Area

Howe / Lawson

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PART A

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PART A

Begins: 11/11/82

Ends: 9/12/83

DD: 25 years

5/9/95

CHANCELLOR'S PAPERS ON TAXATION AND THE 1983 BUDGET AND AUTUMN STATEMENT

PERSONAL AND CONFIDENTIAL

(PWP)

MR RIDLEY

FROM: J O KERR
DATE: 11 November 1982

FST
CST
EST
MST(C)
MST(R)
Mr French
Mr Harris

CRD BRIEF ON AUTUMN STATEMENT

The Chancellor has seen your minute of 10 November to the Chief Secretary, and has commented as follows:-

> "It is very worrying that this has occurred. Annex II to the brief also differs from what has been circulated to Ministerial colleagues (though the discrepancies are not important in substance). Procedures must be tightened to avoid any recurrence."

Mr Kerr

I spoke to the Chancellor about this this evening. We will tighten up our procedures.

AR 11/11

J O K.

J O KERR

CONFIDENTIAL

cc CST
FST
EST
MST(R)
MST(C)
Sir D Wass
Mr Bailey
Mr Middleton
Mr Kemp
Mr Lovell
Mr Chivers
Mr Halligan
Mr Griffiths
Mr Robson
Mr Ridley
Mr Moore

PS/IR
Mr Corlett - IR

PS/C&E
Mr Howard - C&E

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

7 December 1982

The Rt. Hon. Patrick Jenkin MP
Secretary of State for Industry

Dear Patrick

1983 BUDGET: MOTORING TAXES

Thank you for your letter of 30 November.

As you know, the President of the Society of Motor Manufacturers and Traders came to see me recently to press the industry's case for the abolition of car tax. Like you I have yet to be persuaded of the merits of their case - either for reductions or for abolition, which would cost about £450 million in 1983-84 and £650 million in a full year plus around £100 million for the VAT consequentials. But I fully agree with you that the SMMT's case, and the options for changes including those for other motoring taxes, should be examined further by our officials who have already had a preliminary discussion of the questions which need to be considered. If a case for reductions were to emerge we would of course need to consider how it would be financed and, in so far as offsetting increases in other motoring taxes were not practicable or desirable, how it ranked against other possibilities for helping manufacturing industry.

I have asked David Moore, the head of the Fiscal Policy Group here, to take charge of this work and to ensure that it is completed in good time. He will be in touch with your officials about it.

I am sure that Nigel Lawson and David Howell will wish their officials to continue to take part in this interdepartmental work and I am sending copies of this letter to them.

This is without prejudice to my firm scepticism!

Yours ever
Geoffrey

GEOFFREY HOWE

JH 615

CONFIDENTIAL

(PLOP)

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 3301
SWITCHBOARD 01-212 7676

Secretary of State for Industry

12 January 1983

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

EXCHEQUER
13 JAN 1983
Mr Kemp 13/1
CST, FST, EST,
MST^C, MST^R,
Sir D Wass, Sir A Rawlinson,
Mr Burns, Mr Bailey, Mr Middleton,
Mr Burgner, Mr Lovell, Mr Moore, PS/IR
PS/C&E
Mr Traynor

Dear Geoffrey,

1983 BUDGET

In your reply of 10 December to my letter of 6 December, in which I set out my views on industrial measures for the Budget, you invited me to let you have early in the New Year my further thoughts on major taxation measures and my proposals for items that might be included in an expenditure package to encourage innovation.

Taxation Measures

2 So far as taxation measures are concerned there is in fact little that I want to add to my earlier letter at this stage. Developments in the economic situation since early December have not I imagine made it easier for you to judge what room for manoeuvre there will be at budget time, nor have they encouraged me to think that the prospects for industry have improved, despite the recent fall in sterling.

3 I need not go over the domestic and international grounds for concern which are all very familiar to you, but I thought the CBI presentation at NEDC on Wednesday brought out starkly the serious implications for the corporate sector of persistently inadequate profitability and liquidity. Terence Beckett's point that the liquidity ratio for the corporate sector as a whole in the third quarter of 1982 was far below what an individual company would regard as the danger point serves to confirm indications we are getting that a further surge in closures and redundancies could be in the offing.

4 Against this still sombre economic background it remains my view that further help to industry should remain our highest priority. And I would place the emphasis emphatically on providing that help by reducing industry's costs rather than on stimulating consumer demand. You are aware of my continuing concern about energy costs and non-domestic rates, but unfortunately there seems little realistic prospect of major

changes here in industry's favour in the near future. This makes it the more important that the Budget should include at least one major measure that will bring significant benefit to industry.

5 In my view abolition of the NIS is far and away the best of the taxation possibilities. It would be generally welcomed by industry, as have been the successive reductions you have already been able to make. Equivalent concessions through reductions in Corporation Tax would be less well received and they would be of less help to many of the manufacturing sectors in greatest difficulty.

6 Presumably a reduction in personal income tax is the main alternative you will be considering. I appreciate that this too would benefit industry, but the benefit would be less direct and less certain. The main effect would be to increase consumers' expenditure, which would mean that a significant part of the benefit would be lost to imports. Abolition of NIS, by contrast, would directly and immediately improve industry's cash flow, competitiveness and profitability.

Innovation

7 I very much hope that, as last year, it will be possible to include some expenditure measures in an innovation package, and I welcome your willingness to look at our further proposals. These are shown in the annexed list.

8 My main priorities are SEFIS (and I am pleased that you recognise this as something of a special case), the "Alvey" programme of support for research in advanced Information Technology, and holding the level of grant support for our "Support for Innovation" programme at 33⅓% beyond the one year period ending in May this year.

9 You are familiar with the SEFIS concept: the annex describes some adjustments to its terms we should wish to propose. Despite my high priority for the Alvey programme, funding it - or any major new measure - is difficult for the DoI programme. Even after assuming a lower build-up of spend than in the Alvey Report we cannot provide all the DoI contributions we consider necessary without cutting other innovation support programmes. It would make little sense to cut, for example, our programme of support for Space - an important form of Information Technology - in order to finance Alvey. Indeed we see scope for usefully increasing support for Space, for example, through "demonstration projects". Over the past two years or so our Support for Innovation programme has achieved a considerable momentum. In order to maintain that we believe that it is very necessary to hold the level of our grant support at 33⅓% beyond the one year period ending in May this year. Certainly industry would welcome an announcement to that effect.

10 The remaining items in the Annex (items 4 - 12) are listed in no particular order of priority. They are all proposals to stimulate innovation and, given the general state of industry, and the priority this Government has given to the stimulation of innovation as a means of helping industry to become more competive, I believe that further help along these lines could not but have a beneficial impact. I have included, as item 4, a possible investment support facility for "pulling through" the development of new products and processes that have successfuly completed the R&D stages but need further help to surmount the investment stage. Again, the need for something on these lines arises primarily because of the
very low levels of profitability which we discussed at NEDC on Wednesday. Unlike the R&D support, I would not see this as permanent but as something aimed at a carefully defined target for a limited period of time.

11 Estimates of possible costs are shown against each of the dozen measures listed but of course these give only orders of magnitude. Some of our posposals will need further working up, at which point I should be happy for your officials to be associated with mine; but I believe the list contains the ingredients for a very effective and presentable package of expenditure support.

Loan Guarantee Scheme

12 I should also like to take this opportunity of mentioning the desirability of raising the limit on loans supported under the Small Firms Loan Guarantee Scheme. The current £300m limit may well be reached in the next month or two, and an increase by another £250-300m would provide the assurance necessary to take us over the three years to May 1984. Of course, any extra expenditure arising from such an extension would be very much smaller, as premia will largely offset any calls on our guarantees. We shall have an opportunity to discuss this scheme at our Health of Industry meeting on Tuesday 11 January.

13 I am sending copies of this letter to the Prime Minister, Sir Robert Armstrong and John Sparrow.

Yours ever

Patrick

ANNEX

CONFIDENTIAL

BUDGET INNOVATION PACKAGE - POSSIBLE EXPENDITURE MEASURES

Measure	Proposal	Possible Spend (£m (1983/84, 1984/85, 1985/86
1 Small Engineering Firms Industry Scheme	Reintroduction of 1982 SEFIS scheme with shorter timescale and possible minor modifications, eg increase size limit to community figure of 500 employees for small and medium-sized firms, and extension to cover use of similar machinery in wood-working industries.	30/40/3
2 Alvey - a programme of pre-competitive research in advanced IT	About half of the desirable DoI contribution consistent with the likely build-up in Alvey spend could be provided from existing DoI PES provisions, without cutting other innovation support programmes. But extra funds are needed to make the full DoI contribution likely to be needed if other support is not to be foregone.	0/10/1
3 Support for Innovation guidelines	First, the level of SFI grant should be maintained at 33⅓% beyond May 1983. It would be a significant blow for our promotion of Innovation if the grant were now reduced. Our PES forecasts were partly based on the presumption of holding the present level, so the cost would not be large. Secondly, there would be advantage in introducing a new element of innovation support - ie for market assessments prior to the undertaking of R&D.	3/10/1

CONFIDENTIAL

Measure	Proposal	Possible Spend (£m) (1983/84, 1984/85, 1985/86)
4 A new facility for supporting innovation-linked investment	Support would be available at 20-25% of project costs for investment resulting from the development of new products and processes with significant innovation. This would fill a gap in our array of support measures and enable successful R&D projects to be "pulled-through" the investment stage. Support would also be available for the initial marketing of the new products.	6/16/20
5 Advisory Services	Existing advisory services, including the Manufacturing and Design Advisory Services and the Small Firms Technical Enquiry Service, would be extended, and a new Marketing Advisory Service introduced.	7/8/9
6 Advanced equipment for education centres	The "micros in schools" approach would be followed with micros and computer numerically controlled equipment and computer-aided design and manufacture equipment in higher education and further education.	5/6/8
7 Computer-Aided Equipment in Industry	The existing support scheme for computer-aided design and testing would be extended; a new scheme for computer-aided production management, possibly leading to linked business schemes, would also be introduced.	4/12/19
8 Robots for Small Firms	A possible development from the machine tools in SEFIS to robots.	2/6/2
9 Electronics	The existing Software Products Scheme would be extended, and support provided for the stimulation of the medical instrument area.	5/6/9

CONFIDENTIAL

Measure	Proposal	Possible Spend (£m) (1983/84, 1984/85, 1985/86)
10 Quality Assurance	A new scheme to help small companies to implement QA systems, thus improving the quality of UK manufactured products as recommended in the White Paper "Standards, Quality and International Competitiveness".	1/6/8
11 Space	Support for "demonstration projects" for remote-sensing receivers for Third World markets, satellite business ground stations and mobile terminals, etc.	2/5/5
12 Science Parks	Support for equipment facilitating the support for the development of science parks and innovation centres, and for the creation of "incubator units" enabling several small firms to tackle high technology projects with minimum overheads.	2/3/5

Theoretical Total 67/128/155

= £350m overall

B H KNOX
Director
VAT Administration

C/ok?
JR
26/1

Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE
01-626 1515 Ext 2322

26 January 1983

PS/CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State (C)
PS/Minister of State (R)
Mr Moore
Mr Monger
Mr Griffiths
Mr Robson
Mr Fawcett I.R.
PS/C+E

VAT AND CHARITIES

1 At the meeting chaired by the Chancellor on 11 January, we were asked to revise the draft letter provided with my submission of 4 January, addressing it to John Hannam MP with a copy to Mr Tim Yeo, Chairman of the Charities' VAT Reform Group. The Chancellor said he aimed to reply by about 1 February. A copy of the revised draft is attached.

2 Ministers agreed it would be useful if the letter were given wider dissemination - for example it could be sent to Sir William Clark, Terence Higgins and the Chief Whip. We suggest a copy might also be sent to Michael Morris MP, whose letter of 15 December to the Chancellor (copy attached) on this subject dismissed the practical problems of a VAT refund as non existent. A draft covering letter from the Financial Secretary, who acknowledged Mr Morris' letter, is provided for this purpose.

Bryce Knox
(B H KNOX)

Internal Circulation:-

CPS	Mr Porter
Mr Fraser	Ms Caplan
Mrs Strachan	Ms Gilding (Parl.Unit)

pl. type

DRAFT LETTER TO JOHN HANNAM MP

~~You will recall that,~~ When we ~~when you~~ discussed ~~with Jock Bruce-Gardyne and myself on 30~~ in No 11 on 30 November ~~November~~ the question of VAT relief for charities, you will ~~remember~~ recall you said that the campaign of the Charities' VAT Reform Group (CVRG) was more clearly focussed this year on the technical problems involved. ~~In developing this point, you~~ You explained that research carried out by a statistician for CVRG indicated that probably no more than 10,000 charities would apply for a refund of VAT on their purchases if a de minimus limit of £150 refund was introduced; and you suggested that in this event the administration of such a refund scheme would only require about 70 Customs and Excise staff.

Tim Yeo, Chairman of CVRG, subsequently wrote to me to explain the basis of this research and I asked Customs and Excise to give the most careful consideration to its findings. I attach a copy of the analysis which Customs and Excise provided following discussions with the Charity Commission and Inland Revenue, together with a copy of Tim Yeo's letter of 9 December. You will see that, in Customs and Excise's view, the number of potential claimants for the VAT refund scheme you have in mind would be at least ten times greater than CVRG's estimate.

Tim Yeo also made the point you raised with me about the cost of administering a VAT refund scheme, by contrasting the statement in my letter of 19 October that this would be of the order of 10 pence of each pound refunded with the 72nd Report of the Commissioners of Customs and Excise which gives VAT administration costs of 1.2%. There is no real conflict between these statements. The cost of collecting VAT from registered traders bears no relation to the cost of making VAT repayments to charities, most of whom are comparatively small and have no other dealings whatsoever with Customs and Excise. The figure of 1.2% is the average cost of collecting nearly £11 billion VAT from 1.3 million registered traders. It is low because no less than £6.5 billion comes from some 5,000 very large traders (ICI, oil corporations, nationalised industries and the like), usually with sophisticated computerised accounting systems, and is collected at minimal cost to Customs and Excise. The administrative cost of collecting VAT from the

smallest traders is of course very much higher, as would be the cost of making a large number of comparatively small refunds.

This letter and the attached analysis are confined to the technical arguments which have been presented. But I do assure you that we have again looked at the charities' case as sympathetically as Tim Yeo kindly acknowledges we have done in the past.

I am copying this to Tim Yeo and hope he will accept it as a reply to his letter of 9 December.

GEOFFREY HOWE

(Fmp)

PS/CST
PS/FST
PS/EST
PS/MST(C)
PS/MST(R)
Mr Moore
Mr Monger
Mr Griffiths
Mr Robson
Mr Fawcett IR
Mr Knox
PS/C&E

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

John Hannam, MP
House of Commons

27 January 1983

Dear John

When we discussed the question of VAT relief for charities in No 11 on 30 November, you will recall you said that the campaign of the Charities' VAT Reform Group (CVRG) was more clearly focussed this year on the technical problems involved. You explained that research carried out by a statistician for CVRG indicated that probably no more than 10,000 charities would apply for a refund of VAT on their purchases if a de minimus limit of £150 refund was introduced; and you suggested that in this event the administration of such a refund scheme would only require about 70 Customs and Excise staff.

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/(ICI, oil

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... This letter and the attached analysis are confined to the technical arguments which have been presented. But I do assure you that we have again looked at the charities' case as sympathetically as Tim Yeo kindly acknowledges we have done in the past.

I am copying this to Tim Yeo and hope he will accept it as a reply to his letter of 9 December.

GEOFFREY HOWE

27/1/83

FINDINGS OF RESEARCH CARRIED OUT AT THE CHARITY COMMISSION BY THE CHARITIES VAT REFORM GROUP: OBSERVATIONS FROM CUSTOMS AND EXCISE

The research was carried out on a sample of charities registered with the Charity Commission for England and Wales. We have no information about the size of the sample or whether it is typical of the whole population.

(1) TOTAL NUMBER OF REGISTERED CHARITIES

Finding: Only 125,257 registration numbers have been allocated.

Conclusion drawn: The Charity Commission's figure of 142,903 given on 5 November 1982 is wrong.

Observation: We do not understand the basis of this finding. Perhaps the researchers have not fully understood the complex registration system introduced in 1960 (registration was not required before this date) whereby the Charity Commission allocate numbers in various series which far exceed 125,000 - for example the Spastics Society's registered number is 208231, the Sheffield Area Kidney Associations registered number is 506386, and other numbers are in the 600,000 series. The figure of 125,257 is the number of files in a separate system introduced in 1853 for bodies who were not then required to register and which has been continued for unregistered bodies, so perhaps the researchers have mistakenly relied on this information. But in any case the Charity Commission have confirmed that their own figure of 142,903 is correct, so we must assume the researcher's conclusion in invalid.

(2) DELETED CHARITIES

Finding: 27% of the research sample were formally 'deleted' from the Charity Commission's register.

Conclusion drawn: 27% of all registered charities can be deemed 'deleted'. By applying this percentage to the figure of 125,257 given in (1) above, the number of charities is reduced to between 85,000 - 98,000.

Observation: 'Deleted charities will be found in any sample because registrations given to charities are never re-allocated. The Charity Commission's figure of 142,903 does not include 'deleted' charities. The conclusion is invalid.

(3) INACTIVE OR DEFUNCT CHARITIES

Finding: 70% to 80% of the research sample have not submitted annual accounts for 5 years, despite annual reminders from the Charity Commission.

Conclusion drawn: These charities are inactive. On this basis 70% to 80% of all registered charities can be accepted as inactive. Therefore only 28,000 to 42,000 registered charities are 'going concerns'.

Observation: Only those registered charities which have a permanent endowment are obliged to submit annual accounts to the Charity Commission. It is true that many of them fail to do so, but since there is no advantage in submitting accounts - and, in practice, no penalty for failure - it is not safe to assume that these charities are inactive or that they would be inactive in reclaiming VAT. It is not the practice of the Charity Commission to issue routine reminders; the Commission concentrates on requesting those accounts which it has a specific reason to scrutinise. The conclusion is therefore invalid.

(4) TURNOVER OF ACTIVE CHARITIES

Finding: An examination of the accounts of the 20% to 30% of the charities in the research sample who submit annual accounts show that 75% had a turnover of less than £1,000 a year.

Conclusion drawn: Smaller charities "would be unlikely to consider the administrative burden of claiming relief as worthwhile when such a relatively small benefit is involved". The Charities VAT Reform Group does not wish to propose a de minimis limit for VAT refunds but concludes that a limit of £150 a year would render 75% of all active registered charities ineligible.

Observation: Since charities, particularly the smaller ones, tend to rely on voluntary effort for administration, they would not need to count the cost of claiming relief. A small VAT refund would be a significant sum to a small charity. Those making small refund claims would expect at least that claims would be allowed to accumulate until any threshold was exceeded. It is doubtful therefore, whether a de minimis limit would have the effect suggested.

(5) POTENTIAL NUMBER OF CLAIMANTS FOR VAT REFUND SCHEME WITH A DE MINIMIS LIMIT OF £150

Conclusion: .....'no more than 10,000 charities in England and Wales would be eligible..... Thus the administrative burden on Customs and Excise..... would be insignificant'.

Observation: The figure of 10,000 is derived from invalid conclusions about the total number of active registered charities in England and Wales, as explained at (1) to (3) above. But we think the Charities' VAT Reform Group would not wish to exclude charities in Scotland or Northern Ireland or those charities and voluntary groups in England and Wales who are not required to register with the Charity Commission. The latter mainly comprise:-

- Charities with no permanent endowment or land
- Churches and congregations (some 60,000)
- Voluntary schools (some 8,000 in England and Wales and substantial numbers in Scotland and Northern Ireland)
- Universities, the British Museum, the Church Commissioners and institutions administered by such bodies
- Industrial and Provident Societies and some Friendly Societies (eg. Housing Associations)

Because it is very difficult to estimate the total number of potential claimants from the information held by the Charity Commission, we have turned to the experience of Inland Revenue in connection with the administration of direct tax and charities. They have files on some 160,000 charities in England and Wales and Northern Ireland which either put in

claims for refund of tax on income which has been taxed at source (ie. income from donors' covenants and from investments) or which have come to notice because they have reportable untaxed income. Inland Revenue estimate that about 130,000 of these bodies are active, as are perhaps 10,000 charities in Scotland. It is not unreasonable to suppose that the vast majority of these active charities would seek VAT refund on their purchases, as would other charities and voluntary bodies which, whilst having no regular contact with Inland Revenue, may well be active enough to incur significant amounts of VAT on their expenditure.

We therefore believe that the likely number of potential claimants for VAT refund would be at least ten times the figure suggested by the Charities VAT Reform Group. The administrative burden and consequential demands on Customs and Excise manpower therefore remains formidable and could not be met within existing resources.

CONFIDENTIAL

C

Board Room
H M Customs and Excise
King's Beam House
Mark Lane London EC3R 7HE

Well done

From: A M Fraser

Date: 3 February 1983

cc: Economic Secretary
Mr Peretz

CHANCELLOR OF THE EXCHEQUER

VAT LOSS IN GOLD TRANSACTIONS: OPERATION 'JAUNTY'

This minute describes, for your information, a VAT operation which is now coming to fruition.

Officers from our Investigation Division have for some months been keeping observation on an organisation which was set up to evade VAT. The organisation's scheme depended on obtaining a tax-free source of gold and they achieved this by smuggling quantities of krugerrands, concealed on the person, into the UK. The krugerrands were for the most part purchased in Jersey but in the last month the organisation had also used Luxembourg as a source. The organisation registered for VAT a business through which the krugerrands were sold to London bullion houses. The bullion house paid the VAT to the 'bogus' business whose intention was to vanish with the VAT due to the Exchequer. By the end of January 1983 the VAT owing was some £600,000.

Operation "Jaunty" was launched on 1 February when, as part of a planned operation, three couriers were intercepted at London Airport (Heathrow) and one at Dover. Each courier was found to be carrying 100 krugerrands in a body belt. All four couriers were arrested and in the follow-up operation another six people - some with serious criminal records - were arrested. All ten have been

---

Internal circulation: Mr Hawken, Mr Knox, Mr Weston, Mr Porter, Mr Cutting

charged with offences under Section 170 of the Customs and Excise Management Act 1979 and remanded in custody. At their next appearance in court some will be further charged with conspiracy to evade VAT.

The Investigation Division are continuing with their enquiries and further arrests are expected.

Ministers will recall that when the Value Added Tax (Finance) Order 1982 was introduced on 1 April 1982 to tax gold coin there were some who expressed fears in the House that there would, as a consequence, be an increase in smuggling. The Minister of State(R) replied to the effect that whilst some smuggling could occur Customs had considerable experience in catching smugglers. This case has proved his point.

The Value Added Tax (Finance) Order 1982 and the administrative measures taken to limit use of the postponed accounting facility were taken to combat the massive gold frauds involving an estimated VAT loss of £120 million per year. Frauds, using gold as the vehicle, have not died away completely but our Investigation Division estimate that evasion has been markedly reduced and is now in the range of £2 million to £4 million per year.

A M FRASER

FROM: J O KERR
DATE: 7 February 1983

PWT

MR FRASER- CUSTOMS & EXCISE

cc Economic Secretary
Mr Hawken - C&E
Mr Knox - C&E
Mr Peretz

OPERATION "JAUNTY"

The Chancellor has seen your minute of 3 February, and would be grateful if you would pass on his congratulations to all concerned with this operation.

J O KERR

CHANCELLOR OF THE EXCHEQUER

John

This only reached us today.

The PQ should be answered tomorrow

to tie in with Fowler's statement so

we need clearance this afternoon

to get it tabled tonight.

M.

1. This looks OK to me.

2. The PM has approved Fowler's Statement

[illegible]

[illegible]

Approved

[illegible]

CONFIDENTIAL
UNTIL 18 February

3/5/2

From J G Colman
15 February 1983

RwR 15/2/83

1. MR RAYNER
2. CHANCELLOR

copies attached for:
Chief Secretary
FST
EST
MST(C)
MST(R)
Sir D Wass
Sir A Rawlinson
Mr Wilding
Mr Kemp
Mr Monger
Mr Mountfield
Mr D J L Moore
Mr N J King
Mr Salveson
Mr Harris

CONTRACTING OUT AND VAT: ANNOUNCEMENT

The Secretary of State for Social Services has decided to make a Statement in the House on Thursday 17 February about contracting out in the NHS. He wishes to refer to the decision to refund VAT health authorities where services are contracted out. It would be convenient therefore for that decision to be announced on Thursday too.

Earlier, we had thought that the decision on VAT, which extends of course to services contracted-out by Government departments, would be announced in answer to an arranged PQ. That still seems a sensible arrangement. I attach a draft, which has been cleared with Customs as well as FP and GEP4.

I shall be submitting separately draft letters to those MPs who wrote to you on this subject, and to whom a non-committal reply was sent.

By way of background I also attach a copy of Mr Fowler's draft statement. It is entirely in line with our previous understanding of his approach but the idea of making an oral Statement, which will invariably put the exercise in a higher key, is new.

J. G. Colman

J G COLMAN

DRAFT PARLIAMENTARY QUESTION

Q: To ask the Chancellor of the Exchequer, if he will make a statement about the payment of VAT by Government departments and by health authorities in respect of contracted out services.

Up to now, Government departments and health authorities have had to bear VAT on contracted-out services which are acquired for non-business purposes.

A: I shall be seeking powers in this year's Finance Bill to refund payments of Value Added Tax both to Government departments, and to health authorities, where such services have ~~work has~~ been put out to private contractors. This will remove a possible disincentive to the use of outside contractors when it would otherwise be cost-effective to do so.

CONFIDENTIAL

PwP

NOTE: T A M POLLOCK
DATE: 16 FEBRUARY 1983

PS/CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State (C)
PS/Minister of State (R)
Sir D Wass
Sir A Rawlinson
Mr Wilding
Mr Kemp
Mr Monger
Mr Mountfield
Mr Moore
Mr Rayner
Mr Colman
Mr King
Mr Salveson
Mr Harris

CONTRACTING OUT AND VAT: ANNOUNCEMENT

The Economic Secretary has seen Mr Colman's minute of 15 February and attachments.

The Economic Secretary is most concerned about the Secretary of State for Social Services decision to make an oral Statment in the House on Thursday 17 February. It would be particularly bad from the VAT and charities aspect (coming so close to the Budget) and the Secretary of State might well come under questioning on this.

The Economic Secretary would very much prefer the announcement to be made by written answer as previously intended.

MISS T A M POLLOCK

(C)

FROM: C J A CHIVERS
DATE: 16 February 1983

1 ~~MR BAILEY~~

cc:Mr Mountfield
Mr Gordon
Mr Robson
Mr Brazier
Mr Halligan

2 CHANCELLOR

cc:Chief Secretary
Financial Secretary
Economic Secretary
Minister of State (C)
Minister of State (R)
Sir Douglas Wass
Sir Anthony Rawlinson

MEETING WITH MR JENKIN, 18 FEBRUARY: EXPENDITURE MEASURES

There are three items under the heading:

(i) The innovation (expenditure) package;
(ii) Alvey;
(iii) The loan guarantee scheme

The innovation package

2 You can tell Mr Jenkin that you are thinking in terms of a package totalling £200m over 3 years which would comprise 5 itmes:

	1983-84	1984-85	1985-86	3 - year Total
SEFIS	20	40	40	100
Computer aids and software	7	10	13	30
Innovation linked investment	5	15	20	40
Advisory services	12	9	9	30
Science parks	"	"	"	"
	44	74	82	200

(You could hand over a copy of this table to Mr Jenkin).

3 The figures for the first four items will be recognisable to Mr Jenkin. They have been revised by his officials since he wrote to you. Your line on Science Parks is that you would not be averse to a couple of projects being funded (especially if they can be located in difficult parts of the country) provided that Mr Jenkin can accommodate the expenditure within the three yearly total - £44m, £74m and £82m.

4 Two other points you will want to make:

(i) SEFIS — You will want to ask if anything can be done to keep down the import content;

(ii) $33\frac{1}{3}\%$ grant — The continuation of $33\frac{1}{3}\%$ rather than 25% as the standard rate of grant under Mr Jenkin's "Support for Innovation" schemes was one of his preferred options. The Chief Secretary is by no means convinced of the case for this, and will want to think further about whether to allow the Department to do it even if they offer to finance it out of their existing allocation. You might invite Mr Jenkin to write to the Chief Secretary setting out the case for the higher rate of grant if he wishes to pursue it.

Alvey

5 Minister of State (R) minuted you on 14 January with an account of the ... Alvey proposals (attached).

6 You need not completely rule out the possibility of putting Alvey into the Budget package: it would obviously be an announcement of more than usual interest But:

(i) we would advise you strongly not to agree to it at this meeting. A special meeting of HIG has been called for 1 March at which you can go into it much more thoroughly. It is not straight forward: is it a complex set of proposals with long-term economic as well as expenditure implications.

(ii) if(not a foregone conclusion) you were to agree on 1 March, it would have to be on the basis that Alvey would displace the present item 2 in the innovation package, which conveniently has roughly the same expenditure profile. The size of the package must now be regarded as fixed.

Loan Guarantee Scheme

Flag 5 7 Mr MacGregor wrote to you on 11 February about next steps. You may have replied before this meeting with Mr Jenkin.* The points you may like to mention to Mr Jenkin are as follows:

i. You are content that the Scheme should continue on its present basis until May 1984, and that a further £240 million of guarantee funds should be made available for this purpose.

ii. You wish to announce extension in the Budget statement, and you do not want it to be foreshadowed in any way by publication of the Robson Rhodes reports. You would therefore like to see publication of the latter on Budget day, with Mr MacGregor handling the reports and extension as one entity.

iii. On extension of coverage to some tourist related businesses and industrial/commercial/trading businesses, you are willing to contemplate this subject to Treasury officials being satisfied as to definitions and to there being no substantial increase in lending involved.

iv. Any need for an interim statement about continuing availability of guarantees should be handled in a low-key way, saying that these will continue to be made available until a definitive announcement is made.

v. You will wish to stress that nothing should be said for the time being about the future of the Scheme after May 1984, or any variation of it.

KIT CHIVERS

* - separate submission from Mr Andrew

EXP DITURE MEASURES

A. The innovation package

Proposal	State of Play	Comments
1 Small Engineering Firms Investment Scheme.	Agreed	Cost £100M over 3 years
2 Alvey	HIG discussion (March 1)	Could be included but only instead of something else in the innovation package.
3 33⅓% grants for innovation projects	Rejected	DOI thinking of doing within present budgets. Chief Secretary opposed.
4 Innovation linked investment	Agreed	Cost £40M over 3 years
5 Advisory Services	Agreed	Cost £30M over 3 years
6 Advanced equipment for education centres	Rejected	
7 Computer indeed equipment in industry	Agreed	Provision of £30M over 3 years for this and item 9
8 Robots for small firms	Rejected	
9 Software Products	Agreed	Provision of £30M over 3 years for this and item 9.
10 Quality assurance	Rejected	
11 Space	Rejected	
12 Science Parks	Conditional acceptance	Agreement subject to money being found within total innovation package.

B. Loan Guarantee Scheme

Proposal	State of Play	Comments
Extension to March 1984	Agreed	Increase in guarantee ceiling of £240M. No extra PES cost. Guarantee calls to be met by DOI's existing provision

FROM: A. M. BAILEY
17th February, 1983.

CONFIDENTIAL

CHANCELLOR OF THE EXCHEQUER

c.c. Chief Secretary
Financial Secretary
Minister of State (R)
Sir Douglas Wass
Mr. Middleton
Mr. Burnger
Mr. Lovell
Mr. Moore
Mr. Chivers
Mr. Robson
Mr. R. H. Wilson
Mr. A. R. Williams
Mr. Ridley
Mr. Harris
Mr. P. Gordon
Mr. Battishill, I.R.

MEETING WITH SECRETARY OF STATE FOR INDUSTRY - 18th February

As briefing for your meeting with Mr. Jenkin tomorrow, I attach notes which those concerned have produced on the main agenda items:

(a) Macro-economic stance - note by Mr. Norgrove (flag A); you have already outlined this to Cabinet, and there should be no need to spend long on it. Also attached is a note on the position of the company sector as against the personal sector.

(b) Tax measures affecting industry - note by Mr. Moore (flag B)
- main tax changes (NIS, CT, petrol/derv, and car tax - see Mr. Jenkin's latest letter of 16th February, copy (Flag J) attached);
- enterprise and small firms (in the same order as in (Flag G) Mr. Jenkin's letter of 6th December - you will want to concentrate particularly on stock options and BES);
- minor tax proposals, including 2 agreed for the innovation (Flag I) package - also oil tax, CTT and other items (para 24) which may be worth listing to show that more is being done for business outside the list in Mr. Jenkin's letters.

/(c)

(c) Expenditure measures - note by Mr. Chivers (flag C)
- innovation package (SEFIS etc); Flag L
- Alvey;
- Loan Guarantee Scheme (you will want to give the agreed response to Mr. MacGregor's proposal, also covered in Mr. Andren's separate submission and draft letter). Flag K

Annexed is a check-list of all the expenditure measures put forward by Mr. Jenkin.

(d) Petrochemicals - note at flag D; you will want to outline the approach agreed at your meeting on Flag M 15th February, and I have discussed the note on this with the Minister of State (Revenue).

(e) BTG financial regime - note by Mr. Chivers (flag E); your office asked for defensive briefing - a submission has ~~also~~ gone to the Chief Secretary (copy attached).

(f) Incentive scheme for Chairman of BT - note by Mr. A. R. Williams (flag F); again defensive briefing was asked for.

2. In summary, Mr. Jenkin asked in his original letter of 6th December for three main things:

(i) "at least one major measure affecting industry as a whole", such as a further reduction in NIS;

(ii) an innovation package as spelled out later in his letter of 12th January;

(iii) a further package of measures to encourage enterprise and small firms.

You are in a position to reassure him fully on all three. Only on stock options is there perhaps continuing room for argument. So there should also be time to discuss the difficult petrochemicals issue, where you will want to rule out anything for the Budget and propose a fact-finding exercise, using consultants and in close co-operation with DOI, as the next step.

AMB

A. M. BAILEY

Jill we spoke re
A meeting next week
next week.
JOK

D.12

FROM: ADAM RIDLEY
23 February 1983

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State (C)
Minister of State (R)
Mr French
Mr Harris

CRD MEETING ON VOLUNTARY ORGANISATIONS

Mr French's record in his minute of February 22nd of the points which emerged at this meeting is quite thought-provoking. First, it is clear that there is some persuasion to be done within the Government if "VAT reform for charities was pressed very strongly, especially by Tony Newton and Lynda Chalker". Surely it is vital at some stage soon to get the handling of charities agreed with as many Ministerial colleagues as possible. Even if you can get your way in the immediate Budget period, the issue is sure to resurface if and when the time comes to discuss manifesto proposals.

2. The other slightly worrying issue is raised in paragraph 8 of Mr French's minute. One learns there of a samizdat "formal standing committee" on charity policy, which Mr Kohler is clearly all set to develop. I am sure there is some sense in having such a body; but it looks like another self-propelled policy group, amongst other things, on which Ministers will be playing a free-wheeling freelance role, and is that not a little worrying? ?

AR

ADAM RIDLEY

BUDGET: CONFIDENTIAL.

PUP

ECONOMIC SECRETARY TO THE TREASURY

FROM: T A M POLLOCK
DATE: 25 FEBRUARY 1983

PS/CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State (C)
PS/Minister of State (R)
Mr Ridley
Mr French
Mr Harris

CRD MEETING ON VOLUNTARY ORGANISATIONS

The Economic Secretary has seen Mr French's note of 22 February and Mr Ridley's of 23 February.

The Economic Secretary agrees with Mr Ridley's comments and thinks he should speak to Mr Kohler as soon as possible - before his Standing Committee is formed.

MISS T A M POLLOCK

JOHN WATSON, M.P.

HOUSE OF COMMONS
LONDON SWIA OAA

cc PS/CST
PS/FST
PS/EST
PS/MST(C)
PS/MST(R)

Mr Bailey
Mr Harris

28th February, 1983

Dear Geoffrey,

I was not able to get my oar in at our meeting earlier today so I am taking the liberty of writing briefly to express my opinions about some of the matters discussed.

1. Tax

I am positive that an increase in tax thresholds should be given priority over reductions in the standard rate.

2. The 5% Abatement and Child Benefit

I do not feel quite so strongly about the 5% business as do most other signatories of Richard Needham's letter. If resources are limited then I would have thought our social, economic and political purposes would be much better served by an increase in child benefit.

3. Mortgage Interest Relief

My own part of the country (Yorkshire) is not an area of traditionally high house prices. Nonetheless, the is something of a log jam in the movement of house sales which seems to be caused by the relative low turnover of higher priced homes. An increase to £35,000 for the MIR threshold would, I think, be of considerable assistance to the building industry locally.

4. The Working Population

I am sure there is now more political sex appeal in encouragement for (but not compulsion of) early retirement than for more youth training, job splitting, community programmes etc. Specifically I would suggest the following:

a. that the Job Release Scheme be extended immediately to age 61 with a view to an extension to 60 next year.

b. We should remove the provision whereby people who stay on at work after retirement age have their retirement pension rights increased by 7% per year as a result. There are currently some 300,000 people in Britain in full time employment over the normal retirement age.

c. For men between 60 and 65 we should abolish the rule whereby they become ineligible for supplementary benefit etc. if they possess liquid assets of more than £2,500. That would encourage many men to stop working and to live on supplementary benefit until their pension rights accrue.

There is absolutely no need to reply to this letter. You might just feed it into our system of thought in the normal way.

Kind regards,

John.

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

From: C W Kelly

Date: 21 March 1983

PS/CHIEF SECRETARY

cc: Principal Private Secretary
Sir Anthony Rawlinson
Mr Kemp
Mr Mountfield
Miss Seammen
Mr St Clair
Mr Stibbard
Miss King

ESTIMATES AND THE BUDGET

The Chief Secretary asked Sir Anthony Rawlinson whether the Estimates were made available before the actual Budget Speech.

2. The answer is that they were, by a few minutes. They were formally presented at 3.30 on Tuesday, 15 March and were available from the Vote Office from that time. This follows the practice of the last few years.

3. Mr St Clair has separately provided a paragraph for the Chancellor's winding up speech tonight about the superannuation Estimates. This covers the timetable point. But I thought it might be helpful to set the timetable out rather more schematically as below:

1 December	All Estimates to be submitted to Treasury
December/January	Treasury scrutiny
Mid-Jan/early Feb	Estimates approved and sent to printer
4 Feb	Corrected proofs sent to printers
2 March	Read at press (last date for amendments)
3.30 p.m. 15 March	Estimates presented and available from Vote Office

4. This timetable is, of course, highly simplified. In practice more than a few Estimates were not submitted to the Treasury by 1 December, which delayed both subsequent scrutiny and approval. But the date of 2 March for reading at press was a fixed one.

5. Main Estimates are not sent in proof form to the Select Committees. Proof copies are sent to the committees for Supplementaries because of the short timetable. This has always been felt to be unnecessary for main Estimates, since the committees have from Budget day to the beginning of August for their scrutiny.

C W KELLY

1-15

24 JUN 1983

CONFIDENTIAL

For the 12.15 meeting

F(exp)

FROM: D R NORGROVE
DATE: 24 JUNE 1983

MR MIDDLETON

cc Mr Battishill

THE REGULATOR

The table below shows the revenue gain from using the regulator on VAT and specific duties. The figures are rough. To improve them would mean consulting Customs. Under the rules for the regulator the maximum change in VAT from its present level is 3¾ percentage points (ie to 18¾ per cent) and for the specific duties, 10 percentage points.

Revenue gain in 1983/84
£ million, 1983/84 prices and incomes

Change effective from		1 July	1 August	1 November	1 January
1% point increase in VAT		350	290	120	-
		1300	1200	450	
1% point increase in specifics*	rough	80	70	40	20
	rough	800	700	400	

* approx 1p on cigarettes
5p on spirits
1p on table wine
1p on petrol
1p on derv
(effects on prices)

D R Norgrove

D R NORGROVE

20-24-6

29 JUN 1983

From: P J Stibbard
29 June 1983

MR MIDDLETON

cc Mr Bailey
Mr H Evans
Mr Lovell
Mr Mountfield
Mr Watson
Miss Court
Mr Macafee
Mr I Webb

MAIN CHANGES TO THE BUDGET FORECAST: EXPENDITURE

Mr Williams asked for more detailed briefing on the reasons for expenditure revisions since the Budget, as identified in EA's table - a revised version of which I understand will be sent to the Prime Minister in readiness for her meeting tomorrow with the Chancellor.

<u>Cash limited items (£0.6 billion)</u>

2. This is a direct result of a much larger than expected surge of spending which took place after the Budget numbers were finalised in early February. The Budget numbers were influenced by the fact that for defence nearly 15 per cent of the cash limit was underspent by the end of February, yet they managed to come within ½ per cent at the year-end. (thus, to our and their surprise, retained their record for spending close to cash limits). For many other votes we seemed to be on course at the end of February for an underspend roughly the same as in 1981-82 - about 5 per cent. The eventual outturn on these votes was a 2½ per cent underspend. In years before 1981-82 the underspend was also about 2½ per cent on average. So we now see, with the benefit of hindsight, that the 1981-82 underspend was not typical and not a good basis for the 1982-83 forecast, nor the 1983-84 forecast. In 1983-84 we are now generally expecting that underspend will be similar to that in 1982-83. The main exception is the MSC which was underspent in 1982-83 by £¼ billion. In 1983-84 the underspend is assumed to be nil.

Non-cash limited items (+£1.1 billion) of which - Agricultural Support (£0.3 billion)

3. This is a classic example of highly volatile demand-determined expenditure. The forecasts remain uncertain. The IBAP vote reflects the difference in a particular year between the gross costs of CAP support measures and receipts from the Community Budget. Much of the expenditure is 100 per cent pre-funded from the Community Budget. But there are two main requirements for substantive Exchequer expenditure:-

i. a few schemes, particularly the UK beef premium, are only partly funded by the Community;

ii. all purchases of goods into intervention have to be financed initially by the Exchequer. The money is recovered when goods are resold from a combination of sale receipts and reimbursement of losses from the Community. Hence during periods when purchases exceed sales, and stocks are rising, there is a heavy call on Exchequer funds. (And when stocks are falling there is a net flow of finance into the Exchequer.).

Forecasting these net expenditure flows is extremely difficult. The beef premium scheme involves deficiency payments representing the difference in any week between the predetermined target price and average market prices. Latest forecasts of meat supply over the coming year now point to depressed price levels. Predicting levels of intervention activity is at least as difficult. It is the net result of a large number of variables. Key factors include the balance between production and consumption levels, with production depending on the weather. Other factors are EC decisions on management of the agricultural market. The main means of disposing CAP surpluses is subsidised exports; this is at Commission discretion and depends on judgements on world market conditions, availability of Community Budget finance and international trade relations. Unfavourable conditions have become more exaggerated since the Main Estimates were prepared just before the Budget and the present

flow of milk products into the UK intervention is proceeding much more rapidly then than anticipated.

Grants (£0.3 billion)

4. This change reflects estimation changes in these demand-determined votes. There are new estimates of the number of beneficiaries coming forward to claim rate rebates, rent rebates and rent allowances. Also the number of beneficiaries of all kinds of supplementary benefits has been reassessed since Budget time.

Family Practitioner Service (£0.1 billion)

5. This has been revised because of a new view of the number of cases expected to be dealt with by the FPS and because more patients are coming forward with exemptions.

EC Contributions (£0.3 billion)

6. The change to the forecast simply represents the difference between an estimate based on the Stuttgart refund and the stylised assumption about refunds used in the public expenditure white paper and in the FSBR.

Debt Interest (net) (£0.5 billion)

7. The increase on debt interest is due to the higher than expected 1982-83 and 1983-84 borrowing, higher debt interest outturn figures for 1982-83 (which have increased the base used in the forecasting model) and revised national savings figures.

Tailpiece

8. We are always trying to improve our forecasting methods. But these changes of view should be put in perspective. Central government cash limits total over £50 billion and non-cash limited expenditure over £30 billion. Central government debt interest totals over £11 billion.

PJS

P J STIBBARD

CONFIDENTIAL

19

From : R R MARTIN

INLAND REVENUE
POLICY DIVISION
SOMERSET HOUSE

5 September 1983

PRIVATE SECRETARY TO THE CHANCELLOR OF THE EXCHEQUER

TAXATION AND INDUSTRY

... 1. I attach three sets of comments on the proposals set out in your minute of 2 September.

2. The comment on the stamp duty point is from Mr Draper; the business taxation piece has been co-ordinated by Mr Corlett; and I have contributed the comments on the employee share ownership points.

R R MARTIN

cc PS/Chief Secretary
Mr Middleton
Sir T Burns
Mr Monger
Mr Robson
Mr Green
Mr Isaac
Mr Blythe
Mr O'Leary
Mr Beighton
Mr McConnachie
Mr Corlett
Mr Draper
Mrs Ayling
Mr Martin

BUSINESS TAXATION

1. On the business taxation side, the Chancellor has been asked for:

i. a fundamental review of corporation tax

ii. a simplified system levied at a lower rate

iii. consideration of a switch from an imputation to a flow of funds system

iv. the extension of capital allowances to buildings used for development work

v. 100% capital allowances on patents.

Corporation tax (i. and iii.)

2. The Government introduced a major review of corporation tax in its Green Paper published in January 1982. This covered possible structural changes in the system, including a flow of funds or company expenditure tax as well as the case for adjustments for the effects of inflation and major changes in the present, imputation system.

3. A substantial majority of those who responded - in particular those representing industry - urged the case for stability in the corporation tax system. Only a small number of respondents, notably the Institute for Fiscal Studies, pressed for a flow of funds approach, even in the longer run. Accordingly, in the Budget Speech earlier this year, Sir Geoffrey Howe said that he recognised the force of the view put forward by industry, that change was not costless, and accordingly there should be no

change in the broad structure of the present arrangements. However, he announced more detailed changes following the points made in the representations (some of which have been enacted while others have been deferred to next year's Finance Bill) and more detailed consultations have been set in hand on two other areas (the treatment of groups and capital allowances for the mineral extraction industries).

4. Against this background, there would seem little point in setting up another fundamental review of the tax so soon after the last one had been completed.

Simplified corporation tax (ii.)

5. In principle, there would be much to be said for a simpler corporation tax at a lower rate. But each reduction of 1% in the corporation tax rates (main rate 52%: small companies rate 38%) would cost some £m180 in a full year (half that in the first year). Withdrawing the complex set of reliefs, assuming that it were politically feasible, would not in practice recoup much of the cost, at any rate for many years because of the overhang of past tax losses. Ministers are however considering the possibility of reducing capital allowances for plant or machinery, or narrowing their scope, but the amounts and timing of any savings would not permit a substantial reduction in the rates of corporation tax; and Ministers may in any event prefer to put any savings which emerged towards the cost of the abolition of NIS.

Capital allowances for buildings used for development work (iv.)

6. This is something we are already looking at. It is very similar to the suggestion made by the then Secretary of State for Industry (Mr Jenkin) before the last Budget, but not pursued by him then. The proposal was to widen the scope of the 100% scientific research capital allowance, to cover expenditure on assets used for development work, as well as expenditure on original research. The present proposal focuses specifically on expenditure on buildings.

7. At present, expenditure by a builder on buildings used for scientific research associated with his trade qualifies for 100% first year allowances; and such buildings could be used for a certain amount of development work also. Other development buildings used by industrial companies qualify for the industrial buildings allowance - 75% in the first year and 4% writing down allowances thereafter.

8. The argument, as put to us by DOI officials, has two legs. First, that those development buildings which at present qualify for the 75% industrial buildings allowance, should in future get 100% in the first year. Second, that there are certain buildings used for development work which slip between the existing scientific research and industrial buildings allowances, and get nothing.

9. We have been in touch with DOI officials to try to discover what specific instances of this latter type they are concerned about. We have asked them to let us have actual examples, and

a meeting is due to take place shortly. Meanwhile, we have been making our own enquiries in certain tax districts which handle firms active in high-technology development work.

10. There are questions of cost, definitions and economic and industrial priorities here. But we shall be reporting further to Treasury Ministers as soon as current enquiries, and consultations with DOI officials, have been completed.

Purchase of patent rights (v.)

11. Capital expenditure on the purchase of patent rights at present qualifies for writing down allowances which are given by equal instalments, spread over 17 years (or the remaining life of the patent, if shorter). The proposal here is that the expenditure should be written off in full in the first year.

12. The question whether there is a case for making this allowance more generous is something which we have recently been looking at, in connection with innovation expenditure generally. Again, we are proposing to report shortly to Ministers. Both this proposal and the previous one will - as Miss O'Mara's note recognises - need to be seen against any ideas which Ministers have for re-shaping the capital allowances generally.

EMPLOYEE SHARE OWNERSHIP

There are really three parts to the employee share ownership proposals.

i. Encouragement for schemes involving payment of a deferred profit sharing bonus, as payment towards the exercise of a share option. It is not clear what sort of encouragement is envisaged, but the general area of executive share options is one which we have very much under review at the moment - see the attached Annex put up by FP Division as part of the Chancellor's recent "methods of tackling unemployment" exercise. We think it is probably reasonable to assume that the author of the suggestion has in mind some form of tax relief for the "deferred profit sharing bonus". In fact, this is likely to be less desirable - from the executive's point of view - than a tax relief for the gain on the exercise of the share option itself. Proposals put to us have so far focussed on the latter: this is because (particularly in a small high technology company) the option price itself may be relatively low, and the gain on exercise of the option relatively high. For this reason the proposal - viewed as an incentive - looks misdirected.

...

and incorporated in your own paper for Chequers

ii. Linking tax relief for executive shares to a requirement to provide similar facilities for the company's employees more generally. Effectively, the Government has moved in this direction already. The Finance Act 1983 converted the annual limit for allocations under 1978-type profit sharing schemes - see paragraph 1(a) of the Annex - from a straight cash limit to a limit incorporating a percentage of salary. This means that senior executives can now take advantage of generous allocations under a profit sharing scheme, but only in a context in which the company's employees more generally are involved. A formal link might be possible

between (say) 1978-type profit sharing scheme and reintroducing income tax relief for executive share option gains - by making the availability of the latter conditional on the former. However, this could be complicated to legislate for and to operate, and has no advantage of principle over the approach the Government has already adopted.

iii. Making provision for employees to receive a proportion of their remuneration in shares tax free. In effect, this is what the 1978 profit sharing tax relief already does. The Truck Acts are no bar to it. The shares have to be retained for a period - at present seven years, to avoid income tax altogether - but without this the relief would be open to abuse and would not necessarily encourage commitment by the employee to the company.

ANNEX B

TAX RELIEF FOR EXECUTIVE SHARE OPTIONS

1. At present there are three reliefs for employee shares, as follows:

a. Profit sharing This relief, introduced in 1978, allows companies to allocate shares to employees, free of charge, up to a certain annual limit per employee (currently £1,250 or ten per cent of salary, which ever is the higher). The employee pays no income tax provided he holds on to the shares for at least seven years. The company's scheme must be open to all full-time employees of over five years' standing who wish to participate.

b. SAYE linked share options This relief, introduced in 1980, is based on a five or seven year monthly savings contract by the employee (upper limit on contributions of £50 per month). At the start of the contract, the company grants the employee a share option. At the end of the contract, he can exercise the option (assuming the share price has gone up) using his savings proceeds; the gain he makes is free of income tax. Again, must be open to all full-time employees of over five years' standing who wish to participate.

c. "Executive" share options For share options outside the SAYE linked relief, income tax is charged on the gain when the option is exercised; the gain is the difference between the market value at the date of exercise and the option price (plus the cost of the option, if any). These options are normally the preserve of directors and senior managers. There is a tax relief, introduced in 1982, allowing the income tax charge (without limit) to be spread by instalments over three years.

2. Treasury Ministers looked at this general area in January and February of this year, in the context of the enterprise and small firm package in the 1983 Budget. They decided to introduce improvements to all three existing reliefs. First, the "ten per cen of salary" was added as an alternative to the existing £1,250 annual

limit for profit sharing allocations. Second, the £50 monthly limit in b. above was to be raised to £75. Third, the instalment period in c. above was to be increased from three to five years. The first of these three was enacted but the latter two were dropped out of the original Finance Bill (because of the Election) and have not yet been reinstated.

3. At the same time, Ministers considered (but decided against) a more thorough-going relief for "executive" share options - for example, replacing the income tax charge on exercise of the option with a CGT charge on ultimate disposal of the shares. (This was broadly speaking the effect of the short-lived Finance Act 1972 relief for share options.) Looking at companies generally (ie both large and small), executive share option schemes seem to be flourishing; a share option is effectively a one-way bet (you cannot lose on it), and the effect of the 1979 reductions in the higher rates of tax and the subsequent instalments relief has been nearly to treble the post-tax return on a share option for a top rate taxpayer. In addition, a general relief would be fairly costly (we estimated last year a deadweight cost in the range of £m50-100); it would need 6-7 pages of legislation, and be politically contentious and would go against the general policy aim of encouraging remuneration in cash as opposed to benefits.

4. It would be possible to introduce a relief of this sort limited to smaller companies, with the aim of shaking able executives out of the larger firms and into new and smaller ones. The Bank of England support this proposal. Their view is that the priority is to induce the individual to leave the large company and take the relatively risky course of promoting a new business, that the new firm cannot compete by offering a larger salary, and that its main attraction must be the prospect of a bigger financial reward if all goes well. Without prejudicing future consideration, we should record that previous Ministers attached importance to the "universal application of the present reliefs to all sizes of company and all levels of employee and were reluctant to introduce discrimination to favour special classes. They also saw some difficulty in trying to draw the line between small and large or quoted and unquoted companies

It was recognised too that, although a special targetted relief would help to encourage movement, it should be fairly easy for a manager to take a stake in the early stages of a new small company's development. Share values are generally low in relation to the sometimes heavy gains that can ultimately be expected subject only to capital gains tax if realised and a key employee coming in from outside can therefore buy himself a significant stake for a smallish investment, normally raising a loan for the purpose. The 1982 interest relief relaxation - allowing interest relief on a loan to acquire shares in a close company to be extended to anyone engaged in the management of the company - was made with precisely this sort of situation in mind.

5. Ministers will no doubt want to look at these issues again, and we would expect the case for further share option relief to continue to be pressed by the Bank and the Department of Industry. A decision to bias the relief towards small firms (as in paragraph 4 above) would put a question mark over the re-introduction of the two measures dropped from this year's first Finance Bill: these both tend on the whole to work in the direction of making life more comfortable for the large- firm executive.

STAMP DUTY : THRESHOLD FOR SMALL SHARE TRANSACTIONS

The transfer duty exemption and reduced rates do not apply to transfers of stocks and shares. The proposal that there should be an exemption for very small share transactions is not new. It was looked at as part of the internal review that preceded the publication of the consultative document and it was mentioned in the consultative document. As the consultative document points out (paragraph 5.10) the objection to the proposal is that it would be difficult to prevent larger transactions being split to get the benefit of any exemption from small transactions. The great majority of duty on share transfers is handled by Stock Exchange computer with the minimum of Revenue supervision. The duty on transfers of stocks and shares was forecast to yield £m335 this year. The consultative document called for responses by 30 September.

UNITARY TAX: LINE TO TAKE WITH SECRETARY REGAN/PRESIDENT REAGAN

1. Now that Secretary Regan has announced the Administration's disappointing decision to refrain from submitting an amicus curiae brief in support of Container Corporation's petition to the Supreme Court for a rehearing of its case, and announced the setting up of a tripartite working group to study unitary taxation further, a new line to take is recommended. (A copy of last Friday's US Treasury press release is at Annex A.)

2. Line to take.

Decision

Timing

Surprised that you did not want to hear the Prime Minister express her views personally before making a decision not to submit an amicus brief in the Container case, particularly as it was not necessary to make a decision before 6 October (the Supreme Court would have accepted an amicus brief up to that date).

Content

The decision will be interpreted as meaning that the Administration's Chicago Bridge and Iron brief no longer stands (i.e. a step backward) and will give encouragement to those States at present using unitary taxation and encourage others to follow suit. It will also encourage the spread of unitary tax to LDCs. An amicus brief, even if it did not secure a rehearing for Container, would have clearly stated the Administration's view as being against worldwide combined reporting, influenced forthcoming Supreme Court cases involving foreign parent multinationals and discouraged the spread of worldwide combined reporting.

/Working

Working Group

(i) We hope that the tripartite Working Group will contain objective representation, including representation from States which have a heavy concentration of foreign multinationals, Illinois (where there is combined reporting for certain mainly-American multinationals only) as well as other States which have worldwide combined reporting.

(ii) Industry representatives on the Group should include foreign multinationals, especially since the largest problems of worldwide combined reporting are those caused to these multinationals.

(iii) The Working Group should certainly receive advice from a panel including representatives of the US's trading partners, since unitary tax is clearly an international issue of concern to governments. (The UK would like to be represented.)

Court Cases

We also hope that the Administration will not feel barred from issuing amicus curiae briefs in support of forthcoming Supreme Court cases involving foreign parents such as Alcan, Shell and EMI. A first step would be support for Alcan's and Shell's requests to the Supreme Court to obtain Federal jurisdiction over their cases.

FROM: A R H BOTTRILL
DATE: 3 OCTOBER 1983

MISS O'MARA

cc CST
FST
EST
MST
Mr Middleton
Mr T Burns
Mr Bailey
Mr Byatt
Mr Cassell
Mr Wilding
Mr Battishill
Mr Hart
Mr Hall
Mr Lord
Mr King
Mr Ridley
Mr Mountfield/Mr Scholar

X please

LONG-TERM PUBLIC EXPENDITURE: OPENING UP THE DEBATE

We have now checked the statements about other countries' public spending in Mr Mount's note to Mr Ingham enclosed with Mr Scholar's letter of 27 September to you. I am afraid that this has taken a few days since it has involved in some cases telephone calls to overseas posts.

2. International comparisons are notoriously difficult in this area but there appear to be a number of inaccuracies in Mr Mount's material. The comparisons of public spending and borrowing between the UK and 'the most successful countries since the war - Germany, Japan and Switzerland'- are not as clearcut as Mr Mount suggests.

3. The OECD estimates that public spending in Germany, for example, accounts for a higher share of GDP than in the UK. General government borrowing in Japan has taken exactly the same share of GDP over the past 20 years as in the UK. Welfare spending in the UK is lower than in Germany but higher than in Japan. It is also not clear why Switzerland qualifies as 'most successful'. Its growth rate since 1960 has been lower than any other industrial country except the UK and New Zealand.

4. There are some minor problems with the specific country examples of Mr Mount's. Finally, perhaps we should be chary of claiming M Mitterrand's austerity package is more stringent than any such measures seen in the UK since the Attlee government. The OECD has calculated that the UK fiscal measures taken since 1979 have reduced our own structural deficit by 5½-6 per cent of GDP. M Mitterrand's package still appears to fall short of this.

5. You may wish to let No 10 Private Office have a note making some of these points. We certainly do not want to throw stones. We are too aware ourselves of the pitfalls in this area, and Mr Mount's contribution is clearly intended to be helpful. You may also like therefore to enclose a short annex of some of our own material. This is an abbreviated version of Mr King's note of 27 September to Miss Simpson.

A Bottrill

A BOTTRILL

ENC

FROM: A R H BOTTRILL
DATE: 6 OCTOBER 1983

MR KERR

cc Miss Sinclair
Mr Graham

LONG-TERM PUBLIC EXPENDITURE: OPENING UP THE DEBATE

My minute of 3 October. You had some additional queries on public spending measures overseas, particularly in the light of the Prime Minister's own conversations with Chancellor Kohl and Mr Lubbers.

i. German civil service pay: our embassy in Bonn advises that Chancellor Kohl was wrong to claim that he has frozen civil service pay for nine months. He has only frozen the pay of the Beamte who account for about a third of German public sector workers. They include mainly members of the armed forces, railworkers, postmen, teachers and some civil servants. Their distinguishing feature is that they have 'no strike' agreements. Other public sector members covering office workers and manual workers, including many civil servants who do not have 'no strike' agreements, are getting pay increases by three stages between March 1983 and August 1984.

ii. German social security uprating: the Bonn embassy's expert is not in the office today so that we have not been able to verify Chancellor Kohl's claim to have skipped a year's uprating. It is not mentioned in the reports of the draft budget that we have seen.

iii. Dutch pensions and wages: Mr Lubbers' attempts to contain pensions and public sector wage costs are covered in the annex. We have not been able to verify either with our embassy in The Hague or with the Dutch embassy in London that private sector employers are ready to follow the government's lead in reducing civil service salaries by 3½ per cent.

2. You said that you would be revising the covering letter to Andrew Turnbull. May I suggest that you revise my existing paragraph 6 to take in Miss Sinclair's caveats which go more widely than public sector pay?

> "You will be aware that we take a keen interest in other countries' public spending experience, and we have compiled the attached annex which you may find useful. Our ability to monitor developments closely is limited by the sometimes sporadic nature of reports both from overseas posts and in the Press. It is particularly difficult to be certain that all the measures proposed by governments will actually be passed by their domestic legislatures. The present annex is up to date as far as we are aware but it should be deployed with care both because of the difficulties of verifying the facts precisely and because of the sensitivities of other governments".

3. I have made some very small modifications to the annex that

... we sent you previously. A new version is attached.

4. You will also want to be aware that we are conducting a separate exercise for Mr Middleton on public sector pay abroad. Returns are currently coming in from posts and we will write these up as soon as possible.

A Bottrill

A BOTTRILL

FROM : R H AARONSON
DATE : 6 OCTOBER 1983

1. MR BAILEY
2. CHANCELLOR

cc attached for

Chief Secretary
FST
MST
EST
Mr Middleton
Sir T Burns

cc Mr Wilding
Mr Byatt
Mr Cassell
Mr Battishill
Mr H P Evans
Miss Brown
Mr Monger o/r
Mr Hart
Mr Hall
Mr Spackman
Mr G P Smith o/r
Mr Ridley
Dr Rouse
Mr Lord
Mr Haacche
Mr Martin

IFS ON THE 'PUBLIC EXPENDITURE CRISIS'

The IFS will issue a press release tonight under the heading 'Crisis? What Crisis'. I attach a copy.

2. Their work was originally prepared as background to a Channel 4 programme next Friday 14 October. It has been accelerated because Gavyn Davies gazumped them in the Simon & Coates bulletin earlier in the week.

3. Unofficially, we have a leaked copy of their workings (poetic retribution!). But it is Channel 4 copyright and we cannot use it publicly till the full thing is published next week (following the TV programme). The whole thing is based on the leaked Treasury (not CPRS) LTPE reports of last year. They have no new official material.

4. Their main message is that the Treasury has cried 'Wolf' too early. They do not quarrel with the LTPE projections of expenditure. But they claim we were much too pessimistic about taxation, and they add a third scenario.

5. The IFS have worked on three different scenarios. Case I assumes annual GDP growth of 1½%. Case II, which corresponds to scenario B of LTPE, assumes ¾% to 1985-86 and ½% thereafter. Case III, corresponding to scenario A of LTPE, assumes 2½% growth.

The IFS projections of the PSBR on unchanged expenditure and tax policies in each of the three cases are as follows, with LTPE projections for comparison:

PSBR as % of GDP

	Case I (1½% growth)	Case II (¾%/½% growth)	Case III (2½% growth)
IFS	1.2	3.1	-1.1
LTPE	N/A	6-7	1-2

(The LTPE figures are given as a range because that study measured expenditure and tax separately and the two figures cannot be directly compared to give the PSBR).

7. In the two cases where comparison can be made the IFS estimates give s PSBR 3-4% of GDP less than the LTPE projections, and thus more room for tax cuts (or less need for increases). The difference corresponds to £9-12bn at today's prices. The IFS say that it lies mainly on the revenue side. They believe that on any scenario it will rise in real terms (we agree) and not fall as a share of GDP (we disagree).

8. Forecasting tax and revenue seven years ahead is clearly a very hazardous business. The margin of error on each will inevitably be large, perhaps larger than the difference between them. Even small errors on each side of the equation can make a very large change to the PSBR forecast and even change its sign. On the tax side in particular estimates are sensitive to the composition of GDP, since different types of income are taxed at different rates. Thus even for a given level of GDP tax revenue can vary substantially. We estimate that a shift of 1% of GDP from wages to profits can reduce tax revenue by nearly £1bn at today's prices.

9. Thus it is not surprising that the IFS should have been able to produce different answers from ours. From what we have seen of their methodology it is no more sophisticated than ours. But they have made different assumptions at various points. For example:

(a) they assume that defence spending rises by 3% a year in real terms - against the Treasury figure which they put at 5% - (ie a positive Defence Relative Price Effect of 2% on top of the NATO 3%);

(b) they do not allow for revenue from VAT and the specific duties to grow slower than consumers' expenditure (or net income). Our evidence is that a 10% increase in the latter leads to an increase of about 9% in the former;

(c) they assume that national insurance contributions grow in line with wages (ie the rates unchanged). We assumed that the NI Fund balanced with an unchanged Treasury supplement. This meant that at least on Scenario A ($2\frac{1}{2}$% growth) the NIC rate could be cut because NI benefit expenditure grew more slowly than wages;

?

(d) they assume that local authority rates grow in line with GDP. As with NIC's we allowed rates to be determined by expenditure, which grew more slowly than GDP on both scenarios;

?

(e) against this, the IFS have rather lower estimates for corporation tax and North Sea taxes.

10. There is one further point on these differences. It could be argued that the fall in NIC rates and in LA rates as a share of GDP represent a "tax cut". If the Treasury supplement or rate support grant were reduced the yield of these taxes could be held up, making room for cuts in, eg, income tax.

yes

<u>Line to take</u>

11. There are major problems in forecasting revenue and expenditure seven years ahead. Forecasters disagree about prospects even one or two years ahead. The IFS will have made one set of assumptions: we will have made another. So far as we can tell from their press release they do not differ much from us on expenditure. The main argument is about tax revenues. Other commentators may produce further different answers - for example Simon & Coates are at the pessimistic end of the scale. The important thing is not to get bogged down in arguing about the numbers but to accept that decisions on expenditure will have implications for what can be done on taxes.

R.H. Aaronson

R AARONSON

THE INSTITUTE FOR FISCAL STUDIES
1/2 CASTLE LANE, LONDON SW1E 6DR Tel. 01-828 7545

PRESS RELEASE

EMBARGOED UNTIL 23.00hrs THURSDAY 6 OCTOBER

THE 'PUBLIC EXPENDITURE CRISIS'

CRISIS? WHAT CRISIS?

We have noticed in recent weeks that increasingly wild statements are being made by politicians and others about a 'Public Expenditure Crisis' at the beginning of the next decade. In work at the Institute we can find no serious basis for such statements.

In preliminary work for the IFS Green Budget for 1984 (which discusses various possible economic strategies) we have been examining likely movements in public expenditure and government revenue over the remainder of this decade, on the basis of a detailed consideration of individual programmes and taxes. The results, which are reproduced below, indicate that many of the recent statements forecasting a serious crisis in 1990, and therefore implying the need for a reduction in expenditure in order to keep borrowing within existing targets, may be seriously misleading.

Our results indicate the following deficiencies between expenditure and revenue in 1990/1, which we expressed in 1983/4 prices and may be directly compared with a PSBR for 1983/4 of £8-9 billion.

		Implied PSBR in 1990/1 (1983/4 prices)	% GDP
CASE I	1.5% growth p.a. 3.5 million unemployed in 1990/1	£4.0 billion	1.2%
CASE II	0.75% growth to 1985/6, 0.5% thereafter	£9.7 billion	3.1%
	3 million unemployed in 1990/1		
CASE III	2.5% growth p.a. 2 million unemployed	-£3.8 billion (surplus)	-1.1%

The last two Cases utilise growth and other assumptions which are believed to be identical to the two main cases in a recently leaked Treasury document on the subject. Our results, on the expenditure side, broadly match those in this document. The major exception is defence on which the document assumes a 5% real growth rate - we have assumed 3% (consistent with current policy and NATO commitments). Expenditure in 1990/91 will, both on our estimates and apparently according to this document, constitute a lower share of GDP in 1990/91 than it does in 1983/4.

Future demographic trends will cause very real problems with public expenditure, but these are unlikely to become apparent until the 21st Century.

It is worth noting that the Treasury assumptions which we evaluate in Cases II and III are somewhat strange: if the growth rate were as low as in Case II, it is likely that unemployment would rise significantly.

It is on the revenue side that we believe other commentators have been seriously misled. With the exception of North Sea Oil revenue (which we estimate using the IFS Field-by-Field Model), there is no reason to expect tax revenue to fall in real terms, and some reason to expect that it will at least increase in line with the overall growth rate.

On our main, Case I, assumptions, with unchanged policies, the position in 1990/1 is extremely healthy, with an implied PSBR of 1.2% of GDP (compared with 2.8% in 1983/4). Major policy changes, such as increased defence spending, substantial tax-cuts and over-indexation of benefits, would, of course, increase the PSBR. However, such policy changes would be deliberate and are not inevitable.

One possible explanation of the contradictory forecasts is that the Government hopes to be able to afford substantial tax cuts and that the current 'scare' reflects an attempt to make room for such cuts in advance. There is no difficulty in the foreseeable future in maintaining current policies at current tax rates.

For further details please contact Andrew Dilnot or Nick Morris on 01-828-7545.

Work on this topic has been accelerated to assist the Channel 4 programme 'A Week in Politics' to be screened on Friday, 14th October.

FEV7

FROM: A. M. BAILEY
6th October, 1983.

CHANCELLOR

c.c. Mr. Wilding
Mr. Byatt
Mr. Cassell
Mr. Battishill
Mr. H. P. Evans
Miss Brown
Mr. Monger o/r
Mr. Hart
Mr. Hall
Mr. Spackman
Mr. G. P. Smith o/r
Mr. Aaronson
Mr. Ridley
Dr. Rouse
Mr. Lord
Mr. Haacche
Mr. Martin

IFS ON THE "PUBLIC EXPENDITURE CRISIS"

Some further points, to supplement those in Mr. Aaronson's note below, on the "line to take" in response to the IFS press release:

(i) We have not seen (officially) the IFS detailed workings, and until we do it is impossible to comment in detail on the differences from our projections, particularly on the revenue side.

(ii) The two cases in last year's Treasury projections were chosen as plausible sets of assumptions, though by no means the only ones possible. There is nothing "strange" about the unchanged level of unemployment assumed in the low growth scenario (Case II) - low productivity might well be associated with, and indeed a cause of, low growth.

(iii) The IFS projections look to us at first sight on the optimistic side (cf Simon and Coates), and we see no reason to doubt the broad message drawn from LTPE - that current expenditure and revenue trends imply a continuing problem in the longer term (Ministers have not used the word "crisis") unless GDP growth improves dramatically.

(iv) GDP growth will not improve unless the tax burden is reduced.

2. When the detailed IFS workings are officially published, by Channel 4 on 14th October, we must be ready with a more detailed critique for public use(and there does seem a degree of vulnerability about the rates and NIC contributions to overall "tax burden" - though they are less relevant to incentives).

AMB

A. M. BAILEY

SECRET

From: P E MIDDLETON
Date: 7 October 1983

CHANCELLOR OF THE EXCHEQUER

cc Sir T Burns
Mr Bailey
Mr Littler
Mr Cassell
Mr Battishill

THE FORECAST AND THE PUBLIC EXPENDITURE CABINET

You asked for my views on the desirability of your putting to Cabinet for the public expenditure discussion on 20 October a paper on the economy to supplement the Chief Secretary's report on the bilaterals. You would no doubt want to discuss this first with the Prime Minister, and clear any paper with her. But when we spoke I think your instinct was rather against such a paper, and having discussed this in PCC that is also my considered advice.

2. There are perhaps three considerations which might have led to a different view.

Regular Cabinet discussions

3. It is obviously right and sensible for there to be regular opportunities during the year for Cabinet to discuss the progress of the economy and confirm the broad thrust of the Government's economic strategy. Your predecessor placed some importance on establishing these discussions as a regular part of the annual round, and a discussion of the economy in July before the public expenditure discussions, and again in the new year before the Budget, can be helpful in setting the right framework and in conditioning expectations. But there is no established practice of a third discussion in the autumn. Sir Geoffrey Howe circulated a paper in October 1981, but not last year when the October Cabinet rested solely on the former Chief Secretary's report. So there is no precedent to be broken by not circulating a paper this year.

In Year Fiscal Action

4. Second, a paper would almost certainly be required if you contemplated taking in year fiscal action to reduce the prospective PSBR for the current year. At £11 billion, the forecast outturn is £3 billion above the Budget forecast; but it is basically unchanged from the level the forecasters were expecting in July after allowance is made for the July measures. As you know, a forecast at this stage of the year is still subject to an average margin of error of around £2½ billion in either direction; and though £11 billion remains the forecasters' central estimate, some of us have a hunch that the figure could come out below that, given the indications of a rather firmer recovery in output this year. A critical factor, of course, is how far your 7 July measures will help to produce a better pattern of spending at the end of the year, and avoid a repeat of last year's surge; on this we can only hope for better results. Despite the high PSBR the monetary prospect seems all right at present and we have just allowed interest rates to come down by ½%.

5. Against this background, our advice is against any immediate action on the fiscal side. Clearly, the idea of further public expenditure measures this year is a non-starter. On the tax side, there is only the regulator available at this time of the year. Maximum use of that from 1 November could bring in, at most, some £800 million revenue over the remainder of 1983-84. (These figures have not been checked with Customs but they are the right order of magnitude). But this would mean putting up VAT from 15% to 18¾% and the specific duties by 10 percentage points (eg 10 p on cigarettes; 52 p on a bottle of spirits; and 8½ p on a gallon of petrol). Increases of this size would smack of serious economic crisis, or at least a fairly desperate situation on public expenditure, whereas lesser increases would cause a great deal of hassle without really being commensurate with the size of PSBR over-run. The July 7th package has amply demonstrated your determination not to allow things to get out of control.

6. Tax measures which were inadequate to deal with the present year might still be justified if the purpose was to bring in more revenue in 1984-85 by consolidating the regulator increases in the Budget. But even if, as must be a distinct possibility, you

have to contemplate putting up taxes in the 1984 Budget, you will presumably prefer to avoid substantial increases in these particular taxes - which put our inflation record at risk next year. Putting up VAT is likely to come pretty near the bottom of any list of options.

?

7. So, for all these reasons, I would not recommend further consideration of fiscal measures at the present time.

Public Expenditure

8. The third and last possible reason for having a paper on the economy is if you felt it would help in Cabinet to secure the right outcome on public expenditure - and that you could achieve that more easily than deploying the arguments orally. In the last analysis this can only be a matter for your personal judgement. My own view, which is shared by others, is that the availability of an economic paper is unlikely to affect the outcome more than marginally, if at all, and most importantly, carries some risks of restricting your room for manoeuvre when we come to publish the Autumn Industry Act Forecast.

9. On this last point, as I have said, the fiscal prospect has not changed since your paper to Cabinet in July. In that you described next year's fiscal prospect as "distinctly uncomfortable" and mentioned that, even keeping to the White Paper public expenditure figures, there was a risk that "taxes may still have to be put up next year if we are to keep to the Medium Term Financial Strategy". You do not need a paper to reaffirm that this still remains the position, and to assure your colleagues that you are not looking to them for public expenditure savings simply to allow you to cut taxes next year. In any case, Cabinet decided in July on the need to keep within the White Paper total for next year, and the discussion on 20 October needs to be focussed on how that is to be done. Not on whether it should be done. A paper on the economy would distract from the main business in hand.

10. Finally, it would be much easier for you to handle any discussion of the PSBR outlook for this year and next if this is dealt with orally, and in fairly general terms. We certainly do not want a number getting into circulation, and we do not want to start

a detective hunt by the press to get hold of the economic forecasts. It would then give you a freer hand over the coming weeks to consider how best to present the forecast and the fiscal prospects in the Autumn Statement, bearing in mind that we shall be looking carefully again at the figures as more information comes in.

11. To sum up, the only decisive reasons for circulating a paper would be to get your colleagues' endorsement of in year fiscal action, or if the forecast showed a seriously worse position than that on which the public expenditure exercise is predicated. The present PSBR forecast, with all its uncertainties, does not seem to warrant fiscal action at the present time, whilst the forecast basically tells the same story as that conveyed in your July Cabinet paper. On the whole, therefore, and because it makes for maximum flexibility in handling these difficult figures, I would advise against a paper on this occasion. If that is also your conclusion, you may want to find an opportunity to mention it to the Prime Minister.

12. Sir T Burns will of course be letting you have his usual impression of the implications of the short term forecast.

P E MIDDLETON

prop.

CHANCELLOR OF THE EXCHEQUER

FROM: C J RILEY
DATE: 7 October 1983

C.
As expected
G

cc Economic Secretary
Mr Middleton
Sir T Burns
Mr Cassell
Mr Evans
Mr Odling-Smee
Mr Battishill
Mr Ritchie

FISCAL POLICY IN 1984-85

You asked about the economic effects of not implementing the negative fiscal adjustment of £1½ billion for 1984-85 contained in the September forecast. This would imply a PSBR of about £9½ billion, but unchanged figures in later years.

2. The effects would depend on how this departure from the illustrative PSBR path in the 1983 MTFS was viewed by financial markets. However, assuming the Government was able to convince the markets that it was only a temporary change, consistent with continuing low inflation, and that the PSBR would be back on track in the next year, the effects would probably be very small and largely reversed over the next couple of years.

3. Taxes would be lower than assumed in the forecast, and this would tend to boost consumers' expenditure. But the effect of this on activity would be partially offset by the effect of slightly higher interest rates needed to maintain monetary growth broadly unchanged, and hence also a very slightly higher exchange rate. The net effect on GDP in 1984 and 1985 would probably be very small - less than ¼% - and would subsequently be reversed. It would make no difference to the rounded numbers quoted in the forecast report.

4. The effects on inflation as measured by the RPI would also be trivial. Lower income tax might lead to marginally lower wage settlements in the 1984-85 pay round, and the slightly higher exchange rate would also tend to reduce prices. But these effects would be offset by a slightly higher mortgage rate than might

otherwise have occurred. Again the net effect would be lost in the rounding, as would the effects on money GDP.

5. Some of the higher PSBR would leak overseas in the form of a slightly weaker current account, but the main counterpart in 1984-85 would be higher private saving. This would tend to boost the growth rate of the broad monetary aggregates temporarily. With slightly higher interest rates - base rates would perhaps need to be held at 9%, instead of falling to 8½% as in the forecast - the pattern would probably be slightly faster growth of broad money and slightly slower growth of narrow money in 1984-85. But again the effects would be small, probably less than ½% on the annual growth rates, leaving M1 still a little above the 6-10% target range and £M3 just within it. The effect on M0 would also be negative but even smaller because it responds less to changes in interest rates. In subsequent years the monetary effects would be negligible.

[what about the world!]

	September Forecast	No fiscal adjustment	Difference
Short term Interest rates (%)			
1984-85	8½	9	+½
Effective Exchange Rate (1975 = 100)			
1984-85	83	84	+½
Growth of £M3 (%)			
1984-85	9	9½	+½
Growth of M1 (%)			
1984-85	11	10½	-½
Current account (£billion)			
1984	0	- ½	-½

6. The forecast contained a positive fiscal adjustment of about £½ billion for 1985-86. In other words, taxes were assumed to be reduced in the 1985 budget by £½ billion more than the increase in

the previous year. In practice the level of taxes in 1985-86 would not be significantly affected by a decision not to raise taxes in 1984-85. Higher borrowing in 1984-85 would add slightly to debt interest payments in the next year, but a small continuing addition to activity would tend to raise net revenues. The net effect would probably be very small.

7. All this assumes no change to the PSBR after 1984-85. However, if the higher PSBR in 1984-85 were to be interpreted in the markets as signalling a more lasting relaxation of the Government's fiscal stance, the economic effects could for a while be rather larger. If the markets expected the monetary objectives still to be adhered to, they would probably expect even higher interest rates and this could well be self-fulfilling. The exchange rate would probably also rise more, and the net effect on activity could become adverse. On the other hand if the markets expected higher monetary growth as well as a higher PSBR, increased inflationary expectations would push up interest rates further and lead to a weakening of the exchange rate. In this case the rate of inflation might become noticeably higher.

8. Uncertainty about reactions in financial markets is just one aspect of the general uncertainty surrounding estimates of this sort. But the general conclusion is that if the change can be portrayed as implying no significant change to the overall stance of policy, the effects are likely to be small.

CJR

C J RILEY
7 October 1983

So, as you said, there would be a strong case for a £½B tightening, getting us to 9B, just to demonstrate to the markets that we hadn't gone floppy

JuK

CONFIDENTIAL

From : M PRESCOTT

C
The council comes in
8/12.

MOM
8/12

INLAND REVENUE
POLICY DIVISION
SOMERSET HOUSE

I agree with this advice. [initials]

8 December 1983

1. MR BEIGHTON

2. FINANCIAL SECRETARY

I am very sorry - particularly given the technical complexity and the fine balance of the political arguments - that you have so little time to deal with this issue. The case for legislation was not put to M. Prescott until yesterday afternoon. [initials] 8/12

TELECOMMUNICATIONS BILL : TAX ASPECTS

1. The Revenue has been asked to consider urgently (and very late in the day) a number of tax questions concerning the privatisation of BT, provisions for which are contained in the Bill currently going through the House. Some of these points concern the proposed flotation arrangements. But these arrangements themselves have not yet been settled, and are not covered in the Bill. It is too early to say what if any tax changes would be needed to facilitate the flotation arrangements, but if changes are needed they clearly could not now be introduced in the present Bill which reaches Report Stage in the Commons tomorrow or on Monday. They would, therefore, have to be dealt with in the Finance Bill.

2. But there is one more immediate problem which DTI and Treasury would like to be dealt with in the present Bill, concerning the liabilities under a Deed of Covenant which BT at present has to the Post Office Pension Fund. As explained below, to deal with this particular tax problem, legislation would definitely seem to be needed.

---

cc	Chancellor of the Exchequer	Mr Green
	Chief Secretary	Mr Beighton
	Economic Secretary	Mr Lawrance
	Mr Burgner	Mr Bush
	Mr Monger	Mr Prescott
	Mr Wilson	Mr Laffin
	Mr R I G Allen	Mr Willis
	Mr Lord	PS/IR

THE PROBLEM

3. As you know, when BT was split from the Post Office under the BT Act 1981, it was given the responsibility for servicing a deficiency of the Pension Fund of the old Corporation. The liability to the Pension Fund is to be discharged by way of payments under a Deed of Covenant over a 14 year period running to 1992, calculated to fund a liability of £1.25bn.

4. We understand that for political reasons Ministers have decided that this liability should not pass to the successor company of BT, BT plc. Nor should it be taken over by the Secretary of State. We also understand there is a wish to maintain the cash flow position of the Pension Fund. It has been decided, therefore, that the liability will remain with BT and an amendment to the Bill will be introduced to achieve this. In return, the Secretary of State will take sufficient loan stock in BT plc, and endow BT with that stock, so that BT will have sufficient receipts by way of interest and redemption of loan capital to meet its payments under the Deed of Covenant.

5. Whilst this arrangement meets the objective of distancing the Pension Fund liability from BT plc, it creates a number of tax problems.

6. The first of these is that BT plc will be worse off in tax terms than if it had assumed these liabilities. The BT Act 1981 ensured that payments under the Deed were admissible under the Pension Fund legislation and, as such, wholly allowable against BT profits. They would similarly be wholly allowable to BT plc if the liability to make them was transferred to BT plc, and BT plc in fact made those payments. But this will not happen. Instead, BT plc's liability will be by way of debentures on which interest is payable and as such BT plc will be eligible for relief only in respect of the interest payments thereon. Funds paid towards redemption of the debentures will be capital and consequently will not be allowable as a deduction for corporation tax purposes. We understand that this particular problem is to be tackled in the context of deciding BT plc's capital structure in general.

7. But that still leaves a problem concerning the tax position of BT itself. In greater detail, the problem is

(a) As the Bill stands at present, there is specific provision for BT and BT plc to be one and the same for CT purposes. This frustrates the objective of isolating BT plc from the pension payments.

(b) But even if BT were a separate entity, there would be problems with its tax position. Without special provision, BT will be liable to CT on the interest and (as a chargeable gain) on the capital sums it receives from BT plc in respect of the debentures. But, after vesting, BT will not be carrying on a trade; nor, probably, will it be an "investment company" under Section 304 Income and Corporation Taxes Act 1970. It would not therefore be able to claim relief for the payments under the Deed either as an expense of a trade, or as an expense of management. The effect of all this would be to leave a CT liability in the hands of BT, and this in turn would create a mismatch between BT's net available funds and its payment obligations to the Pension Fund. Even if the pension payments could be regarded as a "charge" on total profits BT would then be obliged to withhold tax on those payments at the basic rate. Thus, again, disturbing the cash-flow to the Pension Fund.

WAY FORWARD

8. We are assuming that the objective is to leave the payments under the Deed of Covenant in the same standing in BT after vesting day as they are now under Section 82(4) of the BT Act 1981 - ie as Pension Fund contributions paid gross and wholly deductible for CT purposes. To achieve this objective, we have to tackle each of the two problems above. This could be done as follows;

- As regards (a) above, amend the Bill to treat BT as a separate entity for tax purposes, but only in respect of payments to the Pension Fund and of dividends and other sums received by BT to discharge that liability.

- As regards (b) above, <u>either</u> to exempt BT from CT altogether in respect of the pension payments and debenture receipts; <u>or</u> to deem it to be an investment company in respect of these payments and receipts. (Under the latter, BT would then be within CT but it would be allowed to offset the whole of the deed payments as an expense of management so there should be no net liability.)

9. There would still be a cash-flow timing difficulty for BT, whether it was exempted or treated as an investment company. This arises because the interest payments on the debentures by BT plc would be paid under deduction of tax at 30%. If BT was exempt, it would then be able to reclaim this tax, but there would be a temporary mismatch between its (net) receipts from BT plc and its payments under the Deed. Similarly, if BT was treated as an investment company, it could claim credit for the tax deducted by BT plc, but this could not be taken into account until BT's tax position was determined after the end of the year. However, we understand that DTI do not see this as a serious problem; the proposed solution is that BT would be left with a sufficient cash "float" to cover this temporary mismatching between payments and receipts.

COMMENT

10. Clearly, the second of these points, concerning the tax position of BT, is the crucial one. Of the two alternatives, exemption might be the most straightforward. But for presentational and other reasons, Ministers might consider investment company status more preferable.

11. As regards presentation, although the two alternatives achieve essentially the same result exemption might appear to the uninitiated to be offering BT a more generous concession than would investment company status. And, presentation part, it is also not wholly beyond doubt that BT would qualify as an investment company, and this too is an argument in favour of the second alternative.

12. The fact remains, however, that either alternative will entail legislation to create favourable tax treatment for a particular public sector corporation. The danger here, of course, is that this will set a precedent for other companies - public or private sector. It would also run counter to wider Government objectives to ensure, as far as possible, that public sector corporations are not treated more favourably for tax purposes solely by virtue of being in the public sector. Although going down this route may mean that one presentational objective will have been achieved (distancing BT plc from the Pension Fund liabilities), this will be at the expense of creating another presentational difficulty which may be just as difficult - if not more difficult - to handle. On the other hand, it might (just) be possible to argue that the origins of the problem and the proposed solution are peculiar to the public sector and have no private sector parallel.

CONCLUSION

13. Given the decision to go down this route, we think that the problem has to be tackled in the way described above and that of the two alternatives, that of giving BT investment company status is probably the more preferable. May we therefore know, please, whether you are content for the necessary amendments to the Bill to be introduced. In view of the urgency, perhaps your Private Office could communicate your decision to the Secretary of State's office directly.

M Prescott

M PRESCOTT

CONFIDENTIAL

FROM: MISS M O'MARA

DATE: 9 December 1983

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Economic Secretary
Mr Burgner
Mr Monger
Mr R H Wilson
Mr R I G Allen
Mr Lord

PS/Inland Revenue
Mr Beighton - IR
Mr Prescott - IR

TELECOMMUNICATIONS BILL: TAX ASPECTS

The Chancellor has seen Mr Prescott's minute of 8 December and agrees with his advice. In particular, he believes it is preferable to give BT investment company status.

MOM

MISS M O'MARA