Speeches by the Governor of the Bank of England

Given at the Lord Mayor's dinner to the bankers and merchants of the City of London on 18 October 1979.

The Chancellor has, if I may say so, set out with great clarity the economic priorities of the new Government.

Governors enjoy—or suffer—a longer spell of duty than Chancellors; and this is the seventh time that I have been privileged, as Governor, to attend this dinner. Having been, for this span, a participant in the economic scene, I have conceived that it might be appropriate to take one step back from our current preoccupations, and try to view them in a brief historical, and also international, perspective.

It is one of the mitigations of a Governor's responsibilities that he enjoys a friendly relation with representatives of other governments and central banks, very many of whom I was able to meet again at the annual meeting of the International Monetary Fund and World Bank in Belgrade. What I learned there underlies some of what I have to say tonight.

The main thing that must strike anyone attending such a gathering is how very generally it is now expected that we face, not only in this country but in many others, a difficult situation as the 1980s open. To some, My Lord Mayor, it may seem a heartless procedure, and a poor return for your hospitality, to report these widespread expectations. My purpose, however, is constructive. For I believe it is easy to draw quite the wrong lessons, and situate quite mistakenly the hopes that must sustain us.

We should, I think, ask ourselves what are the roots of the trouble with which we are now faced. We have had slow growth, and may now see slower. But underlying this, confronting the world economy, there is inflation. I need scarcely elaborate on its complex entanglement with countless economic, social and political factors. What I am concerned to emphasise is its tenacity and present alarming force.

It is instructive to cast our minds back six or seven years—to the time before the great increases in oil prices in 1973. For even before that shock, the acceleration of inflation had got under way. When oil prices were increased, there was, quite generally, an over-sanguine evaluation of the inflationary danger. Many countries—this country among the foremost—thought that they could ride out the difficulties by maintaining demand. The hope was that inflation, though exacerbated by the oil-price increase, could be got down gradually, lower year by year. That attempt has unfortunately foundered. Inflation did not come down enough; and it is again on the increase.

Now the world has been faced with further steep increases in the price of oil. But practically no country now takes the earlier confident view. I was very struck at the Belgrade meetings how developing and developed countries alike now put the defeat of inflation as their first objective.

Over the last fifteen years or so, and especially during this decade, inflation levels have been pushing upwards. Each inflationary peak has been higher than the last, and though there have been falls in some years, each new upsurge has started from a higher base. So it is now; the surge we are witnessing starts from a higher level than the previous surge about seven years ago. This country is more addicted to inflation than most; and there is no alternative but that we, like other countries, make the defeat of inflation our first task.

Of the dangers and disadvantages of inflation I am sure I do not need to convince you. It represents a very great source of insecurity, uncertainty and inefficiency. Nothing works as it should; conflicts are intensified; what should be rational is made random; and planning for the future is frustrated. This we all know.

Some argue that we are free to choose between defeating inflation and satisfactory growth. My case is that we no longer have such a choice. Inflation has got far too serious. Until we have got inflation under control, we cannot secure satisfactory economic growth. It might be possible to achieve a short-term spurt in activity. But while inflation persists at anything like its present pace, fiscal or other means of demand stimulus are unlikely to produce sustainable gains in activity and employment. They would, however, undoubtedly exacerbate inflationary pressure.

My Lord Mayor, it is inflation, not the policies needed to counter it, that threatens the ideals of the welfare state and of full employment, by undermining the basis of the sound economy on which they depend. It is sometimes said that we have been forced to abandon these ideals and the post-War consensus on which they rested. But let me read you the following words:

> Action taken by the Government to maintain expenditure will be fruitless unless wages and prices are kept reasonably stable.

and then these additional words:

> . . . the stability of these two elements is a condition vital to the success of employment policy . . .

These words were not written in the 1970s. They are taken from the classic statement of that consensus—the 1944 White Paper on Employment Policy. It was recognised then, as our actual experience teaches us to recognise more emphatically now, that there is no real trade-off between inflation on the one hand and employment and growth on the other—that action to maintain employment will be fruitless without reasonable price and wage stability.

The truth is that if we do not defeat inflation now, because the treatment is unpalatable, it will be worse tomorrow. Some feel that living with inflation of, say, just within single figures would be good enough. Inflation, however, is unlikely to be so obliging. At such a rate it is much more likely, left to itself, to increase further than to slow down; and there would be little restraint or limit to how fast it might go.

In the course of this last year, our rate of inflation has increased substantially. A year ago, a combination of monetary, fiscal and incomes policies had succeeded in reducing inflation from the peak levels of 1974 and 1975 to around 8%. But one leg of that tripod, incomes policy—inherently liable to erosion—collapsed last winter. By February it was clear that the turn in industrial relations and the size of pay claims threatened faster inflation. The threat only too quickly became reality.

Price levels have since been further boosted by the rise in energy prices, and by the shift—desirable for the longer-term health of the economy—in the structure of taxation from direct to indirect. That effect is once for all, not a continuing source of inflation.

In all these circumstances, it is essential to hold firm to our monetary policy. It is precisely at a time like this that monetary discipline is most needed—though inevitably it is at such times that discipline becomes most painful. To hold monetary growth substantially below the rate at which nominal incomes are rising must involve pressures—pressures associated with fiscal restraint, a strong exchange rate and high nominal interest rates.

Some people blame the monetary authorities for these pressures. But a central banker is surely entitled to ask precisely where lies the cause of any sense of monetary tightness in an economy whose output is not growing in volume terms, but where money supply is rising above 10%. If the escalation of costs could be held within saner bounds, such monetary growth would provide ample room for real growth and improvements in real living standards.

As you know, the rate of monetary expansion has in recent months been running at a rate around the upper limit of our monetary target, or higher if one allows for the distortions that have resulted from the enforcement of the corset. We have been facing strong pressure resulting from a high government borrowing requirement so far this year, combined with unusually strong borrowing from the banks by the private sector; and the need for the action we took on minimum lending rate at the time of the Budget has been fully demonstrated by subsequent events. The September money figures published today suggest some slowing down in the pace of monetary expansion. But no-one can judge from one month's figures, and the future is far too uncertain to come to a view that there has yet been a change in the trend.

Sustained reductions in interest rates depend on success in reducing inflation. That in turn will be influenced by the rate of monetary expansion; the way to get lower interest rates is to persevere with monetary control.

I am conscious too of how difficult it is for business to live with exchange rate instability of the kind that the world has seen recently. But, at bottom, this also has reflected failure, or rather different degrees of failure, among the major countries to deal with inflation.

Here at home the prospects are obviously uncertain. World trade unfortunately looks likely to slow down; and business investment may be falling away—largely perhaps because past economic growth has been slow. Moreover, profits have been very low and in many cases companies are already experiencing a worsening financial position. Thus it is in industry that the most vulnerable sectors of the economy lie, and it is a fall in business spending—on investment and perhaps stockbuilding—that is most likely to weaken the economy next year.

The conclusion I wish particularly to point to is that if wage increases are large, and unmatched by increases in productivity, profits will be reduced further and recession hastened.

There is understandable concern that higher productivity will reduce jobs. In individual cases it may. But there is little doubt that higher productivity would add to employment prospects in many areas by enabling firms to compete and secure orders which are still there to be had in many world markets. On the national scale it is success in improving efficiency that will lead to additional jobs.

We do indeed need to work towards a position where wage increases are earned by increases in productivity equally large, and where increases in wages outside this limit are hardly expected.

The moral of what I have been saying is plain. How badly firms are hit will depend, in quite large part, on how well they can control their costs; it will depend on the ability of management and workers to back wage increases with comparable strides in efficiency. The situation no doubt varies widely. Many industrialists I have met remain confident, especially those successful in new product areas. But in general the future will depend importantly on co-operation by all concerned to produce much better results. A constructive and positive approach of this sort to our difficulties would lay sound foundations for a sustainable expansion. We shall not, I fear, avoid a period of difficulty. But what is crucial to the future of this economy is how quickly, and how effectively, we can position ourselves for recovery. Our productivity is so low that we could immediately transform our prospects by improvements which are easily discernible and ready to hand.

My Lord Mayor, I have told an unvarnished tale. What I have had to say about the task that faces us is not new. The country's needs have not changed. They cry out for positive responses from us all. In such a task there is a part for each and every section of the country.

At the Bank, we seek, in discharge of our responsibilities, to ensure a financial framework which holds firm. We believe this contribution, if limited, is vital to the major aims of employment and growth which we share with all. For it is only within such a framework that the true springs of prosperity—effort, organisation, enterprise and forethought—run clear and strong.

Given to the Institute of Fiscal Studies on 6 November 1979 as their annual lecture.

Companies, inflation and taxation

Introduction

The title I have chosen for tonight covers an important group of questions, which have been much in the forefront of discussion in recent years. They touch directly on matters in which the Bank has, by necessity, a close and continuing interest. We have a general concern with the health of industry and commerce. Monetary policy and external financial policy—which are the Bank's immediate operational responsibilities—impinge directly on business. And the Bank is closely interested in seeking to ensure that financial institutions provide the support that business requires.

It is mainly in the corporate sector where the wealth of our economy is generated; and in the capital markets where the financial counterpart is largely to be found. An essential element in this economic and financial process of wealth creation is the profitability of companies. It is widely recognised that, in the inflationary conditions we have suffered, the conventional measures of profits and profitability have become increasingly misleading. My aim tonight is to discuss, first, the importance of appropriately-adjusted company accounts for management and reporting purposes; and, secondly, the possible implications for the taxation of business profits of this development in the accounting system. My aim is not to offer firm conclusions but to clarify where the practical issues lie and to identify areas that seem likely to require a good deal of further discussion.

Inflation and inflation accounting

Events in the course of this decade have all too forcibly reminded us of the damage which inflation can wreak in the economy. In response to the erosion by inflation of the real value of wealth, personal saving has increased in this country, as in some other industrialised countries; and in an environment made uncertain by inflation, there has been greater reluctance to undertake investment. These have been factors contributing to reduced demand and output, not only in this country, but world wide.[1] Persistent inflationary pressures, such as we have known in recent years, hit at the dynamic of business, and the uncertainty they create confounds the process of decision-making. I have no need, I am sure, to emphasise my conviction that inflation must be brought under control, and that this must be the first priority for economic policy.

I believe also that it is of great importance for business to adopt accounting procedures that remove the distortions which arise in accounts when conventional accounting practices are followed in inflationary conditions for which they were not designed; and that the system of taxation should take due account of such distortions.

There is no contradiction between those two aims. To lay emphasis, as I propose to do, on the importance of appropriate adjustment of accounting standards in an inflationary environment does not imply any diminution in the emphasis to be placed on the importance of bringing inflation under control. It is surely the purpose of accounts to show accurately the realities of a company's situation. To conceal it leads to self-deception and may well exacerbate the inflationary process.

It is clear in any case that it will take time to break the deep hold that inflation has taken in this country, and, in the meantime, even with an inflation which was well below the present rate, the distorting effects on profits figures would still be significant, and important to correct. Even if inflation fell to zero immediately, some of these effects would still be with us for many years: the valuation of plant or buildings put in place even two years ago would, on conventional practices, fall well short of present values and remain so for the lifetime of the equipment in question. It would be realistic, too, to recognise that we shall not be able to avoid fluctuations in the price of international commodities. These inevitably have repercussions on our domestic price levels in general and, of course, much bigger repercussions on the costs, and stock values, of firms who process the commodities. For these reasons, the need to remove distortions from profit figures will continue.

[1] See J. C. Townend, 'The personal saving ratio', March 1976 *Bulletin*, page 53, and C. T. Taylor, 'Why is Britain in arecession?', March 1978 *Bulletin*, page 38.

It is sometimes argued that to take this route is to encourage the spread of what goes by the name of indexation, that is the tying of incomes to a price index. That argument rests, I submit, on an important confusion of thought. To seek to correct profits figures for distortions is not to seek to stabilise profits in real or money terms. They will still fluctuate according to the market for firms' products and their own efficiency. It is, therefore, not at all the same thing as the indexation of income payments, whether pensions or wages, to past prices. The aim must be for tax to be levied as far as possible according to a true, not a distorted, measure of profits. A policy instrument such as taxation should clearly be equitable in this sense. This will not obstruct or fossilise the adaptability of the economic system.

The impact of inflation on company profits

During the last decade, the real profitability of companies has fallen in most industrial countries. But in this country, where inflation rates were among the more pronounced, the fall has been particularly sharp, to real rates of return which are abnormally low.

For the industrial and commercial sector taken as a whole, calculations made in the Bank suggest that, as compared with some 10% to 12% in the 1960s, the real rate of return on trading assets before taxation has been as low as 4% to 5% in the last few years. These calculations relate to the average behaviour of a wide spectrum of individual companies and firms. Nevertheless, the average fall in profitability is such that few can have escaped the adverse pressures, though some may have fared better than others.

What lies behind this fall in profitability? Some fall was to be expected in conditions where demand was weak. Competition in markets growing so much more slowly than before was bound to have its restrictive effect on profit margins. Even so, it seems likely that the mentality of historic cost accounting has played a significant rôle in the sharp decline in real profitability. Perception of this real decline has been obscured by the comparative stability of historic cost profitability, [1] related in particular to the inclusion of stock appreciation in profits even where replacement of such stocks is necessary for maintenance of the business; and to the persistence with depreciation provisions for fixed assets based on original purchase price rather than replacement cost.

Inflation accounting

Awareness of the need to adjust company accounts for inflation is far from new. In the 1950s, concern about the impact of inflation led the accounting profession to draw attention to the need to ensure that sufficient funds were retained to replace fixed assets; and then in 1974, to the issue of the CPP voluntary accounting standard.

The present Exposure Draft—ED24—issued by the Accounting Standards Committee now suggests procedures which, I believe, come close to general acceptance. For my part, I would hope that that were so. It is our general view that the proposals in the present draft should be adopted for the presentation of company accounts with only minor modifications, and the Bank has made this clear in its submission to the Committee in response to the draft proposals.

The principles set out in that Exposure Draft will be familiar to you all. If I recall them briefly here, it is mainly because they represent the backdrop against which consideration of adjustments to the present company taxation system may be viewed. The Draft is principally concerned with the calculation of profits to the equity interest in the company, and suggests the adoption of:

- measures of depreciation of fixed assets at current replacement cost;
- a cost of sales adjustment, namely the exclusion of stock appreciation from the measure of profits;
- a monetary working capital adjustment applicable to the balance of trade credit, and a 'gearing' adjustment intended to take account of the reduction in the (net) real burden of borrowed funds resulting from inflation.

The first two adjustments may appear straightforward. In practice, however, the establishment of what is the replacement cost of stocks or fixed-capital assets has been an area of some controversy as between the advocates of the current purchasing power (CPP) approach and the current cost accounting approach (CCA). In the event, the present proposals for accounting practice follow the CCA approach, and it is not my intention to muddy the waters by stirring up this debate.

The third set of adjustments relates to the reduction in the real burden of debt incurred by a company, which occurs with a rise in the general level of prices. In an inflationary period, the real value of capital borrowed in nominal terms must fall, resulting in an increase in the net worth of the equity interest. This gain is not reflected, however, in the conventional measure of profits. Where interest is paid on the debt, and interest rates rise with inflation, profits reported as at present will be adversely affected by the need to make bigger interest payments. However, the higher nominal interest payments reflecting faster inflation are the counterpart to the fall in the real value of the debt, and effectively represent, for both debtor and creditor, an early repayment of real capital.

[1] Calculations made in the Bank show that, for industrial and commercial companies, excluding North Sea activities, the pre-tax rates of return on net trading assets were as follows:—

Per cent

Basis	1961–1971 Average	1972	1973	1974	1975	1976	1977	1978
Real (inflation-adjusted)	10.4	8.4	7.3	4.0	3.8	4.1	4.9	4.7
Historic cost	15.3	15.8	17.2	16.7	15.6	17.3	17.8	16.5

The mis-statement of profits and its consequences
As I have already suggested, the mis-statement of profits inevitably has important consequences. It is true that many companies are well aware of the distortions which inflation can introduce into conventionally-based accounts. But even as recently as a year ago a survey by the Accounting Standards Committee suggested that a third of the larger listed companies had neither included a current cost income statement in their report and accounts, nor—more telling—had made any undertaking to do so. Beyond this, I suspect that even many of the firms which publish their accounts on an adjusted basis still fail to carry this through into the internal management accounts. I recognise the difficulties of this, but it is plainly important that the decisions of management at all levels should be realistically based.

Lack of adequate adjustment can lead to many pitfalls. A firm may be seriously misled in its investment decisions. Dividend policy may effectively lead to the distribution of capital because of misjudgment of the earnings available. Even where there is no danger of confusing capital with income, a company may well feel obliged to distribute overgenerously in order to meet the expectations of shareholders generated by the dividend policies of other companies based upon historic cost accounting procedures. Decisions as to costs and pricing can likewise be prejudiced by misleading information.

The persistent presentation of profits unadjusted for inflation may also be misleading in pay negotiations if either party takes historic cost profits as an indication of what a company can afford to pay. Though profitability has not been the sole factor behind the determination to seek large pay increases, the process of negotiation has surely not been helped by the prominence given to figures which have generally overstated the real profitability of companies. I know that within their own firms some chairmen have sought to get this message across, but even so, the majority of statements made at company meetings and reported in the press are still predominantly couched in historic cost terms.

Finally, there is also the danger that the capital market may be misled by inadequately adjusted figures, though the sophistication of company analysts has probably now gone some way towards mitigating this source of inefficiency.

In short, inflation has distorted the information on which decisions by management, pay negotiators and investors are based. At the national level, the decline in real profitability in recent years has been accompanied by a marked shift in national income away from profits. That in turn may well have led to a misallocation of national resources in favour of consumption to the detriment of investment. Increasing recognition of the need for inflation-adjusted accounts, and increasing agreement as to how these adjustments might best be made, are major steps towards the removal of these distortions.

Company taxation

In the second stage of my discourse this evening, I want to consider how far the principles of inflation accounting are relevant to the taxation of company profits, and what changes might be appropriate. But first, let me set the scene in a somewhat wider perspective. For in a lecture given under these auspices, no treatment of taxation would be complete without reference to the massive study of an expenditure tax. For this we are all indebted to the Institute as well as to the authors, Professor James Meade and his colleagues; and others better qualified than myself have paid tribute to its thoroughness and intellectual rigour. They carry one line of thought to a consistent and logical conclusion. What ought to be taxed, it is argued, is not income as such, but income only so far as it is spent; in other words, saving should go free of tax. There would be need neither for the present form of income tax nor for individual indirect taxes: both would be absorbed into one single expenditure tax. Such large changes could not be produced overnight but only in successive stages. As the authors themselves recognise, we have to start from the world as it is. That is what I propose to do tonight, but I propose also to limit myself to the taxation of business profits.

We have recently seen the incidence of taxes bearing on persons significantly shifted, away from direct towards indirect taxation. It is clear that there are constraints on how far or fast this process could go, and a balance has to be struck. It could be argued that companies should be taxed more, so that persons might be taxed less. But it could also be argued, perhaps equally cogently, that companies should be taxed less. In practice, however, the possibilities of movement in either direction are likely to be constrained. One factor limiting movement is the need not to add to the total of government borrowing. The limitation on the other side arises from the present situation of industry. Profits are low, as the figures I quoted earlier show, and it is questionable how soon the financial situation of business will strengthen. In these circumstances, it would be undesirable to increase the difficulties of business, and in particular manufacturing, by asking it to bear a higher tax burden.

For these reasons, I suggest that discussion of possible adjustments to the tax system to take account of inflation should start from the premise that it is not a necessary part of such adjustment to change the yield of corporation tax. In other words, such adjustment can be thought of in itself as neutral in revenue terms, though it could have significant implications for the incidence of taxation as among companies.

I would like also to make some preliminary remarks about the recent rapid growth of leasing. This has resulted, in particular, from a combination of 100% first-year allowances for plant and machinery on the one hand and, on the other, the general fall in rates of return; more companies therefore now find themselves with an insufficient tax liability to reap the full benefit of free depreciation on owned assets. Since initial allowances are available to lessors, financial companies have, directly or indirectly, purchased plant and equipment and have become lessors on a very substantial scale, passing on a significant part of the tax benefit of free depreciation to lessees. Although the development of this industry will need to be kept under close review, it has made a major contribution in support of fixed investment through a difficult phase for British industry. It has also enabled financial institutions, in particular the banks, to reduce their tax liability by acting, directly or indirectly, as lessors and effectively selling their taxable capacity to their lessee clients. It is understandable that, given the transferability of taxable capacity, the banks should have ordered their affairs in this way, significantly widening the range of financial services that they and their subsidiaries have been able to provide to industry. This is a matter to which I will revert later.

Company taxation and inflation

With these wider considerations in mind, I wish now to discuss more systematically the suitability of our present arrangements for the taxation of companies when costs and prices are rising. This question has been made increasingly topical by the progress which has taken place in the debate on the adjustment of accounts for inflation. The Chancellor of the Exchequer in his Budget speech last June stressed that '. . . it is important that the tax system should take account of the effects of inflation on businesses. . . .'[1] And under the guidance of Lord Cockfield the Inland Revenue has this under close consideration.

I shall not try tonight to reach hard and fast conclusions, but shall raise issues which would seem to deserve close attention—from business, accountants and informed opinion in general—as the debate and consultation which the Chancellor has envisaged on these difficult issues develops in the period ahead.

One reason for the growing interest in the fiscal aspects is, perhaps, the belief that, because profits are overstated in conventional accounts, they must be overtaxed under the present system. I shall take leave to doubt whether in aggregate this is so:

- for the fact that the tax system does not take inflation into account has not in practice, I suggest, resulted in a general overtaxation of companies;
- but a number of adjustments are none the less needed, and it is important they be made. Their implementation would raise, however, various practical questions which I shall touch upon.

The present system of taxation has its roots in historic cost conventions. Depreciation is chargeable for tax purposes on the basis of historic cost; stocks also are valued at historic cost. Interest payments are fully deductible in arriving at taxable profits, but there are no adjustments for changes in the real value of debt.

In recent years, however, two changes have gone a long way towards removing distortions created by inflation. First, accelerated capital allowances, originally intended as an investment incentive, especially for plant and machinery, have been in different degrees extended to other assets, and have been increased. Secondly, since 1974, tax relief has been given in respect of stock changes. Without these measures, the overall tax burden on the real profits of companies in 1978, which was somewhat above 50%, would have virtually doubled, thus absorbing almost the entire real profits.

These somewhat rough and ready adjustments are the starting point from which further changes need to be contemplated. There are, as I see it, three areas of this present company tax system open to change, namely:

- modification of the tax relief arrangements associated with changes in stocks;
- the imputation to taxable profits of changes in the real value of monetary assets or liabilities; and
- modification of depreciation allowances.

An important question is whether changes could be introduced by stages, or only as a single reform embracing all aspects of company taxation. Some of the changes which might be contemplated raise fairly complex questions both of principle and of practicability.

The treatment of stocks

I will consider first the treatment of stocks for tax purposes and then pass on to the rather more complex question of the treatment of depreciation of fixed-capital assets.

The present form of stock relief was adopted in 1974 in the face of the liquidity crisis then confronting the corporate sector. It exempted from taxable income increases in the value of stocks held: that is, it excluded from taxable income not only stock appreciation —which is what ED24 would suggest—but also increases in the volume of stocks. This form of relief was accepted at the time as an effective way of doing what was then needed and, in general, has served its purpose very well. It is probably not overgenerous in total, because it has been subject to limitation—at present only stock changes in excess of 15% of total profits qualify for the relief. But with the passage of time the deficiencies of the scheme have become increasingly apparent. In particular, the relief works inequitably as between companies; it gives an incentive to companies to build up stocks artificially; and clawback works as a discouragement to running them down.

[1] The Chancellor's full statement on this question was:

Looking further ahead, however, it is important that the tax system should take account of the effects of inflation on businesses, and do so in a way that is reasonably objective, equitable and simple to administer. The Government will therefore be reviewing this matter along with the accountancy profession's latest proposals for current cost accounting. I am arranging for the Inland Revenue to consult the accountancy profession and business later in the year.

Hansard, Vol. 968, No. 15, Col. 257.

To give such relief the simplest course was to take the total change in value: it was only necessary to subtract the value of stocks held at the beginning of the accounting year from those held at year-end. To separate the volume and price components, an index of price is needed. And the question is: which index—or which indices?

One solution would be that a single agreed general price index should be accepted for the purpose. This would be administratively simple, but it could introduce major distortions. Commodity prices, in particular, clearly do not all move in the same way.

If draconian simplicity is not sought, how much complication can be tolerated—by the Inland Revenue, and by accountants in their audit capacity? The range of price index numbers recently published by the Central Statistical Office might offer a solution. [1] The experience of some countries, notably the United States, suggests that some degree of complication is feasible. The tax authorities there allow, as an option, stock valuation on a last in first out basis—an arrangement which can in some, but not all, cases provide a close approximation to the valuation of stocks at replacement cost. But, as I understand it, valuation, not surprisingly, raises difficulties for firms employing the less sophisticated forms of stock control. This is clearly a practical problem, for which a practical solution should be possible.

The adoption of a cost of sales adjustment on these lines might entail little change in tax revenue over time, though the yield could fluctuate substantially from year to year reflecting the interaction between stock price and stock volume changes. The distributional implications of a cost of sales adjustment could, however, be substantially different from those of the present form of relief, with probably some tendency for manufacturing industry to gain.

Substitution of a cost of sales adjustment in place of the present stock relief could be done on its own, but, perhaps more appropriately, it could be adopted along with adjustments designed to take account of real gains or losses on monetary items in the balance sheet—a subject to which I now turn.

Monetary assets and liabilities

Conventional measures of profit and loss fail to take into account the change in the real value of corporate monetary assets and liabilities as a result of inflation. A company that is a net debtor gains from inflation as its debt diminishes in real terms and, indeed, to the extent that interest includes an element of real debt repayment a company even enjoys tax relief for the latter. The argument is thus that its taxable capacity should be increased by this real gain.

This principle does, however, give rise to a number of difficult questions. If the adjustment for monetary items were limited to a specific category such as the net trade debt or credit position, companies might be induced to switch to other forms of debt, such as overdraft or trade factoring, with the object of avoiding any addition to their taxable profits on account of financial items. This suggests the need for adjustments that cover all financial items, as in the ED24 proposals, for both a monetary working capital adjustment, relating to net trade debtors or creditors, and a gearing adjustment, which takes account of other elements in a company's debt.

While there might be convenience for tax and other purposes in combining the monetary and gearing adjustments, acknowledgement of a separate monetary working capital adjustment has special relevance for the tax treatment of financial companies, in particular the banks. In a position which is the reverse of that of most other companies, the banks hold net monetary assets, broadly the counterpart of free capital. This free capital, or capital base, needs to be maintained in real terms, but under present arrangements, corporation tax is payable on the surpluses which are required in a period of inflation to top up the capital base in nominal terms. In consequence, the banks have unavoidably had to apply part of their post-tax profit to the maintenance of their existing volume of business, rather than to increasing it. These considerations appear to strengthen the case for seeking to introduce something close to a monetary working capital adjustment in the tax system. This would to some extent diminish the inducement to financial companies to engage in leasing business.

Whether this would in time lead to tighter conditions in the leasing market would depend also on developments on the demand side, in particular the evolving state of corporate profitability.

It is plainly relevant to consider what might be the possible overall and distributional effects of the introduction into the tax system of adjustments for stock appreciation and monetary items. The study being undertaken by the Inland Revenue, with which the Bank is associated, is beginning to suggest that a cost of sales adjustment alone could be somewhat more generous to the corporate sector than the present stock relief, in particular because the net benefit from stock relief is limited by the 15% profit rule. If, however, the cost of sales adjustment were complemented by monetary working capital and gearing adjustments on the lines that I have discussed, there might be a modest fall in tax relief to the corporate sector. On the basis of recent experience, tax relief associated with stock holding would be most reduced for wholesalers and retailers, who have enjoyed relative benefit under the present stock relief scheme. In contrast, there might be little or no change in respect of manufacturing industry, whereas erosion of the capital position of financial companies, on this account, would be avoided.

The tax treatment of capital depreciation

I turn next to the treatment of depreciation on

[2] Central Statistical Office, *Price index numbers for Current Cost Accounting* (HM Stationery Office, August 1979).

fixed-capital assets. The issues here appear more complex, and a solution may take longer to achieve.

Let me first summarise the present position. For investment in plant and machinery, the availability of 100% first-year allowances comes fairly close, in broad effect, to meeting the call for replacement cost depreciation. For other forms of investment, the present system of allowances is less favourable. Industrial buildings are eligible for 50% first-year allowances and agricultural buildings and hotels for 20%, the balance in each case being allowed in annual allowances based on historic cost. For commercial buildings no tax allowances are available; for the moment I set aside this question.

One possibility, which has undoubted conceptual attraction, would be to abolish the system of initial allowances, and substitute for it annual allowances reflecting not the historic cost of the equipment, but the current replacement cost—as in ED24. This would raise practical problems, for example as regards the price indices to be used in calculating replacement costs—problems similar in principle to those arising in the case of stock valuation which I have already discussed.

Although this approach is unlikely, at the end of the day, to have a significant effect on the degree of tax relief currently available, in the early years of transition relief would be sharply reduced, creating cash problems for companies, especially manufacturing companies. Unless some way could be found round this difficulty, this approach would, I think, have to be ruled out as not being practicable, especially in the present circumstances of industry.

A second possibility would be to generalise the availability of 100% initial allowances. In contrast, this would involve a substantial loss of revenue in the early years of the transition or, looked at from the other side, a heavy injection of cash, with the larger part probably benefiting non-manufacturing. It seems questionable whether this solution could be contemplated.

A third possibility could be to retain the present first-year depreciation allowances but, for assets not eligible for 100% first-year allowances, to adjust the residual element of depreciation after the first year so that it reflected the current replacement cost. Apart from enabling firms to provide for the replacement of assets adequately, this approach would preserve the present element of tax incentive for investment in fixed assets. Subject to one exception, to which I refer later, this third possibility would be much more modest in scale and would entail a relatively small increase in tax relief associated with depreciation charges, and thus a small loss of tax revenue. Most industrial firms would benefit; but firms with a high proportion of plant and machinery among their assets would benefit least. The important exception is, however, the treatment of motor cars. To include them would involve very considerable cost and it seems hard to think that they would not require special rules.

There remains the question of commercial buildings for which no capital allowances are at present available. Taken in isolation, a change here (if thought desirable) could be expensive in terms of revenue. It would, however, seem appropriate that if such a change were to be contemplated it would have to be considered along with possible changes in the tax treatment of real gains or losses arising from monetary items, so that the high cost to the Exchequer would be mitigated. But this raises particularly thorny questions about the scope and coverage of the gearing adjustment to which I referred earlier.

Recapitulation

It is clear that there are many problems to be resolved. I would not be so bold as to claim as yet to see a way through them.

At the present stage of the debate it is plainly impossible to give reliable estimates of how different sectors of the economy might stand to be affected. We are likely, however, to have to live within certain limitations; and these may be fairly compelling. The total taxation of business may, I have suggested, have to stay much at its present level: for the public purse may not easily be able to afford less, nor companies more. It is difficult to think that manufacturing business, in particular, should be asked to pay more. These are tests which, I think, changes in the structure of business taxation will be likely to have to pass. Furthermore, it will be necessary to think carefully about the distributional effects amongst sectors of business of any proposed changes.

Conclusions

Let me now try to attempt some summary of what I have sought to argue.

The second part of my address has been about taxation. Let me first refer back to what I said in the first part, which was concerned with inflation accounting. For the many reasons I invoked earlier, it is clearly desirable that inflation-adjusted accounts should replace historic cost accounts in all discussion of company profits. The test will be when the press ceases to report the latter, or at least relegates them to the small print, and gives the headlines to the inflation-adjusted figures. Now that we seem so near to agreement about the basis for inflation accounting, I hope that, after the long and necessary debate of these complex issues, we shall move swiftly from the age of debate to the age of implementation.

The hope that agreement is near on inflation accounting makes it a logical next step to examine the implications for the tax system. But there is a reverse connexion. The adoption for tax purposes of principles similar to those advocated for accounting might greatly concentrate attention on how best to apply these principles and hasten the day when they were universal for accounting purposes.

The debate on the inflation adjustment of business taxation is less far advanced; and I have sought rather to single out the main issues than present you with conclusions of my own.

The present system was not designed for inflationary circumstances and, though it has to some extent been modified in this respect, it has become, in detail, unfair and inefficient. My aim has been to indicate the directions in which it may need to be changed.

Though the present tax system originates in historic cost conventions, the modifications to that principle already incorporated in it have, as I have argued, gone a long way in the direction of inflation adjustment. Consequently, the further adjustments that may be called for ought not to be expensive in terms of tax revenue. To ensure that this will be the case is, I am sure, a limiting constraint on what can be done. The expectation that it need not be expensive in revenue terms gives hope that a set of proposals can be worked out which will prove to be acceptable on broad economic and political grounds.

The elaboration of a full set of proposals will no doubt take time. But it may be that a partial reform will be possible more quickly. The most obvious candidate for early change is perhaps the present tax treatment of relief in respect of changes in stocks. If an early change could be made here, it would be desirable for this to be accompanied by the adoption of monetary adjustments as advocated for reporting purposes by the accountants. This would also open up the possibility of providing tax relief on working capital employed by financial companies and, in particular, banks, for which in my view a good case has been made.

I am conscious of having touched on only some limited aspects of taxation. It seemed best to restrict my remarks to the taxation of business enterprises. Somewhat similar issues, however, arise, for example, with respect to personal taxation. But that would be to open up further wide areas of discussion which I eschew tonight in the confidence that they will claim the attention of future speakers in this series of lectures.