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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

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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.

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21 February 1984