

W. R.

Orig. Defence May 79  
Budget.

SECRET

from P. 6

PRIME MINISTER

MEETING WITH THE CHANCELLOR: THURSDAY 13 DECEMBER

The following issues are likely to be raised by the Chancellor:

(i) Public Expenditure

There is the note he sent you about defence expenditure (Flag A) on which Robert Armstrong commented at length. You will presumably want to persuade the Chancellor not to make a pitch in Cabinet against the defence spending volume figures. We are likely to have enough trouble getting Mr. Pym to agree the cash limits. There is also a note which came today (Flag B) on the other main options for spending cuts.

(Robert Armstrong's note on handling of bilateral  
on 'the chamber' is at Flag F).

(ii) Capital Taxation

There is a minute at Flag C in which the Chancellor sets out his provisional proposals - these involve abolishing the investment income surcharge altogether, and significantly reducing the burden of capital gains tax and capital transfer tax. You won't have time to discuss this in detail tomorrow. You might prefer to set up a meeting with one or two other Ministers - for example Mr. Nott and Sir Keith Joseph because of their interest in the industrial implications, and perhaps the Home Secretary to provide a political steer. The main issue will be whether the Chancellor can afford the whole package which will cost about £600 million. In the light of this afternoon's discussion on small firms, it might for example be better to spend rather less on CPT and spend £50 million on the small firms "start up" scheme.

(iii) Treasury Appointments

A meeting has been arranged for Friday morning with Ian Bancroft and others to discuss this, but the Chancellor wants a preliminary word. (Ian Bancroft's note at Flag E).

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Following your meetings today about the Local Government Bill, you may want to mention to the Chancellor the capital controls issue. Mr. Heseltine told you that his full package would be saleable, but that the aspects which the local authorities most wanted could not be announced until he and the Treasury (Mr. Lawson) had come to terms over the new arrangements to replace project controls. You told Mr. Heseltine that you would send a message to Mr. Lawson urging the fastest possible progress on this. In practice it might be best to do this by asking the Chancellor to see that work is expedited.

At E this afternoon, it was decided that the Chancellor should look again at the small firms "start up" scheme. But I think there was no suggestion that there should be any announcement before the Budget. I wonder whether the Chancellor should not be pressed to have something ready for an announcement earlier than the Budget. Although implementation would have to await the Finance Bill, this might bring forward decisions by potential investors. And it would be politically helpful. (We did write to the Treasury last month suggesting that an announcement before the Budget would be helpful - see Flag D.)

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More summary  
- June 16.  
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Prime Minister

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The Chancellor with regard to  
with this with you tomorrow.  
The main question in my mind  
is whether we can afford the  
package - and whether  
other things (such as the  
£50 a for small firms start-  
up) might not be better

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PRIME MINISTER

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CAPITAL TAXATION

I don't think you have  
a chance to read this -  
you can  
discuss  
America.

My colleagues and I have been making a very thorough review of the Capital Tax situation and I should be glad of an opportunity to discuss with you our provisional conclusions.

2. In the General Election Manifesto we said:-

"We reject Labour's plans for a Wealth Tax. We shall deal with the most damaging features of the Capital Transfer Tax and Capital Gains Taxes, and propose a simpler and less oppressive system of capital taxation in the longer term." (page 14)

3. We made a start in the June Budget: we raised the threshold for the investment income surcharge (IIS) and made reductions in development land tax. However capital transfer tax (CTT) and capital gains tax (CGT) raised issues that were too complex to be dealt with in the time available. In my Budget Speech I said:-

"I have, therefore, decided that we should not attempt to deal with them in the coming Finance Bill - abbreviated as it is bound to be - but should press ahead with a thorough study, with a view to legislation on these matters at an early date."

4. It was clear then, and it is clear now, that we should want to remove the uncertainties in this field as soon as possible, and I have envisaged the 1980 Budget as the occasion. This assumption has meant that it would be impossible to go through

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a full Green Paper - Select Committee process of consultation; nonetheless we have invited and received submissions from a great many quarters.

5. The main constraint on action is now likely to be the revenue cost - and political difficulty - of a full-scale reform of the capital taxes in a year when tax reliefs will generally be very hard to come by.

6. There are five taxes which are either charged on capital or which are directly related to the ownership of capital. The present yield and manpower requirements are approximately as follows:-

	Yield £m	Staff
(i) Capital Transfer Tax	360	1,235
residual estate duty	25	
(ii) Capital Gains Tax	385	1,050
Individuals	215	Not quantifiable
Companies		
Total	600	
(iii) Investment Income Surcharge	215	300
(iv) Stamp Duties	550	380
(v) Development Land Tax	35	185

7. Much of the damage done by these taxes is caused by their number and by the fact that they interact haphazardly. I have therefore approached our recent review with the aim of eliminating one of them entirely, and I should naturally like to make substantial reductions in the others.

8. Development land tax and stamp duties can be disposed of quickly. In the case of the first I think we should stick to the line set out in "The Right Approach to the Economy" in 1977:

"We accept that capital gains resulting from planning permissions are in a category of their own and require special treatment."



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In the recent Budget we cut the rate and removed the rougher edges of this tax and we may have a little more trimming to do. But in general I think the property development sector will be best served by a spell of fiscal stability, and I said so in my Budget Speech. Stamp duties one would like to reduce - both in house purchase and on investments - but I think this is something to be decided when we have a clearer idea of the budgetary position as a whole.

9. That leaves us with a choice of three taxes for elimination: investment income surcharge, capital transfer tax or capital gains tax. The choice is not an easy one but after examining them exhaustively with Treasury colleagues, I have made up my own mind that it is IIS that should go.

10. Capital transfer tax started out as a sharp political weapon. Since its introduction, however, we have succeeded in having it amended substantially. The tax was represented by 34 sections in the 1975 Finance Act. Subsequent amendments run to 71 sections. Relief for agricultural property now extends to a reduction of 50 per cent in the value brought to assessment, while in the case of business assets the 30 per cent concession introduced in 1976 was extended to 50 per cent in the following year. And, of course, because the reliefs are applied to assessment values, there is an effective reduction in amounts of tax payable averaging some 70 to 75 per cent. Meanwhile numerous reliefs have been introduced for trusts and for the heritage and the rate on lifetime gifts is half that on death over much of the range. We have other improvements in mind (paragraph 14 below). There has been a legacy duty continuously since 1796 and I think we got it about right in "The Right Approach to the Economy" when we said:-

"We would not think it right to remove all restraints on the aggregation and transmission of substantial wealth. It is no part of our aims to encourage the concentration of the country's assets in fewer and fewer hands. We are deeply concerned to enable many more people

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to acquire and transmit property through the reduction of penal imposts on incomes, savings and transfers."

In these circumstances, I do not think that we should today contemplate abolishing CTT, since I do not think there is a sufficiently strong case for any of the alternative forms of 'death duty' to justify the upheaval that would be caused by replacing it.

11. There remains the choice between abolishing CGT and abolishing IIS. We have debated this at length within the Treasury - and indeed with many outsiders.

12. Capital gains tax has operated very unfairly during the recent inflation, and the Inland Revenue have examined the two possible solutions - indexation and tapering - pretty thoroughly. On this basis, our predecessors decided that neither change could be implemented without severely cutting the yield of the tax, while at the same time requiring more staff and so hugely increasing the proportional cost of collection. We have concluded similarly. The yield would be reduced by five-sixths to about £100 million; but we should need an extra 300 staff. Nevertheless I find it difficult to argue that genuine capital gains should be exempt entirely from taxation. Too often they represent the capitalisation of income and I believe we would lay ourselves open to the charge of inviting tax avoidance if we were to remove the tax altogether; the Opposition would almost certainly pledge themselves to reintroduce it. Our suggested solution, therefore, is to raise the CGT threshold very substantially to £5,000 (from £1,000). This allowance would run all the way up the scale. It would not effectively be withdrawn by a marginal provision as at present. This will exempt from the tax about three-quarters of the people now affected by it each year, with a consequent staff saving of 550.

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lower you  
hold the  
asset, the  
less CGT  
you pay.  
P..

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13. That leaves us with abolition of investment income surcharge which can, I believe, be justified on both theoretical and practical grounds. There is, I think, much less case today for levying a higher rate of tax on investment income than on income from earnings. Whereas in the past investment income was deemed to be more secure than earned income, that is no longer the case; inflation has bitten deep into private capital and into the income derived from it. Removal of IIS will be particularly helpful to the elderly, who account for approximately a half of its total yield; it will remove a damaging disincentive to saving and enterprise, and it will remove distortions in the economy. The loss of revenue, at £215 million on a 1979/80 basis, will be rather less than in the case of the other two taxes, but there will be an economy of approximately 300 staff.

14. I now return to our detailed CTT proposals, which will between them save up to 525 staff. These are:-

- (i) to raise the threshold from £25,000 to an indexed £60,000 - or, if we do not index it, to £70,000. This will again reduce the number of individuals affected, by up to three-quarters;
- (ii) to cut the rates at all levels, with a scale running to a top rate of 60 per cent on estates over £2 million;
- (iii) to abandon lifetime cumulation and cumulate gifts for ten years only;
- (iv) to increase the annual exemption from £2,000 to £4,000;
- (v) to give a measure of relief to agricultural landlords.



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In addition, it is essential that we find a way of ensuring that both CGT and CTT are not charged on the same gift at the same time, as sometimes happens now.

15. With all these steps, which will between them very substantially lighten the load, we need not also improve the reliefs for businesses which we persuaded our predecessors to make; as I said in paragraph 10 although expressed as a relief of 50 per cent of the value of the property charged, they do in fact cut the burden by 70 - 75 per cent on average. Peter Walker is content with this approach in relation to farmers where similar considerations apply. But he does want us to give a measure of relief to agricultural landlords, who at the moment do much worse than farmers in many tax respects. I think this is reasonable and that we should put landlords on broadly the same footing as farmers for CTT, bearing in mind the differences between them, and particularly the effect on the tax charge of the lower value that let land commands. We must also look to the commitments we have made on the treatment of forestry and the heritage.

16. The main elements of the package are thus:-

	Full Year Cost	Staff Saving
IIS - abolish altogether	£215 m	300
CGT - exempt the first £5,000 gains in each year (£2,500 for trusts)	£100 m	550
CTT - as in paragraph 14	£265m-£290m depending on threshold	425-525
CGT/CTT overlap - remove year	small	-

*me*  
The full revenue cost of this set of proposals would be about £600 million and the staff saving some 1,300. In the first year only the CTT changes would result in a loss of revenue - some £125 million. The other changes would not affect tax receipts until the following year.

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17. All this can only be provisional at this stage. While I should like to be able to go further in lightening the burden of capital taxes, the budgetary prospect for the next year - and, as far as I can tell, for the year after that as well - does not look like providing much scope for further reductions in the income tax. There must, therefore, for presentational and budgetary reasons be a limit to what can be done about the capital taxes in the 1980 Budget. It is possible that I may not be able to go even as far as I have outlined above.

18. I know you will want to think about this, and you may want to discuss it with two or three of us. In the meantime I have authorised planning and the drafting of legislation to go ahead on the basis I have described.

*G.H.*

(G.H.)

12 December 1979

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