

JH 447



DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB

TELEPHONE DIRECT LINE 01-212 3301
SWITCHBOARD 01-212 7676

Secretary of State for Industry

6 December 1982

The Rt Hon Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London SW1

Prime Minister

Worth reading, at
least the yellowed bits.

MCS 7/12

Dear Geoffrey,

1983 BUDGET

It may be helpful to you at this stage if I set out the main industrial measures I hope you will consider for the next Budget and give an indication of my priorities.

2 Both your last Budget and the further measures you announced on 8 November gave considerable help to industry. Both packages were well received - not just by industry itself, but by the public generally. Help to make industry more enterprising and more competitive is widely seen as helping to save and create jobs. I hope, therefore, you will feel it right to use the 1983 Budget to give further substantial help to industry. In my view the industrial situation and prospects would justify such an emphasis. Despite improvements in productivity and efficiency, profitability is still much too low. There is still a long way to go to recover lost competitiveness. Reports suggest that in a number of sectors British firms are too weak to take advantage of any upswing in demand.

3 My suggestions are grouped under 3 broad headings. First, I hope you will be able to include at least one major measure affecting industry as a whole, as you were able to do in this year's Budget with the NIS reduction. Second, I hope you will be able to repeat the concept of including in the Budget an "innovation" package which you successfully introduced this year. Third, I hope you will build on the momentum of previous Budgets by including a further package of measures to encourage enterprise and small firms.

4 In addition, I have already written proposing a review of motoring taxes and, subject to the outcome, this might possibly be a fourth area where useful measures could be taken.



Major Industrial Measures

5 I intend to write to you again in the New Year with more detailed proposals under this heading when the convergence may be a little clearer. Developments on interest rates and the exchange rate will need to be carefully watched. The fall of interest rates (and of course of inflation) during the year has brought considerable benefit to industry and I certainly would not urge any measure which could put these helpful developments in jeopardy. Subject to that important point, I believe that so far as room for manoeuvre allows, the policy of reducing the costs imposed on industry remains the most valuable contribution we can make. The successive reductions of NIS to 1½% from next April have been very welcome. My preliminary judgement is that to make further reductions of this tax should be the highest priority. Indeed, I hope you will consider announcing in the Budget the abolition of the NIS from the earliest convenient date in 1983. NIS adds directly to costs; it is a tax on exports as well as on employment; its abolition would be a further direct enhancement by Government of industry's competitiveness.

6 You are obviously considering full revalorisation of the personal income tax allowances in the Budget, and the possibility of going further on this or related fronts. I would not wish to argue against these measures in any way on their own merits. But despite the improvement to personal disposable income such measures would bring, I would not regard them as the best available way of helping industry at this stage. Industry's main problems remain on the supply side, as we appreciated before 1979, and our principal industrial measures should, I suggest, continue to be directed there. I have been impressed by the number of industrialists who reject the view that income tax cuts are likely to make a significant difference to wage settlements.

7 The main alternatives to further action on NIS are perhaps a reduction of the Corporation Tax rate (or the introduction of new allowances, eg on commercial buildings) or some action on non-domestic rates. On Corporation Tax, I believe we should have a reduction in mind for the longer term. But in present circumstances it would not substantially help many of the sectors facing the greatest competitive gaps. On rates, while we still await Michael Heseltine's proposals, I have reserved my position on cutting or capping non-domestic rates, which are now the biggest tax paid by industry and commerce. At this stage I believe action on the NIS should continue to have priority.



Energy Prices

8 Despite the useful measures announced on 8 November, this remains an area we must keep a close watch on. If by next spring it seems clear that further action is required to keep British industry's energy costs in line with competitors, I would hope you would give the necessary measures high priority.

INNOVATION

9 Under this heading I hope you will consider repeating the successful format you adopted this year of a combined package of tax and expenditure measures. I would certainly like to propose as a high priority that you announce a revival of the Small Engineering Firms Investment Scheme (SEFIS) in the Budget. This would be very well received in industry and would help this important sector to modernise itself. Some detailed changes to the previous scheme would probably be made and I will let you have these separately.

10 If you are willing to pursue the combined package approach, I should like to make further proposals for measures involving expenditure. The possibilities I am considering include:

- i support for other innovation - linked investment in addition to SEFIS;
- ii an expansion of our support for R&D, possibly including a response to the Alvey proposals;
- iii increased support for technology transfer;
- iv support for the development and improvement of management skills.

If you could let me know whether you favour this approach, I will develop these proposals further into more precise suggestions.

11 On the tax side I should like you to consider a further extension of the 100% first year capital allowance for rented teletext receivers. While recognising the general case for removing preferential capital allowances for rented consumer goods I believe special consideration should continue to be given to the position on teletext receivers. I am especially concerned to maintain the growth in the market in this area where British products compete successfully with imports, because it may prove to be the first stage in a succession of technological developments leading to cable TV, direct broadcasting by



satellite and interactive home terminal uses. Teletext and viewdata lost their marketing advantage over other sets with the removal of HP controls. An extension for a further year of the 100% first year allowance for teletext would bring it into line with viewdata. You will recall that I proposed a two year extension before this year's Budget with the same object in mind, but you only felt able to grant an extension for one year at that time.

12 My officials have prepared a paper setting out the arguments on teletext in more detail and will be in touch with yours shortly.

ENTERPRISE AND SMALL FIRMS

13 For convenience I am dividing my proposals under this important heading into major and minor items. I list the major items below in order of priority, and Annex A carries further details. The minor items are set out in Annex B. This distinction is purely for convenience and does not imply that I regard all the minor items as lower priority than the major. Some of the minor items should, I believe, have a high priority, as indicated in Annex B.

Share Option and Incentive Schemes

14 I attach the highest priority to improving the tax treatment of share option and incentive schemes. The present relatively unfavourable treatment of such arrangements is a major obstacle to the development of "growth" companies in the UK and contrasts unfavourably with the position in the US. The existing schemes are useful but they are tied to comparatively low limits and must be widely available to employees. I should like to see companies able to offer substantial schemes restricted, if they wish, to key executives to give them a real interest in the success of the company without incurring heavy income tax charges. I am convinced that this would give a strong incentive to executives to improve the performance of their companies. It would also help growing companies attract key managers by being able to offer attractive overall remuneration terms even though they may only be able to provide a modest salary in the early years.

15 I know that some companies are offering such schemes despite the present tax position. Even in such cases I believe a more generous tax treatment would so enhance the incentive effect of these schemes that the loss of revenue will in no sense be "wasted".



16 More details on this proposal are at Annex A. It goes beyond the small firms sector, of course, and could I believe form a major element in your Budget in its own right.

Encouraging Investment in Equity Capital

17 My second priority is that you should develop the valuable measures you have already introduced to encourage outside investment in the equity capital of small firms. The Business Start-Up Scheme is now proving its worth but is still being taken up relatively slowly. I hope you will announce in your next Budget that the scheme will be continued beyond its present expiry date in 1984, otherwise the uncertainty surrounding the scheme's future will inevitably affect it badly during 1983/84. I also hope you will be able substantially to increase the annual maximum allowed under the scheme and introduce the other improvements detailed at Annex A.

18 In parallel with this improvement to the Start-up Scheme, I believe we should extend the incentives to equity investment in established unquoted companies. This would simultaneously ease the provision of finance to established companies aiming to expand (and reduce their dependence on bank borrowing) and help to avoid the criticism that too many of our measures are directed towards start-ups.

19 I am attracted by the CBI's proposals on Small Firms Investment Companies which I know you have already considered. I hope you will consider introducing a scheme on the lines of these proposals. This would, I think, be particularly helpful if we are unable to meet the CBI on reducing the burden of non-domestic rates substantially, which is likely to be another of their main Budget proposals.

Loan Guarantee Scheme

20 The existing allocation to this valuable scheme is likely to be exhausted in February or March 1983. I am sure we should extend the scheme at least until its original 3-year term is completed, though we may wish to make some detailed adjustment to the scheme. This might require a further £150m, though I would need to re-examine this estimate nearer the time. This is, of course, an expenditure measure, subject to the normal conventions governing the treatment of guarantees for public expenditure survey purposes.

Stamp Duty

21 I consider that stamp duties on property conveyance should be reviewed again, both because a reduction would give a welcome boost to the construction industry and because it would assist labour mobility. I see particular merit in the suggestion that



stamp duty should be reduced for first-time buyers, to assist the buyers themselves and to provide a stimulus to the construction of smaller "starter" homes.

22 While on the subject of stamp duty, I would like to put on record my view that the tax bias against holding industrial shares and in favour of other forms of saving is something we must examine in the longer term. I am sure that this is one of the reasons for the decline of the individual investor in favour of the institutional investor.

The Self Employed and Agency Workers

23 I hope you will agree not to re-introduce the draft 1981 legislation on agency workers operating through companies. I am becoming concerned that current Inland Revenue policy is giving the wrong signal to the self-employed about Government attitudes towards them. The Inland Revenue must, of course, administer the law correctly as it sees it but I believe we must take care not to harass the self-employed and press-gang them into Schedule E unless this is fully justified by the facts.

Enterprise Bonds

24 The preceding three items I would rank as equal third in priority after the first two under this broad heading. Finally, I hope you will consider the proposal for "enterprise bonds" raised by John Loveridge, Graham Bright and others last year, though I believe it is of less importance than the previous measures. It is widely acknowledged that expenditure is sometimes incurred which may not be commercially justifiable in timing simply for the purposes of saving tax in a particular year. Enterprise bonds would be tax-deductible but taxable on redemption. In this way expenditure could be deferred until the most opportune time but the Treasury would have had use of the money meanwhile.

Minor Items

25 These are listed at Annex B, with an indication of my priorities between them.

CONCLUSION

26 I very much hope you will be able to include items from each of the broad headings I have suggested. I shall write to you again about possibilities for major industrial measures in the new year. In addition I shall develop detailed proposals for a



package of "innovation" expenditure measures if, as I hope, you see advantage in this course; and I may wish to return to the question of motoring taxes subject to the outcome of the review I have suggested.

27 I am copying this letter to the Prime Minister, Sir Robert Armstrong and John Sparrow.

You are
R
Kathleen



ENTERPRISE AND SMALL FIRMS

Further Detail of "Major" Measures ProposedShare Option and Incentive Schemes

- 1 My detailed proposals are as follows:
 - i a new scheme increasing the permitted maximum of approved share incentive or option schemes to £10,000pa or £50,000 overall.
 - ii companies to be able to restrict eligibility for approved schemes to key executives if they wish.
 - iii deferral until the shares are sold of any charge to tax arising on exercise of an option. Such charge to be to capital gains rather than income tax.
 - iv a review of the rules relating to the growth in value charge particularly the definition of "restrictions" and the application of this charge to transactions involved in management buy-outs.
 - v particular consideration to be given to charges facilitating schemes within groups of companies.
 - vi particular consideration to be given to relaxing the present tax treatment of "partly-paid" schemes which can at present be adversely affected by the 1972 and 1976 Finance Acts. In most cases the employee in a "partly-paid" scheme is at risk from the value of shares going down as well as up, which would seem to justify capital gains treatment (I do not seek to disturb the "stop-loss" arrangements in the 1976 Finance Act).

Business Start-Up Schemes

- 2 I propose the following improvements:
 - i increase the annual limit qualifying for relief to £50,000;
 - ii increase the maximum shareholding permitted to any individual to 49%;
 - iii abolish any restriction on the proportion of a company's shareholding eligible for relief;

CONFIDENTIAL

- iv relaxation of the relationship rules which determine who are connected persons. I think it is especially important, given our commitment to the family which has emerged from the Family Policy Group, that lineal antecedents and descendants should be eligible for relief;
- v abolition of the requirement for a trading company to have traded for at least four months before relief can be granted (to be replaced by a mechanism to withdraw relief retrospectively if the company turns out to be non-qualifying). Experience shows that the existing requirement has a severe disincentive effect;
- vi companies which license out a process not to be treated as disqualified. Particularly important in the new technology field;
- vii extension of relief to trustees of family and similar settlements;
- viii allow differentiation into classes of share capital other than merely as to voting rights; and admit participating preference shares and redeemable fixed rate preference shares;
- ix abolition of the requirement that subsidiary companies of the qualifying company must be wholly owned provided the departure relates only to minority shareholdings taken by company employees.



ENTERPRISE AND SMALL FIRMS

"Minor" Items

1 The first two items listed below are high priority:

i) Small Firms' Corporation Tax

Much has already been done to bring down the rate in the marginal field; but this remains a continuing source of complaint. It is suggested that the marginal rate should be reduced still further by widening the band to £475,000 (upper) and £95,000 (lower) producing a marginal rate of 55%.

ii) VAT Threshold

Revalorisation would suggest a new main VAT registration limit of around £17,850. It is proposed that the limit be raised to £18,000 with suitable increases in the other limits.

2 The next group of items are roughly of equal importance, lower in priority than the first group:

iii) Scientific Research Allowances: Definition

At present these allowances are restricted to 'activities in the field of natural or applied science for the extension of knowledge'. This definition is too restrictive and uncertain, and excludes, for example, much expenditure of development (as opposed to original research) character; yet development is precisely the field in which our industries' efforts are often found lacking. It is proposed that the allowance should be suitably redefined along the lines of research and development, as many of our overseas competitors do.

iv) Interest Relief

Useful relaxations in the provisions relating to interest on loans taken out for the purpose of investing in a close company have been made over the last few years but these do not go far enough. It is proposed that the requirement that the company be close should be replaced by its merely being unquoted; and that all full-time employees (not merely managers) should potentially qualify for relief. Further, now that sleeping partners can qualify for interest relief on loans for partnership investment there seems to be no reason why limited partners should be discriminated against and this should be removed.

v) Business Formation and other Legal Costs

Relief should be made available to those relatively minor capital costs which are incurred for reasons such as setting up the framework of a business or establishing an



incentive scheme. These are legitimate business costs and there seems to be no reason why they should not be allowed.

vi) Capital Gains Tax Rollover Relief

It is unfortunate that, while relief is available on disposal of business assets which are replaced, no similar relief is available on disposal of shares in unquoted trading companies even though these may be replaced by other unquoted trading company shares or business assets. The proposal is that rollover relief should be extended to include rollover into or out of unquoted trading company shares, subject to safeguards similar to those which apply to retirement relief.

vii) Loss Relief Carry Back for new Companies

At present the special relief for losses sustained in the first few years of a new business is available only to unincorporated traders. It is undesirable that normal commercial considerations as between incorporation and non-incorporation should be affected by fiscal distortions. I propose that the relief should be available according to participants' interests in a newly-trading company.

3 Finally, the following item is lower priority but has nevertheless caused problems in particular cases:

viii) Assets Acquired in a Series of Transactions

A problem sometimes arises, particularly with family company shares, that a series of disposals to a connected person falls foul of the special capital gains tax rules such that the value to the disposers is taken to be the (higher) proportionate majority holding value rather than the (lower) minority holding value. This can result in excessive CGT burdens on the disposing minority holders, and this should be remedied.