TREASURY

FILE BEGINS 8/7/87 ENDS 11/1/88

PO -CH /NL/0007

PART A

CHEVENING 1988

FOR DISPOSAL ADVICE SEE INSIDE COVER

DISPOSAL DIRECTIONS	DATE	SIGNATURE
DESTROY AFTER 25 YEARS	8/11/93	[illegible]
PRESERVE		

PO -CH /NL/0007

PART A

[...]ATION USE ONLY

REFER TO	DATE	REFER TO	DATE
PA(15/7/87) PAR	8/11/93		

ps/3A UNCLASSIFIED

pups

FROM: A C S ALLAN
DATE: 8 July 1987

PS/CHIEF SECRETARY

cc PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr F E R Butler
Mr Cassell
Mr Scholar
Mr Cropper
Mr Tyrie

Mr Battishill - IR
Sir A Fraser - C&E

CHEVENING: 1988

The Chancellor would once again like to hold a pre-Budget house party at Chevening in early January. The most likely weekend is 9-10 January, the equivalent date to last year. I understand Sir Geoffrey Howe would be content with this.

2. Before we go firm, does anyone want to make a strong representation for a different weekend? If so, they should do so without delay.

ACSA

A C S ALLAN

To Allan

Fine by me. There should be no clash with cricket matches then!

J

3758/012

pup

ECONOMIC SECRETARY TO THE TREASURY

FROM: P D P BARNES
DATE: 9 July 1987

PS/CHANCELLOR

CHEVENING : 1988

The Economic Secretary has seen your minute to the Chief Secretary of 8 July. The Economic Secretary has no objection to 9-10 January.

PB

P D P BARNES
Private Secretary

RA7.34

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

15 July 1987

The Rt. Hon. Sir Geoffrey Howe QC MP
Secretary of State for Foreign & Commonwealth Affairs

Dear Geoffrey

I understand that our offices have been in touch and that you have agreed once again to make Chevening available in January for what has become the traditional Treasury pre-Budget weekend meeting. I am most grateful.

I gather that 9-10 January is mutually convenient; my office will be in touch with yours later on about numbers and precise timings.

Last year we only just managed to avoid being snowed in for a week. I hope that we will not impose on your generous hospitality longer than planned this year!

Yours

Nigel

NIGEL LAWSON

ps2/2M RESTRICTED

pnp

FROM: MISS M P WALLACE
DATE: 4 January 1988

NL/7
PT.A.

MISS E A CLARKE cc Mrs Morrison

CHEVENING: SATURDAY 9 - SUNDAY 10 JANUARY 1988

The Chancellor has seen your minute of 21 December. He is content with the table plans, subject to one amendment - swapping Mrs Lilley and Mrs Call at Table 1 for Saturday dinner.

MPW

MOIRA WALLACE

APS

Mr Monks: I agree with your comments. However, the PX argument works in the opposite direction. Colleagues will not want to reverse a large tax cut in order to finance higher PX, but they will be as loth to reverse a PSBR surplus. NL

FROM: A C S ALLAN
DATE: 5 JANUARY 1988

1. ~~Jonathan~~
2. ~~Moira~~
3. ~~Andrew~~
4. pmp.

CHANCELLOR

PCC DISCUSSION OF TERRY'S CHEVENING PAPER

Terry introduced his paper along lines with which you will be familiar. He said the conclusion reached in the paper was that the prospect presented seemed satisfactory, though there were some worries about the current account deficit. If this created financing difficulties, then we should have to be ready to raise interest rates.

2. The point he made which drew most attention was the changes in the pattern of public and private savings and sectoral balances (charts attached for ease of reference). He highlighted two points: first, whether the private sector savings ratio was displaying cyclical or secular trends - ie would it rebound or would it continue to fall; and second, whether we really were seeing crowding in - which would imply it was not very attractive to keep cutting the PSBR if the only consequence was further cuts in the private sector savings ratio. He doubted whether any such precise relationship existed, but noted that the role of fiscal policy was less clear now that demand seemed largely driven by private sector behaviour.

3. Ian Byatt was mildly pessimistic: he thought some slowdown was inevitable and that the fiscal position was cyclically favourable and would deteriorate. He therefore favoured caution on fiscal policy in anticipation of this. He recognised the difficulties of arguing for a large PSBR surplus, but noted that the (cash-based) PSBR did not take full account of growing public sector pension liabilities.

4. Nick Monck was primarily worried about the effect on industry if the exchange rate went through 3DM. He was concerned that taking too much of the strain on interest rates might imply this happening, so he tended towards tightening fiscal policy to diminish this risk.

5. Michael Scholar generally agreed with the propositions in the paper: he thought it would be dangerous to make a substantial cut in tax as a proportion of GDP, but could see no reason why the ratio should increase.

6. Peter Kemp thought Ian Byatt's point about lurking under-funding of pensions had wider applications: there were other areas, such as infrastructure spending, where the Treasury's cash approach concealed underlying pressures that were building up. He also thought we would face problems over the lack of opportunity we were giving people to spend rising incomes on additional health care, education etc, instead of Japanese videos. He thought there would inevitably have to be some give in public expenditure plans eventually, and so favoured being very cautious on fiscal policy now, so as to provide a reserve against that contingency. He also commented that the papers paid only lip service to the objective of eliminating inflation, and seemed to regard five per cent as acceptable.

7. John Anson saw risks on public expenditure, but thought it was hard to see how we could justify an even tighter PSBR. The forecast had allowed for some increases in public expenditure, mainly on wages but with some volume increases. He thought there would eventually be strong pressure to uprate pensions etc. by earnings rather than prices, though this was not likely until nearer the next election. He felt the paper had the balance about right.

8. Tony Wilson was concerned about the security of the buoyant revenue forecasts, particularly inasmuch as they relied on a continuing large contribution from the City. He thought that

with the sharply reduced level of activity there, the income generated from CT, stamp duty and CGT would be sharply lower.

9. Stephen Davies (who was sitting in on PCC as a major contributor to the paper) commented that it was possible that 3DM was too good a rate for industry: unemployment was falling very fast, and there were signs of overheating. He thought we might need a higher deutschemark exchange rate eventually. Peter Sedgwick said he had some worries about the fiscal position: the effective rate of CT might not continue to rise as forecast, and CGT receipts would be hit by the stock market fall. He felt that if we combined a large tax cut and a large cut in borrowing in 1988-89 we might not be able to sustain both in the following year.

10. Geoff Littler said he had some queasiness about whether the prospect could continue to be so good, but no additional points to make. Anne Mueller made no comment.

11. Peter Middleton noted that no-one had expressed great concern about the current account deficit and how it might be financed. He thought the main reason for this lack of concern was the fact that the PSBR was in surplus (ie the traditional PCC response had been removed!). In general, he thought the combination of a PSBR excluding privatisation proceeds in rough balance, and unchanged effective tax rates presented a sustainable position, though he thought this made it all the more important to look at the supply side effects of the tax package. He repeated the view he has expressed several times earlier that having tied ourselves to the deutschemark we should stick with it through thick and thin. He would not want a larger tax package than suggested in the paper: it was already twice as large as anything done before, and anything bigger would create great difficulties for public expenditure control.

not true! (see 87s a b years)

quite NL 21.vi.16

12. Terry was given the last word. He took Stephen Davies' point that the DM/£ rate was extremely favourable for industry, but thought that this was sustainable because it was offset by

such a high $/£ rate. The critical point on the tax package was that since the magnitude would be so big we must be seen to be making good use of the money: he had some sympathy with the arguments that with increasing incomes we were denying people the opportunity to spend more on health and education, but thought that this was a once-for-all opportunity for tax reform.

Comment

13. All-in-all a pretty low-key discussion. Peter was clearly a bit surprised by the lack of concern about the current account, but I think rightly surmised it was because nobody knew what to do about it anyway. The inevitable arguments for fiscal caution have clearly now shifted ground towards the perceived pent-up demand for extra public spending. It will be important to stop this permeating Treasury thinking too far and conditioning a defeatist attitude to the next Survey.

14. It seems to me that the crucial thing is to find safety-valves to satisfy some of the additional demand, in particular for health care, without being forced down the route of simply increasing aggregate provision from central government, financed by higher taxes. This is the familiar cliff-edge: either totally free public care or wholly private treatment - no ability to top-up or buy additional care on top of the basic state service. The Prime Minister has a meeting on health now fixed for 25 January and we shall set up a briefing meeting well before that to discuss what line you and the Chief Secretary might want to take.

A C S ALLAN

EXTRACT

need for gilt sales to finance redemptions. Even after allowing for privatisation the PSBR is in broad balance. However there are some unusual features in the behaviour of the private sector.

53. It is interesting to examine recent and projected behaviour of the budget deficit, domestic private sector savings and the current account (as a proxy for the flow of overseas capital) in recent years. Further details are presented in each of the Annexes.

CHART 4

PRIVATE SAVINGS AND INVESTMENT

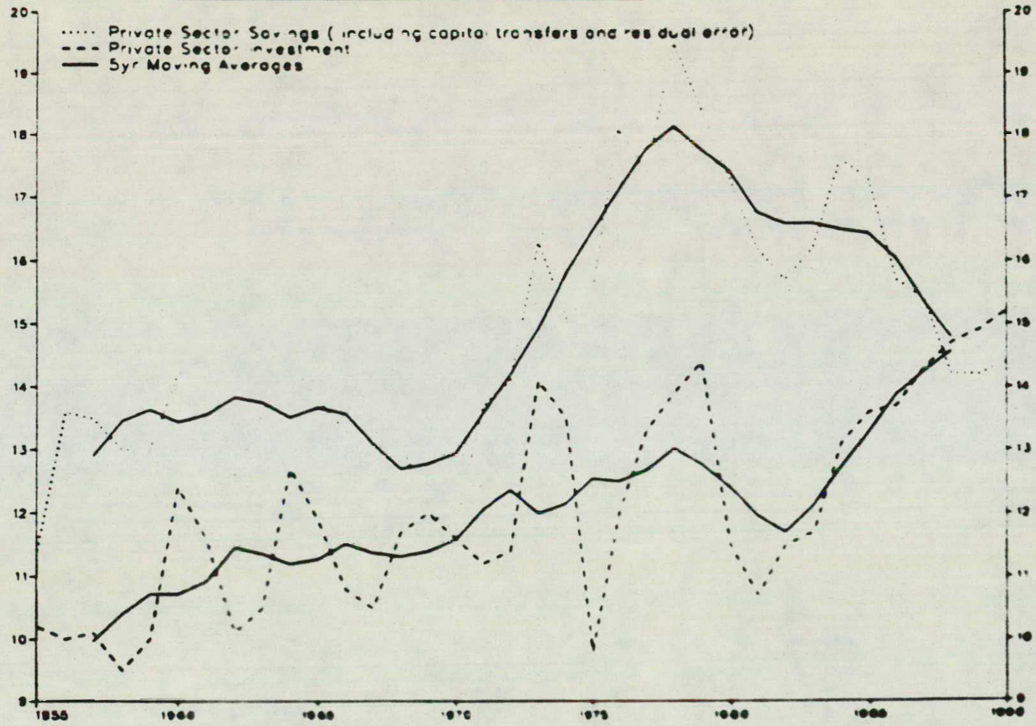
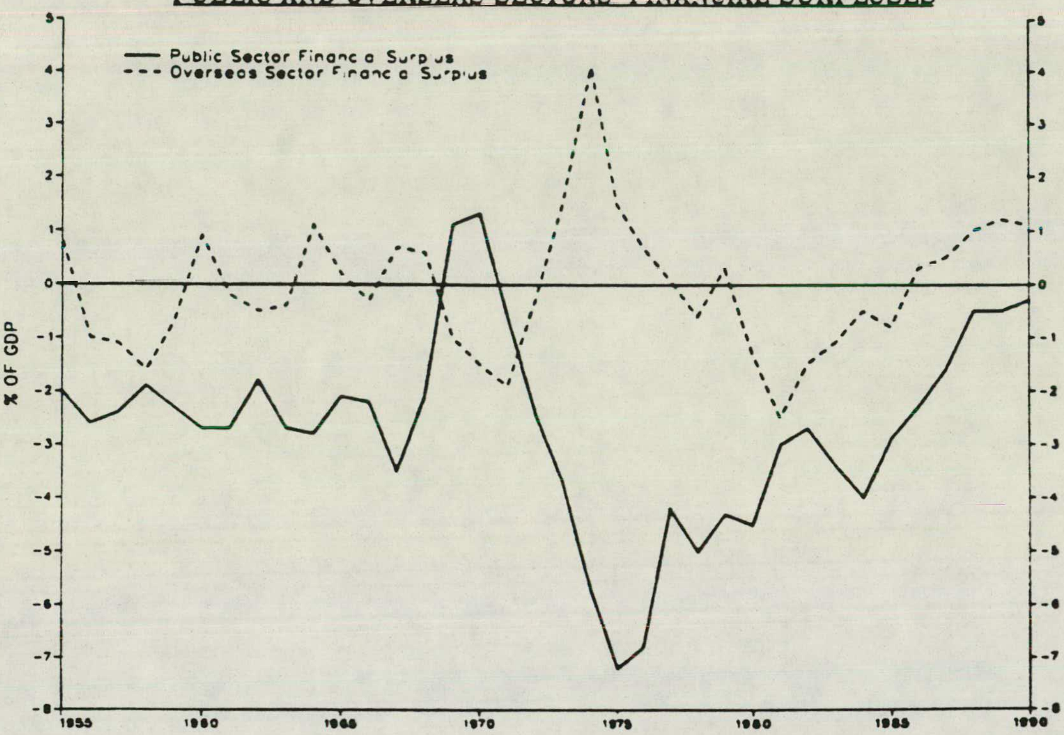


CHART 5

PUBLIC AND OVERSEAS SECTORS' FINANCIAL SURPLUSES



54. During the 1970s private sector savings rose as a ratio of GDP (Chart 4). We would associate this with the rise in inflation: individuals saved more of their current income to try and make good the erosion of existing savings by inflation. Since the late 1970s the figures suggest that the private sector savings ratio has been on a falling trend. As with the rise in the ratio, we would associate much of the fall with the decline of inflation. In addition there may have been some other temporary factors at work, which may continue to depress savings over the medium term, including pension contribution "holidays" and the effect of financial liberalisation. At the same time the ratio of private sector investment to GDP has been on a rising trend. Much of this is accounted for by the transfer of investment from the public sector (particularly housing and the privatisation programme).

RESTRICTED

~~584 4296~~

From: MISS E A CLARKE

Date: 6 January 1988

CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Paymaster General
Sir Peter Middleton
Sir Geoffrey Littler
Sir Terence Burns
Mr Anson
Mr Odling-Smee
Mr Scholar
Mr Culpin
Mr Cropper
Mr Tyrie
Mr Call
Mr Allan

Mr Battishill) IR
Mr Mace)
Mr Unwin) C&E

CHEVENING: SATURDAY 9 - SUNDAY 10 JANUARY 1988

... I attach the programme for Chevening.

2. Dress for the weekend is informal, with lounge suits for dinner on Saturday evening.

3. I attach my minute of 10 December 1987 which contains Christian names, for ease of reference.

EA Clarke

MISS E A CLARKE
Assistant Private Secretary

CONFIDENTIAL

From: MISS E A CLARKE

Date: 10 December 1987

MR A C S ALLAN

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Paymaster General
Sir Peter Middleton
Sir Geoffrey Littler
Sir Terence Burns
Mr Anson
Mr Odling-Smee
Mr Scholar
Mr Culpin
Mr Cropper
Mr Tyrie
Mr Call

Mr Battishill) IR
Mr Mace)
Mr Unwin) C&E
Mrs Morrison) FCO

CHEVENING: SATURDAY 9 - SUNDAY 10 JANUARY 1988

Below is a list of acceptances for Chevening:

Chancellor of the Exchequer (Nigel Lawson)	and	Mrs Lawson (Thérèse)
Chief Secretary (The Rt Hon John Major)	and	Mrs Major (Norma)
Financial Secretary (The Rt Hon Norman Lamont)	and	Mrs Lamont (Rosemary)
Economic Secretary (Peter Lilley)	and	Mrs Lilley (Gail)
Paymaster General (The Hon Peter Brooke)		
Sir Peter Middleton		
Sir Geoffrey Littler	and	Lady Littler (Shirley)
Sir Terence Burns	and	Lady Burns (Anne)
John Anson	and	~~Mrs Anson (Myrica)~~ Can't come

CONFIDENTIAL

Michael Scholar	and	Mrs Scholar (Angela)
Alex Allan		
Robert Culpin		
Peter Cropper		
Andrew Tyrie		
Mark Call	and	Mrs Call (Francoise)
✓ Tony Battishill	and	Mrs Battishill (IR) (Heather)
✓ Brian Mace (IR)		

<u>**Saturday only**</u>

Brian Unwin	and	Mrs Unwin (C&E) (lunch and dinner) (Diana)
John Odling-Smee	(Saturday morning and Saturday lunch).	

2. Please could recipients of this minute check this minute carefully for any mistakes in Christian names etc.

3. Also please could I ask at the same time for the registration number, colour and make of car you will be taking to Chevening; and to indicate whether you will be driving yourself or driven there by a Government driver; also if by Government driver could you let me know if they would like to have the buffet lunch at Chevening on Sunday 10 January.

4. The Saturday morning meeting at Chevening starts at 10.45 am and the weekend ends after lunch on Sunday (2 pm approximately). A programme will be circulated nearer the time.

5. Perhaps I could remind those bringing wives and who are staying overnight for their cheques for £30 made payable to HM Treasury.

EA Clarke

MISS E A CLARKE
Assistant Private Secretary

RESTRICTED

pvp

From: MISS E A CLARKE

Date: 6 January 1988

CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Paymaster General
Sir Peter Middleton
Sir Geoffrey Littler
Sir Terence Burns
Mr Anson
Mr Odling-Smee
Mr Scholar
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EA Clarke

MISS E A CLARKE
Assistant Private Secretary

83/1.

CONFIDENTIAL

From: MISS E A CLARKE

Date: 10 December 1987

MR A C S ALLAN

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Paymaster General
Sir Peter Middleton
Sir Geoffrey Littler
Sir Terence Burns
Mr Anson
Mr Odling-Smee
Mr Scholar
Mr Culpin
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EA Clarke

MISS E A CLARKE
Assistant Private Secretary

pup

FROM: **P N SEDGWICK**
DATE: 7 JANUARY 1988

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Anson
Sir T Burns
Sir G Littler
Mr Scholar
Mr Culpin
Mr Evans
Mr Odling-Smee
Mr Peretz
Mr Turnbull
Mr Bottrill
Mr Hibberd
Mr Matthews
Mr Mowl
Mr A Allan
Mr Hudson
Mr Cropper
Mr Tyrie
Mr Call

Mr Battishill I/R
Mr Unwin C & E

PAPER ON RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS FOR CHEVENING

I attach a paper that summarises the provisional conclusions that we have reached in the current forecasting exercise. Some of the judgements could change significantly by the time we report to you on January 22.

P.N.S

P N SEDGWICK

ECONOMIC PROSPECTS

The principal uncertainty is the effect on the domestic and world economy of the recent turmoil in world securities and foreign exchange markets. This note considers the evidence that has become available since the Autumn Statement forecast (itself completed within ten days of the initial stock market crash on October 19). A final section considers recent developments in and prospects for the UK's public finances.

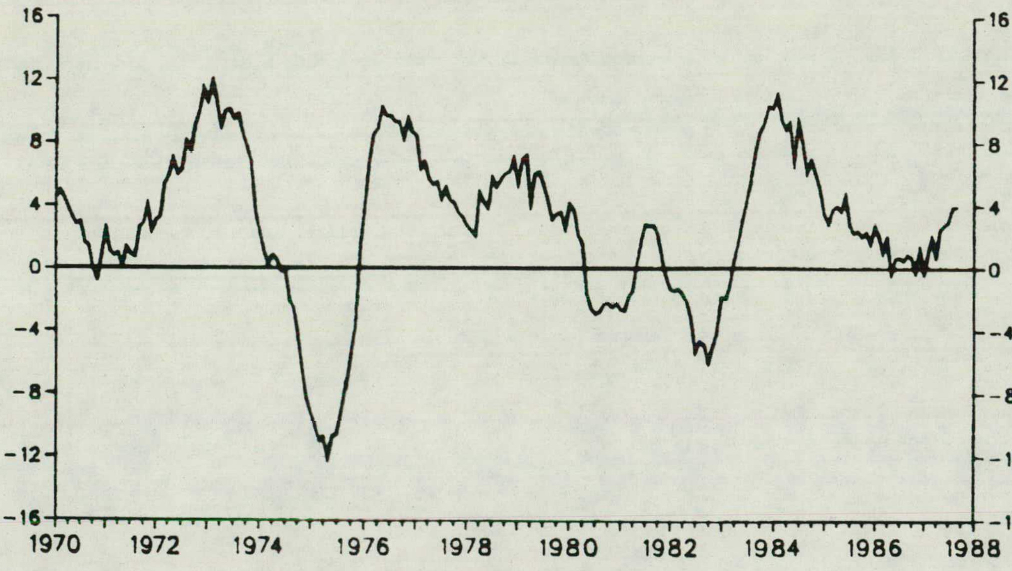
(1) THE WORLD ECONOMY

Recent developments

<u>Activity and demand</u>

1.1 Although there is little information relating to the behaviour of demand since the stock market crash there is considerable evidence that activity in the major countries in 1987 was stronger than perceived at the time of the Autumn Statement. The rather higher than previously expected growth of G5 GNP has been helped by a recovery in the volume of net exports to the rest of the world that compensated for some slowdown in domestic demand. (See Table 1.) Industrial production, which tends to respond to trade performance, has been growing particularly strongly, especially in the US and Japan, and for the G5 as a whole was over 4 per cent higher in October than a year earlier.

CHART A: G5 INDUSTRIAL PRODUCTION



PERCENTAGE CHANGE OVER YEAR EARLIER

Table 1: Growth of real expenditure in the G5 countries

	Private Consumption	Investment	Government Expenditure	Domestic* Demand	Exports	Imports	Real GNP
			Annual percentage change				
1983	3.6	3.2	1.4	3.5	0.3	3.4	2.9
1984	3.4	8.1	3.2	5.5	9.5	12.9	4.9
1985	3.6	4.2	4.6	3.2	3.2	3.3	3.2
1986	4.1	3.2	3.4	3.9	0.5	7.3	2.7
			Change from four quarters earlier (per cent)				
1986 Q1	3.7	3.8	3.5	3.9	-0.4	4.3	3.0
Q2	4.4	3.5	4.1	4.5	-0.6	7.9	3.0
Q3	4.3	2.8	2.7	3.9	1.3	9.4	2.4
Q4	3.8	2.7	3.5+	3.4	1.8	7.5	2.4
1987 Q1	3.1	1.7	2.6	3.1	3.2	6.5	2.5
Q2	2.6	2.7	1.9	2.5	4.0	5.1	2.3
Q3	2.4	5.5	2.2	3.1	7.0	6.3	3.2
			Indices (1980=100)				
1986 Q1	116.4	112.9	114.8	116.1	115.3	122.8	114.8
Q2	118.1	114.3	116.4	117.8	116.1	128.7	115.6
Q3	119.8	115.1	117.4	118.9	117.0	132.1	116.2
Q4	119.8	116.7	120.2+	119.2	118.1	132.2	116.8
1987 Q1	120.1	114.8	117.7	119.7	119.1	130.8	117.7
Q2	121.1	117.4	118.6	120.8	120.7	135.4	118.3
Q3	122.7	121.4	120.0	122.6	125.1	140.5	119.9

* Including stockbuilding

\+ Inflated by Japanese Government's issue of commemorative medals.

World trade

1.2 Although little information is available for the second half of the year it appears that total world trade, like G5 activity, grew faster in 1987 than expected at the time of the Autumn Statement. OECD countries' imports have grown slightly faster than expected, and non-OPEC developing countries imports appear to have been quite strong. The available scraps of information on total world trade in manufactures suggest that it grew strongly in 1987 - by approximately by 4¾ per cent following weak growth in 1986.

1.3 Table 2 compares our latest view of 1987 with earlier forecasts.

TABLE 2 : FORECASTS OF ACTIVITY AND TRADE IN 1987

	FSBR	June Internal Forecast	Autumn Statement	Latest Estimate
Major 7 Real GNP	2½	2½	2½	2¾-3
Total World trade in goods	3½	3	3½	3¾-4
World trade in manufactures	4	4	3¾	4½-5

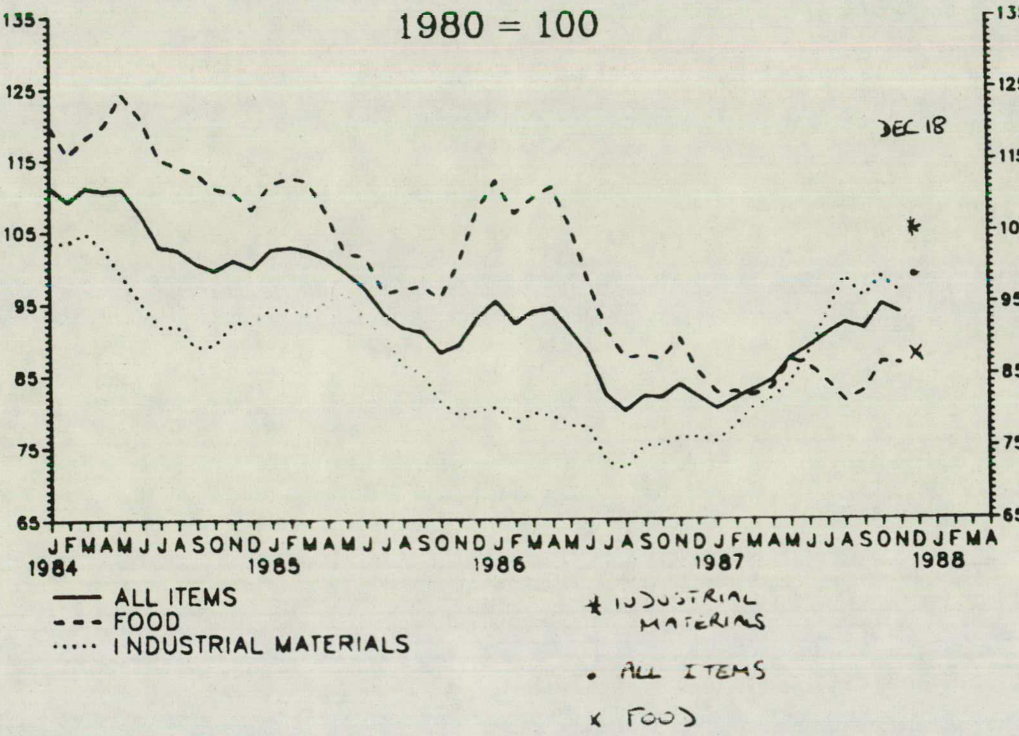
Current accounts

1.4 The composition of demand within the G5 has not adjusted to the extent that had been hoped. In the year to the third quarter domestic demand grew by 2.3 per cent in the US, by 4.8 per cent in Japan, but by only 2.2 per cent in Germany. As a result current account imbalances remain large, though there are signs that the Japanese surplus, and to a lesser extent the German surplus, are contracting. The US deficit, of course, remains large even though trade volumes have been adjusting for some time.

Inflation

1.5 As expected consumer price inflation in the G5 has risen from 1 per cent at the start of the year to around 3 per cent in October as the effects of the earlier fall in the oil price dropped out. Reflecting exchange rate movements, inflation in the US has picked up to 4¾ per cent, while in Japan and Germany it remains at or below 1 per cent. Real commodity prices recovered rapidly during the first half of the year, levelled off in the third quarter and, despite the stock market collapse, rose further in the last two months of 1987. Average world oil prices weakened further following the recent OPEC meeting, but have since recovered somewhat.

CHART B : ECONOMIST SDR COMMODITY PRICE INDICES



<u>Exchange rates and interest rates</u>

1.6 Since the Washington meetings in September/October the dollar's exchange rate index has fallen some 8 per cent. Short term interest rates in the US are now 1 per cent lower than on 19 October, German short rates have fallen 1½ per cent over the same period, while Japanese short rates have been unchanged for almost three months, although long rates have fallen.

Prospects

1.7 Prospects for world activity, inflation and trade in 1988 depend crucially on the behaviour of foreign exchange markets and stock markets, and on the continuing policy response to these developments.

1.8 **Fiscal policy** plans for 1988 seem unlikely to change much, if at all. The agreed package to reduce the US Federal deficit by $30 billion in fiscal 1988 is expected to produce a deficit of around $160 billion - slightly <u>above</u> the 1987 outcome. Japanese fiscal policy for 1988-89 was set out in the recent budget. Despite the Government's commitment to maintain public works spending at its 1987-88 level the government deficit is projected to decline between 1987-88 and 1988-89 because of buoyant revenues. Germany will probably do no more than implement the cuts in personal taxes already announced for 1988. The recent package to encourage investment is likely to have only a marginal impact on demand.

1.9 It is harder to assess prospects for **monetary policy**, especially in the US. The current account deficit is unlikely to fall much, if at all in the first half of 1988 (in part due to the J-curve effects of the recent depreciation of the dollar). Attracting the necessary private flows to finance the current account will probably involve a still lower dollar exchange rate, an even higher differential between interest rates in the US and those elsewhere, or some combination of the two. Since the scope for lower interest rates outside the US is limited, this points to a rise in US rates.

1.10 It still seems that the Administration is more concerned to avoid the risk of slowing growth before the Presidential election than about a further fall in the dollar. If the Federal Reserve acquiesces in this approach then a sharp depreciation of the dollar in 1988 could be accompanied by only modest rises in US interest rates. A sharp fall in the dollar during 1988 would, however, at some stage lead to some further tightening of monetary policy and - probably somewhat later - to further action to reduce the Federal deficit. Such policy adjustments could lead to at least a partial reversal of the earlier fall in the dollar exchange rate. The prospect is therefore for prolonged exchange rate instability.

1.11 On the basis of these assumptions our provisional conclusions on prospects for 1988 are set out in Table 3:

TABLE 3 : FORECASTS FOR 1988

	OECD	**Autumn Statement**	**Provisional January WEP**
Major 7 real GNP	2½	2	2-3
Major 7 inflation*	3¼	2¼	3-4
Total world trade	4½	3½	3½-4½
World trade in manufactures	5¼	4	4½-5½

* consumers expenditure deflator

<u>Activity</u>

1.12 Growth of domestic demand and real GNP in the G7 is expected to remain buoyant in the first half of 1988, though both may slow a little. Real GNP may increase by 2½ per cent in 1988 (compared to nearly 3 per cent expected in 1987). Industrial production growth will remain high, due in part to a continued strong net export performance. The stock market collapse is likely to have a perceptible effect on demand in the US, though much weaker effects are expected in other economies. The recent realignment of exchange rates will, cet.par., benefit activity in the US at the expense of other major countries. It is probable that the real exchange rate of the G7 as a whole has appreciated again against the rest of the world, which could dampen activity in their tradeables' sectors.

Inflation

1.13 Consumer price inflation in the US could pick up to almost 6 per cent by the end of 1988. In other countries inflation will be held down by the appreciation of their currencies against the dollar, but G7 inflation could still reach 3½ per cent.

Trade

1.14 Total world trade growth is expected to continue to grow at around 4 per cent in 1988, with trade in manufactures again growing faster.

1.15 This is a more buoyant world economic outlook than presented in the Autumn Statement reflecting the emerging evidence of the strength of activity in 1987 and a less pessimistic view about the confidence effects of lower equity prices on world activity. Should the US authorities raise interest rates earlier and by more than assumed, a less buoyant world economy would be in prospect. At the moment this policy-induced slowdown seems likely to be "postponed" until 1989.

(2) THE UK

Recent developments

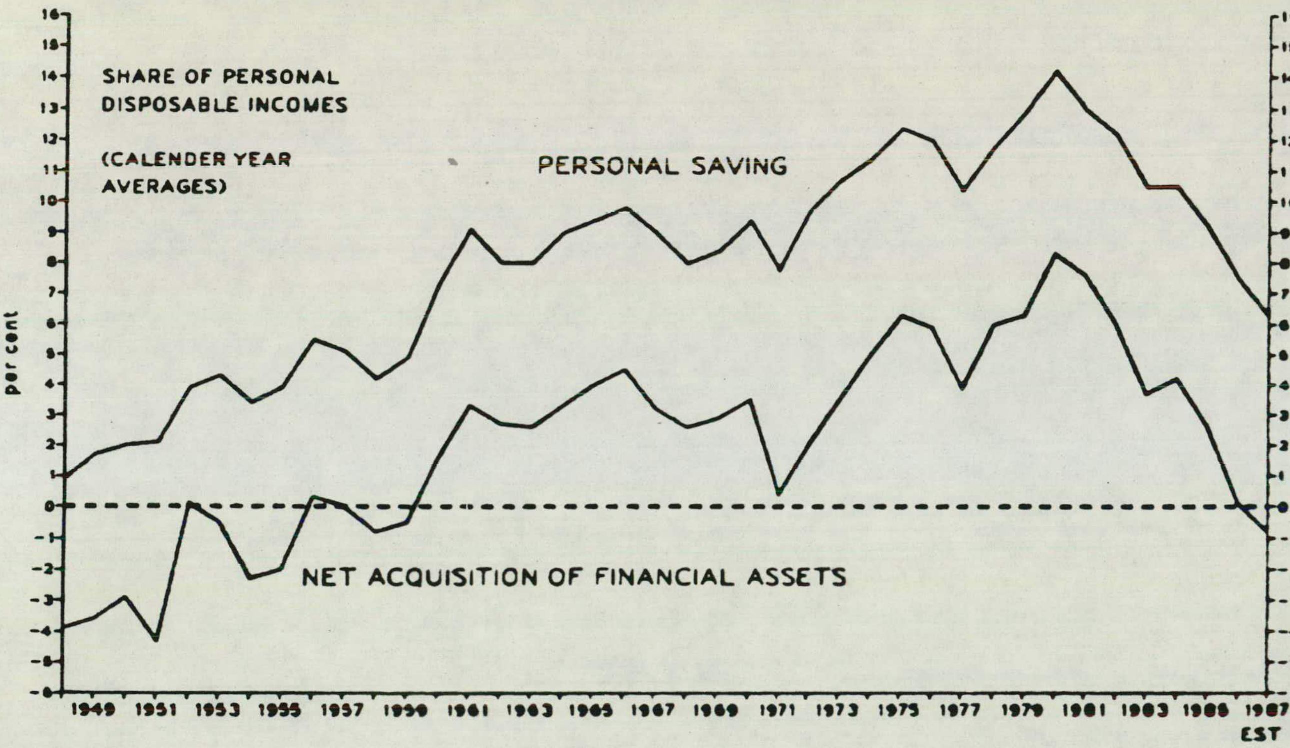
Activity and Domestic Demand

2.1 The three measures of GDP show growth of about 5¼ per cent in the year to 1987Q3. This rare agreement between the measures, however, masks considerable differences in the first half of 1987. The output measure is probably still the most reliable measure of recent short term trends. It shows particularly strong growth in the last year and a half and is consistent with the sharp fall in unemployment.

2.2 The CSO's first estimate of growth in 1987, which is available around budget time, may show growth of 4 per cent. On past experience the CSO are likely to revise up their early estimates of growth and the average measure of GDP in 1987 could eventually show growth above this - perhaps of 4½ per cent or even more. Much of the upward revision is likely to be to the expenditure measure, with investment, stockbuilding and consumption the principal candidates for revision.

2.3 Even though the statisticians have not yet allocated all of recent growth to expenditure categories recorded **consumers' spending** has been growing rapidly, and retail sales in November showed no signs of any slowing down following the stock market crash. The saving ratio has now fallen from 14 to 5 per cent since its peak in 1980. The latest data - which could be revised substantially - shows the personal sector's net acquisition of financial assets to be negative for the first time since the late 1950s.

CHART C : PERSONAL SAVING AND NET ACQUISITION OF FINANCIAL ASSETS



2.4 The latest DTI Investment Intentions Survey (mid-December) suggests that, after falling in 1986, **business investment** picked up in 1987, broadly in line with Autumn Statement projections. Company expenditure on **stocks** showed little growth in the first half of the year and stock-output and stock-sales ratios continued to decline. There was, however, significant stockbuilding during the third quarter of 1987, which probably accounts for a good deal of the surge in imports. Export volumes (partly the result of faster growth in world trade) and import volumes (responding to rapid increases in domestic demand), both rose faster than was expected at the time of the FSBR.

Money GDP

2.5 Following upward revisions to the preliminary data the "undershoot" of money GDP in 1986-87 has disappeared. Money GDP growth in 1987-88 will almost certainly overshoot its value in the 1987 MTFS, mainly as a result of higher than expected growth in real GDP.

Inflation

2.6 Both RPI and producer price inflation for 1987Q4 are turning out very slightly higher than in the Autumn Statement. RPI inflation for the majority of consumer goods appears to have shown a slight upward shift over the past three months (though the recently announced error in the RPI makes it difficult to interpret the November figure). Nevertheless once seasonal factors are accounted for, recent CBI surveys show no sustained rise in the proportion of firms expected to raise prices in the next few months.

Pay

2.7 Pay settlements in manufacturing industry monitored by the Department of Employment fell by about a point in the pay round just concluded. However, manufacturing behaved differently from the rest of the private sector, where the decline was much less pronounced. In both manufacturing and the rest of the private sector there was a discernible upward trend in settlements during the 1986-87 pay round. Overtime working in manufacturing is now at record levels.

The exchange rate and competitiveness

2.8 In spite of the reduction in domestic interest rates and at times heavy intervention the sterling exchange rate has recently been firmer than assumed in the Autumn Statement. The rise in the sterling index during 1987 as a whole has reversed a large part of the exceptionally large competitiveness gain that occurred during 1986, but still leaves UK manufacturers' relative unit labour costs some 7 per cent lower (ie more favourable) than the average of 1984 and 1985.

The current account

2.9 The current account which swung temporarily into small surplus in early 1987, has returned to deficit and for 1987 as a whole the deficit should be close to the £2½ billion in the FSBR and Autumn Statement forecasts. One significant feature has been a lower surplus on invisibles than previously expected, partly reflecting the effect of the pound's appreciation which reduced the sterling value of overseas earnings.

Prospects

TABLE 4: PROSPECTS FOR THE DOMESTIC ECONOMY

	Autumn Statement November 1987	Preliminary View of current forecast
<u>GDP growth</u>		
1987	4	4
1988	2½	2½-3½
<u>Money GDP growth</u>		
1987-88	8½	10
1988-89	7¼	8-10
<u>Current balance, £ billion</u>		
1987	- 2½	- 2½
1988	- 3½	-4 to -6
<u>RPI</u>		
1987) change over previous) year to the fourth	4	4
1988) quarter	4½	3½-4½

<u>Activity</u>

2.10 GDP growth in 1988 could be higher than the 2½ per cent envisaged in the Autumn Statement. **Consumer spending** is expected to rise at about the same rate as in 1987, reflecting a substantial increase in real personal disposable income - partly due to the a large assumed reduction in personal taxes in the 1988 Budget. The latest DTI Investment Intentions Survey suggests that **business investment** is likely to be higher than in the Autumn Statement. There is no sign yet of any serious dent to business confidence as a result of the equity price fall and the effect of higher equity yields on the cost of capital has probably been offset by the fall in interest rates. The balance of investment is expected to shift relative to 1987; manufacturing investment is expected to grow considerably faster than other private non-manufacturing.

<u>Inflation and Pay</u>

2.11 The increase in the RPI over the year to 1988Q4 is likely to be below the 4½ per cent in the Autumn Statement <u>if</u> recent trends in the exchange rate and short term interest rates persist.

<u>The current account</u>

2.12 The UK's recent loss of competitiveness and the prospect of growth continuing to be more rapid than overseas is likely to lead to a further widening of the current account deficit. Any weakening of the oil price would add to this widening. It is probable that the forecast current account deficit for 1988 will be greater than the £3½ billion published in the Autumn Statement.

(3) PUBLIC FINANCES

1987-88

3.1 A first estimate of the CGBR(O) in December is now available (though it will not be published until January 19), showing a considerably larger surplus than had been expected, mainly the result of higher Inland Revenue receipts. (But the provisional figure is more liable to revision in December than in other months.) The first estimate of the LABR and PCBR, and therefore the PSBR as a whole, will not be available until Tuesday, 12 January. At end November central government own account borrowing had accounted for the vast bulk of the PSBR undershoot of the 1987 Budget profile - £4½ billion out of a total £5½ billion. (The undershoot of the budget profile for the CGBR(O) increased further in December.)

TABLE 5 : THE PSBR IN 1987-88 (£ billion)

	Outturns Apr-Nov	Budget Profiles Apr-Nov	1986-87 Outturns Apr-Nov
CGBR(O)	0.6	5.1	7.3
LABR	-0.8	-0.2	-0.7
PCBR	-0.8	-0.5	-0.9
PSBR	-1.1	4.4	5.7

Memo:-	Apr-Dec Outturn	Apr-Dec Budget Profile
CGBR(O)	-0.2	5.5

3.2 Forecasts for 1987-88 as a whole are still subject to significant margins of error. Average errors on the final internal January forecast of the PSBR have, over the last ten years, been equivalent to £1½ billion.

3.3 Our latest estimate of the outturn for the year as a whole is a public sector surplus of £2-3 billion. This assumes privatisation proceeds around £5 billion and a planning total outturn of £147.1 billion. The rest of this section discusses the outturn so far and the forecast for the year in a little more detail.

3.4 At end December the cumulative undershoot on **central government** own account borrowing was £5¾ billion, three quarters of which was accounted for by higher than expected receipts and the other quarter by lower than expected expenditure. On the receipts side:

- North Sea receipts were about £½ billion above profile as a result of the higher than assumed average oil price in 1987.

- The largest single contributor to the revenue overshoot is non-North Sea corporation tax, including ACT, which was around £1 billion above profile and could be about £2 billion above the Budget forecast in 1987-88 as a whole. This overshoot is mainly due to the profits data for 1986 available at Budget time being too low and to higher than expected dividend payments in 1987. The latter generates more ACT (at the expense of mainstream CT later on).

- Income tax and national insurance contributions are above profile due to higher than expected wages and salaries.

- VAT is £½ billion above profile - the main explanation is probably higher than expected consumers'expenditure. Specific duties by contrast are about £¼ billion below profile.

3.5 Table 6 shows the massive changes in the composition of the receipts that have taken place in recent years with large increases in onshore corporation tax and in capital taxes continuing unabated in the current financial year.

TABLE 6

(a) COMPOSITION OF TAX REVENUES, 1983-84 TO 1987-88
(% OF TOTAL TAXES AND NICS)

	1983-84	1984-85	1985-86	1986-87	1987-88 (Forecast)
Income Tax	27	26	26	26	25
Corporation Tax (Non-N.Sea incl. ACT)	4½	5½	6	7½	9½
North Sea Revenues	7½	9½	8	3½	3
VAT	14	15	16	16	16
Capital Taxes & Stamp Duty	2½	2	2½	3	3½
Other Taxes	27	25	24	25	25
NICs	18	18	18	18	18

(b) GROWTH IN TAX REVENUES, 1983-84 TO 1987-88
(% growth on year earlier)

	1983-84	1984-85	1985-86	1986-87	1987-88 (Forecast)
Income Tax	+4	+5	+7½	+7½	+5½
Corporation Tax (Non-N.Sea incl. ACT)	+3½	+24	+22	+34	+39
North Sea Revenues	+12	+37	-5½	-58	-5
VAT	+11	+16	+14	+8½	+11
Capital Taxes & Stamp Duty	+20	-2½	+33	+30	+20
Other Taxes	+2	+1	+4	+10	+7
NICs	+14	+6½	+8½	+8½	+9
Total Taxes & NICs	+7	+9	+8	+5½	+10

3.6 **Central government expenditure** (on a cash basis) is about £1¼ billion, 1¼ per cent, below the profile forecast at Budget time. Our forecast assumes that the underspend in the year as a whole is less than the underspend so far.

3.7 Although the LABR and PCBR are each about £½ billion below profile they are at much the same levels as in the equivalent period in 1986-87. The undershoot on local authority borrowing is probably the result of higher than expected capital receipts. On the public corporations' side BSC, the Post Office, the water authorities and New Towns have all borrowed less than forecast. It is reasonable to assume that the LABR and PCBR outturns for the year as a whole will be in line with those for 1986-87.

Prospects 1988-89 and beyond

3.8 The most recent (October) forecast showed, taking the 1987 MTFS PSBR ratio of 1 per cent of GDP as the starting point, a total fiscal adjustment in 1988-89 of £13½ billion (of which £1 billion was due to an assumed increase in privatisation proceeds). For forecasting purposes it was assumed that one third (£4.2 billion) of the total fiscal adjustment (net of higher privatisation proceeds) was allocated to reducing personal taxes and the remainder to increasing the public sector surplus. There was scope for a further modest tax cut in 1989-90, whilst at the same time maintaining the PSBR at its assumed 1988-89 level.

3.9 There are likely to be a number of changes to the detailed forecasts for public sector flows in 1988-89, but at the moment it does not look as if the total fiscal adjustment will be below the October forecast. North Sea revenues could be lower and the fall in stock market prices and lower turnover will reduce the forecast for Stamp Duty receipts. But profits in 1987 could turn out even higher than expected, which would boost onshore mainstream corporation tax receipts in 1988-89.

3.10 Our figuring for 1989-90 is at a preliminary stage. It is just possible that there could be a small fall in the cumulative fiscal adjustment in that year because some components of revenues could be falling or growing more slowly than in the past. North Sea revenues could continue to decline. The adverse effect of the stock market falls on receipts of capital taxes, which will take a year or so to build up, are likely to be more substantial by then. Finally the growth of profits in 1988 could be a good deal lower than in recent years. The resulting reduction in the growth of onshore corporation tax in 1989-90 could be even more marked if capital investment and dividends - and hence ACT - , which are offsets to liability to mainstream CT in the following year, continue to growth strongly in 1988. These worries on revenues are no more than straws in the wind at the moment. They may indicate, however, that the surge in public sector revenues, which has outstripped all expectations during the last two financial years, may moderate.

748/55

FROM: R I G ALLEN
DATE: 8 JANUARY 1988

CHANCELLOR

Ch
Will try to watch it & report
AA

Noted

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
PCC members
Mr Culpin
Mr Bush
Mr Cropper
Mr Tyrie
Mr Call

CHEVENING

Adam Raphael telephoned me this afternoon to say that BBC TV's "Newsnight" programme will be running a major piece this evening on Chevening and the run-up to the Budget. The feature will be in three sections:

(a) The favourable circumstances surrounding the 1988 Budget: the Government's enthusiasm to carry forward tax reform, the healthy state of the economy and the public finances, the first year of a new term.

(b) The Government's long-term fiscal aims.

(c) The options for Budget 88 in the light of (a) and (b) above.

!?? 2. You will want to watch out for the programme. I gave Raphael some general background on what Chevening was all about - and what it was not about - emphasising that it was a first attempt to put the Budget in its overall economic context, but was not intended to take final decisions either about the overall Budget judgement or, more particularly, about individual Budget measures. In short, it provided a general framework within which the specific decisions could be filled out over the coming weeks.

3. I added that we were still working on the basis of the Autumn Statement forecast, and that a revised forecast - from what now appeared to be a rather stronger 1987 base - would not be ready, even for internal use, for some weeks.

4. I refused to be drawn on tax reform, giving the standard replies on the income tax rates, husband/wife taxation, the taxation of personal savings, mortgage interest relief and extending the VAT base.

5. Several other journalists have been asking me similar questions, including Philip Stephens (FT) and Steve Levinson (Independent). Stories are likely to appear in tomorrow's press.

RA

R I G ALLEN

RESTRICTED

~~A.C.S. Allan~~

pmp

The Chancellor of Exchequer's Informal Seminar

Chevening

9 - 10 January 1988

RESTRICTED

ANNEX D

LIST OF USEFUL TELEPHONE NUMBERS

Treasury	01 270 3000
Chevening House (in the Hall)	(0732) 460 654
Foreign and Commonwealth Conference Officer, Mrs Anne Morrison	(0732) 452 373 or (0732) 460 391

(In the unlikely event that there is no reply on the above numbers, the following number will ring throughout the entire house - (0732) 452 353.)

Police Post	Ext 142
Secretary of the Trustees Captain J D W Husband OBE RN	
Estate Office (Weekdays)	(0732) 454 091
Home	(0732) 453 447
House Manager's Flat Mr Ennis	(0732) 457 925
Kent Constabulary Supt McCaughan	(0622) 654 32 Ext 251, 325, 434

Hospitals

Cottage Hospital Sevenoaks	55155 (5 minutes by car)
Orpington General Orpington	(94) 27050 (15 minutes by car)
Farnborough General Farnborough (Intensive Care)	(94) 53333 (15 minutes by car)

Doctors

Dr W R Drysdale, Eilean Donan, Sevenoaks, Otford	Private:	(93) 23288
	Surgery:	459255
Dr Bakkar, 70 Bradbourne Road, Sevenoaks	Private:	459608
	Surgery:	457070

THE CHANCELLOR OF THE EXCHEQUER'S INFORMAL SEMINAR

CHEVENING: 9-10 JANUARY 1988

1. PROGRAMME

The programme is given at Annex A, together with room allocations. Menus are given at Annex B.

2. TRANSPORT

Transport arrangements for the party will be made by the Private Office.

3. DIRECTIONS

Directions plus map to Chevening House, Kent, are given at Annex C.

4. USEFUL TELEPHONE NUMBERS

Useful telephone numbers are given at Annex D.

5. SECURITY

The Police have a list of all the visitors. Members of the party not arriving in official cars should be prepared to offer some form of identification to the Police Officer on duty at the entrance gate to Chevening House.

6. There are some lovely walks at Chevening and those interested should bring suitable walking shoes or gumboots. The less energetic are advised to bring reading material. For those interested there will be an outing to Ightham Mote on Saturday afternoon. This is an Elizabethan House of some historical note, which has recently been acquired by the National Trust. The Administrator has exceptionally agreed to open the house for our party.

Anne Morrison (Mrs)
Visits Section
Protocol Department

FOREIGN AND COMMONWEALTH OFFICE

ROUTES TO CHEVENING

BY ROAD

The basic rule is to get on to the M25 and to exit at Junction 5, following the detailed instructions under Routes 1 or 3 below. But if you are coming from the East (Maidstone etc) on the M20/M26, there is no exit at Junction 5: you have to take Route 4 below.

ROUTE 1

Get onto M25 Eastbound (towards "SEVENOAKS" and "DARTFORD TUNNEL")
- from West Midlands, Wales & the South West: via M40/M4/M3/A30
- from Heathrow (Terminals 1,2,3): via M4 Westbound
  (Terminal 4): via A3113 and M4 Westbound
- from Gatwick (& the South): via M23 Northbound
- from West, South West, South & Central London:

A316	Chiswick	A3	Putney	A219	Putney	A23	Lambeth
	Twickenham		Kingston bypass		Wimbledon		Croydon
M3	Sunbury	M25	Junction 10	A24	Merton		Purley
M3/M25	Junctions 2/12			A297	Morden		Hooley
				A217	Banstead	M25	Junction 7
					Kingswood		
				M25	Junction 8		

At Junction 5 do not branch left on M25 ("M25 THE NORTH DARTFORD")
- take second exit (400 yards on: "A21 SEVENOAKS HASTINGS")

A - after ½ mile on A21: take first slip road "A25 SEVENOAKS MAIDSTONE"
- after 50 yards on A25 turn sharp left: "CHIPSTEAD ¼ MILE"

B - at Chipstead Post Office, fork left onto Chevening road
- Fly-over motorways, stop at crossroads
- Straight over crossroads: "CHEVENING CHURCH: NO THROUGH ROAD"
- Past Church and police gate, bear left into forecourt.

ROUTE 2 - from South East London:
- A20, Lewisham to Footscray roundabout, 3rd exit to A224, Southbound: "ORPINGTON A224" (Sevenoaks way)

OR - A21, through Lewisham and Bromley, to join A224 (4th exit from roundabout: "BADGERS MOUNT A224 DUNTON GREEN")

C - Continue on A224 to Morants Court Cross roundabout, take 2nd exit: "SUNDRIDGE, WESTERHAM & BRASTED"
- After 1 mile, crossroads, turn right: "CHEVENING CHURCH, NO THROUGH ROAD"
- Past Church and police gate, bear left into forecourt.

ROUTE 3 - through Dartford Tunnel, from North/East of London:
- Follow M25 Southbound
- To Junction 4, take slip road: "BROMLEY A21, ORPINGTON A224"
- After 1 mile on A21, take A224 (first exit from roundabout "BADGERS MOUNT A224 DUNTON GREEN")
- Then as from C in Route 2

OR - To Junction 5, keep right onto A21: "A21 SEVENOAKS HASTINGS"
- Then as from A in Route 1.

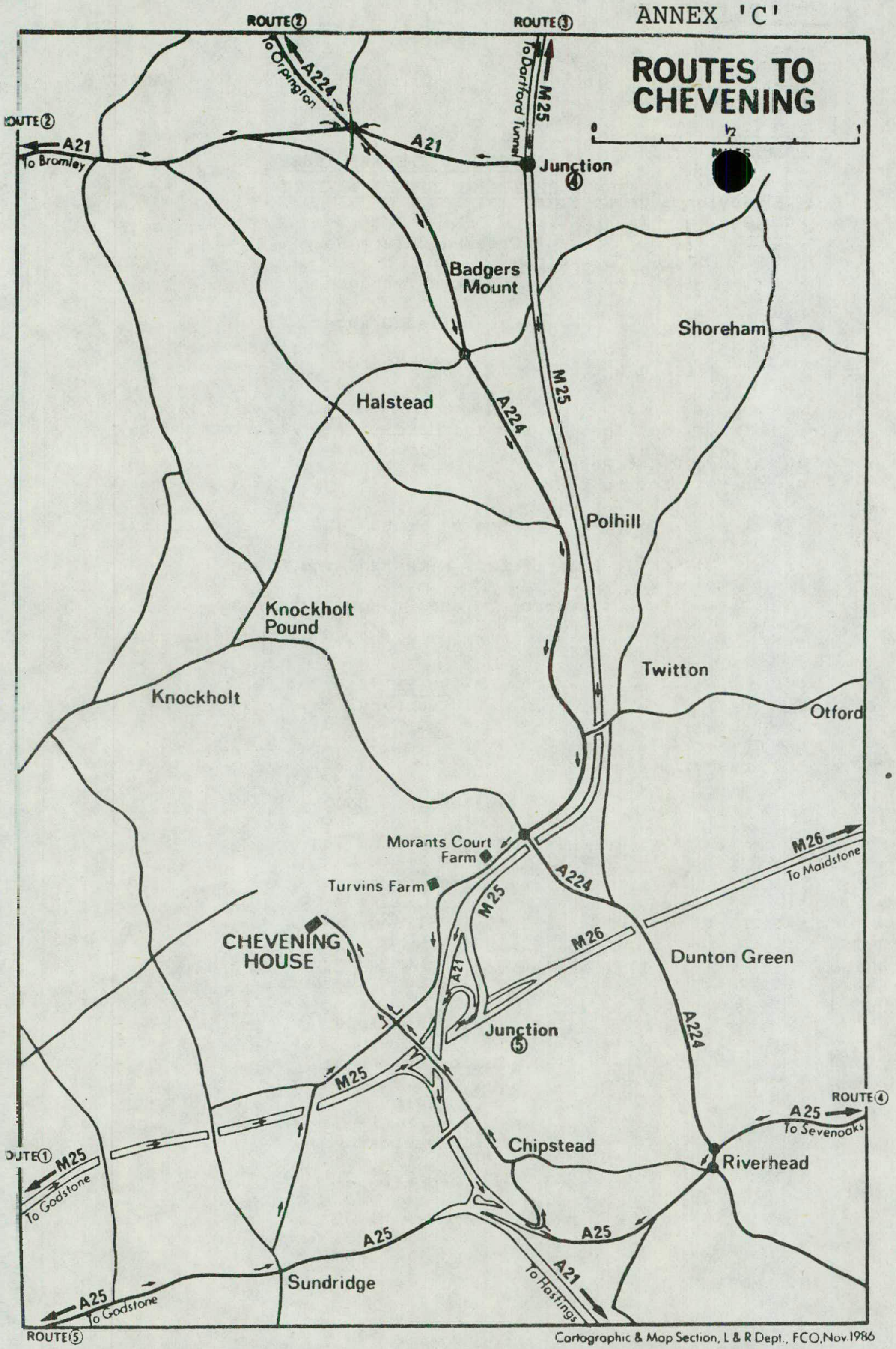
ROUTE 4 - from East (Maidstone etc) on M20/M26:
- leave M26 at Junction 2A on A25 to Sevenoaks
- go through Riverhead, following signs to "A25 WESTERHAM", "A21 HASTINGS"
- 1 mile after Riverhead, turn right: "CHIPSTEAD"
- then as from B in Route 1.

ROUTE 5 - from East Surrey:
- A25 through Westerham, Brasted to traffic lights at Sundridge
- turn left at lights: "CHEVENING"
- Fly-over M25, follow road as it bears to right
- After ½ mile, crossroads, turn left: "CHEVENING CHURCH, NO THROUGH ROAD"
- past Church and police gate, bear left into forecourt.

BY TRAIN

From Charing Cross or Waterloo East to Sevenoaks (35 minutes).
Then by car/taxi to Chevening (10 minutes)

ANNEX 'C'



Cartographic & Map Section, L & R Dept., FCO, Nov 1986

<u>PROGRAMME</u>

ANNEX A

<u>Saturday 9 January</u>

1045	Party arrive Chevening Coffee will be served
1100	Talks in the Library
1245	Drinks will be served in the Drawing Room
1300	Luncheon in the Dining Room/Alcove Room
1430	Talks resume in the Library
1630-1700	Tea will be served in the Drawing Room
1705-1845	Talks continue in the Library
1915	Drinks in the Drawing Room
1945	Dinner

<u>Sunday 10 January</u>

0800-0830	Breakfast in the Dining Room/Alcove Room
0900	Talks in the Library
1030	Coffee will be served in the Library and Drawing Room
1200	Drinks and Buffet Luncheon in the Dining Room
1400 approx	Departure

CHEVENING HOUSE, ROOMS

First Floor	Room Name	Occupant	Ext	Bathroom
	Study Bedroom	The Rt Hon Nigel Lawson and Mrs Lawson	129	Attached
	Yellow Satin	The Rt Hon Norman Lamont and Mrs Lamont	131	Attached
	Red Bedroom	The Rt Hon John Major and Mrs Major	132	Attached
	Chatham	Sir Peter Middleton	128	No 4

(Night line to Sir Peter Middleton's bedroom for Emergency calls only: (0732) 460 470)

Second Floor				
	Pitt Room	The Hon Peter Brooke		No 5
	Centre Bedroom	Mr and Mrs P Lilley	133	No 7
	Dressing Room	Mr Culpin		No 5
	Green Bedroom	Mr and Mrs Battishill	22	Attached
	Don's Room	Sir Geoffrey Littler and Lady Littler		Attached
	Bachelor's Room	Mr Mace	134	No 7
	Minister's Room	Sir Terence and Lady Burns (direct line (0732) 460 541)		No 11

*Traditional Stanhope Room Names have been retained).

Hailsham Apartments Corridor Ext 138

Room 1	Mr Anson	137
Room 2	Mr and Mrs Scholar	
Room 3	Mrs Morrison	
Room 4	Mr Allan	139
Room 5	Mr Cropper	

Cottage No 7

Room 1	Mr and Mrs Call	Room 3
Room 2	Mr Tyrie	Room 4

MORALM

ANNEX B

LUNCH - 9 JANUARY 1988

Sauvignon de St Bris
1984

Creamed Celery Soup

Chicken Tarragon

Caramelled Oranges

Cheeseboard

DINNER

Alsace Pinot Reserve
Chateau Levite 1982

Smoked Trout Paté

Loin of Lamb with Red Wine Sauce

Chocolate and Orange Soufflé

Cheeseboard

BUFFET
(10 January)

Chianti Classico
Frascati-Cesari

Watercress Soup

Cocktail Vol au Vents

Fish Mousse

Cold Sliced Ham

Chicken with Lemon Mayonnaise
Celery, Grapes and Nuts

Various Salads

Raspberry Mousse

Pavlova

Cheeseboard

Coffee

******

MORAMD

RA7.1

BLO REF NO. J 88/2
COPY NO 1 OF 26

FROM: A C S ALLAN
DATE: 11 January 1988

CHANCELLOR
CHIEF SECRETARY
FINANCIAL SECRETARY
PAYMASTER GENERAL
ECONOMIC SECRETARY
SIR P MIDDLETON
SIR T BURNS
SIR G LITTLER
MR ANSON
MR SCHOLAR
MR CULPIN
MR ODLING-SMEE
MR CROPPER
MR TYRIE
MR CALL
MR BATTISHILL - IR
MR MACE - IR
MR UNWIN - C&E

CHEVENING: 9-10 JANUARY 1988

... I attach a note of the main conclusions reached during the weekend discussions at Chevening. As in previous years, it is primarily confined to the decisions reached, and does not aim to be a blow-by-blow account of the discussions.

2. Disclosure of the decisions reached at Chevening is subject to the rules set out in the Budget security instructions which were circulated recently.

ACSA

A C S ALLAN

CHEVENING: 9 - 10 JANUARY 1988

This minute records the main points emerging from the weekend's discussions.

Policy background

2. Sir T Burns introduced his paper. The most likely prospect was that the world economy would remain strong through 1988, softening of its own accord as we entered 1989, with the risk that a policy-induced cycle in the US would exaggerate these movements. But it was possible - and indeed might be desirable - that the financial markets might force the US authorities into earlier action.

3. In the UK, the uncertainties related primarily to private sector behaviour. It was hard to explain why the savings ratio had fallen as much as it had, though low inflation, deregulation, and expectations of continued growth played important parts. But the very large residual errors in the national accounts made interpretation of the position difficult.

4. In discussion, the following points were made:

(i) It looked desirable for there to be some tightening of monetary conditions, if the exchange rate allowed that.

(ii) While there might be in theory be some inconsistencies in having both an exchange rate target and an MO target, in practice this did not seem a problem.

(iii) While this might not be a year in which we could reduce the tax burden, there did not seem to be any justification at all for increasing it.

(iv) Even though there might be some worries about parts of the revenue forecasts, it was hard to believe that there would a large drop-off in CT receipts.

5. It was not necessary to set a precise target for the PSBR at this time. The fiscal position was very strong. There were arguments for caution on the PSBR: revenues were cyclically very strong, and there were uncertainties about private sector savings behaviour. But it would be undesirable to overdo caution, and some substantial tax reductions were needed to lubricate tax reform; it would also not be attractive to publish a rising line for the PSBR. It would be important to concentrate on the quality of the tax package and particular on its supply side impact.

TAX PACKAGE

Excise duties

6. It was agreed that the basic approach should be a package which revalorised excise duties; but, within that, there might be scope for over-indexation of some duties and under-indexation of others. This would be discussed later.

VAT

7. It was agreed that there should be no change in the standard rate of VAT.

8. It was agreed that an extension of the VAT base to cover newspapers and periodicals (but not books) should be added to the tax package. There should be an exemption for learned journals, probably by excluding journals published quarterly or less frequently, perhaps with some additional test of content. The tax charge should also cover theatre programmes, catalogues etc where these were charged for. There should not be a charge for free newspapers: even though there would be some political difficulties, their income from advertising was already fully liable to tax. It would be vital to consider further how we would overcome the comments on taxation of information made in the Custom's note to the TCSC in 1986. It would be necessary at some later stage for the Chancellor to talk to the Secretary of State for Trade and Industry.

9. There could be no question of pre-empting the European Court's judgement on the infraction proceedings on non-domestic construction; if judgement was given after the Budget, it would not be desirable to introduce a tax change of this magnitude at Committee Stage. It would be greatly preferable if the Court judgement was either given as soon as possible (much the best option) or else delayed until closer to the end of 1988-89; there were strong arguments for having the judgement close to the end of a financial year, so as to avoid a period of disruption and forestalling. Mr Unwin would explore the timing further.

10. The Economic Secretary would consider minor changes on the taxation of confectionery to cope with the "chewy bars" problem. But there should be no other changes to the VAT base, except for other items covered by infraction proceedings (eg spectacles), provided judgement was received before the Budget.

Abolishing the UEL

11. There was considerable discussion about whether or not the tax package should include the abolition of the Upper Earnings' Limit for employee's NICs. The main arguments in favour were that it enabled the top rate of tax be lower; it made it easier to assimilate CGT and income tax; it avoided the kink in marginal rates; it reduced the value of the tax breaks we were precluded from attacking directly; and without abolition of the UEL the tax package might be rather thin, especially if other changes fell as a result. But on the other hand, it caused difficulties for the contributory principle; it created a large group of losers, and that prevented us from taking action in other areas (eg on car benefits); it increased the marginal rate for a large group of taxpayers; and it taxed unearned income at a lower rate than earned income. There were some other alternatives, such as having the main NIC above the UEL at 7% rather than at 9% - the contracted-out rate rather than the contracted-in rate; that would more or less get rid of all losers at a relatively modest cost.

12. On balance, the view emerged that abolition of the UEL should not be pursued.

Consequent tax package

13. There was some discussion whether, with a structure of a single top rate of tax, it was practicable to restrict the personal allowances - or reliefs more generally - to the basic rate. But it was pointed out that this was effectively equivalent to changing the higher rate threshold. It was agreed the restriction to the basic rate need not be pursued further.

14. In discussion of the top rate of tax, it was felt that the rate needed to set now for this Parliament; the scope for subsequent reductions would be small. It was agreed that the main option for the package should be a single higher rate of 40%, with a threshold of £20,000 (see also paragraph 17).

CGT Assimilation

15. Even though the problems of differences between CGT rates and income tax rates would be much reduced with the cut in the top rate of income tax, there were still arguments of equity and supply side advantages for aligning the two, though it was recognised that this might cause problems for small businesses. It was agreed that the package should include rebasing of CGT and assimilation to income tax rates. The alternative of having a separate CGT with a basic rate band of 25% and a top rate of 40% was less attractive. A rate of 40% on indexed gains was felt to be sustainable.

NICs at the lower end

16. The step problems created by the NICs package were discussed. Mr Scholar would investigate how much worse we were making the step problem than now.

17. A second option for the tax package was to drop the NICs package, to reduce the basic rate to 24p, and to set the higher rate threshold at £18,700. Costings of this should be prepared urgently.

Personal allowances

18. It was agreed that these should be increased in line with the RPI.

Independent taxation

19. The decision to procede with independent taxation and with the vanishing exemption for the married couples' allowance were confirmed. The precise settings of the vanishing exemption should be considered further.

Mortgage interest relief

20. It was agreed that we should proceed with a change to the residence basis for mortgage interest relief. This raised minor problems over co-habitees, who might claim mortgage interest relief on two principal residences: the Financial Secretary would investigate whether there was any scope for countering this abuse. The proposals on transferability between spouses and between unmarried sharers were agreed.

21. It was agreed that MIR on home improvement loans should be abolished; the Chancellor would need to discuss this with Mr Ridley soon. It would be highly desirable to avoid any increase in the ceiling for mortgage interest relief, and the main package should leave the ceiling unchanged at £30,000. But it was noted that there would be strong pressure for an increase, and that the ceiling could be raised to £35,000 without any net loss of revenue given the ending of relief on home improvement loans.

Maintenance and covenants

22. The principle of the package on maintenance and covenants was agreed. An early meeting was needed on the details, particularly of what compensation should be given for child maintenance and for students.

Benefits in kind

23. It was noted that in a package which retained the UEL, an increase in car benefit scale of the order of 60% could be

accommodated without introducing losers: this would bring in £170-200m revenue. But after discussion it was felt that it would not be sensible to raise car benefit scales in 1989-90 and then to move to a fringe benefit tax in 1990-91.

24. After considerable discussion, it was agreed that the package should include the fringe benefit tax: this was an important supply side initiative, and could usefully be presented as an attack on perks. The formulation for the Budget should be that in 1990-91 we would

1. move to a fringe benefit at tax at x%;

2. increase car benefit scales at that time by y%; and

3. cut the corporation tax rate by z%.

An early discussion was needed of what x, y and z should be. Consultation with DTI would be needed on employer compliance costs and on the impact of the motor industry.

25. If an FBT were not proceeded with, the alternative would be the biggest possible hike in car benefit rates: it would also be worth looking at increasing the minimum business mileage from 2,500 to at least 5,000 and steeply increase the charge for cars which did a lower business mileage.

Inheritance tax

26. It was agreed that we should go for the option ("Mod 1"), with a single rate of 40% and a threshold of £107,000: this would ensure that no-one was worse off than if the existing regime had been indexed.

Green Paper on Savings and Investment

27. It was agreed that it would be unwise to foreshadow a Green Paper on savings and investment while we were unclear about what it could contain. No solutions had yet been found to many practical problems identified in 1985.

Private rented sector

28. After discussion it was agreed that the rent-a-room option should be dropped: and that writing down allowances were not appropriate at present. The proposal for $\frac{1}{2}$ BES looked slightly odd in the context of the Budget, but it was agreed that it should be included as a component of the reform of the private rented sector. The Chancellor would see Mr Ridley soon.

Minor Starters

29. The following additional points were raised on minor starters:

(i) The proposals on forestry was agreed;

(ii) The proposals of current year basis of assessment was agreed;

(iii) On company residence, the principle of an exit tax charge on emigration was agreed: this could be done in advance of the results of the EC judgement;

(iv) The proposals on Lloyds were agreed. It was agreed that no action should be taken on the Special Reserve Fund;

(v) On the North Sea fiscal regime, the Economic Secretary was not convinced that the proposed new regime for the Southern basin was sensible. He would consider this further;

(vi) The proposals on Keith were agreed;

(vii) On BES, it was agreed that a cap should be introduced, and that we should counter the avoidance from secured contracting. The Financial Secretary and the Economic Secretary would discuss further the possible relief for oil exploration;

(viii) Action on Customs searching was agreed;

(ix) Disclosure of importers details was to be discussed at NEDC the following week.

Presentation

30. It was agreed that additional material should be produced on independent taxation, on maintenance and convenants and on the

fringe benefit tax: there was no need for material on the principle of the package as a whole.

ACSA

A C S ALLAN

11 January 1988

Distribution

Those present