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Peace Summit

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DEPARTMENT OF ECONOMIC ... 28 OCT 1994 PRIVATE ...

cc PS/Sir John Wheeler (DFP & L)
PS/Michael Ancram (DENI & L)
PS/PUS (B & L)
PS/Mr Fell
Secretary
Mr Semple
Mr Thomas
Mr Bell
Mr Cole
Mr Quinn
Departmental Board Members
Mr Stephens
Mr Gamble
Mr Dodds
Mr Caine

1. PS/Mr Smith (DED)
2. PS/Secretary of State

NOVEMBER BUDGET

1. *At their VCR meeting on the Peace Dividend on 26 September, Ministers agreed to consider making a submission to the Chancellor proposing a Northern Ireland package in his 1994 budget. The package might include a tax break for Northern Ireland to encourage inward investment and support for the long term unemployment proposal.*

2. *Advice on this, and other matters, is set out below and a draft letter to the Chancellor is attached (Annex A). The formal round of Ministerial correspondence on the budget was in April/May and so the proposed approach is very late in the year. We need, therefore, to make it clear that the timing of the letter is related to the ceasefire. This letter follows on letters to Treasury Ministers on the Survey, on additionality for EU assistance [and on the long term unemployed initiative]. As such, it runs*

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the risk of making HMT more resistant to any other Northern Ireland business and we should, therefore, consider tactics before proceeding. (See para 12 and Annex B).

Tax Break

3. *Attached at Annex C is a copy of a paper which reviews the options for a tax break. It suggests that we seek an option which offers maximum benefit to the NI economy, conforms with EU law, avoids, as far as possible, repercussiveness in GB (the English regions, Wales and Scotland will press very hard for similar treatment) and gives us a base from which to seek a matching US tax break. It describes the existing tax breaks which are unique to Northern Ireland and sets out some options.*

4. *Essentially, the questions which need to be decided are:-*

   (a) *to whom should any concession apply? New inward investment or all new investment? The whole of Northern Ireland or just some parts? Industrial investment only or all investment? and*

   (b) *what type of tax break to seek? A Corporation Tax regime similar to that in ROI, or accelerated capital allowances, or tax deductible revenue grants, or a revision of the Corporation Tax Relief Grant Scheme (or a combination)?*

To Whom Should Any Concession Apply?

5. *The objective of the tax break we are seeking is to encourage industrial (and tradeable services) investment and I recommend that it be restricted to that. As regards investment by inward investors or indigenous investors, there are arguments both ways but the persuasive ones point in the direction of making the tax break available to all industrial*

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investment. Defining inward investment could be difficult and the EU obliged the ROI to apply its concessionary rate to all industrial and tradeable services investment. Furthermore, if our arguments are centred on encouraging investment leading to growth as a means of creating stable employment, then investment by indigenous industry is as important as investment by inward investors.

6. As regards geographical area, there are arguments for the whole of Northern Ireland or only disadvantaged areas. In favour of the latter are that a more narrowly focused area would offer a better prospect of getting the Chancellor's agreement and would have a better chance of avoiding arguments for similar treatment by GB regions. The independently produced Robson indicators enable us to produce a map (Annex D) of disadvantaged areas to which the concession could apply. Focusing the incentive in this way would also enable us to respond to a recent review of the Department's TSN activities which recommends a greater differentiation between disadvantaged and other areas.

7. Recommendation That any tax break apply to all investment by the industrial and tradeable services (including tourism) sectors in disadvantaged areas of Northern Ireland only. "All investment by the industrial and tradeable services sectors" will, of course, need to be defined in agreement with Treasury officials and paragraph 8 starts that process.

What Type of Tax Break to Seek

8. The alternatives are:-

(a) a lower Corporation Tax Rate for Northern Ireland on a par with that in ROI, ie, 10% until 2010. This would have the greatest impact both

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presentationally and in terms of actual investment. On the other hand, it could be the least attractive to the Chancellor. It would breach the integrity of the UK tax system leading to demands for similar treatment in parts of GB and it would lead to significant difficulties and potential loss of revenue in transfer pricing activity which might not lead to employment in Northern Ireland. It would have considerable deadweight in rewarding past investment (lower taxes on the profits therefrom) and might also lead to HM Treasury demanding a reduction of ID grants (and the Block) as a quid pro quo;

(b) accelerated capital allowances. At present plant and machinery (PME) is written off against taxation at 25% per annum of the reducing balance. Property is depreciated at 4% per annum. Options are, for PME, to increase the first year write off to 100% or to change the write off to a straight line basis and for buildings, to increase the first year allowance to, say, 12%. The advantages of accelerated capital allowances are that they directly address what we are trying to encourage and do not, in the end, result in loss of revenue; they merely defer revenue. On the other hand, accelerated capital allowances can distort investment decisions and might encourage costly capital intensive projects as opposed to employment intensive projects;

(c) non-taxable revenue grants. This would be attractive to us in that these grants can address specific problems eg training, R&D, but the idea is unlikely to be attractive to Treasury. It might well argue for a proportionate reduction in the size of the grant or offer a Catch 22 argument; that the proposal is only of benefit to profitable companies and we should not be revenue grant aiding profitable companies. Nevertheless, getting the long term unemployed

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into jobs will often require significant training and it is recommended that we run this proposal for areas of disadvantage (Annex D);

(d) revising the Corporation Tax Grant Scheme. This scheme was an earlier attempt to meet the Republic's tax advantage and offered a grant against Corporation Tax payments. However these grants were themselves taxable and reduced IDB's ability to offer other grants. The scheme became a bureaucratic nightmare and was only used twice. Officials would not recommend resurrecting it.

*9. **Recommendation** This is a matter of political judgement but my recommendation would be for (i) 100% write off of PME in year one in disadvantaged areas. I understand that IDB would welcome this and CBI (to whom I have spoken in confidence) see it as an achievable, valuable, tax break; (ii) a 12% write off of buildings in year one; and (iii) a tax free training grant, possibly targeted at employment of long term unemployed. Again, CBI would find this very welcome.*

Tactics

10. In taking forward these options, we also need to decide how to deal with two other tax concessions which apply in Northern Ireland but which either are open to attack by Treasury or (in one case) have not been cleared in Brussels. These are that capital grants of under 45% are uniquely not taxable in Northern Ireland and that industrial premises are 100% derated.

*11. **HM Treasury.** The capital grants dispensation is renewable every two years and the next date of renewal is March 1995. HMT officials have made it clear that they wish to critically examine the arrangement before agreeing to its continuance and a paper is being prepared. Termination of the dispensation would, of course, send entirely the wrong signals to the*

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business community and political leaders at this time and reduce the value of any new tax breaks. As such, it is recommended that Ministers take this opportunity to make a case for its continuance.

12. As regards derating, this could well come up in the rate support negotiation later this year. DFP recommend that the issue should not be raised at this stage.

13. European Union. All of the alternative tax concessions listed at para 7 above would be regarded as state aids and need clearance in Brussels. It is for consideration whether we seek retrospective approval for derating as well. Officials are currently negotiating with Brussels on a new community "peace" initiative and it is recommended that we seek approval for any tax concession and the existing arrangements as part of these discussions. The new EU initiative is aimed at strengthening the economy as an aid to community reconciliation and the tax concessions are in line with that.

Long Term Unemployed

14. Separate advice is being put to Ministers on this issue with advice that the Secretary of State should write to the Chief Secretary. As such, the matter is proceeding along pre-agreed lines but, nevertheless, it might be worthwhile seeking a commitment to this initiative by the Chancellor in his budget speech if that can be done without being seen to go over the head of the Chief Secretary.

Energy Prices

15. Separate from peace issues, DED officials have discovered that heavy fuel oil is the only fuel burned in power stations which is taxed and that

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power stations in Northern Ireland burn a disporportionate amount of the HFO used by the UK electricity supply industry. Coal and gas - the other power station primary fuels - are not taxed; statistics suggest that Northern Ireland power stations burn approximately 25/35% of the UK total. This tax bears disproportionately on Northern Ireland, therefore, and its removal could lower electricity prices by 1.5%. It is recommended that this removal be pursued.

Conclusions and Recommendations

16. *It is recommended that the Secretary of State should write to the Chancellor (draft attached) seeking (i) 100% first year capital allowances for investment in PME and 12% for investment in buildings by the industrial and tradeable services (including tourism) sectors in areas of disadvantage (as defined by the attached map), (ii) exemption from taxation of grants for training, (iii) withdrawal of HFO for use in power stations from the tax net and (iv) a declaration of his support for the LTU initiative in his budget speech.*

D GIBSON
7 ***October 1994***

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ANNEX A

Rt Hon Kenneth Clarke QC MP
Chancellor of the Exchequer
HM Treasury
Whitehall
London

THE 1994 BUDGET

I am writing to you about measures which might be included in your 1994 budget to help further the peace process in Northern Ireland. I realise that I am considerably out of time in doing so but we now have an opportunity to rebuild both the economy and community relations in Northern Ireland which would not have been possible two months ago and I need your help.

The ceasefire announced on 31 August offers the best opportunity for 25 years to make political progress in Northern Ireland and I am determined to leave no stone unturned in pursuit of that progress. I want to be able to demonstrate that peace and political progress can yield benefits both in economics and community relations terms but I face formidable obstacles. The Northern Ireland Economic Research Centre estimates that some 25,000 manufacturing jobs have been lost due to the violence here and tourism jobs are only one third of what might be expected by comparison with the ROI. Unemployment is the highest in the UK and long term unemployment at 56% of all unemployed is very considerably higher than elsewhere. Low participation rates help to disguise even higher unemployment and long term unemployment *figures. The long term unemployment statistic is, perhaps, the most significant one of all because there is plenty of evidence of two separate labour markets developing; one of long term unemployed who do not participate in the normal workings of the economy. These long term unemployed are often to be found in pockets of intense deprivation and make a significant contribution to the unemployment imbalance in that they are disproportionately Roman Catholic.*

Bad as this situation is, it could get worse in the short term unless I can stimulate more investment and job creation. The change in the security picture has already led to some lay offs in the construction industry and there is a risk of the fears of increased unemployment as a result of the ceasefire being proved right. I need, therefore, to stabilise the situation, calm fears, especially in the Unionist camp and send the right signals to Northern Ireland MPs.

If the present unique opportunity is to be converted into enduring peace and stability, I need to tackle as quickly as possible the social, economic and community divisions in Northern Ireland. In economic terms, this means jobs and opportunities. The CBI has estimated that some 30,000 extra jobs could be created in tourism and industry in the medium/long term as a result of peace and political progress but notes that it will take time for these jobs to be created and that many of the extra jobs will be offset by reductions in employment in the security forces and construction industry.

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Their report confirms my own analysis. Northern Ireland is about to face a significant change in employment patterns, with job losses in security and construction and gains in other areas of employment and unless handled carefully, the losses could come before the gains. As I said earlier, my objective is to show the benefits of peace in terms of employment opportunities but the second problem could work against that.

I have, therefore, been seeking ways to enhance employment prospects especially for the long term unemployed and my officials have been encouraging the US authorities, who are proposing aid for the peace process, to think in terms of encouraging inward investment. There are, however, some measures that you might introduce in your November budget that would also help to speed up the creation of employment and that is why I am writing to you.

I have in mind three things.

The first is, for defined investment in limited areas, to increase the first year capital allowances for investment by industry and tradeable services (including tourism but excluding warehousing). For new plant and equipment the allowance might be raised from 25% as at present to 100% and for new buildings, the first year allowance might be raised from 4% to 12%. I propose that this increased allowance would apply only in economically disadvantaged areas of Northern Ireland and am attaching a map which has been *drawn up on the basis of a detailed study of deprivation by Professor Brian Robson of Manchester University. Such a change in capital allowances would only defer eventual receipt of revenue by the Exchequer but I am told by my officials and (in terms) by the CBI that it would very significantly help the inward investment drive and encourage tourism investment. What is more, a tax concession of this kind would help me to attract the most successful, enterprising companies, which are the highest taxpayers; companies which, having chosen a location tend to remain there and reinvest there. It would certainly help those seeking inward investment to counter the attraction of the Republic's 10% company tax rate in dealing with these companies. By restricting the benefit to areas of disadvantage, it would offer an inducement to locate in those areas and clearly demonstrate the purpose of the higher allowance. I suggest our officials agree the details.*

My second concerns a tax on heavy fuel oil (HFO)). Apparently HFO is the only power station fuel which is taxed and Northern Ireland's power stations, I am told, burn HFO in significant quantities, disproportionate to the rest of the UK electricity supply industry. This tax, therefore, bears heavily on Northern Ireland. Apparently its removal would reduce electricity prices here - the highest in the UK - by 1.5%, a not inconsiderable help to industry. Removal of the tax would, of course, also address a question of tax neutrality vis a vis coal and gas and enable you to announce that you are abolishing a tax. It would certainly be welcome to Northern Ireland MPs and to the business community in Northern Ireland, which has been supportive, and *enable us to deliver an immediate benefit.*

My third proposal is to take training grants offered to companies taking on new employees out of the tax net. If companies are to be persuaded to employ those who have been unemployed for more than one year, they need to be assured that they will get help with training costs. This will be particularly important in the tourism industry where the new jobs will often be created in areas of highest unemployment and which might be expected to offer the prospect of employment to those with few skills.

Finally, I must also mention the Capital Allowances (Corresponding Northern Ireland Grants) Order 1993 which is renewable in March 1995. The effect of this Order is that in Northern Ireland capital allowances are not reduced by grants of up to 45% and it has proved a valuable aid in sustaining industrial development in Northern Ireland. As such, I hope you will see your way to renewing the Order. Any decision not to do so would send quite the wrong signal to the Northern Ireland business community, to NI political parties and their MPs and to the international community which is seeking ways to help us build on the unique opportunity we now have. [It would be helpful if you could confirm this in your budget speech].

There is one other matter, my long term unemployment initiative. I am in separate correspondence with Jonathan Aitken on this but I hope to conclude that shortly and then make an announcement. I believe that it would send a very positive signal to Northern Ireland MPs and to those involved in the

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peace process if you could endorse the initiative in your budget speech.

I realise that the package of measures which I am seeking will not be entirely welcome to you and could cause difficulties in other areas with high unemployment problems. However, I would not be raising these matters if I did not consider them to be very important in securing a prize which has eluded us for 25 years - and longer - and I hope you will be able to look favourably on them. There are, of course, state aid issues to be resolved and if you are content our officials can urgently address these. The EU has offered help to the peace process and this will be a practical means of doing so.

I am copying this letter to the Prime Minister and to Jonathan Aitken.

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Annex B

cc PS/Secretary of State (B&L)
PS/Sir J Wheeler (DFP, B&L)
PS/Michael Ancram (DENI, B&L)
PS/Baroness Denton (DANI, DHSS &L)
PS/Mr Smith (DED, DOE &L)
PUS
Mr Thomas
Mr Legge
NI Perm Secs
Mr Watkins
Mr Bell
Mr Quinn
Mr Hewitt
Mr McConnell

MR FELL:

NI BUSINESS WITH HM TREASURY

1. I suspect we are all acutely conscious that a number of issues are being pursued at the moment which have a direct bearing on the NI/HMT agenda. I thought it would be helpful to you and to copy recipients if I listed them with a brief commentary, so that the broader picture is available to all Ministers, departments and other parts of the system.

2. The main items on, or potentially on, the agenda with HMT are:

(a) 1994 Survey - the Chief Secretary has now replied to the Secretary of State on the general PE and DRC issues, but we may need to go back to him shortly to:

(i) clarify the 1997/98 retrospection reference in the broader Needs Assessment context

(ii) deflect/limit/shape the HMT role suggested by CST in relation to Block DRC in the 1995 Survey.

The key point in the 1994 PE Survey outcome is, of course, that implicitly the Treasury has left the Secretary of State with first go at the Peace Dividend - this notwithstanding HMT's assertion, based on its Needs Assessment model, that the Block is over-provided by about £130m (not counting Police expenditure).

(b) Long Term Unemployment - DED has been dealing with Department of Employment and Department of Social Security on policy issues arising from our proposals. DFP and DED are now co-operating on an approach to the Treasury, with a view to seeking their agreement to important resource implications of our ideas as they are now developing - particularly on the interaction between Social Security and managed Block resources. Again we hope to be writing soon to HMT on this.

(c) EU additionality - we have the Chief Secretary's reply which is broadly helpful but does not yet meet all of our essential requirements. We will, therefore, be putting advice to the Secretary of State on whether/when/how to respond as soon as possible after the 4/5 october Foreign Affairs Council - but further Ministerial correspondence is certainly required.

(d) Taxation measures - Mr Smith has commissioned work on possible taxation proposals to be put to the Chancellor in the context of the 1994 Budget. DED is currently consulting DFP and other departments on the substance and tactics, with a view to an early approach by the Secretary of State.

(e) More generally, we may wish to open up with HMT a debate on whether Ministers can give some public reassurance that NI will be given protection, at least for a transitional period, from the downside effects of peace on security-related employment. This would effectively involve seeking to limit the Chief Secretary's discretion in the 1995 Survey at least.

3. Alongside these exercises, HMT will doubtless be conscious of the possibility of economic assistance coming from the US.

4. It is, of course, right that we should collectively seek to maximise the benefits to NI of the emerging peace scenario, and DFP will continue to play a full and energetic part in that. Equally, it is only sensible to bear in mind how all of this is likely to be seen from a Treasury perspective - even if that perspective has been rather more sympathetic than normal.

5. The risk is that HMT might regard our agenda as opportunistic and unco-ordinated, and that it will revert to negative type. HMT probably believes that leaving the Peace Dividend to us in the 1994 Survey was an act of real generosity and goodwill which discharges its obligations to Government's wider objectives. Tackling HMT, more or less simultaneously, on the sacred cow of non-additionality, regional tax concessions and Social Security transfers to mainstream programmes could well strain their goodwill to breaking-point.

6. The points I would make, therefore, are that:

(a) we should seek to develop our agenda in a coherent way, and this may involve some form of presentation to HMT on the totality of our proposals. Further piecemeal approaches may produce an unhelpful response from the Treasury, and I intend therefore to brief Andrew Edwards of HMT (Grade 2 Public Expenditure) across the board to minimise this risk;

(b) we need to judge the tactics and prospects relating to each proposal carefully, not just on its own merits but in the context of our broader agenda. In doing this we will keep in the closest touch with you and with David Watkins since you are co-ordinating the efforts to secure US and EC financial assistance.

7. DFP will be the channel of communication with HMT at official level, and we will seek to ensure that whatever is put to HMT (at Ministerial or official level) takes due account of the full range of NI/HMT business, while exploiting the opportunities which the political circumstances may provide.

8. I hope that you and copy recipients find this overview and commentary helpful in taking the various exercises forward.

J L Semple

J L SEMPLE

5 October 1994

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ANNEX C

NOVEMBER BUDGET

1. Mr Smith has asked for advice on the merits of making a submission to the Chancellor of the Exchequer proposing a Northern Ireland package in his 1994 budget. He refers to two possibilities, a lower corporation tax, possibly 10%, for inward investment and the long term unemployed initiative.

Considerations

2. In deciding how to advance the tax option, the following considerations need to be taken into account:-

   (a) benefit to the NI economy. We need to be able to demonstrate to HM Treasury that what we seek will have a clear benefit to the Northern Ireland economy.

   (b) conformity with EU law. It could be that some of the options set out below would be regarded as state aids.

   (c) repercussiveness in GB. It is also likely that any tax concessions would provoke requests for similar treatment from other UK regions eg Scotland/Wales. As they too have areas of very high unemployment our argumentation must be essentially political and we must search for tax concessions that offer good reasons for separate treatment for Northern Ireland alone; and

   (d) handling. This is essentially a matter for DFP but we do not want to disrupt other negotiations with HMT eg Survey, additionality, etc, nor do we want to endanger concessions presently available in Northern Ireland (see below). Also, the time for 1994 budget submissions is well past and the Secretary of State will have to lean *heavily on the ceasefire argument and possibly seek no more than a statement of intention in the budget speech with the detail to follow.*

3. There are two other points to be borne in mind:-

(a) to whom do we want any concession to apply? Is it just new inward investment or do we include new investment by existing foreign owned companies or all new investment? Is it just new industrial investment or all investment? Do we include tradeable services? What is inward investment? How, in law, do we differentiate between, say, investment by an "obvious" US company like, say, General Motors and a US company established by, say, F G Wilson or an English company to obtain the tax relief? (My understanding is that the Dublin authorities had to change their tax concession to include all investment in the manufacturing and tradeable services sectors); and

(b) we need a tax concession which will help us to persuade the US authorities to reciprocate. There, the proposal is that we should seek exemption for US companies operating in Northern Ireland, in line with that available to US companies investing in the Republic.

Present Position

4. The Northern Ireland tax position is different at present for three reasons:-

(a) capital allowances. Under the Capital Allowances (Corresponding Northern Ireland Grants) Order, 1993, which will have to be renewed in March 1995, capital grants on machinery of under 45% are ignored for tax purposes. Thus, the purchaser can write off the gross cost of his machinery whereas in GB it would be the net cost;

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(b) *corporation tax relief grant. This grant scheme allows the IDB to offer a grant towards the tax payable by an inward investor and was designed to offset the benefit which the ROI lower tax rate offers. It has not proved beneficial because of its cumbersome rules and the fact that it has to be included in cpj and percentage contribution calculations. As such it merely displaces other grant opportunities; and*

(c) *100% industrial derating.*

Options

5. *Against this background, options for a tax concession are:-*

(a) *a lower corporation tax rate for Northern Ireland eg 10% for 10 or 15 years in line with the ROI rate which expires in 2010;*

(b) *accelerated capital allowances. At present, an investor can write off plant and machinery at 25% per annum of the reducing balance and buildings at 4% per annum straight line. Options are:-*

(i) *to increase the first year write off, of either PME or buildings or both, to 100% or something less; or*

(ii) *to accelerate the write off after year one, eg to write off PME at 25% per annum straight line;*

(c) *tax deductible revenue grants. To exempt revenue grants from the tax net. If we argued for this treatment for training grants there would be an obvious Northern Ireland case, because of our high levels of long term unemployed, and a linkage to the LTU initiative;*