PERSONAL ASSETS TRUST PLC

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MILTON FRIEDMAN'S DEATH

Some people change the way we think. Milton Friedman was one of them. His life was spent trying to persuade politicians to replace the word 'fair' (a concept that exists only in the eye of the beneficiary) with the word 'free' (which distils the independent judgement of a great multitude of individuals throughout the marketplace).

In *Free to Choose* (a 1980 US TV programme, also seen in the UK) Friedman extolled the *laissez-faire* policy of Sir John Cowperthwaite, Hong Kong's Financial Secretary 1961-72. A Scot educated *(where better?)* at St Andrews and Cambridge, Sir John declared in his first speech as Financial Secretary:

'In the long run, the aggregate of decisions of individual businessmen, exercising individual judgment in a free economy, even if often mistaken, is less likely to do harm than the centralised decisions of a government, and certainly the harm is likely to be counteracted faster.'

Sir John's legacy is enormous. On his appointment, the earnings of the average Hong Kong resident were about a quarter of those of a UK resident, but by the early 1990s average incomes in Hong Kong were higher than in the UK. This is what Scots can achieve at their best. To see what they can do at their worst, one today need look no further than inside 11 Downing Street; but, as this Quarterly will relate, not ***all*** the worst taxes were devised by Gordon Brown.

A PARTICULARLY NASTY TAX

No, not Inheritance Tax ("IHT"), Ian's *bête noire,* although I may write about that some other time. Which Prime Minister penned the following left-wing plea to which Chancellor of the Exchequer?

'I am sure there should be something in the nature of a capital gains tax. This may not be a good tax technically and it might not bring in much revenue if Stock Exchange prices become steadier. But that would not matter in itself. The tax would show our intention to be politically just, and would be a form of insurance that all sections of the community would have to play their part.'

Clement Attlee to Hugh Dalton? Or Harold Wilson to Denis (*'tax the rich until the pips squeak'*) Healey? No, it was Sir Anthony Eden to Richard Austen ('Rab') Butler, in September 1955.[1] Earlier, Eden had noted in his diary,

'Cabinet [discussion] *on economic situation went well, but was disappointed to find how little* [Rab Butler] *was able to suggest in the way of action in respect of capital gains or dividends to balance the demands he is making on others. I have no sympathy for* [Charles] *Clore and his ilk and would like to hit them hard.'* [2]

Eden's proposal came to nothing, but the idea stayed on the table and was acted on seven years later by Harold Macmillan as Prime Minister and Selwyn Lloyd as his Chancellor of the Exchequer. Macmillan had all the charm and guile of a rascally Venetian Doge; principle was not his strong point. Compared to him, David Cameron is a zealot. As for Selwyn Lloyd, although his career ended well as Speaker of the House of Commons he was a hapless figure, described by Rab Butler as *'far from first class, and was lucky to get where he did'* — Foreign Secretary at the time of Suez and then, as Chancellor, the author of the 'Pay Pause' in 1961. He introduced the first Capital Gains Tax ("CGT") as part of his deflationary 1962 Budget. To quote Harold Macmillan's biographer:

'The most striking measure was the introduction, by a Conservative government, of Capital Gains Tax (Macmillan would have preferred calling it 'Tax on Short-Term Speculative Profits'), which has stuck ever since.' [3]

Short-term capital gains (defined as gains made and realised within six months) were to be taxed at the same rate as income tax and, if applicable, surtax. Income tax was 8s 3d in the Pound (41¼%) at the standard rate. Surtax was charged on incomes above £2,000, rising through nine different rates from 10% up to 50% on income of £15,000 and over, thereby giving a total top rate of 91¼%.

THE WISDOM OF LORD CROMER

This tax on short-term 'speculative' gains had been mooted as part of Selwyn Lloyd's July 1961 package of panic measures, which included the 'Pay Pause'. Later, it moved up the agenda as a way of bribing the trade unions. The Chairman of the Stock Exchange having protested in vain, Lord Cromer, the Governor of the Bank of England, wrote a prophetic letter to Lloyd in December 1961, arguing that what was intended merely as a tax on speculation would inevitably become a much wider tax on all capital gains.

'I deplore, as much as you do, the spivish sort of society which has been created in this country as the result of the excessively high rate of income and surtax. It is because of this excessively high personal taxation that such a high premium has been put on . . . speculation . . . What you are now suggesting will merely aggravate further without removing the cause which stimulates recourse to this form of defence against Government oppression. What is even worse is that you are creating a precedent that future Governments will quote when they extend your measures to all capital gains, as they inevitably will. I would question whether you realise

[1] Quoted in D R Thorpe, *Eden, the Life and Times of Anthony Eden First Earl of Avon, 1897-1977,* Pimlico, 2003, p. 449.

[2] *Ibid.*, pp. 449-50.

[3] Alistair Horne, *Macmillan 1957-1986,* Macmillan, 1989, p. 338.

the degree of disillusionment and bitterness that during the long years of Conservative rule no real move has been made to reward effort and discourage mere opportunism.' [4]

Lord Cromer was right, as James Callaghan's 1965 Budget showed. This, among other unpleasant reforms, imposed CGT on all capital gains. There were two rates, short term (within twelve months, taxed at the taxpayer's highest personal income tax or surtax rate) and long term (over twelve months, taxed at a 30% flat rate).

'There were apoplectic responses to the Budget in some circles. Major-General Spears, chairman of the Institute of Directors, talked of socialist revolution and of the French guillotine of 1790. An inflamed City businessman denounced the budget as Marxist and spoke of fighting the new taxes on the beaches and the farms.' [5]

THE TORIES AND A WEALTH TAX

The Labour governments of 1964-70 are unforgettable for their tax horrors (culminating in Roy Jenkins' 'Special Charge' on investment income in 1968, which gave us an income tax rate higher than 100%) and for their general seedy ghastliness. But even more sinister (indeed, potentially catastrophic) thoughts were being entertained by the Conservatives, who in 1965 marked the start of Heath's leadership by proposing a Wealth Tax.

'They wanted to sweep away stamp duties and the capital gains tax, to halve estate duty and to introduce instead a single graduated tax on capital. This suggestion had the merit of mitigating both the near-lottery effect of death duties and unduly severe penalties on changes in investment . . . The [annual] *wealth tax rates required . . . ranged from ½% on £25,000 to 2% on £1 million or more.'* [6]

Debate on this continued until as late as 1968, when the idea was finally dropped. Iain Macleod, the Shadow Chancellor, was minuted as saying, with great good sense:

'He thought that the important things on which the Conservative Party ought to be concentrating its attention were earning, owning, saving and learning. A proposal to introduce a Wealth Tax would distract from these objectives and raise a lot of red herrings about the relative merits of different forms of capital, pictures, land, industrial shares, etc.' [7]

So the Wealth Tax fell by the wayside, for which our thankfulness should be exceeded only by our bafflement that the Conservatives ever seriously considered it.

TWO SMALL STEPS FORWARD . . .

Callaghan having imposed CGT on long-term capital gains and Jenkins having introduced what he himself called his *'mini capital levy'* (taxing investment income at over 100%),[8] there was at last a step in the right direction when Anthony Barber abolished short-term capital gains tax in March 1971. Barber, who became Chancellor of the Exchequer as the result of Iain Macleod's untimely death, was described by Siegmund Warburg as *'very, very shallow'*, and is remembered now only for the short-lived and unsustainable 'Barber Boom'. Macleod was a 'Big Beast'. Barber was not. The idea of abolishing short-term capital gains tax was Macleod's.[9]

The next step forward came in 1982, when the principle of indexation was introduced; and, since I shall have harsh words to say about him later, I should point out that it was Nigel Lawson, as Financial Secretary to the Treasury, who in July 1979 had proposed to Sir Geoffrey Howe, as Chancellor, the indexation of the entire personal tax system, both income and capital.[10]

The indexation of CGT was well-intended at a time of high inflation. However, it made CGT even more complicated than before; and although by 1982 inflation had passed its worst, only gains made from 1982 onwards were to be indexed. Between the Conservative victory in May 1979 and the March 1982 Budget there had been aggregate inflation of 45%, while between the 1982 Budget and the later catastrophe of 1988 aggregate inflation was much lower, at 31%. It is also sobering that £1 in 1965, when long-term CGT began, was worth 19p by 1982, when indexation came in.

. . . AND ONE HUGE STEP BACK

Ironically, it was a Conservative government that raised CGT from 30% to 40%; and it was Nigel Lawson who struck the blow.

'The taxation of capital gains was more difficult. I had long felt it was highly undesirable that Capital Gains Tax should have given rise to a substantial tax avoidance industry dedicated solely to converting income into capital gains, which were taxed very much more lightly . . . [The] *American tax reform package introduced by President Reagan had* [equated] *income tax and capital gains taxes.* [So] *I decided in the 1987 Budget to tax corporate capital gains at the relevant corporation tax rate . . . instead of at the long-standing Capital Gains Tax rate of 30%. It was an astonishing stroke of luck that no-one guessed that I envisaged this merely as the first stage in a two-stage process, with the principle being extended to individuals in a subsequent Budget. It thus came as a complete surprise in the 1988 Budget when I brought Capital Gains Tax for individuals into line with the basic and higher rates of income tax.'* [11]

Until he unveiled this part of his otherwise tax-cutting 1988 Budget (it reduced the top rate of income tax from 60% to 40%) I had admired Lawson as a brave and brilliant man. His justification of his increase in CGT, however, is odious in its self-congratulatory cynicism. Did he forget that the capital on which gains are made has usually been accumulated out of already taxed income? And had he overlooked how much lower US tax rates were? Only a politician could have written the glib words I have just quoted; and I do not mean this as a compliment.

THE HARM CGT DOES

We seem to be stuck for the foreseeable future with this wretched tax. What is wrong with it? I have already mentioned its complexity, and it will be seen from the arguments Eden, Macmillan, etc, used in its favour that it began life not

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[4] Quoted in David Kynaston, *The City of London, Volume IV, A Club No More 1945-2000*, Chatto & Windus, 2001, p. 289.

[5] Kenneth O Morgan, *Callaghan, A Life*, Oxford University Press, 1997, p. 221.

[6] Nigel Fisher, *Iain Macleod*, Andre Deutsch, 1973, p. 264.

[7] Robert Shepherd, *Iain Macleod, A Biography*, Pimlico, 1994, p. 471.

[8] Roy Jenkins, *A Life at the Centre*, Macmillan, 1991, p. 232.

[9] Fisher, *op. cit.*, p. 302.

[10] Nigel Lawson, *The View From No. 11, Memoirs of a Tory Radical*, Bantam, 1992, p. 114.

[11] Lawson, *op. cit.*, p. 691.

only as an interventionist experiment in social and economic engineering but also as a sort of 'social justice' or 'envy' tax, to convince the trade unions that 'the rich' were bearing their share of the nation's burdens. (Bearing them, of course, in addition to the existing 91¼% top rate of income tax and surtax combined, which was apparently not enough.)

However, there is much more to object to about CGT than that.

- It is unjust.
- It distorts the allocation of savings and investment.
- It yields little and, while paid by few, affects many people.
- It encourages individuals to speculate on rising house prices.

CGT IS UNJUST

There is a fallacy in the minds of many people that income and capital are two distinct 'pots' which bear no relationship to each other. Income is earned, whereas capital is either inherited ('theft from the people', as some socialists would say) or acquired by luck, deviousness or fraud. This, of course, is pernicious nonsense. Most people's capital is accumulated wholly or mainly out of their income, ***and this income has already been taxed***.

CGT is double taxation, like IHT and tax on investment income. If I were devising a new tax system (as Chancellor of an independent Scotland, say), I would decree that once income had passed through the 'toll-gate' of Income Tax, any of its subsequent fruits, whether as investment income or capital gain, would be outside the tax net.

CGT DISTORTS INVESTMENT

If one set out to devise a tax that would encourage maximum inefficiency in the use of wealth while discouraging individuals from investing in equities, a more effective one than CGT could scarcely be imagined.

Let's suppose that I have a holding worth £100,000 in a company I now regard as being less well managed than it should be, and therefore no longer the best home for my savings. The instinctive, and best, response would be to sell it. But suppose that I, being a long-term, supportive investor, have held it for ten years and have made a taxable gain on it of £50,000. Now, the complexity of CGT is fiendish. Never content to leave well alone, Gordon Brown as from 5 April 1998 replaced indexation with Taper Relief. This means that the percentage of a gain charged at 40% declines over time. After an initial three year holding period during which a realised gain is taxed at 40% on 100% of the gain, the tax payable falls to 40% on 60% of the gain after ten years. Thus I would be liable to pay £12,000 of CGT on my shares (£50,000 multiplied by 60%, taxed at 40%).

Do I resign myself to stumping up this £12,000? It's more likely that I'll make the right tax decision but the wrong investment decision. I'll hang on to the shares and see them underperform. Because of CGT, private individuals cannot sell and reinvest efficiently; they miss out on the fruits of their thrift; and over the long term they are increasingly deterred from investing in equities at all.

CGT YIELDS LITTLE

CGT is even less important as a percentage of UK tax receipts than the similarly unpopular IHT.

TAX or DUTY [12]	**2005/06 Yield**	
	£bn	**%**
Income Tax	130.5	32.8
National Insurance	85.5	21.5
VAT	72.9	18.3
Corporation Tax	41.9	10.5
Fuel Duty	23.4	5.9
Stamp Duties	10.9	2.7
Other Miscellaneous	10.7	2.7
Tobacco Duty	8.0	2.0
Beer, Wine, Spirits	7.9	2.0
Inheritance Tax	3.3	0.8
Capital Gains Tax	3.0	0.8
TOTAL	**398.0**	**100**

How many people actually pay CGT? The most recent figures from HM Revenue & Customs cover tax year 2003/04, during which 28.5 million people paid Income Tax and only 160,000, or 5.6% of Income Tax payers, paid CGT. (The number paying IHT was lower still, at 30,000.)

If the proceeds from CGT, and the numbers paying it, are laughably small, why do I argue that it affects very large numbers of people? It is because it acts as a formidable deterrent to investment activity. Hundreds of thousands of people, I believe, are hampered by CGT in this way — many, many more than actually pay the tax.

CGT DISTORTS HOUSE PRICES

The way people now accumulate capital is not by investing in equities, but by borrowing as much as possible to buy bigger houses. Lenders are shovelling fuel on the flames. Abbey National today offers mortgages of five times salary. The mortgage lending arm of Morgan Stanley lends up to seven times. Ever-rising house prices are an insidious evil. A nation is no better off in aggregate from the doubling of the value of its housing stock. This only impoverishes those unfortunate enough to have to borrow ever greater amounts to acquire somewhere to live. When gains made on the sale of one's principal residence were exempted from tax, it was never envisaged that people would use their main residence as an investment vehicle. Yet this is what has happened.

It cannot be healthy for the economic future of the UK, or for the financial future of millions of people, to be so bound up with highly leveraged second-hand bricks and mortar. The best solution would be to abolish CGT altogether. It would cost a mere £3 billion, out of some £400 billion. The reward would be a saner housing market and much greater efficiency for private individuals in planning their future — something that should please a wise Chancellor. So, in a Cameron government, might George Osborne consider it? You may recall his inspiring declaration of Conservative principles last month:

'To those who still want us to make up-front tax cuts now, we say: we will not back down.'

I am not holding my breath.

ROBIN ANGUS

[12] *Source*: HM Revenue & Customs. 'Other Miscellaneous' consists of Petroleum Revenue Tax, Betting & Gaming Duties, Customs Duties & Levies, Air Passenger Duty, Insurance Premium Tax, Landfill Tax, Climate Change Levy and Aggregates Levy.

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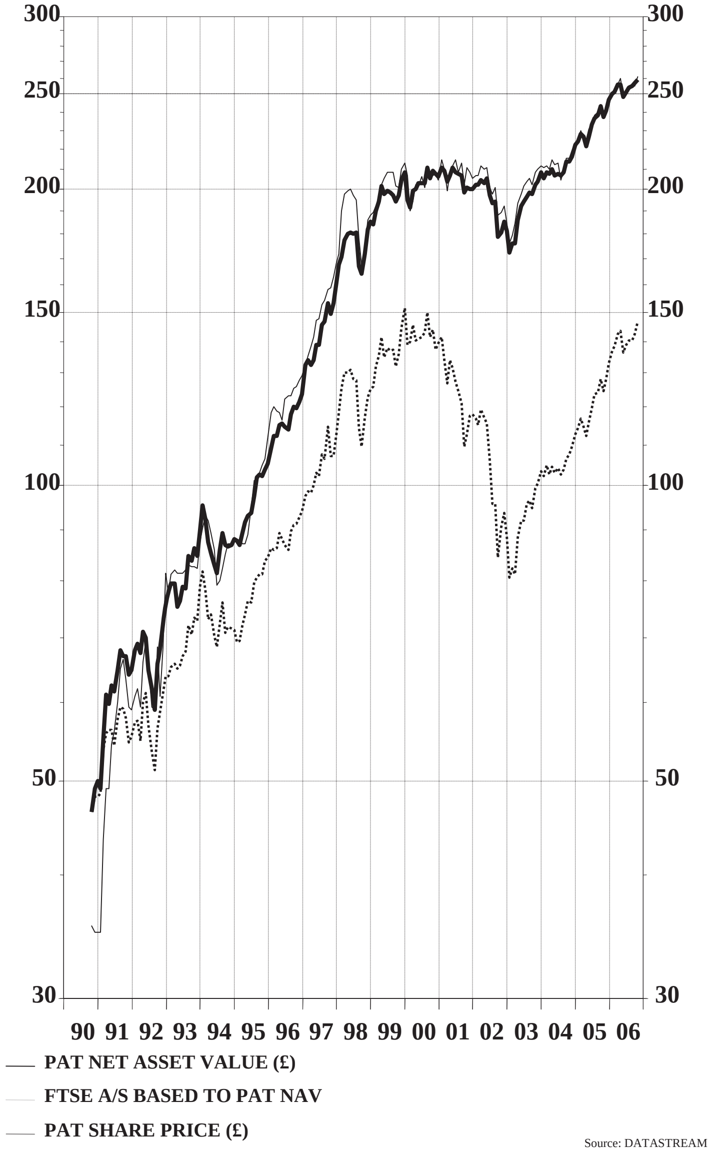
PORTFOLIO (000's)	**31-Oct-06**
Royal Dutch Shell 'B'	14,641
BP	13,992
RBS Group	13,442
HBOS	11,957
Barclays Bank	8,490
BT Group	7,228
GlaxoSmithKline	7,000
Scottish & Newcastle	4,621
Scottish Investment Trust	2,571
British Assets Trust	2,074
Top Ten Equities	**£86,016**
Other Equity Exposure	**£29,834**
Effective Liquidity	**£74,904**
Shareholders' Funds	**£190,754**

PERSONAL ASSETS TRUST PERFORMANCE



% Changes From	31-Oct-90	31-Oct-01	31-Oct-03	31-Oct-05	31-Oct-06
Period	16 Years	5 Years	3 Years	1 Year	Values
SHARE PRICE	633.8%	23.8%	25.2%	9.5%	£260.50
NAV PER SHARE	456.7%	28.9%	27.8%	9.3%	£258.51
FTSE ALL-SHARE	216.4%	30.1%	47.8%	17.9%	3,140.47
NAV REL TO FTSE A/S	76.0%	-0.9%	-13.5%	-7.2%	