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FROM: CHIEF SECRETARY
DATE: 18 July 1984



BIF with Departmental
responses

AF 20/7

PRIME MINISTER

VAT AND CONTRACTING OUT

I was asked at Cabinet on 5 July to consider whether the incidence of VAT distorted appraisal of the merits of carrying out certain work "in house" in the public sector as against contracting it out.

Background

In December 1982, Cabinet agreed that departments and other public bodies should seek to contract out more services to the private sector. It was recognised that a possible disincentive, as far as government departments and health authorities were concerned, was that any service contracted out would attract VAT, whereas work carried out in house would not. To overcome this problem Customs and Excise have operated since 1 September 1983 an extra statutory concession whereby departments and health authorities can claim VAT refunds on specified services, which could be done in house but which are contracted out. This concession is now being given statutory authority by Clause 11 of the 1984 Finance Bill.

This concession gave some departments an unintended benefit in respect of services on the specified list which were already contracted out. Accordingly, for 1984-85 and later years, these departments were asked to surrender PES provision equivalent to this benefit.

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VAT on Building Alterations

The extension of VAT on building alterations, announced in the 1984 Budget, potentially created a new disincentive to contracting out. But building alterations required by Government are already in effect largely contracted out to the private sector, and there is little likelihood of departments seeking to carry them out in house as a result of the VAT change. In the case of Government departments, therefore, there is no advantage for our contracting out policies in adding building alterations to the list of services covered by the VAT refund provision in Clause 11.

The risk of health authorities reverting to in house work as a result of the VAT change is judged to be greater because they have direct works organisations. The Treasury therefore added building alterations to the list of services for which health authorities are able to reclaim VAT under Clause 11. This approach is consistent with the earlier treatment of repairs and maintenance. Repairs and maintenance have always attracted VAT, and health authorities have been allowed to reclaim that VAT since September 1983.

VAT on Civil Engineering Works - Highways

The extension of VAT to ^{alterations including} civil engineering works creates a different distortion for the central government roads programme, and one for which Clause 11 was initially not designed. Clause 11 was intended to remove an incentive to departments to continue carry out work in house and to ensure that comparative costing of in house and contracted out work was not distorted by the application of VAT to the latter. The VAT extension will, however, encourage the roads departments to place work with local authorities (who do not charge VAT for work on roads) rather than to the private sector.

I recognise the need to eliminate this distortion. I have considered the possibility of requiring local authorities

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to charge VAT when carrying out road alteration schemes on behalf of central government. But this solution would probably require primary legislation and would have the practical effect of squeezing highways expenditure done through local authorities.

An alternative approach would be to include road alterations in the specified list of services on which the roads departments could claim VAT refunds under Clause 11. Although their inclusion would represent a widening of the role of Clause 11, it would be fully consistent with its intended purpose. In view of the importance of pressing ahead with our contracting out programme, I am prepared to agree, with effect from 1 April 1985, this widening of Clause 11.

The extension of Clause 11 to roads would remove the distortion concerning contracting out to which attention was drawn at Cabinet. However, it would mean an unintended benefit to the roads programme, at a cost to the PSBR, to the extent of the VAT which would have been paid on work placed directly with the private sector. This sum needs to be deducted from the roads programme and I shall be taking this up in my discussions with the departments concerned in the public expenditure survey.

If you are content with this approach, I will discuss with Ministerial colleagues concerned the necessary details.

I am copying this letter to other members of Cabinet and to Sir Robert Armstrong.



PETER REES

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AT 218

The Rt Hon Peter Rees QC MP
Chief Secretary to the Treasury
HM Treasury
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30 July 1984

Dear Peter

VAT ON HIGHWAYS

18 July -
at HAP

Thank you for your letter of 19 July amplifying your
minute to the Prime Minister.

I am glad that you are prepared to remove the potential
distortion between work placed through consultants and local
authorities. However, as you expected, I do not find the
proposals altogether satisfactory. I really cannot see any
point in going through the motions of determining whether
individual items of work are chargeable to VAT, collecting
it and then refunding it. Setting up a procedure
reminiscent of the selective employment tax is totally at
odds with our drive for better financial management and
savings in manpower and administrative costs. Moreover we
shall have to hand over 1 per cent - soon 1.4 per cent - to
Brussels. Could you have another look at this?

I believe it is vital that we should at least have
clear and sensible rules for determining liability which
do not involve trying to differentiate between the operations

carried out within a single contract. Patrick Jenkin's suggestion that the approach should err on the side of generosity would of course help to reduce the amount of unnecessary work.

In any case, I cannot accept that my PES provision for future years should be reduced to reflect the VAT that would be paid on that amount of work on alterations which is already placed directly with the private sector. (I understand you do not propose to ask for a bigger reduction if the amount of VAT that has to be paid and refunded is increased in future.)

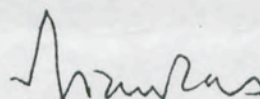
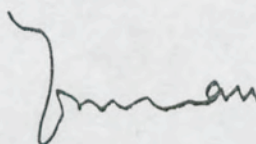
We cannot expect any benefit to the PSBR from levying a tax on a Government Department. Moreover the amount involved is quite fortuitous, depending on decisions which have been taken about the commissioning of particular contracts for quite different reasons, and uncertain in the absence of workable rules. In effect it amounts to a penalty for pursuing a policy of commissioning work through the private sector - the more successful I have been so far the harder my programme is hit. I am quite prepared to discuss the size of my programme with you, on merits, in our forthcoming bilateral. But I cannot agree to an arbitrary cut as a side effect of a tax decision which was taken without reference to its effect on the road programme.

Finally I hope you will be able to agree that my programme should not have to bear the VAT liability in the current year, which we estimate to be up to £10m. Reductions in the cash limit in the middle of the year have a very disruptive effect on the programme. We had to hold up

urgently needed work as the result of the July reduction last year. While I am prepared to accept difficult decisions when they are required in the interest of overall economic management, surely long term capital programmes should not be subject to turbulence of this kind?

Given the problems which the proposals create, I hope you will be prepared to reconsider your proposals. As I said in my letter of 3 July, the simplest and most straightforward solution would be to zero-rate all highways work. I believe that would be defensible in its own right and would not open the door to pressures on other fronts. I also hope that you will be prepared to consult colleagues in future if you are considering tax changes which directly affect their programmes.

I am copying this letter to George Younger, Nicholas Edwards and Patrick Jenkin.



NICHOLAS RIDLEY

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Oddi wrth Ysgrifennydd Gwladol Cymru The Rt Hon Nicholas Edwards MP From The Secretary of State for Wales

31 July 1984

De Rees

VAT AND CONTRACTING OUT : HIGHWAYS

I wrote to the Chancellor of the Exchequer on 23 July in support of Nicholas Ridley who had protested about the extension of VAT to highways improvement work. I have since seen a copy of your note of 18 July to the Prime Minister about the general relationship of VAT to contracting out, which covers this issue.

I am glad that you have been able to accept that the scope of Clause 11 should be widened so that roads departments can reclaim VAT in these circumstances. It is not quite clear how this is to be given immediate effect (it would be silly to have to pay VAT only in the current year) but no doubt you will find means of doing so.

Apart from that technical aspect, the thing which now concerns me is the proposition towards the end of your minute that the removal of this new VAT charge would be an "unintended benefit to the roads programme at a cost to the PSBR" which needs to be reflected in a deduction from the roads programme provision. This is nonsense. Provision for the roads programme was intended to pay for the building of roads. The totally unexpected imposition of VAT on that part of our construction work which we carry out through the private sector meant a cut in the work which could be done for the same amount of money. If you had been unable to agree to effectively lift the new VAT charge then you would have faced a demand for additional PES provision to cover this. Otherwise you are seeking to bring about cuts in departmental programmes through taxing central government spending instead of through the survey process, to say the least an odd way of going about things and not one which is acceptable. It would be quite wrong to make any off-setting deduction as you suggest.

The Rt Hon Peter Rees QC MP
Chief Secretary to the Treasury

/I am ...



/ I am copying this letter to the other members of Cabinet
and to Sir Robert Armstrong.

J. C.
Ned

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