ECONOMIC VIEW  ANATOLE KALETSKY

How Brown could raise £3bn in the Budget

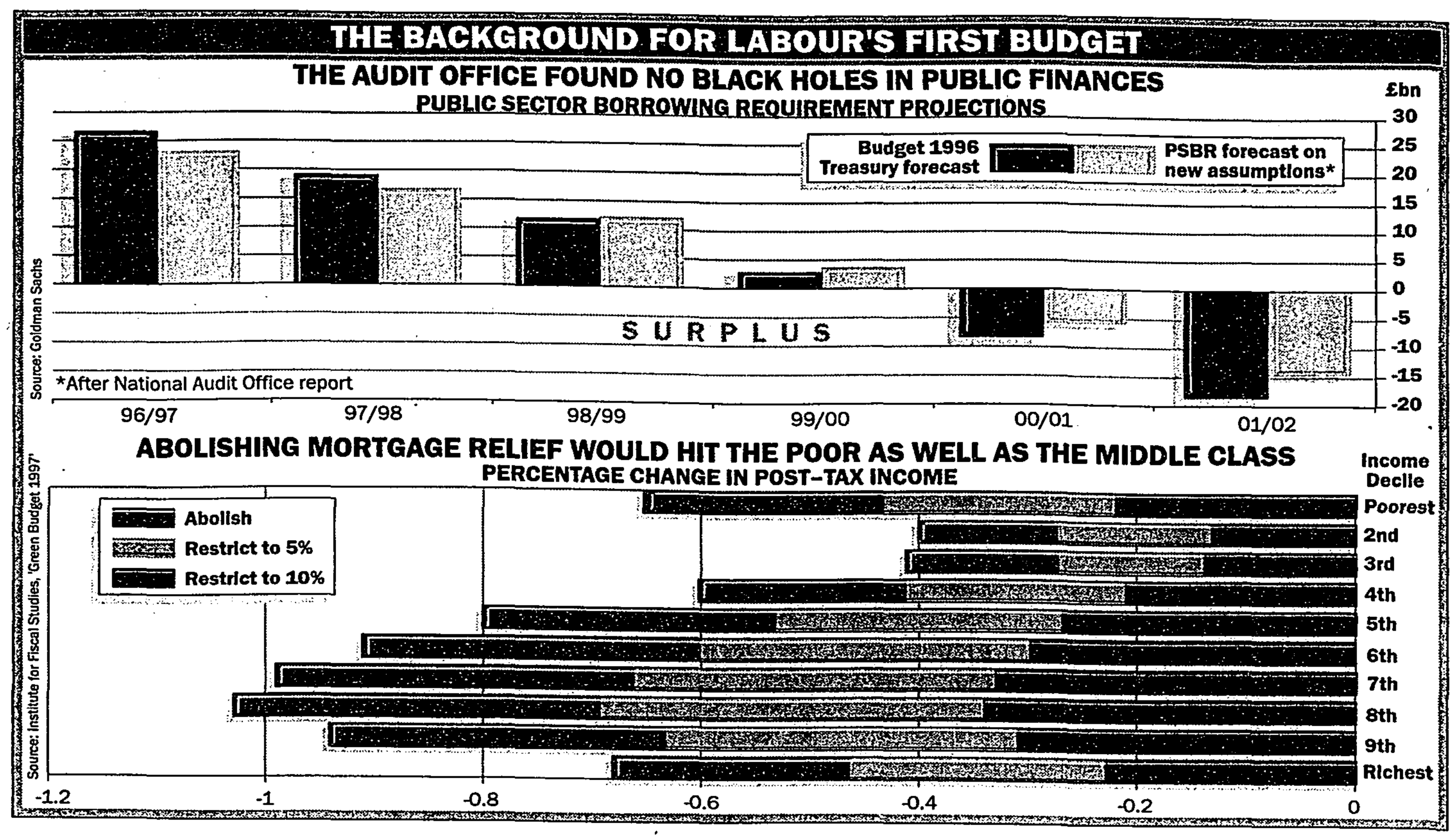
What will Gordon Brown do in Labour's first Budget? The background to the Budget judgment was discussed in last week's Economic View. This suggested three reasons why the Chancellor was likely to raise taxes: the bigger than expected building society windfalls; the pessimistic growth assumptions imposed on the Treasury by Mr Brown himself; and, last but not least, the political expediency of deflating the economy during the first half of the Parliament, when the Tories are still in total disarray.

There could, in addition, be a fourth, more creditable, reason for Mr Brown to raise tax. The British public has expressed a clear preference for moderately higher taxes combined with better-funded public services, as I discussed in my Tuesday column in the front section of *The Times*. But Mr Brown is dead set against public spending, at least in the short term, so it is pointless to pursue this, at least for the time being.

Finally, there is a fifth argument for raising taxes, which is a firm favourite with the City and business lobbies, but now makes no sense at all. This is the claim that a tough Budget will take the upward pressure off the pound. I also used to believe this until two months ago. But Bank of England independence has totally changed the currency dynamics and I now believe that sterling will keep rising whatever happens in the Budget. If anything, a tough Budget would probably add to the international confidence in sterling and push the pound higher by removing any remaining uncertainty about the Government's commitment to economic austerity.

Putting these factors together — and throwing in the reflex resistance to any kind of tax rise from the political side of the new Labour machine — a plausible Budget judgment might be a net increase in taxes of £3 billion to £5 billion, on *top of the utility windfall tax.*

While the net macroeconomic impact of the Budget is likely to be modest, there could be some big tax rises for some people offset by reductions for others, especially those at the bottom of the income tax scale. The probable reductions are already well-known. VAT on domestic fuel will be reduced from 8 to 5 per cent, at an annual cost of £400 million. Much more importantly, Mr Brown's much-touted Welfare to Work programme is likely to be launched with a reduction in the starting rate for income tax to 10 per cent from the present 20 per cent. The cost of this measure will depend on how wide Mr Brown decides to make the 10 per cent band, but to have any noticeable impact at all he will have to spend at least £2 billion.



In addition to these probable tax reductions, Mr Brown will have to find some extra funds to fill the rather small "black hole" in public finances created by his more pessimistic economic assumptions. According to a Goldman Sachs analysis (see chart) the net effect of the new assumptions (which are partly offset by the better performance actually recorded in the economy since last November) will be to reduce the £18 billion surplus projected for 2001-02 by about £4 billion. Mr Brown may decide to announce some long-term measures to "make good" this £4 billion shortfall, both to prove his virility and to provide himself with a war chest for higher public spending in the second half of the Parliament after April 1999.

In total, then, Mr Brown may be looking for £6 billion in new revenues immediately — to fund £3 billion in tax reductions plus another £3 billion in net fiscal tightening. In addition he may want a further £4 billion in long-term revenues to fill his "black hole" in 2001-02. How could this money be raised?

First, there are indirect taxes. Mr Brown could raise taxes on petrol and tobacco. A 5 per cent increase would raise £1.3 billion. An increase of 2 percentage points in the insurance premium tax could add a further £600 million, making a total of about £2 billion from indirect taxes. Unfortunately these measures would push up prices and would hurt poorer voters more than the rich.

Secondly, the Chancellor could look at income tax provisions not covered by pre-election promises. The most attractive is mortgage interest relief (Miras). Abolition would be perfectly timed to help to moderate the mini-boom in house prices and consumer spending and would raise £3 billion in a full year. Despite reports that the Prime Minister has personally intervened to save Miras, I suspect it will go. Mr Brown may, however, decide to phase out Miras over a period, swayed in part by the evidence that immediate abolition would be surprisingly painful to the poorest 10 per cent of families (as indicated by the bottom chart).

If Miras is preserved, in whole or in part, Mr Brown may look for other sources of income tax. One obvious option would be to withdraw personal allowances from higher-rate taxpayers. This would have the merit of leaving the poor unscathed. Its impact would, however, be focused on skilled working class voters who are just on the borderline of paying higher-rate tax. In fact, restricting the personal allowance would be exactly equivalent to lowering the 40 per cent tax threshold from the present £30,145 to £26,100 — hardly a policy likely to appeal to new Labour.

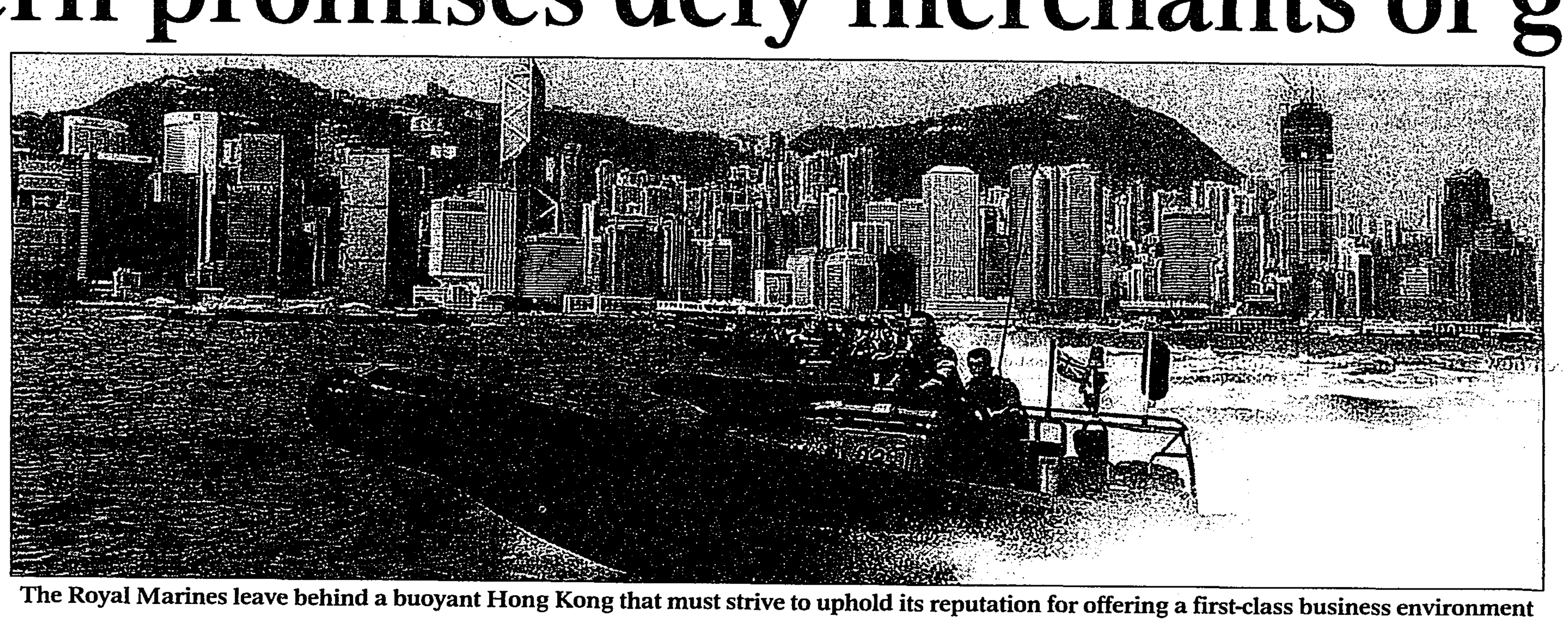
The next option on income tax would be to restrict the deductibility of pension contributions for higher-rate taxpayers to 23 per cent. According to some estimates this could raise as much as £2 billion a year, but this could be harder than it seems. As the Institute for Fiscal Studies has pointed out, employers could increase the tax-exempt contributions they make on behalf of employees and the self-employed would probably divert their savings from pension funds into personal equity plans. Thus, without complicated anti-avoidance provisions or a wholesale reform of the taxation of savings, this measure might produce disappointing results. Mr Brown may therefore prefer not to touch pension contributions and concentrate instead on taxing the pension funds themselves, as explained below. If he still wanted to include a gesture against the "rich" in his Budget, he could focus on inheritance tax, abolishing the bizarre system of lifetime exemptions, which allows the truly rich to pay nothing at all.

This leaves the last and most important item in my catalogue of possible Budget measures: the taxation of *dividends received by pension* funds. Mr Brown could save £5 billion a year by abolishing the tax credits now paid to pension funds, personal equity plans and charities on their dividend income — if he has the courage to resist the spurious arguments against this reform from the City and business lobbies. All of these arguments take for granted the uniquely British system of valuing pension fund assets on the basis of future dividend income. This system, interacting with the dividend tax credit, has generated irresistible pressure on British companies to put the payment of ever-rising dividends ahead of all other corporate goals. It has also encouraged British investment institutions to invest for income rather than capital gains. For example, shunning the bull market in high-tech companies in America on the grounds that dividend yields there are too low.

If Mr Brown decided to abolish the dividend tax credit he would probably have to sweeten the pill for charities, which could lose about £200 million a year. He would also have to recognise that the final yield might be smaller than £5 billion and would take several years to come in. Abolishing the dividend credit would do little to restrain consumer demand in the short term, but over time it would draw *money out of the personal and* corporate sectors just like any other tax. It would therefore be a perfect long-term measure to fill the hole in the public finances created by the more pessimistic economic assumptions that Mr Brown announced last week. And if the economy performed rather better than the Chancellor's sombre expectations, an extra £5 billion annually would certainly come in handy to finance a modest pre-election public spending spree.

Eastern promises defy merchants of gloom

Hong Kong expects return to business as usual, says **David Watts**


The Royal Marines leave behind a buoyant Hong Kong that must strive to uphold its reputation for offering a first-class business environment

British diplomats may have reservations about the future as the midnight hour approaches but the business community cannot wait for the last celebratory firework to transform Hong Kong into the capitalist enclave of communist China.

For 13 years they have been attempting to predict how the cadres in Beijing would come to terms with the world's most rampantly capitalist territory. But none could have foreseen that its dowry would be a booming stock market, massive financial reserves and property prices careering upward, least of all the Chinese who harboured dark suspicions that the British would take home the family silver when they left. The foreigners, for their part, have had grave doubts about the viability of the late Deng Xiaoping's idea of one country, two systems.

The hongs, or trading houses, with one exception, have made skilful accommodations with the new management and the diplomatic bickering has long since been discounted. The Union Jack may no longer feature on Cathay Pacific's Airbuses since Citic Pacific, the Chinese government investment vehicle, has upped its stake in the airline to 25 per cent. But Cathay's parent, Swire Group, still figures in the £70 billion of direct and indirect British investments in the territory — a figure that puts Britain at the top of the foreign stakeholders in Hong Kong.

That Citic purchase was part of the cascade of money pouring into so-called red chips on the Hong Kong market. This has helped to reinforce the optimistic mood as mainland Chinese and others bet on what appears a relatively safe way into the creation of mainland hongs and the first stirrings of the privatisation of China's state industries. Dealings in the red chips regularly comprise as much as 40 per cent of the turnover on the Hong Kong stock exchange, and when the latest mainland concern, Beijing Enterprises Holdings, came to the market early this month the exchange reached an all-time high capitalisation of £2.16 billion.

"The mood when we wake up on July 4 after the handover holidays will be business as usual," said Christopher Hammerbeck, executive director of the British Chamber of Commerce in Hong Kong. "People thought that we would be downhearted after the handover but there just aren't enough hours in the day and it's the same for everybody." British companies have been moving into Hong Kong at the rate of between 20 and 50 a year and there is no sign of that slackening.

In fact, Mr Hammerbeck believes that having the formalities out of the way will make life a lot easier. "There's a feeling that there has been a slowdown in decision-making and that things will return to normal." Normal life means going after the millions of pounds in new contracts that will become available in the building of the new western rail system which will link Hong Kong's container port — the world's busiest — with the booming Chinese hinterland in Guangzhou (Canton).

Everything from tunnelling, tracks and rolling stock will be up for grabs, and the British must hope that a little slice of post-handover goodwill will see some of the work come their way. Ninety-three per cent of the 1,000 British firms in Hong Kong say that they will still be in place at the new millennium and 70 per cent expect their businesses to grow in that period.

The Guangzhou connection is a key part of the territory's success story and, to hear some industrialists speak, such as Raymond Chien, non-executive chairman of Inchcape Pacific, is to believe that China is reverting to Hong Kong rather than the other way. There is no doubting the success of Hong Kong businessmen across the border with everything from Canto-*pop* (*the syrupy local pop* music) to Hong Kong television and countless manufacturers turning the border province into something approaching an extension of the territory. But there is one important exception: the realisation that for Hong Kong to retain its reputation for a first-class business climate there must be a clear division between it and the mainland.

Larry Yung, the Porsche-driving "emperor" of the red chip market and chief executive of Citic Pacific, is the first to recognise that fact. The son of Rong Yiren, the Chinese vice-president, he arrived in Hong Kong in 1978 and set about learning Cantonese and English before becoming head of Citic Hong Kong in 1987. He once said that the day Hong Kong becomes a Chinese city Hong Kong is dead.

Though *some cadres may* come down from Beijing and throw their weight about, Richard Margolis, former deputy political adviser to the Government in Hong Kong and now first vice-president with Merrill Lynch (Asia Pacific), believes that Hong Kong civil servants have proved their mettle in dealing with the Chinese and will be able to withstand pressure. Certainly when General Liu Zhenwu, the People's Liberation Army garrison commander in Hong Kong, tried to cross the border without the requisite pass border officials stopped him dead in his tracks.

However, others fear that the booming property market could turn sour and rebound on Hong Kong's reputation.

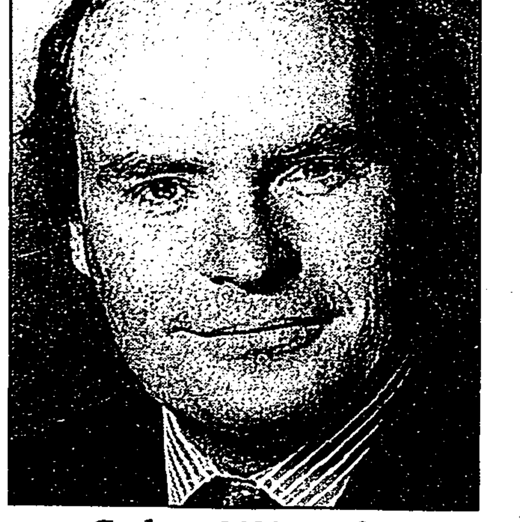
Marc Faber, Swiss-born investment adviser and Hong Kong's resident gloom-merchant, says Hong Kong could prove another South Sea Bubble. The Basic Law, on which the one country, two systems notion is based, is a "worthless piece of paper", he said. Hong Kong has prospered, he argues, because it has not had serious competition until now. While Chinese exports are up 27 per cent, Hong Kong's re-exports are up only 4 per cent.

Why should anyone pay a rental differential of eight to ten times for a base in Hong Kong when the volume on the Shanghai stock exchange has already exceeded that on the local market? "In ten years it will be just one of 26 cities with one country, one system."

Early departure

THE TIMES CITY DIARY

GERALD CORBETT, the amiable finance director of Grand Metropolitan, left the company abruptly last night. His departure was flagged in May, with the proposed merger with Guinness, but I had not expected him to go so soon. Parting is sweet sorrow *in this case; GrandMet is* generous to those it finds no further use for, and he was on a two-year rolling contract and therefore gets to trouser the best part of £600,000. He has not got another job yet, I am told. This raises an interesting debate.


Corbett: £600,000 for an early bath

Had he hung around longer, and found a new post, there could have been shareholder anger over the pay-off. As it is, he has clearly been made redundant, his counterpart at Guinness, Philip Yea, having been given the job with the merged group. However. The merger will take six months at least to complete, which means this length of time, and a set of preliminary figures in December, without a finance director. What if the deal fails to clear the US and EU regulatory hurdles, or is scuppered by GrandMet's new shareholder, the French luxury group LVMH? The company would then be minus one finance director, and have to hire one. Which is most embarrassing: making a pay-off to someone who has another job, or making a pay-off to someone you then have to replace?

● *ASDA'S drive to improve sartorial standards does not stretch to its own board. The store yesterday launched a "fashion police" campaign. Customers wearing "sad socks or grotty ties" will be offered vouchers off its George range of clothing. Allan Leighton, chief executive, does not appear to have caught on; yesterday he appeared wearing a dated, David Steel-style blue shirt with white collar, topped off with a yellow, black and white striped tie. Oh dear.*

German twist

HARD, I know, to feel sorry for the National Lottery, especially after its regulator has rushed to defend those bonus payments. But a piece of junk mail to a colleague turns up a strange anomaly. Something called the North West German Lottery tells him he is "really lucky" and wants him to take part. This is, apparently, entirely legal. What is not legal is for our own National Lottery to leaflet the citizens of Hamburg back. "Despite popular opinion, there are some very tight laws governing our lottery," says Oflot. Welcome to the Euro-Lottery; stacked, as usual, in favour of the Germans.

Late birth

MORE on the embattled euro. As I pointed out in my nature notes a few weeks back, the euro is in fact a small, reddish kangaroo. *Macropus robustus* has a complicated reproductive process. It is the most sedentary of the kangaroos, and an endangered species. More appositely, the euro enjoys what naturalists call delayed implantation; birth can be postponed until conditions are exactly right.

● *FORGET bungee jumping and paragliding — the latest dangerous sport the insurance industry has been asked to provide cover for is zorbing. Popular in New Zealand for some reason, this involves being strapped into a transparent rubber ball, and rolled downhill. For fun.*

Life of Brian

THE London Chamber of Commerce and Industry is to break with a hallowed tradition. Sir Brian Jenkins, chairman of the Woolwich, was re-elected yesterday as president, but his two-year term comes to an end next June. At which stage the deputy, Colin Parsons, chairman of Taylor Woodrow, takes over — and becomes the first president for six years not to be called Brian.

Déjà vu

SO Rodney Galpin, former boss of Standard Chartered, is to run the new body charged with ensuring that banks stick to the new Banking Code. His tenure at the Bank of England saw the registration of BCCI in 1980 and the 1985 collapse of Johnson Matthey. No one could accuse him of lacking experience of dodgy banks.

MARTIN WALLER

"They keep touching their brakes"

Kaletsky, Anatole. "How Brown could raise £3bn in the Budget." Times, 27 June 1997, p. 29. The Times Digital Archive, https://link.gale.com/apps/doc/IF0501227442/TTDA?u=west85252&sid=TTDA&xid=f0e5f1af. Accessed 29 July 2020.