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Inland
Revenue

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Chancellor

COMPANY TAXATION

Effects on Investment

3. The view of the economists is that overall the reform will be broadly neutral in terms of the amount of investment. But the shift towards greater neutrality between retentions and new issue finance and the ending of surplus ACT should make investment more productive. Inward investors and small companies should fare better than the average of all companies. As regards the overall effect on the financial position of companies, the view is that higher employer contributions to pensions are more likely to feed through to prices than into lower investment. If this is so, then the impact of the changing financial position on investment is likely to be limited in aggregate, with perhaps a boost when the transition unwinds.

Pension schemes

7. Further work continues to suggest that the pensions industry should generally be able to cope. We and the Government Actuary's Department believe that most funds have substantial unused surpluses, although the extent of the surpluses varies from one scheme to another, some funds have no surplus, and there is very little information on the size of the surpluses. **There is therefore a very big uncertainty over the extent to which pension schemes could absorb the effect of the loss of tax credits.** But we and the Government Actuary's Department think that, even with the

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surpluses, overall pension funds will probably need to make good much of the loss of tax credits, through a combination of higher dividends and extra (mainly employer) contributions. Our best judgement, after talking to the Government Actuary's Department, is that employers might have to fork out another £3 billion in contributions in 1998/9, rising to £5 billion in 2000/1, and falling back to some £2½ to 3 billion a year for the next ten years or so. Some of this may feed through into prices or lower pay increases rather than a reduction of profits. In most years these costs will be more than offset by the cut in the main rate of corporation tax, but this will not be true of some of the transitional period to in-year instalments. For some types of pension scheme, where the employee bears the investment risk, rather than the employer, pension benefits may fall. In the long term, pension schemes, like other shareholders, should gain from the beneficial economic effects of the package, though they will feel unable to take this into account in their calculations now. As I have stressed before, the pensions lobby will paint a far far blacker picture.

8. If one brings together the combined effects of the tax changes themselves and of possible extra pension contributions, over the transitional period to instalments companies could find themselves several billion pounds worse off in 1999/2000 and 2000/1, but gainers thereafter. This is due to the acceleration of tax payments that comes from phasing in instalments. Again this is an aggregate picture: there will be significant variations between particular companies.

Alternatives for early action

18. There are two possibilities you might want to consider if you wanted to do something fast.

- **denying tax credits to pension schemes**

19. The first (and in my view, by far the less attractive) is simply to stop pension schemes getting tax credit payments, using the money to cut the corporation tax rates, and doing nothing else at this stage. (We would need to keep ACT to avoid a cash flow cost to the Exchequer of well over £10 billion, and to fund tax credit payments to others.) If you are interested, we could look quickly at this, but we would need early decisions if this was to be a runner for a June Budget.

- This would avoid the problems of charities, PEPs and individuals who claim tax credits: they would be unaffected. Against this, pension schemes would argue that they were being singled out for victimisation.
- By removing the movement to instalments from the package, you would avoid the large impact on some companies' cash flow. Without instalments

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we would expect some increase in the level of investment which the package as it stands may not deliver - at least in the shorter term.

- There would be some leakage of tax credits through pension schemes etc using overseas vehicles to claim partial tax credits under double tax agreements. And we could do nothing to stop foreign pension schemes getting partial tax credits under tax treaties. This might cut the yield from scrapping tax credits to pension schemes from £4 billion to £3 billion.
- That yield might still finance a cut in corporation tax rates of around 3%, which in itself seems to me an attractive prospect, enhancing UK competitiveness.
- You would lose the benefits of the move from ACT to in-year instalments - and it would be more difficult to make that change later because the rate cut (which helps companies through the transition) would have been given away now. But what we could look further at is bringing forward, possibly in stages, the payment date for corporation tax from the present 9 months after the end of the accounting year to perhaps 3 months. I do not think we could settle this in time for a June Budget: it would be something to look at for your second Budget.
- The problem of surplus ACT would remain.
- Nothing would be done to reduce the risk of legal challenges to the imputation system in the European Court: it is possible that decisions there could, at some point, force you to look again at the complete abolition of tax credit payments.

20. You may feel that this would not meet enough of your objectives. It would certainly be a much less ambitious set of reforms.

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- **Phasing in the scrapping of tax credit payments**

21. The second alternative is to **phase out the payment of tax credits**. For example you could halve the tax credit rate to 10% this year, and give notice of your intention to abolish tax credits in, say 1999. Or you could reduce the rate by 5% a year over four years. Phasing would give people time to adjust, and, if any transitional compensation was needed, you could, we think, confine it to charities (we are not sure you would need even to do this, especially if the phasing out was over 4 years). You would want to cut ACT as well, but, as when the tax credit rate was cut in 1993, you would probably want to phase the ACT cut differently to avoid a large cash flow cost to the Exchequer. Once the transition was past, the changes would be a revenue-raiser which could be used to reduce tax rates. If you are interested in this, we can look quickly at options and costings, and what might be possible on tax rates.

- The economic benefits of the reform would take longer to come through. So would the cut in tax rates.
- A move to in-year instalments would be more difficult to handle, because it would not be associated with a "big bang" set of reforms with (to mix metaphors) large swings and roundabouts. Again, it might be easier to handle a simple bringing forward of the payment date for corporation tax. I cannot guarantee we would have work on this completed in time for announcements in a June Budget.
- Losers would be much easier to handle, because there would be time for them to adjust.
- There would be some incentive for companies to accelerate dividends to beat the changes. That would accelerate ACT receipts. The strength of this effect would depend on how the phasing was done.

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- We would need to ask our economists to do a little more work on the effects of this, and to see how phasing might alter the impact of the loss of tax credits on pension schemes.

22. 

Questions for Decision

- *Do you want to proceed with the original package in the summer Budget, given the picture on losers from the tax credit change?*
- *If so, do you want*
 - *to extend to, say, seven years the period over which protection for charities is phased out?*
 - *to protect individuals getting tax credits outside PEPs for a transitional period?*
- *Would you prefer simply to deny tax credits to pension schemes and use the revenue to cut company tax rates?*
- *Do you want to consider phasing in the tax credit change, recognising that this will delay cuts in rates and is likely to make it more difficult to move to in-year instalments?*
- *Do you wish to take more time to work through the options, with a view to action in your second Budget?*



