as calculated in accordance with the current cost accounting principles in SSAP 16).

6. There would be a significantly different result if the calculations were based on the total burden of corporation tax on the net profits of the corporate sector as a whole (net of losses by those companies that are making current losses), or if one looked at the effective rate of tax on the profits of those companies that are currently earning profits. The difference is likely to depend greatly on whether the comparison is made in terms of historical-cost or inflation-adjusted profits.

7. The estimates are tentative at present. Very broadly, however, they suggest that the effective rate of United Kingdom taxes on the income (net of losses) of the aggregate of home industrial and commercial companies excluding the North Sea has recently been of the order of a quarter on the basis of historical cost profits and of the order of two-thirds on the basis of inflation-adjusted profits. If ACT is excluded, these figures become very approximately a sixth and two-fifths respectively.

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* This is the accrual of United Kingdom taxes (including income tax borne on investment income but excluding tax on capital gains), with double taxation relief added back but otherwise excluding overseas tax.

8. These estimates suggest that the effective rate of UK tax on "real" profits after adjusting for inflation is slightly higher than the rate on taxable profits (allowing for the fact that the latter are not always high enough to set-off all ACT). The estimates are also broadly consistent with other estimates suggesting that the proportion of home industrial and commercial companies having taxable profits and the proportion having "real" profits have been of the same order - perhaps two-fifths.

Cost of present scheme of stock relief

9. Relief under the present scheme varies substantially from year to year, depending on the extent of stock building and de-stocking. For example, net relief for 1975 was less than £2 billion as, in real terms, industry de-stocked. While for 1979, with book values rising by 21 per cent, relief is expected to exceed £8 billion.

10. In practice, at a time when business profits have been under severe pressure, many individual businesses and indeed many groups of companies have not been able to make full use of all the tax allowances and reliefs available to them. In consequence, the marginal Exchequer cost of stock relief in terms of tax forgone* is much less than the total amounts quoted above multiplied by the marginal rates of tax (for example 52% for companies). The direct effect of stock relief on accruals of mainstream corporation tax has ranged from under £1 billion to £1.5 billion between 1973 and 1978, and is expected to be about £2 billion for 1979. In each case, the costs largely affect tax receipts in the following financial year.

11. The unused portion of the various allowances and reliefs - in amounts now approaching £5 billion a year - has gone to swell the amounts of tax losses which businesses cannot immediately use, but carry forward to set against profits which they may earn in a future year. The cumulative total of such losses is now estimated to be in the region of £30 billion, of which approximately one-third - still treating stock relief as the marginal relief - may be accounted for by stock relief.

12. It is estimated that the value of stock relief is distributed between the main industrial sectors broadly in the following proportions:

	%
Manufacturing	45
Distribution	25
Other HIC	20
Financial, property etc	10

B. EFFECT OF GOVERNMENT'S PROPOSALS ON THE YIELD AND INCIDENCE OF CORPORATION TAX

General

13. The Government's proposals are likely to affect the yield of tax on business profits in 2 main ways, as compared with the present scheme of stock relief.

14. First, the new scheme will:

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* derived as the difference between tax yields with and without stock relief

a. tend to provide more relief to the business sector (yield less tax for the Exchequer) when total stock values are increasing slowly, relative to the increase in prices; and this effect may be particularly sharply felt when the business sector is reducing stock values and would otherwise incur a charge to clawback under the present system;

and conversely

b. tend to provide less relief to the business sector (yield more tax) to the extent that businesses are increasing the volume of their holdings of stock;

in each case, subject to

c. the ending of the profit restriction which tends, naturally, to be most onerous when profits are highest. For the reasons already explained, this will be of particular benefit to unincorporated businesses.

15. It follows that the effect of the proposed changes on the total yield of corporation tax will vary significantly from year to year, depending on the underlying economic conditions. On balance, the new scheme does not seem likely to have the "pro-cyclical" effect of the present scheme which tends to give relief for net investment, and to charge tax on net disinvestment.

16. Second, the new scheme will tend to spread the available stock relief more widely, amongst more businesses (whereas by contrast, the "volume effect" and the profit restriction in the present scheme tend to concentrate the available relief into the hands of fewer businesses). It follows that, of any given amount of stock relief, a larger proportion is under the new scheme likely in practice to be effective in relieving tax currently payable by businesses, and is less likely to be carried forward to swell the total of unused losses.

<u>Effect of proposed changes</u>

17. An exercise has been undertaken to compare how the broad yield of corporation tax and income tax under Schedule D could have been affected, if the new scheme had been in force, rather than the existing scheme, for accounting periods ending in and after 1973-74. Any exercise of this kind must be subject to a very sizeable margin of error. In particular, businesses would in practice have behaved differently, if the tax regime had been different; and no attempt has been made to allow for such changes.*

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* The general approach adopted was to assume that the only change in the basic information in the corporation tax assessment for individual companies was that the existing form of stock relief was replaced by the new scheme. Levels of profits, capital allowances due, and non-trading income were unaltered, but other factors such as the use of group relief and losses brought forward were adjusted in line with expected utilisation under the new scheme. The mainstream corporation tax accrual under the new scheme was then estimated and compared with the accrual under the existing stock relief scheme. The exercise was based on a representative sample of some 5,000 companies to assess the aggregate effects on the corporate sector.

18. Subject to these important reservations, it is estimated that, over the period as a whole, the new scheme would on average have:

a. reduced the tax payable by businesses by substantially the same amounts as the present scheme, or perhaps slightly more; but also

b. produced a smaller contribution to the accumulated amount of unused reliefs and losses being carried forward at the end of accounting periods ending in 1979-80.

Within these broad generalisations there would have been significant fluctuations from year to year. The effect on individual businesses and sectors would also have varied.

Effect of change in present conditions

19. In present conditions, where many businesses have been reducing their stocks, the proposed changes will in general tend to increase the benefit of stock relief to the business sector, and correspondingly reduce the yield of corporation tax and Schedule D income tax to the Exchequer. The precise amounts of the net benefit to businesses - and indeed the underlying yield of corporation tax - will depend on the out-turn for business profits, which themselves are under pressure, and also on the speed with which inflation is reduced. On any likely basis, however, it is clear that both the additional amount of total relief, and the reduction in tax currently payable will be significant.

Effect on the distribution of tax

20. Estimates of the effects of the proposed change on the distribution of tax between the main industrial sectors are necessarily particularly tentative, and will for example be highly sensitive to any differences in stock building or profitability, as between the main sectors. It is estimated, however, that the effect of the proposed changes will probably be to increase the share of the total relief going to manufacturing industry from some 45% to perhaps 50%, and the share of other sectors, in particular distribution will consequently fall. It is emphasised again that these are broad generalisations, and there will be a wide dispersion of experience for individual businesses within each sector.

CORPORATION TAX RECEIPTS BY INDUSTRIAL SECTOR

£m

	1974/75	1975/76	1976/77	1977/78	1978/79	1979/80
Mainstream Corporation Tax (net of all repayments)						
Manufacturing	480	300	570	790	870	920
Distribution	400	260	330	320	440	430
Other Home Industrial and Commercial (HIC)	320	200	260	370	450	560
Total HIC	1,200	760	1,160	1,480	1,760	1,910
Financial	470	300	390	550	620	560
Overseas	20	20	20	30	30	30
North Sea	–	–	–	*	50	170
Public Corporations	10	*	20	30	60	50
All companies	1,700	1,080	1,590	2,090	2,520	2,720
Advance Corporation Tax ≠ (gross; including ACT Addition)**						
Manufacturing	440	350	400	460	610	720
Distribution	200	160	180	170	200	270
Other HIC	100	80	100	130	120	190
Total HIC	740	590	680	760	930	1,180
Financial***	370	300	340	440	440	680
Overseas	50	30	40	50	50	70
All companies	1,160	920	1,060	1,250	1,420	1,930
Total Corporation Tax						
Manufacturing	920	650	970	1,250	1,480	1,640
Distribution	600	420	510	490	640	700
Other HIC	420	280	360	500	570	750
Total HIC	1,940	1,350	1,840	2,240	2,690	3,090
Financial	840	600	730	990	1,060	1,240
Overseas	70	50	60	80	80	100
North Sea MCT	–	–	–	*	50	170
Public Corporations	10	*	20	30	60	50
All companies	2,860	2,000	2,650	3,340	3,940	4,650

* Less than £m5.

≠ ACT ultimately due in respect of distributions made by North Sea Companies are not distinguishable from payments by their parent companies. For the period covered, ACT payments on account of North Sea Companies' distributions can be assumed to be zero.

** This was an additional payment of 50 per cent of ACT imposed for the financial year 1974.

***Including payments by holding companies on behalf of groups' activities.
Estimates as at October 1980.

NUMBER OF COMPANIES PAYING CORPORATION TAX
(AS IN 1977)

	Companies paying:		All live companies
	Mainstream CT	ACT	
Manufacturing	50,000	8,000	120,000
Distribution	40,000	5,000	120,000
Other HIC	90,000	5,000	220,000
Total HIC	180,000	18,000	460,000
Financial	50,000	7,000	140,000
All Companies	230,000	25,000	600,000

Notes: 1. Figures are to nearest 10,000. There are also some 1,000 (out of 3,000) overseas companies and some 150 (out of 350) North Sea companies paying mainstream CT. In addition there are about 50 principal public corporations or groups of public corporations (eg Passenger Transport Executives), of which only a few pay mainstream CT.

2. "Other Home Industrial and Commercial Companies" comprises agriculture, forestry and fishing, mining, construction, water, transport and services.

Examples

1. In the examples which follow the provisional values of the All Stocks Index (see Appendix 1) for December 1976, 1977, 1978 and 1979 are taken as the opening and closing values for years 1, 2 and 3 respectively as follows -

	Opening Value	Closing Value
Year 1	128.6	142.9
Year 2	142.9	155.3
Year 3	155.3	179.2

2. The examples show what the measure of relief would be under -

a the existing provisions for stock relief in Section 37 and Schedule 5 FA 1976

(as amended by S.13 and Schedule 3 F(No 2)A 1979 and S.40 and Schedule 7 FA 1980); and

b the new scheme proposals.

Example 1

This example illustrates for a company -

(i) the computation of the basic relief; and

(ii) the elimination of the "profit restriction".

Company A, carrying on an established trade has the following (rounded to nearest £100).

Period of Account	Profit	Opening Stock Value	Closing Stock Value
		£	
Year 3	172,000	280,000	340,000

a. Existing Stock Relief Provisions

Computation

Year 3

		£
Profit		172,000
Stock Relief		
Closing Stock	£340,000	
Opening Stock	£280,000	
	£ 60,000	
- Profit restriction £172,000 x 15%	£ 25,800	
	£ 34,200	(34,200)
Trading income chargeable to corporation tax		137,800

b. New Scheme

Computation

Year 3

	£
Profit	172,000
Stock Relief (Opening stock - £2,000) x index growth (280,000 - £2,000) x $\frac{179.2 - 155.3}{155.3}$	(42,800)
Trading Income chargeable to corporation tax	129,200

Example 2

This example illustrates for an individual trader the computation of the basic relief.

Individual S, carrying on an established, continuing trade, has the following for year 1.

Profit arising in year 1 was £17,000.

Year 1 opening stock £30,000, closing stock £34,000.

Taking year 1 as the year to 31 December 1980 the assessment is -

a. Existing Stock Relief Provisions

Assessment for 1981/82

Profit of preceding year		£17,000
Stock relief		
Closing Stock	£34,000	
Opening Stock	£30,000	
Increase	£ 4,000	
- Profit restriction £17,000 x 10%	£ 1,700	
	£ 2,300	(£ 2,300)
Net Income		£14,700

b. New Scheme

Assessment for 1981/82

Profit of preceding year	£17,000
Stock relief (Opening stock - £2,000) x index growth	
$(£30,000 - £2,000) \times \frac{142.9 - 128.6}{128.6}$	£ 3,114
Net Income	£13,886

Example 3

This example illustrates for a company -

(i) the computation of the basic relief;

(ii) the elimination of "clawback" for the continuing business; and

(iii) the elimination of the "profit restriction".

Company B, carrying on an established, continuing trade, has the following for years 1, 2 and 3 (rounded to nearest £100).

£

Period of Account	Profit (Loss)	Opening Stock Value	Closing Stock Value
Year 1	(120,000)	400,000	350,000
Year 2	55,000	350,000	490,000
Year 3	220,000	490,000	530,000

There are no other income or gains.

Unrecovered past relief at the beginning of year 1 was £160,000, none of which is eligible for write-off in year 1, 2 or 3.

a. Existing Stock Relief Provisions

Computation		£
Year 1		
Profit (Loss)		(120,000)
Stock Relief		
Closing Stock	£350,000	
Opening Stock	£400,000	
Decrease	£ 50,000*	
Recovery in year 1 (5% opening stock)	£ 20,000	20,000
Defer to year 2	£ 30,000	
Trading Income	(Loss)	(100,000)
Chargeable to Corporation Tax		NIL
Loss carried forward		(100,000)
Unrecovered past relief £160,000 - £50,000		110,000

* There is an election for deferment under S.40 and Schedule 7 FA 1980.

Example 3 (continued)

		£	
Year 2			
Profit		55,000	
Recovery charge (deferred from year 1)		30,000	
Stock Relief			
Closing Stock	£490,000		
Opening Stock	£350,000		
	£140,000		
- Profit restriction £55,000 x 15%	£ 8,250	(131,750)	
Trading Income	(Loss)	(46,750)	
Chargeable to Corporation Tax		NIL	
Trading Losses £100,000 + £46,750		(146,750)	carried forward
Unrecovered past relief £110,000 + £131,750 =		241,750	
Year 3			
Profit		220,000	
Stock Relief			
Closing Stock	£530,000		
Opening Stock	£490,000		
Increase	£ 40,000		
- Profit Restriction = £220,000 x 15%	£ 33,000		
	£ 7,000	(7,000)	
Trading Income		213,000	
- Loss brought forward		(146,750)	
Chargeable to Corporation Tax		66,250	
Unrecovered Past Relief £241,750 + £7,000		248,750	

Example 3 (continued)

b. New Scheme

There is no credit restriction because the opening stock value in each period of account does not exceed [£m1].

Computation	£
Year 1	
Profit (Loss)	(120,000)
Stock Relief (Opening stock - £2,000) x index growth (£400,000 - £2,000) x $\frac{142.9 - 128.6}{128.6}$	(44,300)
Trading Income (Loss)	(164,300)
Chargeable to Corporation Tax	NIL
Loss carried forward	(164,300)
Unrecovered past relief £160,000 + £44,300	204,300
Year 2	
Profit	55,000
Stock Relief (Opening stock - £2,000) x index growth (£350,000 - £2,000) x $\frac{155.3 - 142.9}{142.9}$	(30,200)
Trading Income (Loss)	24,800
- Loss brought forward (£164,300)	(24,800)
Chargeable to Corporation Tax	NIL
Loss carried forward	(139,500)
Unrecovered past relief £204,300 + £30,200	234,500
Year 3	
Profit	220,000
Stock Relief (Opening stock - £2,000) x index growth (£490,000 - £2,000) x $\frac{179.2 - 155.3}{155.3}$	(75,100)
Trading Income (Loss)	144,900
- Loss brought forward (£139,500)	(139,500)
Chargeable to Corporation Tax	5,400
Loss carried forward	NIL
Unrecovered Past Relief £234,500 + £75,100	309,600

Example 4

This example illustrates the operation of the credit restriction.

Company C, carrying on an established, continuing trade and not a member of a group of companies, has the following for year 2 (rounded to nearest £100).

Period of Account	Profit (Loss)	Opening Stock Value	Closing Stock Value
			£
Year 2	6,000,000	20,000,000	22,000,000

a. Existing Stock Relief Provisions

Computation		£
Trading Profit		6 000,000
Stock Relief		
Closing Stock	£22,000,000	
Opening Stock	£20,000,000	
Increase	£ 2,000,000	
- Profit Restriction £6,000,000 x 15%	£ 900,000	
	£ 1,100,000	(1,100,000)
Trading Income (Loss) chargeable to corporation tax		4,900,000

b. New Scheme

As the opening stock value exceeds £m1 the credit restriction applies. The Balance Sheet at the end of year 1 is as follows -

Balance Sheet	£		£
Share capital	20,000,000	Fixed assets	34,000,000
Reserves	14,000,000	Investments	1,750,000
Loans (a)	22,000,000	Stock (b)	20,000,000
Creditors (a)	18,000,000	Debtors	19,000,000
Dividends proposed	1,000,000	Bank	250,000
	75,000,000		75,000,000

Notes (a) Loans £m22 and Creditors £m18 count as 'Borrowing' £m40.

(b) All stocks qualify for relief.

Example 4 (continued)

Computation

		£
Trading profit		6,000,000
Stock relief is the greater of		
a. £1,000,000 x index growth $= £1,000,000 \times \frac{155.3 - 142.9}{142.9}$	= £86,800	
OR		
b. [(Opening stock - £2,000) x index growth] $\times [1 - \frac{\text{"Borrowing"}}{\text{Total Assets}}]$ $= [£19,998,000 \times \frac{155.3 - 142.9}{142.9}] \times [1 - \frac{40,000,000}{75,000,000}]$	= £809,800	809,800
Trading Income chargeable to Corporation Tax		5,190,200

Example 5

This example illustrates, for a company, the operation of the "clawback" provision on the cessation of the company's business.

Company D has the same figures as Company B in Example 3 down to the end of year 1, but it ceases to trade in year 2. In the period to the date of cessation it has a loss of £35,000 (rounded to nearest £100).

a. Existing Stock Relief Provisions

Computation	£
Year 2	
Profit/(Loss)	(35,000)
Deferred Recovery Charge	30,000
"Clawback" on cessation	110,000*
Trading Income/(Loss)	105,000
Loss brought forward	(100,000)
Chargeable to Corporation Tax	5,000

* This is the whole of the unrecovered past relief at the beginning of year 2.

b. New Scheme

Computation	£
Year 2	
Profit (Loss)	(35,000)
"Clawback" on cessation	204,300*
Trading Income (Loss)	169,300
- Loss brought forward	(164,300)
Chargeable to Corporation Tax	5,000

* This is the whole of the unrecovered past relief at the beginning of year 2.

Example 6

This example illustrates the operation of the transitional provisions.

The new scheme of relief is to apply to periods of account straddling or ending on the date of publication of the consultative document, but there are provisions to ease the transition to the new scheme. For the purpose of this example the date of publication is taken to be 1 November 1980. Company D, carrying on an established, continuing trade, has the following All Stocks Index Values (assumed) for the year to 31 December 1980 -

Opening value	155.3
Closing value	179.2

Company D also has the following (rounded to nearest £100) -

Profit	Opening Stock Value	1 Nov 1980 Stock Value	£ Closing Stock Value
140,000	400,000	480,000	485,000

Year to 31.12.80

		£
Profit		140,000

Stock relief is the greater of:

(a) (Opening stock - £2,000) x index growth

$$(£400,000 - £2,000) \times \frac{179.2 - 155.3}{155.3} = (£61,300)$$

(b) Increase in stock value 1.1.80 - 1.11.80

Stock value 1.11.80	£480,000		
Stock value 1.1.80	£400,000		
	£ 80,000		
* - £140,000 x $\frac{10}{12}$ x 15%	£ 17,500		
	£ 62,500		
- £61,300 x 25%	£ 15,300		
		(£47,200)	
Therefore relief is due on (a)			(61,300)
Trading Income (Loss) chargeable to corporation tax			78,700

*Relevant income for the year apportioned to the period 1.1.80 to 1.11.80.

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Original on: Public Exp. Pt 11

cc Mr [illegible] Mr Hoskyns

Econ Pol.

10 DOWNING STREET

From the Private Secretary

7 November 1980

1981 Budget and Public Expenditure White Paper

The Chancellor minuted the Prime Minister yesterday on the above subject - too late for them to discuss it at their morning meeting.

The Prime Minister has now read the minute. She agrees that the Treasury should start planning for a Budget Day of Tuesday 10 March, and that the public expenditure White Paper should be published on Budget Day as it was this year. But she has suggested that it would be better if it could be issued on the morning of the Budget as the Economic Survey used to be, rather than at the end of the Budget speech.

The Prime Minister is not disposed to the idea of a delayed Budget debate unless the Opposition press for it.

A.J. Wiggins, Esq.,
HM Treasury.

Original on: Public Exp: Pt 11

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2. Prime Minister

This came in too late for your meeting this morning. You can discuss with the Chancellor next week along with the other time-table decisions.

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

PRIME MINISTER

1981 BUDGET AND PUBLIC EXPENDITURE WHITE PAPER

In my minute of 4 November I set out my thinking on the handling of policy announcements on public spending, monetary policy and so on over the next month or so. Before we meet on 6 November I thought you might like to know also of the timetable I have in mind for the 1981 Budget and publication of the public expenditure White Paper with details of our plans to 1983-84. Perhaps we can then have a word about this aspect at the same time as we discuss the handling of things over the next few weeks.

The White Paper

2. We need to present the spending figures for all programmes, not only for 1981-82 but for later years, in a medium term fiscal context, showing how they relate to our financial and monetary strategy. The best time to do this is with the 1981 Budget next spring - hence John Biffen's proposal in C(80)58, which I endorse, for publishing the public expenditure White Paper on Budget Day again next year. This year's simultaneous publication was of course welcomed by many outside commentators and by the Treasury Committee as helpful in giving a more

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coherent presentation of economic strategy. It proved too to be very much in line with one recommendation of the Armstrong Report, published subsequently.

3. I take this opportunity of mentioning that I am having further work done on the possibility of including in the White Paper itself some information in terms of planned or forecast cash spending, rather than just volume figures. I cannot be definite at this stage about how much progress we shall be able to make on that for the coming year, but I will keep you informed.

4. For the moment I should be grateful to know whether you would be content with publication of the White Paper at Budget time. I would propose to make clear our intentions on this in any announcement on 1981-82 spending generally, of the kind foreshadowed in my minute of 4 November.

5. There is one aspect of simultaneous publication of the White Paper and the Budget to which we may need to give further consideration. Mr. Callaghan remarked this year about the case for the House having the White Paper (and by implication the traditional Budget documents) 10 days or so "before the Budget". I do not think this request can be met in the terms in which it was put. But one possibility for going some way to give the House more time to consider the Budget proposals before debating them would be to release the documents and announce our proposals on the Tuesday, as is traditional practice, but to resume the Budget Debate not the next day but on the Monday of the following week. There would be some disadvantages in this - e.g. more time for the Opposition to marshal their

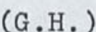
I doubt that the Opposition would like this - they wouldn't be able to mount a sustained attack quickly enough! MS

attack - but by the same token it would give us more time to influence the climate of opinion and on balance I think the idea worth considering further. But before I do - which would involve talking to Norman St. John Stevas and Michael Jopling - I should be grateful for any views you may have.

Date for 1981 Budget and White Paper

6. I have considered this in the light of last year's experience and I am asking my Departments to plan for the time being for a Budget Day of Tuesday 10 March. An early Budget has important revenue advantages - especially next year when we shall need all we can get. The earliest date we can manage is to be preferred if simultaneous publication of the White Paper is not to mean undue delay in telling the country (including suppliers to the public sector) of our detailed plans. (Departments will of course be able to do their own budgeting for 1981-82 as soon as programme figures are decided and without waiting for the White Paper.) 10 March will also enable us to get the Finance Bill second reading through before Easter.

7. Of course no final decision on the Budget date is needed until the New Year and it is best to hold options open until then in case unforeseen developments change the balance of advantages. But it would be helpful to know that you are content with a planning date of 10 March.



(G.H.)

6 November 1980

DEPARTMENT OF TRADE 1 VICTORIA STREET LONDON SW1H 0ET Telephone 01-215 7877

From the Secretary of State

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The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Treasury Chambers
Parliament Street
London, SW1P 3AG

5 November 1980

Dear Geoffrey.

CORPORATION TAX: THE REFORM OF STOCK RELIEF

I have read your minute to the Prime Minister of 31 October, and I wholly agree with the main objectives of the scheme which you listed at (i), (ii) and (iii) of paragraph 3.

However, point (iv) seems to me to be wholly irrelevant to the main issue. It does not matter how companies finance their stock; in general terms it is none of the Government's business. I suspect that the proposal is directed to potential or actual tax avoidance, but I am opposed to cluttering up the Statute Book with complicated provisions to plug every loophole. At best they confuse, and they possibly negate, the very purpose we have set out to achieve.

No doubt this point will be discussed by our officials, but I should like an opportunity to discuss this proposal with you if it is to remain a part of the scheme.

I am copying this letter to the Prime Minister, Keith Joseph and Robin Ibbs.

Yours ever

John.

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JOHN NOTT

File

R H

Blind cc:- David Wright
(Cab. Office)

3 November, 1980

Corporation Tax: The Reform of Stock Relief

The Prime Minister has read the Chancellor's minute of 31 October on the above subject, and is content for you to issue a consultative paper on the basis proposed.

I am sending copies of this letter to Ian Ellison (Department of Industry), Stuart Hampson (Department of Trade) and to Robin Ibbs (CPRS).

T. P. LANKESTER

A J Wiggins, Esq
HM Treasury

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

PRIME MINISTER

CORPORATION TAX: THE REFORM OF STOCK RELIEF

As you know, Arthur Cockfield has been working with my officials on the much needed reform of the present rules for stock relief.

2. We have now reached the point where we are ready to bring forward our proposals for the consultation with outside industry and the accountancy profession, which I promised in my Budget Statement last March.

3. I do not think that I need to trouble you with the details at this stage. The main objectives of the new scheme will be:

i. To place the stock relief on a more rational basis, by adjusting taxable profits much more precisely by reference to the effects of inflation on the holding of stock; and thus to move, even if tentatively, in the direction indicated by the new accounting standard SSAP16.

ii. To reduce the present incentive for a company artificially to build up its level of stocks, simply for the sake of a tax advantage.

iii. To remove the damaging effects of stock relief recovery (or "clawback"), when companies reduce their stocks - for example, in an attempt to ease

liquidity probelms in the current recession.

iv. To deny relief, to the extent that stocks are financed by credit or other borrowing.

4. A scheme on these lines would effectively deal with the abuses of the present stock relief, but the restructuring would in present circumstances have the additional advantage of giving more relief for business as a whole, and in particular for manufacturing indsutry. Depending on the eventual detials of the changes, there could perhaps be something of the order of £2-300m extra injected into the business sector in 1981/82, and this obviously has certain implications for my 1981 Budget. However, I believe, that this is something to which it is right to give a high priority, given the present pressures on business profits and liquidity. And these proposals go a long way - much more effectively than other proposals we have had from, for example, the CBI - to give most help where it is most needed.

5. My officials have kept their opposite numbers in other departments informed about the general nature of the reforms which we have been considering; and have now circulated in the official consultative group a full series of papers, which set out our detailed proposals, as they now stand, the reasons for them and our best estimates of their effects on the yield and incidence of tax.

6. If you and other colleagues are content, the next step will be to issue the consultative paper. This will need to be done quite soon, if we are to give industry and the accountancy profession reasonable time to consider our proposals, and be ready for legislation in the 1981 Finance Bill. The scheme is complex and the paper will need

careful presentation. Some points in it will be controversial, and there are bound - both becasue of the credit restriction and other changes - to be losers as well as gainers. I will of course consult interested colleagues again.

I am sending copies of this minute to the Secretaries of State for Industry and Trade and to Robin Ibbs.

(G.H.)
31 October 1980

PART 3 ends:-

PM to Bennett 12.5.80

PART 4 begins:-

Ch Ex to PM 31.10.80