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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 stance

M

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		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.