CONFIDENTIAL

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

14 March, 1980

Dear Keith

INTERIM REPORT OF THE WORKING GROUP
ON TAX AND SAVINGS

As you know, a Working Group of officials has been looking at various tax reliefs in the savings field. The Departments represented on the group, apart from the Treasury, were the Inland Revenue, the CPRS and the Bank of England. They have produced an interim report which I attach. Before completion it was discussed with a wider group including the Departments of Industry, Trade, Health and Social Security and the Civil Service Department.

The report considers in particular the existing tax reliefs for institutional investment (savings through life assurance and superannuation funds), along with the case for introducing new reliefs to encourage direct personal investment in equities.

I have been thinking about how the issues discussed in the report should be taken forward. First, I should like to expand the membership of the group to include officials from your Department and the Department of Trade. Second, it seems to me that there are some issues, for example how we might encourage direct personal investment in equities, on which it would be desirable to associate outside experts with the work of the group. In that way we should inject some first hand experience of the workings of the capital markets.

If you agree with this approach, perhaps you and I and John Nott could consider who should be invited to join the group. I am copying this letter plus attachments to the other members of E Committee and to Sir Kenneth Berrill.

Yours ever

Geoffrey

(GEOFFREY HOWE)

The Rt. Hon. Sir Keith Joseph, MP

CONFIDENTIAL

Econ Pol. JS

10 DOWNING STREET

From the Private Secretary

31 March 1980

Dear John.

INTERIM REPORT OF THE WORKING GROUP ON TAX AND SAVINGS

The Prime Minister has now had an opportunity to read the Chancellor's letter of 14 March and the officials' report which he enclosed with it. She has also seen the letter of 24 March from the Secretary of State for the Environment and the letter of 25 March from the Secretary of State for Industry.

The Prime Minister thinks the idea of a further study involving outside experts is a good one. She feels, however, that it is important to get the terms of reference right and that it would not be appropriate for such a group to cover the whole area within the scope of the existing Working Group.

The Prime Minister suggests that the new group with outsiders should consider the case for tax changes to encourage personal investment direct in equities rather than through the institutions. It should look in greater depth than the Interim Report both at the case for reducing existing tax reliefs for institutions and at the possibility of new reliefs for individuals on the lines of the Loi Monory.

At the same time, the Interim Report touches on - but does not examine in any depth - the question of whether the present tax relief biasses savings away from investment in productive assets towards investment in assets like gilts, chattels and housing. Further consideration of these sensitive issues would not be appropriate for a group involving outsiders. But the issues are of great importance if the regeneration of British industry is to be given top priority. The Prime Minister suggests that a parallel official group should examine the contents of any biasses in the existing system and consider what could be done to remove them over a period of years. This group would include the Department of the Environment as well as the Departments mentioned by the Chancellor.

I am sending copies of this letter to the Private Secretaries to members of E Committee, Sir Kenneth Berrill and Sir Robert Armstrong, and to John Hoskyns.

Yours ever.

Tim Lankester.

A.J. Wiggins, Esq.,
HM Treasury.

Prime Minister 3 pps

I don't think you need read all these papers, except possibly the working group's conclusions at Flag B. But I think Ken Berrill's advice below is sensible. Agree I should write?

CONFIDENTIAL

Qa 04986

To: MR LANKESTER

From: SIR KENNETH BERRILL

Yes

Interim Report of the Working Group on Tax and Savings

Flag A

1. On 14 March the Chancellor of the Exchequer circulated to members of E Committee the Interim Report of the Working Group on Tax and Savings. He suggested that the issues should be considered further by an enlarged group including officials from Departments of Industry and Trade and also outside experts, as well as Treasury departments. The CPRS would support this recommendation. But we feel it is important to get the terms of reference right and at present the Treasury proposals are rather unspecific.

2. The interim report stems from two concerns of Ministers - first, that the present tax reliefs for savings might be biassed against investment in productive assets and, second, that they might encourage investment via institutional intermediaries rather than by individuals in companies directly. These two aspects are linked but distinct; neither is covered comprehensively in the interim report; and there is a case for continuing the study as two separate exercises.

Direct Investment -v- Investment via Institutions

3. In the case of encouraging direct investment by individuals rather than through institutions the issues to be determined are:

(i) what are the effects of institutional preponderance on the quantity, sectoral distribution and quality of investment?

(ii) what part do tax considerations play in determining the balance between direct and institutional investment?

(iii) should the balance be changed and, if so, should it be by removing existing tax reliefs for institutions or by introducing new reliefs for individuals?

It would be helpful to have the benefit of outside expert advice while not trampling again over all the ground being covered by the Wilson Committee.

Bias against Investment in Productive Areas

4. In the case of the possible bias against productive areas, the issues to be covered are:

(i) do existing tax reliefs encourage investment in assets such as gilts, housing and chattels, rather than equities?

(ii) How strong are the economic and social arguments for retaining the existing preferences?

(iii) If a change is justified should it be by reducing existing tax reliefs for gilts and housing or by introducing new reliefs for equities?

A study on these lines could be very valuable. It can be argued, for example, that partly as a result of distortions caused by tax, Britain is among the best housed nations in Europe while having one of the worst records for investment in industry. The case is set out in greater detail in the Annex. Such a study would, however, be extremely sensitive politically and we assume Ministers would not wish to consult outsiders, at least in the first instance. We therefore suggest that any review by officials of the bias against productive assets had best be conducted separately.

5. If the Prime Minister agrees with this approach she might like to write to the Chancellor of the Exchequer on the lines of the attached draft.

6. I am sending a copy of this minute and the attachment to Sir Robert Armstrong.

KB

27 March 1980

DRAFT MINUTE FROM MR LANKESTER TO THE PRIVATE SECRETARY TO THE CHANCELLOR OF THE EXCHEQUER

INTERIM REPORT OF THE WORKING GROUP ON TAX AND SAVINGS

1. ~~The Prime Minister has seen the Chancellor's letter of 14 March to the Secretary of State for Industry.~~ She thinks the idea of a further study involving outside experts is a good one. She feels, however, that it is important to get the terms of reference right and that it would not be appropriate for such a group to cover the whole area within the scope of the existing Working Group.

2. ~~She~~ The PM suggests that the new group with outsiders should consider the case for tax changes to encourage personal investment direct in equities rather than through the institutions. It should look in greater depth than the Interim Report both at the case for reducing existing tax reliefs for institutions and at the possibility of new reliefs for individuals on the lines of the Loi Monory.

3. At the same time, the Interim Report touches on - but does not examine in any depth - the question of whether the present tax relief biasses savings away from investment in productive assets towards investment in assets like gilts, chattels and housing. Further consideration of these sensitive issues would not be appropriate for a group involving outsiders. But the issues are of great importance if the regeneration of British industry is to be given top priority. The Prime Minister suggests that a parallel official group should examine the contents of any biasses in the existing system and consider what could be done to remove them over a period of

years. This group would include the Department of the Environment as well as the departments mentioned by the Chancellor.

27 March 1980

Att'd: Annex

ANNEX

TAX PREFERENCES FOR GILTS AND HOUSING

GILTS

1. Gilt-edged securities are exempt from capital gains tax provided they are held for more than twelve months. The Exchequer cost of this exemption is not known but is likely to be considerable. However it can be argued that if tax relief were not given the government would have to sell the same amount of stock but at a higher coupon. This might be just as costly. There is nevertheless a case for studying the balance of advantage. If the exemption does have a net public expenditure cost then the implication is that private firms have to offer a more generous return than otherwise in order to compete, thus discouraging investment in equities.

HOUSING

2. Income tax relief on mortgage interest costs the government about £1.5 billion a year and the capital gains tax exemption on principal private residences an amount of similar magnitude. There can be little doubt that these reliefs encourage investment in housing rather than productive assets. No other form of savings can offer tax free capital gains, growth in value at a faster rate than inflation, cheap building society finance subsidised by tax relief, and an asset offering visible social status and rent free living accommodation. This may be one reason why Britain is among the best housed nations in Europe while having one of the worst records for investment in industry. Moreover, the tax preferences distort the housing market. Demand is artificially stimulated

and there is little inducement to use resources economically, for example, by moving to smaller accommodation when children leave home. Excess demand has caused high prices which create barriers for first-time buyers while giving windfall gains to existing owners.

3. On the other hand, the implications for the government's policy of encouraging owner-occupation and the serious political difficulties of adding burdens on the owner-occupier at a time of record interest rates both need to be considered. However, if tax reliefs on owner-occupiers were reduced it might be possible to move faster on removing subsidies for council tenants, thus keeping the relative attractiveness of the two forms of tenure unchanged. And even if immediate action is ruled out, changes might become feasible in a year or so's time if interest rates come down.

27 March 1980

27 MAR 1980

JU

2 pps cc AD

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 3301
SWITCHBOARD 01-212 7676

Secretary of State for Industry

25 March 1980

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London SW1P 3AG

Dear Geoffrey.

Thank you for your letter of 14 March attaching the Interim Report of a Working Group of officials on tax and savings. As you say, my officials were consulted at a late stage before completion of this report.

I assume from your letter that you do not propose to take action in the forthcoming Budget on any of the specific points discussed in the report. Although some are of relatively minor importance, others are not, and I think the issues need more fundamental study before we embark on anything of structural nature. For this reason I welcome your proposal for further work in a wider forum. It will be particularly important to ensure that the group focusses on the problems associated with the undesirable preponderance of pension funds as vehicles for savings. Attention will need to be paid to the libertarian and decentralisation arguments, about which both you and I are convinced, for encouraging wider direct share ownership.

I should certainly wish the Department of Industry to be associated with the further work of the group; Ivor Lightman will be our representative. For outside experts, we need a strong advocate of the non-institutional approach to savings; Harold Rose might be a suitable candidate. I imagine you will also want to ensure that the broad interests and expertise of industry, the City and academic economists are also covered. For the first, Alan Lord might either be suitable himself or be able, in his CBI capacity, to suggest suitable names of people in industry with experience of the problems of raising finance from various sources. From the City, you might like to consider the names of Mr Artus of the Prudential and Mr Quartano of the Post Office Superannuation Fund, both of whom are knowledgeable and thoughtful on these questions. I imagine you would find suitable academics among the membership of the Institute of Fiscal Studies, such as Mr Kay and Mr King.

I am sending copies of this letter to other members of the E Committee, to John Hoskyns and to Sir Kenneth Berrill.

Yours ever,
Keith.

cc AD

OW

2 MARSHAM STREET
LONDON SW1P 3EB

My ref:

Your ref:

24 March 1980

Dear Geoffrey

INTERIM REPORT OF THE WORKING GROUP ON TAX AND SAVINGS

I read with interest your letter to Keith Joseph about the interim report of the Working Group on Tax and Savings.

You know my views that we are being too unadventurous in the introduction of accelerator schemes to stimulate small industrial activity and new investment and I therefore welcome your proposal that John Nott and Keith should be involved in taking a closer look at this area.

May I illustrate my concern by drawing to your attention the approach of the report to the Loi Monory Scheme. Paragraphs

38-44 depict the scheme in about as unenthusiastic a way as possible.

The emphasis is on the problems, extra staff, administrative differences between the two countries, high ratio of subsidy in new investment (asserted not demonstrated).

Perhaps I can reproduce the facts of the above paragraphs.

850,000 taxpayers have taken advantage of the scheme. Half are newcomers to the stock exchange. So 425,000 new investors have appeared in this sector of the market.

The maximum allowable amount is £500 per annum. Over 4 years that would be £2,000 for each but assume the average is only half the allowable total (ie £1,000). £425 million investment from new investors in this area. This puts the 1,200 staff at £6,000 each for 4 years at £29 million in perspective.

If the figures assumed in paragraph 42 are taken then the investment of £500 per annum for 1 million people over 4 years is £2 billion. That sort of money invested in areas of the

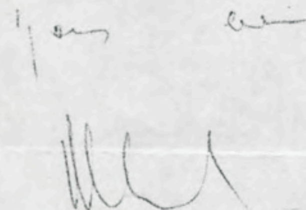
British economy selected by industrial classification should be compared with a total investment in manufacturing industry over the past 4 years of £25 billion in the same prices.

It is asserted that much of the investment would have taken place any way. I would be interested to see the evidence for that.

I also understand that investment in equities often means cash passing from one existing owner to another without new investment in physical assets. The sophistication of the stock exchange in Britain may bring into question the need for a scheme of this sort here.

But I am writing as I have because every time a new approach to stimulating small industrial activity is considered it is dealt with in the same parsimonious and suspicious way. We are experts at saying "No" and even when reluctantly and late we venture into the water it is only to the extent of the most reluctant toe.

I am copying this letter to other members of E Committee and to Sir Kenneth Berrill.



MICHAEL HESELTINE

The Rt Hon Sir Geoffrey Howe MP

25 MAR 1980

CONFIDENTIAL

INTERIM REPORT OF THE WORKING GROUP ON TAXATION AND SAVINGS

This is an interim report of a Working Group under the chairmanship of Mr Littler (latterly Mr Middleton) which has been examining possible changes to the taxation of different forms of savings. The Group has included representatives from the Inland Revenue, Bank of England and CPRS. A draft of the report has also been seen by the CSD, and the Departments of Trade, Industry and Health and Social Security.

2. The report is referred to as an "interim" report because it does not deal with various issues that might be appropriate for a fuller report. These include general questions about the level of total savings (what has been happening to savings? is the level of savings excessive?), a number of conceptual arguments about the tax base (should this be consumption or income?), as well as the examination of certain specific topics -including the taxation of public sector debt, tax relief on interest on borrowing, and the taxation of owner-occupied housing. The Group hopes to consider at least some of these issues in the future.

3. The Group thought that the best way to go about its work was to look at various existing and proposed tax reliefs in the savings field. Priority was given to specific suggestions raised by Ministers (including some proposals put forward in the Hoskyn's exercise) and matters that might be legislated on this year. This report records the Group's preliminary conclusions on

I <u>Institutional Investment</u>

- i. the tax treatment of life assurance premiums and companies;
- ii. the tax treatment of superannuation contributions, funds and payments.

II <u>Personal Investment in Equities</u>

- i. a Loi Monory scheme for encouraging direct equity investment by individuals;
- ii. stamp duty on equities;
- iii. a small savings tax exemption.

4. The Group has also looked at a proposal for changing the tax treatment of the unfranked income of authorised unit trusts. This is the subject of a separate submission.

5. A summary of conclusions is contained at the end of the report. The Group recommends that the rate of tax relief on life assurance premiums should be reduced. On superannuation it suggests that one of the main questions for consideration is whether lump sum superannuation payments should be brought into tax. None of the proposals for encouraging personal investment in equities seemed particularly attractive - though if Ministers favour in principle the idea of a Loi Monory scheme, the Group will be happy to consider it in more detail.

6. A list of papers so far taken by the Group is annexed. Copies of the papers may be obtained from the Secretary on request.

I INSTITUTIONAL INVESTMENT

7. The institutions - primarily the life assurance and superannuation companies - play a major role in the working of the financial markets. They handle savings equivalent to about 5% of GDP (split evenly between life assurance and superannuation business). They are substantial net investors in both company securities (with purchases of around £2½ billion in 1978) and in government stock (with purchases of some £3 billion in 1978). They provide a valuable service to millions of small investors - allowing them to benefit in particular from expert portfolio management, risk spreading and the minimisation of transaction costs.

8. The dominance of the institution in the financial markets depends to some extent at least on the existence of generous tax reliefs for life assurance and superannuation purposes. These reliefs have come under a certain amount of attack in recent years. The general arguments for limiting the reliefs are:

i. the cost. Tax reliefs for life assurance and superannuation are expensive. The cost of life assurance premium relief is expected to be some £425m in 1979/80, while the cost of superannuation reliefs is estimated at £m500 (in the forthcoming Public Expenditure White Paper). This costing rests on the view that, although the combined cost of relief for employees' superannuation contributions and of the exemption for the income of superannuation funds themselves is £m1670 in 1979/80 it would not be possible, if these reliefs were withdrawn, to tax the full amount of the emerging pensions as income. The current yield from tax on pensions is over £1 billion;

ii. fiscal neutrality. It is often argued that, because of the availability of generous tax reliefs, investment in life assurance and superannuation funds constitutes - along with investment in public sector debt and owner-occupied housing - one of the "privileged" forms of savings, in contrast with other types of savings - including investment in equities, bank accounts and building society share accounts - for which no tax reliefs are available. It has been suggested that there is very little justification for the existing pattern of tax reliefs in the savings field, and that there is a need for greater "fiscal neutrality". This could be achieved, in principle, either by "levelling up" (giving new tax reliefs for, say, investment in equities) or "levelling down" (withdrawing tax reliefs for, say, life assurance and superannuation purposes);

iii. reducing the cost of funds for industry. For a given PSBR and monetary target, the total funds available for industry are constrained. The terms on which they are available, however, may depend on institutional channels. It is often argued, for example, that the institutions have a relative preference for gilts, thus making it more difficult and/or more expensive for industry to raise equity finance. It is also argued that they contribute to the small firms equity gap since much of their equity investment is in large "blue chip" companies;

iv. encouraging personal investment in equities. The argument here is that there is a need to increase direct investment by individuals in equities as a way of encouraging a more personal involvement by the investor in the working of industry. The problem is that the institutions now so dominate the equity and money markets that the part played by the individual who invests directly in equities is rapidly becoming overshadowed.

Bearing in mind these points, the Group considered each of the main tax reliefs for life assurance and superannuation purposes to to see whether they could still be justified on their own merits.

The tax treatment of life assurance premiums

9. At present, tax relief is allowable in respect of premiums paid by an individual on a qualifying life assurance policy or deferred annuity contract. There is an overriding limit to the relief of the greater of £1,500 or one-sixth of the individual's total income.

Until 1979, the rate of relief was one-half of basic rate. Since 1979, the rate of relief has been fixed at 17½ per cent. The cost of tax relief on life assurance premiums in 1979-80 is estimated to be £425 million.

10. The historical justification for life assurance relief is that it encourages the individual to save and therefore to make proper provision for dependents in the case of his death. As the Royal Commission on Income Tax, 1920, observed:

> "The distinguishing feature of life assurance, which probably accounts for what would otherwise seem to be an unfair preference /in the allowance of tax relief/, is that by no other means can the less wealthy taxpayer, who has no accumulated capital in his earlier years of productive effort, secure a proper provision for his dependents."

11. It is not clear, however, whether the case for retaining the relief remains good:

i. much of the life assurance business has little to do with genuine life assurance, but is aimed at securing tax relief for short to medium term savings with only a small life assurance element. For example, a typical scheme for a unit linked life assurance fund provides for only 6 to 7 per cent of the gross premiums to be used to provide life assurance for a man aged 40, and for the balance to be used for the purchase of units. In this case, the 17½ per cent tax relief given to the premiums is substantially greater than the total cost of life assurance being purchased;

ii. it is questionable whether it is any longer right to provide a "tax subsidy" for savings for life assurance purposes. These days, dependents are often adequately protected against the death of the breadwinner in the family by the breadwinner's own superannuation arrangements and by the social security system in general;

iii. life assurance is an inefficient way of saving. One reason for this is that the companies are required by law to adopt conservative actuarial practices. A second reason is that the life assurance companies have large expenses (in 1978, for example, expenses and commissions paid by the life companies were £1,400m). One 1978 study suggested that, but for tax relief, investment in building society share accounts had, in recent years, normally been more profitable than saving through a life assurance scheme.

12. There were differences of view with in the Group on the weight that should be attached to those arguments. While a number of members felt that the tax relief should be completely abandoned, it was accepted that it would be difficult to withdraw the relief at one go. The withdrawal of relief would hit those who had recently taken out medium to long term life assurance contracts on the expectation that the availability of relief would continue for at least some years to come. Many of these would be new housebuyers with "endowment-linked" mortgages (at present, about 25% of all new mortgages are endowment mortgages). In the meantime, however, the Group was unanimous in its view that the rate of relief should not be maintained above its traditional level - of one half basic rate. Whether, as a first step, the rate should be reduced to, say, 15% or something less was essentially a Budget matter, and would need to be considered in a Budget context.

13. The Group noted that the life companies would like good notice of any change in the rate of life assurance relief and would object to frequent changes in the rate. There were, for example, 83 million industrial life policies, and each policy would have to be amended manually if the rate of relief were altered.

14. Cutting relief for life assurance premiums to, say, 15% would save about £70m in a full year, while cutting it to 12½ per cent would raise around £140 million. This would probably have some effect on the volume of new business. However, although the life assurance companies are large purchasers of Government debt, it was not thought that reductions in the rate of relief of this magnitude would have a significant effect on the sales of public sector debt.

The taxation of life assurance companies

15. The profits allocated to the shareholders of life assurance companies are taxed at the full rate of 52 per cent. The profits allocated to policyholders, on the other hand, are taxed at a special "pegged rate" of 37½ per cent. Although only a small proportion of the life companies total profits is taxed at 37½%, it has been suggested that this special pegged rate confers an unfair advantage on life assurance companies and therefore gives them an unfair competitive advantage in the market for personal sector savings.

16. The pegged rate of tax was introduced in 1940 to meet the claim of life offices that they had made many long-term contracts on the assumption that pre-war rates of tax on their investment income would continue, and that they could be put in financial difficulties by the burden of wartime tax rates.

17. The Group recognised that there were arguments of principle for both increasing the pegged rate of tax to 52 per cent, and reducing it to, say, 30 per cent. The case for increasing the pegged rate is that such a change would bring the tax treatment of life assurance funds into line with the tax treatment of company profits in general.

18. The case for reducing the pegged rate rests on comparing the position of the man who invests directly in financial assets with the man who invests through a life assurance company. The person investing directly would have to pay income tax (at 30 per cent if he is a basic rate taxpayer) on his income, and capital gains tax on any profit, whereas the person investing through a life assurance company has tax at 37½ per cent paid on the income, while the proceeds of his policy are generally free of tax. Neutrality would demand that they both paid the same rate of tax - 30 per cent - though it would be impossible to fix any single rate of tax on the profits of the life companies which would equate with the varying marginal tax rates of policyholders in general. An argument in favour of a special rate of tax is that life assurance companies are quite different from other companies paying corporation tax, so it is by no means clear that policyholders profits should be taxed at the normal rate of corporation tax. We noted that certain other financial intermediaries (eg building societies and industrial and provident societies) also pay a special concessionary rate of corporation tax.

19. The Group concluded that the arguments of principle did not point clearly either to increasing or to reducing the pegged rate of corporation tax. They noted, however, that the revenue effect of the change either way would be small (probably less than £20 million), and thought that the effects of a change in the pegged rate on life assurance business would be minimal. The conclusion was that there was no good argument for making any changes, so the pegged rate should be left at its present 37½ per cent.

Superannuation arrangements: general

20. Superannuation arrangements enjoy a number of tax reliefs. Both employers' and employees' contributions to approved schemes are (within limits) deductible for both corporation tax and income tax purposes (at a revenue cost, in 1979-80, of around £1860m); the investment income of the superannuation funds is free of tax (at a revenue cost of around £960 million); while (again within limits) lump sum payments to beneficiaries from the superannuation funds are free of tax (at a revenue cost of something less than £200 million). It was explained in para. 8(i) that the cost of each of these reliefs cannot simply be added together to estimate the total cost of relief for superannuation arrangements. Pension payments to beneficiaries are, of course, taxed as earned income.

21. No one in the Group has questioned the deductibility of employers' superannuation contributions for tax purposes. Contributions to approved schemes were regarded as allowable deductions under ordinary profit computational rules.

22. The treatment in the hands of the employee of both employers and employees contributions to approved superannuation schemes is more open to debate. On the one hand, it can be argued that the absence of tax on such contributions is justified and should not be regarded as a "tax subsidy" - that the contributions should be regarded as the "deferred income" of the employee, with the implication that they should not be taxed at the time they are paid in, but only later when the pension is actually received by the beneficiary. This is in line with the treatment of superannuation contributions in nearly all overseas countries. Moreover, it is pointed out that the benefit of belonging to a superannuation scheme is quite different from the benefit received from other types of savings. The employee may have little choice about whether to be a member of the superannuation scheme, and may never receive any benefits. Why tax him, therefore, on his superannuation contributions?

23. On the other hand, it can be argued that income tax relief for superannuation contributions is generous and should properly be regarded as a "tax subsidy". Just because superannuation contributions can be described as deferred income does not, of itself, justify giving tax relief. However, no member of the Group went as far as to suggest that tax relief for superannuation contributions should be withdrawn. It was thought that this particular tax relief was so much a part of people's expectations of the tax system and of their financial planning that to withdraw it would be both disruptive and controversial.

24. The Group thought that, so long as superannuation contributions were exempt from tax, it was right that pension payments to beneficiaries should be taxed as earned income. The Group did not come to any conclusion on how the superannuation funds should be taxed - this was a matter to which they would like to give more thought.

Lump sum superannuation payments

25. In principle the absence of tax on lump sum superannuation payments is an anomaly so long as the contributions financing the payments are relieved. If the payments are to be exempted as being of a capital rather than an income nature, then it is questionable whether tax relief should also be given on the superannuation contributions.

26. One way of restricting relief for lump sum payments would be to deny tax relief to the contributions which finance those payments. One disadvantage with this approach, however, is that it would be difficult to identify the appropriate contributions. A second problem is that it would hit contributory superannuation schemes, but would not affect non-contributory (generally public sector) schemes.

27. Another way of restricting relief for lump sum payments would be to levy some sort of tax on the superannuation funds. But this would leave non-funded schemes at a relative advantage.

28. The more obvious way of restricting relief would be to tax the lump sum payments directly. It is not immediately clear what rate of tax would be appropriate, nor whether there should be a tax threshold below which no tax would be levied. If all the lump sum was taxed at 30 per cent, the revenue gain would be around £200m in a full year.

29. One objection to taxing lump sum payments, however, arises regardless of the way the tax is levied. This is the objection that any change would have a selective effect. The problem arises because about two thirds of all lump sum payments go to those who were previously employed in the public sector - so it would be former public sector employees who would be hit most by any change. This is partly because whereas the right to commute part of a pension into a lump sum is frequently optional in private sector schemes, it is generally obligatory in the public sector. If lump sum payments were brought into tax, there would be strong demands from public sector unions for changes in public sector pension arrangements to bring them into line with arrangements in the private sector (so as to enable beneficiaries to opt for either the lump sum payment or a higher pension). The cost of giving public sector employees the option of retiring on a two thirds pension could rise to around £100 million a year -cutting a large slice in the revenue yield from taxing the lump sum payments.

30. Taxing lump sum payments would be controversial. It would need to be preceeded by widespread consultations both within Whitehall and outside. It would not be a matter for the 1980 Finance Bill. The Group believes it is an issue which might merit further study.

II PERSONAL INVESTMENT IN EQUITIES

31. The arguments for encouraging personal investment in equities are similar to some of those for restricting the scope of tax reliefs for life assurance and superannuation purposes. Tax concessions for personal investment in equities would, for example, promote "fiscal neutrality" (by conferring a tax advantage on one of the "under-privileged" forms of saving), possibly help reduce the cost of funds going to industry, and could well divert funds away from the big institutions. It was argued within the Group, however, that the main reason for encouraging personal investment in equities concerns the merits of involvement - involvement by the population at large in the prosperity of the economy generally, involvement in the prosperity of individual companies, and involvement in the firm for which each individual works.

32. The Group recognised that the most effective way of encouraging more personal investment in equities was by reducing the burden of the investment income surcharge, capital gains tax and capital transfer tax. Possible changes here have been considered in the capital tax review and were not examined by the Group. In considering what equity investment schemes to consider, the Group took note of other work going on in this area. The FASE Group has already looked at two sets of proposals. The first set was designed to encourage greater employee share ownership. They involved extending the 1978 profit-sharing provisions and re-introducing the 1972/73 legislation to give incentives for certain types of share option schemes. The second set of proposals was designed to encourage individuals to invest substantial amounts of money - up to £10,000 or £20,000 - in the equity of small firms. One scheme was designed to give income tax relief on capital losses in equity investment in unquoted trading companies. A second scheme was designed to give income tax relief on funds actually invested in new, small firms. No final decisions on whether these proposals will be implemented have been taken.

33. These proposals are designed to encourage, on the one hand, equity investment in small firms and, on the other hand, equity investment by individuals in their employing company. The Group thought that the next step to consider was some sort of scheme or tax relief which would provide a modest encouragement for individuals generally to purchase shares. The main candidates here are a small savings tax exemption, the introduction in the UK of a Loi Monory scheme, and a cut in the rate of stamp duty on equity transfers. Although the small savings tax exemption would be an incentive for all types of savings - not just investment in equities - it was thought convenient to consider it along with the other schemes for encouraging equity investment.

A small savings tax exemption

34. A small savings tax exemption would give relief, within limits, on the income from a wide range of investments - including, presumably, the income from equities, unit and investment trusts, gilts, building society interest, deposit account interest, NEB ordinary account interest, income from foreign investments, rents etc. A scheme along these lines was suggested by the Financial Secretary at a meeting within the Treasury some time ago. The idea of the scheme would be to give tax relief for, say, the first £250 of investment income as a way of encouraging personal savings and investment. It would not be possible to have both a small savings tax exemption and a Loi Monory Scheme.

35. It is possible that a relief of this nature would encourage some additional savings. Moreover, there would be an administrative saving from not having to assess for tax small incomes from certain types of asset (such as bank accounts) which have to be assessed at present.

36. On the other hand:

i. the cost of an exemption would be high - around £450 million if relief was given on investment income up to £250;

ii. much of the benefit would go to those with investment income above £250. In these cases, the relief would not constitute an incentive for further saving;

iii. there would be a large administrative cost from having to take account for tax purposes of certain types of income which are not assessed for tax at present, or are assessed only to higher rate tax and/or investment income surcharge. This includes income from shares and building society deposits. For example, if, as a result of the scheme, building society interest was paid gross, something like 3 million additional tax returns would have to be issued. This would entail a staff cost of more than 2,000.

37. The Group accepted that the disadvantages of introducing a small savings tax exemption were considerable. They recommend no further action on it.

A Loi Monory scheme

38. The Loi Monory is a French scheme designed to strengthen the Paris Bourse (a much smaller market than the London stock exchange), encourage investment in equities and unit trusts, and improve the gearing of French companies. Under the scheme, income tax relief is given on additional net investment of up to £500 per year in French equities and in French unit trusts provided that a large proportion of their assets comprises French equities. In order to prevent abuse, all qualifying investments (including those held before the relief was introduced) have to be lodged with a bank or other approved intermediary. The relief is clawed back to the extent that there is a net reduction in the individual's equity holdings (assuming the reduction takes place while the Loi Monory provisions are in effect - they were introduced for a period of four years, and so far as is known no decision about extending this has been taken).

39. It is difficult to reach a firm conclusion on the effectiveness of the Loi Monory, but since the scheme was introduced new equity issues in France have quadrupled. Some 850,000 taxpayers have now taken advantage of the relief, of whom possibly one-half are newcomers to the stock exchange. Share values on the Bourse have increased significantly. Nearly 90 per cent of the additional investment has been in unit trusts.

40. There is no doubt that the introduction of a Loi Monory scheme in the UK would help stimulate stock exchange activity. But is is not clear to what extent it would stimulate new equity investment by individuals. If the French experience was repeated here, much of the new money would go into unit trusts, thus strengthening rather than weakening the position of the institutions. Moreover, there must be considerable doubt about both the administrative feasibility of a Loi Monory scheme as well as it cost effectiveness.

41. The problem about the administrative feasibility of the scheme is that it would be very laborious to acquire the appropriate information on each individual's transactions in shares. One possibility would be to get the banks to operate like the French banks and handle the equity portfolios of all those participating in the scheme. The problem here, however, is that the British banks are not really used to operating in this way, and their charges for handling the portfolios of participants could well offset the tax advantages. An alternative way of administering the scheme would be to get the Revenue to keep track of each individual's transactions in shares. But the staff cost of this alternative would be considerable. Some 1200 extra staff would be required if there were 1 million participants in the scheme. This reflects the difficulty of introducing the scheme with the UK tax system as opposed to the French tax system.

42. The cost of introducing a Loi Monory scheme - on the assumption of one million participants, and the maximum take-up of £500 per year - would probably be in the region of £150-200 million per year, equivalent to around 30-40 per cent of the gross qualifying investment. Given much of this qualifying investment would have taken place anyway, the Exchequer subsidy as a proportion of genuine additional investment could well be 50 per cent or more.

43. It is interesting to note that there has been no pressure for the introduction of a Loi Monory scheme from the unit trusts.

44. In the view of these doubts about the administrative feasibility and the cost effectiveness of a Loi Monory scheme in the UK, the Group was not able to advocate its early introduction. If, however, Ministers favour in principle a scheme on these lines, the Group will examine it in more detail.

Stamp duty on share transfers

45. Stamp duty is payable on transfers of stocks and shares. The bulk of the duty - about £170 million in 1978-79 - arises from sales on the Stock Exchange. Since 1974, the rate of duty has been 2 per cent (previously 1 per cent). Transfers of British Government securities, local authority loan stocks, and certain other stocks are exempt.

46. The complaint is often made that the Stock Exchange is a particularly expensive market to buy equities, and that, as the largest contributor to transaction taxes, stamp duty constitutes a major brake on market activity. It is argued that a cut in duty - to, say, 1 per cent - would give a fillip to the market and increase the value of purchases. Other arguments for cutting stamp duty are that it would bring the rate closer to the EEC harmonisation objective (duty at a total of 0.6% on transactions in shares), and that it would largely abolish the stamp duty incentive for individuals to deal in shares overseas rather than at home.

47. In considering the possibility of a cut in the rate of stamp duty, the Group identified as two of the main issues the cost of any change and its effect on Stock Exchange turnover. It was aware that, with the abolition of exchange controls, a cut in stamp duty could also have important international ramifications - but these were not examined in any depth.

48. The Group thought that the cost of a cut in stamp duty would be substantial. A cut in the rate of duty to 1 per cent would cost (in 1979-80) around £70-80 million. However, although a distinction could be made in principle, it would be politically difficult to cut the rate of duty on share transfers to 1 per cent while leaving the rate of duty at 2 per cent on transfers of other kinds of property (including residential property). There would also be practical difficulties resulting from the encouragement of transfers of shares in land-owning companies (at the lower rate of stamp duty) rather than of the land itself (at the higher rate of duty). An across-the-board cut in stamp duty to 1 per cent would cost much more - in 1979-80, around £230 million.

49. The effect on Stock Exchange turnover of a cut in stamp duty is not likely to be large. On the basis of an examination of the effects of doubling the rate of duty in 1974, it has been estimated that a halving of the duty to 1 per cent would lead to an expansion of Stock Exchange transactions of only some 10-15 per cent. Most of these transactions would of course involve existing stock rather than new investment.

50. Taking account of both the cost of any change, and the effect on the Stock Exchange turnover, the Group thought that a cut in the rate of stamp duty to 1 per cent was not a cost effective way of stimulating wider share ownership and new investment in equities. On these grounds, the Group did not think a cut in duty should be given a high priority in the near future.

51. The Group noted a suggestion by the Financial Secretary that a cut in stamp duty might be traded against the introduction of some kind of stock market tax which did not impede share transfers. However, the Group have not so far identified any alternative way of raising revenue from the stock market which would not work its way back into transaction costs, and so restrict trade in stocks and shares.

Conclusions

52. These are:

i. the rate of tax relief on life assurance premiums should not be retained above its traditional level of one half of basic rate. Some of the Group would like this relief withdrawn altogether in the longer term;

ii. there is no good reason for changing the pegged rate of tax paid by life assurance companies on the profits of their policyholders. An increase in the rate to 52 per cent would raise very little money (less than £20 million a year) and would have only a minimal effect on the life assurance business;

iii. some members of the Group thought that income tax relief for employees superannuation contributions was generous. But the relief is such an important part of most peoples expectations and financial planning that the withdrawal of the relief would be difficult;

iv. although the absence of tax on lump sum superannuation payments in addition to relief for superannuation contributions was regarded as an anomaly, the imposition of a tax charge would have a selective effect and would lead to demands for changes in public sector pension arrangements;

v. the introduction of a Loi Monory scheme in the UK would encourage some additional personal investment in unit trusts and equities, but would raise formidable administrative difficulties and would be quite costly (£150-200m a year). If Ministers feel in principle they would like a scheme of this nature, the Group will examine the possibilities further;

vi. a reduction in the rate of stamp duty on share transfers to 1 per cent would probably have only a small effect on Stock Exchange activity and on equity investment by individuals. A reduction in stamp duty on all transfers of property would cost around £230 million a year. The Group does not think that a change here would be a cost effective way of encouraging wider share ownership and new investment in equities;

vii. a small savings tax exemption would be costly (£450 million a year if the relief was on investment income of up to £250), and would raise difficult administrative problems. The Group does not think that the small savings exemption warrants further consideration.

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