

PRIME MINISTER

9 January 1985

BUDGET STRATEGY

Two clear themes are emerging: taking action to lower the cost of employing people; and reforming capital taxes. Nigel may wish to discuss themes with you before Chevening, and the broad conclusions afterwards.

Jobs

Nigel's thesis that rising real pay destroys jobs is right. But companies are too profitable and liquid for us to expect real wages to start falling on their own.

There are three ways in which Government can hope to lower the costs of employment:

1. National Insurance. Employer's National Insurance can be changed to make it cheaper to employ lower-paid people, financing this from abolishing the upper limit on the employer's contribution.
2. Raising tax thresholds. Making people better off at the net level is what counts.

The main problem is to find enough money to make a significant increase in thresholds, and so cut the poverty and unemployment traps and reduce pressure for higher gross pay.

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3. Expanding and amending the Community Programme. Providing work of community value to people on benefit would exert some downward pressure on wage rates, and is a cheap way of cutting the unemployment total.

The £15-30,000 a year people. Within the Treasury, schemes are being worked out to raise higher rate bands, to simplify and lower the tax charge.

Capital Taxation

Major reform of capital taxation has long been promised, but has still not been delivered.

Development Land Tax could be abolished - it now raises only £75 million; or the annual exemption increased substantially from £75,000.

Capital Gains Tax can be simplified by increasing the tax-free sum further, or by scrapping indexation and choosing a new, more recent base date for taxing gains.

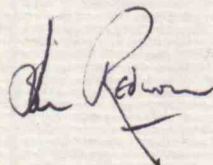
The Treasury are also looking at ways of modifying CTT.

Conclusion

A Budget for Jobs, which does a great deal to lower the costs of employing people, and at the same time reduces the numbers in the poverty and unemployment traps, would get a good press.

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A Budget which simultaneously reforms capital taxation would be doing something which our own supporters would like a great deal; whilst raising tax thresholds and changing the incidence of the middle bands of tax would also help.

A handwritten signature in dark ink, appearing to read 'John Redwood', with a stylized flourish at the end.

JOHN REDWOOD

PRIME MINISTER

8 January 1985

BUDGET STRATEGY

The Treasury team are going to Chevening this weekend to set the framework for the Budget. Two clear themes are emerging:

Taking action to lower the cost of employing people.

Reforming capital taxes.

Nigel may wish to discuss themes with you before Chevening, and the broad conclusions afterwards.

Jobs

Nigel's thesis that rising real pay destroys jobs is right. But companies are too profitable and liquid for us to expect real wages to start falling on their own. And money policy is too lax to put any downward pressure on them.

There are three ways in which Government can hope to lower the costs of employment:

1. National Insurance. It is important that employees should continue to contribute for the benefits they will be receiving. But employer's National Insurance can be changed. For example, you could take everyone below £100 a week out of the employer's National Insurance Contribution, and abolish

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the upper earnings limit on employers' contributions. Or you could have an initial rate of, say, 5 per cent on lower pay, whilst abolishing the upper limit. Such a scheme could be revenue neutral. It has a substantial impact upon the costs of employing low-paid labour, and could help generate many tens of thousands of jobs.

2. Raising tax thresholds. Making people better off at the net level is what counts. It has already been agreed that the main aim of tax strategy is to increase income tax thresholds substantially. This both takes people out of the poverty and unemployment traps, and reduces the pressure for higher gross pay.

The main problem here is finding enough money to make a significant increase in thresholds.

The cheapest way to tackle the traps would be to concentrate tax help where the traps are worst, the family with children. Schemes are being looked at to see if this is feasible.

It will be necessary to look at other sources of revenue to finance any large increase in thresholds. An increase in the standard rate of VAT would be the most obvious runner.

3. Expanding and amending the Community Programme. Providing work of community value to people on benefit would exert some downward pressure on wage rates. The skill is to present the entirely reasonable step of offering worthwhile activity to

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those who would otherwise be unemployed, without triggering strong trade union opposition.

The £15-30,000 a year people. The current thresholds for higher rate tax are too close together, and arguably there are too many bands. The political importance of this group is now understood in the Treasury, and it is they who suffer most from any attacks on middle class privileges. Higher paid people are well enough off for it not to worry them.

Within the Treasury, schemes are being worked out to raise these bands, to simplify and lower the tax charge.

<u>Current Bands:</u>	30%:	£0-15,400	45%:	£18,201-23,100
	40%:	£15,401-18,200	50%:	£23,101-30,600

Capital Taxation

Major reform of capital taxation has long been promised, but has still not been delivered.

Development Land Tax could be abolished - it only now raises £75 million. Alternatively, there could be a further large increase in the annual exemption, eg from £75,000 to £250,000. The main reasons for large windfall property gains were high inflation and restrictive planning. Both these issues are being tackled, thereby undermining the rationale of the tax.

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Capital Gains Tax has been made unduly complex by the indexation provisions, which somewhat anomalously protect people against a period of relatively low inflation, but bring no relief to those who held assets during the period of highest inflation in the 1970s.

Complete abolition of CGT would be best, removing a tax on wealth accumulation at comparatively modest loss of revenue (£710m). This might have to be coupled with taxing short-term capital gains (eg under one year) as income, to mute the criticism that the Government was indulging in a speculator's charter.

There may not be enough revenue to allow this. Another option is to abolish CGT on gains prior to 1979, allow people to destroy their records, and remove the indexation provisions. These are unnecessarily clumsy.

A third way of proceeding is to increase the tax-free allowance substantially, to take more people out of the tax completely.

The Treasury are also looking at ways of modifying CTT.

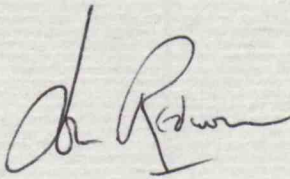
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A Budget for Jobs, which does a great deal to lower the costs of employing people, and at the same time reduces the numbers in the poverty and unemployment traps, would get a good press.

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A Budget which simultaneously reforms capital taxation would be doing something which our own supporters would like a great deal; whilst raising tax thresholds and changing the incidence of the middle bands of tax would also help.

The last Budget made major changes in Corporation Tax, and although there were many losers, they went down well. And they have produced the expected first part of the result - a major increase in capital investment by industry. In a year's time, that effect will have worked through, and we should begin to see the second round effect we anticipated - an increase in jobs - as the balance between the costs of labour and capital even out.



JOHN REDWOOD