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1989 BUDGET

I would like if I may to comment on your 1989 Budget and to suggest measures you might like to consider for inclusion in that Budget which I consider would contribute to a further improvement in the supply potential of the economy.

This year the supply side response has been particularly encouraging with output, productivity and investment surging ahead. Business confidence is high. But demand has been growing at an even faster, unsustainable, rate resulting in increased inflationary pressures and a rapid deterioration in the external balance. I agree that policy should be to concentrate on reining back the growth of domestic demand to a more sustainable level but, at the same time, we need to be careful not to damage business confidence and supply potential. There are already some signs that the increases in interest rates are beginning to have their desired effect.

Of course, high interest rates and the associated strengthening of sterling are not an ideal combination, either for business or to improve the current account, although I accept that it is the price that has to be paid to squeeze out the upsurge in inflation. But I would urge, in these circumstances, a very cautious stance on the 1989 Budget even to the exclusion of a further cut in income tax. A restrained fiscal policy will yield a more balanced policy mix and holds out the best hope of containing both interest and exchange rates and restraining the growth of domestic demand whilst sustaining business confidence and supply potential. I am sure that such an approach is in the best long term interests of business.





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In addition to commenting on personal savings, my suggestions for the Budget are primarily cost-effective measures designed to improve the supply responsiveness of the economy while adding little or nothing to domestic demand.

In my view measures to encourage an increase in personal sector savings could have an important influence on industrial performance. The sharp drop in the personal sector saving ratio means that personal sector savings in relation to income are at very low levels. Of course, given the state of the national accounts it is very difficult to be at all certain about how far the ratio has fallen, but it is certainly true that savings have been much lower than expected and conversely that consumption has been much higher than expected. This has been a key factor in explaining the much faster than anticipated growth in domestic demand which, in turn, has led to a build up of inflationary pressures and the sharp deterioration in the current account. The necessary response has been a tightening of monetary policy with higher interest rates and stronger sterling. A higher level of personal saving would produce a better and more sustainable relationship between demand and output in the economy, thus easing inflationary pressures and allowing a reduction in interest rates.

It is impossible to be certain why the savings ratio has slumped so far: lower inflation, improved consumer confidence, rising employment, pensions, holidays and the increased wealth (particularly stemming from the increased value of the housing stock) are all important. Some of these factors are cyclical and likely to be reversed as the economy slows and most commentators expect the savings ratio to increase in the next year or so. But any further measures to increase household savings would be welcome and should allow the same level of economic growth with a lower level of interest rates.

You have already announced your intention of introducing a new National Savings instrument in the new year. But national savings constitute only one small component of savings. I note that the Treasury have recently invited suggestions on ways of making Personal Equity Plans more popular. A "Savers Budget" would be a prudent use of a small part of the large fiscal surplus likely next year. Thus consistent with my letter of 1 December on taxation of personal savings and life insurance I would strongly support more general tax encouragement of savings.





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TRAINING

I remain very concerned about the low level of vocational training in this country by comparison with our main competitors. A number of improvements have been made in publicly funded training schemes, and Norman Fowler is proposing improvements in the delivery mechanisms. But the fiscal environment must have a strong influence on the amount and quality of training undertaken in the private sector. When training is financed by the employer, our tax treatment is as favourable as that in most other countries. But there is one improvement I should like to suggest. Where an employer pays for a training course for his employee, the employee sometimes has to meet some incidental expenditure himself, the latter cannot be set off against the employee's tax liability.

An extrastatutory concession allows the employee to claim a deduction where the course is a full time one of at least four weeks' duration. But it would be helpful if this provision were given statutory force, and if its scope could be widened to cover all courses where the cost of the training itself is met by the employer. This would be in line with the general trend towards more varied and flexible training modes, including open and distance learning.

I turn now to training financed by the individual. I supported last year a proposal by Kenneth Baker that expenditure by members of professional institutions on continuing professional development should be allowable against tax; and myself proposed that an individual's expenditure on his own management education should be allowable, with a facility to carry forward unused relief to set off against future income. I still consider that these two changes would give good value in stimulating additional high quality training. But they would still leave our tax treatment of training financed by the individual less generous than that in any other European country. I know that concessions in this area are not easy, because they are open to abuse by people claiming relief for courses with no real vocational function.—This might be overcome by limiting relief to courses taken in pursuit of approved qualifications; or by limiting the amount any individual could claim by way of tax relief for his expenditure on training.

COLLABORATIVE R&D

When I wrote to you a year ago about the 1988 Budget, I proposed the extension to consortia set up to undertake



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collaborative R&D the tax treatment enjoyed by trading consortia - notably the ability to set off initial losses against profits achieved by consortium members on their other business. This would be achieved, (subject to appropriate safeguards, already discussed between officials) by deeming R&D to be a trading activity for the purposes of consortium relief. My predecessors had also urged the merits of this suggestion, and I remain convinced of its value. It is not primarily an incentive to firms to carry out more R&D. Rather, it removes a feature of the tax system which discriminates in favour of "in house" R&D by big companies, and against collaborative R&D. The change would therefore support the new direction my Department's innovation policy is seeking to encourage. It would also have the following advantages:

- a) it would encourage two or more companies to set up joint subsidiaries to undertake R&D which was too risky, or too demanding in resources, for them individually;
- b) companies would be encouraged to "spin out" R&D projects peripheral to their main activity into separate companies in which others could have an equity stake. At present, such projects too often remain "on the shelf";
- c) financial institutions would be enabled to invest in an R&D company on the same basis as they can invest in a trading company; and
- d) there would be a convenient new vehicle for collaborative research, not only between companies, but between companies and education institutions.

The cost would depend on take up, but is most unlikely to be significant. I hope that you will examine the case for the proposal seriously.

COMPANY CARS

In your last Budget, you increased sharply the car benefit scales, and indicated that you intended to make further increases in real terms. I accept the case in logic for greater neutrality between the taxation of company cars and other forms of remuneration. But I am concerned about the impact. The effect of higher benefit scales will be felt most



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sharply by middle management in the private sector, on salaries somewhat below the threshold for higher rate tax. This group has benefited rather modestly from our tax cuts, and higher mortgage interest rates have hit them hard. I do wonder if this is the right time to increase the tax burden on their company cars, particularly if there are few if any cuts in general taxation to soften the blow.

If and when you do increase car benefit scales, I hope that you will take the opportunity to introduce full neutrality into the tax on company cars, by ending the limitation on the rate at which expenditure on so-called "expensive" cars is written down, and discontinuing the rule that input VAT on a company's purchases of cars cannot be offset against output VAT on the company's products and services. These restrictions impose both a tax and a significant regulatory burden on companies; and once the incentive for employers to give remuneration in the form of a company car rather than cash disappears, there will be no reason to treat cars differently from other business assets for tax purposes.

UNLEADED PETROL

You will be urged to increase the tax differential in favour of unleaded petrol, given the heightened concern about the environment and the very small number of retail outlets selling unleaded petrol even now. Hitherto, this Department has not favoured using the tax system to promote the use of unleaded petrol, since the majority of models sold by the Rover Group are difficult to convert to the use of unleaded petrol. But despite this, I now believe that it would be right to widen the tax differential in favour of unleaded petrol.

COMPANY PURCHASE OF OWN SHARES

Last year, I suggested a relaxation in the tax arrangements where a company, with the approval of its shareholders as required under the Companies Acts, purchases its own shares. At present, such purchases are treated for tax purposes as distributions, with a very limited exception confined to unquoted companies. I remain convinced that a company ought to be able, without tax penalty, to organise repurchases of its own shares where it feels that the market is undervaluing them. Simply to abandon the present treatment of purchase of own shares as a distribution could lead to avoidance if companies operated repeated small share purchase programmes instead of paying dividends. This could



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be avoided if the only transactions exempted from Advance Corporation Tax were those carried out on the market through intermediaries. The requirement to obtain consent from the shareholders for any programme of company share purchases should remain, as should the law against wrongful manipulation of share prices.

STAMP DUTY ON SECURITIES TRANSACTIONS

You have reduced this duty successively from 2% to 0.5%. On each occasion, the result was an increase in the yield thanks to the expansion of the volume of trading. But since the October 1987 crash volume has fallen sharply. The International Stock Exchange is still handicapped on its competition with New York and Tokyo by being the only centre of the three where securities are subject to a transaction tax. Other EC Governments are considering ways in which they can increase the attractiveness of their own financial centres in the run up to 1992. (The recent Lebegue report on the French system of taxation of financial assets included a recommendation that the French abolish their stamp duty on stock exchange transactions.) I note that the Chairman of the Stock Exchange in his representations to you on the 1989 budget drew particular attention to the implications of 1992 in expressing concern over the continued imposition of stamp duty. London will face increasing competition for its role as the key financial centre in the European time zone. It would greatly help London to maintain and enhance her competitive position if stamp duty on securities was finally removed, and with it the 1.5% Stamp Duty Reserve Tax.

I have written to you separately about the Inland Revenue proposals for changes in the tax regime for individuals who are resident but not domiciled in the UK; about the tax treatment of all forms of personal saving, in the context of Inland Revenue proposals for a new tax regime for life insurance companies; and I am currently considering together with Kenneth Baker writing to you about the tax treatment of gifts to educational institutions.

I also have a number of more detailed proposals, which are set out in the memorandum enclosed with this letter.

I am copying this letter to the Prime Minister, to Norman Fowler and Kenneth Baker, and to Sir Robin Butler.

Case
David

1 This Annex includes:

- i) two more detailed tax points; and
- ii) four deregulation points

I TAX POINTS

A CAPITAL GAINS AND LOSSES OF BUSINESSES

2 Private individuals are subject to separate Income Tax and Capital Gains Tax. Capital losses cannot be offset against income, nor can expenses be set off against capital gains. For companies, both trading profits and capital gains are subject to corporation tax, at a common rate; and trading losses of the same year (but not earlier years) can be offset against that year's capital gains. But capital losses may never be set off against trading profits.

3 This separation of profits and gains is a long-standing source of complaint from business who argue that the distinction between trading profits and capital gains is artificial in a business context, and can lead to harmful decisions. For example, a loss-making retailer may go out of business sooner than would be necessary if he could sell some valuable property and offset his losses against the resulting gain.

4 It is proposed that the limited degree of cross-offsetting already permitted for companies should be extended to unincorporated business. This would end a form of discrimination against unincorporated businesses; and the cost would not be heavy. There would be no need to draw new distinctions between the business and personal affairs of an unincorporated trader if the trading losses were allowable only against capital gains eligible for CGT rollover relief.

B ENTREPRENEURS SCHEME

5 The rapid growth of the venture capital industry in recent years has greatly improved the supply of equity finance for new businesses. The British Venture Capital Association (BVCA) now believe that the main constraint on further growth is not finance as such but the dearth of experienced managers willing to involve themselves in new companies with high growth potential. Paradoxically, the tax changes in the last Budget have not helped. The reduction in the higher rates of Income Tax, and the alignment of Capital Gains Tax rates with Income Tax, have reduced the attractions of the gains from successful participation in venture capital; and increased those of the salaries available in secure jobs in big companies.

6 At present, reliefs under the Business Expansion Scheme (BES) are not available to investors who are directly involved in

managing the company. The reasons are deadweight, and the risk of avoidance. The BVCA have put forward what is in effect a variant of BES for the managers and employees of unquoted companies. The initial investment would not be relieved of Income Tax (unlike the BES proper), but any gains on the disposal of shares would be exempt from Capital Gains Tax; the maximum qualifying investment in any year would be £120,000 (against £40,000 for the BES), but anyone claiming relief under this scheme would be debarred for up to three years from taking advantage of the BES proper. Most of the conditions for BES relief would also attach to the new scheme; but two would be relaxed. The rule against a change of ownership of the company during the qualifying period would not apply; neither would the condition that any subsidiaries must be at least 90% owned by the company receiving the investment.

7 The DTI cannot assess the technical feasibility of the BVCA proposal. But we urge that it be examined carefully; and that Treasury Ministers should give serious consideration to this, or other possible, fiscal incentives to experienced managers to participate in the launch of new unquoted companies.

II DEREGULATION POINTS

C VAT THRESHOLD SCHEME

8 EDU have been discussing with Customs and Excise ways of mitigating the effect on small traders of the way the VAT threshold is operated. At present traders have to register as soon as their turnover passes certain quarterly limits or if they expect their turnover to exceed the threshold in the following 12 months. The Customs have proposed the abolition of the quarterly turnover limits and the 12 months forward look; traders would register only when their turnover actually passed the registration threshold. Under this proposal traders would be able to benefit by having up to 12 or 13 months tax-free trading if they wished. Traders who found it advantageous to register straight away would still be able to do so. The cost of this has been estimated at £80-100m per annum. The DTI support the prompt implementation of this proposal.

D VAT REVIEWS

a) Bad Debt Relief

9 VAT is accounted for on the basis of invoice sales rather than cash receipts (unless the business has a turnover under £250,000 and can opt for cash accounting in which case see Item E). Relief in respect of VAT on debts which turn out to be bad is only available if the customer becomes formally insolvent. A form has to be signed and stamped by the Official Receiver acknowledging the claim before any relief can be granted. In contrast the Inland Revenue allows bad debt relief for income tax and corporation tax by reference to standard accountancy practice for the type of business involved. The Inland Revenue's approach is practical and realistic. The DTI suggest that Customs & Excise should introduce a similar system.

b) Default Surcharge

10 Where two VAT returns from the same trader have been received late by Customs & Excise in a 12 month period he becomes liable to the penalty regime. Any further late VAT return in the following 12 months triggers a default surcharge of 5% of the VAT payable on that return. For any subsequent late return the surcharge increases in steps of 5% up to a maximum of 30%. There has to be a system to deter habitual late payers. But the rate of the surcharge particularly at the maximum level gives cause for concern. As long as the "offence" is simply one of late payment, without any evidence of intent to defraud, it would be sufficient to set the level of the maximum surcharge so that it is approximately equivalent to a commercial rate of interest.

11 At the initiative of EDU, both the above systems are presently being reviewed by Customs & Excise. DTI hope that any proposals for change flowing from these reviews be included in the 1989 Finance Bill.

E VAT CASH ACCOUNTING

12 The 1987 Budget introduced a new scheme to simplify VAT for small traders. Businesses with turnover of up to £250,000 have the option of accounting for VAT on the basis of cash receipts and payments rather than invoiced sales and expenditure. This means that small businesses need not have to pay VAT on unpaid sales invoices.

13 The new scheme has not had as good a level of take up as had been hoped and Customs and Excise are to review it at the end of this year.

14 DTI hope that if the review identifies a need for legislative changes these will be included in the 1989 Budget.

F FREE STANDING ADDITIONAL VOLUNTARY CONTRIBUTIONS (FSAVCs)

15 Members of occupational pension schemes may top up their pension entitlement under the scheme by making FSAVCs, provided that their pension provision as a whole does not exceed the Revenue limits for tax relief.

16 The arrangements needed to police these limits place a burden both on the pension provider who must confirm that total contributions do not exceed 15% of salary; and the employer, who must certify that total pension benefits do not exceed two thirds of final salary. The Inland Revenue do not think it practicable to transfer to the individual pensioner responsibility for ensuring that the limits are not exceeded; but the Financial Secretary has promised to review procedures to see if the burden of compliance can be reduced. The DTI hope that this review can be completed soon, and any resulting changes implemented as quickly as possible.