PREM 19/1197

Part II

Confidential Filing

The 1983 Budget
The 1984 Budget

ECONOMIC POLICY

Part I: May 1979
Part II: March 1983

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~17.3.83~~		~~16.11.83~~					
~~11.4.83~~		~~11.12.83~~					
~~29.4.83~~		~~16.12.83~~					
~~11.5.83~~		~~11.1.84~~					
~~12.5.83~~		~~12.1.84~~					
~~24.5.83~~		~~13.1.84~~					
15.7.83		~~19.1.84~~					
~~27.7.83~~		~~23.1.84~~					
~~5.9.83~~		~~3.2.84~~					
~~14.9.83~~		~~8.2.84~~					
~~23/9/83~~		~~9.2.84~~					
~~7.10.83~~		~~16.2.84~~					
~~12.10.83~~		~~20.2.84~~					
~~20.10.83~~		~~21.2.84~~					
~~2.11.83~~		~~22.2.84~~					
~~10.11.83~~		28.2.84					
~~16.11.83~~		—PART ENDS—					
12.12.83							

PREM 19/1197

PART 11 ends:-

B Ingham to LPC 28.2.84

PART 12. begins:-

SS/DTI to Ch/Exch 1.3.84.

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
CC (83) 18th Conclusions, Minute 1	12/05/83
CC (83) 33rd Conclusions, Minute 5	10/11/83
CC (84) 1st Conclusions, Minute 5	12/01/84
C (84) 5	03/02/84
CC (84) 5th Conclusions, Minutes 5 and 6	09/02/84

The documents listed above, which were enclosed on this file, have 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

Signed OAWayland Date 12 September 2013

PREM Records Team

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.

1. House of Commons: Fifth Report from the Treasury and Civil Service Committee, Session 1982-83
   The 1983 Budget
   HMSO, 11 April 1983

2. Autumn Statement 1983
   HMSO, 17 April 1983 [ISBN 0 10 211284 3]

Signed OWayland Date 12 September 2013

PREM Records Team

LORD PRESIDENT

cc A. Turnbull

BUDGET SPEECH

I understand that an MP, with malice aforethought, has secured a 10-minute rule Bill immediately before the Budget speech on March 13. This will make it more important than ever for the Chancellor to incorporate a positive summary of his Budget's aims very early in his speech in view of the even more limited time available to evening newspapers.

Our aim should be to get as positive coverage as possible for the speech in provincial evenings. This can best be done by the kind of summary I suggest, plus some early good news for taxpayers.

This will also serve the Chancellor's and the Government's radio and TV interests. As these two media cover the Budget as it is delivered it is important to give them as positive an interpretation of its objectives early on and, to colour their approach, an initial dose of good rather than bad news.

I am feeding these thoughts into Treasury but you may care to have a word with the Chancellor.

B. INGHAM

28 February 1984

BUDGET – SECRET

The leaks have made the task of gaining a good press for the budget ~~the~~ more difficult.

Early reaction has centred on condemning the widening of the VAT base: a tax on newspapers & fish & chips is just too much for the media to stomach.

Opinion on attacking institutional savings & supporting the direct saver/investor is more divided.

Hasn't this strengthened the case for taxing investment income accruing to pension funds? The VAT extensions could then be reduced to avoid the most sensitive issues, & extra revenue would be available to lower the PSBR further <u>and</u> raise income tax thresholds. There would be opposition on the grounds that pension fund tax pre-empts Norman Fowler's enquiry but it could be ~~[illegible]~~ combatted & would be unleaked.

Could you discuss the presentational problems on VAT with Nigel tomorrow?

John Redwood

MR. TURNBULL

BUDGET - SECRET

17

10 DOWNING STREET

From the Private Secretary

28 February, 1984.

Nissan

The Prime Minister has seen the Chancellor's letter of 22 February to the Secretary of State for Trade and Industry, and the latter's reply of 27 February. She feels that there is a serious problem to be addressed. She feels the Secretary of State for Trade and Industry is right in arguing that Nissan will look at Phases 1 and 2 together, and will not be assuaged by the fact that the change in the corporation tax regime does not affect Phase 1. She considers it would be damaging if one of the first results of the package was cancellation of a major inward investment project. Finally, the fact that the UK authorities will help Nissan to obtain the best possible leasing deal will not alter the fact that the deal will be less attractive than formerly.

In the light of these arguments, and of the part she personally has played in encouraging Nissan to come to Britain, the Prime Minister feels that some form of transitional arrangement, analogous to that agreed for RDG, should be investigated as a matter of urgency. She would be grateful if a proposal could be put back to her, together with a draft of the terms in which she could write to Nissan. If, when details of the transitional arrangements have been established, there is still disagreement between the two Departments, the Prime Minister is ready to hold a meeting to resolve the problem.

I am sending a copy of this letter to Callum McCarthy (Department of Trade and Industry).

Andrew Turnbull

John Kerr, Esq.,
HM Treasury.
BUDGET - SECRET

PRIME MINISTER

BILATERAL WITH THE CHANCELLOR

The main subject of tomorrow's bilateral will be the handling of the Green Paper on long-term public expenditure. It was agreed at Cabinet that those members who wished to be consulted about the drafting of the document should inform the Chancellor. I understand about eight Ministers have done so - the Chancellor will bring the list tomorrow.

You and the Chancellor will want to minimise the risk of leaks and counter briefing. There are two ways in which colleagues could be consulted:

(i) The Chancellor could send the draft under a private letter to those who have requested it, plus the Foreign and Commonwealth Secretary and the Chancellor of the Duchy whose views would be of interest.

(ii) It could be circulated to all Cabinet members, CMO, with instructions that it be shown only to their Permanent Secretaries.

On the text itself, the most controversial points are:

(i) the hint in para. 31 that SERPS will be changed;

(ii) the choice of growth rates in para. 52 - some observers might have preferred a greater spread;

(iii) the borrowing requirement assumption in para. 53;

/ (iv)

(iv) the alternative assumptions for the growth of public expenditure in Table 6. A number of colleagues suggested using a wider range of assumptions, though it was recognised that this could blur the message of the document. The Chancellor has taken the latter view.

You might also want to raise the handling of the announcement of the changed tax treatment of gilts held by building societies and the leak of the proposal to introduce a composite rate for banks. You will want to be sure that the Chancellor has the public relations aspects of these questions under control.

The Chancellor has not yet reached a final view on the PSBR though he is committed to discussing this with you before making a final decision. Advice on this is due later in the week.

You could ask the Chancellor when we will see a draft of the speech which will allow you to think about the presentation of the Budget. I attach a comment from Bernard on the need to put something eye-catching early on.

28 February 1984

COPY NO: 1

15

SECRET

JU809

If the Chancellor does not agree – we must have an urgent meeting. I agree with DTI

MT

PRIME MINISTER

BUDGET: NISSAN

You will have seen my letter to the Chancellor of 16 February, and his reply of 22 February. The Chancellor's view is that nothing can be done to mitigate the affects of the corporation tax package on Nissan: and he also takes a rather different view from me on what the consequences of that package will be on Nissan.

I agree

2 To me the position looks extremely serious. I cannot, of course, state categorically that Nissan will pull out unless we can find a solution. But I have to say that it is my judgement, and that of those closest to the negotiations, that there is a very high probability that they would do so - not only because of the additional cost to them, but because of the peculiarly central part your private leasing proposal to Mr Kawamata played in converting him to support the project. Without this, the deal would not have been reached.

3 It may help if I set out where Nigel and I are in agreement, and where we differ. There is no difference of the analysis of the cost to Nissan of the proposed budget package. At minimum, Nissan will face an additional cost of over £30m; it could be as high as £45m. Virtually all these costs fall on Phase II of the

project. Where I differ from the Chancellor is in his separation of the project into two clear and distinct phases. I do not believe that this is realistic. Instead, it is necessary to consider the project as one, not two. Quite simply, it would not make sense for Nissan to invest in Phase I unless at the time they made the decision so to do they firmly intended to proceed to Phase II. On Nissan's own figures, Phase I will make a loss of £12m a year; and the production of 24,000 units a year is a quite uneconomic quantity in the context of the motor industry. I do not believe that Nissan will pay £12m a year in order to come to a view on whether to exercise an option in 1986. Rather, if Nissan know before they take the final decision on Phase I that they will not get the terms they expected on Phase II, they may well decide not to go ahead with either Phase I or Phase II. Whatever decision we come to, I do believe it must be based on looking at the cost to Nissan of the project as a whole.

4 If Nissan does indeed pull out, it would clearly be a pity in terms of the project itself; and, of greater importance, would be harmful in terms of our policy of attracting further inward investment from Japan. There would also be a danger, which I discuss in paragraph 5 below, of your being accused of a breach of faith. More central to our economic policy, there is also the risk that withdrawal by Nissan could endanger the case for the budget package itself. That package rests to a large extent on our being able to assert that it will not damage investment.

Such a claim would be hard to sustain if an early, and highly visible, effect of the package was the cancellation, as a direct consequence of the package, of a peculiarly prominent investment for which we have claimed considerable political credit. I fear that were this to happen it would be used by our opponents as a proven, as opposed to a theoretical, case against the Chancellor's reform.

5 There is the further point, which must be for you to judge, of the political consequences in the light of your own personal and crucial involvement in the negotiations. There is a danger that Nissan might interpret the fact that the agreement with them was signed in full knowledge of impending taxation changes which would seriously affect the project as a breach of faith, and that in particular they will regard the undertakings which you made on leasing as having been vitiated. We can, of course, make something of the Chancellor's argument that you offered leasing arrangements, not continuity of capital allowances, but must recognize that the leasing offer becomes significantly reduced in value without the capital allowances. The Japanese might choose to represent this as a direct breach of faith.

So do I

6 Because of these difficulties, I continue to see this as a greater problem than the Chancellor suggests. I therefore believe we should investigate, as a matter of urgency, whether there is a means of avoiding the difficulties that will occur if Nissan choose not to proceed.

7 I am clear that the sums involved are too large to compensate Nissan through additional selective financial assistance (SFA). This would raise difficult presentational issues and in any case we are limited by EC rules governing the amount of financial assistance that can be given. This leaves some form of "transitional" arrangements which would allow Nissan to continue to benefit from the current levels of first year allowances on the project's capital expenditure. What we could do would be to mirror on the tax side exactly what has been done for Nissan (and other companies) on RDGs, where any firm that has negotiated selective assistance prior to announcement of the new regime is assured of the current benefits on the assisted project. The logic for our existing policy for RDGs is that the negotiated level of SFA takes account of other benefits available to the company, such as RDGs. Equally, it can be argued that the level of SFA negotiated has taken account of the tax regime which made leasing attractive. I believe that transitional arrangements on this basis could be offered without driving a coach and horses through the package: there will be few companies which are in the position of Nissan, in terms of both having an offer of SFA, and being heavily affected by the proposed changes in capital allowances. SFA is offered on only a very small proportion of total investment and for many of the projects qualifying for this transitional treatment most of the capital expenditure will have been incurred by the time the full force of the package comes into effect.

8 I hope that transitional arrangements on these lines would prove acceptable. I very much support the Chancellor's proposals to restructure the corporation tax system. I fear, however, that unless we can find a satisfactory solution to the Nissan problem we may incur criticism which could set the whole package at risk. The transitional arrangements I propose seem to me a reasonable price to pay for avoidance of this risk.

9 I am copying this minute to the Chancellor.

NT.

N T

27 February 1984

Department of Trade & Industry

BUDGET - SECRET

14

PRIME MINISTER

Attached is the Chancellor's letter to Mr. Tebbit, setting out his views on the impact on Nissan of the company tax package. I do not think Mr. Tebbit will accept the arguments. On reflection, it seems to me disingenuous to argue that nothing needs to be done now because there is no impact on Phase 1. Phase 1 generates a loss for Nissan and they are only undertaking it because there is a high probability that they will move on to Phase 2. If the latter no longer looks profitable under the new regime, they will not undertake Phase 1. Thus the argument that this can all be left until 1986 is not very strong.

A If the loss of £30-45 million is such as to cause Nissan to cancel the project (and this is not yet firmly established), then it seems to me that the question of transitional arrangements, analogous to those established for regional assistance, will have to be considered. It would be a very poor advertisement for the new package if the first reaction to it were cancellation of a major piece of inward investment.

I also find the statement that the Bank of England will continue to use their good offices to assist Nissan to obtain a competitive leasing package to be rather naive. Certainly the Bank of England can help Nissan obtain as good a leasing package as is available at the time but this will not disguise the fact that such a package will not be as attractive as it would have been under the old regime.

No action at present, to await Mr. Tebbit's response.

AT

24 February 1984

We shall have to act in accordance with 'A' - otherwise we shall be accused of lack of good faith - especially as I was prominent in trying to persuade Nissan to come here etc.

Ch/Ex Ref No B(84)272

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

22 February 1984

The Rt Hon Norman Tebbit MP
Secretary of State for Trade and Industry

Dear Norman

NISSAN

We had a word about your letter of 16 February last week when you confirmed that, despite the Nissan problems, you still favoured the company tax package I am proposing for the Budget.

Since you wrote, officials from our two Departments have examined the effects of the changes on Nissan in detail with the help of the Bank of England. They have concluded that the package will not affect Phase 1 of the project. However, it appears that the net present value to Nissan of Phase 2 will probably be reduced by £30-£45 million.

While this is a significant figure, I very much doubt whether it will lead Nissan to pull out. For the effect of the package on Phase 1 - which is all that Nissan are committed to at present - is neutral. The company will surely wait until the 1986 break point, built into the existing agreement, before taking irrevocable decisions about Phase 2. It is at that stage that any question of compensation would arise: not now. And only then might we face, because of the Commission, the dilemma you describe.

We agreed last week that Nissan had in effect bought an option on Phase 2. My own view is that whether they decide in 1986 to take it up will depend on a whole range of factors that will only be apparent in 1986, including the prospects for the UK car market, the likely European reaction to UK-sourced Nissan exports and labour relations. While the cost of leasing will undoubtedly be one of the factors they can take into account, I doubt whether it will be decisive. Certainly cost does not appear to be a dominant consideration in their choice of location which I gather we expect

CHANCELLOR OF THE EXCHEQUER

to be influenced more by the suitability of the site and local services than the different RDGs applying in SDAs and DAs.

Finally, as we discussed, it is clear from the correspondence between the Prime Minister and Mr Kawamata that leasing was presented as a way by which the company might minimise the initial expenditure, about which they had expressed concern. My understanding is that Nissan see this, rather than the incidental tax advantages, as the main benefit of leasing. The Bank of England, who will use their good offices to assist Nissan to obtain a competitive leasing package, are still confident that this can be arranged.

A copy of this letter goes to the Prime Minister.

Yrs ever
Nigel

NIGEL LAWSON

Prime Minister (2)
To note this exchange. I understand the BSA are, to a degree, contesting the principle at x.
AT 28/2

THE BUILDING SOCIETIES ASSOCIATION
3 Savile Row, London W1X 1AF
Telephone: 01-437 0655

24 February 1984

Dear Chancellor

We were very surprised to receive notice yesterday of the changed tax treatment of gilt-edged gains for building societies. This undoubtedly will have a major impact on the way societies operate in the gilt market and on their interest rate structures.

With regard to gilts, societies probably hold at least one-quarter of all short-dated gilts in issue. Many of the low coupon stocks have been tailored with building societies, not least their tax regime, specifically in mind. Now, after societies have purchased them from the Government, it does indeed seem bizarre that the same Government responsible for their issue without warning seeks to impose a tax on any resulting gains. The whole operation has a distinct element of retrospection in it. Indeed, one could draw an analogy with the personal sector; the outcry would be deafening if a tax were to be imposed on National Savings Certificates whenever they might have been bought.

So far as societies' interest rates structures are concerned, the new measures mean that the corporation tax burden has at a stroke been effectively doubled. This new charge must be passed on either to borrowers in the form of a higher mortgage rate or to savers in the form of a lower investment rate; the prospect of a mortgage reduction within the next month or so is now clearly diminished and at the least any reduction will be less than would otherwise have been the case. If investment rates are reduced this could result in a diminution in the supply of mortgages.

The overnight imposition of what is in effect a retrospective tax, without prior consultation, has had a considerable impact and a much more equitable solution would have been to impose this tax on purchases rather than realisations after a certain date. Indeed it does seem that investors in offshore funds were given far more lenient treatment than societies when their advantages were terminated in 1983.

We should therefore be grateful if you would consider as a matter of urgency applying the new tax treatment to purchases made after 23 February 1984 rather than to sales made after that date.

Yours sincerely

Herbert Walden

Herbert Walden
Chairman

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer

2/.
Mr Beighton
FST Mr Cassell
Mrs Lomax
Mr Pirie
PS/IR

3.4

cc CST
FST
EST
MST
Sir P. Middleton
Mr Cassell
Mr Lankester
Mr Hall
Mrs Lomax
Mr Saunders
Mr Mood
Mr Riley
Mr Portillo
Mr Green (IR)
Mr Beighton (IR)
Mr Bridgeman (RFS)

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

28 February 1984

Herbert Walden Esq
Chairman
Building Societies Association
3 Savile Row
LONDON
W1X 3AF

Dear Mr Walden

Thank you for your letter of 24 February about the changed tax treatment of profits made by building societies on the realisation of gilt-edged securities.

X| I am glad to note that you do not contest the principle of the change, but are concerned rather with what you see as the retrospective nature of its implementation, and with the lack of prior consultation.

I cannot accept the charge of retrospection. As you will be aware, in law it is open to the Inland Revenue to go back and raise assessments on the revised basis for up to six past years. In fact they will not be doing this, and will be applying the new interpretation of the law only to future disposals. I believe this treats the societies in a very fair manner, and I could not therefore agree to the further concession you suggest.

I quite understand that the Association would have liked advance consultations, or more notice of the announcement. But as I hope you will recognise, advance consultation or notification is just not feasible in the case of announcements of such high market sensitivity.

Yours sincerely
Nigel Lawson

NIGEL LAWSON

FILE TL

Copy No 2 of 2

a MASTER SET

13

10 DOWNING STREET

From the Private Secretary

23 February 1984

Budget proposals

The Chancellor discussed with the Prime Minister today his proposals for income tax and the taxation of savings and investment. She welcomed the proposal to raise thresholds by double the amount required by indexation. She queried the removal of the relief on foreign earnings but accepted the Chancellor's explanation that this relief had been subject to abuse and was in any case less justified now that the higher rate of income tax had been reduced. The Prime Minister accepted the Chancellor's proposals on the taxation of car benefits and of share options.

On the tax treatment of savings, the Prime Minister accepted the proposals on stamp duty for sales of securities and for housing and land; for the increase in the stamp duty threshold for houses; and for the abolition of relief on life assurance premia for policies taken out after Budget Day.

On the encouragement of personal savings, the Prime Minister endorsed the abolition of the investment income surcharge and the cut in the top rate of capital transfer tax. On banks and building societies, the Prime Minister accepted the introduction of a composite rate for bank interest (she has already endorsed the proposal to subject building societies' gains on gilt transactions to corporation tax).

The Chancellor said that he was thinking further about the proposal to introduce a credit licence duty.

Andrew Turnbull

John Kerr, Esq.,
H.M. Treasury.

FILE

Copy No 2 of 2

CL MASTER

12

10 DOWNING STREET

From the Private Secretary

23 February 1984

Budget proposals

The Prime Minister held a meeting yesterday with the Chancellor to discuss his proposals for the budget. On excise duties - the Chancellor's minute of 16 February - the Prime Minister was content with what was proposed. The Chancellor explained that the reduction in the differential between the tax on beer and wine was the smallest which was thought to be acceptable to the European Court. Closing the gap with a modest rise in beer duty and a fall in wine duty was the best presentation that could be made though there would inevitably be criticism from anti-European MPs. The Prime Minister agreed but queried the 3p rise in cider duty. The Chancellor explained that the industry itself was happy to see this as a smaller increase would leave it vulnerable to challenge from Europe. On this basis, the Prime Minister was content. She welcomed the removal of the duty on kerosene and accepted the changes proposed for the duties on petrol, tobacco and vehicle excise. She also agreed that the Government should be prepared to impose a temporary surcharge on vermouth, should insufficient progress be made in reducing the Italian duty on whisky. The Prime Minister noted that the package would yield slightly more than strict revalorisation.

The discussion then turned to the business tax package - the Chancellor's minute of 16 February. The Prime Minister endorsed the objectives of the package which would widen the tax base and shift the burden of tax between labour and capital. She wondered whether, in total, too much was being given to the corporate sector which, having already a favourable liquidity position, might relax its control over costs. The Chancellor explained that the introduction of VAT on imports would reduce liquidity in 1984/85 and since the Government was pledged to abolish NIS, there were advantages in using its abolition to smooth the way for the major changes in the corporation tax regime. After further discussion, the Prime Minister agreed the proposed changes in corporation tax, the abolition of NIS and the imposition of VAT on imports.

The Chancellor said he had had further discussions with the Secretary of State for Trade and Industry on the way the budget would affect the Nissan project. He believed the effect of the new corporation tax regime would be rather less than the £50 million

/ suggested

suggested in Mr. Tebbit's letter of 16 February. Furthermore the impact would be felt only in phase 2. Decisions on whether further assistance was needed to compensate Nissan could be deferred until nearer the time when Nissan would be deciding whether to move to phase 2. Officials were continuing to examine the problem and he would submit further advice. It might be desirable for the Prime Minister to write to Nissan immediately after the budget explaining the effect of the changes. He would be happy to provide a draft.

The discussion then turned to presentation. As there would be loud cries from the losers from the budget package, it was important to mobilise the gainers. Lord Weinstock was known to favour the kind of corporation tax system proposed. Sir Nicholas Goodison would undoubtedly welcome the reduction in stamp duty. Mr. Halstead could be encouraged to speak up in support of PAS.

The discussion then turned to the MTFS - the Chancellor's minute of 20 February. The Chancellor said he hoped to publish a figure for the PSBR in 1984/85 of £7-7½ billion. If possible he would like to aim towards the lower end of this range. The budget itself would be presented as neutral. The Prime Minister agreed that a significant reduction in the PSBR should be made in 1984/85; the economy was recovering, there would be substantial asset sales and North Sea oil revenues would be close to their peak. All these indicated that 1984/85 should be a year in which Government borrowing was low. She therefore hoped that the figure would come out towards the lower end of this range. She was content that the MTFS should show the PSBR declining to 1¾% GDP in 1988/89.

The Prime Minister accepted a range of 6-10% for £M3 (with PSL2 in a subsidiary role), and 4-8% for MO (with M2 in a subsidiary role).

The Prime Minister would be grateful if the Chancellor would discuss his final proposals for the PSBR with her when he has available the complete budget arithmetic.

Andrew Turnbull

John Kerr, Esq.,
H.M. Treasury.

BUDGET SECRET

File Turnbull

Copy No 2 of 2

10 DOWNING STREET

From the Private Secretary 23 February 1984

BUDGET PROPOSALS: VAT

The Chancellor discussed his proposals on VAT with the Prime Minister today. She endorsed the aim of widening the base of the tax. She recognised that the Chancellor's proposals to extend VAT to newspapers, periodicals, etc., to building extensions and alterations, and to hot take-away food would be contentious but she nevertheless agreed to them. She accepted the proposal to retain zero-rating for books.

ANDREW TURNBULL

John Kerr, Esq.,
HM Treasury.

BUDGET SECRET

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

Personal.

Budget Secret.

Andrew.

X is indeed true. But the real point is of course that the issue counsel is considering is now academic, because the Capital Allowances he may decide they're entitled to are to be phased out.

2. So if Mr P. starts to stir a campaign against our sloth, please spoke his wheel!

NL.

File

10

From: P R GORDON
Date: 23 February 1984

PRINCIPAL PRIVATE SECRETARY

cc Mr Corlett (I/R)

CABLING AND FYAs

Mr Pascall of the No 10 Policy Unit telephoned me on 21 February to ask where the study on cabling had got to. He keeps a watching brief on the subject for the Prime Minister. His enquiry was sparked by the recent Sunday Times article.

2. I told him that we were awaiting Inland Revenue's Counsel's opinion, but said that I would check to see what the latest position was. He expressed concern at the sluggishness with which things were moving.

X 3. I have spoken to him again today to confirm that Counsel's opinion was indeed awaited, and that the Chancellor was fully aware of the position. He noted that, and asked when Counsel's opinion might be forthcoming. I said that it was notoriously difficult to get Counsel to be firm about when they might utter. He asked whether the present position was causing any real difficulty over take-up of licences, or whether the industry were simply lobbying. I said that I was not aware of real difficulties, and thought the latter might well be the case.

4. Mr Pascall asked me to let him know when decisions were taken on the matter. I undertook to do so. I do not know whether he will take any action internally, eg a note to the Prime Minister.

PRG

P R GORDON

9

PRIME MINISTER

BUDGET : TAX REFORM

It is right to shift the balance to taxing spending rather than earning, to even up the treatment between institutional and personal savings and to put banks and building societies on a more even footing.

The direction is exciting. The only question is one of speed. Capital taxes should be reformed: couldn't DLT be abolished as a starter? Pension funds should be brought into the tax net: there is more than £2 billion of revenue in prospect if their income was taxed. Couldn't Norman Fowler be persuaded of the justice of this case, if only for next year?

The two main worries in the proposals are:-

(i) Will newspaper proprietors object too violently?

(ii) Is the net give-away in the CT package too generous when coupled with abolition of the NIS? Business cash flow and profits are up strongly and it would be a pity to give too much away for next year to the business sector.

J. REDWOOD

22 February 1984

8

PRIME MINISTER

The Budget

You are discussing the budget with the Chancellor again tomorrow morning. In particular, you will be looking at the package on the reform of taxation on income, expenditure and savings.

Looking at the package as a whole, my reaction is that it is an economist's budget. Much of what it seeks to do will represent a major step to a more efficient, competitive and flexible ~~budget~~ economy. It makes a significant contribution in a number of areas:

(i) It continues the progress towards lower borrowing, lower monetary growth and lower inflation.

(ii) It widens the base for indirect taxes, including securing a proper contribution from the financial sector, thereby permitting a substantial increase in tax thresholds which will alleviate the poverty trap.

(iii) In conjunction with the change to regional grants with a cost-per-job ceiling, it brings about a major shift from taxing jobs/subsidising capital towards a more neutral stance. This should contribute to the generation of more employment.

(iv) It begins to reverse the trend towards institutionalised saving, encouraging a swing towards direct ownership of shares and a stake in one's company.

(v) It lowers transactions costs in capital markets and the housing market.

All this should appeal to serious commentators. The weakness of the budget is that by creating a host of losers, as well as gainers, it is vulnerable to having the unpleasant

/ bits

bits picked off, leaving only the give-aways. The aim must be to hold the high ground represented by the major themes, and not allow the budget debate/Finance Bill to degenerate into skirmishing with vested interests.

The list of those who lose in some way is substantial, though almost all of them receive compensating gains:

- newspaper proprietors
- the building industry
- banks (probably the biggest losers in the budget)
- some manufacturing companies
- importers
- beer drinkers in comparison with wine drinkers
- Life offices
- building societies (though on balance they probably gain)
- drivers of company cars
- the poverty lobby who will resent removal of the Investment Income Surcharge.

You should also be aware of what is not included. Very little is admitted on capital taxes or on the tax treatment of pensions, though I think the explanation given in the case of the latter is convincing. On capital taxes, one has to ask whether action here is really a higher priority than on the items included.

Another factor is that the relief of taxes for business is substantial, particularly in 1985/86 when the once-off effect of VAT on imports has passed. In that year, the reliefs total £2.1 billion, the losses only £750 million. Does it make sense to commit so much in advance to companies rather than leave more room for raising thresholds? Or is this the necessary price for achieving a major change in the structure of tax?

/ Specific points

Specific points you might want to raise:

(i) Is it worth taking on Fleet Street over VAT on newspapers? The logical argument for this is strong and there is significant revenue at stake, most of the £340 million coming from newspapers rather than magazines. Furthermore, it would be difficult to establish a dividing line between newspapers and magazines though learned journals e.g. the Lancet, Law Society Gazette, might represent a pressure point.

(ii) What is the combined impact on building societies? The components are set out in the annex. The net position should be favourable.

(iii) Is the combined impact on banks acceptable? Undoubtedly they will be major losers but the argument for this is that they have been very profitable (the figures are in the annex). They will be large gainers from the abolition of NIS and the impact on their leasing business is not immediate but is phased over two or three years.

(iv) Are you content to apply credit licence duty to non-qualifying mortgages? The case for keeping the definitions of mortgage interest relief and exemption from credit licence duty the same seems to be very strong.

AT

22 February 1984

BUILDING SOCIETIES

+ ve	- ve
(i) Composite rate for banks	(i) Tax on gilts
(ii) Removal of life assurance premium relief (making BS's more competitive against life offices)	(ii) Credit licence duty on non-qualifying mortgages
	(iii) Loss of commission on endowment policies

BANKS

+ ve	- ve
(i) Lower CT rate	(i) Credit licence duty on consumer lending
(ii) NIS abolished	(ii) Loss of capital allowances for leasing
	(iii) Composite rate

Clearing bank profits: £ billion

1979	1.7
1980	1.6
1981	1.9
1982	1.8
1983	to be announced shortly

MANUFACTURING COMPANIES

+ ve	- ve
(i) NIS abolished	(i) Lower capital allowances
(ii) Lower CT rate	(ii) Less of stock relief
(iii) lower stamp duty on shares	

VAT on imports advantageous for some, disadvantageous for others

3-6

2

FROM: A SMITH
DATE: 22 FEBRUARY 1984

MR LAWRIE (for No 10)

cc Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Mr Battishill
Mr Riley
Mr Hall
Mr Folger
Mr Norgrove
Mr Aaronson
Mr Ridley
Mr Portillo
Miss Deyes

Prime Minister:

Mr Hattersley takes refuge in vagueness

TJ 24/2

MR HATTERSLEY'S ALTERNATIVE BUDGET

Briefing was requested on Mr Hattersley's speech to his constituency party last night. We have not yet been able to obtain a transcript so this note is based on newspaper reports.

2. The alternative package appears to be similar but rather more moderate in tone to that proposed by Mr Shore at Budget time last year. A significant difference this time is that Mr Hattersley made no attempt to cost any of his proposals; he believes these deflect the Government from the central policy arguments.

3. The five main elements of the alternative Budget are summarised below with a line to take. This is followed by further briefing on three recent and more general themes in the Labour Party's critique of Government policy which were also raised by Mr Hattersley. An overall assessment and line to take is provided at the end of the note.

4. **MAIN ELEMENTS OF MR HATTERSLEY'S ALTERNATIVE BUDGET**

(i) A "planned relaxation" of the PSBR

Line to take: Government's economic strategy is working. The economy has been growing at a healthy pace of 2½ to 3 per cent a year since 1981 against a background of firm fiscal policies (and in the face of 364 economists who said it couldn't be done.) If downward pressure on inflation is to be maintained and if interest rates are to fall further it is essential that Government borrowing continues to be reined back. A low inflation, low interest rate environment is the only basis for a sustainable growth of industry and jobs. Employment now rising again - up 87,000 between March and September last year without any artificial, inflationary stimulus to demand.

(ii) Concentrate "most" extra government spending on investment

Line to take: Taking account of the capital expenditure of nationalised industries, special sales of assets and council houses, and taking some credit for defence capital spending, public sector spending on all capital goods has been virtually stable in real terms since 1978-79. There is no 'right' level of capital spending. Essential that any extra capital spending earns a satisfactory return, and is appropriate to the public sector.

(iii) Change taxes and social benefits to redistribute income to the poor

[Raising all thresholds, it is claimed, is an "expensive and ineffective" means of redistributing income. Only the basic rate threshold should be indexed, with higher rate bands frozen. At the same time various social benefits (child benefit, pensions, housing benefits) should be increased]

No comment on Budget intentions. Government on record about priority attached to increases in allowances when resources permit. This would take lower paid out of tax and help reduce poverty trap.

(iv) A "moderate" depreciation of sterling and "specific and limited" import controls to improve industry's competitiveness

Line to take: A fall in sterling - assuming a controlled fall could be engineered - risks higher inflation without any long run gains in cost competitiveness. On import controls UK has right, under international agreements, to take selective action where UK producers subject to unfair competition. But spread of protectionism reduces choice, increases inflation, fosters inefficiency and destroys jobs. Best and most reliable way to improve our competitiveness is through realistic wage settlements and further productivity gains.

(v) Abolition of NIS and reductions in other Government imposed costs on industry

[Mr Hattersley has sought to present a package with obvious, if superficial, attractions for industry pressure groups. In addition to a lower exchange rate, the abolition of NIS, a reduction and then a freeze on electricity prices, he proposes an easing of industry's rate bill - by restoring the cuts in Government grants - and urges the implementation of all forms of government aids to industry permissible under the Treaty of Rome. The abolition of NIS could be partly financed by the removal of the upper earnings limit on national insurance contributions.]

Line to take: Cannot speculate on what might or might not be in the Budget. Recognise strong case for abolition of NIS - Labour's tax on jobs - but other strong calls if resources available. Stated objective is to abolish NIS within lifetime of this Parliament. Reduction from 3½ to 1 per cent already worth £2 billion to private sector employers. Government's policies have brought down inflation and interest rates - only basis for sustainable growth in industry and jobs.

The Rates Bill currently before the House to curb rate increases of selected overspending local authorities (so called 'Rate Capping' legislation) will benefit industry because councils will be required to consult business representatives before fixing rates.

5. OTHER RECURRENT THEMES

(i) Boost to demand essential to help industry sustain recovery

Line to take: Lack of demand is not the problem - it is the inability of UK suppliers effectively to meet rising demand. Government's policies have enabled non-inflationary growth to get firmly under way. A stable, prudent policy environment is the best help Government can give industry.

(ii) Government has written off manufacturing

Line to take: Nonsense. Desire to see efficient, competitive and expanding manufacturing sector, but must remember that manufacturing output fell between 1974 and 1979. Also long term trend towards services is evident in UK as in other major economies. Encouraging increase in manufacturing output during course of 1983; CBI point to further increases this year and 7 per cent increase in manufacturing investment. Exports of manufactures rose 7 per cent between the third and fourth quarters of 1983.

(iii) A recovery which does not put Britain back to work is not a definition of recovery acceptable in a civilised society

Line to take: Unemployment has risen on average under every Government since the 1950s. In the last two cyclical upswings under Labour (1967-69, 1975-79), unemployment also rose. Total output now running above 1979 levels and number of people in work is rising - up 87,000 between March and September last year.

6. **GENERAL ASSESSMENT AND LINE TO TAKE**

Mr Hattersley's alternative package appears to be a diluted dose of the same medicine served up by Mr Shore at Budget time last year. However, Mr Hattersley has conspicuously omitted to cost any of his proposals. This suggests he does not expect people to take his package seriously.

A. Smith

A SMITH
EB

MR HATTERSLEY'S ALTERNATIVE BUDGET: FURTHER POINTS

1. The PSBR can be expanded without an increase in interest rates because crowding out is not a problem when companies and building societies are "awash with funds"

Argument fallaciously assumes there are surplus funds available which people would be willing to lend to Government at existing interest rates. But this is not how financial markets work. If borrowing is not simply to be financed by increasing the money supply the Government must make its debt instruments more attractive to investors - which in simple terms means raising interest rates on Government paper.

2. Increased public expenditure for jobs than reduced taxes

But even on its own terms Mr Hattersley's argument is contradictory. The kind of increased expenditure he advocates - on capital projects - will have a very small direct effect on employment.

3. Services harder hit by Government policy than manufacturing

[Mr Hattersley correctly points out that UK share of world private invisibles receipts fell from 9.5 to 8.5 percent between 1979 and 1981, last year for which figures available. Over same period UK value share of world trade in manufactures fell from 9.1 to 8.5 percent].

Nonsense, UK share of world private invisible receipts in 1981 (8.5 percent) about same as in 1978, last full year of Labour government (8.7 percent). Service sector output now 2½ percent above average level in 1979.

4. Coopers Lybrand argued that there is a case for a 5-10 percent real cut in electricity prices and a freeze thereafter

But study completed 18 months ago. Since then real electricity prices have fallen because nominal tariff rates have not increased since April 1982. There will be no increase in industrial electricity tariffs this April.

5. There are many new ways of raising extra tax revenue

[Mr Hattersley refers to effect of non-revalorisation of higher tax bands, the abolition of NIC upper earnings limit, the need to look again at (unspecified) tax allowances, fringe benefits and tax avoidance in general, and raises again the spectre of a wealth tax].

This is certainly true - and Mr Hattersley at least recognises that higher expenditure requires higher taxes. But it is highly irresponsible to believe that behaviour in the economy will be unaffected by such major changes in the tax structure, or that changes can be made without many people suffering serious losses. It is also disingenuous of Mr Hattersley to leave unspecified the tax allowances he intends to 'look at again'.

6. Rates have increased because the Government has reduced its grant to local authorities

No. It is the determination of local authorities to increase expenditure, despite Government attempts to restrain it, which has caused rates to increase.

7. General

Injecting a note of realism into his speech Mr Hattersley recognised that the "ability to help the low wage earners and the recipients of long-term benefit will crucially depend on our ability to expand national income and to bring about those structural changes in wage negotiation procedures that enable the low paid to receive higher primary incomes." He sought "wage agreements that increase pay without pushing up unit labour costs".

Whilst this recognition of the crucial link between pay and job prospects is to be welcomed, Mr Hattersley is even more vague than Mr Shore was about the mechanism through which a desirable level of wage settlements is to be achieved and maintained. The overall effect of his policy proposals would probably be to create conditions in which it was more difficult to keep unit wage costs in check.

A SMITH
EB

File

SPEECH

by

The Rt. Hon. ROY HATTERSLEY, M.P.

Shadow Chancellor of the Exchequer

at a

Sparkbrook Constituency meeting

at

Acocks Green School, Birmingham

7.45 p.m. on Tuesday 21st February 1984

It is not my task to describe the details of the budget which the Chancellor ought to introduce. The industrial policy which it augments and compliments is not the ministerial policy which a Labour Government would follow. Our budget would not fit into his economic strategy or political philosophy. And by the time that Labour is back in government three more years of recession will face our Chancellor with even deeper problems which cannot yet be precisely forecast. I can, however, describe the principal ingredients of a budget which, by any standards, is more likely to meet the nation's real needs than the shibboleths of monetarism.

Those ingredients are

1) A planned relaxation of the Public Sector Borrowing Requirement
2) The concentration of most of the extra government expenditure on new public capital investment
3) AN ADJUSTMENT OF TAXATION AND BENEFIT RATES WITH THE DIRECT INTENTION OF REDISTRIBUTING NATIONAL INCOME IN FAVOUR OF THE POOR.
4) An improvement in the competitiveness of British industry by a moderate depreciation of sterling and the introduction of specific and limited import controls

5) A REDUCTION OF THOSE ELEMENTS OF THE PRICE LEVEL AND INDUSTRIAL COSTS WHICH ARE THE DIRECT RESPONSIBILITY OF THE GOVERNMENT.

Those five ingredients will all contribute to the outcome which ought to dominate budget strategy; a reduction in unemployment, an increase in output and an alleviation of poverty.

The budget is still three weeks away. But already we can predict its rough outline--not least because the Chancellor has thought it prudent to break the news gradually through a series of orchestrated press leaks. The autumn threat of tax increases, having done its work of frightening weak-minded Tory backbenchers, is abandoned. The public expenditure white paper confirms that the budget will contain neither dramatic increases nor radical reductions in taxes. The total tax bill will remain over £17 billion above that which the Tories inherited. There will be damaging cuts in public expenditure. Although the Government will spend a bigger proportion of national income than it did in 1979, the concentration on the military budget and increasing unemployment pushing up the total social security bill will result in severe cuts in housing investment and the health, education and welfare programmes. And, as the Government further destroys our public services, it will barely mention and certainly take no action to rectify the other two economic and social catastrophes which it has caused--the massive increase in unemployment and the maldistribution of natural wealth which has made the poor even poorer as the rich have grown wealthier.

The Chancellor's central intention ought to be a reduction in unemployment. Yet there is no prospect of that morally and economically essential aim being achieved under present policies. He has no plans for cutting the dole queues and will not even forecast the total of unemployed which his policies will produce. He knows--and the public expenditure white paper confirms-- that despite the claim of recovery, unemployment will not fall below the present total in this Government's lifetime. The Labour Party believes that a recovery which does not put Britain back to work is not a definition of recovery that is acceptable in a civilized society.

Unemployment can be reduced. WHAT WE MOST NEED is the abandonment of those half-thought-through superstitions which the Government calls its economic policy. But today we have the most doctrinaire Chancellor for fifty years and a Prime Minister who--far from understanding the waste and suffering that unemployment brings--actually boasts about her record in creating it. "Our G.D.P. is about the same as it was in 1979," she confessed in the House of Commons on January the 31st, but then went on to brag about having still only produced the same output as the last Labour Government "but with 1.7 million fewer people in the workforce." So on March the 13th the Government will move the economy further away from genuine recovery and deeper into the underlying recession.

The lesson of 1983--when the pre-election relaxation of the squeeze stirred the economy into life--has been forgotten or ignored. Fiscal and monetary targets will again be elevated into an end in themselves, irrespective of their consequences in the real world. A Public Sector Borrowing Requirement target of £8 billion and a further attempt to reduce the money supply can only tighten the squeeze when all practical commentators--including the CBI--judge that relaxation is the first essential of sustained recovery.

We need an increase--not a reduction--in the Public Sector Borrowing Requirement--a suggestion which, for all its practical advantages, will drive the ideologues of monetarism into a state of advanced hysteria. It is time to meet their theoretical nonsense head on. The world did not end when the Chancellor missed his last PSBR target by £2 billion.

Indeed, the economy was revived. In March we ought to increase government borrowing by design rather than by mistake, and to put aside silly superstitions about the effects of the increase on private investment. "Crowding out" is a catch-phrase that ought to be kept in proper perspective. British money still floods abroad. Building societies are awash with funds. Retained company earnings have increased sharply. A moderate increase in PSBR will not deny investment funds to private industry. It will, however, provide them for the public sector. The case for an increase in the PSBR is overwhelming-- so long as it it used to promote investment in, and demand for, the products of British industry.

Borrowing to finance investment is normal practice in private industry. Borrowing is not sinful. Indeed, if it is well used for sensible purposes, it is a highly desirable--and wholly unexceptional--way of paying for new plant and machinery. I suspect that the famous Grantham grocer's shop was bought on credit. At least in this particular, what is good for Thatcher's family business is good for Britain.

There can be no doubt that an increase in demand is desperately necessary. Ask the CBI. Despite the favourable gloss put on the results of their most recent survey, its results reveal the hard truth about

British industry. Four-fifths of British companies say that it is shortage of demand--sales and orders--that imposes the main constraint on growth and output. Less than a fifth of British companies are expanding their capacity whilst almost two-thirds have spare plant which remains unused because of empty order-books. Manufacturing investment remains over 30% below the level of 1979. And as if to symbolize the Government's failure to stimulate the economy into life, 400,000 construction workers are unemployed, whilst our stock of houses deteriorates and the public sector housing programme is virtually abandoned--a 56% drop in starts since 1978. The case for fiscal relaxation and the consequent stimulation of demand is overwhelming. The extra funds should principally be directed towards public capital investment--roads, railways, houses; and those building projects which contribute to the welfare of the old, the sick and the disabled.

Consumer expenditure grew by over 7% last year as the result of the relaxation of hire purchase controls, a reduction in the proportion of income saved rather than spent and an increase in overall real earnings. With an exchange rate that subsidizes imports rather than supports exports, much of the consequent increase in demand has created jobs abroad rather than in Britain. Some tax cuts--as I shall presently argue--are essential. But the principal thrust of our expansion policy must come in the capital sector in order to boost demand and help the supply side of the economy. Increased public spending creates jobs in Great Britain. And it is a far more effective way of increasing employment than a stimulus to consumption brought about by tax cuts. The independent Institute of Fiscal Studies estimates that an increase in public sector spending of £1 billion creates 165,000 jobs in a year, whilst £850 million spent on reducing personal income tax allowances by 5% would cut unemployment by only 7,000.

The promotion of output by increased capital spending must be matched by positive action to improve the competitive edge of British industry. According to the CBI, changes in the exchange rate have produced a 20% loss of competitiveness since 1975. Britain cannot sell its goods abroad-- or sustain employment in potential export industries-- if an overvalued pound prices our products out of foreign markets. In 1978 the value of our exported manufactured goods exceeded the value of manufactured imports by £1.9 billion. In the next two years the surplus climbed to £2.6 billion. It then fell to £233 million in a single year before it plunged into a deficit of £5 billion-- the first deficit in manufactured goods since the industrial revolution.

No one doubts that it is a conjunction of the Government's monetary policy and its mismanagement of oil revenues which have resulted in sterling's over-valuation. The massive rise in the value of the dollar has opened up some United States markets. But only 10% of British exports go to North America, compared with 40% TO THE EEC. And the over-valuation of sterling against the European currencies is crippling those industries which hope to export to our partners in the EEC. The Government has written off manufacturing industry-- the Chancellor having declared himself "at a loss to understand the selective importance attached to the manufacturing sector"--and has placed its hope of substantial recovery in the service sector--making a bogus comparison with America where, thanks to expansionist policies, manufacturing industry has not suffered a decline of the severity experienced in Great Britain. The truth is that service industries must be encouraged to expand. But manufacturing industry remains vital to our prosperity. That is probably the view shared by the Director General of the CBI who, in a lengthy speech on the issue of manufacturing versus the services on 16th February, stated that "We must avoid giving the impression that manufacturing no longer matters to Britain's wellbeing and long-term prosperity: that it can be safely consigned to the dustbin of our industrial past." He then went on to criticize the Chancellor for his apparent dismissal of the manufacturing sector, and continued with the message: "Without a buoyant manufacturing sector, the potential for growth in the service industries will be severely limited, particularly when North Sea Oil runs out."

But despite its reliance on the service sector, the Government's share of world private invisible receipts fell from 9.6% to 8.5%. Over the same period, the United Kingdom's share of world exports in manufacture fell from 9.1% to 8.5%. The service sector has been even worse hit than manufacturing by the Government's policy.

To reduce costs and restore the competitive position of both the manufacturing and service sectors, five new initiatives are necessary:

1) A reduction in interest rates and a moderate depreciation of sterling
2) An abandonment of those additions to industry's costs which have been imposed by, and remain the direct repsonsibility of Government--notably the National Insurance Surcharge. Total abolition would cost £1.33 billion. Some of that revenue could be reclaimed by abolishing the ceiling on employees' National Insurance Contributions, and therefore imposing a progressive employment tax for higher

paid workers. Weak-minded Conservatives will argue that the NIS is a Labour creation. True. But that no more disqualifies me from urging its abolition in the new conditions than Pitt's invention of income tax prevents Tories from calling for cuts in direct taxation

3) A close look at how energy pricing, especially for energy-intensive sectors, could be brought more into line with our international competitors. Indeed, according to the Coopers and Lybrand report on electricity pricing commissioned by Nigel Lawson, existing electricity prices could be cut by five to ten per cent and then held constant for several years.

4) A reduction in industry's rate bills. According to the Government's publicity machine, escalating rates are the responsibility of profligate local authorities. That is simply propaganda. The Government's grant to local authorities has fallen by £2,800 million in real terms since 1979. That is the principal cause of rate increases

5) A careful examination of the forms of support available to industry under our treaty obligations, and the implementation of those that would promote our exports by reducing costs. For example, many of our competitors subsidize coking coal, thus producing a direct or indirect benefit to large sectors of the economy.

Of course, the release of resources which we need will work best when related to structural changes which encourage greater output. We must therefore promote those policies which increase productivity--both wage agreements that increase pay without pushing up unit labour costs, and investment that is designed to increase efficiency as well as capacity. It is also probable that the moderate depreciation which I propose will not alone be sufficient to prevent growing imports from prejudicing our prospects of industrial expansion. That requires the urgent examination of selective and temporary import controls. General theories of free trade or protectionism should be abandoned. Instead, we should examine, industry by industry, the merits of limited import controls.

Some import controls can be introduced without breach in our treaty obligations and without the risk of unacceptable retaliation. They should be regarded as a brief expedient. For their object must be to provide industry with a breathing-space rather than permanent insulation against the need for increased efficiency, high quality of service and competitive costing.

Ideally, what is required is a co-ordinated international expansion of output so that, as we increase our imports from overseas, other countries in turn take more of our exports. However, in the absence of such a co-ordinated international expansion, the Government should not allow three and a half million people to continue suffering the misery of unemployment. If the balance of payments is a constraint on putting Britain back to work, then we must introduce selective controls on the rate of growth of imports. It is absurd to suggest that we live in a world of free trade. What is required is a positive, planned approach to trade, rather than the ad hoc sets of controls and beggar-my-neighbour deflations that we have now. Using controls on the rate of growth of imports is necessary to allow new industries to develop, old industries to re-structure and the economy as a whole to expand.

Although the principal thrust of our policy for expoansion must be an increase in capital spending, adjustments are essential in the Government's revenue

ACCOUNT. SOME MUST BE DESIGNED TO ADD A MODEST INCREMENT TO THE INCREASE IN CONSUMER SPENDING WE EXPERIENCED LAST YEAR. BUT BY FAR THE MOST IMPORTANT OBJECTIVE OUGHT TO BE A REDISTRIBUTION OF INCOME - INITIALLY A REVERSAL OF THE PRESENT POLICY OF GIVING TO THOSE WHO HAVE AND TAKING AWAY FROM THOSE THAT HAVE NOT. AND NOTHING HAS MORE DECISIVELY CONTRIBUTED TO THE RANKS OF THE HAVE-NOTS THAN THE MASSIVE INCREASE IN UNEMPLOYMENT SINCE 1979. THE FIGURES SPEAK FOR THEMSELVES. THE TOTAL OF THOSE ON SUPPLEMENTARY ALLOWANCE HAS DOUBLED OVER THIS PERIOD, TO NEARLY 5 MILLION. THE NUMBER OF CHILDREN IN FAMILIES ON SUPPLEMENTARY BENEFIT HAS DOUBLED TO NEARLY 2 MILLION.

I DO NOT SIMPLY SUPPORT THE EASY OPTION OF LARGE INCREASES IN ALL THE TAX THRESHHOLDS - FOR A GENERAL INCREASE WILL HELP THE RICH MORE THAN IT WILL HELP THE POOR AND IS, IN CONSEQUENCE, AN EXPENSIVE AS WELL AS AN INEFFECTIVE WAY OF REDISTRIBUTING WEALTH. MOST PEOPLE WOULD BE MUCH BETTER SERVED BY INCREASES IN CHILD BENEFITS AND PENSIONS, A RESTORATION OF THE CUTS IN HOUSING BENEFITS AND EXTENDED LONG-TERM SUPPLEMENTARY BENEFIT RATES TO THE LONG-TERM UNEMPLOYED. THE CHANCELLOR SHOULD INCREASE THE TAX THRESHHOLDS FOR THE STANDARD RATE - TAKING MORE OF THE POORLY PAID OUT OF TAX ALTOGETHER, WHILST STILL REQUIRING THE HIGHER INCOME GROUPS TO BEGIN PAYMENTS OF HIGHER BANDS OF TAX AT THE PRESENT TAX THRESHHOLD LEVELS. CERTAINLY, IF TAX THRESHHOLDS ARE TO BE INCREASED, THE INCREASE SHOULD BE NO HIGHER THAN THE INFLATION RATE, AND SHOULD BE LIMITED TO THE BASIC RATE.

In the short term, our ability to help the low wage earners and the recipients of long-term benefit will crucially depend on our ability to expand national income and to bring about those structural changes in wage negotiation procedures that enable the low paid to receive higher primary incomes. In the short term, fiscal redistribution will depend on our ability to widen the tax base, and to discover new ways of raising extra revenue. The raising of the National Insurance ceiling is one possible source. So is some form of tax on wealth. We have to look again at fringe benefits and allowances, two increasingly popular techniques of tax avoidance. Indeed, we have to look at tax avoidance in general, especially since the Keith Committee revealed that the estimated yearly loss from tax avoidance is £4 billion, while that from Social Security fraud is a comparatively meagre £4.7 million. FURTHERMORE, IF THE GOVERNMENT PURSUED tax evasion with the determination employed by the Department of Social Security in its campaign against illegal benefit recipients, and if the Chief Secretary struggled to block avoidance loopholes in the way the Home Office constantly changes the immigration regulations to prevent their exploitation, the revenue would be millions of pounds better off. Yet I fear that the Finance Bill will deal with few of the abuses of the better off.

I fear that the Chancellor will not pursue the tax defaulters. Nor will he accept the priorities which I urge upon him. That is because his standards are not my standards, and the values of his party are not the values of Labour. But let no one doubt that it will be the Conservatives who introduce a budget based on class prejudice and outdated theory. We are the party of all the nation. We offer the practical solution to the slump. All that is needed for the remedy we propose is the will to implement it.

/ENDS

FILE

KW

B/C N. OWEN.

10 DOWNING STREET

From the Private Secretary

21 February, 1984

RESIDUAL SHAREHOLDINGS

The Prime Minister has seen the Chancellor's letter to the Secretary of State for Energy to which was attached a draft passage for the Budget speech. She was content with the proposals to clarify the Government's attitude to residual shareholdings and to indicate those companies which are potential candidates for further share sales in 1984-85.

I am copying this letter to Michael Reidy (Department of Energy), John Graham (Scottish Office), Callum McCarthy (Department of Trade and Industry), Dinah Nichols (Department of Transport) and to Richard Hatfield (Cabinet Office).

(A. Turnbull)

John Kerr, Esq.,
H.M. Treasury

CONFIDENTIAL

(iv) 7J

Treasury Chambers, Parliament Street, SW1P 3AG
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PRIME MINISTER

BUDGET: TAX REFORM

You already have my Budget proposals on the MTFS, on the Excise Duties, and on the reform of Business taxation. This minute covers my remaining tax proposals, and in particular the two further areas in which I envisage major reform, ie changes in the balance of taxation on income and on expenditure, and changes in the area of savings and investment to increase the role of individuals.

Shifting the balance

2. I am sure it is right to shift when and where we can to taxing spending rather than earning. It is not simply a matter of increasing individual freedom to spend or save: only by cutting income tax can we tackle the poverty and unemployment traps, and maintain the momentum of improving incentives.

3. I do not believe that the right route is a further increase in the VAT rate; my preference is for widening the VAT base, which at present covers little more than half of consumers' expenditure. As you know, there are three areas where I believe we can, and should, extend the base. These are:-

(a) newspapers, periodicals, newspaper advertisements and news services. There is no case on merit for leaving these untaxed. Nor, in logic, is there a case for not applying VAT to books, but I have decided against bringing them in.

(b) building alterations and extensions. The present position, with necessary maintenance and repairs attracting VAT, but alterations and extensions not doing so, is manifestly absurd.

(c) hot take-away food. By this I mean hamburgers and other fast food products, fish and chips, Chinese take-away meals etc. It makes no sense that the fast food restaurants now have two price-lists, one including VAT for those who will do their eating on the premises, another, without VAT, for those who carry their purchases away. VAT is, of course, already levied on ice-cream, confectionery, chocolate, crisps etc.

These changes will raise an extra £600 million or so next year, and over £1 billion in 1985-86 - £340 million on newspapers etc, £490 million on alterations, and £220 million on take-away food. The effect on the RPI will be less than one-half of one per cent, so there is no threat to the counter inflation policy: inflation this year is still expected to be on a declining path.

New law

4. In addition, as a surrogate for VAT - which the EC rules do not allow us to apply to financial services - I envisage a new licence duty on consumer and other forms of personal credit. An effective system of taxing the banks is long overdue. The new duty would be charged on a six monthly basis on outstanding credit issued, but would not be applied to loans made to businesses or to mortgages qualifying for income tax relief. I envisage a rate of 1 per cent. To allow time for preparation, it would apply only from July 1985, raising some £90 million in 1985-86, and some £200 million in a full year.

5. Given the extra money from VAT, it is already clear that, within the context of a neutral Budget, I can this year increase the single income tax allowance by £200 and the married allowance by £300. That is an 11 per cent increase, slightly more than double the amount required by indexation, and will particularly help the low paid. I am considering whether there is any way in which I could go a little further, in order to ensure that every married couple paying income tax gains - NIC apart - by at least £2 a week. There would be considerable attractions in that. The higher rate threshold, and the higher rate bands, would be fully revalorised but no more, as would the age allowance. (The higher paid of course get the largest cash gains from raising the allowances).

Exporters

6. I should also mention that I have decided to sweep away two small out-dated reliefs: the relief on foreign earnings for those who spend 30 days or more working abroad, and (with suitable staging) the relief for foreigners coming here to work for foreign employers. Both date from the days of confiscatory top rates of income tax and have outlived their justification, and both are subject to substantial abuse. I must

also announce the 1985-86 car benefit scales for those who have company cars. We have been slowly increasing these to more realistic levels in recent Budgets. The increase last year was 15 per cent, but, with lower inflation, I plan to hold it to 10 per cent this time.

7. I also propose to make the tax treatment of executive share option schemes markedly more generous, along the lines we discussed before Christmas. The essence of my proposals is that gains under such schemes would in future be subject to Capital Gains Tax rather than (as at present) to income tax. This improvement, which has long been pressed upon us, will be widely welcomed, especially by smaller companies, who will now be able to attract key staff by the promise of substantial rewards.

8. The overall effect of this shift in the balance of direct and indirect taxation should be generally welcome. We have good news for the building trade, eg on Stamp Duty (para 12 below) and DLT (the threshold for which I envisage raising from £50,000 to £75,000, thus reducing by a third the number of cases it affects), and this will cushion the blow of VAT alterations. But I have no illusions about Fleet Street's likely reaction to the change affecting them. It may indeed colour their attitude to the whole Budget, but I am sure that it is right, and should not be ducked on that account.

Savings and investment

9. As you know, I believe that we must also make a start in removing some of the features of the tax system which distort the pattern of personal savings. I have three aims in mind:-

(a) to reduce the extensive privileges for institutional savings and make it more attractive for individuals to invest directly in equities;

(b) more generally, to increase the encouragement given to personal savings; and

(c) to put the banks and building societies on to a more equal footing.

10. First, I have reviewed the array of tax privileges which are putting more and more personal savings into the hands of the institutions and driving the direct investor out of equities. This is a classical case of reliefs and exemptions eroding the tax base and keeping income tax rates higher than they need be. It is something we have been concerned about for a very long time, and which our friends constantly urge us to tackle.

11. We cannot touch the tax treatment of pensions until Norman Fowler has completed his enquiry. But we can act now on life assurance premium relief. Relief from higher rates of tax was removed some years ago, but the allowance (at half the basic rate on qualifying premiums) still costs £700 million a year, is growing, and has been subject to considerable abuse in recent years. So I have concluded that the time has come to withdraw relief on new policies taken out after Budget Day. There is a strong case for gradually phasing out relief on existing policies as well; but to avoid any possibility of hardship, I propose to leave these completely untouched.

12. At the same time I propose to encourage investment in equities by halving the rate of Stamp Duty from 2 per cent to 1 per cent, which will help to strengthen the London market against growing US competition. I intend the cut also to apply to sales of houses and land, which will help housebuyers and the construction industry, and to raise the stamp duty threshold from £25,000 to £30,000, which will mean that 90 per cent of first-time buyers will not have to pay Stamp Duty at all.

13. Secondly, direct encouragement to personal savings. I see no justification whatsoever for continuing to tax savings income more heavily than earnings, and I propose to abolish the Investment Income Surcharge. Of course, our opponents will represent this as a hand-out to the rich; but half those liable to the surcharge are elderly, and many are by no means well-off. And the criticism is one which we shall have to face whenever we remove the surcharge - as we certainly must. I think it best to do it straight away, in the first Budget of the new Parliament.

14. In a broadly neutral Budget, I do not have room for substantial cuts in the capital taxes: we shall in any case be reviewing them, with Arthur Cockfield's help, before next year. But there are some small but useful changes which can be made now at modest cost. In particular, I have in mind to cut the top rate of capital transfer tax from 75 per cent to 60 per cent.

15. Finally, the banks and building societies. The banks have long complained of the unfair advantage enjoyed by the building societies by virtue of the composite rate, and campaigned for its abolition. But the composite rate is a sensible arrangement which simplifies tax return-filling, and saves large numbers of Revenue staff. So instead of taking it away from the building societies, I propose instead to extend it to the banks as well. This will eventually save 750-1000 Revenue staff, and demonstrates our willingness to encourage the movement towards interest on current accounts. The banks have been informed and don't like it; but their case is weakened by their having for so long complained that the composite rate gave the societies a competitive edge. And the fact that the new arrangements will not apply to deposits by foreign residents (or, of course, businesses) will help to meet fears of loss of overseas business. The banks will need a year to prepare: the new arrangements will not therefore apply until 1985-86.

16. The banks may to some extent be mollified by the fact that building society gains on gilts transactions will, as you know, be taxed in future on the same basis as gains by the banks. But it must be admitted that the effect of the composite rate on the banks may well be to cause upwards of £1 billion of bank deposits to be switched to the building societies in 1985-86, and we can expect them to object strongly to the change.

Summary

17. I enclose a table setting out all the main measures proposed (with the exception of North Sea taxation, for I still have to discuss with Peter Walker some possible ACT changes). The net effect is roughly neutral in 1984-85, but they reduce taxes by about £1.5 billion in 1985-86. Most of the extra second year benefit goes to business, but provided we stick to our published plans for public expenditure, the 1985-86 fiscal prospect still leaves room for substantial income tax cuts in next year's Budget.

18. The measures proposed for this year will mean we make a real start on reforming the tax system and getting the supply performance of the economy moving. There will be gainers and losers, as is inevitable in any radical change, and it will be vital to get the presentation right. But the story will be a good one, and I am determined that it should be well told.

NL.

N.L.

21 February 1984

BUDGET SECRET
Provisional Costing of Proposed Changes

		£m*			
		1984-85		1985-86	
		-	+	-	+
A	**Income and Spending**				
1.	Excise duties (see 16 February minute)		10		10
2.	VAT on newspapers etc; alterations; hot take-away food		610		1050
3.	Consumer Credit Duty				90
4.	Withdraw reliefs on foreign earnings and foreign emoluments		42		65
5.	Car benefit scales for 1985-86				30
6.	Income tax thresholds etc**	700		860	
B	**Businesses** (see 16 February minute)				
7.	Corporation tax reform				
	- abolish stock relief and reduce first year capital allowances				750
	- offset by reducing main CT rate to 50 per cent in 1984-85 and to 45 per cent in 1985-86	200		1050	
	- and small companies CT rate to 30 per cent	80		150	
8.	VAT on imports (PAS)		1200		
9.	Abolish NIS from 1 August 1984	465		925	
C	**Savings and Investment**				
10.	Composite Rate on banks		neg		neg
11.	Life Assurance relief		90		240
12.	Halve Stamp Duty on share transfers	160		155	
13.	Halve Stamp Duty on land and buildings	290		360	
14.	Improve Share Options schemes			30	
15.	Capital Taxes				
	- CTT changes	3		7	
	- DLT threshold	1		5	
16.	Abolish IIS	25		210	

*All figures are over and above the cost/yield from indexation
**Assumes double-indexation of basic threshold

-1924 +1952 -3752 +2235

BUDGET - SECRET

MR 7I

10 DOWNING STREET

From the Private Secretary

Prime Minister 2

The Chancellor has now sent across four papers

(i) Excise taxes

(ii) Business taxes

(iii) MTFS

(iv) Reform of taxes on income, expenditure and savings.

We have arranged two meetings, one tomorrow and one on Thursday. Though you will want to see all the papers to get an idea of the shape of the total package, I suggest you discuss (i) and (ii) tomorrow and (iii) and (iv) on Thursday. This is partly because decisions on (i) are more urgent and partly because (iv) is ~~the~~ the most complex and it would be helpful to have more time to think about it.

On (i) I now think the beer / wine package is defensible. Many people are expecting the differential to be adjusted

10 DOWNING STREET

From the Private Secretary

through a large increase in beer duty, the Chancellor can present the adjustment as being largely by reducing wine duty.

On (ii) the package is helpful in two ways. It raises more revenue from the financial sector by making leasing less attractive; and it is a ~~fu~~ major step, in conjunction with regional policy, in reducing tax on labour and subsidy on capital. Though the Nissan problem looks less serious than it did, some special action may still be necessary. Further advice is awaited.

I will put forward notes on (iii) and (iv) tomorrow evening. In particular I will try and sum the gains and losses for banks and building societies.

AT

21/2

PRIME MINISTER

cc Mr. Redwood

Residual Shareholdings

The Chancellor intends to include a passage in the Budget speech on residual shareholdings which will:

(i) clarify the Government's attitude to such shareholdings;

(ii) indicate those companies where the Government is free to sell further lots of shares. This would count as informing Parliament and obviate the need for any further announcement until the share sale itself is announced. This is signalled clearly in the text.

I see no problem with (i). On (ii), the aim is to give the Government greater flexibility while avoiding the kind of row which occurred over the announcement to sell BP shares.

It can be argued that identifying certain shares as possible candidates for sale will cast a shadow over them and will depress prices. Against this it can be argued that Parliamentary proprieties demand some kind of advance announcement and so the ideal of taking the market by surprise, which the private sector would aspire to, is not available to Government. Secondly it is not clear whether advance announcement does in fact cost the Government a great deal. The discount which the Government negotiates should take account of the degree of market information. In the case of both BP and C & W, the final selling price was above that at the time the intention was announced.

Agree the Chancellor's approach reconciles the need to satisfy Parliament and the need to maintain market flexibility?

AT

Yes mt

20 February 1984

CH/EX REF NO B(84)216

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iii

PRIME MINISTER

MEDIUM TERM FINANCIAL STRATEGY

The key to sustained recovery remains keeping inflation down, which in turn means further firm control of money supply growth, and of borrowing. So I plan to emphasise on 13 March the continuity of our economic policies, and to restate the Medium Term Financial Strategy, which, as Cabinet agreed on 9 February, will be extended to cover the next five years.

2. I shall of course be announcing monetary ranges for 1984-85. As you know, I have reviewed the formulation of monetary policy, and the results were foreshadowed in my Mansion House speech in October. I am sure that it is right now to have separate targets, consistent with a continuing reduction in inflation, for broad and narrow money, and the MTFS will therefore show ranges for £M3 and MO. There is no reason to change the range of 6-10 per cent for £M3 shown for 1984/85 in the 1983 MTFS. For MO (mainly notes and coin in the hands of the public) a range of 4-8 per cent would be appropriate. I envisage a subordinate role for PSL2 and M2 as cross checks on growth of broad and narrow money respectively. These changes were discussed with Alan Walters when he was last over; he was very much in favour of the new range for narrow money. For later years the MTFS will include illustrative ranges showing a downward path for both money measures, and making clear our determination to achieve a substantial reduction in monetary growth, taking us towards the ultimate objective of stable prices.

3. The monetary targets need of course to be supported by a consistent policy for public borrowing. The 1983 MTFS suggested a PSBR for 1984-85 of 2½ per cent of GDP, or £8 billion. As you know, I believe it would be right, for three reasons, to aim a little below this:-

(a) First, interest rates are still high both in nominal and in real terms. Lower public borrowing will ease the domestic sources of pressure on our interest rates, and insulate us to some extent against possible disturbances arising from uncertainties about the outcome of United States policies.

(b) Secondly, special sales of assets may bring in some £2 billion next year, or nearly £½ billion more than was assumed at the time of the 1983 Budget. The monetary benefit from this form of reducing expenditure is smaller than from other forms, and we must allow for this in settling the size of the PSBR.

(c) Thirdly, 1984-85 may be the peak year for North Sea revenue, and therefore ought to be a year in which to make a substantial reduction in borrowing: thereafter the PSBR would need to decline only very gradually.

I have of course taken full account of the views expressed in Cabinet on 9 February, and I shall not take a final decision until the latest revisions to the forecasts are available. But my present intention is to publish a figure of 2¼ per cent of GDP, or some £7-7½ billion. The reduction on the 1983 Red Book figure would demonstrate that we had taken account of the three factors mentioned above. Publishing £7-7½ billion would put borrowing firmly back on track after the likely PSBR overshoot this year. And the latest forecast suggests that it would be consistent with the neutral Budget I envisage, and would still leave us a safety margin in hand, which we both think important.

4. The MTFS would show an illustrative path for the PSBR declining further to 1¾ per cent of GDP in 1988-89, with room for cutting taxation next year and over the remainder of the life of this Parliament - provided of course that firm control is on public spending is retained. The path shown in the MTFS will of course be consistent with the assumptions to be used in the Green Paper on expenditure and revenue in the longer term.

If any of the numbers mentioned above cause you any concern, I should of course be happy to discuss them.

NL.

N.L.

20 February 1984

File

NBPM AT 20/2

MR TURNBULL

RESIDUAL SHAREHOLDINGS

Nigel Lawson's letter to Peter Walker concerning residual shareholdings and the Budget Speech conceals a danger.

If it is announced in the Budget that sales of shares in ABP, British Aerospace and Britoil are all possible in the forthcoming financial year, the overhang of these shares will serve to depress the market price and would reduce the companies' room for manoeuvre on any other issues.

It is better to make one announcement at the time that the sale is finally under way. This should be done for each individual issue separately.

Prime Minister

You may like to discuss this with the Chancellor. Would the last paragraph be accepted as having informed Parliament? If so, there could be advantages as the sales of could be brought to market without a further announcement.

John Redwood

JOHN REDWOOD
17 February 1984

Confidential + Personal

Washington DC
Feb 17th 1984

Prime Minister

Economic Policy

My absence here in Washington prevents me from being involved in the budget discussions. I shall be in London on 27th for a week so that I will be able to advise you then in more detail. But I thought it might be useful to set out my general thoughts here.

First I think it is important that in this budget the government be seen to be initiating its programme for reducing inflation to zero. The government needs to convince the sceptical public that it will not rest on its achievment of 5 per cent as "acceptable". (Shrewd market men know that an inflationary floor at 5 per cent will soon see the rate surging again up to 10 per cent or so. And market expectations reflect an inflation rate of more than 7 per cent.) I believe that the distressingly high increase in average earnings in manufacturing last year (to December) at 9.7 per cent reflected inflationary expectations exceeding 7 per cent. These expectations probably reflect the more relaxed budgetary and monetary conditions last year; a modest but unmistakable correction is called for this year.

2 In principle I would like to see the PSBR fall to 2 per cent of GDP or roughly £6 bn. (This would still be ½ per cent over the 1980 MTFS figure for 1983/4) It would be much tighter than anyone at present expects - and for that reason would be quite powerful in revising expectations. The implicit tightening that is already absorbed in the increased contingency allowance will work in the right direction. This will be offset, however, by the fact that ~~much~~ some £1.5 Bn of the increase in revenue is from the sale of assets. On balance I think £7 bn

should be regarded as an upper limit.

Secondly, you are aware, I am sure, of the ambient view that the "government seems to have no real policy for this second term". This view was put to me - albeit in a friendly way - by the leader of the IMF team to the U.K., Mr P. de Fonteney.* He agreed that the policy had been generally successful so far, but there seemed to be no clear policy of reforms ahead. While I know that this is far from true, there is a case for considering whether you could defuse this cause for concern. I believe that a suitable budget, that clearly showed there was no more drift, would help. But there is a long list of other reforms where a clear statement of policy would be of considerable benefit, both economically and I suspect politically.

In the United States, the publication of the budget and economic report of the President has changed nothing. I continue to think that nothing will be done about the deficit until 1986. Meanwhile there are signs that opinion is becoming less sanguine about the continuation of the boom. The stock market, often a very useful early indicator, turned sharply down, interest rates have crept up higher - but nevertheless the shine has gone off the dollar. And there is anecdotal evidence of a rise in the inflation rate. I continue to believe that the marked turndown will come later this year - and this seems to be the way opinion is veering.

Although our recovery in Britain is much more firmly based than that in the United States, the backwash from a marked turndown in the United States would be serious. There is little to be done except continue to ensure that our financial strategy is right for us.

* I believe Andrew Turnbull knows him quite well.

AW

A.A. Walters

7G

PRIME MINISTER

Excise Duties

The principle of valorisation, the overall level of revenue raised and the RPI impact seem reasonable.

You could ask whether the balance between beer, wine and spirits is correct. The Chancellor's proposals will be seen as:

a) a victory for foreigners at the expense of good British beer

b) favouring the rich at the expense of the rest.

Some brewers will undoubtedly try to foment a nationalistic working man's campaign against these proposals.

Would it be possible to reduce wine duty by less and still show willing on the European Court judgement? And couldn't spirits be valorised fully?

The abolition of kerosene duty is a good idea.

Business Taxes

The proposals are bold and imaginative.

1) Speeding up VAT on imports. A good measure: at the moment importers in the UK are favoured unduly.

There will be opposition from some importers whose cash flow will be badly affected by this measure.

It is being used, as the Chancellor spells out clearly, to defer the revenue impact of abolishing NIS. This is sensible.

/ 2)

2) Stock Relief. Now is a good time to abolish it with inflation low and with other changes dwarfing its significance. Some will protest.

3) Capital Allowances. The changes are good. They will cause friction with leasing companies and banks: capital allowance reduction is the best way of taxing bank profits by removing one of the prime types of shelter. Some manufacturers, doubtless egged on by the CBI, will also complain.

The main risks in the package are:

a) Financial. The announcement commits the government to a reduction of £1.4 bn in 1985-86 in total business taxes, despite rising profitability and stronger cash flow for companies. This limits manoeuvre on personal taxes but is about right if expenditure can be properly controlled.

b) Presentational. The many favourable characteristics, particularly ending the tax on jobs and moving to a more neutral stance between capital and labour, have to be hammered home. There are several groups of losers, some with lobbies, who will otherwise dominate the debate.

You could raise these risks with the Chancellor whilst welcoming the central thrust of his proposals.

J. Redwood

17 February, 1984.

7F

PRIME MINISTER

The Chancellor has now sent in his papers on:-

(i) Business taxes

(ii) Excise duties.

On (i), you should be aware of a difficulty raised by Mr. Tebbitt. He, or perhaps more accurately his officials, claims that the withdrawal of capital allowances will make leasing less attractive (as indeed it is intended to do as part of the plan to raise more tax from the financial sector), and will hit the Nissan project. The Department of Trade and Industry fear that this could be interpreted by Nissan as a failure to deliver the assurances which the UK Government, and you yourself, gave to the company.

The Chancellor has spoken to Mr. Tebbitt about this - see the attached letter. The Treasury are questioning the estimate of the effects, have noted that there are offsetting benefits, for example, the removal of NIS, and believe that even if there is a loss to Nissan, there may well be other ways of handling the problem. A further report is awaited.

I think the paper on the business package should have done more to identify who the complainers will be, and how their arguments can be countered. Tax-exhausted companies should not complain if the value of allowances they are unable to use is reduced, but they, along with the banks, may complain that leasing is becoming less attractive. On PAS (VAT on imports) the CBI will find it difficult to speak with one voice. They may direct their efforts towards securing a concession for importers of components and semi-manufactures. This would, however, make the scheme much more complex to operate, and create a new frontier to defend. In any case, importers can hardly complain about a measure which puts them on the same footing as those who buy British.

On excise duties, the point you will need to establish is whether the cut in the wine duty really is the minimum we can get past the European Court.

In considering these measures, you will want to keep in mind the nature of the complete budget package. Next week's paper on the taxation of the personal sector and of savings will include a consumer credit tax, a composite rate for bank interest, the removal of life assurance premium relief, and abolition of the investment income surcharge. It will be apparent that this could be one of the most revolutionary budgets for some time.

Also coming next week will be a paper on the framework of the Budget, for example, the time horizon of the MTFS, the path for the borrowing requirement, and the monetary ranges.

We have arranged two slots: 1100 on Wednesday for 45 minutes and another 30 minutes before Cabinet on Thursday.

AT

17 February, 1984.

BUDGET CONFIDENTIAL

VC

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10 DOWNING STREET

From the Private Secretary

16 February 1984

Building Societies: Taxation of Profits on Gilts

At their meeting this morning, the Prime Minister and the Chancellor discussed your letter to me of 14 February. The Chancellor explained that, in the long term, this measure should not have a significant impact on the flow of mortgages or on the mortgage rate. He told the Prime Minister that it would represent on average a reduction in the margin of 0.1%. In the light of this, the Prime Minister agreed that this change should be made, but without retrospection.

ANDREW TURNBULL

John Kerr, Esq.,
H.M. Treasury.

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JU727

Secretary of State for Trade and Industry

16 February 1984

SECRET

Mr. Butler

A.J.C. 16/2.

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Treasury Chambers
Parliament Street
London SW1

Mr. Turnbull
You may like to show this to the PM before her next tete a tete with the Chancellor.
PERB 16.2.

D Nigel

As your proposed corporation tax package develops, I have been taking a closer look at its effects in the short and medium run - say up to 10 years or so - on manufacturing industry. As a particular example - because of its high profile in political terms - I have looked at its effects on the Nissan project. It may be useful if I briefly set out the facts.

2 We believe that the net present value to Nissan of Phase 1 and Phase 2 combined of the current tax structure, compared with the structure you are now considering, is in the region of £50m. This is a very large sum in relation both to the total cost of capital expenditure and to total Government financial assistance to the project. The gains to Nissan from the reduction in corporation tax will not be any great comfort: the profit profile shows that it is not until the beginning of the next century that this reduction will actually help Nissan.

3 This is made more awkward as in response to a personal appeal from Mr Kawamata to the Prime Minister for the Government to build a factory and lease it to Nissan, the Prime Minister offered her personal support and the good offices of the Bank of England to secure commercial leasing arrangements to finance the capital expenditure. Although no assurance was given on the continuance of the current corporation tax system and capital allowances, you will see from the attached letters from the Prime Minister that the tax benefits accruing to Nissan through the leasing route were explicitly spelt out. Nissan are in no doubt of the considerable advantage afforded by current leasing arrangements in addition to regional development grants and negotiated selective assistance.

4 To have the advantage of leasing so seriously reduced and so soon after the deal was signed can hardly fail to be regarded by Nissan as at least sharp practice and very possibly as a breach of faith. Because of her close involvement, the Prime Minister's personal credit will be called into question. There is a real

risk that it would lead Nissan to cancel the project. At least we must expect them to seek additional selective assistance to make good the loss.

5 I do not see how we could give sufficient additional selective assistance. To do so would increase the level of aid to the point where the European Commission would have a veto over it. Such action would in any case be virtually impossible to defend when we have emphasised that Nissan is being treated no differently from any other would-be investor.

6 We are therefore facing an unpleasant dilemma. I must say I cannot see much prospect of transitional arrangements to protect Nissan from the effects of the change, since those arrangements would of course have to be available generally to all business.

7 I am copying this letter to the Prime Minister.

Yours ever
Norman

NORMAN TEBBIT

10 DOWNING STREET

THE PRIME MINISTER

9 November 1982

Dear Mr Kawamata,

At our meeting in Tokyo, you explained your concern that the UK project would impose a heavy additional financing burden on Nissan. In order to reduce the immediate impact of a UK investment you asked whether it would be possible for the British Government to build and fully equip a factory initially, and to recover the cost from your company over a period through a rental arrangement. I undertook to consider personally whether we could offer a solution to this problem.

As I mentioned when we met in Tokyo, it would be possible for one of the relevant public agencies to build a factory and lease it to Nissan; but it is not the practice under our law for these agencies to equip a factory. So this would not be a complete solution to the problem which you raised.

However, the inquiries which I have made indicate that there is an alternative solution which would achieve the result you are seeking. This is an arrangement that the assets of the project should formally be under the ownership of a group of UK financial institutions who would lease them long term to Nissan on commercial terms. Under such an arrangement, Nissan would in practice remain in effective control of the design, construction and operation of the factory and its capital equipment.

This form of leasing finance is an established part of current corporate financing in the UK. However, Nissan's investment would be of an unprecedented size for such financing, and would in tain years be likely to absorb a significant proportion of the UK's expected capacity for leasing finance. Nevertheless, with the Government's backing - to which I would lend my personal support - and through the good offices of the Bank of England, who would, at my request, use their best endeavours in bringing together appropriate partners, I believe that there is a good prospect that a suitable consortium of financial institutions could be encouraged to participate in order to facilitate Nissan's investment in this country.

Such an arrangement could also offer some additional advantages. As you know, there are taxation allowances relating to the cost of acquiring buildings and plant that can be set on a favourable basis against profits when assessing a company's liability for Corporation Tax in the UK. Your financial projections presented to the Department have shown that these allowances would not be able to be set against taxable profits for some years. Under present tax law the lessors would be able to set these allowances against their own current profits when assessing their Corporation Tax liability. The financial benefits to them would be reflected in the leasing charges made by them to your company. While the exact terms naturally depend on market conditions, such charges might be expected to offer a significant advantage against the equivalent cost of UK bank borrowings by a prime commercial borrower. In the present market, some part of this benefit might be recognised by, for example, a three year period during which no leasing charges at all would be made, with a commensurate increase in the charges made in ensuing periods. The terms and conditions of such a lease would be a matter for discussion with the lessors.

As you know, I had a meeting on 18 October with Mr Ishihara, whom I was delighted to meet. He expressed the hope that we would be flexible over any conditions relating to exports. I was able to reassure him that we have always understood that you are unable to enter into commitments on the level of exports, though it is our common hope that a significant proportion of the output will eventually be exported.

Finally, may I say how much I appreciated the constructive discussion which we had in Tokyo. I hope in turn that the proposal I have outlined above will be helpful in meeting the anxiety which you expressed about the project. Naturally I should be delighted to arrange for representatives of the Government and the Bank of England to discuss these proposals further with Nissan if you feel that this would be helpful.

With every good wish,

Yours sincerely,

Margaret Thatcher

Mr. Katsuji Kawamata

10 DOWNING STREET

THE PRIME MINISTER

6 January 1983

Dear Mr. Kawamata,

Thank you for letting me know your conclusions on the proposal I put to you in my letter of 9 November.

I was surprised that you concluded that the leasing route did not present a bigger advantage; and just so that there should be no misunderstanding between us I should like to make sure that you are aware that the leasing route is not an alternative to the receipt of Government grants. Under a leasing arrangement the grants would continue to be available; the selective assistance under the Industry Act would be available to the lessee and the regional development grant to the lessor (though in certain circumstances to the lessee). Where the lessor was the recipient, this would be reflected in a reduction in the leasing charge. Since I was not entirely clear that you had taken this into account in your studies, I have thought it worth clarifying the point.

As you say in your letter, the terms and conditions of any leasing arrangement would have to be negotiated with the financial institutions. My point about the Bank of England was not that they could help you to secure more favourable terms, but that such a leasing arrangement would be extremely large, even by the standards of the City of London, and that the Bank of England's good offices would be helpful in enabling you to secure arrangements on this scale.

As I said in my letter, I am very willing to arrange for experts to discuss with your people these or any other aspects of the project if it would be helpful to you. I still hope that, when you are ready to do so, you will reach a favourable decision on the project which would be to our mutual advantage.

All best wishes.

Yours sincerely

Margaret Thatcher

Mr Katsuji Kawamata

ANNEX D

10 DOWNING STREET

18 March 1983

THE PRIME MINISTER

Dear Mr Kawamata,

I was grateful for your letter of 17 February 1983; and I have now had a report of the discussions Mr Kawai has had with officials at the Department of Industry, and with leasing experts from the Bank of England and from the City of London, all of which have taken place in conditions of the strictest confidentiality. I can assure you that the knowledge that you put to me a proposition on these lines when we met in Tokyo has been restricted to a very small circle indeed.

I was naturally disappointed to hear of some of the changes in the project which Mr Kawai proposed. But those who took part in the talks on the British Government's side have tried to respond helpfully, provided that our essential requirements can be met. I am glad that Mr Kawai has been able to study the leasing route; I am confident that, despite the unprecedented size of the project, this could be available to you through the good offices of the Bank of England which I have offered, and I am confident also that in terms of net present value this facility should compare most favourably with any alternative financing route. Together with the grants and selective financial assistance we have offered, these add up to a substantial contribution to the cost of the project.

You will have noted, as I have, the welcome signs that the international recession, which I know has contributed to your caution on this project, is at last coming to an end. There have also been major movements in currencies which are in most respects significantly favourable to this project. But unemployme remains high here as elsewhere, and the pressure for British people to have the opportunity of the jobs involved in producing the goods sold in this country shows no signs of abating. For all these reasons, I warmly hope that we shall soon be able to bring this matter to a favourable conclusion, and I look forward to hearing your conclusions following Mr Kawai's report to you.

Yours sincerely,

Margaret Thatcher.

Mr Katsuji Kawamata

Japan: A-J. Relations
Pt 4

BUDGET SECRET

B(84) 166

7D

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

16 February 1984

M C McCarthy Esq
Private Secretary to the Secretary of State
for Trade and Industry

Dear Callum,

Your Secretary of State had a word with the Chancellor tonight about his letter earlier today on Nissan.

The Chancellor queried the estimate of £50 million for the disadvantage to Nissan, taking phase 1 and phase 2 of the project together, of the proposed corporation tax/capital allowance changes. It was not necessarily right to include both phases, and allowance should be made for other factors - e.g. NIS. It was agreed that Treasury and DTI officials should urgently conduct a joint analysis of the effects on Nissan of the total proposed tax package.

Your Secretary of State confirmed that he still favoured the package. He was sure that it would be beneficial to the economy: the problem was the handling of the transitional phase. It would be necessary to find a way of finessing the Nissan problem: if nothing was done, there must be a risk of action by Nissan which would be seized upon by the critics as concrete evidence that inward investment would be deterred by the tax changes. It was however noted that some investment might actually be drawn forward by the proposed Budget announcements.

It was agreed that the Nissan problem required early joint consideration, not least because of the Prime Minister's letters to Mr Kawanata, though the Chancellor drew attention to the fact that the main point made by the Prime Minister was that leasing arrangements would be available: the tax benefits for the lessors "under present tax law" had been mentioned only as a subordinate point.

I am sending a copy of this letter to Andrew Turnbull at No 10.

Yours ever,

John Kerr.

J O KERR

BUDGET SECRET

FINANCIAL SECRETARY TO THE TREASURY

Treasury Chambers, Parliament Street, SW1P 3AG

File

Andrew Turnbull Esq
10 Downing Street
LONDON

16 February 1984

Dear Andrew,

At Questions last Thursday, the Prime Minister was asked about the way the Financial Secretary appeared to be treating NICs as a tax in answers to Parliamentary Questions. I enclose a short note about our practice, and a suggested line to take. I am sorry you have not had this before now.

Yours sincerely,

Andrew Hudson

A P HUDSON

NOTE FOR NO 10

NICS AND "THE TAX BURDEN"

There is a quite clear distinction, both in principle and in practice, between NICs and taxes. National insurance contributions are paid to provide entitlement to specific benefits - the general rule is no contributions, no benefits - whereas taxes are collected to meet general government expenditure. NICs are applied solely to the costs of social security benefits, being paid into a specific fund - the National Insurance Fund, from which these benefits are financed - and not to the Consolidated Fund which meets general expenditure. Hence NICs are treated as a separate category in the national accounts and the same distinction is made in other countries operating social security systems based on separate contributions.

2. This distinction is not invalidated by replies which take NICs into account when Parliamentary questions are asked about disposable income or net take-home pay after state-imposed deductions. NICs are included where it is accurate and helpful to do so; they clearly are, in such contexts, a deduction from gross pay like income tax. It is on other occasions helpful and accurate to take into account the effect of child benefit, though no-one suggests that as a result child benefit should now be classified as some form of tax rebate. Similarly, NICs are often included in replies to questions seeking international comparisons, because to do otherwise would give a false impression of the comparative burden of deductions from gross earnings.

Line to take

(i) Arguments about classifications are not particularly productive.

(ii) NICs are not a tax and they have not been classified as a tax since their inception.

(iii) In answering questions about disposable income or net take-home pay my Rt Hon and Hon Friends have taken NICs into account when this is helpful or appropriate to the purpose of the question.

(iv) NICs have increased because spending on benefits has increased - if the Opposition want reduced benefits, they should say so. (Note: The Treasury supplement has also been reduced. This to keep a proper balance between taxpayers and contributors in financing the total social security programme. And the last time there was such a reduction - ie, for 1984-85, NIC rates will not be increased.)

(v) Income tax has been reduced because the Government has cut rates - with the basic rate reduced from 33 per cent to 30 per cent - and increased allowances by 7½ per cent in real terms, in contrast with the party opposite's record of a <u>reduction</u> in real terms of 20 per cent in the value of the single allowance and 5 per cent on the married mans allowance. With this record, it is not surprising that the Opposition seeks to quibble about definitions.

(vi) Important to remember that NICs are not paid by pensioners.

(i) 7c

Ch/Ex Ref No. B(84) 162

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

PRIME MINISTER

MT

I owe you a report on the changes in the excise duties which I envisage for the Budget.

2. I am sure that it is right to aim at broad revalorisation: this is what people have come to expect, and the RPI impact effect is small, given low inflation. But I propose a number of minor exceptions.

3. The most politically sensitive items are of course petrol and derv. For petrol, I have in mind an increase of 4.5p a gallon, exactly what is required by revalorisation, but on derv I propose an increase of only 3.5p a gallon, which is a slight rounding down of the strict revalorisation increase (3.8p). I have consulted Nick Ridley, Peter Walker, George Younger, Nick Edwards, and John Wakeham: all are content with my plans. (But I might of course still have to review them again if our forecast, or the outlook for crude oil prices, were to change significantly before the Budget.)

4. As to tobacco, I have in mind an increase of 4p for 20 cigarettes. This is a rounding up of the straight revalorisation increase of 3.5p. As a minor concession, sought by Jim Prior, because of the industrial implications in Northern Ireland, there would be no increase in the duty on pipe tobacco.

5. On the Vehicle Excise duty, straight revalorisation of the £85 rate for cars and light vans would produce £89.50, but

Nick Ridley and I have agreed that this should be rounded up to £90. We have also agreed changes in VED on goods vehicles which will produce very slightly (£3m) more than revalorisation. The duty for most goods vehicles will in fact rise broadly in line with revalorisation but there will be reductions for the lightest lorries offset by higher increases for some heavier lorries, to recognise their differing contribution to road costs.

6. Finally, drinks. After consultation with Geoffrey Howe about the recent European Court judgement, I propose an increase in the duty on beer of 2p a pint, and a reduction in the duty on wine of about 18p a bottle. Following the unsatisfactory talks which Michael Jopling and I had in Rome with our Italian counterparts over the Italian foot-dragging on the implementation of the analogous European Court judgement against their discrimination against Scotch whisky, I am in touch with Geoffrey Howe about the possibility of a temporary surcharge on vermouth, to put pressure on them. On other drinks, I have in mind an increase of 10p a bottle for spirits - well below revalorisation - 10p a bottle for fortified wines, and 3p a pint for cider.

7. I have in mind one other small concession: abolition, at a cost of only £5m, of the 1p a gallon duty on kerosene, which applies to paraffin used, mainly by the elderly, for home heating.

8. Altogether these increases will yield about £660m in a full year, compared to £640m from strict revalorisation. The RPI impact effect will be only 0.4 per cent, and this has of course already been allowed for in our forecast.

9. I see no serious problems here, but I would be grateful to know whether you too would be content with the proposed changes. I would of course consult you again if I had to consider larger increases for petrol and derv; and I shall let you know in due course what conclusions Geoffrey and I reach about vermouth.

NL.

N.L.
16 February 1984

(ii) 7B

Ch/Ex Ref No B(84) 163

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

We may well lose one of the "unpopular" measures, while M.P.s pocket the reliefs. We must consider this and its possible effects on the budget strategy. MT

PRIME MINISTER

REFORMING BUSINESS TAXES

In the last Parliament our major achievement was bringing down inflation. It was accompanied by some valuable changes in the structure of personal taxation. But we could do little to bring about the radical structural reform of the present complex and unsatisfactory system of business taxation which we are agreed is long overdue. We now have a rare opportunity. The economic prospect is favourable, with output, liquidity, profits and investment all rising. The first Budget after the election is the right time to launch this reform.

2. My basic aims are to reduce distortions, entrenched in the present tax system, between different types of asset, different forms of finance, and the cost of labour and capital; to widen the tax base and simplify the system; and to lighten the tax burden on business in the next two years and ensure a progressive alleviation thereafter. The reforms will benefit business and the economy as a whole by improving the quality of investment, and by taking less from business profits. At the same time we shall sweep away a host of complex special provisions.

3. The overall package will have three main elements - reforming Corporation Tax; abolishing NIS (which you have called "Labour's pernicious tax on jobs"); and speeding up the payment of VAT on imports. The cash flow effect in the next two years is summarised in Table 1 (annexed).

Corporation Tax

4. This major structural reform will be staged over several years.

It will accompany the further lowering of inflation and inflationary expectations indicated by the MTFS. Stock relief, which was introduced as a rough-and-ready means of coping with high rates of inflation, will be abolished immediately. First year capital allowances, which discriminate heavily in favour of plant, machinery, vehicles and industrial buildings, irrespective of the profitability of the investment, will be phased out, and the Corporation Tax rate will come down in parallel from 52 per cent to about 35 per cent (see Table 2 annexed). This will also greatly reduce the undesirable discrimination in the present system in favour of loan finance and against equity finance. The Corporation Tax rate for small companies will come down in one single step from 38 per cent to 30 per cent. So that business can plan ahead, I intend to announce all stages for allowances and rates in the 1984 Budget, though I have not yet decided how much to put in this year's Finance Bill.

5. These changes will:

a. improve the quality of investment. On average a slightly higher pre-tax yield will be required to achieve a given after-tax yield on new investment, and at the margin projects with a low pre-tax yield will not go ahead; but there will still be some tax assistance for most investment that gets it now. Projects not at present assisted, like commercial buildings, will show a better post-tax yield;

b. reduce the total tax take from companies over the next two years and also in the long run when the revenue gains from reducing capital allowances run out but the benefits of low corporation tax rates continue.

6. These fundamental changes will provide large overall benefits for companies. But there will inevitably be some losers as well as gainers. Tax exhausted companies will not gain from the CT package and some will lose, as will unincorporated businesses which choose not to incorporate; but both these categories will gain from NIS

(see below). Critics of the CT package will claim that it will reduce the quantity of new investment, particularly in manufacturing whose investment is dominated by plant and machinery. But we expect that in reality a considerable amount of investment will be brought forward in the next two years to benefit from the remaining capital allowances. More important, the quality of investment will be raised. Some inward investment may be encouraged by a lower CT rate, while others will be discouraged by the phasing out of allowances which will make leasing finance more expensive. This poses some problems for Nissan, as Norman Tebbit has pointed out, and we shall need to examine that separately. (It is, of course, the present scale of leasing that enables the banks to pay so little by way of Corporation Tax.)

National Insurance Surcharge

7. The abolition of NIS from 1 August is necessary to help sell the CT package by sharply reducing the number of losers. We are in any event already committed to abolition in this Parliament. It was the CBI's first priority and will bring a continuing benefit to all employers, whatever their tax position. Coupled with the Corporation Tax changes, it will also reduce the present tax bias in favour of investment in capital rather than labour, and should thus at the margin help create new jobs.

Speeding up payment of VAT on imports

8. The UK allows postponed payment, unlike most other major EEC countries. Some manufacturers have asked for this to be ended to help them compete with imports, although others will dislike the cash flow impact or its interest cost. But the once and for all revenue gain from ending it is large. I need it to reconcile bringing forward the ending of NIS to this year with the sharp reduction in the PSBR which we must make in this Budget if we are to maintain downward pressure on inflation and interest rates.

Overall effects

9. The summary table shows that there is a cash flow loss to business in 1984/85 (due to PAS) and a considerably larger cash flow gain in 1985/86. I shall of course present the two years together. On a wider basis, including other tax changes directly affecting business, and scoring PAS in terms of interest cost and not cash flow, business gains in each year - about £900 million in 1984/85 and £1500 million in 1985/86. With a neutral Budget in 1984 and a large fiscal adjustment in prospect for 1985, this leaves room for desirable changes in personal taxation, provided we keep public expenditure flat. That will also be necessary in the longer term to keep CT rates low when the temporary revenue gains from ending capital allowances are running out, a point that fits well with the paper on long-term public expenditure.

Conclusion

10. I have discussed the package with Norman Tebbit and Arthur Cockfield, and the EEC aspects of speeding up VAT payments on imports with Geoffrey Howe. They are generally content. I am sure we should now seize the opportunity to launch this major structural reform of business taxation.

11. I will be letting you have a note on the Budget as a whole next week.

John Kerr

P.P. N.L.
16 February 1984

TABLE 1 BUDGET SECRET ANNEX

SUMMARY EFFECTS OF MAIN CHANGES IN BUSINESS TAXATION

Revenue £ million (cost (-)/yield (+))

	1984-85 -	1984-85 +	1985-86 -	1985-86 +
1. Corporation tax reform**				
- abolish stock relief and reduce first year capital allowances; offset by				750
- reduce main CT rate to 50% in 1984/85 and to 45% in 1985/86; and	200		1050	
- reduce small profits CT rate to 30% in 1984/85	80		150	
2. Abolish NIS from 1 August 1984	465		925	
3. Withdraw postponed accounting system (PAS) for VAT on imports*		1200*		
	+455		-1375	

Notes

* Represents once-for-all acceleration in the VAT paid on imports.

** First stage of phased programme. The 1985-86 yield assumes, for capital expenditure incurred after Budget Day, first year allowances are reduced from 100% to 75% for plant and machinery; from 75% to 50% for industrial buildings; and that stock relief is abolished. Later stages are set out in Table 2.

TABLE 2

STAGES OF THE CORPORATION TAX REFORM

	Stock Relief	First year capital allowances for: Plant, Machinery, & Vehicles %	Industrial Buildings %	CT Rate
1984/85	-			50%
1985/86	Abolition	75	50	45%
1986/87		50	25	about 40%
1987/88		25 WDA	4 WDA	about 35%

The table sets out the years in which cash flow would first be affected by each measure if all the stages were implemented in the next three budgets. For example the first reduction in capital allowances and the loss of stock of relief apply in 1984/85 but affect cash flow in 1985/86.

BUDGET
CONFIDENTIAL

PRIME MINISTER

MEETING WITH THE CHANCELLOR: 16 FEBRUARY

Only fifteen minutes is available. The Chancellor will probably set out for you the schedule he has in mind for considering the various Budget issues. A paper on business taxes - corporation tax, NIS, VAT on imports - should reach us before the end of the week, as should another paper on excise taxes. Next week there should be a paper on taxation of the personal sector and savings, including relief on insurance premiums.

The only specific proposal received so far is the change in the taxation of profits on gilt trading by building societies - see separate note.

AT

15 February 1984

CONFIDENTIAL

cc HO

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

15 February 1984

The Rt. Hon. Peter Walker MBE MP
Secretary of State for Energy

Dear Peter

RESIDUAL SHAREHOLDINGS

We recently agreed in E(A) (E(A)(84) 2nd meeting) that residual shareholdings in privatised companies (other than any Special Share) should in future be held by the Treasury. I think it would be helpful in view of the continuing misunderstanding by outside commentators about the function of the shareholdings (to which I referred in my E(A) paper) if I were to make a statement in the fairly near future in order to clarify the Government's position. My Budget speech would provide a natural home for this.

(1) Such a statement would emphasise that our underlying intention was not to use these shares as a lever for exerting continuing influence on the companies concerned but instead to sell the shares as market conditions and other circumstances allowed. (2) The statement could also conveniently refer to those companies where we are not precluded from making further sales in 1984-85. We should then not have to make any further announcement until arrangements for a sale were complete.

I enclose a draft of the sort of passage which the Budget speech might contain. I should, of course, consult you and other colleagues separately about any specific proposals to sell shares in companies which you sponsor.

I am copying this letter to the Prime Minister, George Younger, Norman Tebbit, Nick Ridley and Sir Robert Armstrong.

Yours
Nigel

NIGEL LAWSON

DRAFT

Passage for Budget Speech [possibly following section on public expenditure and asset sales targets]

Mainly as the result of its privatisation programme, the Government holds minority shareholdings in a number of quoted companies. Questions have been asked about the Government's intentions towards these shareholdings. It has been suggested that they represent a continuing and deliberate means of exerting Government influence over the privatised companies. That is not so: indeed, it would defeat the main purpose of privatisation were it so.

Let me put the matter beyond doubt by making it clear that the Government's policy is progressively to sell such shareholdings from its portfolio as the circumstances of the individual companies and market conditions permit. Where there are national interests at stake, they can be adequately safeguarded through the mechanism of a Special Share as has already been done in the case of Britoil, Amersham and Cable & Wireless. Meanwhile, in order to reflect the Government's policy more closely, the Treasury, rather than the former sponsor Department, will in future take responsibility for residual shareholdings other than Special Shares.

During 1983-84 the Government sold substantial shareholdings in BP and Cable & Wireless. The terms of the share sale prospectus rule out further sales of these shares during 1984-85, but sales in ABP, British Aerospace and Britoil are not precluded in this way. The Government will be considering the possibility of further sales during 1984-85 in the light of market conditions and other factors. A full announcement will be made to Parliament at the time individual sales are made.

Econ Pol
Privatisation
Pt 4

16 JAN 1984

BUDGET
CONFIDENTIAL

PRIME MINISTER

TAXATION OF GILT EDGED SECURITIES OF BUILDING SOCIETIES

The Treasury are proposing to tax the profits on the realisation of gilts by building societies as part of their trading profits rather than as capital gains. This follows advice they have received from Counsel. I suspect the findings of Counsel are not unwelcome to the Treasury who have been wanting to make this change for revenue reasons.

This will prevent building societies using capital gains on gilts to keep their margins low. This should not, however, seriously affect the flow of mortgages in the longer term as it represents on average a reduction in the margin of 0.1 per cent (the margin has been about 0.5 per cent). It could, however, be used as an excuse in the short term to delay a cut in the mortgage rate, though in practice this is unlikely to be the case as it is doubtful whether building societies will now make a move ahead of the Budget.

If the Chancellor goes ahead with a tax on the providers of credit, the building societies will not be able to complain as, notwithstanding the change in the treatment of capital gains which brings them into line with banks, their relative position will still be favourable as the credit tax will not apply to that part of their lending which attracts mortgage interest relief.

You might want to confirm with the Chancellor at your bilateral tomorrow that this measure will not have serious effects on the flow of mortgage finance.

AT

15 February 1985

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

14 February 1984

Andrew Turnbull Esq
10 Downing Street

Dear Andrew,

As the Prime Minister knows, profits made by building societies on the realisation of gilt-edged securities and similar stock have so far been treated as chargeable gains, against which losses are allowable, and taxed under the capital gains tax regime. This has represented something of a privilege vis-a-vis the banks, whose gains on gilts have been subject to corporation tax. Counsel have now advised that profits on the realisation of gilts in fact form part of a building society's trading profits, and should accordingly come under the corporation tax regime.

The Chancellor is clear that the Inland Revenue have no choice, given the legal opinion, but to bring the building societies into line with the banks without delay. Strictly speaking, the change should apply to accounts which are still open, or could properly be re-opened, ie to all the societies' 1983, and some of their 1982, accounts. But this would be harsh, given that they have not been providing for the extra tax, and the Chancellor believes that the right course is for the Revenue now to write to the Building Societies Association, informing them of the legal advice, but saying that it will be applied only from the date of the letter.

Since there will no doubt be some publicity, and an Appeal to the Commissioners seems on the cards, the Chancellor thought that the Prime Minister would wish to be aware of these developments, and his decision against any form of retrospection. One small bonus is that the removal of the discrepancy between the tax treatment of gains on gilts sold by building societies and banks will of course be well-received by the latter, who are at present concerned about the proposal, of which the Prime Minister is aware, to extend to them the composite rate income tax arrangements now applying only to the building societies.

Yours ever,

John Kerr.

J O KERR
Principal Private Secretary

7A

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

13 February 1984

The Rt. Hon. Lord Cockfield
Chancellor of the Duchy of Lancaster
Cabinet Office
70 Whitehall
LONDON
SW1

Dear Arthur

CAPITAL GAINS TAX: ALTERNATIVE CHARGE

Thank you for your letter of 7 February.

I have a lot of sympathy with your comments on the indexation provisions. We must think again very hard about their effect both on the administration of the tax and on its likely yield in future years.

As you know, the Revenue have in hand a detailed review of the tax. I have asked them to give specific consideration to your suggestion for limiting the charge to a proportion of the net disposal proceeds.

We need to examine this and perhaps a number of other possible variants for taxing chargeable gains in the future. It is essential to get it right this time and we need to go through all the possibilities before making the next move. Once the Budget and Finance Bill pressures have eased a little, I propose to ask the Revenue to let me have an interim report on their review, and it might be useful if you and I and John Moore could get together to discuss it soon after Easter.

A copy of this letter goes to the Prime Minister.

Yours ever
Nigel

NIGEL LAWSON

File

10 DOWNING STREET

Prime Minister (2)

You might like to look at the pre Budget forecast, summarized in pages 1–10

AT 10/2

Thank you

~~Mr Redwood~~

To see and return pl

AT 13/2

AT

TREASURY ECONOMIC FORECAST

JANUARY 1984 REPORT

Contents	Page number
Introduction and summary	1
Summary table	8
World Economy	11
Exchange rate	13
Trade and the balance of payments	15
Demand and activity	21
Employment, unemployment and potential growth rates	32
Inflation	35
Financial surpluses and deficits	39
Interest rates	40
Monetary aggregates	42

Annex: comparisons of forecasts

TREASURY ECONOMIC FORECAST: JANUARY 1984 REPORT

Introduction and summary

This is the report on the internal forecast and describes our best view of the next two or three years. Separate reports are being produced on the prospects for the world economy, for public finances and for oil. More details on the UK forecast are available on request. A revised and updated forecast will be published on March 13 in the FSBR. The forecast is mainly concerned with 1984 and 1985, but has been tentatively extended into later years.

2. The Autumn Statement, including a short-term forecast, was published in mid November. Economic statistics available since then are, broadly, consistent with that forecast. In particular, the inflation rate remains low; while there has been even stronger growth in consumer demand, and an earlier than expected recovery in exports. The labour market is strengthening. But industrial output, at least on provisional estimates, is still showing only moderate recovery. The balance of payments, with revisions to earlier data, is in larger than expected surplus.

3. On the world economy we take a similar view to that of the IMF and OECD. It looks as though there may be several years of moderate growth and fairly low inflation:

Major 6*, per cent per annum

	1981-83	1983-85
GNP Growth	1	3½
Inflation	6	5

*US, Canada, Japan, Germany, France and Italy

4. But there are major worries about the world economy:

(i) the performance of most European economies continues poor with little progress likely on unemployment;

(ii) the size and duration of the US fiscal and trade deficits threaten turmoil in financial markets.

5. The fiscal prospect is set out in some detail in a separate report, essential reading for a full understanding of public finances in the forecast. For 1983-84 our estimates of the PSBR made from July onwards have moved within the narrow range of £10-11 billion. The precise figure in this forecast is £10.5 billion but that is likely to change as further information, including the new expenditure returns, becomes available over the next few weeks. This estimate assumes that EC refunds of about £½ billion will benefit the CGBR before the end of March. This is one of the main uncertainties about 1983-84, together with local authority borrowing and central government spending.

6. Our forecast of the PSBR and the fiscal adjustment are summarised in the table below:

	£ billions			
	1982-83	1983-84	1984-85	1985-86
PSBR	9	10½	8	8
(per cent of GDP)	(3¾)	(3½)	(2½)	(2¼)
Fiscal Adjustment	-	-	1	5

7. Subject to a margin of error of several billions either way, our latest forecast suggests that a 2½ per cent PSBR, equivalent to £8 billion, is consistent with a cut in taxes - relative to full revalorisation - of about £1 billion in 1984-85. Subject to even larger errors, our assessment of 1985-86 is that there might be scope for a further £4 billion tax cut (cumulatively £5 billion) on the assumption of a 2¼ per cent PSBR.

8. The forecast for 1984-85 is based on:

(i) full revalorisation of direct and indirect taxes by 5.3 per cent;

(ii) asset sales of £2 billion;

(iii) a full spend of the £2¾ billion reserve on public expenditure. This difficult judgment assumes:

a normal level of contingencies (£¾ billion); overspending by local authorities of about £1 billion (highly uncertain in the present climate); overspending on demand-led programmes (much of it social security) of £1 billion; offset by a normal, nearly £½ billion, degree of underspending on cash limited expenditure.

9. The change in the fiscal adjustment since the Autumn Statement mainly reflects increased revenue:

i) Higher North Sea oil receipts (over £½ billion) on account of higher production and higher sterling oil prices (reflecting the higher value of the dollar).

ii) Higher receipts (£1 billion) from personal income tax and national insurance contributions (partly higher employment, partly estimating changes).

iii) Higher receipts (£¼ billion) from Customs taxes because of higher consumer spending.

10. The forecast for 1985-86 is based on:

i) revalorisation of 4½ per cent;

ii) asset sales of £2 billion;

iii) no change in the contribution rates for National Insurance - even though there is a surplus forecast of £1-1½ billion (much the same, we think, as in 1984-85).

iv) A full spend of the reserve of £3¾ billion.

11. On the basis of the public expenditure plans for 1985-86, which show a 4½ per cent increase in cash terms, equivalent on this forecast to little change in cost terms, the growth in onshore revenues induced by a 2½ per cent expansion of the economy provides the basis for the sizeable fiscal adjustment, equivalent to about 1 per cent of GDP, despite the beginnings

of a fall in North Sea revenues. This position in 1985-86 has been a feature of all recent forecasts, although its size is obviously highly uncertain. It is crucially dependent on keeping public expenditure constant in real terms and on growth in the economy.

12. The assumptions of a gradual fall in the PSBR and in the growth rate of the main monetary aggregates points to a continuing slow decline in the growth of money GDP:

	1982-83	1983-84	1984-85	1985-86
PSBR, percentage of GDP	3¼	3½	2½	2¼
Growth rates				
£M3	11	11	9	8½
MO	4	7	6½	6
Money GDP	9	8½	8	6½

13. Growth of nominal income is generally more stable than that of the monetary aggregates, and consequently somewhat less difficult to forecast. The split of money GDP between quantity and price might be as follows:

	growth rates, per cent			
	1982-83	1983-84	1984-85	1985-86
Output	2½	3	3	2½
Prices	6½	5	5	4

14. The broad picture on the demand side is of export growth offsetting for 1984, but not fully for 1985 and beyond, the slowdown in the growth of domestic demand. Consistently with recent and prospective increases in profitability, the recovery continues through 1984 and into 1985:

	per cent changes on a year earlier			
	1982	1983	1984	1985
Domestic demand	3	4½	3½	2½
of which consumer spending	1½	3½	3½	3
Exports	1½	1	5	3
Imports	3	5	7½	4
Total output (GDP)	2	3	3	2½

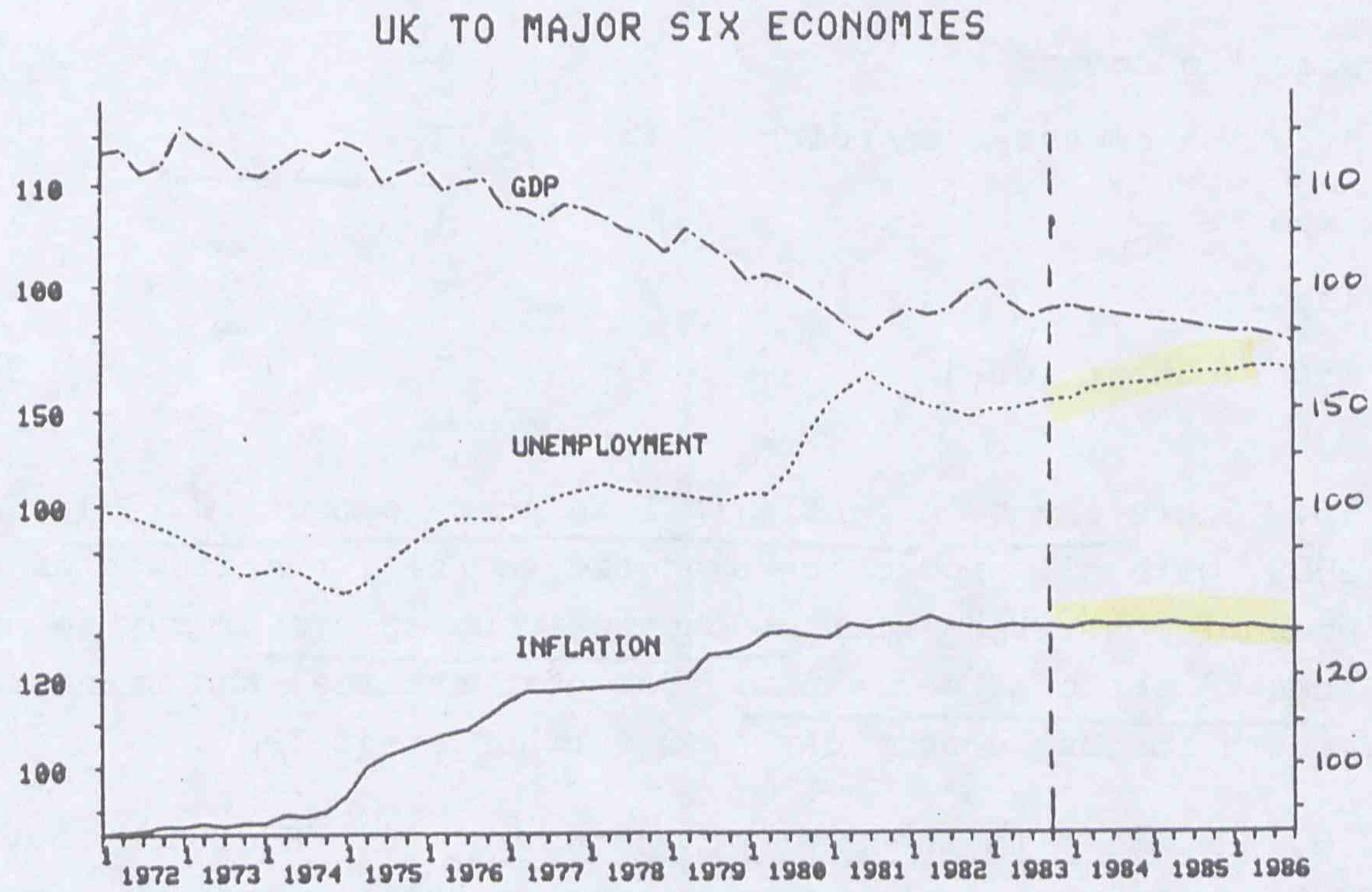
15. There may be a gentle fall in unemployment in 1984. After 1985, with oil production expected to fall, the growth of the UK economy consistent with no change in unemployment may be no more than 1½ per cent per annum. For both cyclical and trend reasons, growth in the economy may slow further after 1985.

16. Relative to the rest of the world, the UK economy both went into and is recovering from recession earlier than most other countries. The comparisons over a longer time span are as follows:

	per cent per annum			
	1964-73	1973-79	1979-83	1983-85
major 6	5.3	2.9	1.3	3½
UK	2.9	1.3	0.2	2¾
UK less oil	2.9	0.6	-0.3	3

Thus the forecast of UK output growth shows a smaller gap than in most past periods, especially when oil is excluded.

17. The chart below shows that UK prices are no longer rising faster than the rest of the world, and that the fall in unemployment in other countries (dominated by the USA) is now, and is expected to remain, greater than in the UK.



18. Monetary growth is assumed to decline slowly, but with the growth of money incomes tending to fall slowly the forecast for activity and prices should be consistent with a fall in interest rates. The extent and timing is bound to be heavily affected by US and other rates and by the movement of the exchange rate but some time in 1984, as inflationary expectations decline, there may be scope for a further fall in interest rates.

19. The uncertainties in this forecast are best illustrated by the average errors from past forecasts:

	Forecast	Average errors* calculated from: Last 10-15 years	Last five Budget forecasts
GDP growth, 1984 on 1983	3	1	½
RPI rise to the fourth quarter of 1984	4½	2	1½
Current account of balance of payments 1984, £ billion	1½	2	2½
PSBR, 1984-85, per cent of GDP	2½	1½	1
(£ billion equivalent in brackets)		(4½)	(3)

*applicable to forecasts made at Budget time

20. There are, as always, some obvious risks attached to this forecast. One that has been highlighted by outside forecasts - wrongly so far - is on inflation. Two recent pieces of information may give cause for concern: the sharp rise [NB CONFIDENTIAL until 31 January] in the CBI balance of firms expecting prices to rise; and the indications from the CBI of an increase in wage settlements in manufacturing in recent months. The CBI balances do not have a very good track record as a forward indicator, and the CBI information on wage settlements is probably less reliable than the data from the DE's economy-wide (but unpublished and confidential) series for wage settlements which suggests little change in wage settlements in recent months. Were the recent combination of sharp rises in exports and consumer spending to continue for long then domestic inflation could be a problem. Otherwise, the main risk to the inflation forecast perhaps lies with the exchange rate.

CONFIDENTIAL

SUMMARY TABLE AND COMPARISON OF FORECASTS

	FSBR/MTFS MARCH 1983	AUTUMN STATEMENT	JANUARY 1984
World Trade in Manufactures (% change on year earlier)			
1982	- 3½	- 3	- 3
1983	1	- ½	1
1984	6½	5½	4½
1985	6½	6½	5
GDP Volume (% change on year earlier)			
1981	- 2½	- 1½	- 1½
1982	½	2	2
1983	2	3	3
1984	2½	3	3
1985	2½		2½
Manufacturing Output (% change on year earlier)			
1981	- 6½	- 6½	- 6½
1982	- ½	½	0
1983	2	1½	1
1984	2½	3	2½
1985	2	1½	1½
Unemployment (UK sa excluding school leavers, millions, new definition)			
1982 Q1	2.7	2.7	2.7
1983 Q1	3.0	3.0	3.0
1984 Q1	2.9	2.9	2.9
1985 Q1	3.0	2.9	2.8
1986 Q1	3.0	2.8	2.8

	FSBR/MTFS MARCH 1983	AUTUMN STATEMENT	JANUARY 1984
<u>RPI</u> (% change on year earlier)			
1981 Q4	12	12	12
1982 Q4	6	6	6
1983 Q4	6	5	5
1984 Q4	5½	4½	4½
1985 Q4	5		4
<u>Effective Exchange Rate</u> 1975 = 100			
1981	95	95	95
1982	91	91	91
1983	81	83	83
1984	82	84	83
1985	81	83	83
<u>Current Balance</u> (£ billion)			
1981	6	6½	6½
1982	4	5½	5½
1983	1½	½	2
1984	1½	0	1½
1985	- ½	1	½
<u>Nominal GDP (mp)</u> (% change on year earlier)			
1981	9½	9½	9½
1982	9	9½	9½
1983	7½	8½	8½
1984	8½	8	8½
1985	8	7½	7

	FSBR/MTFS MARCH 1983	AUTUMN STATEMENT	JANUARY 1984
PSBR and Fiscal Adjustment			
(£ billion)			
1981-82	8½	9	9
1982-83	7½	9	9
1983-84	8	10	10½
1984-85	8 (½)	8 (- ½)	8 (1)
1985-86	7 (4)	7 (4)	8 (5)
Interest Rates Short-term			
per cent			
1981-82	14	14	14
1982-83	11½	11½	11½
1983-84	9½	9½	9½
1984-85	8	8½	8½
1985-86	7½	8	8
Money Supply £M3			
(% change on year earlier)			
1981-82 target period	13½	13½	13
1982-83 " "	9½	10	11
1983-84 " "	9	10½	11
1984-85 " "	9	10	9
1985-86 " "	8	8½	8½
Money Supply £M0			
(% change on year earlier)			
1981-82 target period	N/A	N/A	2½
1982-83 " "	N/A	N/A	4
1983-84 " "	N/A	N/A	7
1984-85 " "	N/A	N/A	6½
1985-86 " "	N/A	N/A	6

The world economy

21. Our forecast for the UK is conditional on the assumption that existing policies will be maintained. For other countries we attempt an unconditional forecast: our best guess at what will actually happen. This involves judgments about policy developments abroad, and in particular about the US.

22. Like nearly all commentators, we judge that the deficits on the Federal Government budget and on the current balance of payments are not sustainable. In the case of the government deficit, the ratio of government debt to national income is continuing to rise strongly and sooner or later will be curbed, either with a lower nominal deficit or by faster growth of nominal income (mainly through inflation) or both. In the case of the current account deficit the rest of the world's dollar assets are rising at a rate that cannot be sustained indefinitely.

23. In our main forecast we assume that there is some fiscal tightening after the Presidential election, to affect mainly 1986 and beyond. This slows growth and helps to limit the rise in inflation stemming partly from what may be a considerable fall in the dollar though we have no way of judging the timing. In Europe efforts to reduce structural budget deficits continue, and growth picks up only slowly.

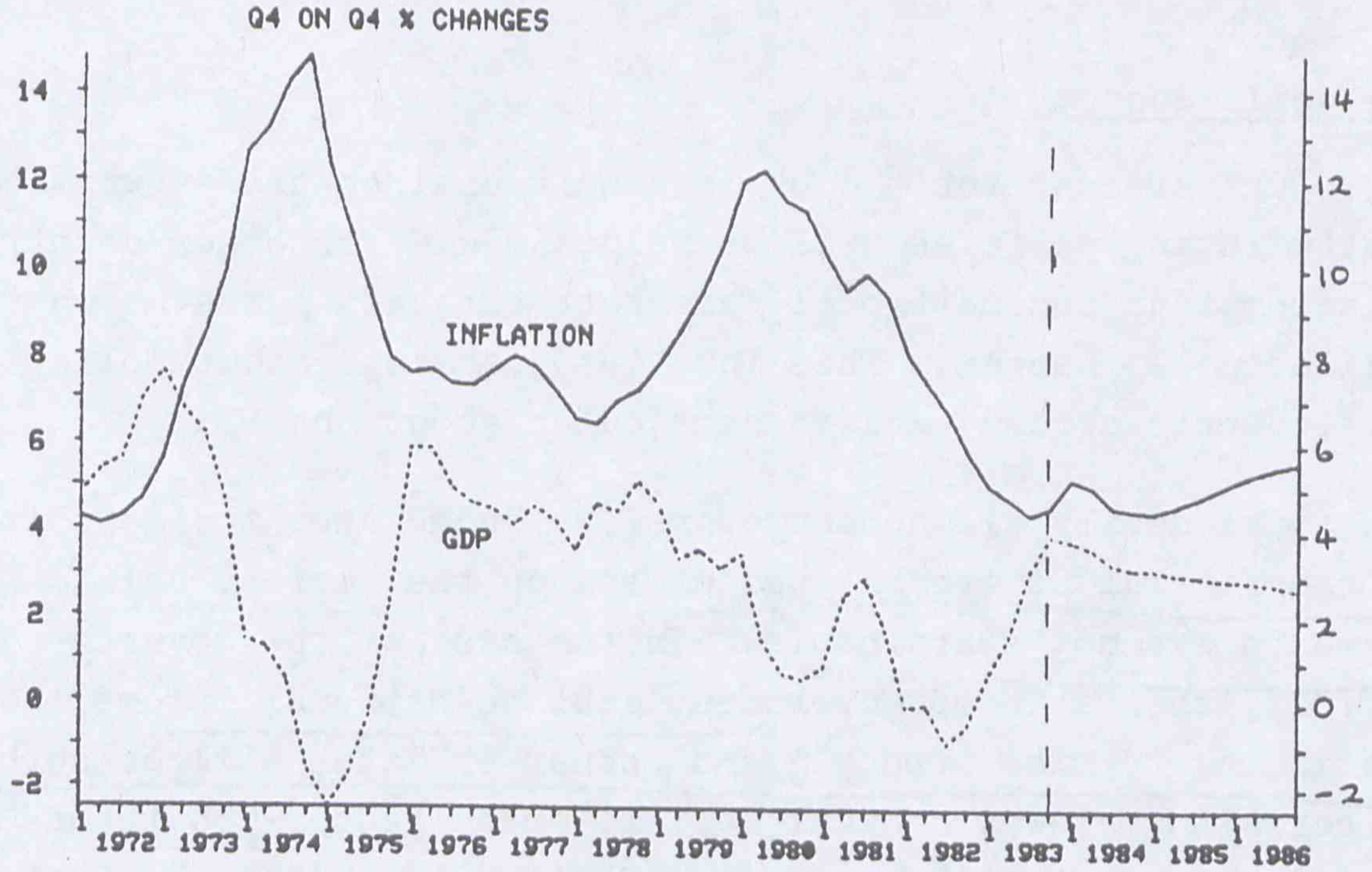
24. The forecast for output, inflation and trade is summarised in the following table and chart:

Output, inflation and trade

(per cent changes)

	1982	1983	1984	1985
Major 6 GNP	$-\frac{1}{2}$	$2\frac{1}{2}$	4	3
Major 6 consumer prices	7	$4\frac{1}{2}$	5	$4\frac{1}{2}$
World trade in manufactures (UK weights)	-3	1	$4\frac{1}{2}$	5

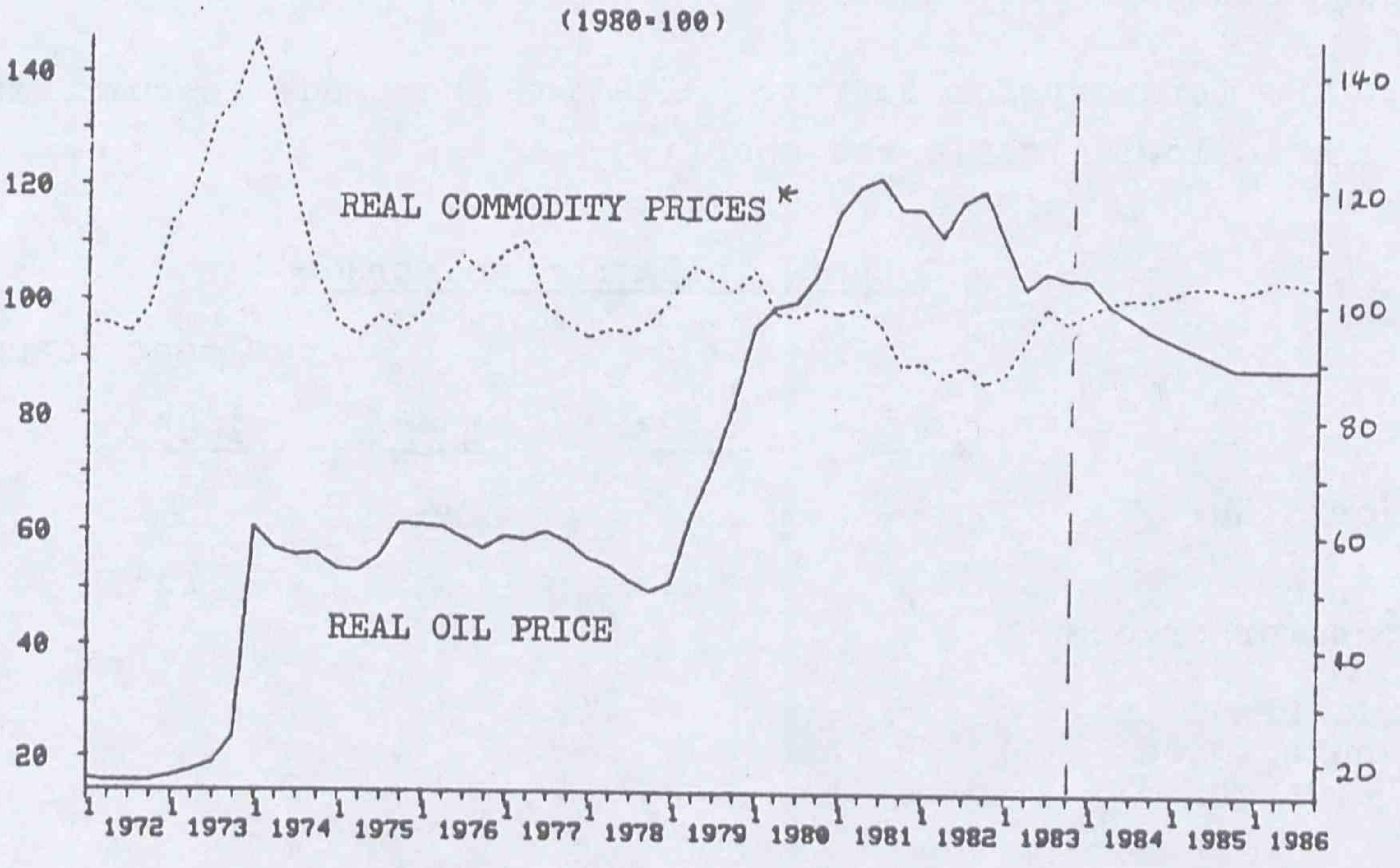
MAJOR SIX GNP GROWTH AND INFLATION



25. There may be some further rise, relative to the general rate of inflation, in prices of industrial materials as industrial production rises 4-5 per cent a year in the OECD. But the scale is modest. For oil, potential supply continues to exceed demand and the real price may continue to fall for another two years or so. Except for oil producers, many developing countries are improving their debt/income and debt servicing positions, and so contributing to the rise in world trade.

COMMODITY PRICES

(1980=100)



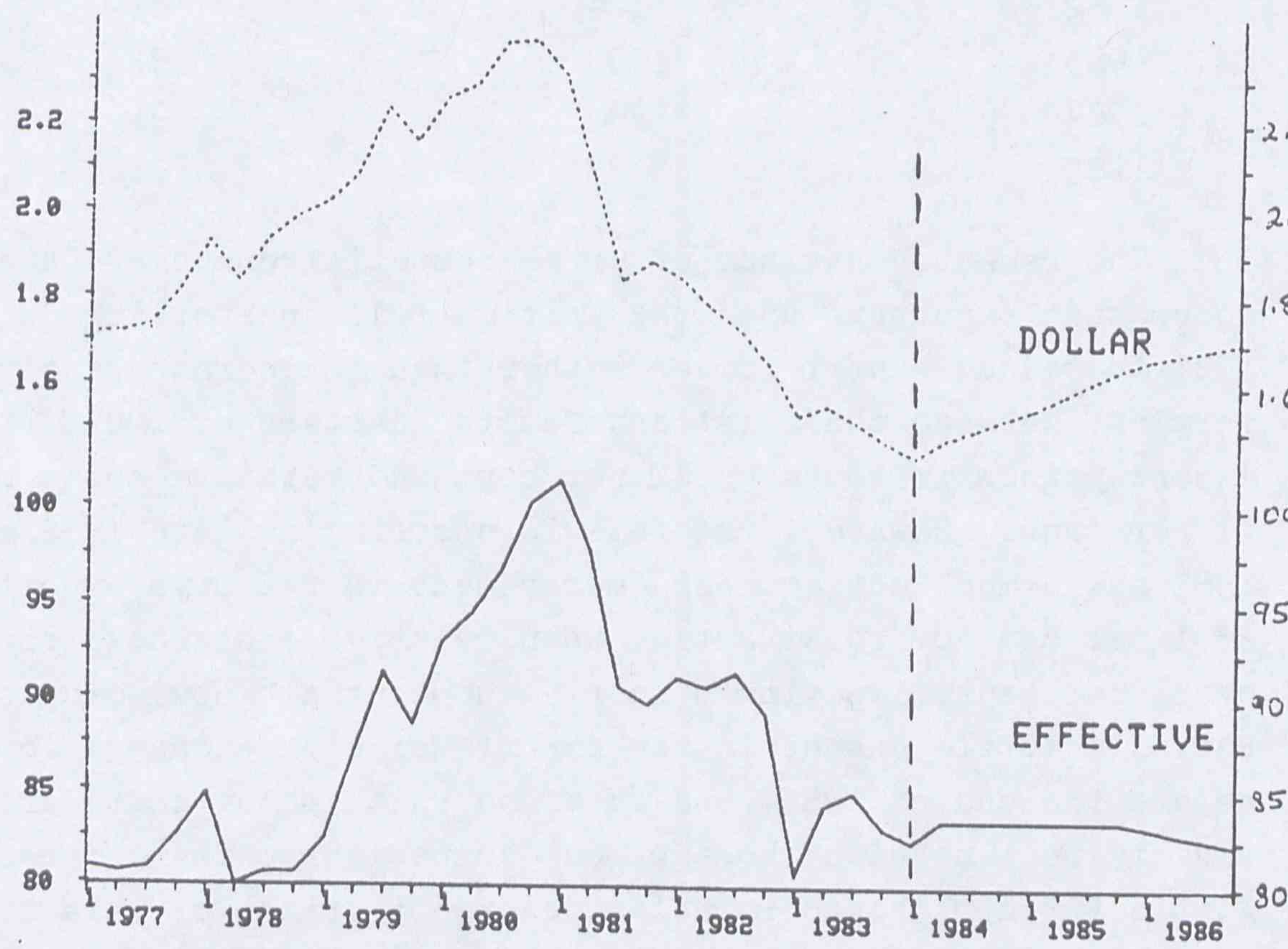
* Excluding Oil and Food

The exchange rate and relative costs

26. Over the past year or so sterling has been falling against the dollar and rising against most European currencies - a pattern which we expect to be reversed over the forecast period. The current level of the effective exchange rate is close to that in the first half of 1983.

27. In projecting a broadly flat effective rate at a level of around 83, we have taken account of forward rates (in the short term), of the path of oil prices (constant in depreciating dollar terms until end 1985), the continuing surplus on the current account, the further fall in UK inflation, and the likely pattern of capital flows. Oil production, expected to decline from 1985 (possibly by 20 per cent by 1988) may lead to some modest fall in the rate beyond 1985 though much of this, and perhaps all, may already be discounted in the current value of the exchange rate.

STERLING EFFECTIVE EXCHANGE RATE AND DOLLAR RATE



28. Tentatively - because we have said this before and been wrong - we see sterling rising against the dollar and falling against the deutschmark. Because of the smaller weight of the dollar, the export weighted index falls a little in the forecast (2 per cent between 1983 and 1985, compared with no change forecast for the effective rate). Thus the weighting of different exchange rates can make some difference when there are sharp movements in cross rates, and the weights used in the effective rate are not always appropriate. But the effect is not large relative to the uncertainties involved in exchange rate forecasting.

29. The table below shows our projections of relative costs and prices:

1980 = 100

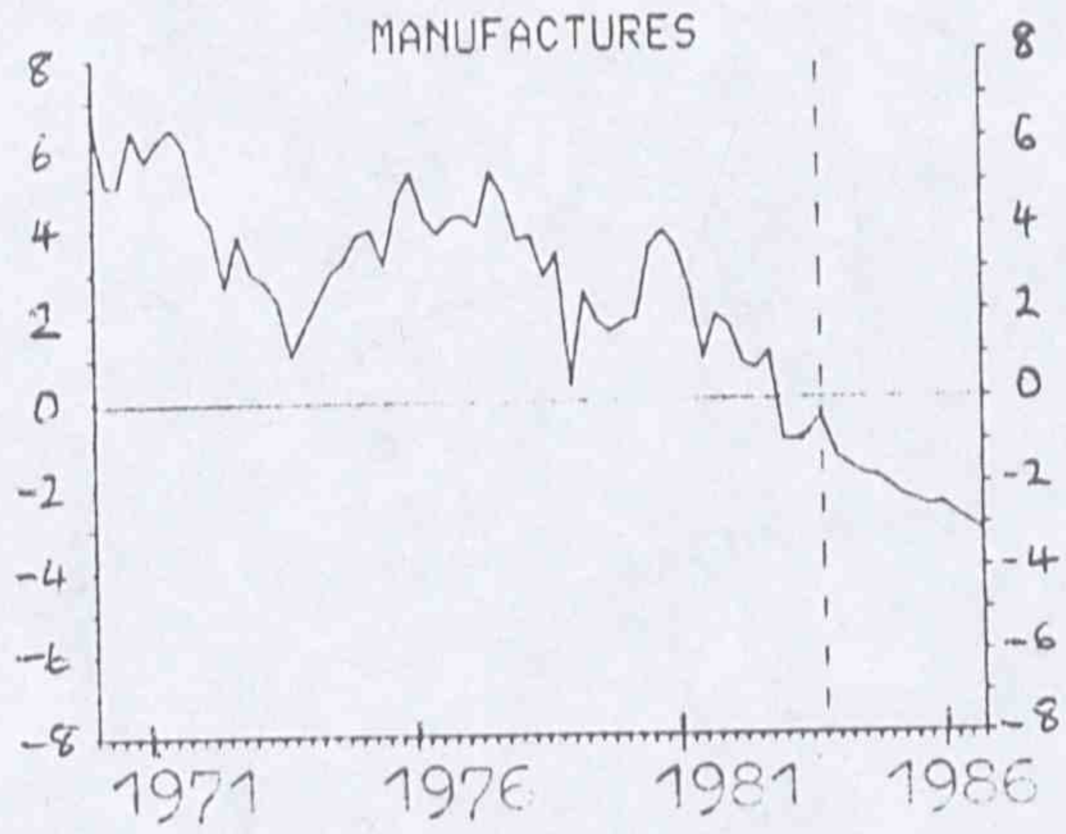
	Relative unit labour costs	Relative export prices
1970-1980 average	75	83
1981	108	98
1982	104	93
1983	96	91
1984	98	91
1985	97	91

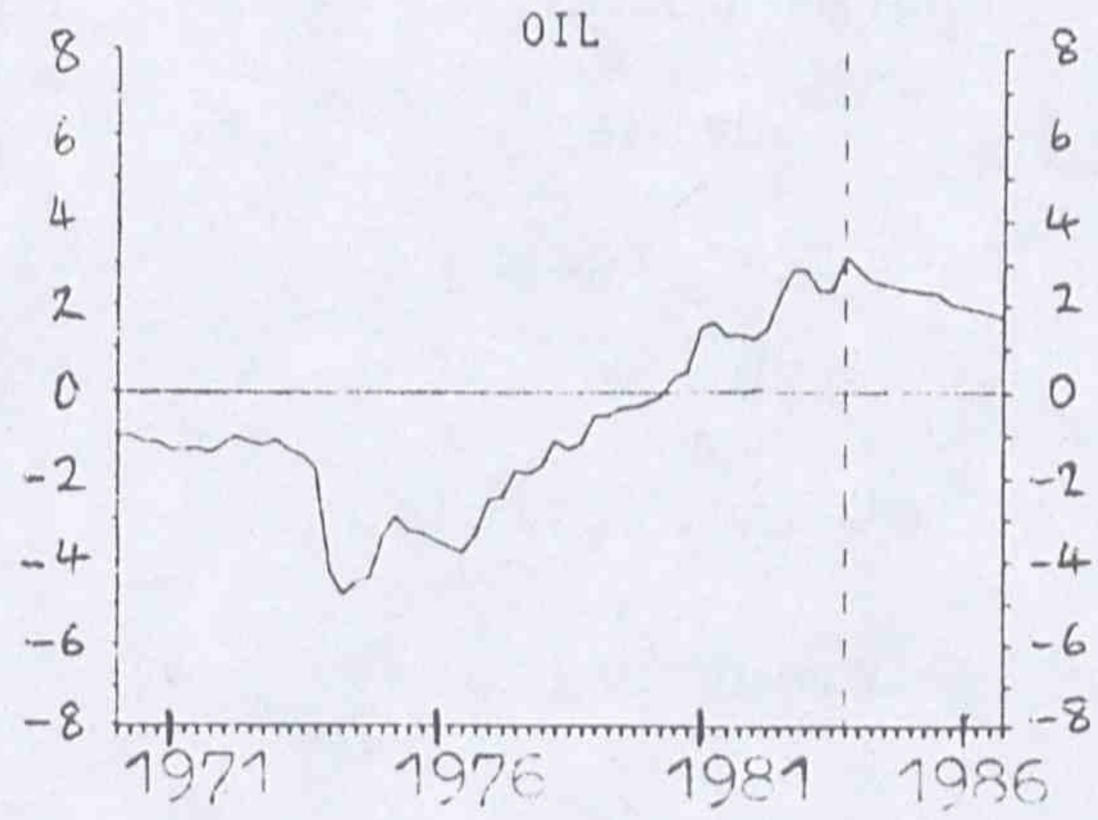
30. The recent behaviour of price competitiveness of UK exports shows that exporters used the initial fall in sterling during 1981 to reduce export prices rather than to increase their profit margins: between the first and fourth quarters of 1981, relative export prices improved by 12 per cent and relative costs by 11 per cent. However, the fall in sterling in late 1982/early 1983 saw a much more modest improvement in relative export prices of 1 per cent or so at a time when relative costs have improved by 5½ per cent, implying a fairly substantial rebuilding of margins. But with little change in the export-weighted exchange forecast before the end of 1985, and UK trend unit labour costs growing roughly in line with those of our competitors, the forecast shows little further change in relative export prices or relative labour costs in the next couple of years.

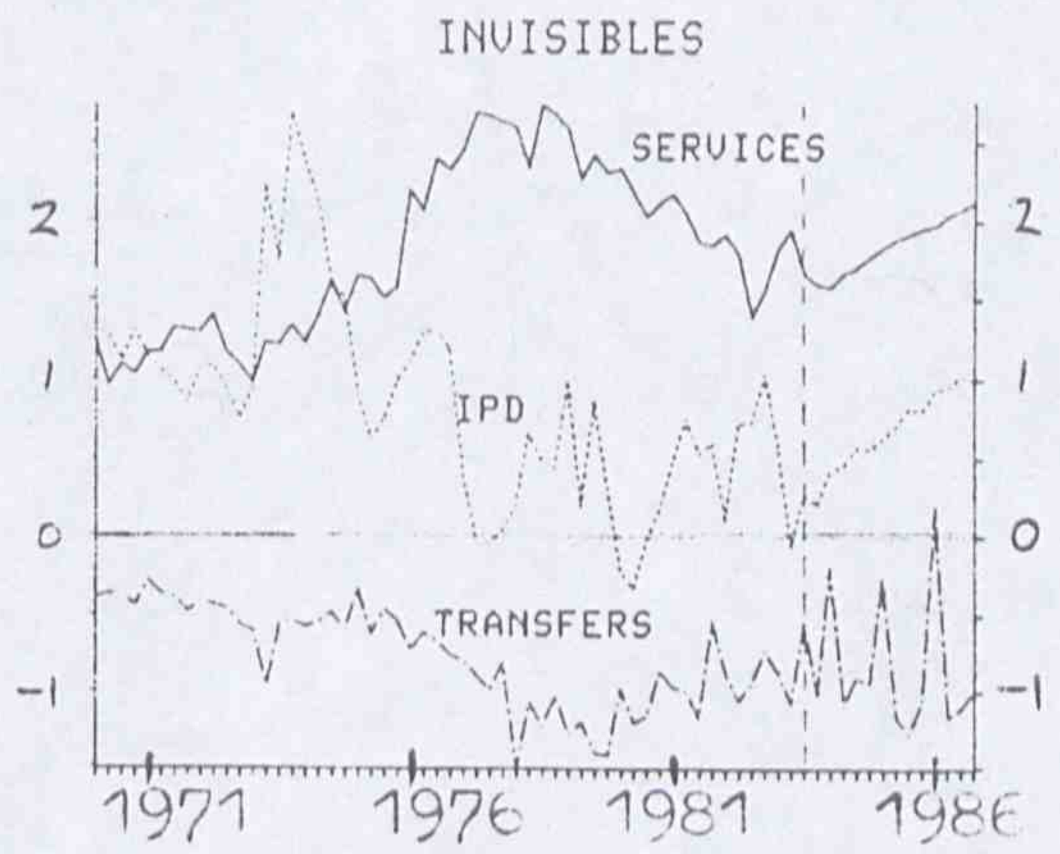
Trade and the balance of payments

31. The large current account surpluses of 1981 and 1982 were succeeded by a moderate surplus in 1983. We expect no major change over the next few years, although forecasting errors and data revisions tend to be large.

32. The changing composition of the current account is shown in the charts below. These show the balances on the main items as a proportion of GDP. (Note that the scale of the two lower charts is larger than the scale of the top two). Since the early 1970s the balance on manufactures has been declining, and is now negative and expected to stay negative, while other goods and services show a generally rising trend. Beyond 1985, as the oil balance declines, and - we think - the other trends continue, there could be some worsening in the overall current account.







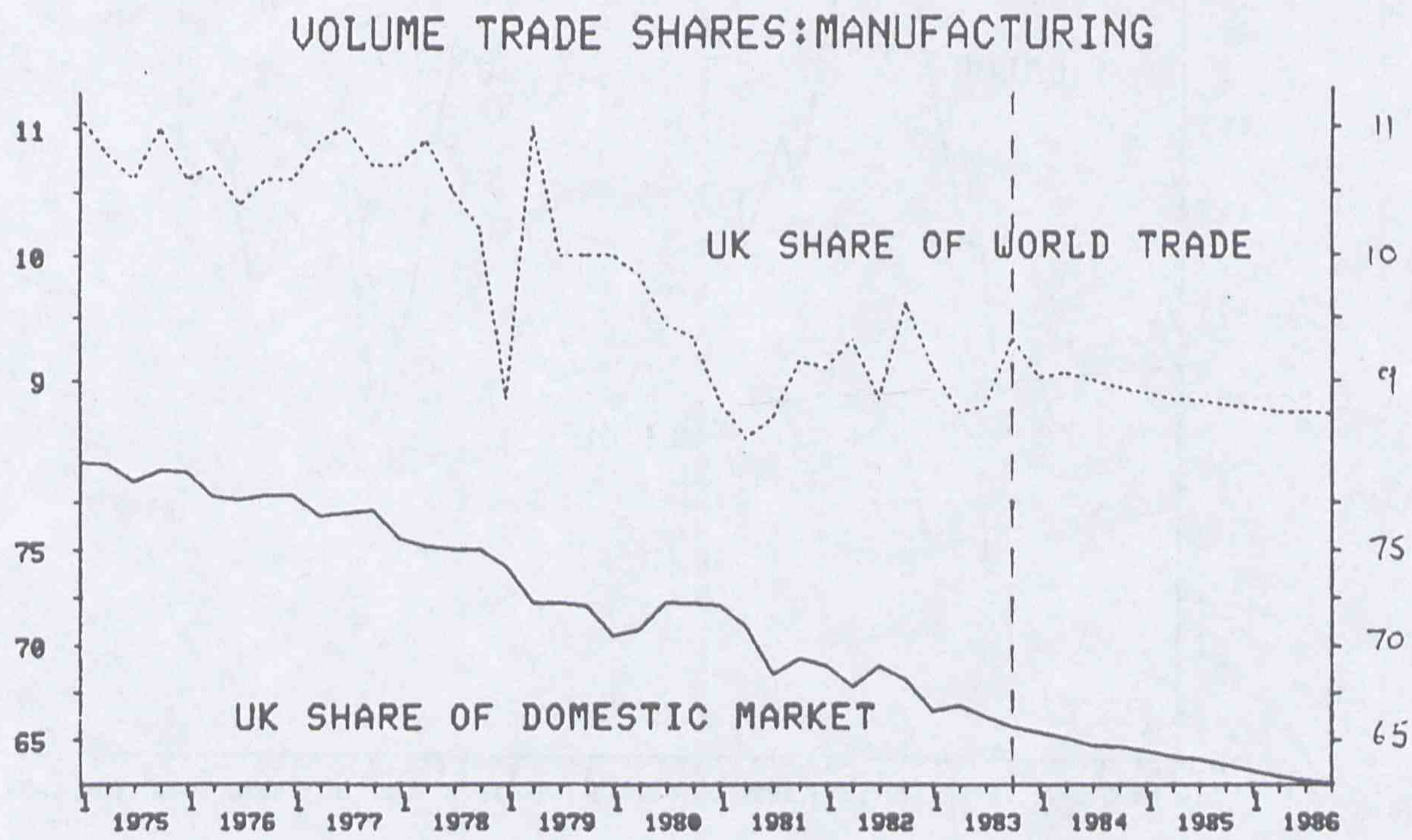
33. The charts give an impression of the longer-term trends. The table below shows our forecast of the balances by sector for the recent past and the next two years:

Surpluses and deficits, £ billion

	(per cent of total goods)	1982	1983	1984	1985
Fuel	(17)	4½	7	7	6½
Manufactures	(66)	2½	-2	-4½	-7
Other goods	(17)	-5	-6½	-5½	-5
Total goods	(100)	2	-1	-3	-5½
Services		4	4½	5½	6½
Transfers		-2	-2	-2	-2½
IPD		1½	½	1½	2
Total invisibles		3½	3	4½	6
Current balance		5½	2	1½	½

34. The prospects for oil reflect the path of production which is expected to peak in 1984 or 1985 and the continued weakness in oil prices through the forecast period (see chart on page). A separate note on the forecasts for oil production and revenues will be circulated by MP2. For goods excluding oil and manufactures, there has been a persistent decline in the deficit, reflecting increasing UK exports of food and some other non-manufactures, and a fall in the propensity to import food and basic materials.

35. The balance on manufactures turned into deficit in 1983. This tendency was inevitable, given the swing in the oil balance (unless the whole of the gains from oil had been invested abroad); a moderate decline in the oil surplus and a rising surplus on other goods and on services suggest that the balance on manufactures is likely to stay in (increasing) deficit. But these arithmetical calculations tell us nothing about the level of domestic output, nor about the level of the exchange rate, likely to be consistent with this overall picture. In volume terms, imports have been increasing their share of the UK market for manufactures for many years; and the UK has tended to lose share in overseas markets.



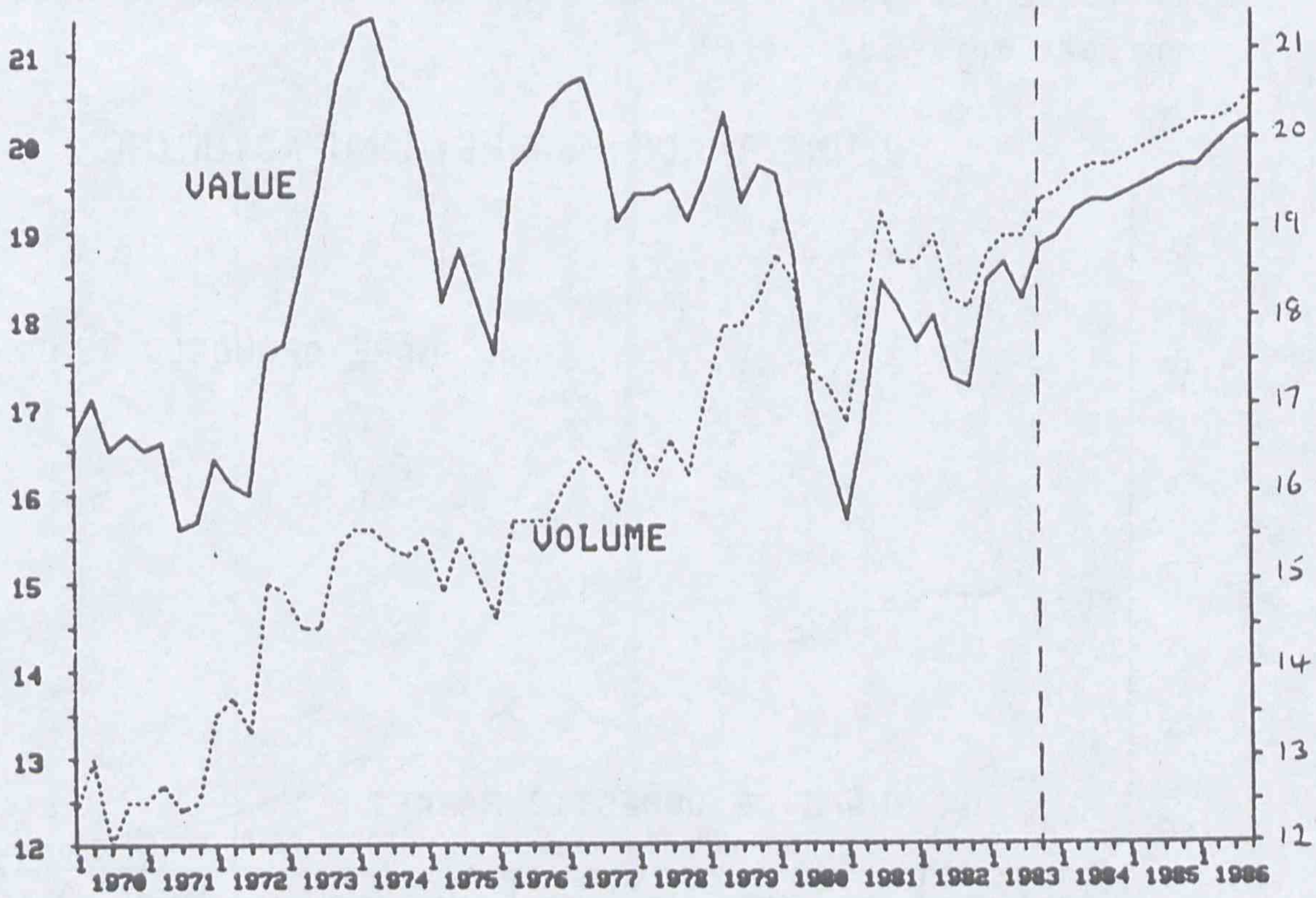
36. The decline since the early 1970s in UK volume shares in manufacturing has been mitigated by two factors:

(i) a low growth in demand for manufactures in the UK, relative to the demand for goods and services in total.

(ii) A gain in the terms of trade - also known as a loss of price and cost competitiveness.

37. The overall picture for import penetration is shown in the chart below. In <u>volume</u> terms there was a slower rise in import penetration economy-wide than for manufactures alone; while in <u>value</u> terms there have been large fluctuations but no major trend. Comparing where we are now with 1972 suggests some upward trend in the value share (continued in the forecast) **after** allowance is made for the commodity price booms of 1973-4 and 1977 and for the tendency for the pressure of demand in the UK, relative to the rest of the world, to fall between 1973 and 1983.

IMPORT PENETRATION EXCL.FUEL (% OF TFE)



38. The fluctuations in export volumes have continued into recent months: after low figures in the middle quarters of 1983, recent monthly figures have risen sharply and the fourth quarter was some 5 per cent above the annual average. But the seasonal adjustment could be at fault and we have therefore discounted, to some extent, the fourth quarter level of exports as a starting point for the forecast.

39. For 1984 and 1985 we foresee a fairly rapid rate of growth of exports of manufactures as the world recovery continues against a background of recent improvements in cost competitiveness for UK products. For imports of manufactures, some fall on the rapid growth rate seen this year seems likely in 1984, while in 1985 the slower growth in the domestic demand for manufactures should restrain import growth.

40. The outlook for trade prices is important both for the balance of payments and for domestic inflation. Overall, the terms of trade (less fuel) have hardly changed over the last three years: the fall in sterling has been offset (at least until 1983) by falls in the world terms of trade between commodities and manufactures; and by importers into the UK cutting their profit margins (which were very high in early 1981) until now it looks as though, taking manufactures and non-manufactures together, importers are charging prices in the UK which are not out of line with those charged elsewhere. (This also implies that were sterling to fall there would probably be somewhat more effect on the domestic price level than was observed in the period 1981-3).

41. Overall the terms of trade are not expected to change much, with both import and export prices rising at an annual rate of about 5 per cent, compared with a rise of 10 per cent in import prices in 1983.

42. The invisibles balance - made up of services, transfers, and net interest, profits and dividends - has, so far, shown disappointingly little improvement. The build up of UK owned foreign assets, from a net £20 billion at end-1980 to an

estimated £70 billion by end-1983, has been accompanied by little growth in net IPD. This may reflect, in part, the inadequacy of the provisional statistics for 1983. Genuine factors include the falls in world interest rates since 1981 and the emergence of the UK from recession earlier than other countries (and hence an earlier rise in UK profits and thus debits). Ignoring, to a considerable extent, the message of the 1983 IPD statistics (which imply a very low return on UK owned assets abroad), the forecast sees a substantial growth year by year. The services balance, as a percent of GDP, should rise as recovery in the rest of the world continues, but, as the chart on page 15 shows, by 1986 the balance in real terms, is still below the level in the late 1970s.

43. Overall, the current account surplus in 1983 is put at some £2 billion; the proposed change in treatment of gold will raise that by £½ billion or so; and it would not be surprising if there were upward revisions (common in earlier years) to early estimates of the surplus on invisibles, particularly IPD. There is not much change in the current account surplus for 1984 and a small decline in 1985. Very broadly, this reflects growth in the UK which is a little less than in the industrialised countries as a whole, with no major change in commodity prices. Beyond 1985 the tendency for the current account to worsen may continue as oil production falls. But that will be only one influence amongst many.

Demand and activity

44. The personal sector's spending, particularly on consumer durables and dwellings, has been rising rapidly since early 1982. By the end of 1983, the volume of total consumer spending was some 7 per cent higher than in early 1982, with durable spending up 40 per cent. Over this period the real income, after tax, of the personal sector rose by only about 3 per cent.

45. While we can explain the modest rise in non-durable spending over this period in terms of the rise in income and falls in inflation and interest rates, the boom in durables has been considerably stronger than we, or our equations, foresaw. Consumers have taken on extra debt - from banks, building societies and shops - in order to finance the fall in the savings ratio. A sharp improvement in consumer confidence since 1982 has reflected: the resumption of a rise in real incomes, particularly for those in work; lower inflation and interest rates; as well as a strengthening of asset prices. We made some allowance for this in earlier forecasts - considerably more than most outside forecasters - but the fall in the saving ratio has been quicker than we expected.

46. The forecast for consumer spending takes account of the flows in income and saving, together with analysis of the stock of wealth implied by the flows and revaluations. In the absence of major shocks, the prospects are for continued real growth in after-tax income, as the rise in earnings remains above price inflation and as employment grows slowly. (A lower growth in real wages, much of which would be offset in the medium term by higher employment, would probably affect the distribution of income between those in and those out of work, as much as the total income of the personal sector). From 1985-86 in particular, the forecast/assumption of a substantial cut in income tax - dependent on keeping public expenditure roughly constant in real terms - allows faster growth in real incomes, which is the main factor behind the rise in consumer demand over the next few years.

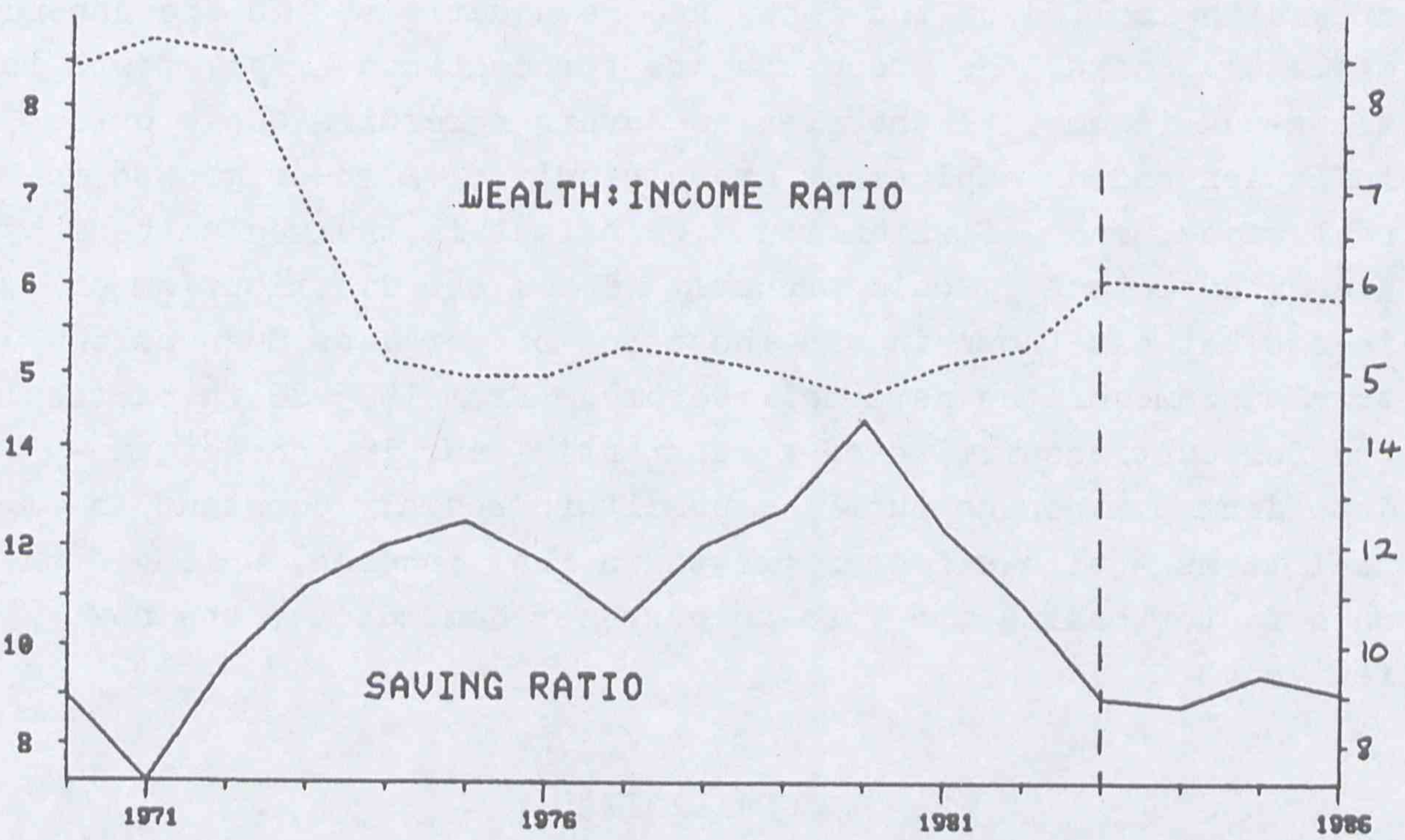
per cent changes on a year earlier

	Real Personal disposable income	Expenditure (constant prices) on: durables	non-durables	dwellings
1982	0	8	1	7
1983	1½	18	2	22
1984	3½ (½)*	9	3½	5
1985	3½ (1½)*	-1	3½	5

*of which fiscal adjustment.

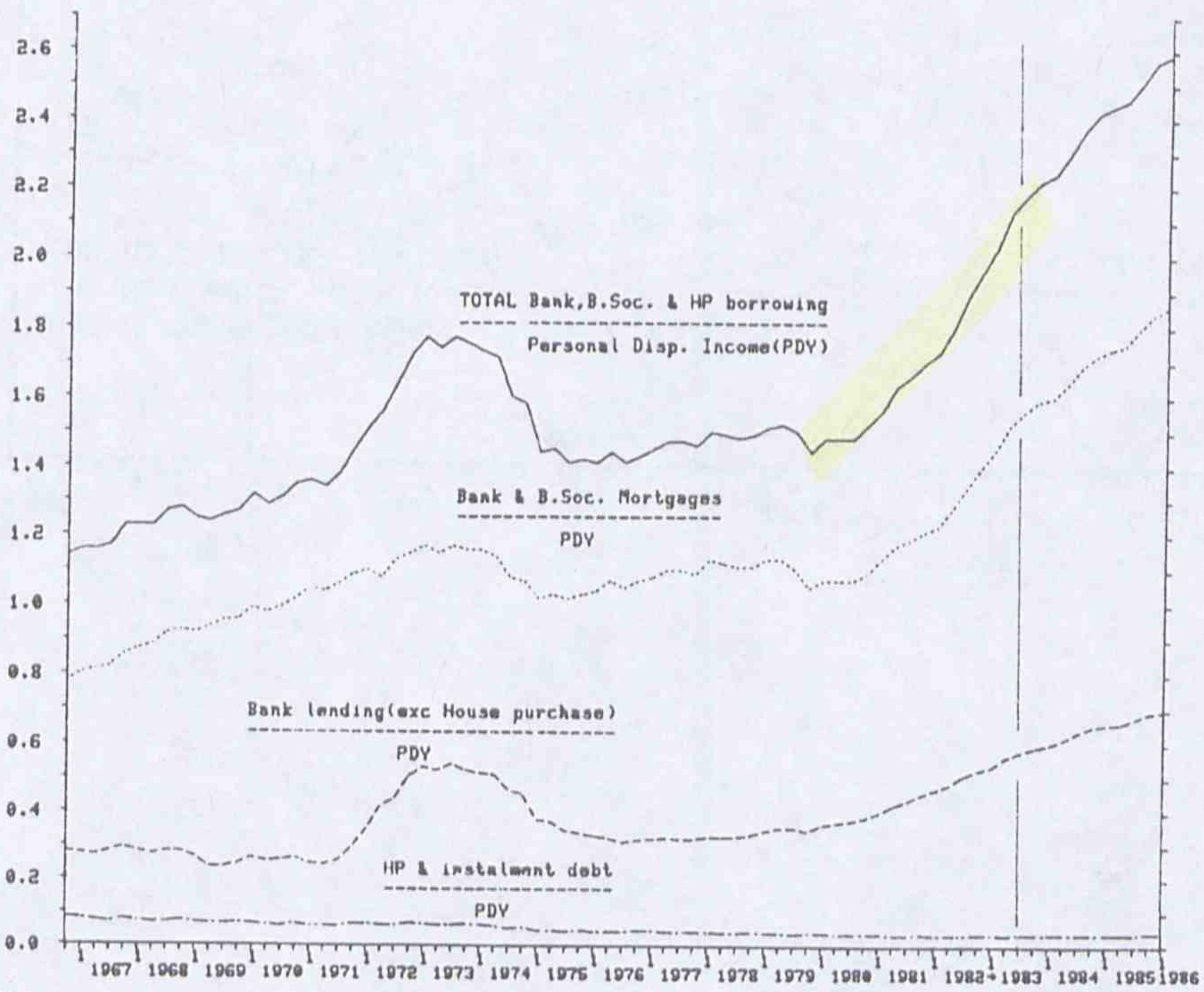
47. Personal sector spending may grow broadly in line with incomes in 1984 and 1985, consistently with little change in the ratio of net financial wealth to income, as falls in interest rates and rises in asset prices increase personal sector wealth. A roughly constant saving ratio reflects the opposite influences of the strong rise in real incomes and the fall in inflation. Investment in dwellings has been helped by the rapid growth in housing improvement grants but investment in new housing is also strengthening.

SAVING RATIO AND WEALTH:INCOME RATIO



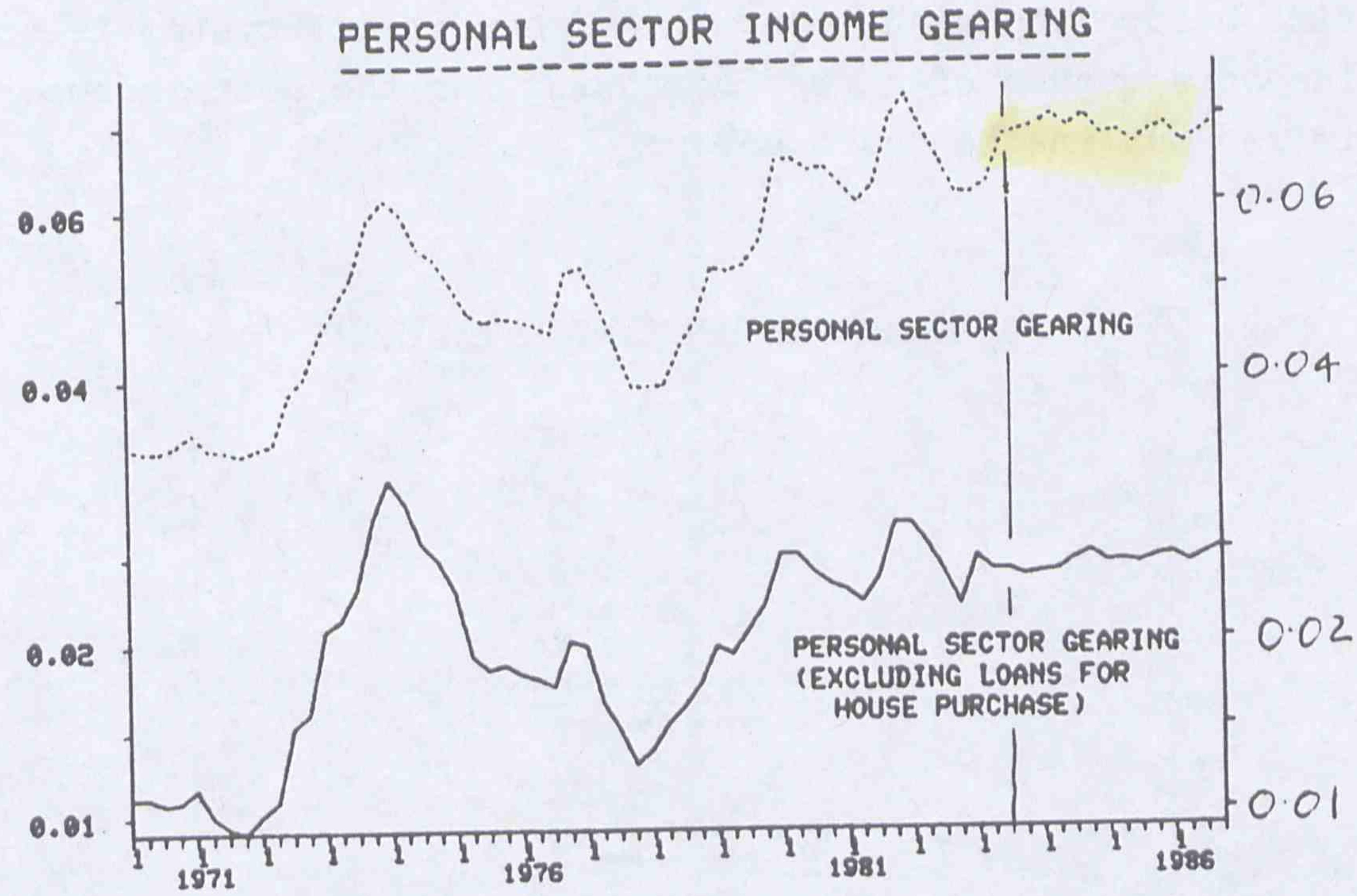
48. This forecast of consumer spending and saving is reflected in continued growth of debt, at a slower rate than in recent years, but still well above the growth of income. We have little idea how far or fast this will go: it may yet be some time before the adjustment to a freer credit system is complete. The consequence of higher borrowing for the debt/income ratios is set out in the chart below:

DEBT INCOME RATIOS OF THE PERSONAL SECTOR



49. The historically high levels of the debt/income ratio suggest that the personal sector could be more vulnerable to rises in interest rates - and possibly more volatile in its spending - than in the past. But there do not seem to be any obvious limits in the short or medium term.

50. While the stock of debt continues to rise in relation to income, the fall in interest rates means that the level of interest payments, in relation to income, has not risen further since 1981, and no substantial change is envisaged:


PERSONAL SECTOR INCOME GEARING
0.06
0.04
0.02
0.01
0·06
0·04
0·02
0·01
PERSONAL SECTOR GEARING
PERSONAL SECTOR GEARING
(EXCLUDING LOANS FOR
HOUSE PURCHASE)
1971
1976
1981
1986

The company sector

51. All the evidence points to a rapid increase in company profits since the low point of early 1981, reflecting both higher domestic sales and better margins at home and overseas. In real terms, the level of profits, excluding North Sea operations, has risen by over one third, back to the level of early 1980. Companies have increased their spending since 1981, but more slowly than income, and so improved their liquidity position. Bank borrowing declined in 1983.

52. It is difficult to go beyond these very general statements because of the size of the discrepancies in the company sector statistics (the "balancing item") in the national accounts:

Industrial and commercial companies (including oil), £ billion

	Financial surplus	Other identified financial* transactions	Balancing item	Borrowing requirement
1981	2½	-4½	-2	4**
1982	2	-4½	-5	8½**
1983 (first three quarters, annual rate)	6½	-5½	-8	7

* including investment abroad

** including effects of CS strike (reduced borrowing by perhaps £2 billion in 1981 and increased it by a similar amount in 1982)

Thus companies borrowed much more in 1982 and 1983 than can be explained by identified transactions, and built up their liquid assets.

53. The CSO are investigating the reasons for these large discrepancies. While columns 1, 2 and 4 are all subject to measurement error, other financial transactions, column 2, may

well be most vulnerable: we have assumed that much of the balancing item represents unrecorded outflows of capital.

54. Our forecast shows business investment rising in 1984, and in 1985 more strongly, especially in manufacturing, than presently indicated by the DTI's intentions inquiry:

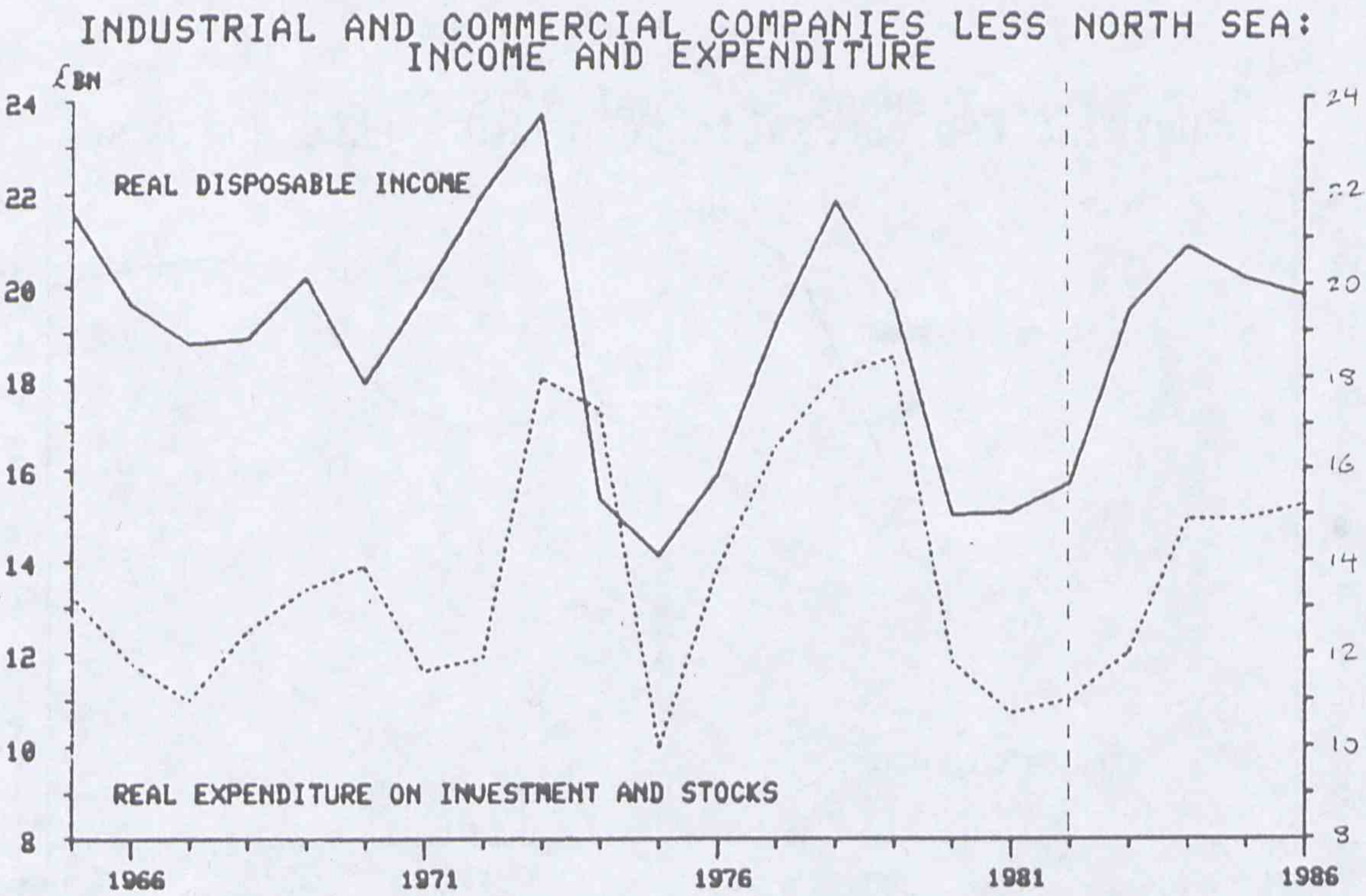
<u>Business investment</u>, constant prices

	level in 1982 £ billion	per cent changes on a year earlier 1982	1983	1984	1985
Manufacturing (including leased assets)	6	-5	-5	9½ [9½]	7 [0]
Other (excluding assets leased to manufacturers)	14	8½	6½	7 [7]	7 [5]

[ ] indicates DTI intentions inquiry

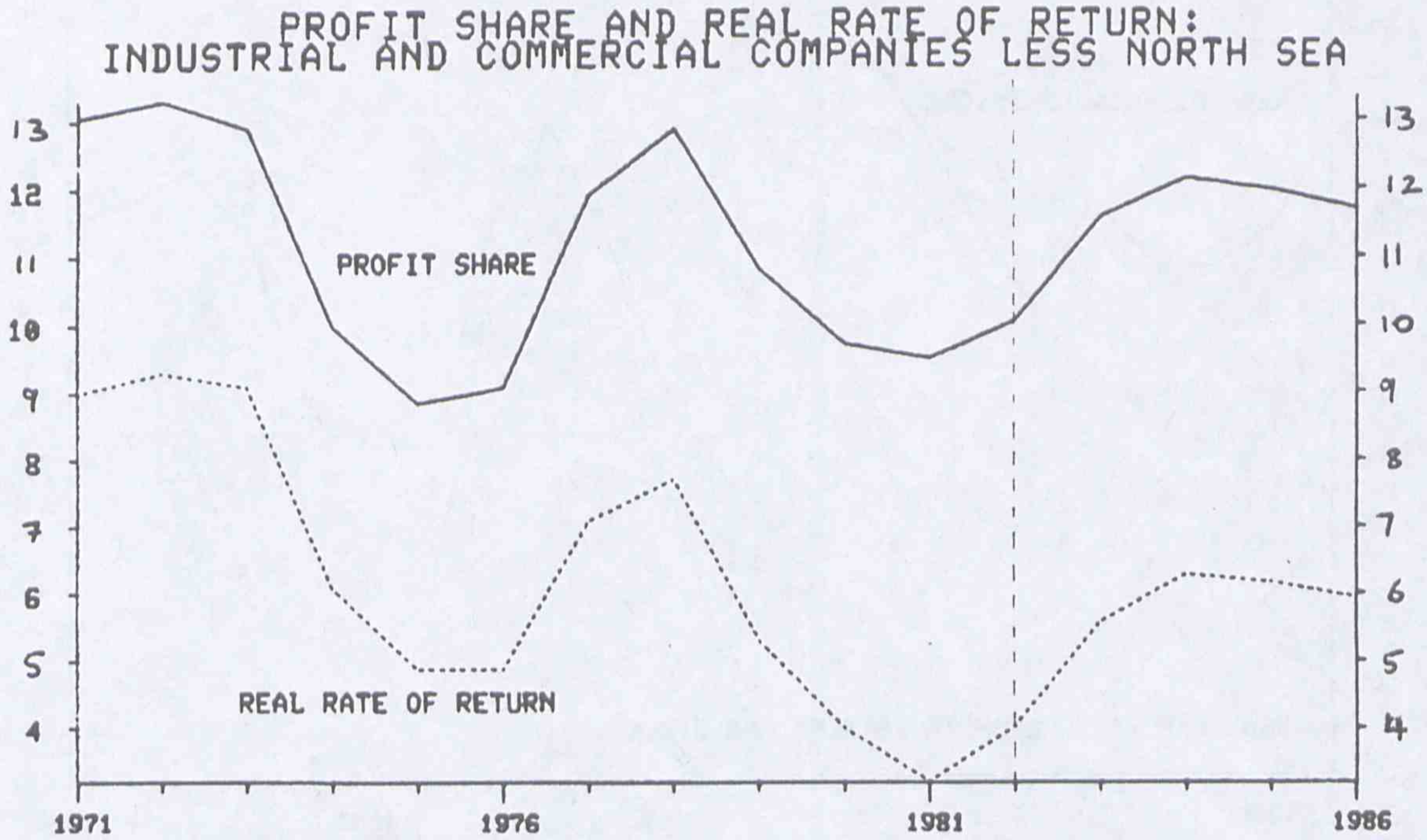
55. Stocks held by manufacturers and distributors were run down in 1982 and 1983 by a total of some £1½ billion at 1980 prices; we forecast an increase of £2 billion by the end of 1985, leaving the ratio of stocks to sales close to its level in the second half of 1983.

56. This growth in expenditure on fixed assets and stocks, together with a resumed rise in dividends and a slower growth of profits, is forecast to lead to a fall in the financial surplus - as would be expected in the second half of a cyclical upturn. It is very unclear what all this means for borrowing by companies, but some increase in bank lending to companies, from current very low rates, seems likely.



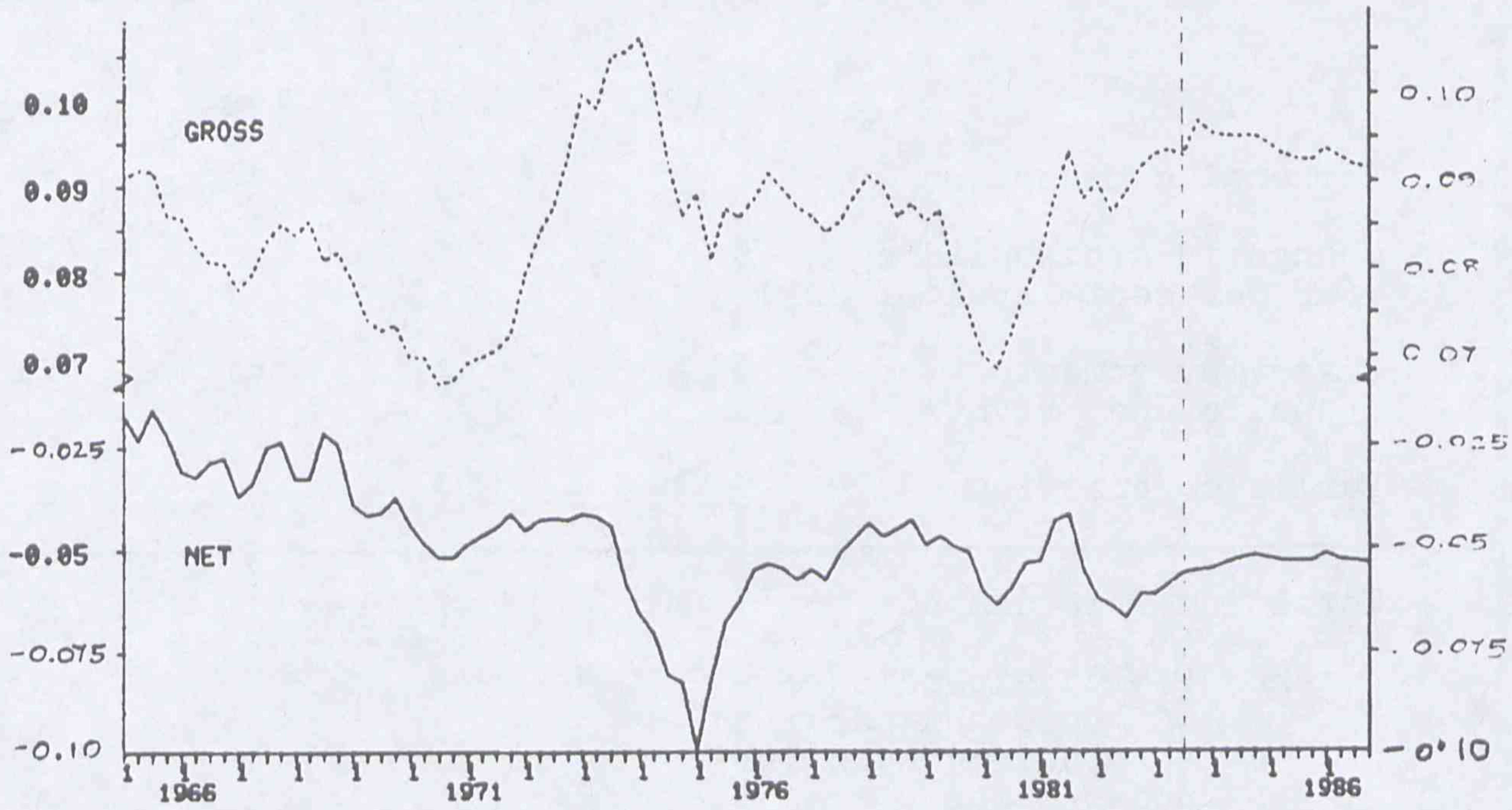
57. Company spending will be influenced by the prospects for growth, profitability and the cost of capital, as well as by their income. While some improvement in all these factors points to a continued increase in the volume of expenditure, the pace of expansion is not expected to be as fast as in most previous periods of recovery - partly because other factors in the recovery (world trade and government policy) are less expansionary than in the past. Business confidence - as indicated by recent CBI surveys and perhaps by recent trends in hours and employment - has improved sharply, though not yet much reflected in the statistics of manufacturing output.

58. While there are many difficulties of measurement, company profitability seems to be low relative to the 1970s and even more in relation to the 1960s:



Even if the (prospective) rate of profitability now and in the forecast period were substantially higher than shown in this chart, it would still be true that the incentive to hold financial assets, relative to real assets, is greater now than it was in the 1960s or 1970s, because of the current level of real interest rates. This is one factor in the current and prospective build up of financial assets by companies, which leaves their liquidity ratios relatively high. In the chart below the net liquidity ratio is defined after deducting bank borrowing. Both the equity and capital gearing forecasts suggest further falls and hence a fairly comfortable position, on average.

LIQUIDITY RATIOS:
ALL INDUSTRIAL AND COMMERCIAL COMPANIES



59. Companies' willingness/desire to maintain their (gross) liquidity ratios at relatively high levels since 1972/3 may reflect in part the much smaller spread between bank borrowing and lending rates, compared with the sixties.

60. The prospects for domestic demand at constant prices are summarised in the table below:

per cent increases on a year earlier

	1982	1983	1984	1985
Personal consumption	1½	3½	3½	3
Change in stockbuilding (as per cent level of GDP)	1	1	½	0
Fixed investment (public and private)	6	4½	5½	3½
Public consumption	1½	2½	0	0
Total domestic demand	3	4½	3½	2½
memo: Public expenditure on goods and services (excluding council house sales)	2	3	0	0

61. With the benefit of better profitability, there are reasonable prospects that as in 1982 and 1983 a good part of this demand will be met from higher production at home, even though, for manufactures, import propensities will go on rising. The growth in demand in 1983 was nearly all domestic; as this slows a little in 1984, we expect world demand for our exports to be picking up, producing another year of about 3 per cent growth in domestic output. With the consumer boom fading a little by 1985, and world recovery not very rapid, output growth may slow down.

	1982	1983	1984	1985
Domestic demand	3	4½	3½	2½
Exports of goods and services	1½	1½	5½	3
Imports of goods and services	3	5	7½	4
Domestic production - GDP	2	3	3	2½
- Manufacturing	0	1	2	1½

62. Prospects for 1986 are for a further slowdown, accentuated by the decline in oil production.

63. Thus far in the recovery, the growth of manufacturing output has been slower than for GDP as a whole, only partly we think because of measurement problems. The faster growth of manufacturing exports, in particular, in 1984 should raise the growth of manufacturing output nearer to that of total output.

64. Problems of measuring GDP, particularly in 1983, remain. Evidence since the Autumn Statement has tended to confirm the 3 per cent estimate for GDP growth between 1982 and 1983, though estimates will remain very provisional until at least August, when the Blue Book data is available, The current annual rate of growth of GDP, at the turn of the year, may well be in the range 3-4 per cent.

Employment and unemployment

65. The labour market improved in the second half of 1983. For manufacturing, where we have the most up to date information on employment and hours, recent monthly figures are shown in the following table:

Manufacturing

	Employees (average monthly change) thousands	Average weekly hours 1962 = 100
1982 Q4	-31	91.0
1983 Q1	-21	91.1
Q2	-20	90.8
Q3	-9	91.7
October	+6	92.2
November	+12	92.4

66. Employment, in total, is now rising slowly, and unemployment not changing much. (This would be consistent with some continuing rise in the labour force). Recent changes have been as follows:

Average monthly changes, seasonally adjusted

	Total Employed labour force	Unemployment excluding school leavers
1982 Q4	-34	28
1983 Q1	-6	26
Q2	+5	25*
Q3	+19	4*
Q4		-2

*After allowing for Budget changes

67. The build-up in the effects of special employment measures has continued. It is estimated that in the absence of changes in

SEMS, unemployment, on the measure used in the table, would have risen by an average of about 10 thousand a month in the second half of 1983.

68. Longer term productivity movements have been as follows:

	output per head, per cent changes on a year earlier				
	1964-73	1973-79	1979-81	1981-83	1983-86
Manufacturing	4	1	-¼	6	3¼
Non-manufacturing (excluding general government and oil)	3½	0	-1¼	2¼	1¾

These are actual growth rates and over the period of the recovery from 1981 are higher than the underlying figures.

69. The judgment in the forecast is that in both sectors productivity growth will continue well above that in the periods 1973-79, and 1979-81 (only a part of the recorded very low growth rates can be explained by cyclical developments), but rather less, mainly for cyclical reasons, than in the 1981-83 period. Very tentatively, we forecast underlying productivity growth rates of 3-3½ per cent a year in manufacturing and 1½ per cent a year in the rest of the private sector.

70. The figures for output per head take no account of lower weekly hours, more holidays and a trend towards part-time work. The National Institute reckon that these factors make for a growth in output per hour some 1 per cent a year faster than in output per employee, for the economy as a whole, over the period 1960-1982. It is not clear that this gap will change over the future.

71. Higher employment may be nearly matched by growth in the labour force, which may continue at around ½ per cent or 125 thousand a year. With a little help, at least until well

into 1984, from special employment measures, the total number of claimants - including or excluding school-leavers - may fall gently in 1984.

Potential growth rates

72. Some years ago all forecasts included an estimate of the growth rate of the economy consistent, once all the lags were worked through, with a constant level of unemployment: at its crudest, this calculation (rather grandly known as productive potential) added together the growth of labour supply and the growth of labour productivity. The limitations of this approach were emphasised by the substantial fluctuations in estimates of productivity growth, and even more by the evidence that unemployment was a very poor indicator - at least over a trend of five years or more - of the general pressure of demand.

73. Nevertheless these calculations retain some value as a way of describing the forecasts of output and unemployment:

	per cent per annum		
	1982-84	1984-86	1986-88
Underlying labour productivity in total (non-oil) economy	1.5	1.7	1.7
Labour force	0.6	0.5	0.3
Oil production (contribution to GDP growth)	0.3	-0.3	-0.5
Total "potential" GDP	2.4	1.9	1.5
Growth of GDP forecast	3	2	

74. Three periods are distinguished, partly because of the very different movements in oil production. Because of the cyclical recovery, actual growth in output per head is currently above the underlying trend and we are not seeing much reduction in unemployment.

75. There is some presumption that, starting from a position in 1982 of a considerable margin of spare capacity, and without - partly by assumption - any major shocks, the economy should be capable of growing at or above its potential growth rate for a time, as the forecast suggests it will in 1984 and 1985.

Inflation

76. The fall in inflation, which had begun by about mid 1980, came in two stages. The first was when the competitive pressures, both domestic and external, drastically reduced firms' ability to pass on cost increases; output was declining; and profit margins were squeezed. But once demand and output began to pick up, from the first half of 1981, and firms were able to control cost increases (mainly by reducing their labour forces, without much contribution from real wages), profit margins began to recover while the rate of inflation continued to fall.

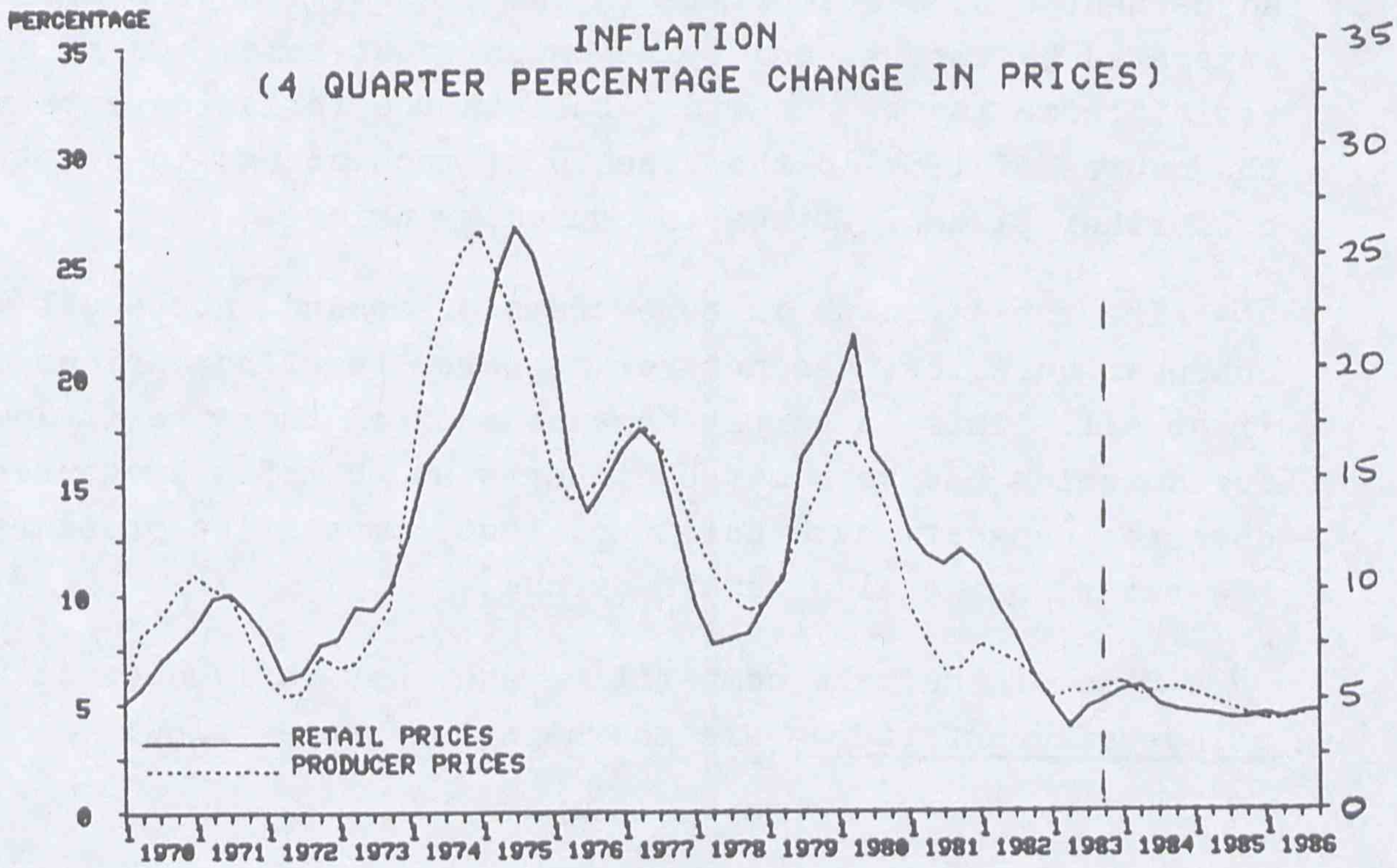
77. Through 1983, despite several factors unfavourable to inflation - the fall in the exchange rate in late 1982/early 1983, sharp rises in some commodity prices, and an expansion of domestic demand of some 4-5 per cent - there was no rise in the inflation rate. This experience suggests continued adjustment by domestic firms to the competitive pressures generated by imports and spare capacity at home. On this basis, there may be a further fall in the inflation rate in the course of 1984 in the absence of much change in sterling or further sizeable rises in commodity prices.

78. The rapid growth in some areas of demand, above all consumer durables, has not yet appeared to affect prices much if at all. This is partly because much of the rise in demand for durables has been met by imports so that few pressures on domestic capacity have built up. But competitive pressures at the retail stage also remain strong.

79. Some of the main competitive and cost influences on UK <u>prices of manufactures</u> are shown in the table below:

	World export prices of manufactures, in sterling	UK unit labour costs (actual)	Import costs	Percentage of firms working below a satisfactory level of capacity
	per cent changes on a year earlier			
1982	13	4	7	76
1983	11½	2½	9	70
1984	5½	4	6	63
1985	4	4	4	59

80. The forecast of private sector prices allows for the improvement in profit margins in the domestic market to continue through 1984 but to peter out in 1985. The chart below shows inflation as measured both by retail prices and by manufacturers' output prices:



81. The forecast of the RPI and its components is summarised in the table below:

per cent changes on a year earlier

	(Weights in total)	1983 Q4	1984 Q4	1985 Q4
Food	(22)	6	3½	3
Housing	(13)	6½	7	4
Nationalised industries	(7)	1½	3½	3
Other	(58)	5	4½	4½
Total	(100)	5	4½	4

The housing forecast allows for (i) a 7 per cent rise in the rate poundage in April 1984 and (ii) a cut in the mortgage rate of ¾ per cent before the end of 1984. (Without that forecast cut, the rise in the RPI would be 0.2 per cent higher.)

82. The May 1984 RPI figure, to be used for the November 1984 social security upratings, we continue to put at 5½ per cent.

83. Despite the recession and the steep rise in unemployment, the rise in average earnings has kept ahead of prices. It is still convenient, and consistent with the behaviour of wage bargainers, to think in terms of pay rounds starting in the autumn. On this basis, earnings and prices have moved as follows:

per cent changes on a year earlier

	Earnings (underlying, whole economy)	Retail prices	Price expectations* formed at start of pay round
1980 Q3	22	16½	[13]
1981 Q3	11½	11	[13]
1982 Q3	9	8	10-11
1983 Q3	7¾	4½	7
1984 Q3 (forecast)	7¼	5	6-7

*consensus forecast of Q4 RPI published in autumn of preceding year

84. To some extent, wage bargains take account of price expectations, as well as the actual movement in prices over the previous year. At any rate since 1981, inflation has fallen faster than expected: this has left wage earners with higher real wages than they (or employers) expected when the wage settlements were made - though the numbers employed have generally fallen faster than expected. Thus the inevitable adjustment of wage costs has come to a greater extent than expected from employment and less from real wages. But the higher than expected outcome on real wages in the last two pay rounds has not yet led, to any significant extent at all, to lower wage settlements. The failure to anticipate fully the extent to which inflation would fall has played a part in offsetting the willingness of both employers and employees to negotiate cuts - or a standstill - in real wages. This opportunity may not recur in the forecast period: we expect the rise in earnings to stay ahead of the rise in prices, though to a diminishing extent as (we assume) price expectations are more nearly correct and the economy slows down after 1984. In addition the sizeable fiscal adjustment - assumed to take the form of increases in income tax allowances - raises real take home pay and so reduces the pressure for wage increases.

per cent changes on a year earlier

	Earnings (underlying)	Retail prices	Real take-home pay (of which fiscal adjustment)
1983 Q3	7¾	4½	3½
1984 Q3	7¼	5	2½ (½)
1985 Q3	6½	4	5 (2½)

85. For the public services as a whole we assume pay settlements in the current round averaging 4½-5 per cent, with earnings growth 5½-6 per cent, a little less than for the economy as a whole. In the manufacturing sector, recent earnings figures (underlying growth of 9¾ per cent in the year to November) suggest, apart from higher overtime, that the faster productivity growth is being reflected, in part, in earnings. We forecast that this will continue.

Financial surpluses and deficits

86. The pattern of financial surpluses and deficits in the economy, past and forecast, is shown in the following table:

£ billion, current prices

	Private sector			Public sector	Overseas sector (- denotes surplus on UK current account)
	persons	companies	Total		
1981	+14	+2	+16	-8	-7
1982	+10	+3	+13	-7	-5
1983	+7	+8	+14	-11	-2
1984	+7	+5	+12	-9	-2
1985	+9	+1	+10	-9	-1

87. The measurement of these balances, depending on uncertain estimates of income and expenditure, is subject to substantial uncertainty and revision. In the case of the company sector, for example (see page 25), there are enormous measurement problems some of which mean that the figures for the financial surplus do not give a true picture.

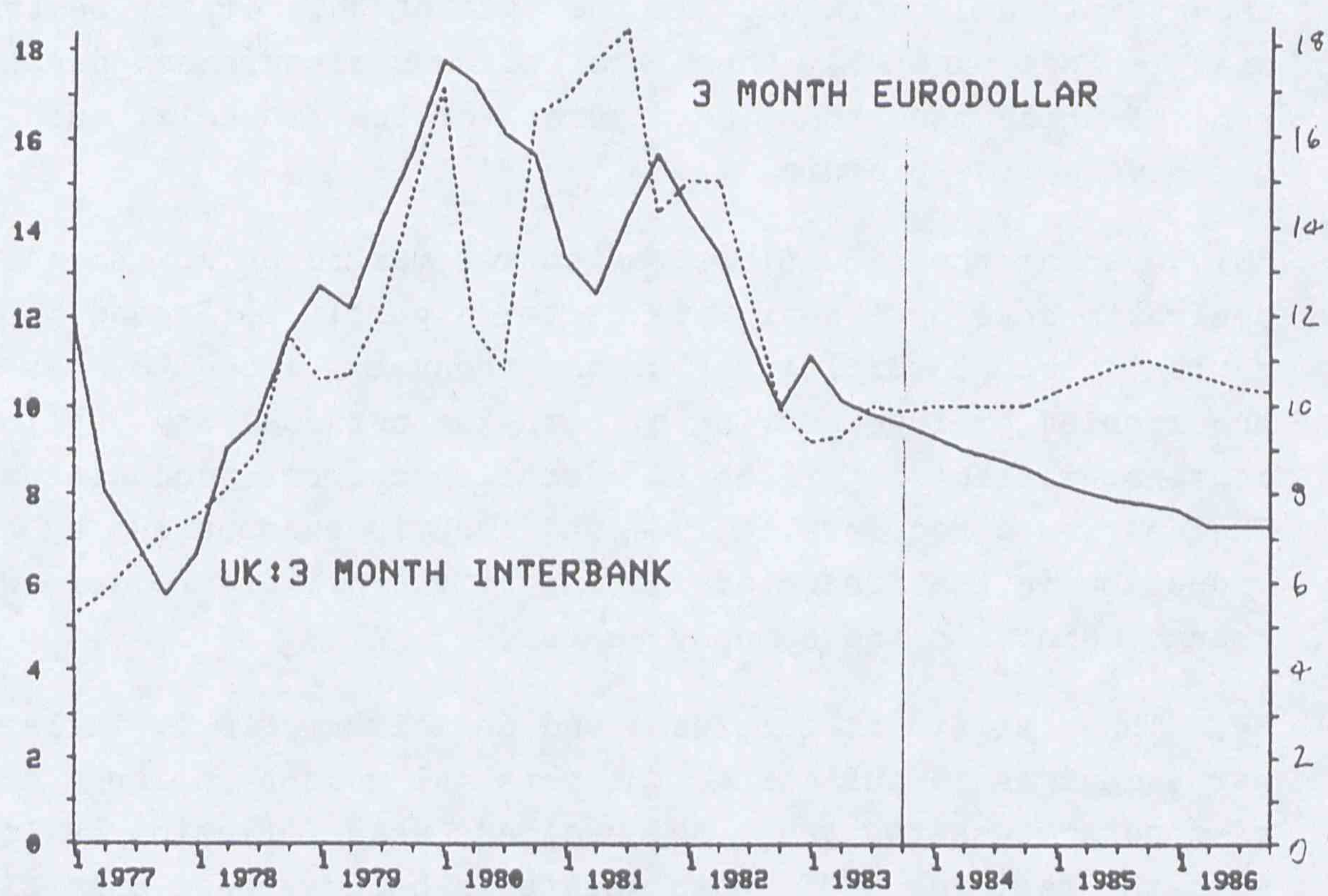
88. Just as the 1980-81 recession was marked by an increased desire to save by the private sector - partly reflected in large current account surpluses - so the recovery since 1981 has been accompanied by lower saving by both the personal and public sectors, reflected by 1983 in a smaller current account surplus. The continued recovery in 1984 and 1985 is accompanied by a further reduction in the financial surplus of the private sector, with the change mainly in the company sector.

89. These shifts in surpluses and deficits reflect, in large part, changes in inflation: the personal sector, a large holder of monetary assets, tends to save less when inflation is low (and when the real value of those assets is being eroded only slowly).

Interest rates

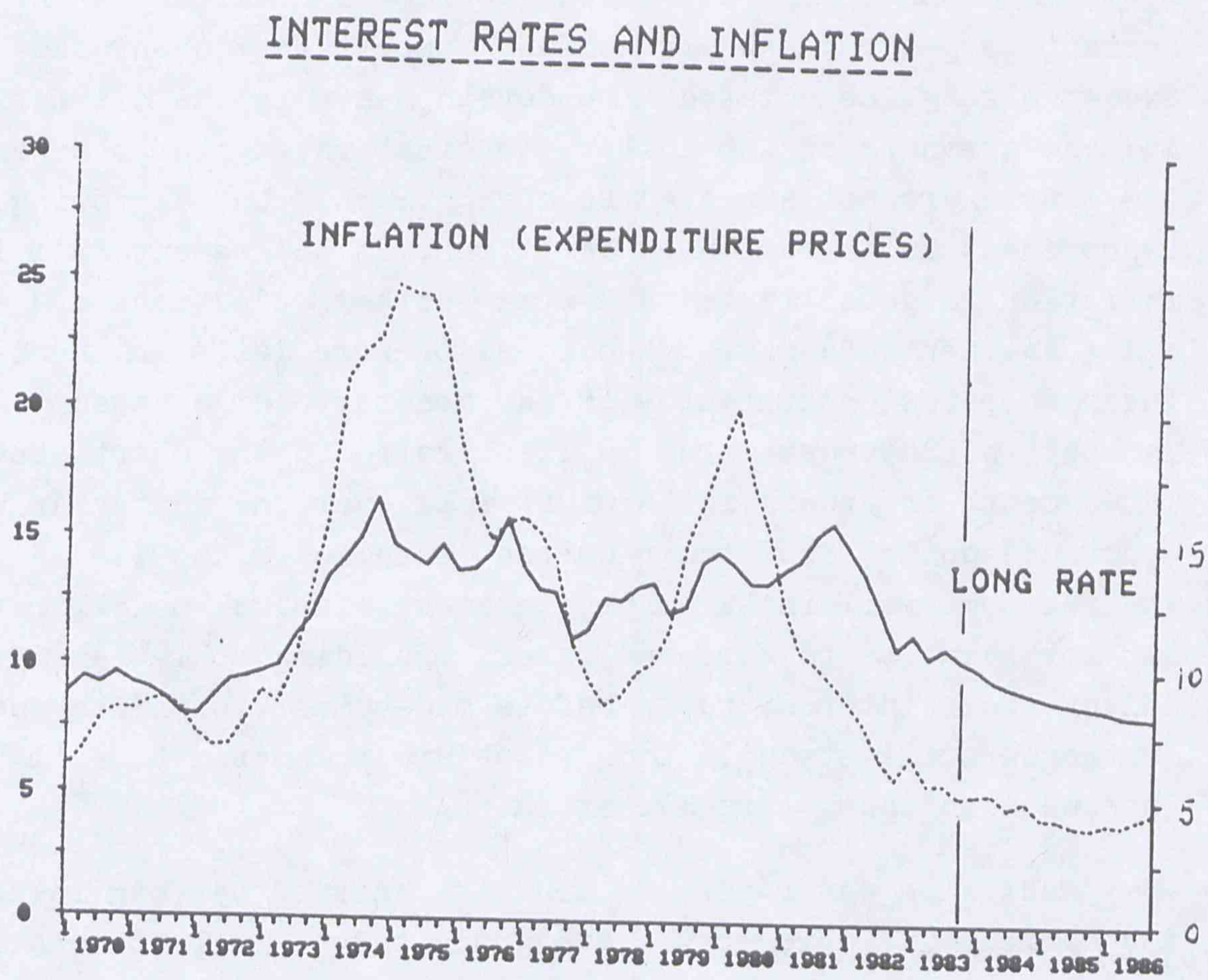
90. The world background is one in which US interest rates are forecast to remain at current levels for the rest of the year, but then to increase a little as the Federal Reserve tightens monetary policy after the Presidential election. If, however, the dollar exchange rate weakens as expected this should allow interest rates to fall in other countries. Thus overseas interest rates on average may fall slightly over the next year or two. In the UK we assume that the general approach to monetary policy will give weight to the exchange rate as well as the target aggregates. More specifically we assume that short-term interest rates are set so that the growth rates of MO and £M3 stay within the target ranges assumed for this forecast - see the table in paragraph 99 .

INTEREST RATES, PERCENT



91. With monetary growth likely to remain at or above the current target range and continuing uncertainty about the exchange rate, associated with developments in the oil market and the strength of the dollar, interest rates over the next few months are not expected to change much. But a growing improvement in inflation expectations, as the recent fall in inflation is consolidated and some further reductions are achieved, and a falling PSBR ratio, should allow some falls in short-term interest rates consistent with the monetary target assumptions. The path of interest rates is illustrated in the chart above. Three-month interbank rates might fall over the next year by about one point, from their current level of 9 to 9½. This implies some fall in UK interest rates relative to dollar rates but not relative to European rates. Building societies may not adjust their interest rates before mid-summer, with the demand for mortgages still strong. Long rates are projected to fall broadly in line with short-term market rates.

92. Real interest rates, as crudely measured by long rates less the current inflation rate, are projected to fall somewhat from current levels of around 5 per cent, but to remain fairly high by historic standards. The implication of this for companies and households varies considerably according to their tax position. The scope for falls in real interest rates is very much limited by high (though declining slowly) real rates overseas and at home by the objectives of falling inflation and falling monetary growth. The chart below shows the relationship between long rates and the rate of inflation measured by a general price index for all final expenditure.



Monetary aggregates

93. Changes in the financial system - especially the abolition of exchange controls and the corset, the more active role of the banks in the personal credit market and the increasing range of services offered by building societies - make it very difficult to understand let alone forecast the path of the monetary aggregates, particularly the broad ones.

94. The forecast uses recent Treasury analytical work on the demand for cash and M0. Past movements in these aggregates have been related to personal income, short-term interest rates and the number of bank accounts, one of a number of factors thought to have contributed to the decreasing use of cash relative to the value of transactions. Between 1977 and 1982 M0 rose on average 5 percentage points per annum more slowly than money GDP - a

sharp rise in the velocity of circulation of MO. The relatively slow growth of MO persisted in 1982-83 but to a smaller extent because falling interest rates made it less costly to hold the non-interest-bearing MO. Thus velocity in 1982-83 rose more slowly than in the preceding years. The lagged effect of these interest rate reductions and further, albeit smaller, reductions will be felt in the forecast period. The increase in MO is expected to be only slightly below that of nominal GDP. The forecast for MO and the other monetary aggregates is summarised in the table on page 45 below.

95. We are not in a position to make a properly considered forecast of M2: data has only been collected since November 1981. However as we already forecast variables which approximate its major components, we can give a rough guide to its future path. It is currently growing at about 8 per cent year on year. However, its recent slow growth has been depressed by the relative attractiveness of building society high interest 3-month accounts (not in M2) vis-a-vis one-month (or less) accounts (which are in M2). Since the latter are likely to become more competitive in the future, a higher share of the continuing brisk inflows into building societies could well push M2 growth up, possibly to 10 per cent or so in 1984-85 and 1985-86. But this is very uncertain.

96. M1 in total has continued to behave in a predictable way in the recent past, with its growth higher towards the end of 1982 and in the first half of 1983. But much of the growth has been in the interest-bearing component, which suggests that the development of new forms of interest-bearing account has been important. In the future the growth of M1 should fall as nominal income growth falls, but only slowly because of the forecast reductions in interest rates. M1 is expected to be the fastest growing aggregate, mainly because it is thought to be the most interest-sensitive.

97. Treasury analytical work has stressed the size of the non-bank private sector's total portfolio of financial assets, referred to as gross financial wealth, as an influence on broad money. A lower level of private saving and a small

slowdown in bank borrowing - the extent of which is very uncertain - is forecast to lead to somewhat slower growth in wealth over the next year or two.

98. In response to profitable opportunities, and since 1981 a desire by consumers to save less, banks have been expanding their lending to persons rapidly ever since 1978 and, since 1981, their housing loans. Persons' income gearing, the ratio of interest payments to income, is broadly flat (see chart on page 24), although with most borrowing at variable rates changes in the general level of interest rates could have a substantial effect on spending. Moreover much of the rise in borrowing has been matched by a rise in liquid assets, although not necessarily held by the same people as those borrowing, with the result that net indebtedness has not risen as fast as gross indebtedness. We have built a deceleration of personal lending into the forecast although it is still projected to grow substantially faster than personal income. A rise in bank lending to companies is likely, even if capital issues remain buoyant: profits are expected to rise more slowly and company expenditures to increase.

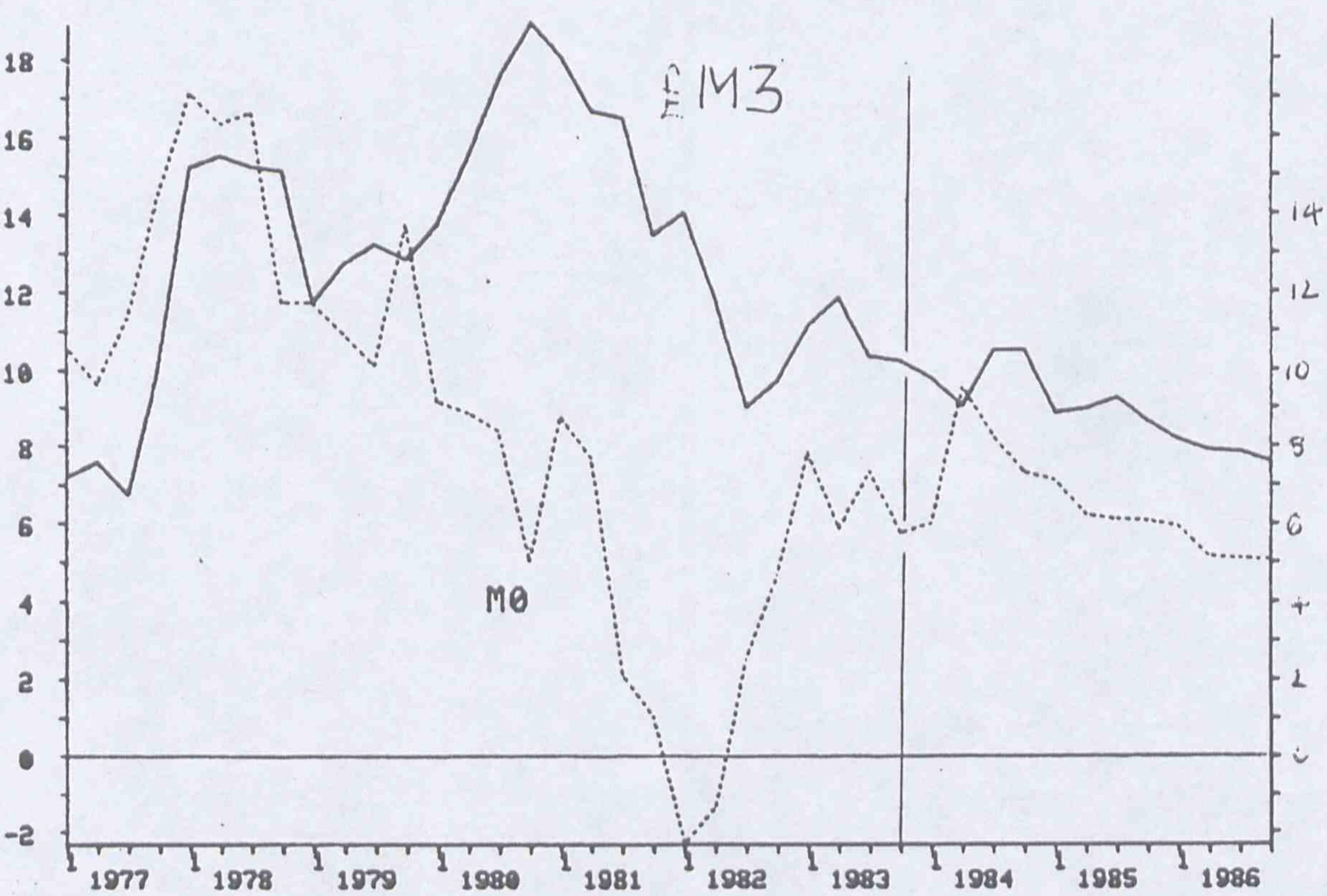
99. With the growth of wealth slowing down, and falling long rates creating a favourable climate for gilts sales, it should not be too difficult for the growth of £M3 to remain within its assumed target range. We expect PSL2 to grow consistently a little faster than £M3 because much of the increase in private sector wealth is accounted for by the personal sector which tends to increase its holdings of building society deposits more than its bank deposits. The forecast of all the aggregates is given in the table below:

per cent per annum

Target periods	MO	Assumed target range	M1	£M3	PSL2	Assumed target range	Money GDP
1982-83	4	-	12½	11	11½	8-12	9
1983-84	7	-	13	11	13	7-11	8½
1984-85	6½	4-8	11	9*	10	7-11	8
1985-86	6	3-7	10	8½*	9½	6-10	6½
1986-87	4½	2-6	8½	7½*	8½	5-9	6

*New definition excluding public sector deposits

MONETARY AGGREGATES % CHANGE ON YEAR EARLIER



100. The forecast involves a small rise in the share of gilts in the non-bank private sector portfolio. Net sales of gilts to the non-bank private sector are forecast to fall from nearly £10 billion in 1983-84 to £6 billion in 1984-85 and £5 billion the year after. With aggregate personal saving likely to remain near current rates, national savings inflows of £3 billion in 1984-85, the same as this year, look feasible. Allowing for likely sales of other forms of debt and the fall in the PSBR, the forecast implies small overfunding, possibly of about £½ billion in 1984-85, much the same as this year. Continued modest money market assistance of about £1 billion a year is also implied. This may involve however a greater level of assistance at certain times of the year which is unwound later in the year.

ANNEX: COMPARISON OF FORECASTS

Treasury Forecasts

1. Table A compares the current Treasury forecast with the last two Budget Forecasts and the Autumn Statement published in November.

2. UK output is expected to grow a little faster in 1984 than the last forecast suggested. This largely reflects a faster growth in consumption and fixed investment. Both import and export volumes are expected to rise faster because of the more buoyant picture for domestic and world demand. The current account is expected to show a larger surplus in 1984 mainly because of improved non-fuel terms of trade and a larger surplus on trade in oil and, to a lesser extent, on invisibles. The forecast for RPI inflation is little changed.

Outside Forecasts

3. Table B compares the latest Treasury Forecast with a consensus obtained by averaging outside forecasts. Unlike previous forecasts there now seems to be broad agreement on prospects for the PSBR in 1984-85 though there is a wide spread between Liverpool (£6.4 bn) and NIESR (£10.1 bn). Despite this agreement the outlook for growth in £M3 is somewhat lower in the Treasury view than the consensus forecast.

4. On inflation in 1984 the Treasury forecast is significantly lower than the consensus, despite a faster growth in earnings than most outside forecasters foresee. In part this reflects a higher level of the exchange rate in the Treasury projections but it probably also results from faster growth in productivity, a slower rise in profit margins and perhaps lower import prices.

5. Prospects for output in 1984 are more buoyant in the Treasury forecast. Consumer demand in particular is much stronger than in the consensus projections. In part this reflects the higher growth in real personal disposable income in the Treasury projections as a result of higher earnings growth and lower inflation.

TABLE A

COMPARISON OF TREASURY FORECASTS

	1982 FSBR/MTFS	1983 FSBR/MTFS	AUTUMN STATEMENT 1983	JANUARY 1984
Money Supply £M3*				
(% Change on year earlier)				
1982 Q1	14.5 (15.5)	13.8	13.8	14
1983 Q1	11.1 (11.6)	9.7	10.2	11.1
1984 Q1	8.9 (9.2)	9.0	9.9	9.8
1985 Q1	7.0 (7.3)	8.8	9.2	8.2
1986 Q1			8.0	8.3
PSBR				
£billion (% of money GDP)				
1981-82	10.6 (4.2)	8.7 (3.4)	8.8 (3.4)	8.8 (3.4)
1982-83	9.5 (3.4)	7.5 (2.7)	9.2 (3.3)	9.2 (3.3)
1983-84	8.4 (2.8)	8.2 (2.8)	10.2 (3.4)	10.5 (3.5)
1984-85	6.7 (2.0)	8.0 (2.5)	8.1 (2.5)	8.0 (2.4)
1985-86			7.0 (2.0)	7.8 (2.0)
Fiscal Adjustments (£ billion)**				
1981-82	-	-	-	-
1982-83	-	-	-	-
1983-84	- 0.3	-	-	-
1984-85	- 2.1	- ½	+ 0.5	- 1.1
1985-86			- 3.8	- 4.9
Nominal GDP (mp)				
(% Change on year earlier)				
1981	10.1	9.6	9.7	9.7
1982	10.6	8.8	9.3	9.4
1983	9.2	7.5	8.4	8.4
1984	9.9	8.6	8.0	8.6
1985			7.6	7.0
RPI				
(% Change on year earlier)				
1981 Q4	11.9	11.9	11.9	11.9
1982 Q4	9.0	6.2	6.2	6.2
1983 Q4	7.1	5.8	5.2	5.0
1984 Q4	6.0	5.4	4.2	4.5
1985 Q4			4.6	4.1

* The 1981 FSBR/MTFS was based on the old monetary sector
** A negative sign signifies a reduction in taxation

	1982 FSBR/MTFS	1983 FSBR/MTFS	AUTUMN STATEMENT 1983	JANUARY 1984
Interest Rates %				
Short Term				
1981-82	14.2	14.2	14.2	14.2
1982-83	13.5	11.3	11.5	11.5
1983-84	11.9	9.6	9.6	9.7
1984-85	10.2	7.5	8.3	8.7
1985-86			8.1	7.8
World Trade in Manufactures				
UK Weighted				
% Change on year earlier				
1981	4.1	3.3	3.3	3.3
1982	4.0	- 3.3	- 3.1	- 2.8
1983	4.6	1.0	- 0.7	1.0
1984	5.5	6.6	5.3	4.7
1985			6.3	5.1
UK Exports of Goods and Services				
(% Change on year earlier)				
1981	- 1.5	- 2.3	- 2.0	- 2.0
1982	3.3	0.7	1.4	1.4
1983	3.7	0.9	0.6	1.4
1984	4.4	5.0	4.0	5.5
1985			3.9	3.1
Average Earnings				
(private cyclically adjusted - % change on year earlier)				
1981 Q3	13.6	10.2	9.6	10.2
1982 Q3	9.0	10.0	10.3	10.0
1983 Q3	8.3	6.9	8.2	7.7
1984 Q3	7.4	6.9	7.2	7.5
1985 Q3			6.4	6.5
Effective Exchange Rates				
1975=100				
1981	94.9	94.9	94.9	94.9
1982	88.5	90.6	90.6	90.6
1983	84.6	80.5	83.4	83.3
1984	81.9	81.8	83.6	83.2
1985			83.0	83.5

	1982 FSBR/MTFS	1983 FSBR/MTFS	AUTUMN STATEMENT 1983	JANUARY 1984
Labour Cost Competitiveness				
(Ratio of UK to competitors.costs 1975 = 100) ***				
1981 Q4	139.3	131.4	102.4	102.4
1982 Q4	136.2	132.2	98.5	102.1
1983 Q4	130.3	121.0	91.0	97.4
1984 Q4	129.8	121.0	90.5	98.3
1985 Q4			92.1	96.7
Current Balance (£ billion)				
1981	8.3	6.0	6.6	6.5
1982	4.2	4.0	5.4	5.4
1983	2.9	1.5	0.6	2.0
1984	3.3	1.5	0.1	1.7
1985			1.1	0.6
Manufacturing Output				
(% Change on year earlier)				
1981	- 6.4	- 6.4	- 6.6	- 6.4
1982	3.2	- 0.6	0.4	0.1
1983	2.2	1.8	1.3	1.1
1984	1.9	2.4	2.8	2.3
1985			1.4	1.7
GDP Volume (fc)				
(% Change on year earlier)				
1981	- 2.0	- 2.5	- 1.6	- 1.6
1982	1.4	0.7	1.8	2.0
1983	2.4	2.0	2.8	2.9
1984	2.8	2.7	2.9	3.2
1985			2.8	2.5

***FOR COLS 3 AND 4 1980=100

	1982 FSBR/MTFS	1983 FSBR/MTFS	ATUTMN STATEMENT 1983	JANUARY 1984
Unemployment (UK sa excl school leavers - millions, new definition)				
1981 Q4	2.6	2.6	2.6	2.6
1982 Q4	2.8	2.9	2.9	2.9
1983 Q4	2.8	3.0	2.9	2.9
1984 Q4	2.8	3.1	2.9	2.9
1985 Q4			2.8	2.9
I & C Companies' Financial Surplus/ Deficit, £ billion				
1981	1.4	2.0	2.7	2.7
1982	0.2	1.1	2.3	2.5
1983	- 1.8	0.7	4.8	7.3
1984	- 0.9	2.3	4.6	4.3
1985			5.0	1.2

BLE B

	Treasury January 1984	Consensus Forecast	Range of outside forecasts
£M3 % change on year earlier			
1983-84	9.8	10.1	10.0 (NIESR, P&D) - 10.6 (LBS, Henley)
1984-85	8.9	10.2	9.1 (S&C) - 11.2 (Henley)
1985-86	8.2	11.4	10.7 (LBS) - 11.8 (Henley)
£M1 % Change on year earlier			
1983-84	11.8	12.3	10.5 (P&D) - 15.3 (LBS)
1984-85	11.2	10.1	8.0 (P&D) - 12.4 (LBS)
1985-86	10.2	8.8	8.5 (LBS) - 9.0 (NIESR)
Interest rates (short-term) Treasury bill rate %			
1983-84	9.3	8.8	No range. (LBS, P&D)
1984-85	8.1	8.7	7.9 (LBS) - 9.5 (P&D)
1985-86	7.2	7.9	no range. (LBS)
PSBR £bn			
1983-84	10.5	9.5	8.9 (NIESR) - 10.0 (Henley)
1984-85	8.0	8.4	6.4 (Liverpool) - 10.1 (NIESR)
1985-86	7.8	7.7	4.7 (Liverpool) - 10.2 (NIESR)
Exchange rate 1975 = 100			
1983 Q4	83.1	83.6	83.0 (P&D, S&C) - 84.7 (NIESR)
1984 Q4	83.5	80.4	78.8 (NIESR) - 82.5 (P&D)
1985 Q4	83.5	77.7	73.5 (NIESR) - 80.0 (P&D, S&C)
Current Account £bn			
1983	2.0	1.1	0.6 (LBS, S&C, Liverpool) - 1.8 (Cambridge)
1984	1.7	0.8	- 0.4 (CBI) - 2.2 (Cambridge)
1985	0.6	1.1	- 0.6 (Henley, PSD) - 5.6 (Liverpool)
Average earnings % change on year earlier			
1983	8.1	7.7	6.0 (Cambridge) - 8.6 (Henley)
1984	7.2	6.6	5.6 (Cambridge) - 7.2 (P&D)
1985	6.6	6.4	4.6 (Cambridge) - 7.5 (Henley)
RPI (CPI) % change on year earlier			
1983 Q4	5.0	5.1 (5.3)	RPI: 5.0 (P&D) - 5.2 (NIESR)
1984 Q4	4.5	6.1 (5.6)	RPI: 5.6 (P&D) - 6.8 (NIESR)
1985 Q4	4.1	6.1 (6.5)	RPI: 5.0 (S&C) - 7.2 (Henley)
RPDI % change on year earlier			
1983	1.5	0.7	0.0 (LBS) - 1.6 (Henley)
1984	3.5	1.2	0.5 (NIESR) - 2.1 (Henley)
1985	3.8	0.9	- 0.8 (NIESR) - 1.7 (LBS)

	Treasury January 1984	Consensus Forecast	Range of outside forecasts
Import Volume goods and services %			
1983	5.2	4.7	4.4 (S&C) - 4.9 (Henley, Cambridge)
1984	7.6	4.0	3.3 (S&C) - 4.9 (CBI)
1985	4.1	2.7	2.6 (NIESR, P&D) - 2.9 (S&C, Henley)
Export Volume goods and services			
1983	1.4	0.5	0.1 (S&C) - 1.0 (OECD)
1984	5.5	3.8	2.5 (CBI) - 4.5 (OECD)
1985	3.1	3.9	2.7 (P&D) - 5.0 (NIESR)
GDP* Output Volume, % change on year earlier			
1983	(2.9)	2.0	1.8 (LBS) - 2.2 (NIESR, S&C)
1984	(3.2)	2.1	1.8 (S&C) - 2.4 (LBS)
1985	(2.5)	1.6	1.0 (NIESR) - 2.4 (LBS)
Unemployment million, Q4 (UK adults, sa)			
1983	2.94	2.97	2.9 (NIESR) - 3.13 (LBS)
1984	2.87	3.01	2.9 (CBI) - 3.12 (LBS)
1985	2.89	3.10	2.88 (LBS) - 3.3 (NIESR)

'Consensus' includes: National Institute (November 1983)
London Business School (October 1983 - Economic Outlook) and (December 1983 - Financial Outlook)
Phillips & Drew (January 1984)
Cambridge Econometrics (January 1984)
CBI (November 1983)
Simon & Coates (January 1984)
Henley Centre (January 1984)
Liverpool (December 1983)

though results are not reported for some variables by some forecasters.

*Treasury figures are for the average measure of GDP, outside forecasts for the output measure.

10 DOWNING STREET

Robin,

You might like to see the record of John Biffen's lobby. Bernard has brought this to Lord Whitelaw's attention and he in turn may speak to John Biffen.

My view is that we should draw this to the attention of the Prime Minister. The Chancellor is angry about it and may raise it himself.

What do you think?

AT

Prime Minister 10/2

I think you should see and may like to have a word with Lord Whitelaw on Monday morning.

Agreed MT

FERB 10.2

t would happen - alas.

THE BUDGET

Cabinet this morning had been one of the most bland, miserably disappointing and boring meetings he had ever been at. It was absolutely awful; there was no lively debate, just unctious self-satisfaction. Things had been described as "coming along nicely", although unemployment was still high.

Asked about the mood, he said the Government was on course to victory - on automatic pilot.

No one had seriously questioned the strategy for the next 12-18 months. It had been reassuring for those afraid of a frenzy of tax cuts.

It had been helpful for the Treasury, in contrast to the early years of the first Parliament of this administration. He preferred any pyrotechnics in the second half of a Parliament.

Asked about the effect of American policy, he said there wasn't much you could do about it. He agreed that asset-selling was a shortish-term device and confirmed the Opposition voices in Cabinet were muted.

The economy was growing at 3% pa, a brisk pace by UK standards, and probably faster than most of Western Europe.

Asked about tax changes, he pointed out there was an obvious inhibition, even in Cabinet to discuss them. The discussion had been discreet, but the main concern, across the whole spectrum of Government was to deal with direct tax threshholds. This was held to be a priority both economically and socially.

The instinctive judgement was that if there was any room for relief, it should be on income tax threshholds.

The argument in the past from the corporate sector had been that it was in a bad way and needed help. The CBI pointed to the NI surcharge above everything else. But our corporate tax structure was not more onerous than the rest of Western Europe.

Today the mood was to back income tax threshholds, especially to combat the "why work" syndrome at the lower end of the tax bracket.

Asked if it would boost industry at home, he pointed out that this shouldn't be expected immediately. If people had more money, they would spend at least 50% on readily available imports.

The discussion on tax had been tentative and shrouded; the instinctive judgement had been to go for personal threshholds.

MG

LOBBY BRIEFING time: 4.20 pm date: 9.2.84

We repeated this morning's Lobby.

ANSWERS OF INTEREST

We added No 111 Written: Mr Alan Williams to ask the Minister for the Civil Service, how many vacancies exist in the Civil Service at executive officer level and above in the Cheltenham travel-to-work area and nationally. (Answer was substantive but didn't add much to the sum of knowledge. (There was no available breakdown of EO vacancies for the Cheltenham travel-to-work area.))

AIRBUS

Asked about an announcement, we did not expect it would be this week.

LEBANON

We confirmed the PM was keeping closely in touch with the situation.

BUDGET

We couldn't help on the stage of preparations. On the Green Paper on Long Term spending, we pointed out the Chancellor had said it would be published in due course, and gave no guidance on timing. We thought work on it had started in the Treasury.

We also confirmed that the Public Expenditure White Paper was pretty firm for 16 February.

Asked about the mood of Cabinet, we said there had been no great dramas. The Chancellor and the Chief Secretary would have opened proceedings.

SCOTT LITHGOW

We had no firm idea of the cost of the write-off, and suggested approaching DTI. Obviously it was being worked on.

LEBANON

Asked if the PM had heard Mr Luce's interview on the Today programme (where it was claimed he "had been torn to shreds"), we said if she had, she had not been greatly moved.

NEW COMMERCIAL VEHICLE SPEED LIMITS

Asked, we were not aware of any controversy.

LEBANON

Asked about the charge for evacuation, we confirmed it was £30, and read the World Service announcement. We could not help with the likely supplementary charge if a helicopter was involved. We suggested asking the FCO for details.

LEADER OF THE HOUSE'S LOBBY 4.40 pm

GCHQ

He pointed out a debate was not in next week's business, and confirmed that the work of the Select Committee had not finished - and he did not know when they would report.

HOUSING BENEFITS

He thought Monday's statement had substantially defused the issue, and he would be surprised if there were more than a handful of rebels.

MATRIMONIAL AND FAMILY PROCEEDINGS BILL

Asked about possibility of a Committee Stage on the Floor of the House, he said it would be very controversial - hence the call for the procedure. It would be absurd to see party affiliations on the issue, but he was not suggesting there would be a free vote. There were some precedents (eg the Bill that created the GLC), for a key clause to be discussed on the Floor of the House. He had undertaken to look into the suggestion but did not think it was likely to happen.

METROPOLITAN COUNTIES BILL

Asked about a Floor-of-the-House procedure, he said he didn't think so.

TELEVISING PARLIAMENT

He didn't think there would be a debate. Most people were happy to see the Lords' moves continue. The pro's thought it would allay fears; the anti's saw it as playing for time. He was not conscious of pressure for subsidies. The question would eventually arise and a budget would have to be arranged at some time.

As for the Austin Mitchell Bill, he would have expected to see a steady stream of PQs to keep up the interest, but they were not there. Personally, he was mildly pro, but he was not aware of pressures.

LONG-TERM SPENDING

About about rumours that the PM was delaying the Green Paper, he had never seen any paper or heard gossip to suggest that (up to now).

BUDGET - SECRET

7

PRIME MINISTER

PSBR

The paper on Economic Strategy still talks about a PSBR of £8 billion. In view of the high level of asset sales, the present rapid growth of private sector borrowing, and difficulties in controlling money growth, £7bn would be a much better target.

Too lax a PSBR figure too early in the government's life will undermine the credibility of the counter-inflation strategy and will not put enough pressure on spending departments to cut back their demands. Our background paper shows how PE could be reined back.

MTFS

It is right to set out an MTFS path up to 1988-89, and each year should show a further PSBR fall.

Balance between taxes

The aim should be to lower income tax by raising thresholds and to abolish/reduce capital taxes to encourage enterprise.

This should be financed by reducing tax reliefs on institutional investment (pension fund income, life assurance relief) and by an increase in corporation tax particularly on financial companies following the strong rate of profits growth. This increase is best achieved by cutting tax allowances for capital expenditure which would force the banks into paying a more realistic rate of tax: they currently mobilise tax reliefs through leasing deals.

AT

M J. Redwood

8 February, 1984.

cc MASTER SET

See K.

6

10 DOWNING STREET

From the Private Secretary

8 February, 1984

TAX REFORM STRATEGY

The Prime Minister held a meeting yesterday with the Chancellor of the Exchequer and the Chancellor of the Duchy of Lancaster to discuss the Government's tax reform strategy. The meeting had before it the Chancellor's minute of 19 January.

The Chancellor of the Exchequer was concerned that there could be difficulties if there were two parallel exercises on the reform of taxes running at one time, his and one in the Chancellor of the Duchy's group. In his view, the structure of tax was at the heart of the budgetary process and should be the responsibility of the Chancellor of the Exchequer. He felt that the proper way forward was for the Chancellor of the Duchy of Lancaster to join in the Treasury work in this area. This would maintain a proper division of responsibility but allow the Chancellor of the Duchy's experience in tax matters to be fully utilised.

The Chancellor of the Duchy felt that structural reform of taxation was more difficult than it had been before. It was inevitable that any major change would create a number of losers, though the Government now had very little scope for reducing taxes in order to compensate them. The tax credit scheme, which would have compensated losers, would cost £5-6 million at current prices to introduce. There were two possible ways out of this dilemma. The first was to ensure that, if new taxes were imposed, the proceeds were devoted, not to higher expenditure, but to the restructuring or abolition of other taxes. He urged that at the start of a new Parliament, a major effort should be made to abolish or reduce the scope of the capital taxes. These raised little revenue and were expensive to administer.

The second route to tax reform should be to eliminate the "money-go-round", where taxpayers were simultaneously receiving social security benefits or substantial tax reliefs. He thought it absurd for occupational pensioners to receive tax relief on their contributions, receive a state pension, while paying tax on both pensions.

/The

NR

The Chancellor of the Exchequer recognised that the capital taxes were unsatisfactory but did not accept that the revenue they raised was so insignificant that it could be easily replaced. He also felt that there was a political case for some taxation of capital. In the pensions field he was concerned that SERPS would prove too expensive if allowed to run to maturity. It should either be abolished or severely curtailed. While the Secretary of State for Social Services was conducting a review of pension provision, he was precluded from making major changes to the tax treatment of pensions.

The Prime Minister said she had dissuaded Mr. Rowland from undertaking a major redrafting exercise of tax legislation on the grounds that it made more sense to undertake structural change first. What was needed was a programme of work.

The discussion then turned to the reform of corporation tax. The Chancellor of the Duchy argued that the best approach was to move much closer to the ordinary commercial measurement of profits, abandoning the attempts to inflation-proof the system; and to move over from the imputation system, with all its defects and disadvantages, to a straightforward two-tier system. This would avoid the discrimination between capital raised in the form of ordinary shares, preference shares or loans. In order to get such a major change accepted by industry, it was necessary first to secure agreement within Government.

The Chancellor of the Exchequer said that adoption of an entirely new basis for corporation tax would take a great deal of time. He preferred a major reform within the existing framework, incorporating the abolition of stock relief, a substantial reduction in first-year allowances, matched by a much lower rate of tax. (As the rate approached 30 per cent, the discrimination between different sources of capital would effectively disappear.)

Summing up the discussion, the Prime Minister said that the Chancellor of the Duchy should be fully integrated into the work on the structure of taxation. He should join the team of Treasury Ministers, attend meetings, and receive papers in this area. In addition, his group would undertake work on the simplification and consolidation of tax legislation. He would not work on minor Finance Bill starters, nor on current budgetary policy.

I am copying this letter to Alex Galloway (Chancellor of the Duchy of Lancaster's Office).

ANDREW TURNBULL

John Kerr, Esq.,
H.M. Treasury.

SECRET

3105

5

Chancellor of the Duchy of Lancaster

Mr Turnbull : TAX REFORM

Lord Cockfield has suggested the attached amendments, designed merely to sharpen up the points he was making - He does not disagree with the conclusions and was grateful for sight of the draft letter.

Sebastian Birch
8.2.84

Page 1

paragraph 3 line 6:

delete: "eventually foundered as being too expensive"

substitute: "did effectively compensate losers" (it foundered simply because the election brought in a Labour Government)

paragraph 3 lines 7 and 8:

delete: "The only way out ... ensure that"

substitute: A "There were two possible ways out of this dilemma. The first was to ensure that, if new taxes were imposed,"

paragraph 4 line 1:

delete: "A further objective of"

substitute: "The second route to"

Page 2

paragraph 3, lines 3 and 4:

delete: "develop ... profits"

substitute: "move much closer to the ordinary commercial measurement of profits, abandoning the attempts to inflation-proof the system; and to move over from the imputation system, with all its defects and disadvantages, to a straightforward two-tier system"

B

paragraph 3, lines 6 and 7:

delete: "He wished ... system"

SECRET

4

Ref. A084/440

PRIME MINISTER

Economic Strategy
(C(84) 5)

BACKGROUND

Flag A In C(84) 5, the Chancellor of the Exchequer seeks the views of his colleagues on the appropriate level of the Public Sector Borrowing Requirement (PSBR) in 1984-85 and the appropriate balance between different taxes in the 1984 Budget. He also seeks agreement to rolling forward the Medium Term Financial Strategy (MTFS) to 1988-89, with an assumption of public expenditure held constant in real terms after 1986-87 (the final year covered by the Public Expenditure White Paper, to be published on 16 February).

2. Although the Chancellor of the Exchequer will take the views of his colleagues into account in preparing his Budget, he will not wish to be bound by them. He will also want to avoid any commitment to further collective discussion during the run-up to the Budget on 13 March, though he will no doubt be willing to discuss particular points bilaterally with individual Ministers.

3. The main features of the economic background are that output has increased by some 3 per cent, compared with last year's forecast of 2 per cent. Inflation also fell more rapidly than was forecast, averaging 4½ per cent in 1983. Most labour market indicators have been moving more favourably than in recent years, though the January unemployment figures were less satisfactory than had been expected. The latest forecasts (which will be updated for publication at the time of the Budget) suggest that inflation will rise temporarily to about 5½ per cent in the early summer, but fall again to about 4½ per cent by the end of 1984; and that output will again rise by about 3 per cent. C(84) 5 contains no forecast of unemployment (though Annex 1 suggests no reduction in 1984); but the paper suggests that the prospect for jobs is better than in the recent past.

SECRET

MAIN ISSUES

4. The main issues are:

(i) in relation to the forthcoming Budget:

(a) whether to aim at a slightly lower PSBR for 1984-85 than the present MTFS figure for that year of £8 billion, thus implying a broadly neutral Budget;

PSBR.

(b) what should be the balance of taxes within the 1984-85 Budget;

Taxes

(c) how far it would be desirable to give any commitments regarding taxation in 1985-86;

Promises?

(ii) in relation to the MTFS:

(a) whether it should be rolled forward for a further three years up to and including 1988-89;

(b) whether for the last two years, for which public expenditure decisions have not yet been taken, the assumption should be that public expenditure will be held constant in real terms at the 1986-87 level.

The level of the PSBR in 1984-85

5. At this time last year the forecast for the PSBR in 1983-84, with tax changes confined to revalorisation, was £6 billion. The forecast at the time of the Budget, allowing for the actual tax changes, was £8.2 billion. Although the outturn for the year is still uncertain, a substantial overrun seems inevitable: the current expectation is that this year's PSBR will amount to some £10 billion, despite the measures taken in July 1983 to reduce the overrun.

6. The Chancellor of the Exchequer argues that this experience suggests that a cautious approach is needed for 1984-85. The main aim should be to hold to the current MTFS figure of £8 billion (equal to 2½ per cent of GDP). The Chancellor also suggests that the fact that asset sales are expected to make an unusually large contribution to reducing the PSBR in 1984-85 is a further reason for caution. Although he mentions no precise figure, he suggests

that it would "probably be right, in terms of market confidence and hence interest rates, to aim for a slightly lower figure" than £8 billion.

7. Given this view of the appropriate PSBR for 1984-85, there will be little or no room for net reductions in taxation (though increases in prospective oil revenue make it unlikely that taxes will need to be increased - a possibility which was mentioned in the Autumn Statement). The Chancellor therefore has in mind a broadly neutral Budget.

8. Some members of the Cabinet may suggest that this is too cautious an approach, for one or more of the following reasons:

(a) Although an overrun in the 1983-84 PSBR seems certain, inflation has been lower and output higher than predicted. Might not a higher PSBR be tolerable in 1984-85 also?

(b) The Government is committed to reducing taxation as a means of strengthening the economy. Would it not be desirable to make the fastest possible progress in this direction?

(c) Industrial confidence may still be fragile; and the January unemployment figures may be an indication that the recovery could falter. Reductions in taxation would improve confidence.

9. Against that, the Chancellor of the Exchequer can be expected to make the following points:

(a) The monetary effects of an excessive PSBR take time to show themselves: it would be wrong to draw conclusions from experience in the current year.

(b) Inflation is forecast to increase temporarily in the earlier part of 1984; there are also some signs of an upturn in wage settlements. Higher inflation, coupled with a higher planned figure for the PSBR, could arouse fears that the Government was reversing its policies. This would have serious adverse effects on confidence.

(c) United States interest rates are high and seem likely to stay so. If we run a high PSBR, there will be further upward pressure on domestic interest rates. This would impede recovery.

10. Most members of the Cabinet may be willing to accept the Chancellor's judgment that it is right to err on the side of caution, so long as this can be done with a broadly neutral Budget; caution in the form of an increase in taxation would be a different matter.

Balance between taxes

11. The Chancellor seeks views on whether, within a broadly neutral Budget, there should be a shift in the balance between taxes, for example between persons and companies, or between direct and indirect taxation.

Persons and companies

12. The main points relevant to the balance between persons and companies are as follows:

(a) Company profitability is still very low by historical standards. We depend on a strong company sector for continued economic recovery.

(b) There were substantial benefits for persons in the 1983 Budget.

(c) On the other hand, the level of personal taxation at lower earnings levels increased sharply in the period 1978-79 to 1983-84, and will increase further in 1984-85 if adjustments are confined to indexation (Table 2 in Annex 3 to C(84) 5). The Chancellor of the Exchequer has drawn attention publicly to the excessive income tax paid by poorer wage earners.

(d) Because of absence abroad, the Secretary of State for Trade and Industry will not be present on 9 February. But his letter of 14 December 1983 said that while he would favour abolition of the National Insurance Surcharge (the change in company taxation most likely to command general support among Ministers) he would not want this at the expense of using up all of any available headroom. Abolition of the NIS from August 1984 would cost £450 million which would

Flag B

not be easy to accommodate in a "broadly neutral" Budget. Moreover the cost in a full year would be £850 million and this would affect the room for manoeuvre in 1985-86.

Direct and indirect taxation

13. The main arguments affecting the balance between direct and indirect taxation are as follows:

(a) Inflation is likely to turn upwards, at least temporarily. A reduction in indirect taxation would at least partly offset the effects of this on the Retail Price Index (RPI).

(b) But to achieve a worthwhile reduction in the rate of inflation by reductions in indirect taxation within a broadly neutral Budget would require substantial offsetting increases in direct taxation. (Each half per cent reduction in the RPI by this means would cost about £750 million in a full year.)

(c) The Government's longer-term policy is to shift the burden of taxation away from direct taxation.

1985-86

14. Paragraph 21 of C(84) 5 says that if the Government holds to its public expenditure plans "the prospect is for worthwhile tax reductions in 1985-86". The paragraph also suggests that it may be possible to consider for the 1984 Budget some measures reducing the burden of taxation in the 1985-86 Budget.

15. The Cabinet may wish to ask the Chancellor of the Exchequer for a fuller indication of what he has in mind here. Does he, for example, have in mind tax changes with small cost in 1984-85, but a significantly larger full year or second year cost? Does he intend to foreshadow in the 1984 Budget a measure such as abolition of the NIS from April 1985? Such an approach would help meet the points mentioned in paragraph 8 above - in particular, the case for fostering industrial confidence by reductions in taxation - while maintaining the Government's financial strategy. On the other hand, it would restrict the room for manoeuvre next year.

Medium Term Financial Strategy

16. The existing MTFS extends only as far as 1985-86. It is logical that it should be extended to 1988-89 to cover the full possible lifetime of the present Parliament. The Chancellor will not wish to involve his colleagues in the technical details of the monetary targets. However, he will wish to secure their endorsement of one of the implications of the approach he wishes to adopt - that public expenditure should be held constant in real terms after 1986-87. (Broadly speaking, it is already being held constant in real terms over the three years 1984-85 to 1986-87 covered by the latest Public Expenditure White Paper.)

17. Some Ministers may feel that the Chancellor is seeking to anticipate decisions on the public expenditure planning totals for 1987-88 and 1988-89 which would normally fall to be taken in the 1984 and 1985 Public Expenditure Surveys. His reply would be that these are merely assumptions, that this would be made clear in the statement, and that the decisions will remain to be taken in the normal way in due course. It would however be realistic to recognise that these assumptions will be taken as an indication that the Government does not intend public expenditure to increase in real terms during the remainder of this Parliament. Such an indication would be consistent with the Government's declared aim of reducing taxation while also continuing to reduce borrowing, interest rates and inflation.

HANDLING

18. It may be convenient to divide the discussion into two main parts: the first concentrating on the 1984 Budget and the second on the extension of the MTFS.

19. After the Chancellor of the Exchequer has introduced his memorandum, you will probably wish to go round the table asking all members for their views on the 1984 Budget. After this discussion, you might then ask whether any members of the Cabinet wish to comment on the Chancellor's suggestions regarding the MTFS. You may then with to ask the Chancellor of the Exchequer to give his general reactions to the discussion.

CONCLUSIONS

20. In your concluding remarks you will wish to avoid any suggestion that the Chancellor of the Exchequer is committed by the discussion to particular changes in his Budget, and to avoid any commitment to further general discussion by the Cabinet, apart from the traditional meeting immediately preceding the Budget.

21. You might then record conclusions which:

(i) invite the Chancellor of the Exchequer to take account of the views expressed in discussion in his further work on the Budget;

(ii) invite any Minister who has particular points on possible tax changes to discuss them directly with the Chancellor of the Exchequer.

RTA

ROBERT ARMSTRONG

8 February 1984

(For Cabinet on Thursday/

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
Telephone (Direct dialling) 01-215 5422
GTN 215)
(Switchboard) 215 7877

3

JH 821

Secretary of State for Trade and Industry

7 February 1984

The Rt Hon Nigel Lawson MP
Chanellor of the Exchequer
HM Treasury
Parliament Street
London SW1

Dear Chancellor,

9 FEBRUARY CABINET DISCUSSION ON ECONOMIC STRATEGY

As you know, because of my visit to the United States during the remainder of this week I will not be able to attend Thursday's Cabinet and the discussion on the Budget. I have, however, had a chance to read the paper - C(84)5 - you have circulated. I am sorry I shall not be able to hear colleagues' views but feel that nonetheless I should give you my brief reaction on the issues (para 24) on which you specifically invited comments.

2 I think you are right to roll the Medium-Term Financial Strategy (MTFS) forward to 1988/89. While I have no doubt of the need to contain public expenditure I would hesitate to nail our colours to the mast of an unchanged level through to 88/89. God forbid that we should encounter another Falklands or similar imperative of expenditure, but even without that, I wonder if we can afford the political cost of an implied ceiling on expenditure on social services and pensions, etc in the face of an ageing population. Let us try to achieve it by all means, but is this the right moment to risk a pitched battle with many of our own supporters?

3 Your immediate concern, of course, is with the PSBR target for 1984/85. Given the prospects for the economy as set out in C(84)5, the case of a £8 billion PSBR ceiling, and thus a broadly neutral budget, seems to me persuasive. More particularly, I would not advocate a significantly softer stance, because of the risk that any extra growth in activity would stand in the way of the further reduction in inflation which must remain an important objective.

4 Cabinet will also discuss your suggestion for a Green Paper on long-term public expenditure and taxation trends. I look forward to seeing the promised draft but it seems to me that to avoid the risks to which I refer above there should not be a "preferred" option but several illustrative options; while I see

the dangers of an unconstructive and overly political response, I do think we should try to put the main issues before the public. In the last Parliament our message about the broad thrust of our economic policy and the absence of "quick fix" solutions was, I think it is fair to say, broadly accepted, in part no doubt because we persisted with the argument. I see need for a similar educational job in relation to the long-term development of expenditure. Naturally I appreciate your reluctance to go into detail on particular programmes but there must be a danger that an approach which concentrates on overall expenditure and taxation levels will not have the necessary impact. It is, I believe, at the level of specific expenditure items that some of the "time bombs" are ticking away, and it would be right to make this clear.

5 Copies go to other members of the Cabinet and to Sir Robert Armstrong.

Yours sincerely,

Ruth Thompson

pp NORMAN TEBBIT

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

File

NBPM

AT 8/2

Chancellor of the Duchy of Lancaster

CABINET OFFICE.
WHITEHALL, LONDON SW1A 2AS

7 February 1984

2B4

Dear Nigel,

CAPITAL GAINS TAX

The introduction of indexation was essential as the only acceptable way of making a start on this problem. But it is incredibly, if not excessively, complex.

The suggestion I made this morning was that the charge should be limited to tax on one half of the net proceeds of sale. Put as bluntly as this it sounds a horrific level of charge: but in a very large number of cases it would be a great deal less than the present charge. In the past ten years prices have increased well over three times. The limit would therefore benefit all long term investments where the value even remotely reflected the change in the value of money. The alternative charge could be calculated in a matter of seconds: and in most cases it would be very obvious which basis would pay the taxpayer.

The objective would gradually be to reduce the chargeable proportion - from one half, to a third and then a quarter. At some stage it would be possible to abolish the indexation provisions so that the choice would be between a simple, relatively small charge on total proceeds or a conventional 30% on the actual gain. As with indexation the alternative charge would apply only if the asset had been held more than one - or possibly in future two - years.

The shorter the period of ownership the more burdensome would be the alternative charge. This would tend to buttress the system against converting income into capital gains.

I am copying this to the Prime Minister.

Yours,
Arthur

COCKFIELD

The Rt Hon Nigel Lawson
Chancellor of the Exchequer
H M Treasury
Parliament Street
London SW1P 3AG

184
Rudge

10 DOWNING STREET

From the Private Secretary

Prime Minister

This meeting with have two objectives

(i) to put more flesh on the skeleton the Chancellor of the Exchequer has provided. What sequence does he have in mind for tackling the various blocks of tax?

(ii) to settle the role the Chancellor of the Duchy will have in work on the structure of the taxes and on simplification/redrafting.

To note also John Redwood's plea for priority to be given to capital taxes.

AT
6/2

2A

PRIME MINISTER

LONG TERM TAX STRATEGY : CAPITAL TAXES

The 1979-83 government was pledged to a major overhaul of capital taxes. Whilst CGT was reduced for many taxpayers little progress was made on simplifying and no taxes were abolished.

Radical change is cheap and is best undertaken in the first budget of a Parliament. Alan Walters is in favour of abolition of as much as possible as these taxes stand in the way of enterprise and the passage of businesses between generations. If the two Chancellors are going to discuss specifics perhaps this could be high on the Agenda.

AT

pp J. REDWOOD

6 February 1984

CONFIDENTIAL

cc NO

NBPM
AT
6/2

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

3 February 1984

The Rt Hon Norman Tebbit MP
Secretary of State for Trade and Industry
Department of Trade and Industry
1-19 Victoria Street
LONDON SW1H OET

Dear Norman

You wrote to me on 23 January recommending a detailed tax amendment for inclusion in this year's Finance Bill. It concerned the removing of the listing requirement to enable Venture Capital Funds to secure capital gains tax exemption.

Needless to say, I share your view of the importance of the small firms sector, but I do not entirely follow your argument for the removal of the listing requirement for Venture Capital Funds. As you say, the Stock Exchange rules require those seeking a listing as an investment trust company to place no more than 25 per cent of their assets in unlisted securities. But there is no such restriction on those seeking a listing as an investment company. This change was introduced a few years ago and a number of companies have taken advantage of it. It is perfectly possible therefore for an investment company to place all its funds in unlisted securities and secure a listing on the Stock Exchange. It is then eligible for exemption from capital gains tax in exactly the same way as an investment trust company.

It has been put to us, by the British Venture Capital Association in particular, that the listing requirement may cause other difficulties for Venture Capital Funds which inhibit them from obtaining funds from institutional investors. We are exploring the possibilities here further. But I have to say that so far we have seen no evidence that the institutions themselves are inhibited from investing in small trading companies by the absence of a suitable tax vehicle. I suspect that the restrictions which the institutions themselves have imposed on the proportion of their assets in the unquoted sector may be a more important factor.

I am copying this letter to the Prime Minister and Sir Robert Armstrong.

Yours
Nigel

NIGEL LAWSON

Econ Pol : Budget Pt 11

1b

This incorporates
Alan's views
AT 27/1

PRIME MINISTER

MO

Budget Stance

Retail demand is strong, bank lending is growing quickly, corporate profits are rising rapidly and monetary policy is lax.

A so-called "neutral" budget (PSBR £8bn + asset sales) is too generous in these conditions. A PSBR of £6½-7bn should be the maximum permitted.

If the PSBR is not reduced this far it will be difficult to tighten the monetary position as much as is needed without interest rate rises. Markets will doubt the seriousness of intent behind the counter-inflation strategy and commentators will attack the policy as directionless. A lower PSBR is also the best protection against US problems.

A PSBR of £6½-7bn is attainable through a combination of expenditure reductions and imaginative changes to the tax base (as below). Expenditure could be reduced by £½bn as a result of the Treasury reviews underway if the work is seen as urgent.

Taxation Policy

This is the budget to be bold. It should stake out the radical tax measures of this Parliament.

The Chancellor's radical proposals for Corporation Tax are to be welcomed. Companies can afford to pay more, allowances should be phased out and the rate can still be lowered substantially. The idea of licensing credit companies should be welcomed.

Equally urgent is the need to encourage wider capital ownership. Individuals should retain more of their own money whilst the

/ cossetted

cossetted life of the savings institutions based on tax breaks should be challenged. The abolition of insurance premium relief on new contracts is a good measure. The Investment Income Surcharge should be abolished (cost £140m). Stamp duty on houses and shares should be at least halved (cost £500m). Capital Gains Tax should be abolished (cost £630m). Gains realised in under one year could be taxed as income to counter the most obvious criticisms. By bringing pension fund investment income into the tax net (with suitable restrictions on bond washing) around £2,000m extra could be raised to pay for the other changes.

Development Land Tax should be abolished (cost £65m) and the top rate of CTT reduced to 50 per cent.

These measures would be attacked as a "help the rich" budget. The abolition of the investment income surcharge will, however, help widows, disabled and others living on insurance monies or modest inheritances. The stamp duty charges can be presented as a major bonus for homebuyers and will assist young people trying to climb on the first rung of the housing ladder. By taxing short-term gains, the CGT measure is more difficult to oppose.

The 1979-83 government promised a major review of capital taxes but little came of it. This budget could do much in this area whilst reducing the PSBR at the same time. I have discussed these views with Alan Walters and he wishes to be associated with them. Such a budget would reaffirm the major planks of your economic strategy: honest money, taking the problem of inflation seriously and removing tax impediments to individual enterprise and initiative. It would not impede recovery.

John Redwood

JOHN REDWOOD
27 January 1984

Inland Revenue
Statistics Division
West Wing Somerset House London WC2R 1LB

Telephone 01-438 7390

Your reference

A Turnbull Esq
Private Secretary
10 Downing Street
LONDON

Our reference

Date

25 January 1984

Dear Mr Turnbull

? 12 January

Andrew Walker asked me to send you the attached tables requested in your letter of 19 January. They are 1983-84 versions of Tables 5 and 6 from the Survey of Personal Incomes. They are based on a projection from the 1981-82 survey and are therefore provisional.

Yours sincerely

Gordon Keenay

G A KEENAY

SJBL11

Table: Format(A) Name(TINI)

Table 6 (right)

Distribution of total net incomes before and after tax 1983-84
After tax
By range of total net income after tax

Range of income (lower limit) £	No. of net incomes thousands	Total net income before tax £ million	Tax £ million	Total net income after tax £ million
1,000	1,455	2,316	56	2,260
2,000	1,334	3,211	194	3,017
2,500	1,619	4,971	501	4,469
3,000	1,713	6,352	786	5,566
3,500	1,739	7,559	1,050	6,509
4,000	1,680	8,455	1,307	7,148
4,500	1,649	9,395	1,558	7,838
5,000	1,423	9,016	1,557	7,458
5,500	1,362	9,512	1,674	7,838
6,000	2,194	17,414	3,185	14,230
7,000	1,712	15,784	2,955	12,828
8,000	2,314	25,597	5,036	20,562
10,000	1,175	16,345	3,527	12,818
12,000	775	13,460	3,206	10,254
15,000	407	9,575	2,718	6,857
20,000	142	5,217	1,921	3,296
30,000	31	2,068	943	1,125
50,000	4	607	330	277
100,000	1	299	177	121
TOTAL	22,729	167,152	32,681	134,472

Table 5 (right)

Distribution of total incomes before and after tax 1983-84
After tax
By range of total income after tax

Range of income (lower limit) £	No. of incomes thousands	Total income before tax £ million	Tax £ million	Total income after tax £ million
1,000	1,425	2,270	53	2,216
2,000	1,289	3,104	188	2,916
2,500	1,567	4,807	482	4,325
3,000	1,624	6,021	741	5,279
3,500	1,611	6,999	964	6,035
4,000	1,543	7,719	1,161	6,558
4,500	1,550	8,764	1,409	7,355
5,000	1,321	8,303	1,380	6,922
5,500	1,274	8,793	1,466	7,327
6,000	2,094	16,417	2,817	13,599
7,000	1,720	15,627	2,742	12,885
8,000	2,526	27,458	4,942	22,515
10,000	1,398	18,882	3,657	15,225
12,000	1,014	17,131	3,646	13,485
15,000	546	12,316	3,040	9,276
20,000	208	7,119	2,260	4,860
30,000	45	2,750	1,118	1,632
50,000	7	852	412	440
100,000	1	358	202	156
TOTAL	22,765	175,689	32,681	143,008

Table 6 (left)

Distribution of total net incomes before and after tax 1983-84

Before tax

By range of total net income before tax

Range of income (lower limit) £	No. of net incomes thousands	Total net income before tax £ million	Tax £ million	Total net income after tax £ million
1,000	1,354	2,067	29	2,038
2,000	1,002	2,249	88	2,162
2,500	1,177	3,237	227	3,011
3,000	1,296	4,231	398	3,833
3,500	1,293	4,840	535	4,305
4,000	1,325	5,625	744	4,881
4,500	1,266	6,017	875	5,142
5,000	1,186	6,230	977	5,253
5,500	1,283	7,381	1,209	6,172
6,000	2,164	14,041	2,455	11,586
7,000	1,871	13,993	2,542	11,452
8,000	2,791	24,954	4,733	20,222
10,000	1,797	19,538	3,890	15,648
12,000	1,434	19,071	4,071	15,001
15,000	923	15,657	3,687	11,970
20,000	428	10,090	2,865	7,225
30,000	128	4,705	1,741	2,963
50,000	35	2,252	1,048	1,204
100,000	6	1,007	577	429
TOTAL	22,759	167,187	32,690	134,497

Table 5 (left)

Distribution of total incomes before and after tax 1983-84

Before tax

By range of total income before tax

Range of income (lower limit) £	No. of incomes thousands	Total income before tax £ million	Tax £ million	Total income after tax £ million
1,000	1,333	2,041	29	2,013
2,000	964	2,164	85	2,079
2,500	1,145	3,153	218	2,934
3,000	1,238	4,046	383	3,662
3,500	1,248	4,668	507	4,162
4,000	1,221	5,186	670	4,516
4,500	1,246	5,914	829	5,085
5,000	1,094	5,748	868	4,880
5,500	1,217	6,991	1,106	5,885
6,000	2,077	13,480	2,243	11,237
7,000	1,756	13,132	2,269	10,863
8,000	2,827	25,293	4,465	20,828
10,000	1,959	21,352	3,911	17,442
12,000	1,611	21,395	4,176	17,219
15,000	1,121	19,061	4,075	14,985
20,000	532	12,540	3,178	9,362
30,000	158	5,801	1,933	3,868
50,000	41	2,633	1,134	1,500
100,000	7	1,125	611	514
TOTAL	22,796	175,724	32,690	143,033

Econ Pol: Domestic Monetary Policy pt. 11.

Budget Pt 11

ecNO

Prime Minister (2)

To note

AT 23/1

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET

Telephone (Direct dialling) 01-215) 5422
GTN 215)
(Switchboard) 215 7877

JF5405

Secretary of State for Trade and Industry

23 January 1984

CONFIDENTIAL

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

D Nigel,

Further to my letter of 14 December I would like to recommend to you one further detailed tax amendment for inclusion in this year's Finance Bill. It concerns the availability of venture capital funds.

2 Over recent years my Department has been active in encouraging the development of the venture capital industry. The industry is playing an increasingly important role in the development of the small firm sector, and is essential if the successful small firms are to make the transition to medium sized firms and beyond with all that entails for availability of finance and management expertise.

3 To date the venture capital industry has been developing satisfactorily, but it is fast reaching the stage where, if its continued development is to be assured, it will need to attract investment funds from the institutions. At present venture capital funds are at a disadvantage, compared with authorised investment trust companies in competing for institutional funds since authorised investment trust companies are capital gains tax exempt.

4 Existing tax law (section 359 Income and Corporation Taxes Act 1970) requires authorised investment trust companies to be listed on the Stock Exchange. But Stock Exchange rules require such companies to place no more than

/25% ..

25% of assets in unlisted securities - clearly a condition unacceptable to venture capital companies. My suggestion is that the "listed" requirement of authorised investment trust companies should be dropped from Section 359. We would need to ensure that a relaxation in the rules did not allow approved investment funds to become private portfolio management vehicles rather than genuine public investment trusts; but this could be done by excluding individuals from participation in such companies or otherwise limiting the class of shareholder.

5 Because this amendment would mainly redirect to some extent institutional funds, I would include it under the "virtually costless" category in my previous letter. I do believe the amendment is important to the development of the venture capital industry. Delay in raising the point results from our making sure that the proposal is not in contravention of either UK or EC company law. I am now confident that it is not.

6 I am copying this letter to the Prime Minister and Sir Robert Armstrong.

Norman

NORMAN TEBBIT

1A

PRIME MINISTER

I have had a report back from the Chancellor's Private Office about the discussion you had with the Chancellor on the prospects for the Budget on Sunday evening. It would be very helpful if you could confirm whether this account is consistent with your understanding of the meeting.

The Chancellor's intention, though still provisional at this stage, was to aim for a PSBR of £8b. in 1984/85. This would be the same as signalled in the MTFS, though the increase in the figure for asset sales meant that it would be slightly more expansionary in its effects. As current expectation was that this could be achieved with a revenue neutral Budget. He was hoping, however, to go beyond simple indexation of tax thresholds (perhaps 3% more) by shifting the balance between direct and indirect taxation. This could be done in part by widening the scope of VAT.

He suggested a number of candidates for this:-

i) Extending VAT to building alterations. Initially you expressed reservations about this but the Chancellor is reported to have defended this on the grounds that it would not affect the RPI; house-buyers as a group would benefit from the proposed reductions in stamp duty; there were already substantial tax reliefs for home ownership; this would produce a more defensible borderline between alterations and repairs. It was not clear whether you had accepted the Chancellor's arguments.

He did still think it was the most difficult section of the budget - but worthwhile if it enables us to go further on thresholds

ii) Extending VAT to newspapers and newspaper advertisements. You were reported to favour this but to have suggested extending VAT to television advertisements. The Chancellor is considering the latter though he may conclude that this is best dealt with by adjusting the levy.

/On

On corporation tax, the Chancellor proposed a radically remodelled system with much lower allowances offset by a lower rate. He is reported as having raised the question of whether some of the savings should be devoted to abolishing NIS. You are reported as giving priority to a reduction in the corporation tax rate. The Chancellor felt that there might be merit in abolishing NIS as failure to do so would provide the business lobby with an obvious focus of criticism. It was left that the Chancellor would look at this again in the light of the way the arithmetic was working out. One possibility was to announce the abolition of NIS but to delay action to, say, January 1985.

Do you have any comments on this?

No

MT.

AT

23 January 1984

CONFIDENTIAL

PRIME MINISTER

Talks with the Chancellor

Budgetary Prospects

The main issue for discussion is the budgetary prospects which you were discussing with the Chancellor on Wednesday when time ran out. The Chancellor had suggested to you that his preliminary thinking favoured a PSBR of £8 billion. While this might be justifiable within the tax increase foreshadowed in the autumn statement, it did not appear to give scope for tax cuts. The Chancellor had also indicated that he might seek some switch in the balance of direct and indirect taxation.

Tax Strategy

You have already seen the note which is to be discussed with Lord Cockfield. I personally thought this rather thin and had expected something more like a programme of work setting out a timescale for tackling the various blocks of tax. You could press the Chancellor a bit more on this and could explore with him how he sees the partnership with the Chancellor of the Duchy working out.

I agree
FERB

Privatisation

The Chancellor's paper will be coming to E(A) next week. Attached is a note by the Policy Unit, arguing that on a number of points the programme could be bolder. The main difficulty will be getting sufficiently adventurous proposals out of the Department of Energy.

Competition Policy

See separate note. You might like to discuss with the Chancellor.

/ Treasury Ministers

Treasury Ministers and Lloyds

The Chancellor has come back with slightly modified proposals. Robin's note suggests a line.

AT

ANDREW TURNBULL

20 January 1984

910

SECRET AND
PERSONAL

Prime Minister

To note. I will arrange a discussion with the two Chancellors.

AT 19/1

1

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

PRIME MINISTER

TAX REFORM STRATEGY

In addition to tax reduction, I believe that we should aim to make substantial progress in the field of tax reform during the life of this Parliament. I have in mind a programme of reform covering both personal and company taxation.

Personal Taxation

2. The priorities here should be:-

(i) to increase the scope for income tax cuts by continuing the process embarked on by Geoffrey Howe in his first Budget of switching some of the burden from income tax to VAT;

(ii) to improve incentives; and

(iii) to remove or reduce distortions.

3. (i) above should not be pursued by increasing the 15 per cent rate of VAT still further, but by broadening the base of the tax, bringing into the VAT net some items at present zero-rated. Only half of all consumer spending is now subject to VAT. The need to have regard to the impact effect on the RPI in any one year points to the desirability of making gradual progress, starting this year. The political sensitivities are obvious, but I believe there is appreciable scope for action.

4. As to (ii) above, the priority here must be to increase personal tax thresholds. The married man's allowance has fallen

SECRET AND
PERSONAL

as a percentage of average earnings from about 60 per cent in 1950 to just over 30 per cent today. The level of income at which people in this country start to pay income tax is well below that in our major competitors. A substantial increase in the thresholds would take many people out of the tax net altogether, ease the poverty and unemployment traps, and improve incentives. We also need to tackle the unsatisfactory 'kink' in the marginal rate of total deductions (income tax plus national insurance) in the present system, which starts at 39 per cent, then drops to 30 per cent, and then rises again to 40 per cent; and to improve the tax treatment of share option schemes. When we have raised the income tax threshold to a reasonable level, we can again turn our attention to the rates of tax.

5. So far as (iii) above is concerned, the present system runs completely counter to our fundamental philosophy by encouraging the institutionalisation of savings and discouraging share ownership by the individual. The specially favourable reliefs for life assurance are the obvious example, but we shall also need to consider, when Norman Fowler's review is complete, the tax privileges of the pension funds. On the other side of the coin, I should like to get rid of the investment income surcharge.

Business taxation

6. At the present time we suffer from an excessively high level of corporation tax (52 per cent) made to some extent tolerable by an extensive and somewhat capricious system of reliefs.

7. Our long term objective should be to bring the corporation tax rate down to 30 per cent, which would remove the present distortion in the system against equity finance and in favour of loan finance. A gradual move in this direction could be financed for the most part by a correspondingly gradual reduction in the generous allowances and reliefs which at present bias investment between different types of assets and between capital and labour.

8. I believe that over the lifetime of this Parliament we should aim to abolish, in stages, the first year allowance for plant and machinery and for industrial buildings. This would leave the annual writing down allowances of 25 per cent and 4 per cent respectively to take account of depreciation. We should make corresponding changes in the less important allowances. We should also abolish stock relief, now that the high inflation which made it necessary is behind us.

9. We are pledged to abolish the National Insurance Surcharge during the lifetime of this Parliament. I am considering the right timing.

Capital taxes

10. I have already mentioned the investment income surcharge. I intend to have completed within the coming year a full review of all the other major capital taxes, starting with capital gains tax. Capital transfer tax was reviewed in great detail during the last Parliament, and many improvements were made, but I plan to take stock again this summer, as soon as the CGT review, now under way, is completed. The retention or abolition of development land tax is, given its small net yield, a straight forward matter of political judgement. Far more important, I believe, is the question of stamp duty, on which replies to Geoffrey Howe's consultative document are still coming in. We must seek the earliest opportunity to reduce the burden of this task, which is a tax on mobility and a disincentive to wider share ownership, as well as a threat to the survival of a strong central securities market in London.

Public expenditure

11. This note sets out my broad thinking on the structure of taxation, on which a great deal of work has already been done within the Treasury, particularly since the Election. But it

is worth noting that tax reform will be greatly facilitated by our success on tax reduction, since only in this way can we be sure of reducing the number of losers (and there are gainers and losers from any reform, at least in the short term) to politically tolerable levels. And it goes without saying that a reduction in the overall tax burden depends on our holding public expenditure to the figures agreed in the Survey, and thereafter continuing to exercise the most stringent control of public spending.

The 1984 Budget

12. This note outlines my proposals for the longer term. In most of these areas I hope to take the first steps in this Budget. I will consult you about that separately.

13. A copy of this minute goes to Arthur Cockfield.

NL.

(N.L.)
19 January 1984

JP

10 DOWNING STREET

From the Private Secretary 19 January 1984

Thank you for your letter of 19 January. By coincidence, Inland Revenue's Survey of Personal Incomes arrived on my desk almost immediately after I had written to you and as you point out it contains the very tables I was looking for. The difficulty, which you mention, is that the published figures refer to 1979-80. If it would not be too much trouble, I would like to take up your offer of figures for the current financial year.

(ANDREW TURNBULL)

A.J. Walker, Esq.,
Board of Inland Revenue.

CC NO

THE BOARD ROOM
INLAND REVENUE
SOMERSET HOUSE

19 January 1984

Andrew Turnbull Esq
10 Downing Street
London SW1

Dear Andrew

Thank you for your letter of 12 January about the distribution of income before and after income tax.

Tables showing the distribution of taxable income before and after tax are published in "The Survey of Personal Incomes". It happens that the 1979/80 volume was published on Tuesday (17 January). I attach a copy of its Tables 5 and 6. The latter is included to provide data consistent with tables published for years up to 1974/75 (including the ones you enclosed for 1961/62), the main difference being that until then the definition of income used to classify income to ranges was net of mortgage interest.

The information that will appear in the corresponding tables for 1980/81 and 1981/82 could be extracted fairly readily, though we do not expect preparations for publication in the next Survey of Personal Incomes to be completed for some months.

For the purposes of examining fiscal policy options and their distributional effects, the Survey data are projected, and estimates of the distribution of income before and after tax could, if necessary, be compiled for the current financial year.

Yours

Andrew

A J Walker

Private Secretary

5 Distribution of *total incomes* before and after tax, 1979–80

Numbers: thousands; Amounts: £ million

Range of income (lower limit) £	Before tax, by range of total income before tax: No. of incomes	Total income before tax	Tax	Total income after tax	After tax, by range of total income after tax: No. of incomes	Total income before tax	Tax	Total income after tax
1,000	2,770	4,280	174	4,100	3,440	5,700	329	5,370
2,000	1,720	3,860	335	3,530	2,400	6,130	720	5,410
2,500	1,810	4,950	573	4,380	2,320	7,400	1,040	6,360
3,000	1,800	5,820	802	5,020	2,120	8,150	1,290	6,860
3,500	1,610	6,040	914	5,130	1,990	8,960	1,490	7,470
4,000	1,570	6,650	1,070	5,580	1,820	9,270	1,570	7,700
4,500	1,560	7,400	1,240	6,160	1,500	8,610	1,480	7,130
5,000	1,400	7,360	1,280	6,080	1,370	7,740	1,540	7,200
5,500	1,190	6,870	1,190	5,670	1,230	8,540	1,480	7,060
6,000	2,180	14,200	2,480	11,700	1,890	14,900	2,670	12,200
7,000	1,700	12,700	2,280	10,500	1,150	10,600	2,030	8,610
8,000	1,930	17,100	3,270	13,900	1,050	11,600	2,400	9,230
10,000	832	9,070	1,860	7,200	409	5,780	1,360	4,420
12,000	502	6,650	1,500	5,160	220	3,990	1,090	2,900
15,000	274	4,640	1,210	3,430	100	2,510	812	1,700
20,000	128	3,030	964	2,060	40	1,420	593	930
30,000	46	1,690	678	1,010	8	551	254	297
50,000	10	628	303	325	2	204	109	96
100,000 and over	2	314	166	148	0.2	66	26	40
All ranges	23,000	123,000	22,300	101,000	23,000	123,000	22,300	101,000

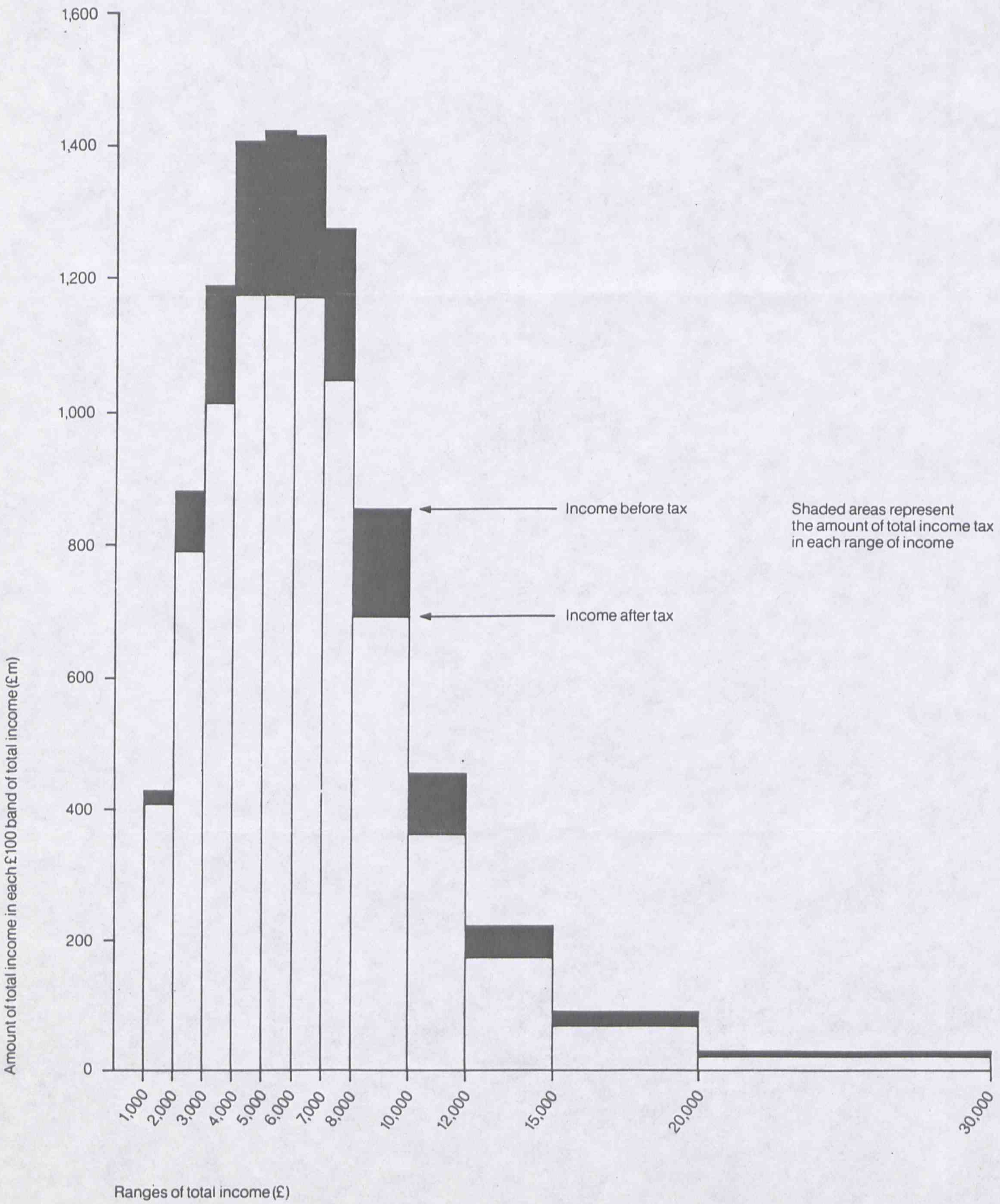
6 Distribution of *total net incomes* before and after tax, 1979–80

Numbers: thousands; Amounts: £ million

Range of income (lower limit) £	Before tax, by range of total net income before tax: No. of incomes	Total net income before tax	Tax	Total net income after tax	After tax, by range of total net income after tax: No. of incomes	Total net income before tax	Tax	Total net income after tax
1,000	2,850	4,390	181	4,210	3,540	5,860	339	5,520
2,000	1,760	3,970	346	3,620	2,510	6,420	761	5,660
2,500	1,910	5,230	616	4,610	2,460	7,870	1,120	6,750
3,000	1,860	6,020	848	5,170	2,310	8,940	1,450	7,490
3,500	1,760	6,580	1,030	5,550	2,130	9,640	1,660	7,980
4,000	1,650	7,010	1,180	5,830	1,850	9,570	1,720	7,850
4,500	1,580	7,500	1,310	6,190	1,560	9,020	1,630	7,390
5,000	1,450	7,600	1,370	6,230	1,400	9,050	1,670	7,380
5,500	1,240	7,100	1,300	5,800	1,180	8,300	1,530	6,770
6,000	2,180	14,100	2,630	11,500	1,730	13,900	2,690	11,200
7,000	1,560	11,600	2,230	9,400	969	9,110	1,900	7,210
8,000	1,740	15,400	3,150	12,200	817	9,390	2,160	7,230
10,000	695	7,570	1,690	5,880	306	4,510	1,200	3,310
12,000	421	5,570	1,380	4,190	149	2,890	921	1,970
15,000	215	3,650	1,070	2,580	71	1,920	720	1,200
20,000	108	2,570	906	1,660	26	1,080	478	602
30,000	37	1,390	610	775	6	416	212	204
50,000	8	535	275	260	1	145	85	60
100,000 and over	2	283	157	126	—	57	23	34
All ranges	23,000	118,000	22,300	95,800	23,000	118,000	22,300	95,800

Distribution of total income before and after tax 1979-80 **CHART 1**

For data, see Table 5



Econ Pol : Budget Pt 11

2

PRIME MINISTER

Social Security

You asked me yesterday about the position of students and their national insurance contributions. You are right in your recollection. Students are exempted during their period of study but subsequently have six years to make up that lost time. If they do not do so they have a reduced entitlement.

DJ

MT

18 January 1984

NBPM
AT
16/1

PRIVY COUNCIL OFFICE

WHITEHALL, LONDON SW1A 2AT

13 January 1984

Dear John,

1984 BUDGET DAY

10th?

Thank you for copying to this office your letter of 12 January to Andrew Turnbull. I confirm that both the Lord Privy Seal and the Chief Whip are content to proceed as you suggest.

Copies of this letter go to the recipients of yours.

Yours,

Charles

C M J MARSHALL
Private Secretary

J Kerr Esq
Private Secretary to the
Chancellor of the Exchequer

CONFIDENTIAL

FILE

Res)

10 DOWNING STREET

From the Private Secretary

12 January, 1984

The Prime Minister has noted the Chancellor's intention to announce 13 March as Budget Day in the course of the first Business Statement after the Christmas Recess, which will be on 19 January. Subject to the views of the Lord Privy Seal and the Chief Whip she is content with this.

I am sending a copy of this letter to David Heyhoe (Lord Privy Seal's Office) and Murdo Maclean (Chief Whip's Office)

(A. Turnbull)

J.O. Kerr, Esq.,
HM Treasury

CONFIDENTIAL

CONFIDENTIAL

PRIME MINISTER

1984 Budget

The Chancellor has a provisional agreement with you that the 1984 budget should be on 13 March. He now wishes to announce this. Agree?

Yes MS

I have discussed the budget timetable with his Private Office. The Chancellor has pencilled in 9 February as the date for the budget Cabinet, which implies a discussion with you on the paper he would submit around 1 February. Thereafter he proposes to use the regular Wednesday bilaterals to clear the various policy decisions.

In addition to this there will be a tax strategy meeting with you and the two Chancellors. This will discuss a paper which the Chancellor of the Exchequer will be circulating in a week to 10 days.

11 January 1984

Perhaps the Chancellor will remember Mr. Heseltine's strictures on the inadequate Treasury information given to Cabinet. You remember Sir Douglas Wass also referred to it in one of his lectures.

MS

CONFIDENTIAL

KC NO

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

10 January 1984

Andrew Turnbull Esq
10 Downing Street

Dear Andrew,

1984 BUDGET DAY

In his letter of ~~29~~ 23 September Michael Scholar confirmed that the Prime Minister was content that we should plan on the basis that 13 March would be Budget Day. If the Prime Minister is still content, the time has now come to announce the date, for this is customarily done in the first Business Statement after the Christmas recess, which will be 19 January. The normal form is for the announcement to be made in reply to a Question by the Leader of the Opposition, who is prompted in advance by the Chief Whip.

I am sending copies of this letter to David Heyhoe and to Murdo Maclean. If the Leader of the House also agrees to an announcement being made on 19 January, I should be grateful if the Chief Whip's Office could make the necessary arrangements.

Yours ever,

John Kerr.

J O KERR
Principal Private Secretary

Prime Minister (2)
Any Questions can be parried by reference to the forthcoming hearing.
AT 19/12

cc NO

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

16 December 1983

Andrew Turnbull Esq
10 Downing Street
LONDON
SW1

Dear Andrew,

ICI'S CASE ON ETHANE VALUATION

I wrote to you on 12 December to warn you that the next hearing of this case would take place on Wednesday. You may have seen the reports in yesterday's Financial Times and Guardian.

attached.

The Inland Revenue tell me that the Financial Times article provides a reasonably fair account of the proceedings but that in the Guardian is more tendentious. The Government was not "finally forced into Court". This is the second procedural hearing in a long and complex case. Nor is the hearing to decide the fair price of ethane. The Court has to decide a number of issues, including whether there is a level of valuation so low that it would constitute a State aid, but this is not the same as determining a "fair price".

At the hearing (which took place in Chambers) ICI, under pressure from the Judge, did not pursue their claim for extensive discovery of Government documents. However it was agreed to make one last effort to secure the oil companies' agreement to release the relevant parts of the Brent contract under restrictive conditions although the Revenue doubt whether the companies will cooperate even on this basis. If they refuse, there will be another brief hearing on this point in the New Year. ICI also requested information on whether the Revenue had made a valuation of ethane and if so, at what level. However, it was accepted that the bulk of the case could be determined without this, although ICI reserved the right to return to the point later, if necessary.

/All

All in all, the outcome was satisfactory for the Government and apart from the question of disclosure of the Brent contract, there are not likely to be any further hearings before the substantive trial which we expect to take place in October or November 1984.

Yours sincerely,

Margaret O'Mara

MISS M O'MARA
Private Secretary

Econ Pol: Budget Pt 11

Financial Times 16.12.83

ICI tax plea terms agreed

A CLAIM by Imperial Chemical Industries' against the Government over special tax concessions to its competitors will come before the High Court next autumn.

At a pre-trial court hearing yesterday, ICI and the Government agreed to put to one side the issue of whether the Government and ICI's competitors had pre-arranged the agreement which gives Shell, Esso and British Petroleum special tax concessions on their purchases of ethane from the North Sea.

The case will proceed on the basis of whether the Government has provided unfair state aid to ICI's competitors without the approval of the EEC Commission.

Guardian 16.12.83

THE overnment, which is alleged to have given secret ethane tax concessions to Shell, Esso and BP, has finally been forced into court by ICI which claims that its petrochemical rivals have received an unfair subsidy in breach of the Treaty of Rome. Mr Justice Woolf ruled yesterday that the foir ethane price should be decided in the High Court and the case is expected to begin in the autumn of 1984.

AT 19/1/22

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
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JF5103
Secretary of State for Trade and Industry

14 December 1983

CONFIDENTIAL

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON
SW1P 3AG

Prime Minister

To note Mr Tebbit's budget suggestions which helpfully recognize the Chancellor's limit scope for action. To see letter and, if time, paras 7-12.

AT 15/12

MT

D Nigel.

In the coming weeks you will be receiving countless representations from industry and commerce about the things they want you to do in next year's Budget. They are likely to want measures which will go far beyond anything which can reasonably be contemplated, so I thought you might find it helpful to have my own assessment of the priorities in this field against the objective of improving industrial performance. I enclose a paper prepared by my Department which sets out my ideas in detail.

2 The Autumn Statement suggested little scope for major hand-outs consistent with the MTFS. I do not want to urge you to overstep the MTFS. The best thing we can do for industry is to make possible a continued fall in interest rates and inflation thus helping to keep costs down and profits rising. I am not in favour of easements on income tax on this occasion apart from revalorisation of allowances.

3 The amount of headroom you will have within the MTFS is uncertain. I still remain in favour of abolishing NIS in line with our declared intention to remove it during this Parliament, but not in this Budget if it would use up all the available head-room.

4 My priority this time is other supply side measures - especially those which take some time to come through in improved performance and which may prove politically more difficult to introduce later in this Parliament. Hence I put (1) more favourable tax treatment of Share Options at the top of my list. The detailed paper describes what I have in mind, but in essence it is that taxation of share options be confined to capital gains tax and only on disposal of shares.

Such a move was widely commended - and rightly so - at the Prime Minister's Technology Seminar in September when successive speakers depicted it as a key to vitally needed improvement in the quality of British industrial management.

5 My second priority is a halving of Stamp Duty on Stocks and Shares. This would reinforce the measures we are taking to revive the competitiveness of UK stock markets. It may also assist our objective of encouraging wider share ownership which in its turn has a bearing on our privatisation plans. (2)

6 My third priority is a group of inexpensive measures to demonstrate our continued need to foster the small firms sector (i.e. raising the VAT registration limit to £19,000, reducing the small companies Corporation Tax Rate to 35% and the introduction of enterprise bonds to smooth the tax payments of small firms). (3)

7 Fourthly, I would like to continue the pattern of the last few Budgets by giving some fiscal encouragement to innovation and new technology by making the costs of acquiring patents eligible for 100% first year allowances, by some modest definition changes to improve the scope of R&D tax allowances and by extending for a further three years the capital allowances for Teletext and Viewdata - Kenneth Baker will be giving John Moore more details about this last point. (4)

8 Fifthly, to follow up Norman Lamont's recent statement to Parliament on Tourism, I would favour a step made to reduce some of the differential between hotels and industry as regards initial capital allowances, which was widened to industry's benefit in 1981. (5)

9 In my estimation these five points should not cost much more than some £300 million in a full year, and about half that cost would arise from the Stamp Duty reduction. If by the time of the Budget you have more headroom than that, I would favour your doing as much as possible to get rid of NIS - even reduction to ½% would be worth having because of the direct and beneficial effect on industry's costs and competitiveness, and hence employment as well as inflation - and adding one or two extra measures to the small firms package (e.g. easing the burden of capital transfer tax on family businesses).

10 The detailed paper also sets out a number of virtually costless - but highly desirable - measures. Some would further encourage small firms and the self-employed, and others would help the film industry and the cable industry. Annex B

11 I hope that the fiscal adjustment turns out high enough to do at least the first five items I have listed. Whatever the Budget arithmetic, I hope you will feel able to introduce not only the virtually costless measures but also a more liberal tax regime on share options. We really must get to grips, and quickly, with the problem of industrial management.

12 My officials are of course readly to discuss with yours any particular points arising from this letter and the detailed paper.

13 I am copying this letter to the Prime Minister and Sir Robert Armstrong.

Yours

Norman

NORMAN TEBBIT

CONFIDENTIAL

1984 BUDGET

The representations that have been received from industry and commerce are comprehensive and in an ideal world a large number would be beneficial. But as explained in the Autumn Statement, fiscal headroom is likely to be tight next year. No doubt representations from a number of industrial representative bodies - perhaps even a majority of them - will be proposing the creation of more headroom by, for example, increasing the size of the PSBR or reducing the contingency reserve.

2. The Department equally has no doubt that this is not the route to improve industry's competitiveness and profitability and the prospects for commerce and industry in general. Industry has benefitted most from the reduction in inflation and the consequent reduction in interest rates which the Government's policies have achieved. While profitability remains very low, the recovery in company profits has been marked and very encouraging. And while manufacturing output in particular is still in a depressed state, the recovery is now well established and the prospects for continued recovery during 1984 look good; although how good is a matter on which opinions appear to differ. In this light it is important that any tax concessions should be consistent with the MTFS and should not jeopardise the continued reduction in inflation and the continued recovery of output.

3. It is nevertheless to be hoped that the position may not be as tight as the Autumn Statement indicated that it might be. There are several measures which need to be introduced at an early stage in this Parliament in order so to change attitudes and performance that we could expect some, if initial, resulting benefits before the next election. If there is some fiscal headroom next year, we beleive that using it to introduce the measures discussed below would be more valuable to industry than a commensurate reduction in the PSBR: it is unlikely that a further small decrease in the PSBR would lead in current circumstances to significant reductions either in interest rates or inflation.

4. Before moving on to the Budget suggestions for trade and industry, it may be useful to make one comment on the general structure of the budget within any headroom that is available. Consideration will no doubt be given to the relative merits of directing help to the various sectors of the economy, particularly the personal sector versus the company sector. The categorisation is not of course all that precise since personal taxation measures will affect the company sector and vice ersa. Cuts in income tax would benefit industry both directly through increased demand, perhaps (though doubtfully) lower wage demands, and by creating higher incentives. But if we are to encourage a stronger commercial and industrial base, then attention should be concentrated on those measures which will have a more direct and dynamic effect on the supply side and which will help to improve industry's competitiveness. The benefits of improved competitiveness and performance will feed through to the personal sector via higher employment and possibly lower prices. While these considerations do not argue against the full revalorisation of income tax allowances, the Department would hope that further concessions could concentrate on taxes which affect the corporate sector more directly, especially as expectations of immediate income tax cuts have now successfully been deflated.

5. Uncertainty as to the amount of any fiscal headroom in next year's Budget causes some difficulties in ordering preferences by priority for trade and industry. This is because priority can be determined as much by the need to tackle a variety of problems in the corporate sector and by timing considerations as by the intrinsic merits of the proposals themselves. The CBI and many others, for example, will be pressing hard for the abolition of NIS. There are strong arguments for getting rid of NIS (as set out in Cecil Parkinson's letter of October) and if the Government are able to contemplate some major tax concessions the Department would favour, in current circumstances, action on NIS rather than on income tax or corporation tax. The Government have declared their intention to abolish NIS during the life of this Parliament. But we would be very reluctant to support a reduction in NIS in next year's Budget if that were to monopolise any fiscal room for manoeuvre and hence preclude beneficial measures on virtually all other fronts.

6. It may be most helpful therefore if the Department's priorities are set out on two separate assumptions; (i) that there is very little fiscal headroom over and above revalorisation of personal allowances - a figure of around £300m has been assumed for illustrative purposes; and (ii) that the outturn is not so tight and that a package around £750m can be considered. We would stress that these figures are only illustrative assumptions and represent what we believe would be the full year total cost to the Exchequer of the measures identified under each assumption.

Limited Package Assumption

7. Share Options

The area to which in the Department's view top priority should be given is the introduction of more favourable tax treatment of share options granted to executives and key employees. As is well understood, the attractiveness of significant share options to executives is reduced at present both because options are subject to income tax and because tax becomes due on the exercise of the option, before disposal of the shares and hence before any financial gains have been made. The proposal, broadly, would be to charge the gains from share options to capital gains tax, effective only on disposal of the shares.

8. We are persuaded by the very wide and virtually unanimous representations we have received and by American experience in this field that this more generous tax treatment of share options should extend to all companies. We will also need to find ways of incorporating existing share option schemes. This measure, more than any other, will attract top calibre management - so desperately needed - into industry, by raising their rewards. It will also increase incentives and motivation of existing executives and key employees - on whom company success mainly depends - by linking their rewards to performance. We see share options as a central element in the Department's efforts to improve the quality of management in British industry and so to improve its performance, competitiveness and profitability. In time it could have a larger and longer lasting effect on industrial performance than the direct reduction of imposed costs on industry. The time is now opportune, in the early stages of the Parliament, to introduce these changes to get industry

back on course in a very competitive world environment. This was one of the main points to come out from the Prime Minister's seminar on technology.

9. It is difficult to be precise about the exchequer cost of these concessions, but there would be little cost for several years until shares acquired by exercise of options were disposed. Under the detailed rules and conditions of a share options scheme which are set out in Annex A, participants in schemes could not dispose of their shares before the 1987/88 tax year. There will be some "deadweight" cost because some companies already operate executive share options schemes and tax liability of existing share option schemes will be delayed, but this would be small. It has also been suggested that lost tax revenue would result to the extent that share options substituted for income. We doubt whether such substitution would be significant, but to the extent that substitution took place there would be offsetting savings to the exchequer through higher corporation tax since disposal of shares, unlike remuneration, is not tax deductible. In these circumstances much would depend on the taxable capacity of the companies in question; but it is difficult to see any significant exchequer cost even in the longer term.

Stamp Duty on Stocks and Shares

10. The Department also gives priority to the reduction of stamp duty on stocks and shares as a measure both to remove some of the disadvantage which stamp duty imposes on our financial markets in an increasingly internationally orientated trade and as a measure to encourage wider share ownership. The 2% stamp duty on stocks and shares compares unfavourably with the rates in our EC partners and particularly in the US. Partly as a result we have witnessed growth of dealing in New York of British shares and of ADR business and we have seen the Stock Exchange's share of international business diminish over recent years. Action here would be a valuable complement to the push we are giving through our Stock Exchange policy to more effective international competitiveness for British based firms. A reduction in stamp duty would have a major psychological impact on operators and would start a cumulative process of expansion. Again, timing is all important, for the benefits from reduction in stamp duty and the fundamental changes being introduced in competitive practices on the Stock Exchange to be self-reinforcing.

11. As to wider share ownership a concession on stamp duty would be particularly helpful to the small investor who often views the duty as an additional deterrent to investment in industry. With the BT flotation next year, it will be particularly important to attract into the markets the small investors if the stock market is to remain buoyant.

12. As a first step to securing parity with practices in our closest trading partners we would favour reduction in the duty on stocks and shares to 1%. This would to some extent limit the direct cost while giving the right signals. Reduction, as opposed to abolition, would also offset in part the tax loss through the resulting increase in volume.

Small Firm Measures

13. The Government have, over recent years, done a great deal both with the start-up of new and the expansion of existing small firms. More needs to be done further to encourage enterprise and to help small firms to help themselves. There must be continuity of commitment and it is important that the Government do not give the impression of resting on their laurels. However, we perhaps do need a period of consolidation as far as major new schemes and innovations in the small firms field are concerned. For this reason we would not support requests for Small Firm Investment Companies; we need to see how the BES works in practice. But we would hope that this would not rule out considered improvements to the current system, necessary updating and straightforward but valuable changes such as further reductions in the small companies' rate of tax.

14. Within this limited package we recommend three measures in particular, although further measures benefitting small firms are included in the "costless" measures below:-

(i) Raising the value added tax registration limit. Although business would lose the ability to reclaim tax on inputs if unregistered, the administrative burden of the tax is such that many smaller businesses would opt not to register if they could. We realise that there is pressure from the EC Commission on this point but as a minimum we need to raise the limits in line with inflation - an increase in the main limit to £19,000, with corresponding changes for the related limits. The exchequer cost would be small but the benefit to small firms in terms of reduced administrative costs would be much larger.

(ii) Reduction in the small companies rate of corporation tax to 35%. These cuts are highly visible, show clearly the Government's desire to help, reward the successful and are not particularly expensive.

(iii) The introduction of enterprise bonds to allow small businesses to smooth their tax payments by allowing them more easily to match profits with tax allowances on capital expenditure. The bonds would take the form of a special gilt, tax deductible on purchase but taxable on redemption. It is proposed that no interest is payable on the bonds. Enterprise bonds would approximate to the open-ended carryback of allowances. There would be some cost to the Exchequer, probably very small; and the Treasury would have the advantage of interest free loans on all the money until redemption, compared with the smaller tax receipts, in the absence of the bonds.

Measures to help Innovation

15. We believe it is important to continue the precedent of the last few Budgets of giving fiscal encouragement to innovation and new technology, an area where British performance has been particularly poor compared with our competitors. There are four separate proposals:

(i) Widening the definition of scientific research allowances to include development work which is not necessarily related to "the extension of knowledge". At present, the position is confused and not all development expenditure is allowable. Given the importance the Government attach to innovation and the use of research there would be important presentational advantages in R&D rather than "scientific research" allowances.

(ii) Allow R&D expenditure by enterprises not yet actually carrying on a trade (as in the US). This would be of particular help in stimulating R&D limited partnerships by allowing members to offset expenditures by the limited partnership on research against members' profits arising elsewhere, much earlier than they are able to do at the moment.

(iii) Allow 100% initial allowances on the capital acquisition costs of patents. The acquisition of R& D through the purchase of patents is just as important as the capital costs of R&D expenditure itself in the innovation process.

(iv) A three year extension to 1986/87 of 100% initial allowances granted to the rental industry on teletext and viewdata equipment, in order to help the rental industry pull through new advanced IT products into the market place. We consider concentration of tax concessions on these high technology products to be more important than the rental industry's preference for a general 40% minimum writing down allowance on all equipment. Mr Baker will soon be writing to Mr Moore in greater detail on our proposals for the fiscal treatment of capital expenditure by the rental industry on televisions and associated equipment.

Tourism

16. Tourism is a service industry to which we attach a great deal of importance. It has considerable growth potential which we need to exploit, is itself labour intensive and creates much business for other service and manufacturing industries. Mr Lamont, in his recent statement to Parliament on the conclusions of the tourism review stressed the importance which the Government attaches to the industry. An increase in the initial capital allowance on new hotel construction and improvements would be helpful - from the current 20% to 30%. This would go some way towards restoring the differential between hotels and industrial buildings which was widened to the benefit of industrial buildings in 1981.

17. In addition to these measures, we would also give priority to a number of more or less costless measures. Some of these relate specifically to small firms and are considered in Annex B. They cover small but important changes to the BES, disincorporation reliefs, allowances for certain business capital costs, and loss reliefs for self-employed traders.

18. Within this 'costless' category are two further measures which we regard as essential to the successful and rapid development of the film and cable industries respectively. For the film industry, the current interim arrangements on capital allowances for the costs of a master negative of a film are due to end in 1987. We are seeking to have the allowances made permanent for British film making. These capital allowances are of enormous value to those making films for both cinema and television. Without the continuance of capital allowances the British industry would be put at a severe competitive disadvantage and the film industry in this country would be significantly reduced. For this source of funding to end in 1987, just when the new media will be starting operations, would be totally incompatible with the Department's policy on the film industry. Mr Baker, in his review of relations with the film industry has secured the industry's agreement to a range of radical changes which will transform the financing of the industry but continued capital allowances are central to the industry's reorganisation. 1987 is still some way off but the knowledge of stability is important and Mr Baker is committed to announcing the outcome of his review in the near future. In order to fit in more closely with the timescale of the review Ministers here are looking for a prior announcement of the intention to make permanent these allowances in the 1984 Finance Bill.

19. As to the cable industry there are a couple of straightforward changes to the tax legislation which would maintain the momentum of the industry which we are anxious to foster and ensure that the huge sums of finance necessary to fund cable developments are forthcoming. Both relate to consortium relief:

(i) To raise the maximum number of participants in a consortium from 5 to a minimum of 10 and perhaps as high as 20. There is no particular logic about the number 5 except that when legislation was framed the sums to be raised could on the whole be met comfortably by five participants. Times have now changed.

(ii) To allow overseas members of consortia, with consortium relief confined to UK members and to consortia where UK members have a majority holding.

20. We are aware that the Revenue are currently in the midst of a consultation exercise on taxation issues relating to groups and that they may prefer to deal with consortium relief in that context, given the inter-relationship of tax measures in this field. But with the birth of this industry now upon us, we do now need to act quickly and we would hope that these two proposals are sufficiently self-contained to albw progress in the coming Budget. Timing here is very important.

21. The Revenue have also raised a very serious problem relating to the eligibility for 100% first year allowances of much of the capital expenditure incurred in the installation of telecommunications systems. We are still awaiting the Revenue's finding on this technical point; but if they find against eligibility we will need to find a way round this problem, perhaps through legislation. An unfavourable ruling would have very serious consequences not only for the cable industry but also for telecommunications generally and BT (including the BT flotation) and Mercury in particular.

Higher Package Assumption

22. The main addition to the package of measures set out above if in the event there is fiscal headroom of around £¾ billion would be a reduction of ½% in NIS. the arguments are now well understood and need not be repeated in detail here. But preference for NIS over other forms of taxation cuts is because it is a tax on jobs, it would directly reduce costs and improve competitiveness, it would be more beneficial to the tradeable sector and particularly to some sectors in greatest difficulty, and it would take effect more quickly and provide a greater stimulus to employment.

23. We could also usefully introduce a further limited number of measures to encourage the self-employed and small firms. In particular to:

(i) Ease the burden of capital transfer tax on family businesses. The proposal is to introduce "holdover" relief for CTT; so that where the taxpayer would qualify for business or agricultural relief, he could elect to hold over the charge until the assets were sold.

(ii) Extend small workshops allowance beyond March 1985 and extend definition of "qualifying user" (for small workshops only) so as to disapply the various qualifying criteria while retaining the general exclusion of offices, retail shops, dwelling houses and showrooms. This should bring greater certainty.

(iii) Extend interest reliefs to employees investing in their company, provided it is close.

24. It may be too optimistic even to contemplate measures which push the full year exchequer cost much beyond £¾billion. But in that unlikely event out strong preference would be to abolish NIS altogether.

Conclusion

25. We would hope that the fiscal adjustment turns out to be high enough to introduce at least those measures in the "limited" package. In particular, whatever the Budget arithmetic, there is an urgent need to introduce a more liberal tax regime on share options along the lines indicated. We need to get to grips, and quickly, with the problem of industrial management.

26. Several technical tax points have been covered fairly quickly in this submission. Officials are of course ready to discuss any particular points which may arise.

SHARE OPTIONS: OUTLINE OF A NEW SCHEME

Subject to the following conditions there would be no tax consequences when the option is granted or exercised; the participator would be taxed at capital gains rates when the shares are sold; there would be no growth in value change; and there would be no tax deduction for the employing company.

Conditions

(i) The Scheme must be approved by shareholders.

(ii) Only full time directors and employees are to be eligible.

(iii) Options may not be issued more than 10 years after date of approval of the scheme by shareholders.

(iv) Shares must be of a class quoted on a recognised stock exchange, the majority of which are not held by employees or are shares in a company not under the control of another company. They must also be shares of the company for which the employees work, or its parent.

(v) The option must be exercised within 7 years of date of grant, and within 6 months of leaving company service.

(vi) Options must be non-transferable.

(vii) Shares subject to the option must be free of special restrictions which depress their value.

(viii) Exercise price must be stated at time of grant and must not be less than the then market value of the shares.

(ix) The participant must be precluded from disposing of his beneficial interest in the shares within 3 years of acquiring the option, except in case of death, dismissal or takeover.

(x) If the shares are of a close company, the participator must not have, or acquire, a significant interest.

ANNEX B

"COSTLESS" SMALL FIRMS MEASURES

Business Expansion Scheme

1. Improvements to the BES:

   i) revalorise annual qualifying investment limit;

   ii) reduce the length of the "relevant" period during which the company has to remain unquoted from three to two years. This restriction can hinder the development of the very high risk but high growth companies;

   iii) allow trades of research and development and film production to be qualifying, even though income may be received as royalties. In order to avoid tax abuse which could result from this proposal companies in these two areas would need to be individually approved by the Secretary of State for Trade and Industry as qualifying under the BES. Officials have already held detailed discussions with the Revenue on this proposal;

   iv) amend regulations relating to 100% subsidiaries with overseas connections. At present, relief is denied if such a subsidiary is incorporated outside the UK. It is suggested that the place of incorporation should be disregarded and the test of where activities are carried out be confined to the group as a whole, so that a subsidiary with overseas activities would not necessarily prejudice relief if this was merely a part of mainly UK activities of the group.

Disincorporation Reliefs

2. While it is fairly easy for an unincorporated business to become a company without tax penalty, movement from company to partnership or sole trader is penalised. Quite a number of small company traders would welcome the opportunity to rid themselves of the fairly onerous company reporting and other requirements. But capital gains tax and stock relief 'rollover' provisions are needed to avoid any tax penalty.

Capital Costs of Setting up Share Option and Profit-Sharing Schemes

3. It does not seem logical that special tax reliefs are given to encourage share ownership through options and profit sharing schemes, yet the costs of establishing the schemes are not deductible. To allow such costs would be a limited but useful change; the cost should be negligible.

Loss Relief for Self-Employed Traders

4. Companies that make a trading loss are allowed to carry such losses back for up to three years against other income to the extent that the loss arose from first year allowances on plant and machinery. Self-employed traders and partnerships, on the other hand, are allowed to carry losses forward against other income for one year as well as setting off losses against income assessed for the year in which the loss arises. It would be fairer to the self-employed if losses arising from plant and machinery first year allowances were permitted to be carried back two years.

CC NO
BI

Prime Minister ②
The original briefing is attached
AT 12/12

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

12 December 1983

Andrew Turnbull Esq
10 Downing Street
LONDON SW1

MT

Dear Andrew,

ICI's CASE ON ETHANE VALUATION

You will remember this case on which I wrote to Michael Scholar on 15 July and on which Judith Simpson wrote again on 27 July.

We have now heard that the next hearing of the case will take place on Wednesday. This too will be a purely procedural hearing, although it is likely to deal with the issue of disclosure. We expect the hearing to take place in Chambers, but there is a small possibility that it will attract renewed publicity. If so, the questions and answers which we provided in July remain valid. We still do not know when the hearing on the matters of substance will take place.

Yours sincerely,

Margaret O'Mara

MISS M O'MARA

Econ Pol : Budget
Pt 11

10 DOWNING STREET

Prime Minister [1]

Treasury have provided further explanation of their proposals to extend legislation to life assurance. They argue

(i) that proposals satisfy "Rees rules" on retrospection

(ii) unlike offshore funds existing investments in insurance policies are unaffected

(iii) delaying action would allow money coming out of offshore funds to go into offshore insurance, where it could stay.

Are you content in light of these further explanations?

Yes mt

AT 16/11

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

16 November 1983

Andrew Turnbull Esq
10 Downing Street
LONDON SW1

Dear Andrew

OFFSHORE AND OVERSEAS FUNDS: OFFSHORE LIFE ASSURANCE

You told us yesterday evening that the Prime Minister had asked some further questions on the announcement of which I told you in my letter of 14 November. with AT.

We would not in fact create a new precedent by announcing this measure before the Finance Bill: exactly the same approach was followed when the Government acted against "second-hand bonds" in 1982 and "Capital and Income Bonds" earlier this year. These were also tax avoidance devices in the life assurance field.

In both these earlier cases, existing policy holders were not penalised. We propose to take the same approach here. Where no penalty is involved, the life assurance industry generally accepts such measures without much complaint.

In principle, the Chancellor, like his predecessor, dislikes retrospective legislation, but we have always accepted that it can be justified in some circumstances, provided it is done in the right way. Our stipulations as to what constitutes the right way were spelled out by the present Chief Secretary when in Opposition, and have subsequently been known as the "Rees rules". These state that the Government must give a clear and precise warning of its intentions, with the legislation applying only from the date of the announcement, and that wherever possible, draft clauses should be published before the Finance Bill. We aim to publish draft clauses in this case as soon as possible. However, if, through consultation, we were to provide the industry with any warning before the legislation came into effect, we fear we would simply provoke a major marketing campaign, leading to a stampede to invest in such devices before it was too late.

/The Prime

The Prime Minister might like to note that there is an important difference between what we are proposing on offshore funds and on life assurance. In the case of life assurance, the new measures would have no impact on existing policies, unless their terms were altered. In the case of offshore funds, the different tax treatment would apply to disposals on all investments after 1 January. The reason for this difference in approach is that the investor in offshore life assurance will in practice be committed for a number of years and early withdrawals are penalised, whereas the investor in offshore funds can withdraw his investment at any time without penalty. This is why we gave an early warning to investors in offshore funds, so that they could change their investments if they wished and this is why it is essential to protect the existing policy-holder.

Unfortunately, the proposed measures on offshore life assurance cannot safely await next year's Finance Bill. The money at present invested in offshore funds will be coming out before the end of this year. If it were subsequently channelled into offshore life assurance, the tax leakage could amount to as much as £100 million and the legislation on offshore funds would thus be criticised as ineffective. It is in order to avoid this that the Chancellor believes we must make an immediate announcement on offshore life assurance.

Since no change is to be made to existing policies, to allow offshore funds to go into life assurance before acting would be bolting the stable door

Yours sincerely,

Margaret O'Mara

MISS M O'MARA
Private Secretary

Econ Pol : Budget Pt 11.

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10 DOWNING STREET

From the Private Secretary

15 November 1983

Offshore and Overseas Funds: Offshore Life Assurance

The Prime Minister has seen your letter to me of 14 November which reported the Chancellor's wish to tighten up the tax treatment of overseas life assurance policies. This would be announced at the same time as the details of the measures on offshore roll up funds originally announced in September. The Prime Minister has also seen your letter of 16 November which explains the reasons for extending legislation to offshore life assurance and explains that these measures would satisfy the so-called "Rees rules". In the light of this information she is content with the Chancellor's proposals.

Andrew Turnbull

Miss Margaret O'Mara,
H.M. Treasury.

Prime Minister (1)

(i) Ch/Ex wishes to announce details of action on offshore roll-up funds originally announced in September

(ii) He feels it is necessary to stop life assurance being used as an alternative

Agree his proposals?

AT. 15/11

pps

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

14 November 1983

Andrew Turnbull Esq
No 10 Downing Street
LONDON SW1

Have we consulted about this - & given the same warnings? If not then I think it should wait until the Finance Bill. It is MOST unusual to do this kind of thing at this time of year and could be a dangerous precedent. MT

Dear Andrew,

OFFSHORE AND OVERSEAS FUNDS

The Chancellor announced on 15 September, with the Prime Minister's agreement, that he intended to propose legislation in the 1984 Finance Bill to ensure that an appropriate amount of income and corporation tax was paid when an investor disposed of a holding in an offshore or overseas fund. (Judith Simpson's letter to Michael Scholar of 5 September sets out the background.) The announcement promised a subsequent statement giving full details of the new rules.

... I now enclose a copy of the further announcement which the Chancellor has agreed should be made on Wednesday 16 November. It takes the form of a brief reply to a Parliamentary Question, and a more detailed Inland Revenue statement.

You will see that the announcement also gives details of the measures proposed to correct a potentially serious anomaly in the tax treatment of offshore life assurance policies held by UK residents. The present rules are almost as attractive as the regime which has applied for offshore funds. There were preliminary indications that some UK life companies were preparing a marketing campaign for policies issued by their offshore subsidiaries (usually located in tax havens) and that money in offshore funds might therefore simply have been diverted into offshore life assurance. This would have rendered the offshore funds legislation largely ineffective and the Chancellor felt it essential to act quickly in order to block this loophole before it was too late.

Yours sincerely,

Margaret O'Mara

MISS M O'MARA

INLAND REVENUE Press Release

INLAND REVENUE PRESS OFFICE, SOMERSET HOUSE, STRAND, LONDON WC2R 1LB
PHONE: 01-438 6692 OR 6706

[3X] November 1983

OFFSHORE AND OVERSEAS FUNDS;
LIFE ASSURANCE POLICIES ISSUED BY NON-RESIDENT LIFE OFFICES

In a Written Answer to a Parliamentary Question, Mr John Moore MP, Financial Secretary to the Treasury, today

i. outlined the shape of the proposed legislation on offshore and overseas funds, and

ii. announced that legislation would be included in next year's Finance Bill to amend the present tax treatment of life assurance policies issued to UK residents by non-resident life offices. The provisions will apply from midnight tonight.

The Financial Secretary's statement, and a more detailed statement which he has authorised the Inland Revenue to issue, are reproduced below.

NOTE TO EDITORS

Offshore and Overseas Funds

The Chancellor of the Exchequer announced on 15 September his intention to propose legislation in the 1984 Finance Bill to ensure that an appropriate amount of income or corporation tax is paid when an investor disposes of a holding in an offshore or overseas fund. The statement was published as an Inland Revenue press release.

WRITTEN PARLIAMENTARY QUESTION AND ANSWER

In reply to the following Parliamentary Question:-

"To ask Mr Chancellor of the Exchequer what will be the details of his proposed legislation for taxing disposals of holdings in offshore and overseas funds, and whether, in addition to proposing legislation on investments in such funds, he intends to change the tax treatment of life assurance policies issued by non-resident life offices to UK residents,"

the Financial Secretary to the Treasury said today:-

"I have authorised the Inland Revenue to issue today a statement giving the details of the new provisions for investments in offshore and overseas funds and of changes we intend to introduce in the tax rules for life assurance policies issued by non-resident life offices.

"The overall shape of the new provisions relating to the funds will be as follows:-

(i) they will apply to disposals after 1 January 1984 of interests in funds held by investors resident or ordinarily resident in the United Kingdom;

(ii) they will apply to all funds not resident in the United Kingdom, irrespective of the type of investment they undertake - they will not be confined to specific types of fund such as money funds;

(iii) the new rules will not apply where it is established that a fund genuinely distributes all its income. For this purpose, funds will be able to obtain regular clearance as "distributors" from the Inland Revenue;

(iv) except for any gain accruing before 1 January 1984, the whole of the investor's gain on disposal will be taxed as income;

(v) as at present, the capital gains regime will apply to gains accruing before 1 January 1984: the new rules will not apply retrospectively to such gains.

"As regards life assurance policies issued by non-resident life offices to UK residents, there are a number of anomalies in the present rules. We propose to make the following changes in their tax treatment:-

(i) policies issued in respect of insurances made after midnight tonight will not satisfy the qualifying conditions unless issued or administered in the course of UK branch business.

(ii) UK residents will be liable to income tax in full on their profits from non-qualifying policies issued after midnight tonight.

The provisions will also apply to existing policies in certain circumstances; but special measures will be taken to safeguard the bona fide expatriate business of non-resident life companies. Fuller details are given in the Inland Revenue statement.

It is proposed to legislate in the 1984 Finance Bill. Draft Clauses will be published in due course.

OFFSHORE AND OVERSEAS FUNDS; LIFE ASSURANCE POLICIES ISSUED BY NON-RESIDENT LIFE OFFICES

As announced in a Written Answer today, the Financial Secretary to the Treasury has authorised the Inland Revenue to issue the following statement.

I. OFFSHORE AND OVERSEAS FUNDS

Introduction

1. On 15 September, the Chancellor of the Exchequer announced that in the 1984 Finance Bill he would be proposing to Parliament provisions to ensure that an appropriate amount of income or corporation tax was paid when a United Kingdom investor disposed of an interest in an offshore or overseas fund.

2. The paragraphs that follow describe the basic shape of the new provisions. They do not cover all the fine detail of the new rules and their application in the more complex cases. Draft Clauses giving full details will be published in due course.

The Tax Charge

3. There will be a charge to income tax or corporation tax under Case VI of Schedule D on an investor when he makes a gain on the disposal of an interest in an offshore or overseas fund after 1 January 1984.

4. Broadly, the computation of the gain chargeable as income will follow the capital gains tax rules. The major exceptions to this will be as follows:-

(i) Death will be an occasion of charge under the new rules, with the gain calculated by reference to the market value of the interest in a fund at that date.

(ii) Claims to roll over gains under Section 79 Finance Act 1980 (gifts etc) will not be possible.

(iii) The indexation allowance will not be available.

(iv) Some restrictions will be imposed on the working of the company reorganisation provisions (Section 77 et seq Capital Gains Tax Act 1979). These restrictions will not apply where the reorganisation is only within one company.

Persons chargeable

5. The rules on persons chargeable will broadly follow those for capital gains tax and corporation tax on capital gains.

6. The provisions will apply to an investor who, in the chargeable period, is a person (including a company or body of persons) resident or ordinarily resident in the United Kingdom. They will also apply to disposals by a non-resident company of interests held in connection with a branch or agency carrying on a trade in the United Kingdom.

7. Individuals resident or ordinarily resident but domiciled overseas will be charged only in respect of amounts received in the United Kingdom.

Definition of Offshore and Overseas funds

8. Offshore and overseas funds will be defined as non-resident concerns whose investors have, at the time of acquiring their interest in the concern, a reasonable expectation of being able to dispose of that interest to the issuer or some other person, within ten years of the investment, for a consideration substantially equivalent to their proportionate share of the fund's net assets.

9. The non-resident concern may be a non-resident company or a unit trust scheme with non-resident trustees or a similar arrangement governed by foreign law. For this purpose companies and trustees will be treated as non-resident if they were not resident

(i) at the time the investor disposes of a holding, or

(ii) at any time between 1 January 1984 or (if later) the investor's acquisition of the interest and the date of disposal.

However, gains on disposals of interests in companies and unit trusts which become resident in the United Kingdom before 1 January 1985, and remain so resident up to the date of disposal, will be excluded from the new rules.

10. The new provisions will apply to interests in all types of fund: they will not be confined to "money funds". But they will not apply to:-

(i) rights under life assurance contracts;

(ii) rights in respect of loans made in the ordinary course of a banking business;

(iii) interests held by managers of a fund which entitle the holder only to repayment of the original consideration; and

(iv) interests which entitle the holder to have a fund wound up and to receive on the winding-up more than half the assets.

Funds which Distribute their Income

11. The new charge on the disposal of an interest in a fund will not apply where it is established that the fund distributed all its income throughout the period for which the investment was held. A disposal of such an interest will continue to be chargeable under the capital gains tax regime.

12. To this end there will be a clearance procedure under which funds will be able to establish "distributor" status. The clearance procedure will operate separately for each period of account of a fund. To obtain clearance, funds will have to demonstrate to the Inland Revenue that:-

(i) they distribute all their net income as computed in their accounts, and

(ii) the accounts figure of income is at least 85 per cent of the taxable income, computed broadly in accordance with corporation tax principles, which they would have if they were resident in the UK.

13. To protect the Exchequer, it will be necessary to impose some restrictions on the pattern of funds' investments if "distributor" status is to be established. A fund will not qualify as a distributing fund if

(i) more than 5 per cent by value of its portfolio consists of investments in other funds, or

(ii) more than 10 per cent by value of its portfolio consists of investment in a single company, or it holds more than 10 per cent of a class of share in a single company (there are similar restrictions for authorised unit trusts in the UK and for comparable institutions in other European Community countries).

14. A fund will not be able to establish "distributor" status where income is distributable to some investors but not to others.

15. Where a fund which meets the criteria does not seek clearance as a "distributor" the investor will have an opportunity to establish that the conditions were met during the period for which the interest was held.

Gains Accruing before 1 January 1984

16. Gains accruing before 1 January 1984 will continue to be chargeable to capital gains tax or corporation tax on chargeable gains. They will not be treated as income.

Computation of the Tax Charge

(a) Interests acquired on or after 1 January 1984

17. Where the investor acquired his interest in the fund on or after 1 January 1984, the whole of his gain on disposal will be charged as income.

(b) Interests acquired before 1 January 1984

18. Where the interest was acquired before 1 January 1984, the amount to be treated as income will normally be that part of the investor's gain on disposal attributable to the period commencing 1 January 1984 (broadly the difference between the value of his interest at 1 January 1984 and its value on disposal). Where the value at 1 January 1984 is less than the value on acquisition, the charge will be limited to the actual gain on disposal.

Indirect Holdings

19. Provisions may need to be included to ensure that a UK investor cannot avoid the new rules by investing via an intermediate entity, wherever resident.

II. LIFE ASSURANCE POLICIES ISSUED BY NON-RESIDENT LIFE OFFICES

20. Life assurance policies issued by non-resident life offices to UK residents may at present be qualifying or non-qualifying. If a policy is qualifying, no tax relief will be given in respect of premiums paid (unless paid to the UK branch of a non-resident life office) but the profits on maturity will be entirely tax free, as is the case with such policies issued by UK companies. But, because the life office is non-resident, it will generally pay no UK tax on its investment income. If a policy is non-qualifying, the UK investor will be liable to income tax at the higher and additional rates (if relevant) on any profits but, as with such policies issued in the UK, there will be no basic rate income tax liability. Again, the life office will generally pay no UK tax on its investment income.

21. The Chancellor regards the present tax treatment of policies issued by non-resident life offices as anomalous and he proposes to change it. Legislation to this effect will be included in next year's Finance Bill. Policies issued in respect of insurances made after midnight tonight by non-resident life companies will not satisfy the qualifying conditions unless such policies remain, throughout the policy holder's period of residence in the UK, a liability of a UK branch of that life office, and are either issued or administered by that branch. Existing policies issued by non-resident companies will come within the new provisions if, after midnight tonight, they are varied so as to increase the benefits secured (by injecting further capital) or to extend the term of the insurance.

22. The Chancellor also proposes to change the rules for computing the tax charge on profits received by UK investors from non-qualifying policies issued by non-resident life companies. Since such companies will generally pay no UK tax on their investment income, there is no justification for waiving investor's basic rate liability in respect of such profits. UK residents will therefor be liable to income tax in full on profits arising from new

non-qualifying policies issued after midnight tonight, or existing policies into which further capital is injected after midnight tonight.

23. In order to ensure that bona fide expatriate business carried on by non-resident life companies is not penalised, the computational and top-slicing rules for non-qualifying policies will be amended to cater for cases in which the policy holder is non-UK resident for any part of the period over which the policy runs.

24. Draft clauses on these new rules will be published in due course.

Econ Pol
Budget Pt. 11

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SUBJECT cc Master

file

LPO

10 DOWNING STREET

From the Private Secretary

10 November 1983

Dear John

NET PAYMENT TO EC INSTITUTIONS

At their bilateral this morning, the Prime Minister and the Chancellor discussed his minute of 4 November. The Chancellor explained that to enter an uncorrected net contribution in the White Paper would imply entering a figure something like £700 million higher than a corrected figure He suggested that for 1984/85 the simplest solution would be to enter the same figure as last year, i.e. £450 million. The Prime Minister agreed.

I am copying this letter to Brian Fall (Foreign and Commonwealth Office) and Richard Hatfield (Cabinet Office).

Yours sincerely
Andrew

ANDREW TURNBULL

John Kerr, Esq.,
H.M. Treasury.

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FILE

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10 DOWNING STREET

From the Private Secretary 8 November, 1983

NET PAYMENTS TO EUROPEAN COMMUNITY INSTITUTIONS: AUTUMN STATEMENT AND PUBLIC EXPENDITURE WHITE PAPER

The Prime Minister has seen the Chancellor's minute of 4 November. She was not happy with his recommendation to adopt option 2. She commented that this year's figure turned out to be very embarrassing. She would rather put in uncorrected net contributions with a footnote.

BK/ She would like to discuss this further with the Chancellor and I suggest that this be raised at their next bilateral.

I am sending a copy of this letter to Brian Fall (Foreign and Commonwealth Office) and Richard Hatfield (Cabinet Office).

(A. Turnbull)

J. Kerr, Esq.,
HM Treasury

SU

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cc Euro Pol, Budget
~~cc~~ AJC (1)

Prime Minister

Agree Option 2 ?

AT 7/11

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

May we discuss – this year figure turned out to be very embarrassing & I would rather put in uncorrected net contributions with a footnote MT

PRIME MINISTER

NET PAYMENTS TO EUROPEAN COMMUNITY INSTITUTIONS: AUTUMN STATEMENT AND PUBLIC EXPENDITURE WHITE PAPER

I promised at your meeting this morning to let you know what I plan to show in the Autumn Statement and Public Expenditure White Paper for net payments to European Community institutions in 1984-85. While I hope that the Autumn Statement will be published on 17 November, the White Paper will not come out until February or March.

2. In all recent Public Expenditure White Papers and Autumn Statements, we have assumed that the 1 per cent VAT ceiling will be maintained and that we shall receive refunds of 66 per cent of our uncorrected net contribution to the allocated budget for the previous year. The White Papers have been careful to describe the latter as a 'stylised assumption'.

3. The latest projections prepared by officials are based on the same assumptions, and are as follows:

NET PAYMENTS TO EUROPEAN COMMUNITY INSTITUTIONS (excluding overseas aid)

£ million

	1983-84	1984-85	1985-86	1986-87
Latest figures	350	400	450	500
Previous White Paper (Cmnd 8789)	380	450	530	..
Change	- 30	- 50	- 80	..

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The downward revisions for 1984-85 and 1985-86 mainly reflect lower projections for inflation and economic growth in the Community than were assumed in the last White Paper.

4. Obviously, much may change between now and the deadline for the White Paper, and we shall be reviewing the position in the New Year.

5. So far as the Autumn Statement is concerned, all we need to publish is a single figure for net payments to European Community institutions in 1984-85, plus the change compared with the last White Paper. As I see it, we have four main options:-

1. retain the now-traditional assumptions and repeat the last White Paper figure;

2. retain the now-traditional assumptions and show officials' latest estimates based on these (ie a reduction of £50 million compared with the last White Paper);

3. show our uncorrected net payments, on the basis that we have no agreement at this stage on future refunds or reliefs; or

4. show a much lower figure for our net payments, intended as a signal of what we are prepared to pay.

I do not think that it would be right to adopt options 3 or 4. Both would draw attention to the figures, which would I think be best avoided. Under option 3, we would show a large increase compared with the last White Paper; under option 4, a large reduction. We would have to explain these changes. Under both options, the figures would be even less realistic than under our traditional assumptions, and the path of the public expenditure totals would be affected. Option 4 would also raise public expectations as to what will be achieved in the future financing negotiations.

6. In my judgement, therefore, the choice lies between options 1 and 2. Option 1 (no change) would be likely to attract the least notice. But I doubt however whether Option 2 would attract much notice either, for the improvement of £50 million compared with the last White Paper could be explained as an estimating change. Since there is a presumption in favour of publishing latest best estimates, unless there are strong reasons to the contrary, I propose to go for option 2.

7. I am copying this minute to Geoffrey Howe and Sir Robert Armstrong.

NL.

(N.L.)
4 November 1983

CONFIDENTIAL FILE da

10 DOWNING STREET

From the Private Secretary 24 October 1983

Taxation of International Business

The Prime Minister has seen the Chancellor's minute of 19 October. She was grateful for the further explanation given of the points made in his minute of 20 September. She is satisfied that sufficient steps have been taken to meet legitimate criticisms of these proposals. She therefore agrees that draft clauses can be issued shortly.

Andrew Turnbull

John Kerr, Esq.,
HM Treasury.

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MT

10 DOWNING STREET

4

Prime Minister

The Chancellor minuted you on 20 September on Taxation of International Business - Flag A. This minute merely said that the clauses had been modified and were ready for publication.

I asked Treasury to set out more fully

(i) what criticisms had been made
(ii) what modifications were being made
(iii) with whom they had been discussed.

This is in the Chancellor's minute of 20 October - Flag B.

Treasury are confident they have met most of the legitimate criticisms.

Agree clauses may now be published?

AT 20/10

Yes MT

NBRM

AT 21/10

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

20 October 1983

The Rt Hon Norman Tebbit MP
Secretary of State for Trade and Industry
Department of Trade and Industry
1 Victoria Street
LONDON SW1

Dear Norman

attached

Cecil Parkinson wrote to me on 12 October about National Insurance contributions and National Insurance Surcharge. I am of course very conscious of the points he made, and will take them fully into account.

Copies of this letter go to the Prime Minister and to the Secretaries of State for Health and Social Security and for Employment.

Yours
Nigel

NIGEL LAWSON

Econ Pol: Budget : Pt 11

2.26 CONFIDENTIAL cc NO

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

PRIME MINISTER

TAXATION OF INTERNATIONAL BUSINESS

I understand that you would like some additional background information on the proposal mentioned in my minute of 20 September. I apologise for the length of this minute: as you know, the issue is a highly complex one.

2. As you will recall, the proposed legislation enables a charge to corporation tax to be imposed on certain UK resident companies in respect of the income of their tax haven subsidiaries. In this way it seeks to recover the revenue loss - estimated to be running at £m 100 a year - as a result of companies using tax havens deliberately to avoid their UK tax liabilities.

3. The charge would be confined to certain quite narrowly-defined circumstances (eg where the tax haven subsidiary is under overall UK control). Even where all the relevant conditions were present, a company might well escape the charge under one of the three major tests for exclusion incorporated in the legislation. An ability to satisfy any one of these three tests - which focus in turn on the nature of the haven company's activities, its distribution policy and the motives for operating through a haven - would ensure exemption from the proposed tax charge. A more detailed description of how the legislation would work is given in the Annex to the Inland Revenue's 30 March press release (attached).

4. As it appeared in the December 1982 consultative document, the proposed legislation took on board many of the business community's criticisms of the original (ie November 1981) draft. This was universally seen as a great improvement on the original proposals. A few bodies still questioned whether it was right for the charge to extend to profits earned abroad which are then parked in a tax haven rather than being remitted to the UK. But it is clear from the response generally that the business community accepts the case in principle for a UK tax charge on the revised lines we are now proposing.

5. The detail of the December 1982 draft was however criticised in a number of respects. In particular the business community wanted more certainty as to the circumstances in which the charge would apply. We were able to go a long way to meet this - quite understandable - criticism when on Budget Day the Inland Revenue published a provisional list of countries which would not be regarded as tax havens for the purpose of the legislation. This effectively provides a cast-iron guarantee of exemption for every overseas subsidiary resident and carrying on a business in any one of the countries given a clean bill of health. There were 85 such countries on the provisional list. (The issue of this list also provided us with an opportunity to consult the Foreign Office about the possible implications for those territories which would be regarded as tax havens for this purpose. In his 14 March response to John Wakeham, John Belstead expressed himself content with what we propose.)

6. Otherwise the legislation on controlled foreign companies incorporated in the original 1983 Finance Bill was in the same form as it had appeared in the December 1982 document. But in an announcement on the day the Bill was published, John Wakeham made clear that the Government intended to introduce a number of important modifications to reflect the business community's criticisms of the consultative document proposals. (These modifications are detailed in the attached 30 March press release.) In the event Parliament was dissolved before the necessary amendments could be tabled.

7. The 30 March modifications have been incorporated in the draft clauses which we would propose to issue shortly. A draft revised in this way should meet all the business community's criticisms of the structure of the legislation - though not of course any objections of principle which still remain. There are two specific points about these modifications to which I should perhaps draw your attention. The first is the various amendments to the "exempt activities" text (subparagraph d of 30 March Press Release). Taken together these provide a valuable element of added protection for those many UK companies whose operations in low tax areas are commercially based and thus of benefit to the UK economy as a whole, rather than simply an artificial contrivance designed to avoid their UK tax bills.

8. Second is the clarification of the "motive" test promised at subparagraph (e). This is a sensitive area, where feelings run particularly high. Accordingly we thought it right to solicit the views, on a personal and confidential basis, of two individuals who are informed and influential in the international tax field - Bruce Sutherland and John Avery-Jones. Both said they were satisfied that the projected Committee Stage amendments succeeded in meeting the criticisms of the previous version of the test. These amendments have now been incorporated in the revised draft.

9. Against this background, I feel we can go ahead and publish the revised draft legislation on controlled foreign companies with some confidence. It would be naive to think we shall escape criticism altogether. But I think our revised proposals will be generally regarded as a fair and moderate way of dealing with what is widely acknowledged to be a real - and increasingly costly - problem for us.

10. If we are to leave enough time for representations on the proposals before legislating next year, we ought to publish soon, preferably by about the end of this month. Otherwise we shall risk running into a repetition of last years complaints that the business community had been given inadequate advance opportunity to comment before the introduction of legislation.

NL.

(N.L.)

19 October 1983

INLAND REVENUE PRESS OFFICE, SOMERSET HOUSE, STRAND, LONDON WC2R 1LB
PHONE: 01–438 6692 OR 6706

INLAND REVENUE Press Release

[3x]

30 March 1983

TAXATION OF INTERNATIONAL BUSINESS
CONTROLLED FOREIGN COMPANIES

1. Commenting on the legislation on controlled foreign companies as introduced in the Finance Bill, the Minister of State at the Treasury, Mr John Wakeham MP, said:

" In his Budget Statement the Chancellor announced that he would be introducing legislation to take effect from 6 April 1984. This legislation is contained in clauses 44-52 and Schedules 7-9 of the Finance Bill. These clauses and schedules are the same as set out in the December 1982 consultative document "Taxation of International Business". But I wish to emphasise that we have decided to make a number of important modifications to the proposals in that document in the light of the representations received. We will be tabling amendments to the Bill as soon as possible to give effect to these changes. In addition we intend to institute an administrative procedure for providing advice and clearances for the purposes of the legislation, which is designed to be both flexible and wideranging."

(The December 1982 proposals, to which Mr Wakeham referred, are summarised in the Annex.)

PROPOSED AMENDMENTS TO THE LEGISLATION

2. The amendments Ministers propose to table for Committee Stage will give effect to the following changes, among others:-

(a) <u>To base the charge on an apportionment of profits rather than notional UK tax</u>. A large number of detailed amendments will be necessary to change the basis of the charge in this way. But it is proposed that the main features should be:

(i)/

(i) the profits apportioned will be the CFC's profits as measured for UK tax purposes;

(ii) the apportioned profits will be the subject of a separate charge to corporation tax on UK resident companies;

and (iii) the tax credit method (paragraph 3 of Schedule 9) of preventing a double charge to tax where a dividend is paid by the CFC out of profits subject to an apportionment will be retained.

(b) To modify the "acceptable distribution" test. First, it is proposed, where the CFC has only one type of issued share capital or where in addition there is a single type of fixed rate preference share, to take account of interests held by non-residents. In these cases the specified percentage will be applied to the proportion of the commercial profits which is attributable to shares held directly or indirectly by UK resident persons. Second, paragraph 2(1)(b) of Schedule 7 will provide for the test to be satisfied in all cases where the appropriate dividend is paid within 18 months of the end of the accounting period to which it relates.

(c) To provide more information for UK companies subject to a direction/assessment. It is proposed that the notice of direction should be required to specify the CFC's territory of residence in every case where the CFC is liable to tax in a particular territory (or territories) by reason of domicile, residence or place of management. In addition a notice of assessment under these provisions will be required to show the basis on which the CFC's profits have been apportioned.

(d) To modify the "exempt activities" test. Several amendments will be tabled to Part II of Schedule 7.

(i) Presence in the country of residence. A number of amendments will be made to clarify and relax the conditions which require a CFC to have a genuine presence in its country of residence. First, the concept of "control" will be dropped from the "effectively controlled and managed" condition in paragraph 5(1)(b). Second, the definition in paragraph 6(2) of premises which constitute a business establishment will be expanded to include mines, oil wells, quarries and long-term building sites. Third, the "number of employees" condition in paragraph 7(1)(a) will be widened to include the case where the CFC uses either labour sub-contracted from, or the employees of, another group company resident in the same territory.

(ii)/

(ii) <u>Distribution from other CFCs</u>. Paragraph 5(2)(c), which prevents an overseas company from satisfying the test if distributions received from other CFCs exceed 5% of its gross receipts, will be dropped.

(iii) <u>Holding companies.</u> The provisions of paragraph 5(3) will be modified to ensure that certain holding companies whose trading subsidiaries are situated in another country or countries are able to satisfy the test. In addition, the definition of holding company in paragraph 11 of Schedule 7 will be relaxed, so that a company with at least a 51% (rather than 90%) interest in its trading subsidiaries will qualify.

(iv) <u>Banking.</u> The provisions of paragraphs 10(3) to 10(5) applicable to banking and similar financial activities will be amended to enable the conditions to be satisfied by an overseas subsidiary set up to collect deposits which are then channelled back to the UK parent bank.

(v) <u>Insurance.</u> The special rules in paragraph 10(6) for insurance companies will be amended to enable the test to be satisfied by subsidiaries in the same overseas territory which operate group pooling or reinsurance arrangements in relation to third party insurance business written in that country.

(e) <u>To clarify the motive test.</u> (Clause 44(8) and Schedule 7, Part III).

(f) <u>To allow relief for losses incurred prior to the first direction.</u> Amendments will be proposed to provide a measure of relief for trading losses a CFC incurs in accounting periods prior to that in which the first direction is made. The main features of the new relief will be:-

(i) losses incurred by the CFC during the previous 6 years may be taken into account in computing the profits of the accounting period for which the first direction is made (the "starting period") and subsequent accounting periods;

(ii) a right to claim such relief will arise only when a direction is made for the starting period; and

(iii) once such a claim is made in respect of the losses of a particular accounting period, a computation of profits or losses will be made for that and each subsequent accounting period.

(g)/

(g) <u>To introduce a monetary de minimis provision.</u> This will ensure that no charge will arise if the apportionable profits of a CFC for a 12 month accounting period do not exceed £20,000. If the CFC's accounting period is less than 12 months, the £20,000 limit will be reduced proportionately.

(h) <u>To clarify the appeal rights.</u> This will clarify the extent of the Special Commissioners' jurisdiction when a company lodges an appeal against a notice of direction. In particular, it will spell out that, in all cases, the Special Commissioners' jurisdiction extends to reviewing any decision made by the Board <u>de novo</u>, taking account of fresh evidence where appropriate.

CLEARANCE PROCEDURE

3. Ministers have considered possible methods of providing clearance arrangements for the purposes of the legislation. Rather than impose a statutory procedure, which would necessarily be limited in scope and restrictive in application, they have decided on a more informal method which will be flexible enough to provide clearances in a wide variety of circumstances.

4. After the legislation is enacted, a technical unit in the Head Office of the Inland Revenue will be available to provide -

(i) advice on technical points in the interpretation of the legislation;

(ii) advice on the application of the provisions to group structures, existing and proposed (though not purely hypothetical);

(iii) guidance on the treatment of other group subsidiaries where a UK company has been subject to a direction in respect of one of its overseas subsidiaries; and

(iv) advance clearance where shares in a controlled foreign company are sold.

ANNEX/

ANNEX

STRUCTURE OF THE DECEMBER 1982 PROPOSALS ON CONTROLLED FOREIGN COMPANIES

The clauses and schedules set out in Part IV of the December 1982 consultative document "Taxation of International Business" enable a charge to corporation tax to be imposed on certain UK resident companies with interests in controlled foreign companies. The charge, which will arise only if the Board of Inland Revenue so direct, will be calculated by reference to the profits of the overseas company. But it will apply only where:

(i) the overseas company is under UK control;

and (ii) the overseas company is subject to a lower level of taxation in its country of residence - ie the tax paid in the country of residence is less than half the amount which would have been payable had the company been resident in the UK;

and (iii) a UK company, together with connected or associated persons, has at least a 10% stake in the overseas company.

2. Even where all of these conditions are present, no direction will be made if for the particular accounting period the controlled foreign company (CFC) satisfies any one of the three tests for exclusion incorporated in the legislation. These are:-

(i) the CFC remitted by way of dividend a specified proportion of its profits to its UK resident shareholders ("acceptable distribution" test);

or (ii) it was engaged in one of the activities which fulfil the conditions for exemption specified in Part II of Schedule 7 ("exempt activities" test);

or (iii) it was not a main purpose of the CFC's transactions to achieve a significant reduction of UK tax, nor is it an underlying reason for the company's existence to divert profits from the UK ("motive" test).

O.T.O.

JF4401

Secretary of State for Trade and Industry

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
TELEPHONE DIRECT LINE 01-215 5422
SWITCHBOARD 01-215 7877

12 October 1983

CONFIDENTIAL

Prime Minister

SS/DTI seeks abolition of NIS and shielding of employers from NIC increases

AT 13/10

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

Dear Nigel,

THE AUTUMN STATEMENT

I have been giving some thought to the possible content of the Autumn Statement as far as it affects industry and trade, particularly any changes to national insurance contributions and the national insurance surcharge. Since I shall be abroad for much of the remainder of October I am writing now to let you have my views.

2 The Autumn Statement will be presented this year against a more encouraging background for industry and indeed for the economy as a whole than we have seen for many years. The recovery is well established, although less so for manufacturing than for the rest of the economy. We have successfully brought down the rate of inflation and created the conditions in which enterprise and initiative are again beginning to flourish. The recent half point reduction in base rates will provide a timely boost to industrial confidence.

3 However a continued and full recovery could be undermined by two remaining and quite fundamental problems - competitiveness and profitability. Despite impressive gains in productivity over the past three years, the cost competitiveness of manufacturing industry still remains about 15 per cent lower than at the beginning of 1979; while the loss of competitiveness against our main European rivals has been much larger. Although there has been some recovery in profitability recently, the real rate of return to companies remains very low by historical standards.

/As ...

CONFIDENTIAL

few?

As the recent Treasury Finance Group report emphasized, companies' liquidity is expected to cause for problems only because low profitability will be matched by little in the way of positive stockbuild and by no marked increase in investment. Without a substantial further improvement in profitability it is hard to see how industry will be able both to adapt to the new technologies and exploit the new market opportunities necessary to maintain the recovery.

4 There is no doubt what industry would like to see Government do as the main means of our contributing to the solution of these twin problems. That would be an announcement, in the Autumn Statement, of the abolition of NIS effective from April next year. Abolition of NIS would directly reduce industry's costs and improve its competitiveness. A high proportion of NIS (paid by the private sector) falls on the tradeable sector and abolition would therefore help the supply side of the economy where improvements are most needed. Its abolition would have a much more immediate impact on industry, trade and employment than an equivalent reduction in corporation tax. It is the single step which the CBI would most like to see taken.

5 I therefore hope that, in considering the options available to you this Autumn you will consider very seriously the claims for action on NIS. I deliberately do not press the argument further, since I am aware that the fiscal outturn looks like being tighter than either of us would have wished, and I do not wish to press a course that might prove incompatible with the MTFS.

6 I should however be extremely concerned were there to be no action on NIS reductions and were there also to be an increase in NIC. The Government Actuary has not yet reported on the changes in NIC which will be necessary to balance the National Insurance Fund, but contributions will no doubt need to rise again to fund the increasing outflows from the Fund. Ideally I would wish to shield employers from increases in their contributions. Otherwise if there were to be an increase of any size, it would be regarded as most damaging to industry: higher NIC and retention of NIS would certainly lead to our being criticised for increasing the financial burdens on industry at the very time that industry is looking anxiously to Government for some help in improving its competitiveness and profitability.

7 I am copying this letter to the Prime Minister and to the Secretaries of State for Health and Social Security and for Employment.

Yours Ever,

Cecil.

f ile

PRIME MINISTER

I have consulted Inland Revenue about the effects of redistributing income from high taxpayers to the generality of taxpayers.

Inland Revenue have calculated what revenue would be produced by setting the marginal rate of income tax at 100 per cent above certain levels. The attached table illustrates the effects if the 100 per cent rate were introduced where the 60, 45, 40 and 30 per cent bands currently start.

For example, if all taxable income over £17,200, after allowances and reliefs, were taken away, the yield would be £1.75 billion.

This could be redistributed in the following ways:

a) Reduce basic rate tax from 30 per cent to 28 per cent in the pound.

b) Give £1.40 per week to each taxpayer.

c) Give 82p per week to each adult.

d) Give 60p per week to every man, woman and child.

If the starting point were where the 60 per cent band now starts, the yield would be £400 million and the effects about a quarter of the size.

These figures do not produce as telling a story as I had expected. It can be argued that by redistributing more selectively, significant benefits could be achieved.

/The

The real objection is not that the amounts received are trivially small but that such a basis of taxation would totally destroy incentives and whatever the majority had gained, any redistribution would be lost as the functioning of the economy deteriorated.

ANDREW TURNBULL

7 October, 1983

Inland Revenue
Statistics Division
West Wing Somerset House London WC2R 1LB

Telephone 01-438 7390

A Turnbull Esq
10 Downing Street

Your reference

Our reference

Date

7 October 1983

Dear Andrew

REDISTRIBUTION OF INCOME

We discussed your letter of 4 October to John Kerr. I am replying direct and copying the reply to him to save time. attached

I have calculated the effects of taking the current income tax regime but choosing a level of taxable income beyond which the tax rate would be 100%. This would not be practical but it illustrates the theoretical maximum tax yield which could be redistributed. The table below shows the yields for thresholds between the upper decile of taxable income (£9,600) and the existing threshold for the top (60%) rate of tax (£36,000).

You felt that you might focus on the present threshold for 45% tax - taxable income of £17,200. Allowing for tax allowances and reliefs this corresponds to gross incomes over about £22,000 - say 2½ times average earnings. The yield is £1750 million at 1983-84 levels of income etc. This could be redistributed in any of the following ways:

(a) Reduce basic rate tax from 30p to 28p in the pound.

(b) Give £1.40 per week to each taxpayer.

(c) Give 82p per week to each adult.

(d) Give 60p per week to every man, woman and child.

I would advise caution in using this illustration. The £1¾ billion would produce large sums per head if distributed more selectively - for example £8 per week for the 4 million or so who receive supplementary benefit.

I also mentioned the yield from increasing all higher rate taxes by 20p in the pound. This would produce a maximum tax rate of 80% for earned income (95% where the investment income surcharge also applied). The yield would be just over £1 billion.

YIELDS FROM INCREASING HIGHER RATES OF INCOME TAX TO 100%

Threshold of taxable income*	Current tax rate at this level	Percentage of taxpayers affected	Yield**
£	%	%	£ million
36,000	60	0.2	400
17,200	45	1.9	1750
14,600	40	3.2	2500
12.600	30	5	3500
9,600	30	10	6000

* After deduction of allowances and reliefs.

** In a full year at estimated 1983-84 levels of income.

Note :- Adding allowances and reliefs implies actual income perhaps £4,000 higher on average. Thus the £17,200 threshold implies total income of about £22,000 or $2\frac{1}{2}$ x average earnings.

The source of information on income tax changes is the annual survey of personal incomes. We project the most recently completed survey using assumptions compatible with the Treasury economic forecast and the results are used extensively for budget costings, PQ's etc. The income tax figures above have been obtained from this system and relate to 1983-84.

Published tables are usually based on completed surveys and therefore for earlier years. I enclose the 1980-81 version of the Social Trends table which will come out in the next edition. It differs from the 1979-80 table in that the quantiles take account of low earners not covered by the survey. I also enclose the taxpayer numbers table from Inland Revenue Statistics 1983 which is about to be published.

We also looked at the effect of redistributing the top slices of wealth. If the top 1% of the adult population (in terms of marketable wealth) were reduced to the second percentile all adults could be given £1950. If the top 5% were reduced to the sixth percentile the figure becomes £3600. These figures are for 1981, the latest available.

Please do not hesitate to contact me if you want any further information.

Yours sincerely

Gordon Keenay

G A KEENAY

copies:

PS/Chancellor
PS/FST
Mr Cassell
Mr Monger
Mr Aaronson
Mr Green
Mr Isaac
Mr Blythe
Mr Painter
Mr Walton
Mr Spence
Mr Gonzalez
Mr Calder
Mr C J C Brown
PS/IR

Table for next edition of Social Trends

Table 5. DISTRIBUTION OF TOTAL INCOME[1] BEFORE AND AFTER TAX[2]

1980-81
United Kingdom Pounds and percentages

	Average income before tax (£s)	Average income after tax (£s)	Percentage of income paid in tax
Quantiles of tax units			
Top 1%	31,200	20,000	35.9
1-2%	15,100	11,700	23.0
6-10%	11,300	9,010	20.2
Top 10%	14,800	11,200	24.6
11-20%	8,700	7,080	18.6
21-30%	6,970	5,720	17.9
31-40%	5,700	4,710	17.3
41-50%	4,520	3,800	16.0
51-60%	3,480	3,010	13.5
61-70%	2,480	2,260	8.8
71-75%	1,660	1,600	3.4
Bottom 25%[3]	..	..	..

[1]Gross income (earned or unearned) less employees superannuation contributions, employment expenses, losses, capital allowances, stock relief, and any expenses allowable as a deduction from gross rents assessable under Schedule A.

[2]After deduction of income tax, but before deduction of national insurance contributions.

[3]Covers approximately 7.4 million tax units whose income in the main was not subject to tax. See Appendix Part 5 Distribution of personal incomes.

Source Survey of Personal Incomes, Inland Revenue

To be published in Inland Revenue Statistics 1983

1.3 Estimated numbers of taxpayers
United Kingdom

See notes on page

Thousands

Year	Income tax: Number of taxpayers: With income greater than reliefs and allowances due	Income tax: Number of taxpayers: Building society investors not included in previous column[1]	Income tax: Number of taxpayers: Including those in previous column	Income tax: Taxpaying wives	Income tax: Higher rates	Income tax: Investment income surcharge	Surtax	Corporation tax	Capital gains tax	Estate duty and capital transfer tax
1938-39	3,800	..	..	..	–	–	105	–	–	153
1948-49	14,500	..	..	..	–	–	218	–	–	58
1958-59	17,700	..	..	..	–	–	393	–	–	66
1968-69	20,700	..	..	3,600	–	–	474	..	385	81
1972-73	18,900	..	..	2,900	–	–	370	..	410	36
1973-74	19,700	110	19,800	3,600	392	296	–	215	285	47
1974-75	20,400	120	20,500	4,100	752	652	–	215	175	42
1975-76	20,800	126	20,900	4,700	1,240	729	–	215	210	49
1976-77	21,200	117	21,300	4,900	1,430	889	–	215	200	61
1977-78	20,600	262	20,900	4,400	1,060	701	–	220	175	48
1978-79	21,400	138	21,600	4,700	763	611	–	225	225	44
1979-80	21,600	148	21,800	4,500	674	236	–	230	200	49
1980-81	21,000	177	21,200	4,400	796	273	–	235	140	39
1981-82[2]	21,100	..	..	4,300	970	290	–	..	..	28
1982-83[2]	21,000	..	..	4,200	850	280	–	..	..	..
1983-84[2]	20,600	..	..	4,000	650	205	–	..	..	..

[1] Includes only those investors covered by the Survey of Personal Incomes.
[2] Provisional.

1.4 Estimated numbers of income tax payers by country

See notes on page

Thousands

Year	United Kingdom	England and Wales	Scotland	Northern Ireland
1938-39	3,800	3,380	360	60
1948-49	14,500	13,100	1,230	190
1958-59	17,700	15,800	1,560	310
1968-69	20,700	18,700	1,620	410
1972-73	18,900	17,000	1,510	410
1973-74	19,800	17,700	1,740	390
1974-75	20,500	18,300	1,750	440
1975-76	20,900	18,600	1,820	450
1976-77	21,300	19,100	1,790	440
1977-78	20,900	18,700	1,770	420
1978-79	21,600	19,200	1,880	460
1979-80	21,800	19,400	1,960	470
1980-81	21,200	18,800	1,870	450

new file to be made

File

T-25

10 DOWNING STREET

From the Private Secretary

4 October 1983

REDISTRIBUTION OF INCOME

We are trying to assemble some material on the "fallacy of redistribution", i.e. how much the incomes of the majority of tax-payers would be increased if all the income over a certain level of the very rich were taken away in taxation and redistributed. The analysis is rather complex though at the end of the day the Prime Minister is looking for a short, snappy statement.

I would be grateful if you could arrange for some material on this to be provided. One possibility would be to work from the kind of table published in Social Trends which in turn is based on the Survey of Personal Incomes. I notice, however, that Table 5.17 in the 1983 edition is based on 1979-80 data. Is there any more recent data, or, failing that, would it be possible to gross up the figures so that the final result is expressed as current money values?

Clearly, the formulation of the question is vital and I must look to you for advice on that. One possibility would be how much each tax-payer would benefit if the incomes of all those above the first or fifth percentile were reduced to/the average/the level of those at the sixth percentile/the average of the 5-10 per cent band.

The Prime Minister may wish to deploy this material in her Party Conference speech and so I would be grateful if this material could reach me during the course of this week.

BH

AT

John Kerr, Esq.,
HM Treasury.

SA

The impact of taxes and benefits on various types of household in 19[illegible] is illustrated in Chart 5.16. Retired households, on average, receive more in benefits than they pay in taxes. Among non-retired households those with children have a more favourable balance of all cash benefits less taxes than those without children mainly because the former receive more benefits in kind such as education and health services.

Distribution of income

The data in Table 5.17 are taken from the Inland Revenue Survey of Personal Incomes. The table shows how income before and after tax is distributed amongst the 23 million tax units included in the survey in 1979–80. In both distributions shown in the table the tax units are ranked according to their income before tax. The distribution excludes about 6 million tax units whose incomes were not high enough to be taxable. However, estimates of the distribution of income for earlier years, based on all tax units, have been included in previous editions of *Social Trends*. See, for instance, Table 5.23 in *Social Trends 12* for the 1978–79 distribution.

Table 5.17 Distribution of total income[1] before and after tax[2], 1979–80

United Kingdom

	Income before tax (£s million)	Income before tax (percentages)	Average income before tax (£s)	Income after tax[3] (£s million)	Income after tax[3] (percentages)	Average income after tax (£s)
Quantile groups[4]						
Top 1%	6,410	*5·2*	27,800	4,140	*4·1*	18,000
2–5%	12,600	*10·2*	13,600	9,600	*9·5*	10,400
6–10%	11,600	*9·4*	10,100	9,290	*9·2*	8,060
Top 10%	30,600	*24·8*	13,300	23,000	*22·8*	10,000
11–20%	19,200	*15·6*	8,340	15,700	*15·5*	6,790
21–30%	15,800	*12·8*	6,850	12,900	*12·8*	5,610
31–40%	13,600	*11·0*	5,880	11,200	*11·1*	4,860
41–50%	11,300	*9·2*	4,920	9,490	*9·4*	4,120
51–60%	9,620	*7·8*	4,170	8,080	*8·0*	3,510
61–70%	8,140	*6·6*	3,530	6,870	*6·8*	2,980
71–80%	6,530	*5·3*	2,840	5,860	*5·8*	2,540
81–90%	4,930	*4·0*	2,140	4,440	*4·4*	1,930
Bottom 10%	3,580	*2·9*	1,550	3,430	*3·4*	1,490

[1] Gross income (earned or unearned) less employees' superannuation contributions, employment expenses, losses, capital allowances, stock relief, and any expenses allowable as a deduction from gross rents assessable under Schedule A.
[2] After deduction of income tax, but before deduction of national insurance contributions.
[3] Based on the numbers from the distribution of total income before tax.
[4] Based on 23 million tax units with a total income (before tax) of £1,000 and over. See Appendix, Part 5: Distribution of personal incomes.

Source: Survey of Personal Incomes, *Inland Revenue*

Wealth

Estimates of the distribution of marketable wealth among adults since 1971 are given in the top section of Table 5.18. The figures are based on the estimates of individuals' marketable wealth obtained from grossing up Inland Revenue statistics of estates. They are adjusted for elements of wealth not accounted for in the Inland Revenue data, such as certain types of trust property and the wealth of those who are excluded from statistics of estates because they have relatively small wealth holdings.

Apart from housing and land few forms of marketable wealth have kept pace in value with inflation in recent years, and for many adults their non-marketable rights in pension schemes, whether occupational schemes or the state pension scheme, have represented an increasingly important component of personal wealth over and above holdings of marketable wealth. The centre and lower sections of Table 5.18 show the distribution of personal wealth after adding on successively the values put on accrued occupational pension rights and rights to state retirement pensions and widows' benefits. The value of rights in the state pension scheme increased in real terms during the period 1971–80, and the rights of most members of occupational pension schemes are protected to some degree against inflation.

There were substantial reductions in the shares of wealth of the richest groups up to 1975 (largely because of the fall in the prices of stocks and shares which form a significant part of the wealth of the wealthiest). For the next five years there was very little change in the pattern of ownership of marketable wealth. The distribution of wealth including occupational pension rights broadly follows the same trend, although the levels are significantly affected by adding in these rights with, for example, the share of the

~~Topic made out yet~~
Budget

CONFIDENTIAL

HL

cc LPS
CWO

10 DOWNING STREET

From the Private Secretary 23 September 1983

bcc Rose Padwick

John Kerr wrote to me on 19 September about Budget Day 1984.

The Prime Minister is content that the Treasury should plan provisionally on 13 March 1984 as Budget Day.

I am sending copies of this letter to David Heyhoe (Lord Privy Seal's Office) and Murdo Maclean (Chief Whip's Office).

M. C. SCHOLAR

Miss Margaret O'Mara,
H.M. Treasury.

CONFIDENTIAL

Econ Pol - Budget 83/84 pt 11

(4)

c N.O.

Prime Minister

This doesn't tell us very much. A subject for a regular Wednesday meeting?

Yes MES 21/9

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

PRIME MINISTER

TAXATION OF INTERNATIONAL BUSINESS

In view of your previous interest in these matters, I am sure you would like to hear of our current plans on the taxation of international business. I am minuting you now because, subject to your approval, we shall shortly be publishing revised draft legislation on 'controlled foreign companies' (tax havens).

2. You discussed the subject with Geoffrey Howe last November and agreed to the publication of a Consultative Document, including draft clauses. We were proposing to legislate in this year's Finance Bill, and were intending to introduce a number of important modifications to reflect the business community's comments on the proposals in the Consultative Document. The Election called a halt to this but in an arranged Parliamentary Question shortly before the Summer Recess, I confirmed that the Inland Revenue would be publishing draft clauses (or revised clauses) on a number of matters left over from the 1983 Finance Bill, including the proposed provisions on controlled foreign companies. These revised provisions are now ready for issue and I think there would be merit in publishing them as soon as possible. This would give the business community ample opportunity to study the revised draft clauses before April 1984 which is the proposed starting date for these particular provisions. (April 1984 is also the starting date proposed

for the other half of the international tax 'package' left over from the 1983 Bill (helping companies by allowing them to set off double taxation relief before ACT).)

3. You may also be interested to hear how matters now stand on the other two issues which have hitherto been considered alongside the tax haven proposals - company residence and upstream loans. As foreshadowed in December's Consultative Document, the Inland Revenue recently issued a Statement of Practice amplifying the current case law test of company residence. This should finally lay to rest any remaining fears that we still intend to legislate to replace these tried-and-tested rules with a statutory definition. I would not, however, wish to rule out at this stage the possibility of legislation either on upstream loans or on certain specific abuses of the company residence rules. But these are complex matters, on which further consultation may well be required. Any legislation, therefore, would not be included in the 1984 Bill, but would be a matter for 1985 or later.

4. I shall, of course, continue to keep you in touch with developments on all these issues.

Margaret O'Mara

(N.L.)
20 September 1983
(approved by the Chancellor and signed in his absence)

CONFIDENTIAL

MO

(1)

Prime Minister

Agree (I can foresee no problem)?

MCS 20/9

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

19 September 1983

Michael Scholar Esq
10 Downing Street
LONDON SW1

Yes MT

Dear Michael,

1984 BUDGET DAY

The Chancellor has been giving some thought to the timing of Budget Day next year. He has provisionally concluded that the best date would be 13 March. Our preliminary consultations suggest that this is feasible in terms of diaries and of the Parliamentary timetable, and statistics to be published around that date should give no special difficulty.

2. The Chancellor would be grateful for confirmation that the Prime Minister is content that we should plan provisionally on 13 March 1984 as Budget Day. An announcement of the date would of course not be made until the New Year.

3. I am sending copies of this letter to David Heyhoe in the Lord Privy Seal's Office and to Murdo Maclean at No. 12.

Yours ever,

John Kerr.

J O KERR
Private Secretary

CONFIDENTIAL

Econ Pol : Budget 83/84 Pt. 11

CONFIDENTIAL

cc AW

NBPM

MCS 14/9

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

14 September 1983

Michael Scholar Esq
Private Secretary
10 Downing Street

Dear Michael,

OFFSHORE AND OVERSEAS FUNDS

You wrote to Judith Simpson on ~~8~~ September.

2. On reflection, the Chancellor agrees with the Prime Minister's suggestion that his forthcoming statement should specify the "period of grace". The period will be up to 1 January 1984, and the statement will be issued tomorrow.

Yours ever,

John Kerr

J O KERR

CONFIDENTIAL

econ Pol Budget Pt 11

14 SEP 1983

CONFIDENTIAL

bcc Walters

HL

10 DOWNING STREET

From the Private Secretary

8 September 1983

Offshore and Overseas Funds

Thank you for your letter of 5 September about the statement which the Chancellor of the Exchequer proposes to issue shortly about offshore and overseas funds.

The Prime Minister saw your letter, and commented that it would be better if there was one statement rather than two, so that the "period of grace" before the new rules apply will be specified from the start. The Prime Minister believes that two statements rather than one might give the impression that the Government had not thought the matter through.

M. C. SCHOLAR

Miss Judith Simpson,
H.M. Treasury.

CONFIDENTIAL

2.6 CONFIDENTIAL

cc BI
TF

(1)

Prime Minister

MCS 6/9

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

5 September 1983

Michael Scholar Esq
10 Downing Street
LONDON
SW1

Dear Michael,

I am writing to let you know about a statement that the Chancellor proposes should be issued very shortly about Offshore and Overseas Funds.

As you know, a number of funds have been established outside the United Kingdom, mainly in the Channel Islands, which roll up income rather than distributing it year by year. The result, under present law, is that the investor pays only capital gains tax on the rolled up income in the fund when he disposes of his investment. Income has effectively been converted into capital gains. And the capital gains tax liability may itself be nil or very low because of the £5300 annual exemption limit and indexation relief.

The funds have recently grown very fast in size. They may now total £1500m. The tax loss is already around £60m a year and possibly substantially more. It is clear that, without early action, the sums involved and the tax loss will continue to grow fast. The absence of such action has already attracted a fair amount of press comment.

The Chancellor therefore intends to issue an early statement to say that since existing legislation does not give adequate protection to the Exchequer, he will propose new provisions in the 1984 Finance Bill. These will provide that when an investor resident in the UK disposes of a holding in an offshore or overseas fund, an appropriate amount of income or corporation tax will be paid.

The statement will also say that there will be a "period of grace" before the new rules apply, and promise a second statement to specify the date from which this will happen. Those who wish to dispose of their holdings before the change takes place will therefore be able to do so. This procedure should help to ensure that funds are run down gradually, and so reduce the risk of disruption in the markets.

Yours,

Judith

MISS J C SIMPSON
Private Secretary

It would be better if the whole thing came in one statement. The proposal to have two is most unsatisfactory: it indicates that the matter has not been thought through.

MT

2.53

CC NO

NBPM
MS 28/7

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

27 July 1983

Michael Scholar Esq.
10 Downing Street
LONDON
SW1

Dear Michael,

ICI LEGAL CASE ON TAX VALUATION OF ETHANE

Margaret O'Mara wrote to you on 15 July asking you to give the Prime Minister advance warning of the procedural hearing in this case. In reply you asked for defensive briefing, to be regularly updated as the case progresses.

We have now heard that the hearing, on 25 July, took place in Chambers, that ICI did not submit any further evidence and that the Judge decided it was premature to hear their claim for discovery of documents. The hearing of the issue was put off until the next term, which begins in October.

Publicity is now unlikely before then. The briefing material you have is still relevant, but we shall update it in October and keep you informed of progress.

Yours,

Judith

MISS J C SIMPSON
Private Secretary

Econ Pol, Budget, Pt 11

Budget

disciplines or professions of (a) economists and statisticians, (b) medicine and health, (c) natural resources, (d) engineers, (e) architects and (f) planners.

Mr. Raison: The total number of professional advisers in post in the Overseas Development Administration headquarters, including senior managers in professional disciplines, is 104. Of these the numbers in the categories quoted are:

	Numbers
(a) economists and statisticians	44
(b) medicine and health	6
(c) natural resources	25
(d) engineers	17
(e) architects	2
(f) planners	1

Mr. Chapman asked the Secretary of State for Foreign and Commonwealth Affairs if he is satisfied with the methods of the Rayner scrutiny which looked into the efficiency and effectiveness of the post of physical planning adviser in the Overseas Development Administration.

Mr. Raison: Yes.

Mr. Chapman asked the Secretary of State for Foreign and Commonwealth Affairs if he will place in the Library a copy of the Rayner scrutiny of the post of physical planning adviser in the Overseas Development Administration together with any responses he may have received.

Mr. Raison: I have arranged for the conclusions of the relevant section of the Rayner scrutiny to be placed in the Library. I have received 19 letters, some from overseas, expressing concern about the decision on the post of physical planning adviser, which could not be published without the writers' consent.

Mr. Chapman asked the Secretary of State for Foreign and Commonwealth Affairs when he intends to respond to the fourth report from the Foreign Affairs Committee, session 1982-83, on the Overseas Development Administration scientific and special units, with particular reference to the conclusions summarised in paragraphs 102-117.

Mr. Guy Barnett asked the Secretary of State for Foreign and Commonwealth Affairs when he expects to respond to the report of the Foreign Affairs Committee on Scientific Units.

Mr. Raison: The Government's response will be published as a White Paper (Command 9003) at noon on Wednesday 27 July. Copies of the White Paper will be placed in the Libraries of both Houses.

NGPI (Loan)

Mr. Canavan asked the Secretary of State for Foreign and Commonwealth Affairs whether there has yet been any further payment of part of the Commonwealth Development Corporation loan of 6·4 million to NGPI, Agusan del sur, Philippines.

Mr. Raison: No disbursement has yet been made by the CDC under the loan agreement.

THE ARTS

Yorkshire Water Colour Society

Mr. Mason asked the Under-Secretary of State answering in respect of the Arts, if he will arrange for an exhibition relating to the Yorkshire water colour society to be displayed in the Upper Waiting Hall during 1983.

Mr. Waldegrave: I understand that arrangements have been made with the authorities of the House for the exhibition to be held in the Upper Waiting Hall from 21-25 November.

NATIONAL FINANCE

Energy Assets (Sale)

Mr. Waller asked the Chancellor of the Exchequer what proposals he has for achieving the expanded programme of asset sales in 1983-84 which he announced on 7 July, *Official Report*, column 418.

Mr. Lawson: I expect to raise up to £500 million of the asset sales which I am seeking before the end of the 1983-84 financial year from an offer for sale of a further tranche of BP shares. Parliamentary approval for expenditure in connection with such a sale of BP shares will be sought in a new Vote which will be introduced in a Supplementary Estimate. Pending that approval, any necessary expenditure will be met by repayable advances from the Contingencies Fund.

Finance Bill

Mr. Woodcock asked the Chancellor of the Exchequer if he can now give any further information about the action he intends to take on those proposals in this year's first Finance Bill which were neither enacted in the Finance Act 1983 nor reintroduced in the current Finance Bill.

Mr. Malone asked the Chancellor of the Exchequer whether he intends to introduce legislation to implement the provision of clause 58(4) relating to capital gains tax of the Finance Bill introduced in the last Session of the previous Parliament.

Mr. Lilley asked the Chancellor of the Exchequer when he intends to bring forward legislation introducing new rules governing the tax treatment of domestic sterling loan stock issued by companies at a discount, in accordance with the Budget statement; and if he will publish draft clauses in advance.

Mr. Lawson: I have already announced that the oil taxation changes dealt with in chapter II of part IV of the first Finance Bill will be the subject of an oil taxation Bill to be introduced in the autumn.

As previously indicated, I have been reviewing the rest of these proposals for inclusion in the 1984 Finance Bill. Having regard to the representations which were made following the publication of the earlier Finance Bill, it would clearly be helpful to take the opportunity for further consultation on some of the original proposals, and also to publish for comment the draft clauses which the Government had intended to add to the earlier Bill but which were in the event not published before the Dissolution of Parliament. I am accordingly authorising the Inland Revenue to publish draft clauses (or revised clauses), when ready, on the following subjects:

C[illegible]SE AND SCHEDULE IN FIRST FINANCE BILL

Group relief
38, 39 and schedule 6

Controlled foreign companies
44 to 52, and schedules 7, 8 and 9

Capital gains tax: foreign trustees and non-resident settlements
61 and 62, and the proposed new clause on non-resident trusts announced by the Financial Secretary in a written answer on 29 March 1983

Special commissioners
95 and schedule 17

NEW CLAUSES OF WHICH THE GOVERNMENT HAD GIVEN NOTICE BUT WHICH WERE NOT PUBLISHED BEFORE THE DISSOLUTION

Capital and income bonds
Announced by the Financial Secretary in a written answer on 29 April 1983

Pension funds: transactions in financial futures
Announced by the former Chief Secretary in a written answer on 5 May 1983

Furnished holiday lettings
Announcements made by the Financial Secretary during the Finance Bill dabates on 11 May 1983 [*Official Report*, Vol. 42, c. 840] and 6 July 1983 [*Official Report*, Vol. 45, c. 361]

Interest on Eurobonds and Deep discounted stock
Proposals announced in the Budget (15 March 1983) and further details given in Inland Revenue budget day press release

I intend to reintroduce the following provisions in the 1984 Finance Bill with effect from the starting dates originally proposed:

	Starting date	*Clause number in first Finance Bill*
Self-employed persons living in job-related accommodation	6 April 1983	20
Trustee savings banks	21 November 1982	37
Stock relief: houses taken in part exchange	15 March 1983	40
Capital gains tax: monetary limits for reliefs (relieving provisions only)	6 April 1983	Part of clause 58
Capital gains tax: foreign currency accounts	6 April 1983	60
Capital transfer tax: special discretionary trusts	9 March 1982	67
Capital transfer tax: property moving between settlements	15 March 1983	68
Capital transfer tax: adjustments of tax	1 April 1983	71
Development land tax: own use deferment	Continues relief which would otherwise expire on 1 April 1984	89
Development land tax: payment by instalments	6 August 1983	91

Since current tax liabilities may in some cases be reduced by these proposals, the Inland Revenue will be authorised, where appropriate, to hold over the collection of tax for the time being, or to settle liabilities provisionally, having regard to the reliefs proposed.

I propose that provisions on the following topics should also be included in the 1984 Finance Bill, subject to the comments noted:

	Comments	*Clause number in first Finance Bill*
VAT: refund of tax to Government Departments and health authorities	To be implemented on an extra-statutory basis from 1 September 1983	10
VAT: conditions imposed on discretionary registration	It will be proposed that this measure should take effect from Royal Assent to the 1984 Finance Bill	11
Reliefs for share options	Under review for the financial year 1984-85	29
Increase in limits for apportionment of income of close companies	It will not be proposed that this change should apply for 1983-84	32
Relief for discounts on bills of exchange of trading companies	It will not be proposed that this change should apply for 1983-84	33
Relief for incidental costs of obtaining loan finance	It will not be proposed that this change should apply for 1983-84	36
Carry back of surplus ACT	It is intended that this measure should be phased in from the original starting date (1 April 1984) and at least as quickly as originally proposed	41
Double taxation relief to be given before ACT	As before, the proposed starting date will be 1 April 1984	42
Recovery of taxes in lower courts	It will be proposed that these provisions should take effect from Royal Assent to the 1984 Finance Bill	43 and 72
Capital gains tax	The withdrawal of out-dated reliefs will be proposed to take effect from April 1984	58 (part)
Development land tax: non-resident vendors	There will be further consultation on this provision	90
Freeports	The criteria governing the selection of the first experimental freeports are being announced separately, and applications will be received in 1983	Proposed new clause

Manufacturing Industry

Mr. Gould asked the Chancellor of the Exchequer whether he will publish in the *Official Report* a table showing for each year since 1953 the increase in productivity in manufacturing industry for the Organisation for Economic Co-operation and Development countries collectively and individually.

Mr. John Moore: For the period 1966-1981 this information is published by the OECD in table 3.10 of its annual report Historical Statistics 1960-1981. For earlier years information is not readily available. Nor are comparable data for 1982 available yet.

Civil Service Pay

Mr. Ralph Howell asked the Chancellor of the Exchequer for each of the years 1976, 1978, 1980 and 1982, what is the percentage amount of the Civil Service basic pay award, the number of employees in that year and

FROM: M A JOHNS

20 JULY 1983

INLAND REVENUE
POLICY DIVISION
SOMERSET HOUSE

MISS O'MARA

ICI LEGAL CASE ON TAX VALUATION OF ETHANE

I suggest the following line to take for possible Prime Minister's Questions on the ICI ethane case. We will update the Answers if there are any significant developments in the case. I assume your letter of 15 July to Michael Scholar can be used as background note. As the case itself is covered by the sub judice rule, the Prime Minister will need to restrict replies to general policy issues.

1. IS THE GOVERNMENT SUBSIDISING PETROCHEMICAL USE OF ETHANE THROUGH THE TAX SYSTEM?

A, Section 134 and Schedule 18, Finance Act 1982 remove an anomaly in the PRT valuation rules for ethane used for petrochemical purposes. They allow the use of a long term price formula in valuing ethane not sold at arm's length provided the formula is comparable to the formula which would be used in an arm's length sale. This removes a discrimination against non arm's length deals in ethane; it is not a subsidy.

(2. IS SECTION 134, FINANCE ACT 1982 CONTRARY TO THE TREATY
(OF ROME?
(
(3. WHAT IS THE POSITION ON ICI'S LITIGATION?

PS/Economic Secretary
Mr Cassell
Mr Lovell
Mr Turnbull
Mr Robson
Mr Hall - IDT
Mr Salveson

Mr Crawley
Mr Elliss
Mr Pitts
Mr Cleave
Mr Johns
PS/IR

A. These matters are sub judice.

4. ARE 10,000 JOBS AT STAKE AT WILTON?

A. I am aware of the worries about jobs at Wilton but I believe that despite the undoubted pressures on the petrochemical industry from depressed demand and newly available ethane feedstocks there is a good future for efficient naphtha crackers like the Wilton cracker. It would be wrong to keep a tax anomaly and put jobs elsewhere at risk to provide protection for naphtha crackers.

M. A. Johns

M A JOHNS

010.

32

Mr Ricketts

Oops!

MCS 15/7.

Inland Revenue
POLICY DIVISION
Somerset House
London
WC2R 1LB

Telephone Enquiries 01-438 ....

Your reference

Michael Scholar Esq
Prime Ministers Office
10 Downing Street
LONDON

Our reference

Date
15 July 1983

Dear Michael

Effect of higher rate changes in Finance Bill - Prime Ministers comments at Question Time on 14th July.

I am afraid it looks as if the figures given by the Prime Minister about the proportion of stevedores, dockers, miners etc who will benefit from the current Finance Bill are over optimistic, and would be difficult to defend if anyone challenged them. The attached note explains why.

I thought you should know of this straightaway in case there is a chance that the Prime Minister would repeat the figures. As Martin Haigh says in his note, we are seeing what defensive gloss could we put on the figures if they are challenged. So you might like to come to us if anyone does question them. I am copying this to Robin Aaronson in the Treasury, so that he is in the picture if Treasury Ministers are questioned on it.

Perhaps the moral - if it does not sound too pious to say so - is that it is worth getting the Revenue to produce (or at least check) figures of this sort, which involve some knowledge of the serpentine complexities of our tax system (even the apparently simple bite!). In the personal tax field the best people for your people to contact are:-

Julian Calder	extension	6472	
Ian Spence	"	6497	Federal 2288
Martyn Haigh	"	7349	

Yours ever,
Ian

I R SPENCE

cc Mr Calder
Mr Martin

POLICY DIVISION

Mr Spence

TAXPAYERS AFFECTED BY HIGHER RATE CHANGES

I have been trying to establish the basis for the figures quoted by the Prime Minister at Question Time yesterday for the proportion of various occupational groups affected by the higher rate threshold change in the current Bill (Hansard extract at 'A').

It turns out that these were commissioned by No 10 direct from Department of Employment, who were asked to estimate the proportion of employees in selected occupational groups earning more than £14,500 in 1983/84. In practice, the latest available data on the distribution of earnings by occupational groups is from the April 1982: Department of Employment choose the results for male employees earning over £250 per week at that point. This implies an increase of 11.2 per cent from April 1982 to average 83/84 earnings levels, which seems broadly OK. (The Prime Minister did not in fact say that her figures related only to men: but in practice I would guess that the proportions for both men and women are pretty much the same for the particular groups we quoted.)

New Earnings Survey

The problem, of course, is that gross earnings as recorded by the NES are not a very useful guide to the tax position of the employee. It looks as though the earnings level of £14,500 requested by No 10 was meant to correspond to the higher rate threshold for a single person (ie £1785 allowance plus £12,800 basic rate band equals £14,585). This is clearly a grossly unrealistic level to choose. For a start, the majority of male taxpayers in the groups cited are probably married, in which case the minimum income for higher rate liability under FA 83 is £15,595. Secondly the great majority of employees (and all of those in some of the groups cited ~~will have~~) will have other reliefs which push up their personal higher rate threshold. For example all "medical practioners" are members of the NHS contributory pension scheme: the contribution rate is six and two-thirds per cent which means that a single doctor with no further reliefs will need earnings of about £15,650 before entering higher rate liability under FA 1983. And a good proportion of the taxpayers concerned are likely to have other reliefs as well, notably mortgage interest relief. About a third of all taxpayers currently have mortgage interest relief, at an average of something over £1000 a year each at current interest rates: it seems reasonable to suppose that the proportion and the average relief is rather higher for our present target group. You will recall that this last point was raised by Robin Cook only last Tuesday (Hansard extract at 'B').

No 5/CR

It is impossible to pull these effects together to produce a single target level of gross earnings: but it is clear that in many cases a realistic figure might be £17,000 or so rather than £14,500. On the other hand,

other/ the No 10 figures take no account of any/contributions to income: wife's earnings in particular may push down the level of husband's earnings at which FB 83 starts to give relief. And I suppose some of the groups mentioned (the miners?) may have enjoyed faster earnings growth than Department ofEmployment have assumed. But on balance, I would have thought these effects are very unlikely to outweigh the bias in the opposite direction.

I will be pursuing with Department of Energy and ours Statisticians what we might say if the Prime Minister's figures are challenged, but I am not hopeful we will be able to come up with anything very convincing.

M HAIGH
15 July 1983

HANSARD THURSDAY 14th JULY '83

A

Mr Spence
Mr Haigh
Miss Owen

Mr. Rooker: Will the Prime Minister, as leader of the nation and as a housewife, give us her practical advice and tell us what her practical advice is to the unemployed and their families about eating healthily within their means, in view of the assessment by the National Advisory Committee on Nutrition Education that the average British diet puts people at risk?

The Prime Minister: I do not think that those people need advice from me, and I think that it would be presumptuous of me to give it.

Mr. Foot: When the right hon. Lady says that she is not prepared to give advice to some of the poorest people in the land, is that not what she sought to do last week? Has the Cabinet had a chance to consider the growing anxiety throughout the land about the way in which some of the poorest people may be treated under her Government? Will she give an absolute guarantee that supplementary benefit is to be sustained, because that provides the minimum needs that must be met if proper standards are to be sustained? Will the right hon. Lady give a guarantee that she will protect the standard of supplementary benefits throughout the coming years?

The Prime Minister: No. I cannot go further than the pledge given previously in the manifesto that pensions and other long-term linked benefits would be protected. Supplementary pension is such a linked benefit, and is therefore protected.

Mr. Foot: Does the right hon. Lady recognise that it is not only the protection of the standards of people on supplementary pensions; there are many other people who depend for a minimum standard of life on the protection of supplementary benefits? Does she accept that if unemployment continues to increase, as it has done under her Government, and if the value of the benefit is cut, as she is now suggesting, we shall soon have 8 million or 9 million people living on the poverty line? Is she content that such a thing should happen in this country?

The Prime Minister: There is no definition of the poverty line — [HON. MEMBERS: "Oh."] — and there never has been under any Government — when they answered from this Dispatch Box. We gave a pledge in our manifesto that pensions and other linked long-term benefits would be price protected. I cannot extend that pledge.

Mr. Foot: In the light of the anxiety, which can now only deepen as a result of her answers, will the right hon. Lady ask the Cabinet to look afresh at this matter to see whether the minimum standard of life of some of the poorest people in Britain cannot be guaranteed over the coming years?

The Prime Minister: I cannot go further than what I have said. The retirement pension and other long-term linked benefits are price protected. Those long-term linked benefits include widows' pension, industrial death benefit when it is paid by means of a widow's or widower's pension, war disablement and industrial disablement pension, war widow's pension, attendance allowance, invalidity care allowance and non-contributory invalidity pension.

Q2. **Dr. MacDonald** asked the Prime Minister if she will list her official engagements for Thursday 14 July.

The Prime Minister: I refer the hon. Lady to the reply that I gave some moments ago.

Dr. MacDonald: Where is the morality in squandering £280 million this year on tax cuts to the rich instead of raising child benefits by a further 50p per week and raising benefits for the unemployed?

The Prime Minister: Child benefit, as the hon. Lady knows, will be at a record level when it is increased in November. That is better than anything achieved by the Government that she supported. I imagine that tax relief is the subject of the Finance Bill which is now going through the House. The 1 million people who will be better off as a result of the Finance Bill include one-sixth of all stevedores and dockers, one-sixth of all transport foremen, 5,000 miners, a quarter of all journalists, many working couples, half of all medical practitioners, the heads of many secondary schools, and half of all university academics.

Sir Ian Gilmour: Although I agree with my right hon. Friend that there is no acceptable definition of poverty, does not she accept that the fact and presence of poverty is not in doubt? Since those who receive short-term benefits are at least as poor as those who receive long-term benefits, will she give an assurance that the fact will be fully taken into account when the Cabinet next considers public expenditure?

The Prime Minister: As my right hon. Friend will know, many of those who receive short-term benefits receive supplementary benefit if the amounts are inadequate for their purposes. For example, the unemployed often receive a rather larger proportion of their income from supplementary benefit than from unemployment pay. However, I cannot go further than the promises that I have given, upon which my right hon. Friend fought the last election.

[Mr. Cook]

"We will reduce taxation as soon as we believe we have the headroom to do so . . . But to talk about it now is inappropriate."

The Chancellor has just said that it is inappropriate to talk about reducing income tax, but the Committee is now being invited to consider a measure which, by this clause alone, will result in a reduction of tax of £280 million, all of it going to the better-off section of the population.

On Wednesday we were told by the Chief Secretary that the Government could afford the handouts to the rich. On Thursday the Chancellor told us that the Government could not afford a similar sum to maintain public services such as the health services to the sick and the disabled. On Tuesday, having hit the weak and the vulnerable by cutting their services, the Financial Secretary is presumably about to tell us that the Government can, after all, afford the handouts to the rich. That conjunction of statements is an insult to the intelligence of the Committee.

Let no one be in any doubt that we are dealing with the better-off section of society. Those who are caught by the investment income surcharge, after this clause is agreed, will only be those who have interest-bearing assets worth £70,000. Those people, on the whole, with doubtless the odd exception, are the better-off members of society.

The same is true of those who are caught in the higher rate tax bands. When we debated this matter on 11 May, shortly after the announcement of the election, the then Chief Secretary, who has been summoned to a higher plane, attempted to belittle the income of those who were caught in the higher rate tax bands. He produced the interesting statistic that it would be possible for a married couple, in which both partners were working, to be caught in the 40 per cent. tax band if they both received—and I quote his own definition—"the average male wage".

That is a curious statistical concept. On the whole, one does not find two males married to each other, and even when one does, they are not allowed to claim the married man's allowance. It would be more realistic to contemplate the average couple of a male and female receiving the respective average income, which would leave them comfortably below any of the higher rate tax thresholds. There was, of course, another equally unrealistic assumption in that interesting example, in that the couple received no other form of tax relief whatever, other than the tax allowances. They had no mortgage, insurance or superannuation payments. In reality, virtually everyone caught in the higher rate bands would have at least one, if not all, of those tax reliefs.

The Inland Revenue statistics show that the people in the higher rate tax bands, the people affected by this clause, are the top 4 per cent. of all top taxpayers, and an even smaller proportion of all income earners. They total 820,000. I am indebted to the Financial Secretary for his reply of 11 April, giving a breakdown—as near as we can get one—of what they earn: 200,000 earn over £25,000 a year; 500,000 earn over £20,000; and only 120,000 of them earn less than £20,000. It is not possible to segregate them from the million who earn between £15,000 and £20,000, but as there are only 12 per cent. of the total number in that band, it is reasonable to assume that they are not far below £20,000.

Those sums measure a salary that leaves the recipient, by any normal definition, comfortably off. We could use another measure—a measure that I am sure will hit home to all members of the Committee—in that each of those whom we are considering and each of those who is affected by the clause earns more than Members of Parliament earn. In saying that, I am not suggesting a new tax principle that the threshold for the higher rate tax band should be set just above a Member of Parliament's salary, although that principle may commend itself to the Committee. I advance the principle because we can now assert with some confidence——

Mr. Nicholas Ridley: The hon. Member for Livingston (Mr. Cook) is suggesting that Members' salaries should be set just below the higher rate tax threshold. That is how what he says could be interpreted.

Mr. Cook: I suspect that if the Financial Secretary is offering to negotiate with me across the Dispatch Box, I would be well advised to seize what he is offering with both hands, because it is likely to be well in excess of anything that the Chancellor of the Exchequer will allow us.

That brings me to the point that I was coming to: the vigorous and vehement opposition of the present Chancellor of the Exchequer to implementing the proposed increase in salaries of Members of Parliament. [HON. MEMBERS: "Oh."] I see that one or two hon. Members share his opposition to the increase. There is, of course, force and reason behind that opposition, if we accept that Members of Parliament are intolerably overpaid and that any increase would be an offence to human decency. If the Chancellor of the Exchequer urges that view of Members' salaries, he cannot then turn round and say that those who are earning even more than those bloated Members of Parliament deserve our sympathy for the modest incomes on which they are forced to survive, subject to penal rates of taxation.

Mr. Anthony Beaumont-Dark (Birmingham, Selly Oak): As the hon. Gentleman has drawn so much attention and expressed so much bitterness to the pay of Members of Parliament, will he say where he stands? Does he believe that Members of Parliament should take a bigger increase than the man in the street or not? The hon. Gentleman seems very virtuous. How virtuous is he for himself?

Mr. Cook: If the hon. Member for Birmingham, Selly Oak (Mr. Beumont-Dark) reflects on what I said, and if he reads it tomorrow in *Hansard*, he will see that I spoke without a taint of bitterness. Indeed, I find the contradiction into which the Treasury Bench is forced mildly amusing. I accept entirely that Members should get the rise enjoyed by the man in the street, and no more, and should get it each year and not every fifth year.

There are two other reasons why those who find themselves among those 820,000 can live without an extra sou. The first is that they are precisely the people who have benefited most from the tax policy of the last Government. That Government came to power on a pledge that they would take the poor out of tax, and succeeded in doing so only by taking 2 million of them out of work altogether. Those who managed to remain in work, and receive average income, have seen the tax burden go up, not down. A married couple with no children—I take that example to avoid the controversy about child benefits—have seen the proportion of their income paid in income tax and national insurance contributions go up by 4½ per

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EC NO Press

(2)

Prime Minister

MCS 15/7

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

15 July 1983

Michael Scholar Esq
10 Downing Street
LONDON
SW1

Thank you — we must be prepared for this in [illegible] MT

- Brief requested CS 18/7

Dear Michael,

ICI LEGAL CASE ON TAX VALUATION OF ETHANE

PJ8 → You may recall that Jill Rutter had some correspondence with you last July (her letters of 1, 6 and 9 July and your reply of 13 July) about complaints ICI were making about a provision in the 1982 Finance Bill on the tax valuation of ethane. This provision was designed to remove an anomaly in the Petroleum Revenue Tax rules for valuing ethane used for petrochemical purposes where it is not sold at arm's length. ICI complained that the provision effectively provided a subsidy to their competitors - Shell, Esso and BP - and that as a result ICI's activities at Wilton were at risk of closure. The detailed background was set out in the Revenue's note attached to Jill Rutter's letter of 1 July 1982.

Following the failure of ICI's intensive lobbying last summer to have the clause dropped or radically amended, they decided to go to the Courts in an attempt to render it inoperative as contrary to the Treaty of Rome. They started proceedings last July, broadly seeking a declaration from the Courts that the legislation either as enacted or as applied by the Inland Revenue constitutes state aids to industry under Article 92 of the Treaty of Rome; that state aids cannot be implemented unless notified to the Commission; and that as the Government has not notified the Commission of any aid in this case the legislation should not be implemented.

Since last summer, preparatory work on the case has been proceeding. ICI filed their evidence in November; the Government filed its counter-evidence at the beginning of May. The Chancellor thought that the Prime Minister ought to be aware that we have just learnt that there will be a procedural hearing on the case on 25 July. This hearing is only to seek various procedural directions on the conduct of the case but one of these seeks discovery of confidential papers relating to the tax affairs of Shell, Esso and BP. The Government lawyers will be resisting this.

The case potentially raises (directly or indirectly) several sensitive political and constitutional issues, such as whether the Treaty of Rome can override a subsequent Act of Parliament, the adequacy of the Government's industrial policy towards the petrochemical industry and the proper balance of interests between disclosing all the papers relevant to a legal action on the one hand and the desirability of protecting the confidential records relating to a taxpayer not directly involved in the Court action on the other hand. The hearing on 25 July will not raise these issues directly . However, it will be public and there is always a slight risk of adverse publicity extending on to the substantive issues:

a. Doubts may be raised about the long-term viability of ICI's Teesside complex (employing up to 10,000 people).

b. This may be blamed on the Government as being the result of tax changes in favour of ICI's competitors.

c. It may be alleged that discussions which took place in the summer of 1981 between the Government and Shell/Esso, and later with BP, imply some sort of preferential treatment.

d. The Government may be accused of trying to cover up relevant facts by refusing to release relevant documents in the case.

We have good arguments to rebut allegations of this sort:

a. While the long-term future of an industrial complex can never be guaranteed, ICI have a highly efficient naphtha cracker at Wilton and ethane crackers are highly unlikely to replace naphtha crackers for the foreseeable future. (By 1990 ethane is still not likely to constitute more than about 6 per cent of ethylene feedstock in Western Europe.)

b. The tax changes removed an anomaly which discriminated against non-arm's length disposals of ethane; they did not grant a subsidy. The principle implemented in the legislation is that non-arm's length disposals should be valued for tax purposes at the price which would be achieved in comparable arm's length deals.

c. It is not unusual or improper for taxpayers to discuss with the Government tax anomalies which adversely affect them, or to discuss with the Inland Revenue the effect on their affairs of possible changes in the tax legislation. This cannot affect the Revenue's responsibility to administer enacted legislation properly and impartially.

d. It would be wrong to allow one taxpayer to see confidential papers about another taxpayer's affairs - in this case relating to sensitive commercial information about a competitor. This is a generally accepted principle.

Press reaction to ICI's lobbying last summer was not too unbalanced, and it seems unlikely that the press will on this occasion accept ICI's case uncritically. It may also turn out that any adverse publicity generated by ICI and Teesside will be countered by more helpful publicity from the companies and the localities benefiting from the removal of the anomaly (Shell and Esso at Mossmorran and BP at Grangemouth, both in Scotland). However, we clearly have to be prepared to deal with criticisms if it arises. Press Offices are being suitably briefed.

Yours sincerely,
Margaret O'Mara

MISS M O'MARA
Private Secretary

CONFIDENTIAL

PS. WMzd/5

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

24 May 1983

Michael Scholar Esq
10 Downing Street
LONDON SW1

Dear Michael,

TREASURY COMMITTEE REPORT ON INTERNATIONAL MONETARY ARRANGEMENTS

In my letter yesterday I promised to write again when the TCSC Report on International Monetary Arrangements had been published this morning. I now attach a copy of the Report, together with a quick analysis of it. This shows that there are no surprises in the Special Report proper, which remains exactly as at Annex A to my letter yesterday; that two sensitive points in the "Chairman's Draft Report" - those at (b) and (e) in my Annex B - do not appear in the published version; and that Dr Bray's rival version of the concluding sections is not unhelpful.

see inside on d/file

On the substantive issues, our suggested "line to take" - my Annex C - needs no amendment, though the second question addressed in it will not arise in precisely the form suggested, given that the "Chairman's Draft Report" no longer suggests that over-valuation of sterling caused more than half of the rise in unemployment in the UK between 1979 and 1981: instead it comments only that "the over-valuation of sterling was an element in the rise in unemployment". Dr Bray's scepticism about exchange controls, and import controls, may also be worth noting.

On the procedural issues, we shall be taking the line set out on the second page of my letter yesterday. It would of course be inappropriate to comment on differences between the published version and earlier versions of the "Chairman's Draft Report": any such questions are presumably a matter for Mr Du Cann.

The note mentions that Dr Bray apparently still intended, this morning, to hold a press conference later today, in London. I gather that this has now been subsumed in a plan for Mr Shore to hold a press conference on the TCSC report at Transport House this afternoon.

Copies of this letter go to Nick Huxtable in the Lord President's office, Murdo MacLean at No 12, Alex Galloway in the Paymaster General's office, and Richard Hatfield in the Cabinet Office.

Yours ever,
John Kerr

J O KERR

wh
28/5

FROM: J O KERR
DATE: 24 May 1983

MR RIDLEY

cc Mr Peretz
Mr Allen
Mr Hall
Mr Hague
Mr Scholar: No 10

TCSC/IMA

... I attach the text of a press release by the Economic Secretary put out tonight by Conservative Central Office.

JOK.

J O KERR

I suppose we shouldn't be surprised, after the desperate muck-raking of the past few days, that Mr Shore should contrive to pluck two straws and try to make of them a dunghill. But it doesn't say much for the numeracy of a man who is promoted as the Labour Shadow Chancellor.

A draft report prepared by some anonymous adviser for the House of Commons Treasury Select Committee makes a fairly crude comparison between the growth of unemployment in Britain and other countries up to last autumn, and comments that "something under half the rise in British unemployment may be plausibly ascribed to the world recession". It thereby ignores the fact - which it is hard to believe the Committee would have failed to note had it had the time to scrutinise what was put out in its name - that in a country such as Germany, with a far stronger economic inheritance than ours, the percentage growth of unemployment has been worse than Britain.

It demeans debate to claim that the draft put to the Select Committee attributed the rest of the rise in unemployment to any actions of the present Government. In fact it didn't even discuss the matter. Even in this anonymous commentary there is no word which remotely lends support to that proposition. It could not be otherwise. For the sad truth of the matter is that between 1975 and 1980 wage costs per unit of output rose by a half in Canada, a third in the US, a sixth in Germany - and not at all in Japan. In Britain they doubled. That was Labour's legacy: and that is where responsibility lies. Mr Shore and his colleagues may not like their progeny. But they cannot plead a Commons Select Committee in extenuation.

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

23 May 1983

cc PS/GST
PS/FST
PS/EST
Mr Middleton
Mr Littler
Mr Lavelle
Mr Ridley
Mr Kemp
Mr Peretz
Mr Hall
Mr Norgrove

Michael Scholar Esq.
10 Downing Street
LONDON
SW1

Dear Michael,

TREASURY COMMITTEE REPORT ON INTERNATIONAL MONETARY ARRANGEMENTS

You will recall that Cabinet on 12 May discussed the possible publication of the outstanding Report by the Treasury and Civil Service Committee (TCSC) on International Monetary Arrangements (IMA). Nick Huxtable's letter of 19 May to Willie Rickett reported on subsequent action by the Lord President.

Our understanding is that a Report on IMA will be published on Tuesday 24 May, and that it will consist of a 1½ page note simply saying that the Committee have been unable to finish their work, that they have not agreed to any final Report, and that there were likely to be disagreements over some difficult areas. However, two Annexes will be attached: first, the draft of the full Report which the Committee had been discussing, in approximately the state which it had reached when work stopped; and, second, a rival version of certain sections, prepared by Dr Jeremy Bray, and not discussed in Committee.

We have seen the 1½ page main Report, and I attach a copy (Annex A). But we have not been able to see the Committee's draft Report in the form in which it will be published, because we are told that some last minute changes were made to it by the Chairman; that he is reluctant for the rest of the Committee to know of these in advance; and that he is therefore unwilling to show us a copy. But I attach at Annex B a note of some of the sensitive points in an earlier draft which we did see, and which may or may not have survived. Dr Bray has not allowed us advance sight of any version of his rival sections.

The original plan was for publication of the Report to be accompanied by a Press Notice and Press Conference. Now, however, Mr du Cann apparently intends publication to be extremely low key; no Press Notice, no Press Conference, with the document simply being put on sale by HMSO at 11 a.m. tomorrow. But we gather that Dr Bray may himself wish to issue a Press Statement and/or hold a Press Conference, probably in Scotland where he is campaigning. Perhaps because of this, the dossier could attract some attention. And it is also possible of course, that Dr Bray will suggest, or his Press Conference etc will lead others to suggest, that the Government had thought they were potentially embarrassed by what will be published, and had taken steps to try to suppress or otherwise diminish the effect of the Report.

The line we propose should be taken on this is simply to draw attention to the nature and status of the Report itself. The 1½ page covering document is mere recital, saying nothing of substance. The first Annex is an unagreed draft prepared by an Adviser to the Committee (in fact Professor John Williamson, though we will not volunteer the name), which would not have commanded the full support of all the Committee. And the second Annex is the personal work of Dr Bray, who alone is responsible for it. Thus the Report is really neither here nor there, and there are no agreed conclusions or agreed views on which the Government need take a view.

On the Government's attitude to the Report's publication, the line we shall take is that the Report is that of the Committee, and any question about it or its Annexes, or about its publication, is a matter for the Committee and its Members. The practice of publishing Committee Reports after the dissolution of Parliament is not uncommon; and while the TCSC's decision to publish a Special Report in the form chosen on this occasion is unusual, this is entirely a matter for the Committee and the House authorities.

If pressed, we would add that we had been involved in preliminary stages of this exercise - the Chancellor and officials gave evidence - and have since tried to keep in touch with its progress, but the Report itself and arrangements for its publication are not in any way the Government's responsibility.

Notwithstanding this line, there may still be questions put about Government views on some of the obiter dicta which may be in the drafts. Not having seen the final texts, we have had some difficulty with briefing. We shall be preparing a fuller note as necessary when we see them, and what they say will be reflected as appropriate in the briefing for Williamsburg (our understanding - implausible though it may seem - is that at least some members of the Committee - including, presumably, the Chairman - think that their Report, albeit in its half-baked form, could be an important contribution to the Summit deliberations.) Meanwhile Annex C sets out the line we shall take on one or two matters which came up on the earlier draft which we saw, if they survive.

I am copying this to Nick Huxtable in the Lord President's office, Murdo Maclean at No.12, Alex Galloway in the Paymaster-General's Office and Richard Hatfield in the Cabinet Office.

Yours ever,

John Kerr.

J O KERR
Principal Private Secretary

TCSC SECOND SPECIAL REPORT

INTERNATIONAL MONETARY ARRANGEMENTS

1. The Committee embarked on an enquiry into International Monetary Arrangements in the Spring of 1982. The enquiry is a sequel to the Report on Monetary Policy (Third Report of Session 1980-81), (this followed work by the Expenditure Committee in the previous Parliament (especially the First Report of Session 1978-79)). From the outset the Committee had set itself the task - in addition to its routine work on the Budget, the Public Expenditure White paper and the Autumn Statement and its work on Civil Service matters - of producing major Reports on these two aspects of economic policy, which it was hoped would be regarded by the House as valuable contributions to the public debate on these issues for many years to come.

2. On 15 March 1983 the Committee reported to the House on one aspect of the enquiry - International Lending by Banks; the situation revealed in that Report remains of concern to the Committee. The report was taken into account when the House debated the Second Brandt Report on 18 April.

3. It had been the Committee's intention to make a Report to the House on the remaining aspects of the enquiry (dealing with exchange rates, monetary policy, reserves, and arrangements for international coordination of economic policy) and to publish it in time for its contents to be available before the forthcoming Summit Conference at Williamsburg, at which many of these issues are to be discussed. The early dissolution of Parliament prevented the completion of all stages prior to the presentation of the Report to the House

4. An Annex A is a Draft Report proposed to the Committee for discussion, on which no formal proceedings had begun. At Annex B is an alternative version of Sections IV and V of the Draft Report (arranged in eight sections), which Dr Jeremy Bray had presented to the Committee (again, no consideration had been given to the text by the Committee).

5. The Committee emphasises that no final decisions had been taken on any of the recommendations of the draft Report or on the draft Report as a whole. Some issues might have proved difficult to resolve, including the analysis of past events (e.g. in Section 3 of Annex A) and the proposal that targets for monetary expansion and/or long term interest rates and the exchange rate should be publicly announced and debated by Parliament (see Paragraph 5.11 of Annex A). The Committee nevertheless believes that the text in its present form will prove a useful discussion document in the days leading up to the Williamsburg Conference and beyond. The draft Report is published now - in somewhat unusual circumstances - as part of the process to which this Committee (and the other departmentally-related select committees) have devoted themselves throughout the lifetime of this Parliament of keeping the House informed on the major issues of the day.

ANNEX B

Sensitive passages which may survive in the draft report

a) A central feature of the analysis is the conclusion that over recent years several exchange rates - with sterling as the most notable example - have clearly been "misaligned". "Misalignment" is defined as "a persistent departure of the rate from the equilibrium level of competitiveness".

b) "Overvaluation of sterling" up to 1981 is said to have caused more than half the rise in unemployment since 1979.

c) The analysis of the impact of oil factors on sterling is incomplete; and leads to the conclusion that such factors did not, or need not have been allowed to, influence the rate significantly.

d) The analysis assumes that lower inflation and higher employment are alternatives, not complements.

e) An estimate that a depreciation of approximately 30 per cent relative to the rates of 1981-1982 might be required.

f) A heavily implied conclusion that the Government should have relaxed monetary policy in 1980-1982 to reduce the exchange rate.

g) A recommendation that for the future the Government should have publicly announced joint real exchange rate and monetary (or interest rate) targets.

h) The UK contribution to Williamsburg should be "further" relaxation of both monetary and fiscal policy.

Useful points in the draft report

a) The report accepts that intervention on its own can achieve little other than smoothing.

b) Exchange controls also are only likely to have a limited impact on the rate, and have costs.

c) Protectionism is no answer.

d) The report comes down against moves to regulate the Euromarkets on the grounds that the markets would simply migrate away from London towards unregulated centres.

e) It also comes down against joining the EMS exchange rate mechanism.

Dr Bray's version

We have not seen this at all, but on past form it can be expected to contain a good deal about the inter-national use of policy optimisation techniques. It seems unlikely that even well-informed commentators would be able to make much of this.

ANNEX C

Line to Take on sensitive issues

Sterling was misaligned or overvalued at least until recently.
No-one can ever know for certain the correct long-term equilibrium level of any exchange rate. It will depend on the course of future events, including crucially, the future rate of increase of domestic costs(inflation),and the price of oil - which affects the relative current account position of the UK and countries with the world's other major currencies, the deutschemark, the yen, and dollar. A major cause both of the £'s rise in 1980-81 and subsequent fall, has been shifts in expectations about the future course of world oil prices. During the process of adjustments to such "shocks" many variables such as the exchange rate and competitiveness will not be at their long run equilibrium levels; and any attempt to avoid this would merely create greater misalignment elsewhere in the economy during the adjustment process.

Overvaluation of sterling caused more than half the rise in unemployment.
No. Unemployment has risen more in the UK than other countries over the whole period since 1979 because our problems have been more deep-seated than theirs. If UK wage bargainers had reacted quicker to outside events in 1979-81 - as wage bargainers did in some other countries - then certainly the rise in unemployment here would have been less.

Government should have relaxed monetary policy to reduce the exchange rate.
This would simply have led to faster inflation - and a currency today worth a great deal less than it is. What the Government did do in 1981 was to take action to reduce interest rates by cutting the PSBR.

Should be a joint real or nominal exchange rate and monetary target for the future.
The two would be bound to conflict: which should take priority? The sensible policy is the one the Government has adopted. Performance

of the monetary aggregates is interpreted taking account of the level and movement of the exchange rate. This is a policy very similar to that operated by the Germans (and quoted with approval in the report). It would be wrong to try to turn this into some mechanistic rule. Interpretation of financial conditions and policy must reflect the reasons for exchange rate movements: if the main cause is events abroad, like movements in the dollar or in the oil price, clearly the implication for policy is different than if a rise or fall in the exchange rate reflects excessive financial tightness or laxness at home.

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

23 May 1983

Michael Scholar Esq
10 Downing Street
LONDON SW1

Prime Minister:

A note on the substance of what Mr du Cann proposes should be published is at flag A; a note on the propriety of publication is at flag B.

JT 23/5

This should not come up at tomorrow's press conference - if it does, you can say that you have not seen the draft report - but it may need to be dealt with later in the day. FERB 23.5.

Dear Michael,

TCSC REPORT ON INTERNATIONAL MONETARY ARRANGEMENTS

As the Prime Minister may already be aware, a number of attempts were made by and on behalf of the Chancellor and the Chief Whip, during the last week of the Parliamentary session, to persuade Mr Du Cann that the Treasury and Civil Service Committee should not go off at half-cock, publishing interim draft papers produced during their unfinished enquiry into "International Monetary Arrangements". As my separate and substantive letter today reports, these attempts failed, and a TCSC dossier, which could evoke some controversy, will be published on 24 May. The fact that such attempts were made is of course rather sensitive: it is not therefore mentioned in my substantive letter. But I think that you should be aware of the events listed in the annex to this letter.

A common feature in most of the discussions with Mr Du Cann was that he claimed fully to understand the undesirability of publishing before the Election a document on which Opposition Parties might seize during the campaign. He gave frequent assurances that the danger would be defused, and it may be that he has so arranged matters, by late amendments to the "draft report" which neither Ministers nor the members of his committee have seen. But it was a cause of some concern to the Chancellor that the decision on 11 May to publish a dossier of sorts, despite a contrary decision on 10 May, appeared to be reached on Mr Du Cann's initiative.

I am sending a copy of this letter only to Murdo MacLean at No 12.

Yours ever,

John Kerr

J O KERR

MONDAY 9 MAY: Treasury officials report to Ministers on first draft of part of Report (no recommendations), received pm on 6 May.

TUESDAY 10 MAY:

i. Treasury officials forward to TCSC extenstive "factual" criticisms/comments on draft.

ii. Chief Whip points out to TCSC Chairman undesirability of publication pre-Election

iii. Chancellor conveys same message to Higgins

iv. TCSC meet, and agree that Report should lapse. Chairman confirms this to Whips (Goodlad).

v. Further meeting of TCSC convened, very late, for Wednesday 11 May.

WEDNESDAY 11 MAY:

i. Whips (Goodlad) speaks again to Chairman

ii. TCSC meets (without Shepherd, Browne who have not been informed) reverses engines and agree to publish, on 24 May, a draft of the Report, under a special report saying that they believe "The draft's main thrust .... represents the general line the Committee would have taken if time had permitted it to complete its work."

iii. News of outcome of 11 May meeting reaches Treasury officials who report to Chancellor

THURSDAY 12 MAY:

i. Discussion in Cabinet

ii. Chancellor speaks (twice) to Chairman, and further message sent via Whips urging no publication pre-Election

iii. Text of Special Report reaches Treasury officials who report to Chancellor

iv. Chancellor sends further message to Chairman via Whips (Goodlad) (a) confirming that he continues to see objection to release of draft on 24 May, and (b) objecting also to wording of covering Special Report, and suggesting changes.

FRIDAY 13 MAY:

i. Chancellor's office negotiate with Chairman, who (a) agrees to drop proposed press release and press conference on 24 May (b) agrees to all proposed changes to wording of Special Report (including dropping of suggestion that the main thrust of the draft would have commanded the Committee's support), but (c) refuses to contemplate postponement of release of texts beyond 24 May, arguing that Opposition Members would create an immediate political furore.

NB. Treasury Ministers and officials have still seen no complete version of the draft to be released on 24 May. Nor have Committee members; chairman is thought to have made changes to the version discussed on 10 and 11 May.

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WR/ await information* from Ch/Ex's office about talk with Du Cann MLS 20/5

*promised for 23/5

PRIVY COUNCIL OFFICE

WHITEHALL, LONDON SW1A 2AT

19 May 1983

Dear Willie

REPORT OF THE TREASURY AND CIVIL SERVICE SELECT COMMITTEE(TCSC): INTERNATIONAL MONETARY ARRANGEMENTS

Following the discussion in Cabinet last week concerning the above, the Lord President invited the Clerk of the House of Commons and the Clerk to the Treasury and Civil Service Select Committee to call on him at their earliest convenience in order to establish precisely the rules of procedure governing the issue and publication of Select Committee Reports and Draft Reports. The meeting took place at 12.20 pm.

The Lord President first requested the Clerk of the House to comment on the propriety of publishing Select Committee Reports during the period of Dissolution. The Clerk explained that this was an entirely proper procedure and one which had been followed on many previous occasions. As soon as a Select Committee reported to the House, the Committee's Report was ordered to be printed. In the case of the Treasury and Civil Service Select Committee's Report on International Monetary Arrangements, the Committee had agreed that a Special Report, incorporating a Chairman's Draft Report at Annex 1 and a Minority Report at Annex 2, should be made to the House. This was done on Wednesday, 11 May and, in accordance with established practice,the Report was ordered by the House to be printed (I attach an extract of the relevant part of the Votes and Proceedings for 11 May). No formal proceedings on the floor of the House were involved, since all Select Committee Reports to the House are dealt with as "book entries" and have been so dealt with for a very long time. On further questioning, the Clerk of the House agreed that the House could always overturn the Order to print, but this would require a debatable Motion to be put down by the Government. As only one day of the Parliament remained, the tabling of such a Motion for debate on the Friday morning would attract very great interest. This avenue was not pursued further, since the Lord President judged that it would draw undesirable attention to the Government's wish to postpone publication of the Select Committee's Report.

W F S Rickett Esq
Private Secretary
10 Downing Street
London SW1

.../...

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On the question of the timing of publication of Select Committee Reports, the Clerk of the House explained that once the House had ordered a Report to be printed, then the date of publication was a matter for the Select Committee concerned: the Clerk followed the Select Committee's instructions, subject only to the constraint on timing imposed by the need to print the Report. In the case of the Report in question, the Select Committee had instructed its Clerk to arrange publication shortly before the date of the Williamsburg Summit, since the Select Committee took the view that the contents of their Report were relevant to the matters likely to be discussed at the Summit. Pressed further on this point, the Clerk of the House agreed that dates of publication could of course be changed if the Chairman of the Select Committee were to inform the Clerk that the Select Committee had agreed on new instructions: the date of publication was entirely a matter for the Select Committee.

The question of making Special or Draft Reports to the House was then raised. The Clerk of the House said that a Select Committee was empowered to make Reports and that the form and title of such Reports were determined entirely by the Select Committee concerned. In this case, the Select Committee had decided to describe their Report as a Special Report and that it should comprise a Chairman's Draft Report plus a Minority Report, presumably because of lack of time to complete the usual paragraph-by-paragraph revision before Dissolution. But the House Authorities had no locus in determining the form or title of a Report, since the House itself had established no rules to qualify the power of a Select Committee to make Reports. Although the decision of the TCSC to make a Special Report in the form agreed was unusual, nothing was involved that might be deemed improper in a procedural sense.

Following his meeting with the Clerk of the House the Lord President reported the position to the Chancellor of the Exchequer. I understand that the Chancellor's intention was subsequently to discuss the position with the Chairman of the TCSC, Mr du Cann, in the light of the procedural position reported by the Lord President.

I am copying this letter to John Kerr (Chancellor of the Exchequer's office), Murdo Maclean (Chief Whip's office) and to Richard Hatfield (Sir Robert Armstrong's office).

Yours ever

Nick Huxtable

N P M HUXTABLE
Private Secretary

16 Treasury and Civil Service,—Mr Edward du Cann reported from the Treasury and Civil Service Committee, That it had agreed to a Special Report, which it had directed him to make to the House: And the Report was brought up and read (Second Special Report) [International Monetary Arrangements].

Report to lie upon the Table; and to be printed [No. 385].

17 Treasury and Civil Service,—Mr Edward du Cann reported from the Treasury and Civil Service Committee, That it had agreed to a Special Report, which it had directed him to make to the House: And the Report was brought up and read (Third Special Report) [The Structure of Personal Income Taxation and Income Support].

Report to lie upon the Table; and to be printed [No. 386].

Minutes of Proceedings of the Committee relating to the Report from the Sub-Committee to be printed [No. 386].

18 Treasury and Civil Service,—Mr Edward du Cann reported from the Treasury and Civil Service Committee, That it had directed him to report Appendices to the Minutes of Evidence taken before it.

Appendices to lie upon the Table; and to be printed [21-iv].

19 Treasury and Civil Service,—Mr Edward du Cann reported from the Treasury and Civil Service Committee, That it had directed him to report Appendices to the Minutes of Evidence taken before its Sub-Committee.

Appendices to lie upon the Table; and to be printed [20-II].

20 Welsh Affairs,—Mr Donald Anderson reported from the Committee on Welsh Affairs, That it had agreed to a Special Report, which it had directed him to make to the House: And the Report was brought up and read (First Special Report).

Report to lie upon the Table; and to be printed [No. 377].

21 Welsh Affairs,—Mr Donald Anderson reported from the Committee on Welsh Affairs, That it had directed him to report Memoranda laid before it.

Memoranda to lie upon the Table.

22 Welsh Affairs,—Mr Donald Anderson reported from the Committee on Welsh Affairs, That it had directed him to report Appendices to the Minutes of Evidence taken before it.

Appendices to the Minutes of Evidence to lie upon the Table; and to be printed [No. 61-x].

23 Message from the Lords,—A Message was brought from the Lords as follows:

The Lords have agreed to the Solvent Abuse (Scotland) Bill, without Amendment.

Private Bills (Suspension),—The Lords communicate that they have made the following Orders, viz.:

(1) That the promoters of every Private Bill which shall have been introduced into or presented to this House in the present Session of Parliament, shall have leave to introduce or present the same in the next Session of Parliament, provided that notice of their intention to do so be lodged in the Private Bill Office not later than Noon on the last sitting day of the present Session; and provided that all fees due by them thereon, up to that period, be paid;

CONFIDENTIAL

~~Await comments from A.W.~~

✓ AW A

PA
MCS 3/6

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

18 May 1983

M C Scholar Esq
Prime Minister's Office
10 Downing Street
LONDON SW1

Dear Michael,

CLAUSE 90 OF THE FINANCE BILL

You wrote to me on ~~4 May~~ 29 April asking for a note on Clause 90 of the Finance Bill for the Prime Minister.

... I now enclose a note setting out the background to this clause and discussing the particular issues of concern to the Prime Minister.

Yours,

Judith

MISS J C SIMPSON
Private Secretary

CLAUSE 90 OF THE FINANCE BILL

1. The Prime Minister asked for a note on this clause.

Background

2. Development Land Tax is charged when a disposal of land results in a realisation of development value. Residents outside the United Kingdom as well as residents here are liable. A foreign court will not however enforce a claim to United Kingdom tax so in practice someone who is outside the jurisdiction can ignore such a claim with impunity.

3. To meet this problem a purchaser of development land from a non-resident vendor has been required since the inception of the tax, and subject to the let-outs mentioned below, to withhold 50% of the purchase price and remit it to the Revenue. If the amount withheld is more than the ultimate liability the balance is repaid with interest; if it is too little the Revenue have to take their chance in collecting any extra that is due.

4. There are a number of let-outs from the requirement to deduct tax:-

(i) the vendor may seek the agreement of the Revenue that there should be no deduction, or that the deduction should be less than 50%. Applications of this nature are always given high priority; and

(ii) there is no requirement to make a deduction if -

(a) the consideration does not exceed £50,000 (under the previous Government £10,000);

(b) the property is a dwelling house and the consideration does not exceed £25,000 (this has been effectively swept up under the previous head); or

(c) the land is not development land, ie there is no unused planning permission in force.

5. The weaknesses in the existing provisions have led to a loss of tax of about £5 million so far, which is not insignificant compared to the total yield of DLT of some £110 million over the six years of its life. The great bulk of the losses are not in fact due to foreign investors but to overseas subsidiaries of ultimate UK taxpayers.

Clause 90

6. Clause 90, which did not impose any new liability to tax, but sought to make the collection procedure simpler and more evasion-proof,

(a) Increased the exemption limit for private dwelling houses from £25,000 to £150,000;

(b) reduced the normal rate of deduction from 50% to 40%;

(c) but improved the machinery for collecting the tax which is due under the existing law, by extending the scope of the requirement to deduct tax to include disposals of land other than development land. The new rules should be simpler than the old ones and easier for solicitors to apply, and the Law Society have agreed with this.

The Prime Minister's Questions

7. The Prime Minister asks first whether the clause would introduce new risks into lending on mortgage security. In a

theoretical way the present provision can throw up some such risk. But in practice there have been no cases which have given rise to any difficulty in the past, and there seems no reason why such cases should now arise. But in view of the Prime Minister's query, the details are being looked at again to see if there is scope for removing any such risk, however theoretical it may be.

8. Second, the Prime Minister asks if the clause would make inward investment less attractive. The answer must be no, unless foreigners were only investing in this country on the assumption that they could avoid their UK tax liabilities. In any case, as stated in paragraph 5 above, in the large majority of problem cases, the underlying taxpayer is a United Kingdom resident rather than a genuine foreigner who has purchased property here as an investment.

9. DLT generally is a tax that we intend to look at again after the Election.

Recd Pd,
Budget #11

Prime Minister

MJS 18/5

Budget

Treasury Chambers, Parliament Street, SW1P 3AG

Caroline Varley
Private Secretary to the
Secretary of State
Department of Industry
Ashdown House
123 Victoria Street
London SW1E 6RB

18 May 1983

Dear Caroline

FINANCE BILL

I attach as requested a table showing the increase in taxation married people would face at various levels of earnings if the existing Finance Act was to stand and the original Budget proposals were not re-introduced.

Copies of this go to Private Secretaries to the Prime Minister and Paymaster General.

Yours sincerely

John Gieve

JOHN GIEVE
Private Secretary

MARRIED

Multiples of average earnings	Income tax as a % of Income: 83/84 Budget	83/84 Opposition Amendment	82-83	Increase in tax due 83-84 Opposition Amendment/ 83/84 Budget: £/per wk	£/per year
2x (about £17,000)	25.6	26.6	26.6	2.36	122.72
3x (about £25,000)	32.1	33.7	33.3	8.07	419.64
5x (about £42,000)	41.4	43.2	42.7	15.86	824.72
Higher Rate Threshold (about 17,500)	25.1	26.2	27.0	3.46	179.92
60% Threshold (about 39,000)	38.5	40.6	41.2	15.86	824.72
IIS £7100 and upwards	18.2	20.0	21.5	2.46	127.92

(e) PAYE - EFFECT OF "CLAWBACK" ON TAX BILLS

The amendment contains a 'PAYE saving" provision so that PAYE can continue to be operated according to the original Budget proposals up to [31 August]. If when that date comes, the opposition's higher rate thresholds have to be put into effect and PAYE were restored to the cumulative basis straightaway, higher rate taxpayers would find massive increases in the tax deducted from their September pay as compared with the deductions due under the Budget proposals

- on 2 average earnings - about £60 for the married taxpayer and some £10 a month more in later months
- on 3 average earnings - over £200 and nearly £35 a month in later months
- on 5 average earnings - over £400 and nearly £70 a month in later months

If PAYE were not restored to the cumulative basis straightaway, these taxpayers would instead be faced with a similar sized underpayment at the end of the year

DEVELOPMENT OF TAX BURDEN SINCE 1978-79

A Factual

Since 1978-79 total taxes have risen from 34½% of GDP to an expected 39¼% in 1982-83. Estimates of the effects of tax increases on typical households at various earnings levels were given in recent answers to Jack Straw, MP[1]. The table at Annex A picks out some main points: it shows that the percentage of income taken in income tax and NIC (together) will have risen by next year (compared with 1978/79) for every household type and earnings level except those above three to four times average earnings with a tendency for larger proportionate increases for the lower paid.

2. Taxes are only one part of the picture. Average earnings in 1982-83 are expected to be some 69½% higher than in 1978-79 compared with an increase in retail prices of 64½%. Thus, even when account is taken of tax increases, disposable income after income tax and NIC will have risen faster than prices (which include the effects of indirect tax increases) for households - other than two-earner households - at and above average earnings.

3. For the larger number of households, however, those with incomes below average earnings (and two-earner households below twice average earnings), real disposable incomes may well be lower next year than they were in 1978-79, assuming that earnings grow as projected by the Government Actuary (by about 7½%) and prices rise in line with projections in the FSBR (by 9%). For instance the real disposable income of the representative 2 earner household on 75% average earnings is expected to be about 3¼% lower in 1982-83 than in 1978-79, in spite of the above-indexation of the personal allowances in the Budget. Similarly, the single adult on one-half average earnings will find himself about 2½% worse off next year than in 1978-79. On the other hand, because of the upratings over recent years of FIS and child benefit in

line and in some years more than in line with inflation the couple with two children on one-half average earnings who claim FIS will be very slightly better off (¼%) next year than they were in 1978-79.

4. Comparing 1982/83 with this year, the increase in the NIC rate announced last December will lead to income tax and NIC's taken together accounting for a higher proportion of most households gross income in the coming year than this year. Only those tax payers at the very bottom and top of the income range - married men with less than one-half average earnings and single adults with less than one-third average earnings on the one hand, and households with incomes over twice average earnings on the other - will see their direct tax burden reduced. This, combined with the assumption of falling real gross earnings over the coming year, will mean falling real disposable incomes in 1982/83 for all households types at virtually all income levels (up to an including five times average earnings).

B. Positive

Income tax burden lower for nearly all households next year than it would have been under strict legislative indexation of allowances.

2. More honest to raise taxes to finance higher expenditure than to increase borrowing. If taxes had not risen result would have been higher interest rates and/or higher inflation. Real villain of piece excessive wage increases (20% between 1979-80 and 1980-81).

C. Defensive

Tax burden has risen since 1978-9?

Essential to pursue responsible policy towards money supply and Government borrowing. Average earnings will have risen about 70% between 1978-79 and 1982-83. Rise in real earnings has increased tax burden directly (through progressive income tax). Tax increases essential to combat inflation.

Poor getting poorer?

Low-paid with children entitled to benefits such as FIS. When account taken of these and of earnings rises, the real disposable income of the low paid is broadly unchanged. For example, disposable income at half average earnings and retail prices have both risen by 65%.

Low paid paying for the unemployed?

Working population generally has to finance payments of unemployment and other benefits. But it is excessive wage increases that have created the unemployment - so only fair to expect those in work to pay more.

(1) 3rd Dec 1981 H, Vol 14 no 22 cols W 188-192, 17 Feb 1982 Cols W 151-154, 19 Mar 1982 Vol 20 no.81, cols W199-201

1978/79 to 1982/83

	50%	75%	100%	150%	20%
Single	-2.0	-0.2	0.8	1.4	1.8
Married, both working	-0.7	-3.2	-2.4	-0.6	0.4
Married + 2 children	-1.8(1)	-0.5	0.4	1.1	1.5

(1) +0.2 for families claiming FIS in both years.

See also table in Budget Brief F2 'Real Net Incomes"

for comparison of 1982/83 with 1981/82

ANNEX A

GROSS INCOME, AND PERCENTAGE TAKEN IN INCOME TAX AND NIC

	1978/79 Gross Income £ per week	Income Tax and NIC % of gross income(1)	1982/83 Gross Income £ per week	Income Tax and NIC % of gross income(1)	82/83
50% Average Earnings	47.21		80.00		
Single		23.8		27.1	27.5
Married, both earning		6.5		10.4	9.9
Married + 2		12.5		18.6	18.6
75% Average Earnings	70.82		120.00		
Single		29.0		30.6	31.3
Married, both earning		14.4		19.6	19.5
Married + 2		20.8		24.5	24.7
100% Average Earnings	94.42		160.00		
Single		31.7		32.4	33.2
Married, both earning		20.1		24.1	24.3
Married + 2		25.2		27.6	28.0
150% Average Earnings	141.63		240.00		
Single		33.3		33.4	34.2
Married, both earning		26.6		28.7	29.2
Married + 2		28.9		30.1	30.8
200% Average Earnings	188.84		320.00		
Single		33.8		34.7	34.5
Married, both earning		29.8		31.4	31.6
Married + 2		29.9		31.4	31.4

(See overlead for 500% and 700% Average Earnings)

(1) Including child benefit in the case of the family with children; excludes FIS

Constitution: Gross Income & Percentage taken in Income Tax & NIC

	1978/79 Gross Income £ per week	Income Tax and NIC % of gross income(1)	Gross Income £per week	Income Tax and NIC % of gross Income(1)
500% Average earnings	472.10		800.00	
Single		52.6		46.1
Married, both earning		37.6		37.2
Married + 2		49.7		44.3
700% Average earnings	660.94		1120.00	
Single		61.2		50.1
Married, both earning		44.5		41.3
Married + 2		58.9		48.7

(1) Includes child benefit where approriate

1. Taxes as a proportion of GDP at market prices

82/83 39¼%

2. Average earnings increase (82/83) over 78/79

69½% over 78/79

3. RPI increase in same period

64½%

4. Taking account of FIS, Child Benefit, real disposable income of low paid broadly unchanged eg. disposable income at half average earnings has risen by 65% compared with RPI increase of 64½%.

SUBJECT

cc MASTER.

CONFIDENTIAL

BF

cc: CSO, HMT
CWO
DOE

File

10 DOWNING STREET

CC ELECTION: The General Election 1983

From the Private Secretary

11 May 1983

NEGOTIATIONS ON THE FINANCE BILL

The Prime Minister held a meeting yesterday evening to consider how to resolve the impasse which had arisen in the negotiations between the Government and the Opposition about the Finance Bill. The Lord President of the Council, the Chief Secretary, the Chief Whip and Mr. Gow were also present.

The Chief Secretary said that the Opposition were making it a condition of their agreement to facilitate the whole of the Finance Bill that the Government should drop three clauses granting concessions on Capital Transfer Tax, raising the higher tax rate thresholds, and raising the mortgage interest relief ceiling to £30,000.

After a short discussion, the Prime Minister said that it was agreed that these reliefs could be dropped in order to secure the Opposition's co-operation on the remainder of the Finance Bill. The alternative course, to vote down the Opposition's demands, would have too damaging an effect on the rest of the negotiation. Besides, the Opposition's attitude was likely to harm them in electoral terms, given the sizeable number of people who stood to benefit from these reliefs. The Government should make it plain that, if returned, it would on the first available day after the Election introduce a Finance Bill No. 2 which would restore these reliefs. For the present, the aim should be to place the responsibility for withdrawing these tax reliefs squarely upon the Opposition.

I am sending a copy of this letter to John Gieve (Chief Secretary's Office), Murdo Maclean (Chief Whip's Office) and David Edmonds (Department of the Environment).

M. C. SCHOLAR

David Heyhoe, Esq.,
Lord President's Office

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DS

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PLF B SU

bcc: Mr. Walters

10 DOWNING STREET

From the Private Secretary

29 April, 1983

Clause 90 of the Finance Bill

The Prime Minister understands that Clause 90 of the Finance Bill extends considerably the power of the Inland Revenue to deduct 40 per cent from transactions involving land where the disposer has a usual place of abode outside the United Kingdom, and that this power was hitherto restricted to development land and is now extended to all land where the price exceeds £50,000.

BLF The Prime Minister enquires whether this new power introduces new risks into lending on mortgage security in the United Kingdom; and whether it makes inward investment of its property less attractive. The Prime Minister would be grateful for a note on this topic.

M. C. SCHOLAR

Miss Margaret O'Mara,
H.M. Treasury

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RM

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Prime Minister:

Shall I ask the Chancellor what the score is?

MES 27/4

Yes please

PRIME MINISTER

CLAUSE 90 OF THE FINANCE BILL

It may have escaped your notice that this Clause extends very considerably the powers of the Inland Revenue to deduct 40% from transactions involving land where the disposer has a usual place of abode outside the United Kingdom. Hitherto this power was restricted to development land. Now it is extended to all land, where the price exceeds £50,000.

This will:

i. introduce risks into lending of money on mortgage security in the United Kingdom, especially when there is a chance that the owner is likely to live abroad;

ii. make inward investment into UK property unattractive, including such desirable investment as, for example, Japanese manufacturers acquiring commercial sites, or Greek shipowners buying houses or offices; and

iii. give the Inland Revenue considerable discretion to control by regulation the sale of land in the UK.

It is very odd indeed that the extension of the 40% deduction should be applied under conditions where there has been a very considerable collapse in the price of land. And in any case they are subject to the normal levy on capital gains and income. Doubtless it will be argued that the deducted 40% can be reclaimed after the usual delays and paper work from the Inland Revenue. True, perhaps, but the new clause smacks of the presumption of guilt. And in any case we have ample evidence of the fact that deduction at source, irrespective of liability, does greatly inhibit capital flows and trade.

AW

ALAN WALTERS
27 April 1983

CONFIDENTIAL

Prime Minister 2

MCS 17/3

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

17 March 1983

The Rt. Hon. Margaret Thatcher MP
Prime Minister

Dear Margaret

As you know, last year's Finance Act introduced new arrangements for giving tax relief for mortgage interest, which take effect in April. The change is entirely an administrative one, but it is nonetheless important. Most people with mortgages will come within the new scheme, and it will simplify the way in which they get their tax relief. It will also make a significant contribution to our drive for manpower savings in the Civil Service.

A first round of publicity about the scheme is already under way, and there will be a second round in April when the scheme comes into operation. As the change may give rise to enquiries from Members' constituents, Nicholas Ridley is writing to all Members to give them some explanatory notes about the new scheme. You may find it helpful to have the enclosed copy of his letter and enclosure, in case points are raised with you by constituents or on other occasions.

In the context of the Budget I am concerned to ensure that, so far as possible, there is no confusion in the minds of the five-six million owner-occupiers concerned. On the one hand, the effects of the new scheme will be to reduce net pay (from the first pay day on or following 6 April) because the tax relief due will be given direct by deduction from the mortgage payments rather than through PAYE. On the other hand, there will be improvements in net pay as a result of my Budget. The effects of the latter will be felt in pay packets rather later - on the first pay day after 10 May. The main risk therefore is that some people might think that the reduction in net pay as a result of the new mortgage interest relief scheme had something to do with the Budget. The publicity campaign in early April referred to above, as well as publicity on the Budget measures themselves, is designed to minimise this risk. But I thought you might like to be aware of the point, as it underlines the need to get the message on the new scheme over as clearly as possible.

We have, of course, spoken about this

Yours ever

Geoffrey

GEOFFREY HOWE

PART 10 ends:-

DHSS Press Release 15/3/83

PART 11 begins:-

Ch/Ex to PM 17/3/83