



10 DOWNING STREET

Prime Minister 2

The CBI's Budget proposals are summarised opposite page 5.

I can find no reference to the PSBR or the likely fiscal adjustment, an astonishing omission. The document says simply that the Budget must be set within the MTFS.

I have acknowledged.

[Signature]

DKS
20/1

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From
Mr David Nickson CBE DL
President



The Rt. Hon. Margaret Thatcher MP
Prime Minister
10 Downing Street
London SW1

R17/1
16 January 1987

Dear Prime Minister

I enclose a copy of our Representations to the Chancellor for this year's Budget. These will be published on 19 January.

The Representations are the result of wide consultation with our membership during the autumn and were presented to the Chancellor of the Exchequer on 9 December. Our priority this year is to give the maximum possible encouragement to enterprise and to smaller firms; these are the growth areas. I hope that you will support our proposals which are summarised in Chapter 1.

I am also sending copies of our Representations to your Cabinet colleagues.

Yours ever

David

CBI Budget Representations to the
Chancellor of the Exchequer 1987

CBI

WANTED
FOR ENTERPRISE-
REAL
REWARDS

CBI Budget Representations to the
Chancellor of the Exchequer 1987

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Introduction

The Budget is a time to review progress and look ahead. Much has been achieved on the business front in recent years. Inflation has been reduced and business has become more productive. Output is now picking up again after a pause in 1986.

For the momentum to be maintained, business must keep adapting to the changing demands of world markets and become even more competitive. Much of this depends on business itself – the control of costs, marketing and product development is up to individual firms.

But the Government also has a role to play if the UK is to be successful. Enterprise should be rewarded, and there need to be genuine incentives to effort.

The CBI had recently published its general guidelines for Government in its *Business Manifesto*. Among the guidelines for economic policy are:

- a stable fiscal and monetary policy accompanied by full UK membership of the European Monetary System;
- control of growth in real public expenditure and further reduction in the overall tax burden;
- the creation of a business climate which favours enterprise and the growth of small firms;
- lower cost burdens on business, particularly regarding rates and energy costs.

The CBI retains its commitment to the Government's Medium Term Financial Strategy (MTFS) as a basis for achieving lower inflation and lower interest rates. For the 1987 Budget, room for manoeuvre within the MTFS is limited and the position on the current account suggests caution.

The CBI's proposals are as a consequence modest, and comprise:

- a package of measures to encourage enterprise;
- additional spending on the nation's infrastructure;
- a 5% real increase in personal tax allowances.

These measures build on the progress made so far towards the competitive economy Britain needs.

But not everything can be achieved in one Budget. The CBI's Representations therefore look beyond this year to the more fundamental changes which will be needed to set the stage for business in the 1990s.

TABLE 1

The CBI's enterprise package

Measures to encourage investment, innovation and marketing by small firms:

	First Year Cost £ m 1987/88	Full Year Cost £ m
Marketing		
• Expansion of Department of Trade and Industry's 'Support for Marketing Initiative' to £12 million	10	10
Research and development		
• Allocation of 1% of all major Government spending departments' R&D budgets to small firms	—	—
Investment		
• Exchange risk cover for low-cost finance from Europe.	—	—
• Introduction of 100% capital allowance on investment up to £25,000 a year for unincorporated businesses and firms paying the lower rate of Corporation Tax	—	c 375 (Average over 5 years)
Business Expansion Scheme		
• Extension of BES to give relief for 'connected persons'.	20	50
Inheritance Tax		
• Extension of Business Asset Relief from Inheritance Tax to 10%	20	65
Value Added Tax		
• Exemption from VAT penalties, when circumstances justify	not costed	not costed
• Full VAT relief on bad debts.	50	500

TABLE 2

CBI 1987 Budget proposals

	Exchequer cost £bn 1987/8	£bn full year
Enterprise		
• Measures to help smaller firms	0.05	0.5
Business costs		
• Infrastructure improvements	0.3	0.3
Improved incentives		
• 5% increase in personal allowances	0.85	1.1
Feedback effect		
Total cost 1987/8	1.2	c - 0.3
Total full-year cost (net)		1.6

The CBI's priorities for enterprise and competitiveness

- 1 Sound economic growth which brings higher living standards and lower unemployment requires business to prosper. For this to happen, business itself must take the right decisions and become more competitive.
- 2 But it also requires the Government to provide a climate in which business is profitable and enterprise can flourish.
- 3 With the need to control public borrowing and reduce the tax burden, the MTPS gives little room for manoeuvre. This is reinforced by the prospects for the balance of payments and inflation.

The CBI's priorities

- 4 Against this background, CBI priorities for the 1987 Budget are:
 - first, measures to improve the prospects for smaller firms;
 - second, additional spending on selected areas of the infrastructure;
 - third, a 5% increase in the real value of personal tax allowances, to hold down the tax burden and avoid the drift of more people into the tax 'net'.

Enterprise and small firms

- 5 Much has been done over the last few years to encourage enterprise. Smaller firms help provide the flexibility in the economic system which is needed to respond quickly to change and competitive pressures, and it is these firms which are creating jobs at the present time. So the CBI believes the Government's first priority should be to help them further.

- 6 To achieve this, the Government should introduce a package of measures to encourage investment, innovation and marketing by small firms in the 1987 Budget. This should include:
 - expansion of initiatives to encourage R&D and marketing by small firms.
 - introduction of 100% capital allowances on plant and

machinery to benefit small firms and unincorporated businesses;

- tax relief to 'connected' persons under the Business Expansion Scheme;
- exclusion of business assets from inheritance tax;
- more flexible application of the system of VAT penalties and easier recovery of VAT on bad debts.

Costs and competitiveness

- 7 Improvements in competitiveness are largely up to business itself. On labour costs, the CBI has through its Pay Presentations strongly urged members to ensure that pay increases are justified by improvements in performance.
- 8 The cost of capital in this country is high relative to the UK's competitors. The Government's scope for reducing interest rates is limited by international circumstances. The CBI believes that full UK membership of the EMS would provide a better environment, in which interest rates could more easily be reduced.
- 9 Poor communications put up transport costs and impede development. The CBI has put proposals to the Government on increased infrastructure spending in its *Fabric of the Nation* reports. In the latest of this series, *Building a Better Britain**, the case was made for almost £1 billion a year in extra spending.
- 10 In the Autumn Statement the Chancellor raised planned capital spending by £1 billion for 1987/88, mainly by increasing allocations to local authorities. The Government should:
 - ensure that this corresponds to a real increase in spending and is not dissipated in pay increases;
 - follow up this initiative by ensuring the capital spending is correspondingly increased in future years.
- 11 More needs to be spent on roads and urban development than the Government has allowed for, even in its new plans. Capital spending in these areas should be increased by a further £300 million.
- 12 The Government can contribute further to reducing business costs by:
 - continuing to exert downward pressure on rate increases;
 - reducing the rate burden on business when legislation is introduced on Local Authority finance;
 - ensuring that tighter financing constraints for nationalised industries do not represent a hidden tax burden on business through higher energy and water prices; and
 - avoiding any upward pressure on labour costs through changes in National Insurance Contributions.

* Published CBI, October 1986; price £3.50

Improving incentives

- 13 The CBI is committed to a reduction in the tax burden.
- 14 The Government's recent Green Paper recognises the need to overhaul the personal tax system. The interaction between the tax and social security systems provides definite disincentives at the lower end of the income scale. Furthermore, recent changes to the tax system in the United States have heightened awareness of the effect of tax on incentives further up the income scale.
- 15 The CBI seeks progressive simplification of the tax system to improve work incentives. This is not something that can be tackled in one Budget alone. Changes need to be phased in over a number of years.
- 16 In the 1987 Budget, it is imperative that the burden of tax is not increased and is, if possible, reduced. There has been considerable progress over recent years in taking people out of tax by increasing the real value of the personal allowance. It could be argued that now is the time to reduce tax rates. Indeed, this is the CBI's long term commitment.
- 17 However, the CBI believes the need to improve incentives at the lower end of the income scale must have priority for 1987/88 and that, before the Social Security Act comes into force in April 1988, this is still better achieved by a rise in personal allowances. This also has the effect of taking many people out of the tax 'net' altogether. The CBI therefore recommends a 5% real increase in personal allowances in this Budget, or more if it can be afforded when the Budget judgement is taken.
- Into the 1990s**
- 18 The CBI's main Budget proposals aim to boost enterprise and promote personal endeavour. Both business and Government have a role in achieving this.
- 19 The CBI looks to the Government to sustain the progress made in recent years, providing an environment in which enterprise can flourish and business succeed. Unless this happens, growth will be disappointing and unemployment remain high.
- 20 But there are other factors crucial to business's longer-term performance that need to be addressed in the Budget Statement. The CBI particularly emphasises monetary policy, education and training, innovation and tax reform. Measures also need to be taken to secure the long-term future of the UK oil and gas industry.
- 21 Business looks to the Government to create a stable environment, remove barriers to enterprise and reduce the tax burden. Only then can it help business to be competitive and enable the UK to meet the challenge of the future.

Chapter 2

The economic outlook

- 1 The economic prospects for the next two years, crucially dependent on oil prices and the exchange rate, provide the backdrop to the CBI's Budget Proposals, considered in detail in Chapter 3.

Economic growth

- 2 Economic growth in 1987 and 1988 will, with annual rates of 2.7% and 3%, be somewhat faster than in 1986. The components of growth should become more balanced, as investment and export growth quickens, and consumers' expenditure slows from the 5.1% rise in 1986 (charts 1 and 2).
- 3 Manufacturing output showed negligible growth in 1986, as industry suffered from the slowdown in world trade that immediately followed the fall in oil prices last January. As world trade picks up and industry feels the benefits from the lower level of the pound, output in manufacturing will respond, and grow by about 3% in 1987 and 2% in 1988.
- 4 The acceleration in economic growth will create about 550,000 new jobs by the end of 1988.

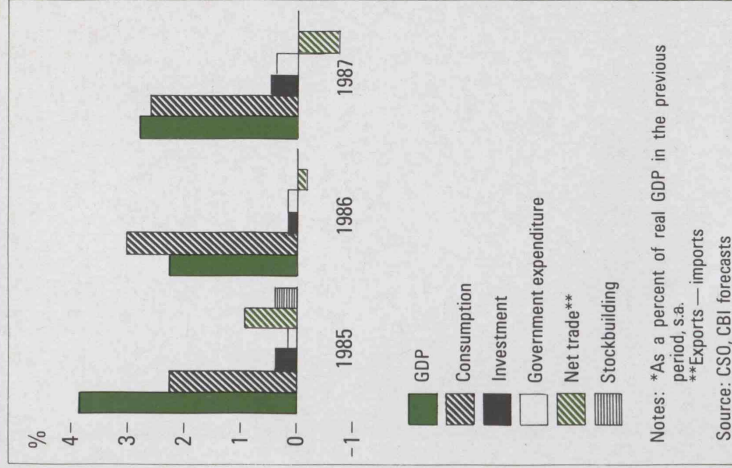
Chart 1

GDP growth rates 1982-88



Chart 2

Contributions to changes in GDP*



predominantly in the service sector. Employment in manufacturing is expected to fall by an average of 8,000 a month for 1987 and 6,000 a month in 1988 — the result of the continued drive for efficiency in the face of intense international competition. Despite job creation, unemployment is expected to decline only slowly from current levels.

- 5 Unemployment can be brought down substantially in the longer term only as the competitiveness of British industry is improved and maintained at a level that allows an increase in world market share. Success here depends on industry. But it also requires a climate of confidence enabling businessmen to plan ahead, invest and develop both their products and their markets.

Tax cuts, overheating and the Current Account

- 6 Both consumer spending and investment are forecast to grow rapidly over the coming year and, on the basis of the announcement in the Autumn Statement, Government spending will also rise in real terms.
- 7 Fuelled by the rise in real wages, consumers' expenditure is forecast to rise by more than 5% for 1986 as a whole. Even though inflation is expected to

Chart 3

Balance of payments on current account; oil and non-oil visible trade

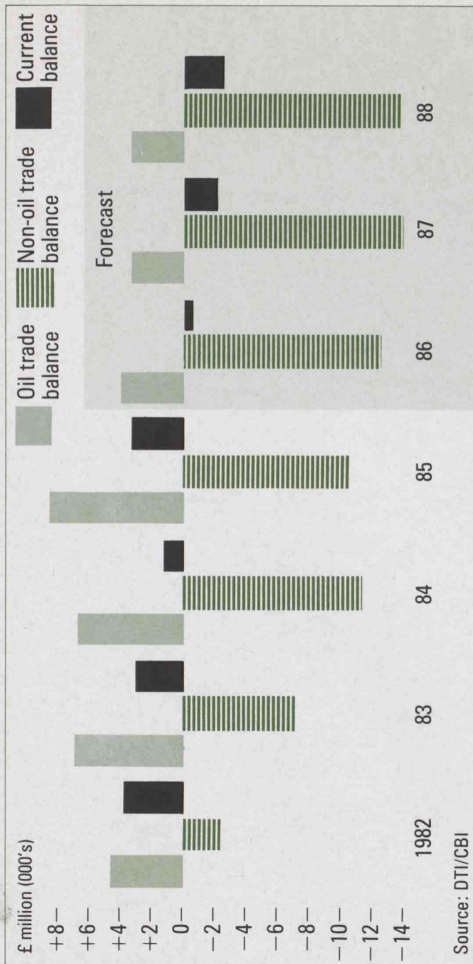
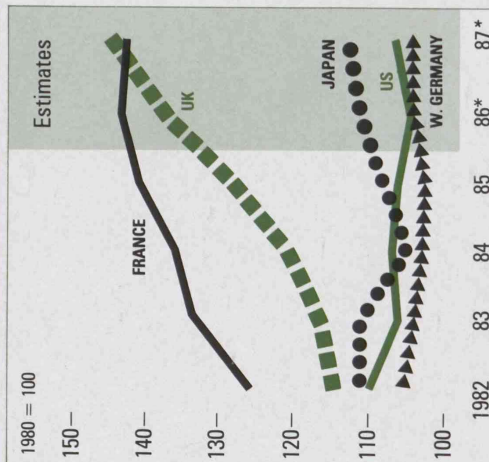


Chart 4

Comparative unit labour costs 1982-87 (wage costs per unit of output in manufacturing)



*CBI estimates based on OECD forecasts and data for first half of 1986

Source: NIESR, CBI estimates

accelerate through 1987 and will restrain the growth in real incomes, consumer spending is forecast to grow by 4.1%.

8 The CBI's Industrial Trends Survey suggests that investment growth will also quicken, encouraged by the faster growth in output. For 1987, manufacturing investment should grow by some 3.2% and other private investment, excluding the North Sea and housebuilding, by 6.1%.

9 Industry should be able to respond to the increases in demand expected during 1987. However, the experience of 1973 and 1978 indicates that, when demand is subject to rapid short-term surges, overheating can appear rapidly and with little warning. The quarterly profile of the growth in demand will therefore be crucial. The extent of any cut in income tax should be such as to avoid putting undue short-term pressure on the factor markets, causing upward pressure on prices and a further deterioration in the current account.

10 The fall in oil prices has reduced the 'cushion' of the surplus on oil trade, and the non-oil trade deficit is set to increase. In spite of the more rapid 3.4% growth in exports in 1987 (as world trade picks up and the pound is more competitive), the rise in consumption and investment will increase imports of goods and services by about 4.4%. The current account will therefore move into deficit for the first time since 1979, probably by about £2.4 billion (chart 3).

11 The Budget strategy must therefore include measures to improve business competitiveness so as to minimise the effects on the current account of more rapid growth. Only if industry can win and maintain a larger market share, can growth be sustained at a rate that can bring unemployment down substantially.

Chart

UK inflation rate compared to OECD average 1982-88

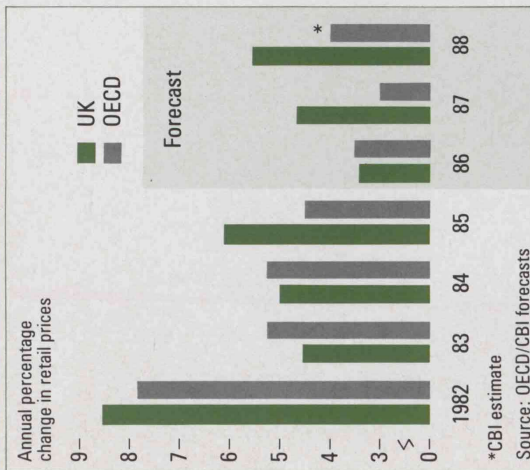
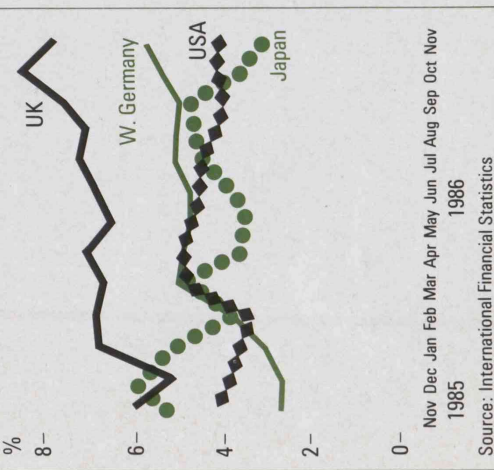


Chart 6

Real interest rates: an international comparison



Employment, wages and skill shortages

12 The UK's labour costs per unit of output are still rising faster than most competitors' (chart 4). The CBI continues to press home the message (for example, in its *Pay Presentation 1986/87 - Time for change*), that settlements must be closely linked to performance. If this is not achieved throughout the economy, our position in markets both at home and abroad will deteriorate.

13 The difficulty faced by employers in recruiting, and the retention of key personnel, necessarily influences the level of wage settlements. Skill shortages currently affect one in eight firms in manufacturing. Despite this, potential employees are inhibited from moving to new industries in different locations, because of housing market and other conditions.

14 While those seeking work must be prepared to adapt to changing circumstances, much needs to be done to reduce the disincentives to labour and capital mobility. The provision of education and training, in particular, needs to be improved if skill shortages are to be overcome and competitiveness increased.

Inflation and interest rates

15 The deterioration of the Current Account will put downward pressure on the pound, and hence upward pressure on inflation. From an average rate of 3.4% for 1986, retail price inflation is forecast to increase to 4.7% for 1987 as a whole, and by rather more in 1988 (chart 5).

16 The pressure on the pound will also limit the scope for reducing interest rates over the next two years. Currently, real interest rates in the UK are considerably higher than for major competitors (chart 6).

17 The Budget strategy must therefore be set within the Medium Term Financial Strategy if further upward pressure on interest rates is to be avoided.

Taxation and public expenditure - a strategy for enterprise

1 This chapter develops the CBI's proposals for promoting enterprise.

Smaller firms measures

2 The first priority is a package of measures (summarised in Table 2, Chapter 1) to encourage investment, marketing and innovation by smaller firms, and so stimulate their growth.

Chart 7

UK job creation by firm size 1982-84

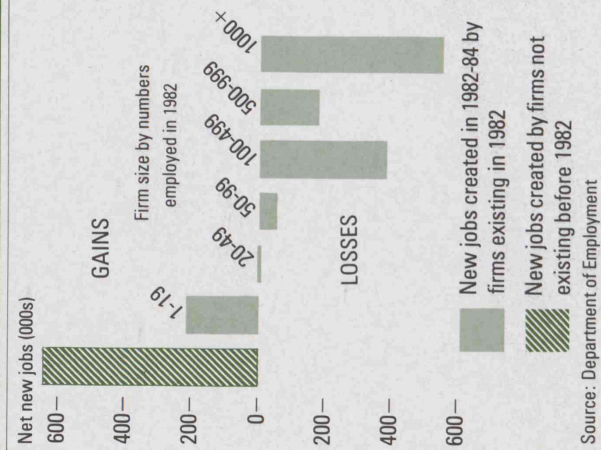
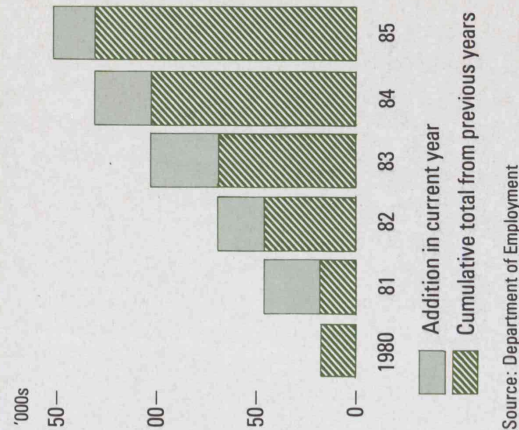


Chart 8

Net births of UK companies 1980-85



3 Smaller firms should account for much of the employment growth expected over the next few years (chart 7). The CBI therefore welcomes the measures already taken by Government to encourage the start-up of new businesses (chart 8). The need now is not simply for more start-ups but for a business environment which nurtures and favours continued growth and innovation by smaller firms. With these objectives in mind, the section below outlines a range of tax and other measures aimed at providing that environment.

Marketing

4 Recently the DTI introduced a 'Support for Marketing' initiative aimed at small- and medium-sized businesses, which the CBI has warmly welcomed. It will improve the understanding of the importance of marketing among smaller firms and help develop market intelligence, thereby improving marketing effectiveness and performance. It has received such an enthusiastic response that demand has outstripped the budgeted programme. The CBI urges that further funds be made available.

Research and development

5 Chapter 4 refers to the need to develop a longer-term strategy to promote research and development. Here the CBI concentrates on more immediate issues. In the US 1.1% of the research and development budgets of each of the Federal Administration's major spending Departments is allocated to smaller firms. The UK's Ministry of Defence has recently announced moves along similar lines which the CBI has welcomed, including setting up a Small Firms Advice Division to act as a contact point for smaller firms interested in developing business with the Ministry. The CBI proposes that this initiative be extended to other

Government departments, so re-allocating the available funds within given Budgets.

Exchange risk cover

6 The CBI was concerned when exchange risk cover for European Investment Bank Loans was withdrawn last year, and wrote to the Minister of State for Industry accordingly. The absence of such cover is a major disincentive to smaller firms taking advantage of this low-cost source of funds. Under the European Commission's Fourth New Community Instrument, low-cost finance is being made available specifically for small- and medium-sized enterprises. Without exchange risk cover or some equivalent measure, UK smaller firms are unlikely to benefit from these Community loans. So, in addition to their higher interest-rate burden, they will be further disadvantaged compared to European trading rivals.

7 The CBI therefore proposes that the Government should re-introduce exchange risk cover for this form of low-cost finance available from the European Community. This need not be costly to the Government as the scheme could be made self-financing over a number of years. Such a move would be consistent with the cover provided on loans from the European Coal and Steel Commission.

Capital allowances on plant and machinery

8 The CBI's 1985 Budget Representations pointed to the 'dip' in tax reliefs and the consequent effects on the cash and investment positions of businesses which would result from the 1984 changes to corporation tax and capital allowance. The effects of the dip are now being felt, particularly by smaller firms.

9 Unincorporated businesses and smaller companies, faced with higher tax bills as allowances have been reduced, are finding themselves unable to maintain their desired level of investment. At the same time they have not benefitted from the offsetting cut in the main corporation tax rate in 1984 because:

- unincorporated firms had no corresponding reduction in income tax;
- the smaller companies' rate of corporation tax was not reduced to a matching extent.

In addition, smaller firms generally find it relatively more difficult to finance the gaps in their cash position created by their endeavours to maintain their investment programmes.

10 To provide an additional incentive for such smaller firms, and help them meet their tax liabilities without having to cut their investment, the CBI proposes the introduction of 100% capital allowances on, say, the first £25,000 of their capital expenditure on plant and machinery. The current system would continue to apply to all capital expenditure above that limit.

11 In order to target this incentive towards smaller firms, the relief could be restricted to unincorporated businesses and companies taxed at the small companies' rate. The CBI would be pleased to discuss with the

Government its more detailed suggestions on how this could be achieved.

Business Expansion Scheme

12 Since the welcome inception of the BES, the CBI has campaigned against the exclusion from tax relief of persons connected with the firm, such as employees, directors, partners and their associates. CBI members remain convinced that there is considerable untapped potential for equity investment in smaller firms by these 'connected' persons, particularly in areas away from financial centres.

13 The CBI therefore proposes that the Government should extend the Business Expansion Scheme to allow relief for 'connected' persons. There are several ways of doing this without imperilling the concept of the BES:

- giving tax relief to connected persons at less than their highest rate of tax, thus recognising that they may already have a greater association with the company than unconnected persons;
- giving relief up to a more limited ceiling of annual investment by these individuals. A limit of, say, £10,000 would still be of use to smaller firms which are not able to attract BES investment at present.

14 Clearly there could be a number of variations on this theme. Our concern is that something more should be available so that opportunities for funding are not lost. The CBI is ready to explore these ideas further with the Government.

Taxes on business assets

15 For many years the CBI has suggested changes to the capital taxes to encourage smaller firms, particularly in the reinvestment of profits by owner-managers. Accordingly the CBI welcomes the steps in this direction already taken by Government such as the replacement of capital transfer tax by inheritance tax.

16 However, CBI members still believe that all categories of business property should be given complete relief from inheritance tax, thereby providing greater long-term stability for business owners. Making this extension would:

- bring to an end the distinctions between types of business property at present qualifying for different rates of relief;
- meet the problems which remain under inheritance tax of a charge arising where a business owner dies before transferring the relevant business assets, or within seven years of doing so.

17 The CBI remains concerned that the capital gains tax indexation rules apply only from 1982. Because of this a large element of purely inflationary gain for 1965-82 (a period of exceptionally high inflation) is locked into the system. In 1982, the Government recognised that taxation of the inflation element in gains is wrong in principle. The CBI also believe that assets held over the longer term should be relieved

from the tax. The CBI urges the Government to review the way this tax impacts on business, and re-emphasises its previous detailed submissions on this subject, most recently in 1985.

Value Added Tax

18 A number of aspects of the VAT regime still cause concern; these have been described in the CBI's *Technical Budget Representations 1987*.*

19 The CBI has welcomed the Government's publication of its recent paper – 'VAT: Small Business Review' – and is responding to that paper separately. The paper contemplates, inter alia, a cash basis of VAT in place of the invoice basis. This could alleviate some of the present difficulties for those smaller firms eligible under the proposals, but there would still be difficulties for firms outside their scope.

20 An aspect of VAT which has attracted considerable adverse publicity over the past year is the new system of VAT penalties. The CBI accepts that VAT should be paid on the due date, but members are still unhappy that the new penalty system remains mechanical and lacks adequate provision for mitigation and appeal. In each case the penalty should take proper account of the concomitant circumstances. For instance, where VAT falls to be paid to Customs before the taxpayer has been paid by his own customer, there can be genuine financial hardship.

21 The CBI's *Technical Budget Representations* point out that the system of VAT relief for bad debts needs further improvement to bring it into line with bad debt relief for direct tax. The latter has long recognised commercial criteria for determining when debts are to be regarded as bad, and VAT should follow suit.

Infrastructure

22 For business of all sizes, a poor infrastructure raises costs and impedes the steps firms themselves are taking to become competitive. So the CBI's second priority for the 1987 Budget is additional public spending in this area. In 1980, capital expenditure was nearly 10% of total government expenditure. With the exception of 1984-5, it has fallen steadily, to below 5% in 1986-7 (Chart 9).

23 According to the Autumn Statement, capital expenditure in 1987-8 is set to be £1 billion higher than was previously planned. This increase acknowledges the force of the case that the CBI has been putting in its *Fabric of the Nation* reports, most recently in *Building a Better Britain*, which called for additional spending of £1 billion on the nation's infrastructure.

24 The shift in the balance of public spending towards capital is welcome, though the composition of the increase is slightly different to the CBI's proposal, with more on housing and less on roads and inner cities.

*Published CBI, October 1986, price £3

25 But more needs to be done:

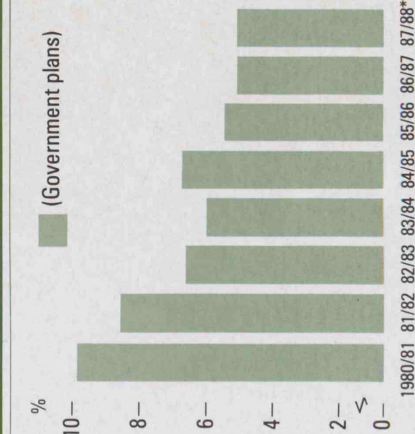
- the announced increases in the Autumn Statement partly reflect an over-run in spending this year as a result of higher than expected increases in wages and salaries. The result of this is lower growth of the volume of capital spending than the plans suggest;
- the increase in expenditure on roads does little more than preserve spending in real terms at its originally planned level;
- the Government has increased the Urban Programme by only £40 million and allocated an additional £75 million to the Urban Housing Renewal Unit. This compares to CBI proposals for an extra £300 million for inner cities. The CBI has always argued that spending in this area provides good value for money and attracts private investment.

26 Having studied the Chancellor's Statement, the CBI proposes additional funds should be made available for:

- Urban Development Grants. Every pound spent so far by the Government on this form of grant has been matched by four pounds of private-sector money;
- Urban Regeneration Grants. Firms can claim this new form of grant directly from the Government, not via local authorities;
- Urban Development Corporations. The Government has taken the initiative in setting up four new corporations. Consideration should be given to extending this approach as a means of speeding up action on urban decay;
- accelerating the National Road Programme.

Chart 9

Capital expenditure as a percentage of total government expenditure



*CBI estimates

Source: Public Expenditure White Paper, January 1986 and 1986 Autumn Statement

27 We also propose that the Government takes steps to ensure:

- the increased allocations to the local authorities are spent on capital and are not used to fund higher current expenditure;
- the higher level of capital spending in 1987/88 is continued in 1988/89 and 1989/90.

28 The CBI will continue to urge the Government to pursue value for money in the public sector. This includes involving private-sector management skills in public projects. Within the existing allocation of expenditure to housing, the Government is urged to give a greater role to Housing Associations, and set up the Building Improvement programme.

Personal taxation

29 To promote enterprise, there must be incentives for personal endeavour. Therefore the changes in personal taxes that can be afforded should reflect this. The CBI's third priority for the 1987 Budget is therefore for a reduction in personal taxation.

30 The question of tax reform is still being considered by the CBI and Chapter 4 touches on this subject. The CBI has already made its response to the Government's recent Green Paper* on personal taxation, and has highlighted the potential Exchequer costs of some of its proposals. The work disincentives brought about by the interaction of the social security and tax systems at the lower end of the income scale is one issue which needs particular attention.

31 Members of the CBI believe that levels of taxation on individuals, and the numbers subject to tax, remain too high. The CBI has consistently recognised the need to improve incentives throughout the income scale by reducing rates of tax. This has been brought into sharper focus by the recent US tax reform which dramatically cut the top rate of federal tax. The effects on the whole free world could well be considerable, but because of language Britain is more vulnerable to the loss of entrepreneurial, financial and scientific skills to the US.

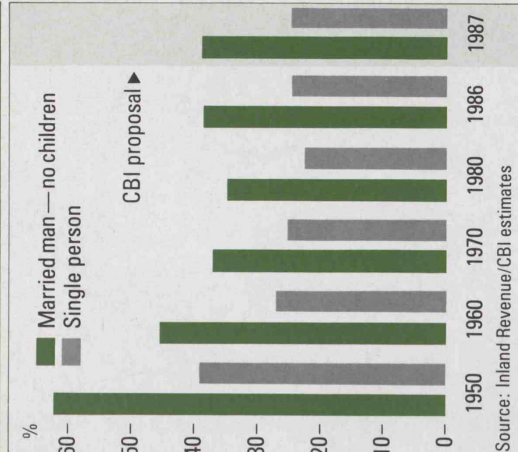
32 However, increasing personal allowances to make work more worthwhile to those on low pay has in past Representations been a major CBI recommendation. The Government and the CBI are united in endeavouring to make the labour market more flexible so that unemployment can be reduced. Furthermore, taking people out of tax represents administrative savings.

33 Since last year's Budget, the Social Security Act has been passed. One important implication of this is that, from April 1988, low-income families receiving the new Family Credit and Housing Benefit will lose over 90% of any reduction in tax payments through lower social security entitlements. This change will mean that raising tax allowances will no longer be an effective means of improving incentives for lower-paid heads of households from 1988/89 onwards.

*The Reform of Personal Taxation, HMSO, March 1986

Chart 10

Tax allowances (as % of average manual earnings)



Source: Inland Revenue/CBI estimates

34 But raising tax allowances remains the better way of improving incentives for the lower-paid in the 1987 Budget. As there is limited room for manoeuvre, the CBI believes any scope for tax reduction should be targeted towards this group.

35 The CBI therefore recommends an increase in all main personal allowances above the rate of inflation by 5%. As Chart 10 shows, this would ensure that the overall burden of income tax does not increase relative to the position after the last Budget.

Other taxation measures

Technical Budget Representations

36 Although not discussed in detail here, the CBI's *Technical Budget Representations 1987* already submitted to the Government have highlighted 58 action points to ease the burden of the UK's complex tax system. They are categorised under three themes:

- competitiveness** – aspects of UK tax law which render more difficult the operation of UK business in the international arena;
- incentives** – measures to encourage wealth creation and employee participation;
- burdens on business** – areas where unnecessary compliance and administrative costs arise.

37 Many of these technical adjustments could be made at relatively little cost to the Exchequer. The CBI renews its call for a review of the system of preparation and enactment of fiscal legislation which at present precludes, for want of Parliamentary time and Finance Bill space, early action on these more-technical changes.

38 A separate Technical Taxation Bill has already been suggested by the CBI as one possible way forward. Anxious that the Government should, as a matter of urgency, institute a review of the UK's fiscal legislative process, the CBI would be pleased to participate in discussions on this. The experience of recent Finance Bill programmes, particularly in 1986, has served to reinforce CBI members' conviction that change is overdue.

Indirect taxes

39 The CBI responded to the Government's proposals of August 1986 for changing the VAT rules on partial exemption, and despite the modifications announced in December still has three concerns:

- the scale of the compliance burden entailed by the new standard method;
- the fact that more workable methods will be available only by reaching agreement with Customs or getting a Tribunal decision;
- the start date of 1 April 1987 gives little time to adapt company procedures to the new Treasury Order, and none at all to the changed definition of 'input tax' that is scheduled to be introduced in this year's Finance Act.

40 It is essential not to burden a broad cross-section of business unnecessarily by measures intended to close specific loopholes.

Corporation Tax - migration of companies

41 Section 482 of the Taxes Act 1970 relating to the migration of companies and their overseas activities has long been a cause for concern to business. Since exchange controls were dismantled in 1979 and the controlled foreign companies legislation was introduced in 1984, the Section has seemed increasingly anomalous. In line with the CBI's response to recent Government consultations, its repeal is urged.

Foreign exchange transactions

42 In 1985 the CBI made strong representations to the Government in response to the consultative paper on a proposed Inland Revenue statement of practice on the tax treatment of foreign exchange transactions. The CBI continues to urge early legislation to provide tax relief for losses on foreign currency borrowings.

International taxation

43 The CBI urges the Government to press the European Community to implement in 1987 the long-

debated proposals for an independent arbitration procedure in cases of relevant double taxation disputes between a taxpayer and two or more Member States. Government should endeavour to ensure that this item of taxpayer protection takes precedence over the proposed draft OECD/Council of Europe multilateral convention on mutual assistance between tax administrations.

Worldwide unitary taxation

44 In 1986 the CBI has appreciated the continued support of Ministers and officials in initiatives to try ending worldwide unitary taxation. Serious problems still remain, and further close liaison and co-ordinated lobbying therefore remain vital. The CBI hopes to strengthen existing contacts with Government in continuing the campaign to secure a satisfactory end to this pernicious tax.

External trade

45 The CBI's *Technical Budget Representations 1987* emphasise the importance of the tax system in relation to the international competitiveness of British business. Competition in world markets is becoming increasingly severe as new suppliers emerge. UK overseas trade depends primarily on the competitiveness of its goods and services.

46 Government assistance through the British Overseas Trade Board, the Export Credit Guarantee Department and the Foreign and Commonwealth Office commercial posts must be on a scale equal to that enjoyed by our major rivals. It is essential, therefore, that the Government's present export services, both financial and advisory, are maintained and further cuts avoided. The return offered by such services, in terms of additional overseas earnings, could well justify a modest increase in the Government's support next year.

Chapter 4

Setting the stage

Tax and National Insurance

6 The CBI is concerned about the effects of taxation on the performance and international competitiveness of UK businesses of all sizes. The tax and national insurance systems must be directed to the promotion of economic growth and, in its consideration of tax reform, the CBI continues to examine how this can best be achieved.

7 The CBI has consistently urged that the UK tax burden be reduced; it is a major proposal in the *Business Manifesto*. CBI members' perceptions of this burden and the complexity of the present system, with its negative impact on incentives and competitiveness, have been clearly illustrated in *Change to Succeed - the Nationwide Findings**.

8 In a changing and highly competitive world the UK cannot afford a tax system which 'demotivates', is 'excessively complex', and 'discourages employment'.

Personal tax

9 To promote enterprise UK businesses needs the right incentives. Questions that need to be addressed include:

- the rate structure - the effects of high marginal tax rates and the impact of the tax and social security systems on the operation of the labour market;
 - the tax treatment of husband and wife - where efficient use of the nation's manpower requires that men and women be treated equally for tax purposes;
 - the unequal tax treatment of income derived from saving - a discouragement to certain forms of saving.
- As the CBI has pointed out in its response to the Government's recent Green Paper on Personal Taxation, careful evaluation is needed before introducing potentially costly reforms.

Business taxation

10 Some of the many problem areas identified in recent representations (in addition to points raised in the CBI's *Technical Budget Representations 1987* and those covered in Chapter 3) include:

- the treatment of the effects of inflation;
- stamp duty on share transactions, new issues and depositary receipts which should not impair the pre-eminent position of the UK securities market;
- distortions such as car tax;
- the scope of the capital allowances system;
- the compliance burden of direct and indirect taxation;

*Available from CBI Publications Sales, £1.50.

*CBI, October 1985.

- the impact of employers' National Insurance Contributions on competitiveness and the labour market.

The CBI urges consultation between Government and the business community on remedying defects in all these areas.

11 Any changes to personal or corporate taxation need to take account of developing international circumstances which could affect competitiveness. The United States has modified its personal tax regime and replaced 14 rates for individuals by two main rates. Tax reform is also in hand or contemplated in other countries, including Germany and Japan. There is pressure within the European Community for approximation of indirect taxes which could affect the scope for changes in direct taxes in the UK.

12 In view of the worldwide climate of change there is every incentive to look at the options and set down a plan of action. The CBI is fully aware that major changes would affect each taxpayer's economic behaviour. For that reason, the CBI's *Business Manifesto* stresses that change should be effected only after the fullest consultation, not just on the changes but also on the timing of their introduction.

Local Authority rates

13 The CBI has long argued that business rates are a bad tax which are:

- not related to ability to pay;
- unpredictable, varying much more from year to year and across locations than do the services they fund.

Business had no control over the level of rates it pays or of the local services it receives.

14 The total business rate burden, currently over £7 billion annually, significantly inhibits the competitiveness of British business.

15 Nor is the present domestic rate system a satisfactory local tax. The high degree of mismatch between those who vote for services and those who pay for them means accountability is poor. Hence the incentive for local authorities to operate cost-effectively is limited.

16 The CBI therefore welcomes the Government's commitment to the long-term reform of the local tax system. In responding to the Green Paper 'Paying for Local Government' (January 1986), the CBI supports in principle the replacement of domestic rates by a community charge, though with reservations about the practical administration and the durability of such a tax.

17 The UK's competitive performance would be improved if the property tax on business were phased out altogether, and this is the CBI's long-term objective. Business would then pay for local services by direct charging wherever possible, and contribute towards the remaining services via national taxation. As a first step towards this, CBI members would

support the introduction of a Uniform Business Rate (UBR), but only on a number of conditions:

- the first UBR is set at 25% less than the average poundage in the year preceding its introduction. This can be achieved by a gradual, centrally funded derating between now and the introduction;
- the UBR is set at the same level throughout England, Wales and Scotland;
- the UBR is not allowed to increase faster than the rate of inflation;
- all non-domestic property in England, Wales and Scotland is revalued, on the same basis, before the introduction of the UBR;
- the changes are phased in so that no business faces a rate rise of more than 10% in any one year.

18 The CBI accepts, however, that the earliest that these reforms can practicably be introduced is 1990. In the meantime the growth of the business rate burden must immediately be limited by introducing a ceiling on business rate increases, limiting them to the rate of inflation or the increase in domestic rate, whichever is the lower.

19 The CBI also supports the steps the Government is taking to improve efficiency in local government by making it a legal requirement that competitive tenders are sought for a greater number of local services. Members urge that as many services as possible are covered by this legislation.

Monetary policy

20 Both the levels and the volatility of interest rates and exchange rates have a major impact on the operations of companies, particularly their investment, export and recruitment strategies. In the early 1980s, the high level of sterling was the main issue. In recent years it has been the *variability* of the exchange rate (chart 11), and its impact on interest rates (see chart 6).

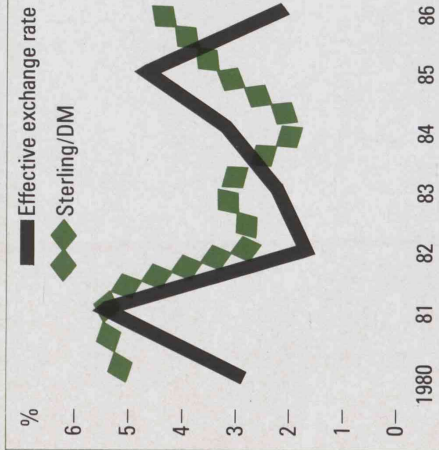
21 These economic variables are influenced by international events and by the monetary stance of the Government. This stance has evolved over recent years from a narrow commitment to targeting sterling M3 to a more or less explicit exchange rate target.

22 To buttress sterling against unnecessary speculative pressure, the CBI would urge the Government to join the Exchange Rate Mechanism of the European Monetary System. This would reduce the volatility of sterling at least against the currencies of other European Community members (who now take half of the UK's exports) and provide scope for reducing interest rates.

23 Monetary policy has evolved as experience with different monetary targets has developed. Against this background, an informed debate on the impact of monetary policy is vital. The CBI has always emphasised the inhibiting effect of high interest rates and exchange rate volatility on business. The conclusions and recommendations of a CBI Working

Chart 11

Volatility of sterling: coefficients of variation (based on monthly average exchange rates)



Notes: 1. The coefficient of variation is defined as the ratio of the standard deviation to the mean; it is a measure of relative dispersion.
2. 1986 figures to September.

Source: Financial Statistics, HMSO

Party studying the impact of monetary policy on business will be published later in 1987 as an important contribution to the debate.

Infrastructure

24 The physical fabric of the nation is in constant need of refurbishment and enhancement. Improvements to the infrastructure can directly lower business costs, improve profitability and so help the UK compete more effectively in international markets. Government action on this front stimulates private-sector developments and draws in private capital. The M3 and M11 motorway 'corridors' and the M25 ring are evidence of this.

25 *Building a Better Britain* set out proposals for increased capital spending over the next five years. It stressed the need:

- to respond to changed trade flows and provide better land access to Southern and Eastern ports;
- to match overseas competitors' transport costs;
- to attract business to this country and meet the challenge of the Channel Tunnel.

26 The Government has already announced higher spending for 1987/88. Chapter 3 argues the case for going further in the Budget. But there is no certainty that the higher level will be continued in the future. It is not only lack of resources but fluctuations in spending which have contributed to the poor state of Britain's infrastructure.

27 The higher level of capital spending needs to be continued and major projects advanced. This particularly applies to cost-effective projects in communications, inner cities and housing. This will not only help to generate wealth and jobs, but also improve the mobility of labour.

28 Though the Government must take the initiative in this area, it need not provide all the resources. It is important that full use is made of partnership between the public and private sectors. As proposed in *Financing the Future**, this includes:

- making full use of private-sector management resources;
- taking full advantage of leverage—where small amounts of public money attract significantly more private resources;
- greater use of contracting out;
- more extensive use of private financing arrangements such as in the Dartford crossing.

The CBI is studying other ways in which this partnership can develop and will be reporting as soon as possible.

Education and training

Education

29 The business community is concerned that the education service in general, and schools in particular, have failed to prepare students for life after full-time education, especially at work. One major recommendation has been that the volume of spending on Higher Education should not be cut back, and the CBI therefore welcomes the increases announced in the Autumn Statement.

30 Many pupils leaving UK schools are inadequately educated even in the most basic disciplines of communication and mathematics. The 40% of pupils in the bottom ability range appear to receive much less benefit from 11 years' full-time education than do their counterparts in countries such as Germany. This undermines both their ability to earn a satisfactory living in a competitive world, and British industry's ability to compete.

31 Employers are particularly concerned at the lack of understanding of the needs of business and its role in the economy.

32 Government at national and local levels has responded to such criticism by changes such as:

- reforming the secondary examinations system to achieve more sharply-defined criteria of performance linked to a 'core' curriculum;
- more vocational orientation through the introduction of the Certificate of Pre-Vocational Education and the Technical and Vocational Education Initiative, both of which include elements of work experience;

*Published CBI, June 1985.

- streamlining examinations under the new National Council for Vocational Qualifications.

33 But much remains to be done, not least the re-establishment of teachers' morale and professionalism after the damaging pay dispute of 1985/86.

34 Business also has an important role to play. The schools/industry links (particularly Understanding British Industry) that have been developed in recent years, should be maintained and improved. Employers should be willing to find work-experience places and establish links with schools and colleges. This way business can help the education service to develop all the available talent to meet the challenges of the world at work.

Training

35 Three out of five employers report difficulty in filling jobs requiring certain skills, qualifications or experience. The problem is particularly prevalent in high-tech industries, though other sectors are also affected, including more traditional areas such as footwear, catering, clothing and furniture.

36 A number of initiatives have been taken to deal with problems. For example:

- industry and government have acted together to set up, as part of the CBI Education Foundation, the Information Technology Skills Agency to help meet a shortage in the workforce of those with IT skills;
- business and the MSC are involved in a project to establish a local employers' network with the key objective of identifying local labour market needs and trying to meet them;
- proposals for meeting the shortage of mathematics and science teachers have been put forward for discussion by Government.

37 It is vital that these and other initiatives yield results if the growth of the economy is not to be threatened.

38 There is a general perception that expenditure on training in this country is too low and, some would argue, not as cost-effective as it should be. This can lead to the conclusion that training is a low priority, one of the causes of the UK's disappointing economic performance.

39 Many companies can point to a first-class performance, but the CBI would like to see more and better training by business as a whole. Measures which lead to bureaucratic burdens and a pre-occupation with financial devices rather than training must be avoided. The CBI has therefore not supported the use of measures such as a refundable training tax being collected from companies by central government, or the re-establishment of statutory training boards with levy-raising powers across all sectors of industry.

40 Specific proposals are being developed and studied, including the allocation of responsibility for paying for

training between companies, individuals and government. The CBI emphasises that:

- the responsibility for training employees rests with their employers, and business accepts this;
- the Government should pay for basic education, as well as having prime responsibility for funding general vocational education;
- the prime responsibility for training the unemployed must rest with government, although –
- industry has an important role to play in providing work experience places under the Youth Training Scheme and, where possible, the Community Programme.

41 Individuals who wish to develop their own capabilities in areas not relevant to their present employment should look to Government or themselves for support. The report of the MSC study on the funding of vocational education and training will, when published in 1988, act as a trigger for public debate and decisions in this field.

42 The CBI is consulting members in a review of all education and training policy, including the merits of fiscal incentives to encourage more and better training. When completed, the CBI will discuss its conclusions with the Government.

Innovation

43 Innovation is essential for the long-term prosperity of business. It can sometimes lead to substantial and dramatic breakthroughs. At a more work-a-day level, it is incremental innovation – frequent, modest improvements to product and management – which enables a firm to maintain its competitive edge.

44 Many aspects of innovation – product design and engineering, training, patenting and licensing, and marketing – depend largely on the individual company concerned. However, additional stimulus to innovation from government is highly desirable and is probably most readily applied to the first stage of the innovation process, namely research and development (R&D).

45 Though spending more than in the early 70s, the UK spends a lower percentage of GDP on non-defence than its major competitors. Other countries (particularly Germany and Japan) have accelerated R&D spending at a greater rate. (See Table 3, page 19).

46 At present, expenditure for trade purposes on scientific research, both on revenue and capital account, receives favourable tax treatment, as it can be written off against tax in the year in which it occurs. The CBI will be considering whether changes to the tax treatment of R&D as a whole should be introduced in the UK.

47 While recognising the many programmes through which the Government supports industrial innovation, members urge endorsement of the proposals developed by the I786 Committee, chaired by Sir Austin Bide. In contrast to the Alvey Programme of Information Technology, this represents a radical switch in

TABLE 3

Gross Expenditures on R&D as % of GDP (excluding proportion spent on defence)

	1965	1972	1978	1983
UK	1.55	1.39	1.58	1.60
US	2.03	1.87	1.77	1.94
France	1.41	1.47	1.42	1.68
W Germany	1.25	2.08	2.11	2.47
Japan	1.46	1.82	1.92	2.46

Source: 'Industrial Competitiveness and Britain's Defence', Kaldor, Sharp, and Walker, Lloyd's Bank Review, October 1986.

emphasis, away from R&D towards applications, giving users the dominant role (and the necessary funding) to demand the products they really need, rather than accept what suppliers think they want.

Resource allocation

48 To improve economic performance, flows of materials, capital and labour need to be more responsive to market signals. This issue is highlighted by the North-South divide. Urban decay is one aspect, covered in an earlier chapter and addressed more fully in *Reviving the Cities*.*

49 Much has been made of the need to encourage labour to accept work where it is available, rather than wait for work to come to labour. The disparity of regional unemployment alongside labour shortages attests to the urgency of this problem. The housing market has been a major factor impeding labour mobility and contributing to skill shortages.

50 While the move to increased owner occupation (now accounting for 60 per cent of households) is welcome, the private sector's decline within the rental market has itself contributed to the difficulties. This sector now accounts for less than 10% of the housing market – a much lower proportion than in competitor nations (see Chart 12) and a substantial decline from around 50% in the early 1950s. We need to examine the legislative and fiscal framework which has contributed to this.

51 Increased availability of privately-rented accommodation could encourage workers to accept jobs elsewhere more readily, and would allow the young greater mobility early in their careers.

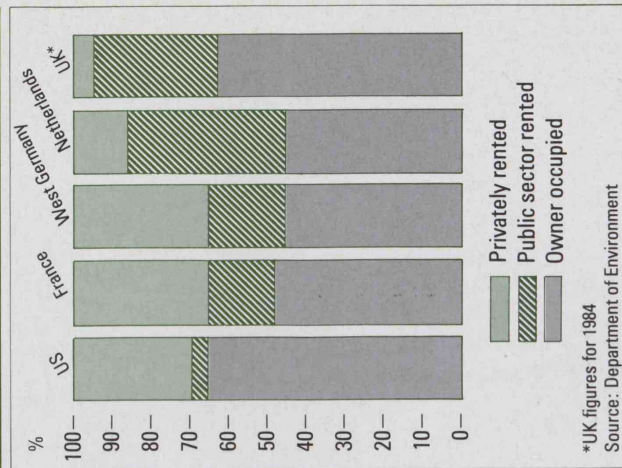
52 To help improve labour mobility, more favourable tax treatment of the payment of relocation expenses by firms should be considered. Relocation is important to businesses wishing to re-deploy labour for greater efficiency. The CBI has set up an Employee Relocation Council to examine all relevant aspects, and is separately considering the tax issues in greater detail.

UK offshore oil and gas industry

53 The impact of the recent precipitous fall in the international price of oil has been particularly serious as

Chart 12

International comparison of tenures 1985



*UK figures for 1984

Source: Department of Environment

far as the current account of the balance of payments, the exchange rate, and the local economy in Scotland are concerned. The buoyancy of non-oil revenues, which has to some extent cushioned the impact of this on the Exchequer, should not be allowed to conceal the seriousness of these economic implications.

54 Notwithstanding the acceleration of PRT repayments (announced on 6 November) serious consideration should be given to easing the North Sea fiscal regime, to provide incentives for companies to sustain the pace of exploration and development. This would be justified not least in order to reduce the exposure of the UK economy if prices were to rise sharply during the 1990s.

Conclusion

55 Budget measures can do only so much and no more. The performance of the economy depends on industry and government working together to help foster the spirit of enterprise and endeavour.

56 CBI members have identified the importance of education and training, regional differences, innovation, taxation, monetary policy and the infrastructure for industry's long-term performance. Specific measures have been suggested in some areas. Others are under review.

57 Action on such issues is crucial if the UK is to plan ahead effectively for new products, new designs and new markets.

58 Becoming more competitive is largely down to business itself. Government measures can either go with the grain, and help, or go against it, and handicap.

59 UK business is now making progress. But it needs to sustain the momentum of change so that the benefits of economic growth can be enjoyed now and by future generations.