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

PRIME MINISTER

REPORT OF THE WORKING GROUP ON TAX AND SAVINGS

You may recall that you agreed early last year to the setting up of a mixed group of officials and outside experts to look again at some of the main tax reliefs for institutional saving through life assurance and superannuation, along with a case for introducing new reliefs to encourage direct personal investment in equities. You suggested (your Private Secretary's letter of 31 March) that a parallel official group, without the outsiders, should consider the more sensitive issue of whether the taxation system biased saving away from investment in productive assets towards gilts and chattels.

2. You may be interested to see the final reports of both groups, which I now attach. The idea of involving outsiders in exercises of this sort has proved to be successful. The reports, taken together, raise a number of issues which I intend to give further consideration after the Budget.

3. The existence of the mixed group was announced last summer in answer to a Written PQ, but in a very low-key way which does not appear to have attracted any attention. I do not intend to publish their report in any way. The outside members were assured that it was intended to be confidential to me, and, since they acted as individuals and not in a representative capacity, some of them would almost certainly be gravely embarrassed if its contents were made public.

/I am

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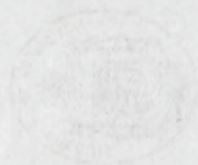
4. I am sending copies of this letter to Sir Keith Joseph and John Biffen, both of whose Departments were represented on the working groups, and to Robin Ibbs.

(G.H.)

27 February 1981

27 FEB 1981



10 DOWNING STREET

From the Private Secretary

16 March, 1981

Report of the Working Group on Tax and Savings

The Prime Minister was grateful for the Chancellor's minute of 27 February and for the two reports enclosed - the conclusions of which she has noted.

I am sending a copy of this letter to David Wright (Cabinet Office).

A J Wiggins, Esq
H M Treasury

cc MR. IBBS
MR. LANKESTER

MR. CRAWLEY (HMT)

REPORT OF THE WORKING GROUP ON TAX AND SAVINGS

Your paras:

3. Agree. I do not see why contractual savings should get special tax relief (p.22). Similarly the pension arrangements discourage labour mobility which is so important today (p.18).

4. One option which is important is to amend capital gains tax and investment income tax to take account of the erosion of the asset value due to inflation. At present capital gains tax is confiscatory and it is very much resented and evaded or avoided. Marginal real tax rates usually exceed 100 per cent on investment income and so have a similar confiscatory effect.

Many countries have both capital gains and investment income taxes that exclude the increase in the general level of prices (eg Brazil and Chile). From my direct observation and research they appear to be very successful.

I am also reminded that the recent reduction (in 1977 I think) in the USA of capital gains tax has been associated with very large - perhaps unprecedented - supply of risk capital (reported in the Wall Street Journal).

I can see no case for the investment income surcharge. It is best - perhaps in stages - to abolish it rather than create more special cases such as higher thresholds etc. It is a double tax on savings.

5. Agree.

6. Agree.

7. The only tax that the owner-occupier bears is local rates - and this is less than the cost (but not value) of the services he receives on the average because of the support grant and because of the super-rating of industry and commerce. I think there is a strong argument in equity and efficiency for taxing implied income from owner-occupiers - but politically it seems a non-starter.

Prime Minister

There is no action on these papers. But this note by Robin Ibbs, and possibly the two flagged sections below might be worth your looking at.

CONFIDENTIAL

Qa 05284

To: MR LANKESTER

From: J R IBBS

13 March 1981

REPORT OF THE WORKING GROUP ON TAX AND SAVINGS

1. In your minute of 3 March you asked for our comments on this report.

2. As you say, we were represented on the Group that produced the Report. We endorse the Chancellor's view (in his minute of 27 February) attached that the involvement of outsiders in the Group was useful. We also generally endorse the Report's conclusions.

3. We think the Report is right to see some cause for concern in the large and steadily increasing proportion of UK equity held by the institutions, notably the larger pension funds and insurance companies, even though some of the evidence of possible damage is inclusive or unconvincing. But there are at least two points which emerge fairly clearly. First, wider share ownership, for which the arguments are as much social as economic, does not appear to be taking place. Second, there is evidence that the institutions play relatively little part in investment in smaller companies, and that for the smallest companies at least there are still serious deficiencies in the supply of outside equity finance.

4. On the first point, we think the most promising options identified in the Report are:

(a) to consider a significant further reduction of life assurance relief;

(b) further alleviation of the investment income surcharge, eg through a higher threshold for retired people, or a new approach to the taxation of married couples' investment income in the context of the recent Green Paper;

(c) an increase in the annual examption for capital gains tax.

There is much to be said, as the outsiders on the Group argued, for linking (a) above with changes under (b) and (c). In this way one of the more anomalous

biases towards institutional investment would be reduced at the same time as tax penalites on direct investment were alleviated.

5. We think the Group is right to conclude against any tax changes affecting superannuation (despite the somewhat anomalous treatment of lump sums), and against any new special tax incentive either for contractual saving generally or for equity investment on the lines of the French Loi Monory. The latter, while superficially attractive, would introduce a new bias into the system without removing any of the existing ones; would be expensive without necessarily generating much new investment; and would be complex to administer.

6. On the second point (additional finance for smaller companies), we think the right way forward is that which has now been taken in the Budget through the new business start-up scheme and the loan guarantee scheme. The wider measures discussed in the Report would have little if any direct effect on the specific problem of inadequate finance for the smallest companies, whereas the Budget measures are aimed directly at this problem and should have a substantial effect.

7. Finally, we think it is important to bear in mind, as pointed out in paragraph 6 of the Report, that the Report does not deal with existing reliefs for owner occupation (which were outside its terms of reference). The revenue cost of these reliefs (estimated at some £3680 million in 1979-80 including £1450 million mortgage tax relief) means that there is a very powerful fiscal bias towards this form of saving in addition to its other attraction. There are clearly great difficulties in altering or reducing this bias, particularly while interest rates remain at relatively high levels. But, as a matter of housing policy, it may be necessary some time to look further at the position, if the movement towards full economic pricing in public sector housing is to be successfully sustained. Undoubtedly, so long as special reliefs for owner-occupation

remain at their present level, the competitive attractions of housing rather than equities as a medium for personal investment will continue to be very strong.

8. I am sending a copy of this minute to Sir Robert Armstrong.

13 MAR 1981

CONFIDENTIAL

ECON POL

File cc: CO (+ copy of report)

10 DOWNING STREET

From the Private Secretary

MR. IBBS

REPORT OF THE WORKING GROUP ON TAX AND SAVINGS

You have received a copy of the Chancellor's minute of 27 February.

I understand that the CPRS were represented on the above Working Group, and your predecessor made recommendations on how the work should be done. I should be glad to know if you have any comments on the Report.

I am sending a copy of this minute, and also a copy of the Chancellor's minute to David Wright (Cabinet Office).

T. P. LANKESTER

3 March 1981

CONFIDENTIAL

WGTS(81)2
16 February 1981

COPY NO

HER MAJESTY'S TREASURY
WORKING GROUP ON TAX AND SAVINGS

Supplementary Report

I attach, for those who have not already got it, the final version of the Supplementary report, which has now been submitted to the Chancellor. The annex was added at the last moment, at his request.

C W KELLY
Secretary

H M Treasury
Treasury Chambers
Parliament Street
LONDON
SW1P 3AG

SUPPLEMENTARY REPORT OF THE WORKING GROUP ON TAX AND SAVINGS

In addition to the areas covered by the main WGTS(E) report, the Prime Minister asked that a parallel official group, without the outsiders, should consider the more sensitive issue of whether the taxation system biassed saving away from investment in productive assets towards investment in gilts and chattels.

2. This supplementary report therefore considers the present reliefs related to gilts and chattels. There are two of the former - an exemption from capital gains tax for gilts held for more than 12 months and an exemption from stamp duty on transfers - which are dealt with in turn.

CAPITAL GAINS TAX EXEMPTION FOR GILTS HELD FOR MORE THAN 12 MONTHS

3. Since 1969, gains on disposals of gilts held for more than 12 months have been exempt from capital gains tax. Conversely, any losses on gilts held for more than this period have not been allowable for capital gains tax purposes. Gains on disposals within the 12 month period are chargeable to the tax at 30 per cent (subject to the £3,000 exempt allowance for individuals or £1,500 for most trustees), and any losses are allowable. There are a number of provisions intended to counter abuse, for example by restricting the use of losses on a re-acquisition of the same stock within one month before or after disposal. In addition, there is a special provision under Section 27 of the Finance Act 1973 whereby gains on the limited number of special issues of deep-discounted stock (which would normally be treated as income) are exempt from income tax.

4. It is not possible to give any sensible estimate of the revenue cost of the gilts exemption. The figures to estimate the potential gross yield at current levels of activity are not available; nor is there any way of estimating the extent to which the gross yield would be reduced by the use of off-setting losses. Furthermore, there can be little doubt that the imposition of a tax charge would have a significant effect on market behaviour, so that the actual yield would be very different from any current potential liability.

5. The exemption is of no value to those who are already otherwise exempt from capital gains tax, including gross funds, non-resident investors and, following the 1980 Finance Act, authorised unit trusts and investment trusts. Modest investors are also unlikely to benefit from it because the first £3,000 of capital gains in a year are exempt from tax in any case. Finally, the gains of banks and stock-jobbers trading in gilts are taxed as income as part of trading profits and are not therefore subject to capital gains tax either. The exemption is therefore an attraction mainly to the insurance companies, building societies and more

substantial private investors and trusts. An approximate breakdown of the total Treasury stock outstanding at 31 March 1980 indicates the following division of ownership:

	£ billion
Exempt	30
Non-exempt	35

6. The Wilson Committee examined the exemption in paragraphs 710-712 of their report. They suggested that it created anomalies and had potentially undesirable effects in concealing the true cost of public sector borrowing. Subsequently they made a general recommendation that the tax arrangements for Government borrowing should be brought into line with those which apply to other borrowers.

Justification for the relief

7. The exemption was introduced originally as a way of improving the marketability of gilts and, at the margin, of reducing the direct cost of Government borrowing. This remains its justification. It has the effect of removing an impediment to investors' freedom to manage their portfolios, for which they are prepared to pay by accepting a lower yield. Very roughly, the exemption is thought to confer a redemption yield advantage on gilts of about ¼ per cent over comparable local authority stocks. The consequent reduction in borrowing costs can in principle be offset against the revenue foregone as a result of it. The Bank of England believe that the improvement engendered in the secondary marketability of gilts, which helps to make it possible for investors to deal in large amounts at any time without turning the market against themselves, brings important benefits in terms of the volume of new issues that investors are willing to absorb. They also consider that the exemption improves market structure, the ability of holders to switch without incurring a tax penalty making it easier for the Bank to influence the structure of yields across the board through open market operations which affect only a few stocks directly.

8. On the other hand, the exemption is an undoubted distortion to the tax system, and one which is open to potential abuse by way of holders realising losses within the 12 month period (and setting these against other gains), but hanging on to gains until these become exempt. It would, however, in practice be very difficult to withdraw it from existing securities (or at least from the existing holders). This is because, while not actually mentioned in the prospectus, the exemption has since 1969 been part of the general environment in which new issues of gilts have been made. It is, for example, invariably mentioned in the accompanying official press notices. It has therefore constructively become part of the terms of issue. Of course, investors must always face the possibility that a fiscal concession of any kind might be withdrawn, or a rate of tax increased. But there seems to be a difference in kind between general changes in taxation, such as, for

example, increases in the rate of capital gains tax which affects all instruments and all holders, and a change specific to the Government's own debt.

A matching rule

9. The same argument also applies, but probably with rather less force, to changes intended to narrow the exemption,but falling short of outright abolition.

10. One possibility of this kind is to allow short-term losses on gilts to be set only against taxable (and therefore also short-term) gains on gilts. A matching rule of this kind would ensure that an investor making overall gains in the exempt field could not at the same time arrange for allowable losses on gilts to be used against gains on other investments.

11. Such a change would inevitably have some adverse impact on the attractiveness and thus the cost of issue, of gilts. But this effect would probably be relatively small; and the Bank would be prepared to live with it if there were strong enough revenue or other arguments in favour of the change - though they would equally prefer not to have to make it at a time when the Government's funding requirements are as heavy as they are at present.

12. Such evidence as there is does not, however, suggest that the case for making the change on revenue grounds is sufficiently strong to offset its disadvantages. It is certainly the case that, other things being equal, holders of gilts can be expected to take advantage of the rules. But market pressures may often over-ride purely tax considerations. An analysis by the Revenue of the holdings of a number of the larger insurance companies and building societies does show a clear pattern of realised losses exceeding realised gains during 1972-75. But this was a period during which gilt prices were more or less continuously declining. The excess of losses over gains may therefore merely reflect the fact that there were more losses than gains in most portfolios by virtue of the performance of the market. In 1975 this pattern was suddenly ended, and gains began to exceed losses at precisely the time when market prices began to rise again. Since then there has been a much more evenly-balanced pattern of gains and losses, which is exactly what might have been expected given the fact that price movements have fluctuated in both directions.

Extension of the exemption to industrial debentures

13. An alternative way of tackling the distortion resulting from the exemption would be to extend it to other borrowers, in particular to industrial debentures.

14. This would constitute a subsidy by the Government to the private sector, unlike the exemption for gilts where the cost (in revenue foregone) and the benefit (in lower borrowing costs) both accrue to the Government and in principle offset each other. It would also have

the effect of extending the anomalous area, in that these financial assets would then also be treated more favourably than other chargeable assets, including, most importantly, equities.

15. It would, moreover, be unlikely to make much difference to the cost of finance to companies. Where the issue price of the debt was about the same as the amount due on redemption, the advantage is unlikely to be more than the ¼ per cent presently enjoyed by gilts. It would be reduced still further if, as seems likely, it proved impractical to limit the extension of the exemption to industrial debentures. Apart from the difficult problems of definition which would arise, Ministers would almost certainly find themselves under considerable pressure to extend the exemption to other forms of loan stock, including that of local authorities who have been arguing strongly for it for some time. It is difficult to tell where this might lead. At present, the Revenue feel that they have a line which is defensible.

16. Different considerations would arise in the case of industrial debentures issued at a substantial discount, or redeemed at a substantial premium. Under present law, such discounts or premiums would be regarded as income and taxed accordingly. But the Finance Act 1973 expressly removed the income tax charge from low coupon gilts. The annex attached discusses the possibility of extending the same treatment, as well as the capital gains tax exemption, to low coupon debentures. It concludes that, despite the superficial attraction of providing neutrality of treatment between gilts and debentures, the prospect of doing so by extending the special gilts rules is not appealing. It would potentially involve substantial revenue and administrative costs. In practice there might prove to be few takers, and the further bending of the basic tax rules, with the risk of abuse and troublesome line drawing, would have been largely in vain.

STAMP DUTY AND GILTS

17. Stamp duty is ordinarily chargeable at a flat rate of 2 per cent on transfers of property. But since at least 1804 transfers of Government stocks have been exempt. Following a series of relaxations in recent years (most recently in the 1980 Finance Act), this privilege is now shared by industrial debentures, local authority stock and most other classes of loan capital, with the exception of convertibles. Transfers of equities are chargeable at the full rate, except in the case of overseas residents who pay at a reduced rate of 1 per cent.

18. The apparent revenue cost of the exemption is considerable. The estimated turnover of gilts and local authority stock in 1979-80 was in excess of £60 billion (separate figures for gilts alone are not available); and the present expectation is that the 1980-81 figure will be substantially higher. But, as with the capital gains tax exemption, the apparent cost could

be misleading. The imposition of a charge to duty would undoubtedly lead to considerable changes in market behaviour, including a substantial reduction in turnover.

Justification for the stamp duty relief

19. The main arguments for the stamp duty relief as it affects gilts are similar to those for the capital gains tax exemption - that it improves the marketability of gilts and, by increasing their attractiveness, reduces slightly their cost of issue. Unlike capital gains tax, stamp duty is normally payable by all investors, without exception.

20. Taking duty from transfers of gilts would imply a greater borrowing cost for the Government in the form of higher interest rates or a reduction in the issue price. It is also possible that it could lead to a switch of gilts into the hands of foreign depositories, with dealings thereafter occurring abroad (with little or no stamp duty liability), to the detriment of markets here. That possibility already exists, of course, as regards dealing in equities. The chairman of the Stock Exchange expressed some apprehension about it last year in the wake of the dismantling of exchange controls.

21. Whatever the balance of advantage, however, the same problem about withdrawing the relief from existing securities arises as with the capital gains tax exemption, if anything in a more acute form. The prospectuses of all Government stocks currently outstanding have consistently included what is in effect a promise that transfers of that stock would be free of stamp duty. In practice, therefore, a different rule could only be applied to new issues.

22. This objection does not, of course, apply to the possibility of re-imposing a charge to duty on other forms of fixed interest stock. But it would be perverse to re-introduce stamp duty on corporate stocks at a time when considerable thought is being given to ways of stimulating the corporate bond market in order to take pressure off bank lending. To single out other issuers such as the local authorities might be difficult, particularly since the extension of the exemption last year to the sterling-denominated loan stock of foreign issuers (which was aimed at attracting foreign issuers to the London market) might reasonably have given rise to an assumption that freedom from stamp duty in this area was now settled policy.

23. The alternative possibility is to extend the scope of the exemption still further to take in equities, or at least to make a substantial cut in the duty on equities. This is discussed in paragraphs 101-105 of the main WGTS(E) report.

Conclusion about gilts

24. The capital gains tax exemption for gilts constitutes an undoubted bias in the fiscal

system in favour of investment in Government debt, though on a smaller scale than the biases in favour of, for example, owner-occupation or superannuation. The stamp duty exemption is now shared with most other forms of fixed-interest stock, including corporate stock, but still involves discrimination against equities. The gross revenue cost of both is probably substantial, but unquantifiable because of lack of data and the greater than usual need to take account of the substantial changes in behaviour which would result from their withdrawal. On the other hand, the cost in both cases is offset by the considerable advantages for debt management, which might be regarded as particularly important at a time when the funding requirement is as heavy as it is at present, and by a reduction in the cost of Government borrowing. Moreover, there is a particular difficulty in withdrawing the exemptions from existing gilts arising from undertakings effectively given in the documents associated with their issue. Any changes would therefore have to apply only to future issues of gilts, which could lead to a number of complications.

25. It is arguable that, had the exemptions not already existed, we would not want to introduce them at the present time. But, given the difficulty mentioned above, it now seems preferable to aim eventually to reduce any bias in the fiscal system in favour of gilts not by withdrawing the exemptions but by reducing the general burden of capital gains tax and stamp duty on other forms of investment, particularly equities, along the lines discussed in the main WGTS(E) report.

THE TAX TREATMENT OF CHATTELS

26. The second area which the Prime Minister asked the group to consider is the tax treatment of chattels - that is tangible moveable property such as consumer durables, antiques or works of art - by comparison with productive assets. There are three aspects to this - capital gains tax, capital transfer tax and income tax.

Capital gains tax

27. In general, and subject to the exempt allowances, capital gains are chargeable to tax at 30 per cent. There are, however, special rules for chattels. First, with certain exceptions, gains on disposals of chattels where the disposal proceeds are less than £2,000 are exempt, with the exemption being tapered off by a marginal relief over £2,000. There is a corresponding restriction on the calculation of losses on chattels sold for less than £2,000. For these purposes, chattels owned by one person and forming part of a set are regarded as a single asset if they are disposed of to the same person.

28. Secondly, gains arising on the disposal of "wasting" assets are entirely exempt from capital gains tax, even if the disposal proceeds exceed £2,000, and correspondingly any losses

are not allowable. Wasting assets are defined as those with a predictable life of less than 50 years, the main examples being race horses and yachts. The object of this exemption, which was introduced in 1968, is not to favour chattels of this type but to prevent losses, particularly on race horses, from getting tax relief. It does not apply where the assets are used for the purposes of a trade and capital allowances have been, or could have been, claimed for them.

29. The chattels exemption is an administrative convenience which saves work both for taxpayers and for the Revenue. It also recognises the virtual impossibility of enforcing a charge on relatively small gains on chattels. The revenue cost is impossible to estimate but, given the fact that gains by indviduals of less than £3,000 are exempt anyway, is probably small. It may even be negative if the potential loss of tax from allowable losses is taken into account.

30. If it does have the effect of imparting a bias into the tax system, and even this is debateable given the extent of the exempt allowance, this is mainly by comparison with the acquisition of shares. Direct investment in productive assets is also given favoured treatment through the capital gains tax system, in that gains arising on their disposal can be deferred by being rolled over into newly acquired productive assets. This is particularly valuable at present when inflation is throwing up large nominal gains. It would in principle be possible to add to this concession by allowing the £2,000 exemption to run against productive chattels (that is wasting assets which do not at present qualify for the £2,000 exemption because they are used for trade purposes). But this is unlikely to stimulate fresh investment. It would merely be a bonus to traders on final disposal, with a revenue cost of perhaps up to £25m.

31. It is also relevant that there is a capital gains tax retirement relief which exempts up to £50,000 on disposal of a business, which is also available for shares in a family trading company.

<u>Capital transfer tax</u>

32. In general, chattels are liable to capital transfer tax in the normal way, subject to the usual lifetime exemption for the first £50,000 transferred and the annual and other exemptions.

33. There is, however, a special exemption for national heritage chattels - that is, "pictures, prints, books, manuscripts, works of art, scientific collections or other things not yielding income which appear to the Treasury to be of national scientific, historic or artistic interest". Chattels which qualify for this relief are exempt from capital transfer tax

provided the recipient gives an undertaking to preserve them and to allow public access. The relief is withdrawn if the undertakings are subsequently broken or if the chattels are sold on the open market.

34. This exemption might make chattels of this kind an attractive investment for the wealthy. But against it must be set the fact that in order to qualify the owner of the chattels must make appropriate arrangements for public access, and this is seen in some quarters as imposing an onerous burden. In any event, it would be difficult to withdraw the relief (which also used to apply for estate duty) in view of the Government's policy of preserving the heritage.

35. Elsewhere in the capital transfer tax system there is something of a bias in favour of some forms of investment in productive assets, in that the transfer of a sole proprietor's business or interest in a business, or of a holding of shares which gives control of a company attracts business relief of 50 per cent - that is the value of the business property is reduced by that amount - and there is a 20 per cent relief for transfers of minority holdings in unquoted companies.

Income tax

36. There is no tax charge on possession of chattels, even though it could be argued that the owner of, for example, a work of art derives a "psychic income" from it. By comparison, an investment in productive assets will usually produce taxable income either directly or, in the case of shares which yield dividends, indirectly on which income tax and, in the latter case, potentially also the investment income surcharge will be paid.

37. The Chancellor has, however, already concluded that it would be impossible to turn back the clock and reintroduce the old Schedue A tax on housing (which could be said to generate an analogous imputed income to some forms of chattels). Taxing the psychic income of a work of art would be even more difficult. In practice it is hard to see how such imputed income could be measured other than by reference to the capital value of the object itself, which would imply something akin to a wealth tax.

38. An alternative way of achieving greater parity of treatment between the real income of a productive asset and the imputed income of a chattel is to make the cost of investment in the former deductible from income. In practice, the availability of 100 per cent initial capital allowances already has this effect in the case of most direct investment. A similar result can arise from the purchase of new issues of shares (but not from the purchase of shares bought in the secondary market) where the money raised from shareholders is spent on productive assets which qualify for the 100 per cent allowances. The provision in last

year's Finance Act for a capital loss on disposal of unquoted shares in trading companies to be set against income also provides a limited relief, as would an Aunt Agatha scheme if one were to be introduced.

Conclusion about chattels

39. The main area where investment in productive assets might be at a disadvantage by comparison with chattels would seem to be the acquisition of shares, though the disadvantage is by no means a substantial one. The owner of a chattel pays no tax on any "psychic" income he may derive from it, and is able to benefit from the special £2,000 exemption from capital gains tax when he disposes of it in addition to the normal annual allowance. By contrast, the owner of a share is subject to income tax on the income from it including, if his total investment income exceeds £5,500, the investment income surcharge. Moreover he may incur a capital gains tax charge if he sells it during a year in which his total gains are greater than £3,000.

40. However, there would seem to be little scope for pushing people out of investment in chattels (or even out of investment in unproductive chattels into productive chattels) by adjusting the existing capital taxation rules; and there are great practical difficulties in taxing imputed income. In practice, therefore, reduction of any bias is likely to depend on the scope for general reductions in capital gains tax and the investment income surcharge of the kind discussed in the main WGTS(E) report.

HM Treasury
February 1981

ANNEX

DEEP-DISCOUNT LOW-COUPON STOCKS

Paragraph 16 notes that a different set of considerations would be involved if debentures carrying a low coupon were to be issued at a substantial discount or redeemed at a substantial premium, comparable to the special low-coupon gilts issued since 1973.

2. Under present law, as interpreted in the Courts, a discount (or premium on redemption) on an issue carrying no interest, or a rate of interest plainly below a commercial rate, is likely to be taxable as income. The Finance Act 1973 expressly removed the income tax charge from low-coupon gilts. Taken together with the exemption from capital gains tax if the gilts were held for more than one year, this makes such gilts very attractive to high rate taxpayers (but not to the exempt institutions).

3. It has been suggested that, if both these tax rules were extended to debentures, then companies wishing to issue deep-discount stocks might find ready takers in the personal sector. The yields on such stocks could be expected to be much the same as on low-coupon gilts of similar maturity, apart from a higher risk premium, and could therefore be as much as 2 per cent less than on corresponding high-coupon stocks. From the issuing company's point of view, it would mean exchanging a high rate of (tax-deductible) interest for a lump sum payable on redemption. This would have to be made non-tax-deductible for the company in order to preserve symmetry with its treatment in the lender's hands. But it is argued that tax-exhausted companies would be no worse off since they could not effectively use the deduction anayway.

4. On the other hand, the Bank have expressed doubts whether there would be much of a market for such issues, unless perhaps issues of gilts were restricted. They have not issued many deep-discount gilts, nor have they issued one for a period greater than five years, and they believe that they have already tapped the market fairly thoroughly.

5. It may also be doubtful whether even companies which are at present tax-exhausted would find the prospect very attractive, since it involves assuming that they:

(a) would have funds to meet the large sum due on redemption but

(b) would remain tax-exhausted.

6. The potential cost to the Exchequer cannot be foreseen. The cost would consist of the loss of tax on exempt lump sums which might otherwise have taken the form of taxable

income - to the extent that these issues replaced what might otherwise have been ordinary loan stock or equity. There would be no countervailing increase of revenue at the company end, on the assumption that only the tax-exhausted would take part.

7. There would be intense pressure from the local authorities to be allowed similar privileges. They would say, with some justice, that they were being discriminated against. To concede this would, of course, add to the cost.

8. Finally, there could be some awkward administrative problems. It would be necessary to define closely the stocks that would be allowed this treatment, otherwise all kinds of short-term borrowing would find their way in. The length of the loan, the coupon and the discount would be factors. In practice a clearance procedure would be inevitable. Companies would want to submit a draft prospectus and be assured that it qualified. There would be marginal cases and argument. This would be a costly process - it could not be done at a junior level and the Revenue, Treasury and Bank would all have an interest.

9. The gilt exemptions from capital gains tax is protected by fairly complicated anti-avoidance provisions which would need to be adapted and applied if the exemption were to be extended to company stocks.

Conclusion

10. There is a superficial attraction in restoring equality of treatment between gilts and corporate stocks; and, if it could be done by withdrawing the tax advantages of the former, this would be appealing. But the prospect of doing so by extending the special gilts rules is not an appealing one. It would potentially involve substantial revenue and administrative costs. The more successful it was, the greater these costs would be. In practice there might prove to be few takers and the further bending of the basic tax rules, with the risk of abuse and troublesome line drawing, would have been largely in vain.

CONFIDENTIAL

REPORT OF THE WORKING GROUP ON TAX AND SAVINGS

INTRODUCTION

Over the years, and for a variety of historical reasons, a complex pattern of tax reliefs for different types of savings has been built up. Some methods of saving receive different forms of very favourable tax treatment. Others benefit from no special relief at all. These differences in treatment, and the distortions which result, have in recent years become increasingly questioned from a variety of standpoints.

2. This report considers the present fiscal treatment of the two main institutional forms of saving (life assurance and superannuation), the case for reducing or modifying the existing reliefs in these areas, and the possibility of introducing new specific or general reliefs intended to redress the balance in favour of direct personal investment. It has been prepared by a group of officials from the Treasury, Inland Revenue, CPRS, Bank of England, Department of Industry and Department of Trade together with a number of outside experts appointed in an individual capacity. A list of the outside members and the terms of reference, as set out in a letter to them from the Chancellor of the Exchequer, are attached as Annexes 1 and 2. A list of papers circulated to the group is at Annex 3.

Background and scope of the report

3. There are a number of factors which have to be taken into account in any consideration of the existing structure of tax reliefs for savings. Three are particularly important in the present context:

(i) the desirability, other things being equal, of achieving neutrality of fiscal treatment for different forms of saving so as to minimise potential distortions to saving flows. Planned divergences from neutrality might, however, be justified for a number of reasons;

(ii) the possibly unintended effects on the capital markets of past decisions to encourage some, generally institutional, forms of saving at the expense of others, in particular direct personal investment;

(iii) the Government's desire to encourage a wider degree of direct share ownership as seen, for example, in the provisions on SAYE-linked share option schemes in the 1980 Finance Act.

4. Unfortunately, of course, changes which might seem desirable in one context might have unwelcome implications in another. The introduction of a new tax relief for direct personal investment as an offset to the incentives already offered to institutional

investment might, for example, impart a greater degree of neutrality to the savings market. But it would conflict with the Government's other objectives of simplifying the tax system and widening the tax base.

5. Because of the group's terms of reference, and the need to restrict our task to manageable proportions, this report is subject to a number of limitations.

6. First, it does not consider the reliefs given to owner-occupation nor, on a much less substantial scale, to investment in government debt. Many, however, believe these to be among the most important reasons for the decline of private equity investment. This is particularly true in the case of owner-occupation, where the reliefs are afforded to a form of saving which by its very nature already enjoys intrinsic advantages. A house purchaser acquires an asset which is essential to his very existence and which historically has proved a much better and more certain store of value than most others. To put this in context, the estimated revenue cost in 1979-80 of mortgage interest relief is £1450 million, that of the capital gains tax exemption for principal private residences £2000 million and that of the exemption or reduced rates of stamp duty on transfers of houses a further £230 million. By comparison, the cost of the tax relief on life assurance premiums is only £430 million, with a further £90 million arising from the exemption from capital gains tax when life policies mature.

7. Secondly, this report is concerned only with fiscal questions. Full consideration of the implications of the growing institutional dominance of the capital markets in the context of stimulating more direct holding of equities would also need to take account of other factors, some of which are possibly more important. The justification for the explicitly funded nature of the nationalised industry and local authority schemes is the most obvious example.

8. Finally, we have not attempted to gauge the social or political consequences of any changes which might be considered. But the taxation of savings is an area which affects many millions of taxpayers. It has been estimated, for example, that 4 out of every 5 households have at least one life assurance policy. A large number of financial transactions have been undertaken, and plans for the future made, in the expectation that something like the present pattern of institutional reliefs would persist. Of course, governments can and do change rates of taxation; and there can never be any guarantee that a particular fiscal arrangement will survive a change of government or economic circumstance. But a number of the existing reliefs have been a feature of the tax system for a very long time indeed and any substantial change in the more important ones would be likely to be strongly resented.

9. The next section of the report discusses the extent to which present savings flows have

become institutionalised and considers some of the claims which have been made about the effect of this on the capital market. Sections III and IV are concerned with the fiscal treatment of life assurance and superannuation respectively. Sections V and VI considers the case for new forms of relief, including one on analogous lines to the French Loi Monory, and alternative ways of encouraging savings. The final section contains the group's conclusions.

II THE INSTITUTIONALISATION OF SAVING AND ITS EFFECT ON THE CAPITAL MARKETS

10. One of the main financial developments over the last 20 years has undoubtedly been the steady increase in the proportion of British equity capital held by the institutions. It was estimated by the Wilson Committee that at the end of 1978 the financial institutions as a whole held 50 per cent of listed UK ordinary shares, compared with only 21 per cent in 1957, and that this proportion had probably risen to about 52 per cent in early 1980. The Stock Exchange believe the proportion to be even higher. According to the Wilson Committee estimates, at the end of 1978 the institutions also held just under half of listed UK company loan capital, three-quarters of listed UK preference shares and about two-thirds of listed public sector securities.

11. The most substantial holders of equity within the institutional group are the life assurance and pension funds. In 1975, the latest date for which comprehensive figures are available, the life assurance funds held 16 per cent and the self-administered pension funds 17 per cent of listed UK ordinary shares by market value respectively. Since then these proportions have almost certainly increased further.

12. The increase in institutional ownership has primarily been at the expense of direct ownership of shares by private individuals, who have been consistent net sellers for at least the last 20 years. As Table 1 shows, the proportion of UK listed ordinary shares beneficially owned by persons fell from 66 per cent in 1957 to 38 per cent at the end of 1975 and, according to the Wilson Committee, was probably as low as 32 per cent by the end of 1978. These figures almost certainly overstate the extent to which portfolios are actively managed by individuals themselves, since a proportion are managed on their behalf by professional trustees or others on a discretionary basis.

13. Alongside the increase in institutionalisation there has been some increase in concentration among the institutions. Figures for earlier years are not easily available. But by the end of 1978 there were already 13 pension funds each with assets in excess of £500 million (including 7 nationalised industry funds). Between them these accounted for 41 per cent of the total assets of non-insured self-administered pension funds. At that time there were also 23 insurance groups each with long-term funds in excess of £500 million, accounting

TABLE 1: BENEFICIAL OWNERSHIP OF LISTED UK ORDINARY SHARES 1957-75
At end-December*; per cent of total shareholdings at market value

Category of beneficial shareholder	1957	1963	1960	1975
Persons	65.8	54.0	47.4	37.5
Charities and other non-profit making bodies serving persons	1.9	2.1	2.1	2.3
Insurance companies	8.8	10.0	12.2	15.9
Pension funds	3.4	6.4	9.0	16.8
Stockbrokers and jobbers	0.9	1.4	7.4	0.4
Banks	0.9	1.3	1.7	0.7
Investment trust companies	5.2	7.4	7.6	6.1
Unit trusts	0.5	1.3	2.9	4.1
Other financial companies	1.6	2.6	1.1	4.0
Industrial and commercial companies	2.7	5.1	5.4	3.0
Public sector	3.9	1.5	2.6	3.6
Overseas sector	4.4	7.0	6.6	5.6
TOTAL	100.0	10.0	100.0	100.0
£ billion	11.6	27.5	37.9	44.6

*Except 1957, which is at 1 July

Source: Wilson Committee report

between them for almost three-quarters of the total UK business assets of the long-term funds as a whole. Four of these had assets of more than £1500 million, accounting for 31 per cent of the total.

14. This has implications for the concentration of ownership of industrial companies. Most long-term institutions generally like to have a reasonable spread of assets; and their individual shareholdings in any one company tend in consequence to be fairly small. But this is not always feasible for the larger institutions, even though they also try to limit their holdings in any one company to five per cent or less, and preferably to no more than two or three per cent. By 1975 there were already 23 holdings by insurance companies of more than 5 per cent in the 165 UK companies which then had equity capital with a market value of more than £40 million. The implications for the relationship between the institutions and the managements of the companies in which they invest have recently been the subject of some debate.

15. The UK is unique among major developed countries in the extent to which its capital markets have become dominated by the institutions. There has also been an increasing institutional presence in the USA, and a corresponding reduction in the proportion of shares held directly by individuals. But this has so far been on a smaller scale than in this country. According to a recent Securities and Exchange Commission estimate, institutional holdings of equity amounted to around 41 per cent of the total in 1980, compared with around 23 per cent in 1965. As Table 2 shows, in Japan, France, Germany and Italy, the household sectors have all been modest net purchasers of shares in recent years.

Causes of institutionalisation

16. There are a number of explanations of the trend towards greater institutionalisation and the associated decline in direct private investment. Taxation has obviously been an important factor. The availability of tax relief has been a major influence in channelling funds into tax-efficient forms of saving such as life assurance and superannuation rather than into direct holdings of equities, and into owner-occupied housing and government borrowing rather than either. It has also been argued that the combination of high and progressive direct taxation and a system of capital taxation which does not discriminate between real and monetary gains has discouraged the private investor generally and, in some cases, encouraged him to acquire assets in the form of small, movable objects which cannot be traced rather than a portfolio of shares. Evidence about the extent of this is, however, by its nature hard to find. To the extent that the level of taxation has been important, the recent reduction in the higher rates of tax can only be helpful.

17. But taxation has not been the only influence. Equally, if not more, important have

TABLE 2: NET ADDITIONS TO FINANCIAL ASSETS BY THE HOUSEHOLD SECTOR' IN MAJOR DEVELOPED COUNTRIES

(1973-77 averages expressed as per cent of GDP at market prices)

	Equity in life assurance and pension funds	Shares	Bonds	Short-term deposits and securities	Other	Total
UK	4.4	-1.1	0.7	6.1	0.4	10.4
USA	2.9	-0.3	0.9	6.6	0.2	10.4
Japan	2.2	0.2	1.5	12.7	0.4	17.0
France	0.4	0.3	0.5	8.2	1.1	10.4
Germany	1.5	0.1	1.1	5.6	0.6	8.9
Italy	..	0.2	0.4	14.7	1.2	16.6

'Households and private non-profit institutions serving households; also includes unincorporated enterprises in UK, Japan, and France. In Germany all the housing sector is included.

Source: OECD Financial Statistics 1978

been the growth in occupational pension schemes and the benefits offered by them (resulting from social security legislation as well as from collective bargaining), and improvements in the state pension scheme and social security system which have reduced the need for individuals to make their own provision for retirement. A related factor is the wider distribution of savings through the population and the potentially greater importance to modest holders of wealth of the spread of risk achieved by holding their securities indirectly.

The effects of institutionalisation

18. The consequences of growing institutionalisation for the capital market are not entirely straightforward.

19. On the one hand, the institutional presence has brought with it some undoubted advantages. It is generally believed to have improved the efficiency of the market in a technical sense - that is in quickly reflecting in prices all currently available information as to the future returns expected from each security and their relative degrees of riskiness; and in the right economic conditions it makes it possible for companies to raise new equity capital through rights issues in amounts which are by no means always available in other, less institutionalised, European capital markets.

20. Against this, it is often argued that the institutions are more averse to risk-taking than private individuals, that for this and other reasons they tend to concentrate their holdings in larger and established companies, thus adding to the difficulty of financing smaller and newer ones, that their activities have added to price fluctuations in both equity and gilt markets, thus increasing general market uncertainty, and that in general increasing institutionalisation has put considerable strain on existing market mechanisms.

21. The validity of these assertions is difficult to evaluate. Most are usually based on a priori argument and anecdotal evidence rather than empirical analysis.

22. For example, the suggestion that institutions are naturally more risk-averse than individual share-holders normally stems from the view that the nature of their responsibilities towards their customers obliges them to place their funds in a more prudent way than might the same individuals acting on their own, despite their greater inherent ability to reduce their risks through diversification. There may be some truth in this. But there is also a danger of taking an over-romantic view of private investors in the past, the great majority of whom were likely to take above-average risks, if at all, with only a small proportion of their total assets. Moreover, there has been a growing tendency over the last few years for institutional investors to show greater awareness of the need to encourage risk-taking and of their capacity to support it without being in breach of fiduciary obligations. The successful financing of North Sea exploration and development shows that,

in the right circumstances, the institutions are not always averse to considerable risk, provided that the expected returns are sufficiently high. This may, however, be something of a special case.

23. Again, on a priori grounds, it would not be all that surprising if institutional investors favoured larger quoted companies at the expense of smaller ones. Assessing the prospects for a company, and monitoring its subsequent performance, involve costs which do not fall proportionately as the value of the holding falls. Larger companies offer institutions the opportunity to acquire more substantial blocks of equity while still holding a relatively small proportion of the total outstanding. Moreover, portfolio theory suggests that most of the benefits from diversification can be obtained with as few as 20 stocks.

24. However, if the institutions did favour larger companies, a fairly substantial yield differential would be expected between listed companies of different sizes. In practice, as Table 3 shows, the differential is relatively small and not out of line with what might be expected given the greater relative costs and potential risk of investing in small companies. It also appears to have been narrowing in recent years. This is not, however, a conclusive argument. Inadequate demand for small company shares would not lead to depressed share prices if it was matched by an inadequate supply of shares, that is by a relative scarcity of equity issues by small companies. There is some evidence that small quoted companies obtain a lesser proportion of their funds from the market than do large quoted companies, and that the position has deteriorated in recent years.

25. An alternative approach is to look at the Department of Industry's Share Register Survey for 1975. This showed no particular tendency for institutional holdings to be concentrated on the very largest "blue chip" companies. But it did suggest that at that time they were considerably under-represented in companies with market values of £4 million or less (see Table 4). This may be partly explained by the prevalence among companies of this size of strongly entrenched family-controlled shareholdings which rarely come onto the market; and these figures date from before the increased interest shown by the institutions in investing in smaller companies, many of them having recently set up specialised subsidiaries for this purpose. But few as yet invest in unlisted companies to any significant extent, and the general belief, voiced among others by the Wilson Committee, is that there are still serious deficiencies in the supply of outside equity finance for very small companies.

26. A third criticism is that the institutions have added to the volatility of the market. It has been argued that the greater professionalism of institutional fund managers, their tendency to use common sources of information and methods of analysis and their close contacts with each other have led them increasingly to form identical or similar views about

TABLE 3: AVERAGE PRICE/EARNINGS RATIOS OF A SAMPLE OF 327 COMPANIES
September 1978

Range of pre-tax profits	Number of companies	Average price/earnings ratio
£ million		
50+	37	9.1
15 - 25	46	8.6*
5 - 6.5	46	8.9
3 - 4	76	8.6
1 - 1.5	62	8.1
0.45 - 0.55	60	7.6

*Excludes the Thomson Organisation which had a P/E of 50.2 which would raise the average for this band to 9.5

Source: Submission to the Wilson Committee by the Prudential.

TABLE 4: INSTITUTIONAL SHAREHOLDINGS BY SIZE OF SHARE ISSUE AT END 1975
(per cent of total in issue)

Category of beneficial shareholder	Market value of share issue (£ million)				
	Over 130	40-130	4-40	0-4	All
Insurance companies	15.9	17.0	19.3	5.5	15.9
Pension funds	17.9	20.1	14.2	6.4	16.8
Investment trust companies	5.8	6.2	7.5	2.4	6.1
Unit trusts	3.4	4.0	5.6	5.0	4.1
Total including institutions	42.3	47.3	46.6	19.3	42.9
Other sectors	57.7	52.7	53.4	80.7	57.1
Total	100.0	100.0	100.0	100.0	100.0
£ billion	21.6	10.0	9.9	2.6	44.6

Source: <u>The Ownership of Company Shares: A Survey for 1975</u>

the prospects for particular securities. On a priori grounds this might be expected to lead to increasingly one-way markets in which institutions showing similar views were unable to trade until large price adjustments occurred. On the other hand, volatility might be expected to be reduced by the ability of the institutions to take a longer-term view about the companies in which they hold shares than the average private investor.

27. In fact, the volatility of the UK market has considerably increased over the last decade, as indeed it has also in the US (see Table 5). But this is not necessarily related to the increase in institutionalisation over the same period. The 1970s were a decade in which the capital markets were subjected to a series of large unexpected shocks - including, for example, the increases in oil prices, the associated bouts of very high rates of inflation and substantial fluctuations in interest and exchange rates. All of these have undoubtedly added to uncertainty and could be expected to have made expectations more volatile irrespective of any effects that the institutions might be having. A study done for the Wilson Committee found no evidence of a general upward trend in volatility over a longer period. Instead there have been three distinct periods when price volatility has been much higher than average - 1931-32, 1939-40 and 1974-76 - the common feature of each being that they coincided with conditions of more than usual uncertainty.

TABLE 5: PRICE FLUCTUATIONS OF EQUITIES IN THE UK AND US

Annualised average standard deviations of percentage changes in capital values

	1959-68	1969-78
UK equities	14.7	28.7
US equities	11.6	15.7

Source: Rowe Rudd

28. A final point is that increasing institutionalisation, together with other factors such as the cost of financing the taking of positions at a time of high interest rates, has put considerable strain on the present system of market organisation in the Stock Exchange - that is the separation of capacity between jobbers and brokers and the principle of competitive market-making by the jobbers. Paralleling the increase in institutionalisation, and undoubtedly closely connected with it, has been an increase in the average size of bargain (which has nearly doubled in real terms since 1966). This has been associated with a decline in the numbers of both brokers and jobbers, an increase in the "spreads" of those jobbing firms which remain, and an increase in the proportion of "put-throughs" (where a broker finds both buyer and seller himself and only puts the transaction through a jobber in a nominal fashion). In 1959 there were 104 jobbing firms in the London market. There are currently only 13 - of whom 5 account for about 90 per cent of total turnover -with a further six operating outside London on the country floors. The result is that markets in many

stocks are now made by only one, or at the most two, jobbers. This process has now gone so far that many observers believe that the viability of the present organisation of the Stock Exchange is in doubt irrespective of the outcome of the current reference to the Restrictive Practices Court.

29. There is no conclusive evidence that the present level of institutionalisation has damaged the effectiveness of the capital markets. But some causes for concern undoubtedly exist, notably about the efficacy of the mechanisms of raising capital for small companies. Moreover, the shift of ownership away from individuals towards institutions, which is presently proceeding at a rate of about 2 per cent a year, has clearly not yet ended. The group do not necessarily subscribe to some of the more extreme forecasts suggesting that by the end of the century ownership of ordinary shares by individuals will account for only an insignificant proportion of the total. But some considerable further growth in institutionalisation is clearly in prospect as existing funds continue to mature, irrespective of any changes of the taxation arrangements. A further factor is the possibility of developments in occupational provision following from recommendations which the Occupational Pensions Board may make when they report on pensions transferability and the initiatives on equal treatment for men and women which are being encouraged by the Equal Opportunities Commission and by the EC Commission. Both of these could lead to fairly substantial additions to pension liabilities.

30. Apart from this, there are often thought to be other reasons for encouraging more extensive direct holding of shares by individuals.

31. In these circumstances the case for retaining the present tax reliefs for institutionalised saving clearly needs to be scrutinised very carefully.

III TAXATION OF LIFE ASSURANCE

32. There are two special tax reliefs relating to life assurance - life assurance premium relief to the individual and relief to life offices on the income received by them.

Life assurance premium relief

33. The conditions for premium relief are laid down in Section 10 ICTA 1970 as amended by the 1976 Finance Act. Relief is given up to the greater of £1500 or one sixth of total income in respect of the aggregate premiums paid by an individual on qualifying life assurance policies taken out by him or his spouse on his own life or on that of his spouse. In order to qualify, a policy must generally be intended to run for a term of at least 10 years and the premiums must be paid not less than annually and evenly spread over the life of the

policy. The proceeds of a qualifying policy on death or maturity are generally exempt from income and capital gains tax.

34. Life assurance premium relief has been given for many years - almost as long, indeed, as income tax has existed. From 1973-74, when income tax and surtax were unified, it was given at half the basic rate of income tax. When the new system of relief by deduction was introduced, with effect from 1979-80, the rate of relief was set at 17½ per cent. In the 1980 Finance Act this was reduced to 15 per cent with effect from 6 April 1981.

35. The cost of the relief is expected to be around £540 million in 1980-81 and £530 million in 1981-82 in current prices. The fall in the real revenue cost results from the reduction in the rate of relief.

36. Neither the US nor Canada give life assurance premium relief. Japan and most European countries do give some form of relief, but the upper limit is generally much lower (see Annex 4).

Justification for life assurance premium relief

37. The historical justification for life assurance premium relief was that it encouraged the individual to save and thereby to make proper provision for his dependants in the event of his death. The Royal Commission on Income Tax observed in 1920:

> "The distinguishing feature of life insurance, 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 not accumulated capital in his earlier years of productive effort, secure a proper provision for his dependants" (paragraph 296).

38. The principle was upheld by the Royal Commission on the Taxation of Profits and Income in 1955. It has, however, been considerably weakened over the years by the growth of state and occupational pension schemes and by the social security system. There now exists a number of other ways in which dependants can be protected against the death of the family bread-winner.

39. At the same time, the investment aspects of life assurance have become more dominant. The industry has developed policies with a large savings element designed to take advantage of the tax relief. This has boosted the return for a given net premium so as to make life assurance attractive as an investment in its own right, as well as a means of provision for dependents. Today there is a wide variety of policies concentrating on savings rather than life cover and with part of the yield coming from the premium relief itself.

40. The existence of the relief has undoubtedly had the effect over the years of mobilising a large volume of contractual saving for investment in private and public sector assets. To

some extent, especially in recent years, this might represent saving diverted from other intermediaries (or which might have flowed into other intermediaries if the revenue foregone had been used to encourage saving in some other way). But a large part has probably been additional saving which would not otherwise have taken place.

41. This is particularly likely to be the case with industrial life assurance, the distinguishing feature of which is that the premiums are collected house to house at frequent intervals. Though collection expenses are inevitably high, industrial insurance is widely believed to tap the savings of lower income groups in a way that has not successfully been done by other media. Industrial assurance accounts for about one quarter of the total new annual premiums of ordinary branch and industrial life assurance business combined, but a rather smaller proportion of the total accumulated funds.

Possible changes and their effects

42. The fiscal encouragement given to saving via life assurance now looks anomalous by comparison with the position of most other forms of saving, including savings invested directly in the equity markets (though not, of course, by comparison with the treatment of housing or additional voluntary contributions to pension schemes). A reduction in the relief, if that was thought to be justified, could be achieved in a number of ways:

(i) reducing, or withdrawing altogether, the relief on all policies;

(ii) reducing, or removing altogether, the rate of relief on new policies only;

(iii) restricting the relief solely to the genuine insurance element in existing and/or new policies. For a wide variety of life offices this would in practice be virtually equivalent to removing it altogether.

There is, of course, no reason why new and existing policies should be treated in exactly the same way. It would, for example, be possible to withdraw the relief completely on all new policies, while retaining that on existing policies or phasing it out gradually over a period of years.

43. None of these options would be without problems, the extent and nature of which would vary with which were adopted and the speed with which they were implemented. The Department of Trade believe that once confidence in the continuation of the relief was lost it might not be possible to influence the time at which the difficulties appear. But other members of the group, while not underestimating the potential problems, consider that they can be exaggerated, particularly if any changes are phased in over a sufficently long period of time and announced in full at the start.

44. First, there is the effect on the policy-holders. A large number of policies have been taken out in the past in the expectation that tax relief would be available on premium payments until the end of the contract. Of course, as has already been pointed out, governments must always retain the right to make changes in the rates or structure of taxation. But life assurance premium relief has been a feature of the income tax system for a very long time indeed. Any substantial change would be likely to be resented, particularly by those using the endowment method of house purchase. Though premium relief is a comparatively small proportion of the total tax relief afforded the average purchaser using this method, without it the balance of advantage in choosing this rather than some other form of house purchase would be altered.

45. This objection would not, of course, apply if any change in the relief only affected contracts made after some future date. But the result could be a very long transitional period, possibly as long as 40 or 50 years. (It has only recently been possible to get rid of special provisions for pre-1916 assurance contracts.) The revenue saving and the effect on capital markets would correspondingly take longer to come through. A distinction of this sort could also have some unpredictable side-effects because it would effectively lock policy-holders into their existing contracts.

46. Secondly, there is the effect on the insurance industry. There is something of a precedent in Australia where, over a period of years from 1973 to 1976, the taxation of life companies and the treatment of premiums were both made substantially less favourable. Since then there has been a steady decline in the total share of savings going to life insurance at a time when total household saving has been increasing. There has also been an increase in the number of policies forfeited or surrendered before maturity and a marked swing away from traditional life policies involving a substantial savings element towards contracts with a greater emphasis on protection, in particular towards term assurance.

47. It would be reasonable to expect something similar to happen in the UK. Complete withdrawal of the relief would raise the annual cost of a given return to the policy-holder by 21 per cent compared with its cost in 1980-81 (17½ per cent compared with 1981-82). The Department of Trade have sought to analyse the probable effect of this in the note attached at Annex 5. In brief, if the withdrawal of the relief was limited to new policies, they would expect a decline in the inflow of funds into endowment policies taken out for savings purposes only and a marked reduction in those policies issued in conjunction with house purchase. Sales of regular premium linked policies would also be made much less attractive. But these effects might in practice be mitigated by successful marketing. This would not, of course apply to those policies whose sole marketing appeal was the existence of the relief. Term insurance, whole life policies and single premium policies would be little affected. The implications for particular companies would depend upon the extent to which they

specialised in the most vulnerable areas. The worst affected are those likely to be the relatively young companies set up to develop linked policies. In principle all of these should be able to meet their liabilities, but a number could be forced into mergers and take-overs. The long established traditional companies should be in a stronger position. But their expense ratios could be expected to rise, at least initially, without a growing volume of new business to share the cost of fixed overheads and this is likely to be reflected in lower bonus rates affecting both old and new policies.

48. If abolition of the relief applied to existing as well as new contracts, there could be expected to be an increase in the number of surrenders of endowment and linked policies and a substantial conversion to paid-up policies. The impact on the companies would be correspondingly increased, and, depending upon how quickly the change was phased in, the Department believe there would be a risk that the industry could not be restructured quickly enough to avoid some failures.

49. Finally, there is the potential effect on the capital markets. A rapid fall in new business, accompanied by an increase in the number of surrenders, would put some life offices in a position in which their cash flow became negative and they consequently had to sell off some of their existing assets in order to meet their obligations.

The taxation of life assurance companies

50. A secondary aspect of the taxation of life assurance is the treatment of the income received by life offices on invested premiums. Since 1940 a distinction has been made in the rate of tax charged on policyholders' and shareholders' profits. Shareholders' profits are charged at the normal corporation tax rate; but income reserved for policyholders or annuitants is charged at a special "pegged" rate of 37½ per cent. This does not affect dividends from UK companies (franked investment income) which are outside the charge to corporation tax.

51. The pegged rate of tax was originally introduced in response to claims from the life offices that they had made many long-term contracts on the assumption that the rate of tax on their investment income would be unlikely to exceed pre-war rates, and that the burden of war-time tax rates could consequently seriously embarrass them and might put some in danger of insolvency. An offsetting reduction in the amount of premium relief was made at the same time.

52. There are arguments both for increasing the pegged rate to the ordinary corporation tax rate (presently 52 per cent) and reducing it to, say, 30 per cent, which is the rate which would be applicable to the majority of policyholders had they received the same income directly.

53. The main argument for increasing the pegged rate to bring the tax treatment of life assurance funds into line with that of company profits in general is that it was intended originally to be a temporary device. The pattern of post-war rates is now well established, and there is no obvious reason why life companies should be permanently shielded from them. They managed to live with fluctuating rates of taxation before 1940 and have subsequently had to contend with other uncertainties of a similar order of magnitude arising from, for example, changes in interest rates.

54. Moreover, policyholders have choosen to place their savings with an institution rather than investing them directly. There is, therefore, no obvious reason for "looking through" the institution to take account of the tax rates that would have been charged had the policy holders invested directly, anymore than with tax payers who choose to invest with unit and investment trusts. The investment income of the latter is taxed under the normal company taxation rules (with the exception, since last year, of those investing solely in gilts or other fixed-interest stock). Increasing the pegged rate of tax to the normal corporation tax rate would, if the pattern of life funds' income remained unchanged, probably yield additional revenue of the order of £10 to £20 million a year.

55. Against this, it can be argued that there is a fundamental distinction between profits accruing to shareholders and those belonging to policyholders. It is the former, which are already taxed as 52 per cent, which are equivalent to the profits of other companies. The latter can never be distributed as dividends. There is also a lower rate of charge (at present 40 per cent) for other non-dividend bodies liable to corporation tax, such as building societies and industrial and provident societies. The unfranked investment income of unit trust holders and investment trust share holders, which is charged at the full rate of corporation tax, is different in that it actually reaches the investor as a dividend. The revenue cost of reducing the pegged rate to 30 per cent would be of the order of £10m a year.

56. These arguments do not seem to point conclusively in either direction. The effects of any change in the pegged rate on life assurance business and the size of life assurance funds would be likely to be very small and, bearing in mind the small amount of revenue involved, the group see no good reason to disturb the present status quo.

IV THE TAXATION OF SUPERANNUATION

57. The second main area of institutional saving considered by the group is superannuation.

58. Saving through an occupational pension scheme is favoured in a number of ways, provided the scheme is approved by the Inland Revenue. First, employees' contributions are

tax-deductible in their hands and no assessment is made on them in respect of the employers' contributions. (For employers themselves the latter are an allowable deduction from taxable profits in the normal way as part of labour costs.) Secondly, the investment income and chargeable gains of an approved fund are exempt from income tax and from capital gains tax; and there is also an exemption for underwriting commissions. Trading profits, which are generally negligible for pension funds, are not exempted from tax, nor is there any relief from a development land tax charge should one arise. Thirdly, regular pensions are taxed as earned income at the time they are received, but up to 1½ times final pay may be taken at the time of retirement as a tax-free lump sum. There are comparable reliefs for approved retirement annuity contracts.

59. The current cost of the special reliefs for superannuation schemes is estimated at around £700 million (made up as shown in Annex 6). This figure reflects the additional yield from withdrawing the deduction for employee contributions and from taxing the funds' investment income (but not the funds' capital gains, about which data are not available). It also assumes that the element of pensions coming into payment representing income earned by the fund (but not that representing the return of contributions) would be taxable, with credit being given in respect of the tax already paid by the fund on its investment income. It does not assume that the employee is taxed directly on his share of the employer's contribution, since special provision - beyond the withdrawal of existing reliefs - would be needed for this. The yield from a new charge on the employee in support of this element of the contribution would depend on the form the arrangements took: it could be up to £500 million.

60. There are also special arrangements for the tax treatment of superannuatuion arrangements in most other industrial countries, though the details vary (see Annex 7).

61. There are a number of points at which the tax treatment of superannuation requires consideration:

(i) the treatment of the employer's contributions in his hands;

(ii) the treatment of the employer's contributions in the employee's hands;

(iii) the treatment of the employee's contributions;

(iv) the treatment of benefits - lump sum and pension - payable;

(iv) the treatment of the investment income of the scheme.

The most difficult areas are (iv) and (v).

Employer's and employee's contributions

62. The treatment of the employer's contributions in his own hands is not contentious. The annual contributions paid by an employer to an occupational pension scheme are clearly part of his labour costs and properly allowable under the normal rules in computing his profits for tax purposes. Additional payments, for example to augment benefits or to make good an actuarial deficiency, might in principle be regarded as being of a capital nature and therefore not strictly allowable. But the legislation makes special provision for them to be deductible (possibly over a number of years) if the scheme is approved.

63. The treatment of the employer's contributions in the employee's hands, and of the employee's contributions in his own hands, is more debatable. In essence, the arrangements treat pensions as deferred remuneration which is taxed as earned income at the time it is paid and not at the time it is earned. To tax remuneration gross of pension contributions (whether made by the employer or by the employee) and then also to tax the capital element of the pension when it is subsequently paid would constitute a form of double taxation.

64. It could be argued that the contributions are a form of fringe benefit on which the employee ought to be taxed. There are other forms of spreading income to provide for retirement, in particular direct investment in equities, which are not relieved of tax and on which a measure of double taxation could consequently be said to result.

65. But there is some justification for treating pensions as a special case. The employee has no entitlement to benefit from the employer's contributions if he leaves before qualifying for preservation rights. In circumstances where social security legislation and pension scheme rules permit a refund to be taken, he may not receive benefit from any employer's contributions to the scheme. To qualify for preservation rights he must have reached the age of 26 and he must have completed 5 years qualifying service. Even then, the actual enjoyment of the rights would normally be deferred until he reaches retirement age. Statutory preserved benefits are calculated as the appropriate proportion of the benefit which would have become payable had the employee remained in service - without regard to inflation or future salary increases. There is no set formula by which a transfer of contributions to another scheme is calculated except where the guaranteed minimum pension which has accumulated in a contracted-out scheme is transferred to another contracted-out scheme. Administratively it would be most unsatisfactory to have to base a tax charge on the value of an individual's rights. The calculation of rights attributable to the employer's contributions at any one time would, in particular, be extremely complicated: employers generally contribute on the basis of a flat rate percentage of the overall salary bill. The employee's interest in the employer's contribution is, therefore, very much a contigent one from which unlike other fringe benefits, he derives no immediate and certain advantage. As

regards his own contributions, they are also distinguished from discretionary savings in that he may, in practice have no choice whether or not he should make them since membership of the relevant scheme is often a condition of employment. Finally, he never actually sees his contributions in his hand, since they are deducted at source.

66. It is sometimes suggested that these arguments do not apply with anything like the same force to additional voluntary contributions (AVCs) made by employees to increase their pension entitlements. Such contributions are allowable for tax purposes up to a limit of 15 per cent of pay for voluntary and compulsory contributions combined. Until recently, relatively little use was made of them. But in the last few years they have become more popular, apparently partly because of greater realisation of the effects of inflation and partly because of publicity about their tax advantages. Since few pension schemes currently require full use of the 15 per cent limit in compulsory contributions, for many individuals AVCs are an attractive alternative use of savings by comparison with endowment life assurance or direct involvement in the equity market. It would, however, be difficult to justify a reduction in the rate of tax relief for AVCs while maintaining full relief on compulsory contributions. This would penalise employees in pension schemes offering only modest benefits and those who join a pension scheme well into their working life, having had no previous opportunity to participate in pension arrangements. It would be relatively easy to circumvent and would be seen as throwing more of the burden on employers, It would also be difficult to justify presentationally, since it would provide different tax treatment to employees paying the same total contributions for the same total benefit, depending on whether or not the whole of their contributions were being paid compulsorily or not.

Pensions in payment and lump sums

67. The treatment of pensions in payment as earned income follows logically from the treatment of the contributions which fund them. There is, however, a major departure from philosophical purity in the freedom from taxation of lump sums. The Wilson Committee drew attention to this as the chief anomaly in the present arrangements.

68. It might be argued that, unlike the pension, the lump sum should not be taxable because it is of a capital nature and therefore not properly subject to an income tax. But in this case the double taxation argument falls to the ground. Logically, either the lump sum should be taxed, or the deduction for the employee's contributions attributable to it should be disallowed, and the employer's contributions taxed in the employee's hands.

69. The main argument against making the lump sum taxable is the same as that for making any reduction in life assurance premium relief gradually. As the Wilson Committee recognised, the tax-free nature of the lump sum has become such an accepted part of the

present arrangements, and one on which so many individuals currently base their future financial plans, that its removal would be likely to be deeply resented. It would, moreover, in itself have no immediate effect on the balance between institutional and direct investment. Indeed, it is possible that the effect could be perverse, given that receipt of the lump sum on retirement is the first occasion on which many individuals acquire a capital sum large enough to make direct investment worthwhile. There is no evidence, however, about the extent to which lump sums are in practice made use of in this way rather than, for example, used to pay off mortgages, deposited in a building society or invested through other institutional media.

70. If the lump sum were to be made taxable, there are a number of ways in which this could be done. One possibility would be to impose a cash limit (and to provide that the remainder be taken in pension form) or to impose a threshold above which the lump sum would be taxable. A different approach would be to tax the entire lump sum at a flat rate somewhat lower than the basic rate, in order to overcome the problems arising from taxing the whole of the sum as income in one year and in recognition of the uncertainties about the tax that would be received on an equivalent pension. It would then be necessary to consider the interaction of these possible solutions with the method of taxing terminal payments such as redundancy payments and 'golden handshakes'. Any move to reduce the present limit on lump sums (broadly speaking, 1½ times final salary) would also have implications for those schemes (mainly in the public sector) where the lump sum is compulsory and those where, though a lump sum is usually taken, there is an option between the lump sum and a higher pension. Other alternatives would be to regard the lump sum as akin to repayments of contributions, or to disallow that part of the employee's contributions attributable to the provision of the lump sum and to tax the corresponding part of the employer's contribution in the employee's hands. The latter would avoid the problems of retrospection, but could be complicated administratively.

71. The additional revenue from taxing lump sums might be fairly small (since many pensioners would simply not exercise the option). In view of this, of the administrative difficulties outlined above and of the potentially unhelpful effect on the balance between personal and institutional investment, we do not recommend that they should be made taxable. The possibility of imposing a flat-rate cash limit, in addition to the existing proportional limit, on the amount of pension which can be taken tax-free in the form of a lump sum could, however, be given further consideration.

Investment income

72. The second possibly contentious part of the present arrangements is the treatment of investment income. It might be reasonable to allow superannuation contributions as a

deduction as a counterpart to the taxation of the subsequently emerging pension. But the freedom from tax of the investment income of the funds may appear to be excessive and unnecessary by comparison with the position of an individual providing for his retirement by investing directly himself. No corresponding reliefs are available to the latter (although he does have direct access to his capital).

73. There are, however, a number of important practical considerations which need to be taken into account.

74. First, taxing the income of the funds would, of itself, not affect their liabilities. But it would affect the way in which they were financed. Some employers might find that the change shifted the balance of advantage in favour of contracting into the earnings-related part of the State scheme (which is on a pay-as-you-go basis) or react by conceding less generous benefits to their employees than they might otherwise. In addition, at the margin, some funds at present flowing into annuity contracts or pension schemes in the form, for example, of AVC payments might be diverted to other uses. But these effects would be offset by the fund's need to acquire and hold a larger stock of financial assets in order to provide the same flow of benefits as before out of post-tax income. The effect of introducing a tax charge is therefore as likely to be to increase the size and rate of growth of pension funds as to reduce them.

75. Secondly, the tax charge would have to be financed in some way. The presumption must be that the major part would be borne by employers rather than employees. Companies with taxable profits would be able to claim their increased contributions as a deduction against any corporation tax liability. But even so the change would result in a considerable further call on their liquidity.

76. Thirdly, a change of this kind would disrupt the whole basis on which most employers have provided for their future pension obligations. The pension industry has only recently begun to settle down after a period of considerable uncertainty during the 1970s. A further upset would be most unwelcome unless the case for it was very clear indeed. The change would also add to the present imbalance between (unfunded) public sector schemes and (funded) private sector ones.

77. The group do not therefore favour any change in the present tax treatment of pension funds' investment income.

V NEW FORMS OF SPECIFIC RELIEF

78. The two previous sections considered the case for withdrawing or modifying existing reliefs. Suggestions are also made from time to time which would have the effect of

extending them. We have looked at two such suggestions. The first involves turning the life assurance premium relief into a more general relief equally available to all forms of contractual saving. The second involves a new form of relief for direct investment in the equity market. Both would, of course, introduce yet further distortions into the system, but might nevertheless be held to be justified for other reasons.

A general relief for contractual saving

79. The first suggestion came from the Wilson Committee. Paragraph 708 of their report recommends that:

> "the tax relief given to life assurance premiums should be extended to any other form of contractual medium or long-term savings plan subject to similar safeguards against early withdrawal and to the same overall limit of £1500 or one-sixth of total income."

80. The main justification for such a change, as they saw it, was that it would provide greater fiscal neutrality without at the same time reducing the incentive to save in a contractual form (which they regarded as important to the institutions' ability to advance medium and long-term finance to industry) They expected the main beneficiaries to be the building societies, the unit trusts and the banks. At present both building societies and unit trust management groups are already able to take advantage of life assurance premium relief, but only through the intermediation of an insurance company.

81. It is certainly true that a modified relief of this kind would introduce greater fiscal neutrality to different forms of institutional saving. But it would do nothing about the balance between institutional and direct investment. Indeed it could well add to the overall incentive to invest through institutions. It could also be difficult and costly to administer.

82. There is also the question of whether it would in practice be possible to make the change on a revenue-neutral basis. In 1981-82 terms, the cost of life assurance premium relief at a rate of 15 per cent is of the order of £530 million. We have no means of making a proper estimate of the amount of saving which would qualify for a wider relief. But, as a broad indication, gross annual deposits in building societies, national savings, savings banks and unit trusts totalled around £32 billion in 1979. If, say, 10 per cent of this qualified for the new relief the rate would have to be set at around 8 per cent to keep within the same revenue cost. But much would depend on the extent to which existing deposits could be made to qualify, which could add substantially to the cost.

A new relief for direct investment in equities

83. The second suggestion is a new relief for the direct acquisition of company securities. This idea has been put forward by, among others, the Stock Exchange drawing on a scheme introduced in France in 1978 by the Loi Monory.

84. The Loi Monory was introduced for a limited period with the intention that it would apply until 1981. It provides relief for new investment in the equities of French quoted companies, French unquoted companies as part of a capital increase, or in the French equivalent of unit trusts (SICAVs) by way of a deduction against taxable income. The deduction is subject to an upper limit of F5000 per household (equivalent to around £450 at current exchange rates) with modest additions where the taxpayer has dependent children. It is given for net new investment, that is the difference between amounts expended on the purchase of shares and the amount realised on any sales of shares. There are clawback provisions where sales exceed purchases in any of the four subsequent years. To make this practical, all qualifying investments (including those held before the relief was introduced) must be lodged with a bank or other intermediary before the first acquisition in respect of which relief is to be claimed is made. All sales and purchases of qualifying assets have also to be made through the same intermediary.

85. The value of the Loi Monory as a precedent for the UK is limited. The encouragement of wider shareholding was one of its objectives (the others being to reduce the gearing of French companies and to lengthen the maturity structure of the financial assets held by the personal sector). But the French authorities appear to be indifferent as to whether this is achieved directly or through intermediaries, which are much less important than in this country. Consequently the proponderant part of qualifying investment has in fact taken place through institutional channels, which would hardly be the desired objective here. There are also a number of other important differences between the French financial and taxation systems and their counterparts here which would make a scheme in this country more difficult to administer and police.

86. We have nevertheless considered whether an analogous scheme to the Loi Monory, adapted to UK circumstances, would be helpful and cost-effective in relation to encouraging individuals to acquire company securities directly.

87. There can be little dispute that the introduction of such a relief would help to stimulate Stock Exchange activity. Investors would undoubtedly be attracted by a relief which, in effect, enabled them to buy shares at a discount. But the extent to which genuine additionality would be achieved is questionable. It would be difficult to limit the relief to new saving without complex legal and administrative arrangements. The Loi Monory deals with this problem by requiring all qualifying assets to be lodged with banks or other approved intermediaries. A similar arrangement seems unlikely to be feasible in the UK.

88. The revenue cost, on the other hand, could be substantial. It is difficult to put a figure to this, since it would depend both upon the amount of relief given and on how many people made use of it. But if, by way of example, a limit of about £500 was used, and 1 million

basic rate taxpayers took advantage of it, the annual cost could be £150 million. The cost would be higher to the extent that the relief would be particularly attractive to higher rate taxpayers.

89. A relief along these lines is subject to a number of other objections in addition to its possible high cost and limited effectiveness:

(i) It would require complex legislation and a large number of staff to administer. In practice there could be considerable difficulties in excluding all forms of intermediaries.

(ii) It would introduce yet another distortion into the fiscal system at a time when one of the Government's major objectives is to try to simplify it.

(iii) If the size of the relief and rate at which it was given was set at a high level, the cost and risk of abuse would be disproportionately increased. But if, for this reason, the relief was limited, most of those taking advantage of it are likely to be mainly attracted to shares in large established companies rather than small private firms and new enterprises. The former already benefit indirectly, however, through the institutional reliefs and it is against investment in the latter that the fiscal system could be said to discriminate most.

(iv) Particularly if set at a low level, the relief could encourage individuals of relatively modest means to acquire assets which they would not otherwise have bought in the market, which might be more risky and less liquid than equivalent assets held through intermediaries and which would be subject to a tax penalty if realised within a certain period. It could therefore bring share investment into disrepute, particularly if its introduction coincided with a fall in the market.

90. In sum, the gains from a general relief of this kind seem to be unclear and unquantifiable, while the costs are clear and substantial. We do not therefore favour it.

91. Some members of the group do, however, feel that, for the reason given in paragraph 89(iii), there is a stronger case for considering whether it is possible to overcome the undoubted difficulties to provide a relief confined to investment in smaller, unlisted companies. They therefore welcome the work which they understand to be already in hand on this in another group.

VI OTHER WAYS OF ENCOURAGING DIRECT INVESTMENT

92. The alternative to specific reliefs as a way of encouraging greater direct personal investment in the equity market is changes in taxation aimed at making the holding of

equities more attractive in a more general way. Some of these changes may, of course, also be justified for other reasons. The benefit from them would not accrue only, or even mainly, to individuals holding shares directly. But they could have a much more powerful effect at the margin than the particular specific measures we have considered.

93. Four main possibilities have been suggested:

(i) the abolition of the investment income surcharge;

(ii) alleviation of capital gains tax;

(iii) a reduction in transfer stamp duty;

(iv) reallowance of interest.

The investment income surcharge

94. The investment income surcharge is at present levied at a rate of 15 per cent on all investment income above a threshold of £5,500 (the investment income of life assurance and pension funds is, of course, exempt). For this purpose the investment incomes of a husband and wife are added together, even if they have jointly elected to have the wife's earned income taxed as if she were single (the wife's earned income election). The yield in 1980-81 is expected to be about £310 million.

95. Investment income has effectively been taxed at a higher rate than earned income for many years on the basis of arguments such as the relatively precarious nature of earned income, the personal work and effort involved in acquiring it and the difference in taxable capacity implied by the existence of underlying capital. But the earned income relief which marked the difference up to 1973 applied to all earned income up to a ceiling, whereas the surcharge applies only to investment income above a threshold (which is now indexed). Since 1973 the differential tax treatment has therefore applied only to those with a fair measure of underlying capital. In this sense the surcharge is justified less by fiscal or economic arguments than as distributional and revenue-raising measure.

96. Its abolition would, because of the present relatively high level of the threshold, mainly benefit those with a fairly substantial amount of income-yielding capital (although 40 per cent of surcharge payers are otherwise liable to income tax only at the basic rate, implying that their total income is by no means substantial). On the face of it, this is exactly the group who might be interested in direct equity investment. But, for the same reason, the change could be politically contentious and the resulting uncertainty about the possible re-imposition of the surcharge with a future change of Government could reduce its impact. There is also the point that such a change would increase the relative attraction of high income-yielding assets such as gilts by comparison with those offering the prospect of

capital gains.

97. Alternatives to complete abolition, which might be politically less difficult, include the following:

(i) The re-instatement of a separate, higher threshold for those over retirement age. This would mean reverting in part to the situation which existed before the increase in the threshold and the abolition of the lower 10 per cent rate band in 1979. The cost of a differential threshold for those aged 65 or over of, say, £6,500 would be around £30 million.

(ii) The provision of separate thresholds for husband and wife, which would cost around £80 million.

(iii) The extension of the wife's earning election to investment income. This would give a separate income tax allowance and rate bands to a wife with investment income, as well as a separate surcharge threshold, and would cost around £300 million.

(ii) and (iii) are possibilities which were discussed in the recent Green Paper on the taxation of husband and wife and, unlike some of the other options discussed there, could be introduced within the next three or four years.

Capital gains tax

98. A second possible approach is to make further reductions in the burden of capital gains tax, which is of course something to which the Government is already in principle committed. Again, this could be done in a number of ways. The most straightforward would be an increase in the £3,000 annual exemption introduced in the Finance Act 1980. An alternative would be to introduce separate exemptions for husband and wife, which would eventually be necessary in any event if the mandatory independent taxation option in the Green Paper were to be adopted.

99. A further suggestion in this area is a capital gains tax rollover relief for individuals who re-invest the proceeds of sales of shares in other qualifying securities, along the lines of the relief which already exists for the replacement of certain business assets. The main beneficiaries would be expected to be fairly wealthy investors, the less wealthy already being substantially assisted by the annual exemption which may well take them out of charge altogether. The cost is difficult to quantify. If the relief was restricted to the proceeds of sales of equities re-invested within the same Stock Exchange account, and present patterns remained unaltered, it could cost up to £20 million. But some behavioural changes to get within the relief would be inevitable and the cost would be increased accordingly.

100. The intention would be to remove an impediment to efficient portfolio management by private investors which is not shared by gross funds. Even if those concerned took full advantage of the annual exemption, it could, however, have the effect of locking them into the market as a result of the ever-increasing tax cost of getting out (when the previously deferred charges would catch up with them). Perhaps more importantly, if confined to equities it would introduce a further distortion into the system. There would be strong pressure to extend it to unquoted shares and securities and it would in practice be difficult to exclude land, given the relative ease with which this can be converted into the form of shares by transfer into corporate ownership. This could add considerably to the cost, which could be increased to anything up to £200 million.

Reduction in transfer stamp duty

101. At present, transfers of equities incur a stamp duty charge of 2 per cent, except for overseas residents who pay at a rate of 1 per cent. Transfers of gilts and most other forms of fixed-interest stock (including corporate debentures) are exempt. Transfers of property (including houses) are exempt below £20,000 and subject to a reduced scale between £20,000 and £30,000. The anticipated yield from stamp duty on stocks and shares in 1980-81 is £235 million.

102. Stamp duty accounts for a fairly substantial part of the total transactions cost involved in buying or selling securities. It is widely regarded in the market as a major impediment to stimulating greater personal investment, though the comparatively small effect on volume of the doubling of the stamp duty rate in 1974 lends only limited support to this view. The "round trip" cost of buying a share in amounts of less than £7000 and subsequently selling it is currently around 8 per cent (including the jobber's turn as well as the broker's commission), of which stamp duty is responsible for one quarter.

103. A reduction in duty to, say, 1 per cent (as urged in the Stock Exchange's recent Budget representations) would probably directly reduce revenue by around £105 million, allowing for some increase in turnover. More than half of the benefit of this would, of course, accrue to the institutions.

104. In practice, however, it would be difficult to restrict a reduction in the rate of duty to equities and exclude other property. As already mentioned, it is relatively easy to convert land into the form of shares by transferring it to corporate ownership; and it might politically be very difficult to exclude transfers of housing over the present £20,000 threshold. The result could be to add very substantially to the revenue cost. An across-the-board reduction in stamp duty to 1 per cent would cost around £275 million in 1980-81, of which less than a third would go to equities. It is sometimes suggested that this could be offset by the simultaneous imposition of stamp duty on transfers of gilts. But this is not in

practice feasible for legal reasons associated with the prospectus documents, even if the case in principle for such a change was accepted.

105. A possible alternative to a general cut in duty would be an exemption or special rate of duty for small purchases of shares. This would, however, encourage the splitting of transactions into smaller parcels, which would increase transactions costs. No effective counter to this kind of splitting is available since stamp duty is geared both legally and administratively to looking at documents relating to individual transactions and not, as with many other taxes, at a series of transactions involving one person. The revenue cost would therefore be likely to be high in relation to the benefit really going to those acquiring small parcels of shares to form part of a modest portfolio.

Reallowance of interest

106. The final suggestion is to reallow tax relief for interest paid on borrowing, possibly subject to an upper limit of, say, £3,000.

107. This is, of course, an issue with a long history. The argument for the relief in this context is that if an individual needs temporary liquidity he cannot borrow against the collateral of any equities he may hold and get relief on the cost of borrowing corresponding to the tax paid on the income arising from his portfolio. If, however, he sells the shares he might be faced by a capital gains tax liability. The effect may be to reduce the attraction of holding shares by comparison with, for example gilts or building society or bank deposits.

108. It would, however, be very difficult to provide relief in this way and exclude hire purchase and other consumer credit debt. The revenue cost would then be very substantial indeed, possibly of the order of up to £500 million even if relief were confined to the basic rate, and the monetary implications would be most unwelcome. The administrative costs could also be fairly substantial. Finally, much of the case for any general change would, of course, fall to the ground if it were possible to make a further substantial increase in the capital gains tax threshold. It might, however, be possible to look again at the existing relief for the cost of borrowing undertaken to purchase shares in private companies to see if it is too tightly drawn.

VII CONCLUSION

109. This report has examined the fiscal treatment of the two main forms of institutional saving, and that of individuals investing their savings directly in the equity market, in the context of a continuing shift in the ownership of equity capital away from individuals towards the institutions. This shift is presently proceeding at a rate of about 2 per cent a year. While we do not necessarily subscribe to some of the more extreme forecasts, some considerable further growth in institutionalisation is in prospect as existing funds continue to

mature and because of other developments which could lead to fairly substantial additions to pension liabilities. There is no conclusive evidence that it has damaged the effectiveness of the capital markets, but a number of potential causes of concern undoubtedly exist. Moreover, a wider degree of direct share ownership is also often regarded as a desirable objective in its own right.

110. Against this background, our main conclusions are as follows.

111. First, the causes of the trend towards greater institutionalisation are by no means confined to the tax advantages of saving through life assurance and pension funds. Institutional factors have also been important; and individuals' investment preference have been affected by inflation and by the fiscal treatment of owner-occupied housing. It follows that action in these areas might be necessary if a reversal of the present trend is to be achieved.

112. Secondly, our broad conclusion is that distortions in the pattern of savings would be countered more effectively by general measures to increase the relative attractions of equity investment than by replacing one form of specific bias with another.

113. We have considered a number of suggestions of this kind involving changes in the investment income surcharge, reductions in the burden of capital gains tax, a reduction in the transfer stamp duty and re-allowance of interest. We would give greatest priority to the first two of these.

114. Thirdly, a number of the possibilities in this area involve changes in the present treatment of husband and wife, which could be justified in terms of the removal of existing inequitable discriminations and might therefore be less contentious politically. For example, separate thresholds for husband and wife could be introduced for the investment income surcharge and for capital gains tax. The effect of such changes is difficult to assess, particularly because of the inadequacy of information about wives' investment income and capital gains. But in principle there should be a greater incentive to saving and direct investment arising from the reduction in the overall tax burden on married couples where both partners have substantial investments. Reactions to the Green Paper may help to indicate how far such changes would be generally acceptable.

115. Fourthly, we do not favour the introduction of a general relief for direct personal investment in equities along analogous lines to the Loi Monory (though we recognise that somewhat different considerations apply to a relief confined to investment in small companies).

116. Fifthly, with the exception of the representative of the Department of Trade, we believe there to be a case for at least a substantial further reduction in life assurance premium relief. How this should be achieved would require further consideration in the light of the difficulties which might be caused for policyholders and the insurance industry. One possibility would be to remove it altogether from new policies taken out after some future date; a second is to make a phased reduction over a fairly substantial period in the rate at which relief is given on premiums paid on existing policies; a third is to do both. We recognise, however, that such changes, worthwhile though they might be, would not immediately release a great deal of additional revenue nor substantially reduce the total volume of institutionalised saving.

117. The outside members of the group believe that any reduction in life assurance premium relief should be balanced at the same time by changes in other areas, such as those discussed in paragraph 113, so as to maintain the overall incentive to saving. Mr Stewart has suggested that one other possibility, described in more detail in his note at Annex 8 but raised too late to be discussed by the group as a whole, would be an SAYE share purchase scheme for employees in unlisted companies providing for investment in authorised unit or investment trusts.

118. Finally, we believe that there is a case in principle for taxing the lump sum element of pensions. But the additional revenue raised might be fairly small, the effect on the balance between personal and institutional investment could, if anything, be unhelpful and there would be a number of practical difficulties. We do not therefore recommend any change in this area at the present time, though the possibility of introducing a flat rate cash limit on the amount of pension which can be taken tax-free in the form of a lump sum, in addition to the existing proportional limit, could be given further consideration.

ANNEX 1: OUTSIDE MEMBERS OF THE GROUP

Ronald Artus	(The Prudential)
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Roger Plant	(Estate Duties Investment Trust Ltd)
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ANNEX 2

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/ July 1980

Dear Ron,

WORKING GROUP ON TAX AND SAVINGS

From time to time doubts are expressed - most recently by the Wilson Committee - about the pattern of tax reliefs for different types of savings. As you know, some forms of savings receive very generous tax treatment indeed - eg savings for life assurance and superannuation purposes - while other types of savings receive no tax relief at all - such as personal direct investment in equities. The doubts which are expressed stem partly from the fact that some of the reliefs were introduced largely for historical reasons which seem out of place in our current circumstances. And partly, I think, because the very existence of a multiplicity of reliefs both complicates the tax system and erodes the tax base, making the rates of income tax higher than they might otherwise be. On the other hand, there is frequent complaint that no reliefs are available for direct investment by individuals in equities, even though there is an acknowledged need to encourage wider share ownership.

There are clearly a lot of major questions to be considered here, with wide ramifications. We have been giving them some thought within the Treasury. To carry this further, I plan to set up within the Treasury a small working group which will, I hope, look at both the case for the main tax reliefs for "institutional" investment - such as investment in life assurance and superannuation companies -as well as the case for introducing new tax reliefs for direct personal investment in equities. I am also asking the working group to examine, amongst other things, the French Loi Monory scheme which, within limits, gives the individual tax relief for equity investment.

I have in mind that the working group could most usefully consist of officials and people from outside Whitehall. The outsiders would be chosen on the basis of their first-hand knowledge of both the working of the city institutions, and the financial needs of productive industry. The chairman of the group will be Peter Middleton, Deputy Secretary in the Domestic Economy Sector of the Treasury. The officials will be drawn from a number of Whitehall Departments which have an interest in these issues. I plan to invite about half a dozen others, to become members of the group, and I very much hope that you will agree to be one of them. I need hardly add that this invitation is made to you on a personal capacity.

I do not think you would find that membership of the group would involve a great deal of your time. What I envisage is that the group will hold half a dozen or so meetings between now and, say Christmas, and produce a report which could be considered by Ministers before next year's Budget. If you felt you needed any further information about the proposal I am sure that Peter Middleton would be happy to have a word with you (his telephone number in the Treasury is 01-233-5627).

I plan to make an announcement in fairly general terms in due course, that a number of people outside Whitehall will be associated with this study of tax and savings. Until I do so, I should be grateful if you would treat the contents of this letter as confidential.

I do hope you will feel able to help.

GEOFFREY HOWE

ANNEX 3: LIST OF PAPERS CIRCULATED TO THE GROUP

1980

1 Institutional and personal investment in equities: note by the Treasury
2 Life assurance premium relief: note by the Revenue
3 Tax relief on superannuation: note by the Revenue
4 Personal investment in equities: note by the Revenue
5 Taxation of life assurance companies: note by the Revenue
6 Future meetings
7 The work of the Group: note by the Chairman
8 Tax relief for investment in private businesses: paper by the AIB
9 Membership of the group: note by the Secretary
10 Dates of future meetings
11 Profit - sharing schemes: note by the Revenue
12 Costs of tax reliefs for savings: note by the Revenue
13 Taxation of dividend income: note by Mr Plant
14 Taxation of life offices and life assurance premiums in Australia: note by the Secretary
15 Equity ownership, the sprats and the dolphins: note by Mr Rudd
16 Tax treatment of life assurance in the EEC: note by the Revenue
17 A general relief for contractual savings: note by the Revenue
18 Tax paid by life assurance companies: note by the Revenue
19 Industrial life assurance: note by the Secretary
20 Occupational pensions: note by the DHSS
21 Comparative benefits of saving in different forms: notes by Mr Critchley and the Revenue
22 Some interim comments: note by Mr Artus
23 Draft report
24 The relative importance of listed and unlisted companies: note by the Treasury
25 The taxation of dividend income: note by the Revenue
26 Two notes by Mr Critchley: life assurance premium relief and lump sum payments
27 Personal share investment: note by Mr Plant

1981

1 Capital gains tax rollover relief for shares and securities: notes by the Revenue and Mr Plant
2 Life assurance premium relief: note by the Department of Trade
3 Possible changes in the tax treatment of husband and wife: note by the Revenue
4 Draft report: second version
5 Comparative revenue costs of various general savings reliefs: note by the Revenue

ANNEX 4: TAX TREATMENT OF LIFE ASSURANCE IN OTHER COUNTRIES

Country	TAX TREATMENT OF PREMIUMS		Tax Treatment of Life Fund Income	Tax Treatment of Policy Proceeds
	Limitations	Special Conditions		
USA	No relief	-	Special tax deductions for insurers	Taxable only to the extent that they exceed the consideration paid. Proceeds paid on death exempt. Income-averaging may also apply.
Canada	No relief	-	Special tax deductions for insurers	Excess over premiums paid taxable except where proceeds paid following death - these are exempt.
Japan	Deductible in full up to 25,000 Yen Between 25,000 & 50,000 Yen, deduction is 25,000 + 50% of excess over 25,000 Between 50,000 & 100,000 Yen deduction is 37,500 Yen + 25% of excess over 50,000 Maximum relief: 50,000 Yen	Not deductible if paid if foreign insurance companies or if a benefit is paid within 5 years.	No special treatment known	Probably taxable as "miscellaneous" income or "occasional" income if the latter 500,000 Yen + ½ balance is deductible
Belgium	Deductible from earned income only, up to 15% of first 50,000F and 6% of next 625,000F. Maximum deduction 45,000F (about £650), including mortgage protection.	Own life premiums only.	No special treatment by statute. Not known if any given by administrative rules.	Generally taxable if relief given for premiums. Reduced liability if surrendered within 5 years of maturity.
Denmark	Deductible, maximum deduction for premiums plus certain other payments is 3,000 Kr (about £225).	Own life premiums only.	No special treatment by statute. Not known if any given by administrative rules.	Not generally taxable.
France	Maximum deductible 3,250F (£325) plus 600F (£60) for each dependent child.	Endowment policies must have a duration of at least 10 years.	No special treatment by statute. Not known if any given by administrative rules.	Not generally taxable.
West Germany	Deductible subject to a limit including also social security and building and loan contributions, which varies with marital status and number of dependent children.	-	Policyholders' income and reserve to meet claims generally exempt.	Not generally taxable.
Ireland	Deductible up to ½ premiums paid subject to limit of lesser of 6% of total income or £I.1,000.	Endowment policies must have a duration of at least 10 years. Eligible premiums may not exceed 7% of capital sum assured.	Policyholders' income generally exempt.	Not generally taxable.
Italy	Joint limit to deductions for life, sickness and accident insurance premiums and voluntary social security contributions 2,500,000L (approx. £1,200).	Insurances on life of taxpayer, spouse and dependent children only.	Reserve required by law exempted.	Proceeds on surrender within first 5 years taxed at 10%. Otherwise not taxed.
Luxembourg	Deductible up to approx. £350 (single) £700 (married) plus allowance for dependent children.	Insurances on life of taxpayer, spouse and dependent children only. Endowment policies must have a duration of at least 10 years.	No special treatment by statute. Not known if any given by administrative rules.	Not taxable. If policy is surrendered premium relief is recovered.
Netherlands	No general relief.	-	Policyholders' share of profits, and reserve to meet claims generally exempt.	Excess over premiums paid is generally taxable unless the occasion is death under 72 years of age.

ANNEX 5

LIFE ASSURANCE PREMIUM RELIEF: NOTE BY THE DEPARTMENT OF TRADE

This note seeks to analyse the probable effect on life assurance companies of the abolition of life assurance premium relief (LAPR) on (1) new policies and (2) existing policies. Under present rules a policy qualifies for LAPR if it runs for at least 10 years, but the relief is not claimed back on lapsed policies if at least four annual premiums have been paid. The note has been written in consultation with the Government Actuary's Department but the judgements are essentially subjective. Quantification of the effects has not been possible. There has been no consultation with the industry except that the forecast of the way in which the industrial life companies would react has been made in the light of advice kindly provided by Mr Artus.

ABOLITION OF LAPR ON NEW POLICIES

Endowment Policies

2 These are the mainstay of the business of the traditional companies. Although they provide substantial life cover throughout their currency their purpose is mainly saving and the majority are with-profits. With high inflation the return to a policyholder is not particularly attractive. Withdrawal of LAPR would raise the annual cost of a given return to the policyholder by 21% compared with the cost in 1980/81. It seems certain that without the incentive of LAPR fewer persons would be disposed to take on the commitment of long term saving and there would be a fall in sales.

3 Sales of this type of policy linked to house purchase have been particularly buoyant in recent years. Without LAPR for most people this route would not compare favourably with repayment mortgages offered by Building Societies and it seems likely that sales of such policies would be considerably reduced.

4 Although the reserving of life companies should enable them to meet their obligations even if new business disappears, at a time of high inflation the expenses of servicing old policies with relatively low premiums are in part borne by the proceeds of new policies. A sharp reduction in new premiums means that expense ratios rise and the return to policyholders becomes less. This reduction applies to an extent to the holders of old policies as well. Most traditional companies pay substantial bonuses to with-profit policyholders and they can vary the rate at which they are declared at any time. If new business falls heavily they are likely to be reduced.

5 If policyholders believed that the return on their policies would fall their propensity to discontinue their policies would increase; and this would exacerbate the effect of falling new income.

Linked Policies

6 The advantage of a linked policy over regular saving with a unit trust is partly life cover and partly the benefit of LAPR.

If the life cover is small the effective selling point is LAPR. The value of units credited after taking account of expenses is normally greater than the premium (net of tax relief) actually paid. If LAPR is withdrawn this sales point disappears and unit trusts are likely to be preferred. They are exempt from capital gains tax and individuals can realise units and take a profit up to £3,000 a year without capital gains tax. Hence premiums on new regular premium linked policies will decline steeply. Part of this saving may go into unit trusts but a significant part will also go into consumption, as there will be no commitment - as there is with a life policy - to regular saving.

Industrial Life

7 The expenses of industrial life policies are already high. The addition of 21% to the cost of a given return would make them less attractive. Rationally this business ought to fall steeply. In practice salesmanship would mitigate that effect.

Single Premium Policies

8 These policies which attract a substantial flow of funds do not enjoy LAPR and would be unaffected by abolition. They are issued on attractive terms by companies who have no tax liability because of credits carried forward and even with companies in a normal tax position they may be an attractive investment to high tax payers.

Term Policies

9 Term policies are not savings policies. Their attraction does not lie in LAPR and the volume of business flowing into them would not be much affected. They tend to be relatively unprofitable. Even if there was some increase in term insurance eg to cover the risk of death by mortgagors the return to the companies would be very modest. Premiums might have to rise if this business had to carry a significant share of life company expenses.

ABOLITION OF LAPR ON EXISTING AS WELL AS NEW POLICIES

Endowment Policies

10 The effect of abolition would be to raise the annual cost of a given return by about 21% compared with the cost in 1980/81. A proportion of these policies is surrendered every year and it is likely that it would rise significantly. More would also be converted into paid-up policies. In sum the effect on life companies would certainly be a reduced premium income and it is possible that surrenders would oblige some to disinvest.

11 Endowment policies covering house purchase are a special case. It would not be easy for the house purchasers to surrender. Many policyholders have committed themselves to the limit to finance house purchase. An increase of 21% in the premiums on the policy providing for the repayment of capital might involve some hardship, particularly if it took effect at a time when interest rates were rising.

Linked Life Policies

12 The penalties on surrendering a linked policy are often not as great as for traditional whole life and endowment policies. Few would want to increase their premium by 21% for a given return and surrenders and conversions to paid-up would be numerous.

Industrial Life Policies

13 Since most benefits were increased (rather than the premiums reduced) when the LAPR system changed the industrial offices would seek to reverse this arrangement as they are doing when LAPR is reduced in 1981/82. It is probable that if there were a further reduction many policyholders would feel cheated and convert to paid-up or surrender. Although salesmanship would mitigate this there would be serious consequences for the smaller companies whose expense ratios are already very high.

Single Premium Policies

14 There would be no effect.

Term Policies

15 It is not likely that there would be any significant effect on policies of this type.

POLICYHOLDER REACTION: SUMMARY

16 In summary if the withdrawal of LAPR was limited to new policies there would be a decline in the inflow of funds into endowment policies taken out for savings purposes only and marked reduction in endowment policies issued in conjunction with house purchases. Sales of regular premium linked policies would also fall very steeply. Together these make up the bulk of the life offices' business qualifying for LAPR. Rationally industrial policies should attract far less savings but the salesforce might delay this. Term insurance, whole life policies and single premium policies would be little affected.

17 If abolition applied to all policies there would be more surrenders of endowment and linked policies and a substantial conversion to paid-up policies. The psychological effect of withdrawing relief on old and new policies together would be very much greater and policyholders would tend to feel cheated and to terminate contracts where it was not prohibitively costly.

PROFITS FROM LIFE ASSURANCE

18 Because of the greater impact of overheads with a smaller volume of business there would be some decline in profits if withdrawal was limited to new policies; and a greater decline if withdrawal applied to all policies. Since many life companies are mutuals and since conventionally 90% of profits in proprietary companies go to with-profits policyholders the effect of withdrawal would be felt not only through the increased premiums but through

reduced benefits. There is likely to be an adverse effect on existing policyholders even if withdrawal affected only new policyholders.

WHERE THE MONEY WILL GO

19 Predictions about the proceeds of surrendered policies are mere guesses. The probability is that much of it would go to consumption. Not much would go into equity holdings. If the sums are large enough to make this sensible surrender is unlikely to be rational. Very large policies are often taken out for reasons unconnected with LAPR.

20 As to new savings those who do not want to put their money into a long term scheme are likely to opt for regular purchases in unit trusts; and those who are prepared to make a long term commitment have an attractive option in taking out pension policies where the premiums are wholly deductible for tax purposes. This will be easier for the self-employed and those not in an occupational scheme but it should be possible also for most of those in approved private schemes by way of additional voluntary contributions. At present there is little scope for brokers to develop this kind of business, but since their present sources of income will be largely cut off their resource in finding new ways of developing business should not be underestimated.

21 In the long run it is likely that the life companies will develop new policies emphasising the life cover available and playing down the savings element. But much less money will find its way into life assurance. Term life cover at lower rates of premium is likely to replace some endowment policies.

EFFECT ON LIFE COMPANIES

22 The effect on individual life companies will vary according to their portfolios. If withdrawal applies to new business only those worst affected are likely to be the relatively young companies set up to develop linked policies. Their main selling point vis-a-vis unit trusts will go. Some of them may not want to continue to take new business. If so, they will have to be run as closed funds with all the disadvantages that entails of lost investment flexibility and rising expenses. Many are likely to be forced into mergers to remain viable. In principle all these companies should be able to meet their liabilities, but a steep decline in business could cause a crisis. If the withdrawal of LAPR applied to existing business also there would be more surrenders and the run down might be so rapid that some would become insolvent.

23 The long established companies with much of their portfolios in traditional with-profit policies are in a stronger position. But some of them have concentrated heavily on mortgage linked endowment policies and new business of this character might be greatly reduced causing a substantial fall in new premium income. Rising expense ratios are already something of an anxiety especially for some of the smaller companies and would be exacerbated if new business fell substantially. This would be reflected in lower bonus rates, but as the return fell surrenders would receive some stimulus and that would reinforce the vicious circle.

24 Many large companies have pension business which would be unaffected by LAPR. Although the pension policyholders would be unlikely to tolerate the subsidising of the ordinary life business out of pension business the sharing of common expenses would ease the problems to some extent. But for companies without significant pension business - in practice the smaller and less dynamic ones - the effect might be serious. The most vulnerable would be those also heavily committed to mortgage related policies. Although in principle all should be able to meet their liabilities the possibility of failures among small companies cannot be ruled out.

25 If withdrawal of LAPR applied to existing as well as new policies the effect would be greater and more quickly felt as income from the old policies would also fall. The psychological effect would also be much greater.

26 In summary the withdrawal of LAPR on new policies would be likely to cause serious difficulties for companies concentrating on linked business and on mortgage-related policies. A number of mergers and take-overs among the former would have to follow. Among the traditional companies the fall in new business would probably be reflected in lower returns to with-profits policyholders and there would probably have to be mergers to reduce the number of small companies. If withdrawal was total the decline in existing as well as new business would greatly increase the ill-effects and there would be a risk that the industry could not be restructured quickly enough to avoid some failures.

A REDUCTION IN LAPR

27 The first results from 1980 show that ordinary life business may well have been rather smaller that year than in 1979. Certainly the buoyancy of recent years has been lacking. Pension business appears to have grown less than recently. This was expected. There has been no suggestion that the impending reduction in the LAPR rate from 17½% to 15% has been a factor in the levelling off. It is therefore worth considering whether a further reduction after a year or two could be imposed without ill-effect.

28 Objectively it seems likely that relief at the rate of say 12½% - ie half the standard rate of tax at which the Government aims - would have a significant incentive effect on saving through life companies. But the psychological effect has also to be considered. One reduction is impending. The companies cannot give effect to any change without a period of notice. Hence a further reduction would not be possible for another year or two. If there were then a further change the impression would probably be created that LAPR was in the course of being phased out and the fall in the mortgage related business and possibly in the linked business would begin at once though the latter would have its full effect fairly slowly. If LAPR had been fixed at 12½% instead of 15% for 1981/82 and onwards the effect on the volume of savings would not have been very large. But as 15% was in fact chosen a further reduction to 12½% would have a different and more damaging psychological effect. For the sake of the small amount of revenue gained the potential damage to the life assurance industry does not seem worthwhile.

Department of Trade
15 January 1981

ANNEX 6: CALCULATION OF THE COST OF THE TAX RELIEF GIVEN TO SUPERANNUATION

The figure of £700 million mentioned in paragraph 59 is made up as follows:

	£ million
Yield from disallowing employees' contributions	850
Yield from taxing investment income of pension funds, net of resulting tax credit for pensioners	750
Yield from taxing income element of pensions in payment	350
	1950
Less tax now payable on pensions	-1250
Cost of present reliefs	700

ANNEX 7: TAX TREATMENT OF SUPERANNUATION IN OTHER COUNTRIES

COUNTRY	TAX TREATMENT OF PENSION FUNDS						TAX TREATMENT OF PENSION PAYMENTS		STATE PENSIONS
	EMPLOYER'S CONTRIBUTIONS IN HANDS OF		EMPLOYEE'S CONTRIBUTIONS	INVESTMENT INCOME OF FUND	CAPITAL GAINS OF FUND	COMMENTS	LUMP SUMS	OCCUPATIONAL RETIREMENT PENSIONS	
	EMPLOYER	EMPLOYEE							
REPUBLIC OF IRELAND	DEDUCTIBLE	NOT TAXABLE	DEDUCTIBLE	EXEMPT	EXEMPT	Combined deductible employer and employee contributions must not exceed 15% of an employee's remuneration.	The greater of £3,000 or 1/20 x average salary of last 3 years x number of years of service is exempted from tax; the rest is taxed normally.	FULLY TAXABLE	Pensions are fully taxable. Contributions are not deductible.
DENMARK	DEDUCTIBLE	NOT TAXABLE	DEDUCTIBLE	EXEMPT	EXEMPT	–	A 35% duty is payable.	Fully taxable subject to certain special reliefs for pension income generally.	Pensions are fully taxable. Contributions are a percentage of taxable income and are not deductible.
FRANCE	DEDUCTIBLE	NOT TAXABLE	DEDUCTIBLE	See Comments	NOT TAXED	i. French dividends are exempt from tax, but nevertheless the tax credit attaching to them is granted to pension schemes ii. Other fund investment income including real property is taxed at rates of between 10% and 24% compared with the normal company tax rate of 50%.	These are believed to be tax free.	Taxable. A reduction of 10% is allowed (minimum 1,800F, maximum 6,700F), and a further reduction of 20% of the remainder of the pension (up to 360,000F).	Fully taxable with the same reliefs as for occupational retirement pensions. Contributions are deductible.

COUNTRY	TAX TREATMENT OF PENSION FUNDS						TAX TREATMENT OF PENSION PAYMENTS		STATE PENSIONS
	EMPLOYER'S CONTRIBUTIONS IN HANDS OF		EMPLOYEE'S CONTRIBUTIONS	INVESTMENT INCOME OF FUND	CAPITAL GAINS OF FUND	COMMENTS	LUMP SUMS	OCCUPATIONAL RETIREMENT PENSIONS	
	EMPLOYER	EMPLOYEE							
GERMANY	DEDUCTIBLE	Taxable on the employee in principle, but see comments (a).	Deductible within limits	EXEMPT Numerous conditions have to be fulfilled; ie there is a limit on the monetary amount of individual pensions that the fund can pay out.	EXEMPT	a. within certain limits the employer may itself assume the tax at a rate of 10% b. There are several types of company pension funding in use. These rates relate only to the UK-type superannuation fund. The tax regime is very complex and the rates should be read in that light.	Exempt (apparently)	Taxed as purchased life annuities, but only on the interest element.	Most social security pensions, including old age pensions, are not taxed. Where pensions are taxed they are taxed as purchased life annuities. Contributions are deductible within limits.
AUSTRALIA	DEDUCTIBLE But see comments (i).	NOT TAXABLE	See comments (ii).	Generally exempt	Not in principle chargeable to tax.	i. Deductible generally within the limit of A $400 or 5% of the remuneration of each employee, whichever is greater, per year. ii. Pension contributions, life assurance premiums etc up to A $1200 are among the expenses qualifying for the general concessional tax rebate. A rebate of 33.07% of all these expenses is given to the extent that they exceed A $1500.	5% taxable.	Fully taxable.	Fully taxable. There are no social security contributions.

COUNTRY	TAX TREATMENT OF PENSION FUNDS						TAX TREATMENT OF PENSION PAYMENTS		STATE PENSIONS
	EMPLOYER'S CONTRIBUTIONS IN HANDS OF		EMPLOYEE'S CONTRIBUTIONS	INVESTMENT INCOME OF FUND	CAPITAL GAINS OF FUND	COMMENTS	LUMP SUMS	OCCUPATIONAL RETIREMENT PENSIONS	
	EMPLOYER	EMPLOYEE							
JAPAN	DEDUCTIBLE	NOT TAXABLE	NOT SPECIFICALLY DEDUCTIBLE (See comments)	NOT TAXABLE	NOT TAXABLE	A generous employment income relief is meant to cover an employee's expenses with the exception of social security contributions.	a. Service 20 years or less - deduct 250,000 yen per year of service, with minimum deduction of 500,000 yen. b. Service over 20 years — deduct 5,000,000 yen + 500,000 yen for each year of service over 20 years. In both instances 50% of the remainder is taxed separately from other income on the general income tax scale.	Taxed as employment income	Treated as employment income. Contributions, unlike other employee expenses, are fully deductible.
CANADA	DEDUCTIBLE (See comments)	NOT TAXABLE	DEDUCTIBLE (See comments)	GENERALLY EXEMPT	GENERALLY EXEMPT	Both employer (in hands of employer) and employee contributions are deductible within a limit of $3500 for each employee per year.	These are fully taxable, but income averaging provisions can be applied to them.	Fully taxable	Fully taxable. The ordinary old age pension is funded from general revenue, but the supplementary (Canada Pension Plan) pension is funded by contributions which are deductible.
USA	DEDUCTIBLE	GENERALLY NOT TAXABLE	DEDUCTIBLE	EXEMPT	EXEMPT	—	Generally lump sum distributions are taxable. Complex rules govern the proportion of the lump sum subject to tax, and in some instances the taxable portion may be reduced to nil.	Taxed as purchased life-annuities.	Exempt from tax. Contributions are not deductible.

ANNEX 8: NOTE BY MR STEWART

Our report comes to the broad conclusion that distortions in the pattern of savings to the disadvantage of direct investment in quoted ordinary shares should be countered by general measures to increase the relative attractions of equity investment rather than by replacing one form of specfic tax bias with another. Although I generally agree with this. I would like to make one positive proposal for consideration.

2. The SAYE terms coupled with share options are not particularly generous in themselves, and the attractions of the scheme are mainly in the potential for capital gain in the value of shares under option. For many practical reasons such schemes are only available to employees of public companies. For others I wonder whether it would be practicable to introduce an SAYE share purchase scheme instead, providing for investment in, say, authorised unit or investment trusts. The shares would have to be purchased at the outset by a trust fund for employees, and I realise that this would involve financing costs. But if such a scheme proved feasible I think it would be more deserving of tax subsidy than life assurance premium relief, which has been used to achieved similar ends (e.g London and Manchester).

3. Obviously this is much too late and embryonic an idea for Budget consideration this year, but I would be interested to know if it seemed workable on examination. It would be consistent with several of the objectives identified by the Working Group.

Ian Stewart

Econ. Pol. March 80.