BUDGET - SECRET

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Secretary of State for Industry

PM seen

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer

1 - Chancellor
2 - P.M.
3 - Secretary
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18 May 1979

TOTAL COPIES 7

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Dear Geoffrey.

It may be helpful to you, as you consider the contents of your Budget, to have a note of the industrial priorities as I see them.

It is clear that substantial measures are needed simply to cut PSBR back to an acceptable level in 1979/80 - especially as we are starting some way in to the financial year, and as some of our own first decisions will increase public expenditure.

However, I believe most strongly that we must, in addition to this, make a dramatic beginning to our programme of cutting income tax. This belief is founded on the view that only a major initial package, that will take people's breath away by its very boldness, will stand a chance of making a real change in attitudes on which the whole of our strategy depends.

Moreover, to undertake these two tasks - both of which have to be done in the lifetime of this Parliament - will involve major surgery: we need to get that started now, in a substantial way, with the impetus of the election still strong and backed by a bold set of income tax cuts that are seen as part and parcel of the same process.

I think the scale of what I have in mind may be a good deal more than the public and the press are expecting: I regard that as an advantage. If I illustrate my suggestions with numbers, you will I know appreciate that the figuring and the details are very crude.

I start from the proposition that we must cut the target growth £M3 from the present 8 to 12% for 1979/80 down to 7 to 11%, and announce our intention to set subsequent annual targets progressively lower than that; and that consistent with that approach, we should aim for a PSBR in 1979/80 of no more than £8 billion. Taking account of demand effects and offsetting increases in public expenditure, I imagine you will need to be looking for revenue, disposals or public expenditure savings of at least £2½ billion, simply to meet that objective.

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In addition, I believe we need to implement in this Budget at least the following on income tax cuts:

- abolish all rates above 60%
- reduce the basic rate by 3p
- increase personal allowances by about £150 (in addition to the Rooker Wise amendments) to make a significant contribution to tackling the "poverty gap"
- increase the width of the higher rate bands - say by £1000 for the basic rate band and £500 for each subsequent band.

The cost of these measures, together with the need to cut the PSBR, must add up to something like £5½ billion in 1979/80, to be raised by other means. My suggestions to meet this requirement are as follows:

- something over £2½ billion from public expenditure cuts and disposals taken together. I believe that more can be done on each of these than is currently suggested, and I am sure that we must approach the question of disposals in particular with the utmost vigour. We can make our contribution in the Department of Industry's field, but the lion's share must come from the sale of a substantial part of the BP shareholding.
- A standardised rate of VAT of 15%
- Revalorisation of the specific duties (apart from heavy oil duty and perhaps derv) by the effect of inflation since the 1978 Budget. I do not favour increasing the heavy fuel oil duty in line with inflation: our duty is already virtually the highest in Europe, and I see no point in making our contribution to global energy conservation in a form which burdens our industrial costs. I would also favour reversing the present bias against derv, and a declaration that we intend to maintain a bias in its favour in future on grounds of its relative energy efficiency.
- Double the yield on betting and gaming (though inevitably less on the pools and more on other forms of gambling).
- A 50% surcharge on ACT for two years, which would give additional revenue in year 1 (1979/80), reversed in year 3 (1981/2). I am most conscious that despite, or perhaps because, of the precedent for doing this in 1974, such a step would be heartily disliked by industry especially at a time of pressure on company finance, and that it runs counter to our general policies. I would propose, however, that it should be presented openly and honestly as a one year emergency measure to make possible steps on income tax that will have a most reinvigorating effect on industry and the economy.

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These measures taken together would, I am told, have an RPI effect of nearly 6% before taking into account the beneficial effects of the tighter monetary control; and I am told they might have a demand effect equivalent to a 3% reduction in GDP. If these effects are likely they could prove too repercussive for our general purposes, and my Department is seriously concerned that we might be forced to back-track later in the year. On this I have two comments to make: first, it would obviously be better to substitute for part of those tax increases which have the most RPI and demand impact other methods of raising revenue which have less RPI and demand consequences. I am not competent to judge whether say £500-£700m could be shifted off the VAT increase, for instance, on to a number of individually smaller methods of raising that amount of revenue with less demand and RPI effects. By such means the RPI effect might be limited to 3% or 4% and the demand effect to 2%. If such means could be found I would prefer to use them in addition to a VAT increase which could then be limited to 12½%. I am quite sure, knowing you, that you will have long ago initiated the search for all such means.

Secondly, I am not sure that in estimating the demand effects conventional forecasting methods sufficiently allow for the stimulus of income tax cuts on the scale envisaged.

I believe we should also make a start in reducing capital taxation, and phasing out the investment income surcharge, both of which would be relatively cheap. These are included for convenience - though they are by no means wholly small firms measures - in the attached annex about small firms taxation.

Finally, I hope you will feel able to include a group of measures to help small firms. I know you will be under pressure to limit the legislative content of the Budget, given the time available before the Finance Bill must be introduced. David Mitchell has prepared some proposals, which will be familiar to John Biffen from his time as spokesman on small firms matters. I have suggested in the annex to this letter a number of steps which could be taken at once with minimal legislative content - changing rates, thresholds etc - and at limited cost; and a list of further matters to be considered for early action thereafter. I should like to propose that you also include in your statement a reaffirmation of the need to reduce the tax burden on small firms, and an undertaking to review the field thoroughly in the coming months including the best way of securing "tax neutrality" for direct equity investment in small firms. We might then invite officials of the interested departments to undertake such a review, taking into account at the same time the recent Wilson Committee report and the representations being made by various bodies about it, to which we shall have to respond in due course.

I shall be happy to discuss these suggestions with you if that would be helpful. In view of the importance of the subject, I am copying this letter to the Prime Minister.

Ever, Keith

ANNEX

SMALL FIRMS PROPOSALS

A. Proposals for the Budget

1 i) A significant rise in the lower and upper limits for the small companies rate of corporation tax and for marginal relief to say, £100,000 and £150,000.

ii) An extension of the period over which first year allowances can be carried back from 3 years to 5 years.

iii) A commitment to phase out the investment income surcharge over a period of 2/3 years.

iv) An extension of the period during which interest on loans taken out before 1974, for the purchase of shares and direct investment where the individual spends less than 75% of his time on the affairs of the business, can continue to qualify, from April 1980, pending a review of policy on interest relief generally.

v) An increase in the capital transfer tax threshold, to, say, £50,000, the starting point of each taxable band and the annual exemption, to, say, £5,000.

vi) An increase in the VAT registration limit to the maximum permitted under the EEC directive, £11,500.

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vii) A reduction in the rate of development land tax to, say, 50 per cent, making clear that there will be no further downward movement.

viii) The introduction of comprehensive VAT relief for bad debts.

ix) The writing-off of deferred tax liabilities arising from stock relief, but at a faster rate for unincorporated businesses.

x) A commitment to review the conditions attached to the issue of 714 certificates to sub-contractors in the construction industry.

xi) No further relaxation of the thresholds for apportionment of the income of a close company without consultation.

B. Proposals for further consideration

2 i) The introduction of tax reliefs for equity investment in small companies.



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ii) A reduction of the restrictions on the amounts that self-employed individuals can set aside for pension arrangements and deduct for tax purposes.

iii) An examination of ways in which the capital transfer tax burden can be reduced further to enable successful small firms to be passed intact to the next generation.

iv) Further changes to the Capital Gains Tax Code to ensure it adequately takes account of inflation.

v) A general examination of the effect of the present corporation tax system on small companies.

15 May 1979