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10 DOWNING STREET

From the Private Secretary

8 February, 1984

TAX REFORM STRATEGY

The Prime Minister held a meeting yesterday with the Chancellor of the Exchequer and the Chancellor of the Duchy of Lancaster to discuss the Government's tax reform strategy. The meeting had before it the Chancellor's minute of 19 January.

The Chancellor of the Exchequer was concerned that there could be difficulties if there were two parallel exercises on the reform of taxes running at one time, his and one in the Chancellor of the Duchy's group. In his view, the structure of tax was at the heart of the budgetary process and should be the responsibility of the Chancellor of the Exchequer. He felt that the proper way forward was for the Chancellor of the Duchy of Lancaster to join in the Treasury work in this area. This would maintain a proper division of responsibility but allow the Chancellor of the Duchy's experience in tax matters to be fully utilised.

The Chancellor of the Duchy felt that structural reform of taxation was more difficult than it had been before. It was inevitable that any major change would create a number of losers, though the Government now had very little scope for reducing taxes in order to compensate them. The tax credit scheme, which would have compensated losers, would cost £5-6 million at current prices to introduce. There were two possible ways out of this dilemma. The first was to ensure that, if new taxes were imposed, the proceeds were devoted, not to higher expenditure, but to the restructuring or abolition of other taxes. He urged that at the start of a new Parliament, a major effort should be made to abolish or reduce the scope of the capital taxes. These raised little revenue and were expensive to administer.

The second route to tax reform should be to eliminate the "money-go-round", where taxpayers were simultaneously receiving social security benefits or substantial tax reliefs. He thought it absurd for occupational pensioners to receive tax relief on their contributions, receive a state pension, while paying tax on both pensions.

The Chancellor of the Exchequer recognised that the capital taxes were unsatisfactory but did not accept that the revenue they raised was so insignificant that it could be easily replaced. He also felt that there was a political case for some taxation of capital. In the pensions field he was concerned that SERPS would prove too expensive if allowed to run to maturity. It should either be abolished or severely curtailed. While the Secretary of State for Social Services was conducting a review of pension provision, he was precluded from making major changes to the tax treatment of pensions.

The Prime Minister said she had dissuaded Mr. Rowland from undertaking a major redrafting exercise of tax legislation on the grounds that it made more sense to undertake structural change first. What was needed was a programme of work.

The discussion then turned to the reform of corporation tax. The Chancellor of the Duchy argued that the best approach was to move much closer to the ordinary commercial measurement of profits, abandoning the attempts to inflation-proof the system; and to move over from the imputation system, with all its defects and disadvantages, to a straightforward two-tier system. This would avoid the discrimination between capital raised in the form of ordinary shares, preference shares or loans. In order to get such a major change accepted by industry, it was necessary first to secure agreement within Government.

The Chancellor of the Exchequer said that adoption of an entirely new basis for corporation tax would take a great deal of time. He preferred a major reform within the existing framework, incorporating the abolition of stock relief, a substantial reduction in first-year allowances, matched by a much lower rate of tax. (As the rate approached 30 per cent, the discrimination between different sources of capital would effectively disappear.)

Summing up the discussion, the Prime Minister said that the Chancellor of the Duchy should be fully integrated into the work on the structure of taxation. He should join the team of Treasury Ministers, attend meetings, and receive papers in this area. In addition, his group would undertake work on the simplification and consolidation of tax legislation. He would not work on minor Finance Bill starters, nor on current budgetary policy.

I am copying this letter to Alex Galloway (Chancellor of the Duchy of Lancaster's Office).

ANDREW TURNBULL

John Kerr, Esq.,
H.M. Treasury.