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DAILY TELEGRAPH/
INLAND REVENUE

As the jobless wait, the taxman fiddles

By SIMON HEFFER

SUPPLY-SIDE economics is suddenly back in fashion. Mr Lawson may not have the funds to cut taxes: "supply side" theorists believe that should not stop him, since the cuts will fund themselves.

As figures published by the Government have recently shown, the proportion of total taxes contributed by the top 5 per cent of taxpayers has increased under this Government even though the tax rates for those people have been cut. This is because increased incentive creates more higher earners and fewer tax-dodgers, as Reagan has discovered in America. But the Inland Revenue's prevailing attitude is one of damage limitation, of safety before risk, and of increasing funds through better policing rather than through innovation. While that is so, the Government cannot hope to match America's achievement—and cannot hope to compete with it in world markets.

The country will fail to compete because its employees will demand higher gross wages to give a net return comparable with countries using a more enlightened tax régime. High taxes on low earnings will also keep people out of work and on the dole. All Lord Young's work to cut red tape and construct training schemes to put people back in jobs will fail unless matched by a more profound reform—of the Inland Revenue.

A number of senior Ministers and officials lay two charges in particular against the Revenue, in addition to the belief that its institutional caution will prevent it ever from embracing supply-side policies.

First, that it has resisted the integration of the tax and benefit systems. This would have ended the poverty trap and provided incentives to take low-paid work—one either pays tax, or receives a "negative" income tax in lieu of benefits. Second, that Revenue policies toward the self-employed discourage self-employment and "reclassification" puts some self-employed people out of work.

Revenue officials deny that their conservatism has any such effect. But officials at the Department of Trade and Industry maintain that the Revenue refuses to yield the principle of employers taking on staff on a PAYE basis. It is believed that if staff could be employed on a self-employed basis—so the employer avoids costly NI contributions, sick pay, holiday pay and so on—more jobs would be created. But the Revenue will not take the risk.

One of the most cogent arguments for reform of the Revenue was made recently by Mr John Kay, in his retirement lecture as Director of the Institute for Fiscal Studies. He argued that the "principles" upon which the Inland Revenue bases its approach to taxation are principles not established necessarily by an intellectual process, but rather because they represent the way in which things have always been done. He contended that the Board of Inland Revenue—currently comprising senior civil servants, many of whom have never worked anywhere else and who are therefore thoroughly out of touch with commercial realities and developments in tax practice—should include non-executive members drawn from business.

But his fundamental criticism was that the advisory role the Board has on policy—policy which is ultimately made by elected Government—should be scrapped and the function transferred to the Treasury. The Inland Revenue has no proper fiscal research base and precious little input of economic thought to support its advisory function. Mr Kay argues that this prevents the type of radical critique of tax systems that preceded President Reagan's landmark reforms enacted in the US this year with a top rate of 28 per cent, one per cent below our basic rate.

Undoubtedly the Revenue has been hamstrung by a resistance to change that has retarded its efficiency compared with the businesses from which it raises taxes. Certainly no financial institution of comparable size (the revenue employs 70,000 people) would still be in the middle of lengthy computerisation, as the Revenue is.

It has also suffered from a haemorrhage of its best talent, thanks to the significantly higher rewards offered elsewhere. A senior principal tax inspector earns £22,900 a year, perhaps half or even only a third of what he could earn in a firm of top City accountants. It costs £40,000 to train a tax inspector. It is no wonder accountants and the tax departments of large companies commonly advise would-be recruits to train at the taxpayer's expense and come back when qualified. Last year 130 inspectors were lost to the private sector.

And in July, the Revenue was criticised by the Public Accounts Committee for the arrears of post that had built up. On one day in October last year 2.7 million items of post over 14 days old were awaiting attention. Twenty per cent of these were over two months old.

So it seems the Revenue is not only obstructing economic growth, it is also doing so with the maximum inefficiency. In its favour, its last annual report showed a tax take of £50 billion that cost 1.66 per cent of total yield to collect, the lowest figure since records began. Staff have been cut by 15,000 since the Tories came to power in 1979, thanks largely to computerisation, though 3,500 posts that were to have been lost have been retained to allow more people to police possible evasion of taxes.

In the last couple of years some staff have been "usefully" employed reclassifying people who had previously been self-employed: fruit pickers, deep sea divers and the like. Inland Revenue officials do not deny that more self-employment means more work for them. Matters like this reinforce the idea that the IR regards its own convenience as a higher priority than innovation.

Hitherto the Revenue has resisted the integrated tax/benefit system because it could not have handled it without computerisation, it claims. As for extending "self-employment", there are fears not just of more work, but of a shortfall in the near future in revenue. Computerisation will be complete by 1990. Then it will only be the lack of a proper economic research base that prevents the Revenue from realising, as America has done, the benefits of reform.

Ministers must take the blame for this poor performance. It is short-sighted in the extreme of them, too, not to see the political dangers of their failure to revolutionise the Revenue. Failure to bring the policy role into the Treasury and away from the administrators could permanently damage any attempt by the Government to embrace supply-side economics.

Unless the Government builds up the political will to tackle reform of the Inland Revenue it risks not only delaying the economic advance of the country but also losing the initiative of this issue to the SDP. That party's plan to integrate tax with National Insurance, announced in August, shows that it at least is prepared to change established practices.

The Revenue is aware that the pressure is on for change, and it has tried—in a rather grey document published in April 1985 called "Direction of Change"—to explain that it is already modifying its practices. Yet it still shows no desire to concentrate purely on administration and to bring in fresh minds from outside the civil service to plan the greater efficiency of its business.

It will not volunteer to change itself. It is up to the Government to find the will to bring about changes—in personnel, in systems, in responsibilites, in "fiscal principles"—and it will be the Government that suffers in the first instance if this change does not come. We expect our businesses to innovate for the good of the nation. It is not too much to expect our civil service to do the same.

DAILY TELEGRAPH
28 OCTOBER 1986

Ch

FST wants to raise the question of whether he shd write to the D. Tel. rebutting this. (I think you felt he shd not?)

AWK
28/10

3361/52

CONFIDENTIAL

PS/CHAIRMAN

FROM: J J HEYWOOD

DATE: 31 October 1986

cc PS/Chancellor

TELEGRAPH ARTICLE ON INLAND REVENUE

The Financial Secretary has consulted with colleagues on how best to respond to the polemical article by Simon Heffer.

2. You will be pleased to learn that the Chancellor intends to say something in make a speech defending the Revenue and the Government's record on tax policy in general. The date for this has not yet been fixed.

3. The Financial Secretary would also like you to approach the IFS to establish whether we could contribute an article to their Journal. This would be a serious piece addressing the issues which were raised by John Kay and repeated by Simon Heffer.

J.H.

JEREMY HEYWOOD
Private Secretary

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

PRAYERS

Para 2 of PS/FST's minute of 31/10 is quite untrue. PSE supplied it.

C.

1. Do you want to do a full speech on the IR and the record on tax policy? I don't see a specially suitable occasion coming up before the Budget – Daventry, 5 December? Is para 2 of PS/FST's proposed minute quite safe?

2. The FST himself does have some suitable speeches next month when he could contribute.

3. A useful time to reinforce the message could be in the Budget speech and on 2nd Reading of the Finance Bill.

AH

3361/51

CONFIDENTIAL

FINANCIAL SECRETARY TO THE TREASURY

PS/CHANCELLOR

FROM: J J HEYWOOD

DATE: 31 October 1986

cc PS/Chief Secretary
PS/Economic Secretary
PS/Minister of State
PS/Sir P Middleton
Mr Scholar
Mr Culpin
Mr Cropper
Mr Tyrie
Mr Ross-Goobey

HEYWOOD
→ PS/CH
31/10

TELEGRAPH ARTICLE ON INLAND REVENUE

I attach a copy of a minute I intend to send to the Revenue concerning the Government's response to the article by Simon Heffer in the Daily Telegraph. As you know, this article drew heavily on John Kay's valedictory address to the IFS.

2. Do you have any idea of when the Chancellor intends to make his speech on this subject? The Financial Secretary is keen for us to move as rapidly as possible on this after the Autumn Statement pressure subsides. He senses that the recent spate of attacks has left the Revenue feeling rather beleaguered.

J.H.

JEREMY HEYWOOD
Private Secretary

3361/52

PWP

Andrew

CONFIDENTIAL

PS/CHAIRMAN

FROM: J J HEYWOOD
DATE: 31 October 1986

cc PS/Chancellor

HEYWOOD
→ PS/CHAIRMAN
31/10

TELEGRAPH ARTICLE ON INLAND REVENUE

The Financial Secretary has consulted with colleagues on how best to respond to the polemical article by Simon Heffer.

2. The Financial Secretary would like you to approach the IFS to establish whether we could contribute an article to their Journal. This would be a serious piece addressing the issues which were raised by John Kay and repeated by Simon Heffer. It would, of course, need to be a piece of high quality.

X 3. Ministers will also take the opportunity, as it arises, to make clear their own appreciation of the Revenue.

J.H.

C,
X is more like it, I will look out for opportunities.

Thanks.

JEREMY HEYWOOD
Private Secretary

INLAND REVENUE
CENTRAL DIVISION
SOMERSET HOUSE

FROM: L J H Beighton
DATE: 21 November 1986

BEIGHTON
→ FST
21/11

FINANCIAL SECRETARY

ARTICLE FOR "FISCAL STUDIES"

You asked us (Mr Heywood's minute of 31 October) to approach the Institute of Fiscal Studies to establish whether we could contribute an article to their journal "Fiscal Studies". This would be a serious piece addressing the issues raised by John Kay in his valedictory address and repeated by Simon Heffer in his Daily Telegraph article. Ministers would, Mr Heywood added, also take the opportunity as it arose to make clear their own appreciation of the Revenue.

The IFS have said that they would be very willing (subject to the usual editorial discretion) to include an article in the next issue. They have asked if they could have a preliminary draft by next Friday and the final text a fortnight later. (These days are important because the editor only works for the Institute on Fridays.) I attach a draft accordingly. We are still working on it ourselves - for example the Chairman has asked for a paragraph or two to be added on the personnel side - and will want to make further changes. At this stage therefore we are not seeking your approval in detail but rather your confirmation that we are broadly on the right lines and that a text on this basis with

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cc Chancellor of the Exchequer
Chief Secretary
Economic Secretary
Minister of State
Sir P Middleton
Mr Scholar
Mr Cropper
Mr Ross-Goobey
Mr Tyrie

Mr Battishill
Mr Isaac
Mr Painter
Mr Pollard
Mr Rogers
Mr Beighton
Mr Cherry
Mr Crawley
Mr Jones
Mr Matheson
Mr Muir
Mr Johns
Ms Tyrrell
Mr Walker
PS/IR

amendments can be sent to the IFS for next Friday so that they can see its broad shape. Thereafter we would of course send you a final draft.

One particular question is the extent to which the article should explicitly be a response to Kay. At one extreme we could pick up his arguments and deal with them one by one: since however some of his points are in essence political they are not ones which the Revenue could tackle in public. There would also be the danger of provoking a response equally as silly as the original but increasingly difficult to handle. The other extreme would be to make no explicit reference to Kay at all so that the article would appear wholly designed as a contribution to public awareness of how Government is carried on. We have adopted a middle route in which a reference is made at the opening to Kay's address, but apart possibly from cross-references in the footnotes to be appended there is no other reference to him. The better informed readers of the periodical will clearly see it as a retort, but it may not so obviously be seen as such by the press generally.

I should be grateful to know whether you are content that we should proceed on this basis and, in particular, that we should send a copy of an article broadly on these lines as a preliminary draft to reach the IFS by next Friday.

M.A. Johns

for L J H BEIGHTON

TAX POLICY AND MANAGEMENT
- THE ROLE OF THE INLAND REVENUE

There has been some public debate in recent months about the approach of the Inland Revenue both to giving advice on tax policy to Government Ministers and to management of the tax system (e.g. John Kay's valedictory address to the IFS). In this article I explain what we are trying to do in the Inland Revenue and how we see our role in the hope that this will help to inform the debate.

The Board of Inland Revenue

The Board of Inland Revenue is responsible for advising the Chancellor of the Exchequer on questions involving policy on direct taxation (including the stamp duties). After the Chancellor has decided those questions and Parliament has enacted legislation giving them effect, the Board is responsible for implementing them as part of their statutory responsibility for the care and management of the direct taxes (Section 1 of the Taxes Management Act 1970 as far as income tax, corporation tax and capital gains tax are concerned).* They are accountable in general terms to Treasury Ministers for their stewardship, but Ministers do not get involved in the day to day business of running the Department. In particular Ministers do not have access to information about people's confidential tax affairs (without their consent) or intervene in how they are to be taxed.

Board members are appointed by letters patent by the Crown. But they are civil servants and in all other respects they are in an identical position to civil servants in other departments. The Chairman, Tony Battishill, is a permanent secretary; five of the other six members of the Board are deputy secretaries and the seventh is an Under Secretary. The Chairman, both Deputy Chairmen and one other Board member have had extensive experience in other departments, and the other three have spent much of their career in a wide range of operational offices of the Department.

Revenue advice on Tax Policy

One respect in which the Board of Inland Revenue is on all fours with civil servants in other departments is in relation to the advice given on tax policy. Treasury Ministers are responsible for taking decisions on what the tax law should be subject always to Parliamentary approval. In taking their decisions it is first to the Inland Revenue that they turn for advice as far as the

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*The Inland Revenue is also responsible for the provision of rating and valuation services, but this aspect of our duties is not covered in this article.

direct taxes are concerned: the conventions governing this advice are exactly the same as in other departments. Ministers take the decisions and are responsible for them to Parliament and the advice they receive from their officials prior to taking the decisions in confidential. Officials are then responsible for ensuring that the decisions of Ministers and Parliament are properly implemented.

Policy advice is provided by six Policy Divisions in the Inland Revenue's Head Office who report to the two Deputy Chairmen of the Board. One division provides advice on personal tax, another on business taxation, another on capital taxes, and so on. Like the Board, these divisions are manned by people with a variety of experience. At a recent count some two-thirds of senior Policy staff (Principal grade and above) had worked for part of their career in various operational units of the Revenue, nearly half had spent some of their career in other Government departments (or quasi Governmental bodies) and one-fifth had experience of employment outside the Civil Service.

These people do not work in isolation. Within the Department, Policy Divisions are in daily touch with their colleagues in other divisions - the role of Technical Divisions is to ensure that Ministers get the best technical advice possible and Management Divisions are concerned that they know the staffing and operational implications of the decisions they take.

In addition, Policy Divisions draw on the support of our economists and statisticians (about 30 professional staff) for advice on the effects of different courses of action on tax yield, economic behaviour, distributional implications and so forth. Most of this analytic work is unpublished because it is intimately bound up with the process of policy advice, but occasional background papers and articles have been published such as the Revenue paper "Cost of Tax Relief for Pension Schemes: Appropriate Statistical Approach" published in 1984. And we publish annually a volume of "Inland Revenue Statistics". This sort of analytic work may also be published in general Government documents. For example, the Green Paper on the Reform of Personal Taxation, Cmnd 9756, contained a detailed analysis of the distributional implications of the introduction of transferable allowances, not only taken on their own but also when resulting changes in entitlement to social security benefits were taken into account.

In addition to the research work which it carries out itself the Revenue sponsors independent research. Apart from one-off consultancy exercises like the BES study mentioned below, the Revenue is a member of a consortium with the Treasury, Customs & Excise and the ESRC which commissions independent research. This has included a number of recent projects on personal and corporate taxation from the IFS, personal taxation studies at the LSE and Stirling University, and research into the compliance costs of taxation at Bath University. [Any suggestion that the Department does not support independent research is simply not true. But research and policy evaluation are, of course, not the preserve of the academic specialist whether inside or outside the Civil Service. The Revenue makes increasing use of private sector consultants in this whole area, including the interaction of policy and management considerations.]

Inadequate description of FP

Inland Revenue, Customs and Excise and Treasury officials work closely together in developing Budgetary proposals for Ministers. The Treasury has a Fiscal Policy Division responsible for looking at the broad balance of the tax system and its relationship to the Government's wider economic, monetary and social policies. They are concerned in particular with the balance between Inland Revenue, Customs & Excise and other taxes (the latter including such taxes as Vehicle Excise Duty). Where the interests of other departments are closely involved (e.g. the Department of Energy on North Sea taxation, the Department of Industry on industrial issues, DHSS on the tax/benefit interaction or the Treasury and Bank of England on financial institutions) there is close consultation with their officials.

The Treasury have a considerably larger cadre of professional economists than we do and our economists work closely with them in order to ensure that Ministers are fully advised on the macro and micro economic implications of tax changes. Close touch is also kept with economists outside the Government service, so as to ensure that we are able to benefit from the latest academic thinking. In our work leading up to the 1984 business tax reforms, for example, we drew on outside economic analysis which was still unpublished by the time of the Budget.

Policy evaluation

Policy advice to Ministers can be divided into two main groups. First it may be concerned with the broad strategy of the tax system - for example, a wide ranging review, with the Treasury, of the whole field of savings and investment focussing in particular on tax neutrality was one of the essential sources from which the 1984 tax changes were derived. Second it may be concerned with consideration of more detailed issues which fall within the broad strategic approach which has been settled by Ministers.

In either event any consideration of proposals has to be evaluated against many, sometimes conflicting, criteria. It is impossible to prescribe an exhaustive list of all the considerations that may be relevant in considering a possible initiative in tax policy. But the 1985 Public Expenditure White Paper contained a check list of the more important ones.

These were:

i. the cost or yield to the Exchequer and the distribution of gainers and losers among different categories of taxpayer;

ii. the economic effects of the proposals and any behavioural changes they would be likely to induce;

iii. the consistency of the proposals with the general thrust of the Government's tax policy, and its broader economic, financial and social policies;

iv. the implications for other parts of the tax system, for the social security system, or for other proposals which Ministers may be considering;

v. the likely effect on the perceived fairness and general acceptability of the tax system;

vi. the effect of the proposals in increasing or reducing the complexity of the tax system;

vii. the administrative implications, including effects on public expenditure and the use of public service manpower,

viii. the compliance burden on employers, businesses and other taxpayers;

ix. any views bearing on the proposals expressed in Parliament, or by representative bodies or by individual taxpayers;

x. any relevant international obligations arising from, for example, double taxation agreements or European Community obligations.

The relative weight given to these various factors will differ according to circumstances and the nature of the proposal being considered.

Our job is to ensure that Ministers are made aware of the relevant considerations, and receive the best advice possible on the likely effects of measures they have in mind. Once changes have been made, or new measures introduced, it is also our job to see whether the intended results are being achieved and, if they are not, to consider whether some further action should be taken and if so what. Let me give an example.

The Business Expansion Scheme was designed to encourage a greater supply of outside equity capital for risky small businesses. Officials worked up a detailed scheme under Ministerial guidance, based on the Business Start-up Scheme and the legislation was introduced in 1983. This, however, was not the end of the story. We also needed to monitor whether the new scheme was meeting its objectives. Consultants (Peat Marwick Mitchell) were employed to examine how far the BES was in fact providing additional risk capital for small businesses. Their report suggested that by and large the scheme was generating additional equity capital as intended but not all the projects were of the risky type originally envisaged. So earlier this year in the Finance Bill Ministers made permanent the original temporary scheme but narrowed the scope of qualifying investment so as to target the relief more accurately. It was unusual for a proposal to stem from an external survey of this type, but a substantial proportion derive from studies made within the Revenue of how far tax reliefs or rules are fulfilling the intentions behind them. No scheme is likely to be free of deadweight, but it is important with tax provisions - just as with public expenditure - to keep the accuracy of targeting under review. It is not simply a matter of tax avoidance but of ensuring that tax reliefs are cost effective.

Where proposals for tax change come from

There are many other sources of tax changes. Naturally many stem from Ministers' own political objectives and obviously all have to be consistent with those objectives. Others come from representations by the various representative bodies and interest groups. A third source is Ministers and officials in other Government departments and public committees and commissions of enquiry (such as the Keith Committee on the enforcement powers of the Revenue departments). Lastly some proposals for change originate within the Revenue itself.

I'm not sure that these %s [illegible] [illegible] given the [illegible] nature & [illegible] of the various proposals

[It is not always easy to separate out the different sources of a particular proposal but in a recent year, of the proposals initially considered in detail (a tithe of those put forward) 13% were provisions which had to be considered each year (like the rate of income tax, it being an annual tax), 17% derived directly from Ministerial initiatives, 21% from private sector representations, 28% from other government departments and committees and 21% from Revenue officials.] But wherever the ideas originated, it is the Chancellor of the Exchequer who decides, giving such weight as he thinks fit to our advice.

The cycle of policy work

The annual cycle in which officials draw together the various sources of advice and information, assess them against these criteria, discuss them with Ministers, convert Ministerial decisions into Instructions for Parliamentary Counsel to draft into legislation, and assist Ministers in piloting the legislation through the House of Commons is described in detail in Chapter 7 of the Board's annual Report for 1983. There is not room to repeat the description here. But two aspects stand out. First is the growing importance of direct consultation to supplement full Parliamentary scrutiny of tax proposals. There are regular discussions between the leading representative bodies and senior Revenue officials. And ad hoc discussions are held with interested parties on specific proposals. These vary in formality from the full scale type of consultation such as that on the recent Green Paper on the Reform of Personal Taxation with a published paper, a timetable of several months for comments and a full-scale review by Ministers, to a quick discussion during the course of a Finance Bill with interested parties about a problem they have identified in legislation to be debated in the House of Commons perhaps in a couple of days.

Second is that - as society becomes increasingly complex - so time scales lengthen. Representative bodies who want their views to influence thinking must let us have them earlier and earlier. November is nowadays none too early for the following Budget.

<u>The Revenue and the individual taxpayer</u>

Turning from policy to implementation, it is in relation to its dealings with individual taxpayers that the Revenue's statutory independence is most significant. We do not, as explained above, normally involve Ministers in individual decisions. But we are tightly bound by the general law on what we can do. Taxpayers can appeal to independent tribunals (the General Commissioners in the case of income tax) if they are dissatisfied with their assessments. On points of law there is appeal to the Courts. If they are dissatisfied with the way their case has been handled in other respects they can get help from their MP or Ministers (and the taxpayer can waive his right to confidentiality to enable the facts to be reported). MPs can call on the Parliamentary Commissioner for Administration (the Ombudsman) to investigate a case of alleged maladministration and he will examine our papers and can interrogate officials during his investigation.

Last July the Board issued a Taxpayer's Charter setting out the principles of service to taxpayers which for many years we have aimed to achieve. The rights which this identified for taxpayers were the rights to help and information, to courtesy and consideration, to fairness, to privacy and confidentiality, and to expect the Revenue to have regard to taxpayers' costs in complying with the law. These are general aspirations which guide our dealings with taxpayers and with a Department of 70,000 and a taxpayer population approaching 30 million it is not always easy to achieve them to our complete satisfaction in every case. But the Department is concerned to try to achieve this level of service in as high a proportion of cases as we can consistent with the resources available to us.

We have played

In fulfilling our statutory tasks of assessing and collecting tax, we have to be - and are - fully aware of the impact of the tax code on our consumers - individuals and businesses alike. We are also conscious of our responsibilities towards taxpayers, both in our day to day dealings with them, and within the broader policy context. ~~And it is for this reason that we have been pleased to play~~ a very positive and constructive role within ~~Lord Young's~~ wider deregulation initiative in attempting to reduce the burdens which the tax system places on the taxpayer. This is a good example of the very careful balance we have to draw at all times between getting tax receipts to flow into the Exchequer and our wider responsibilities to taxpayers - a balance which also lay at the root of the recommendation of Lord Keith's enquiry into the enforcement powers of the two Revenue departments.

The Govt's

Departmental Management

The Revenue is a large and decentralised organisation employing nearly 70,000 staff in around [1000] offices up and down the country. There are three main networks of local office s- tax offices assessing tax, collection offices collecting the tax and valuation offices valuing property. There are a number of operational offices not linked to the main networks including Capital Taxes Offices (administering Inheritance Tax and its predecessors) and Stamp Offices (administering stamp duties) and a number of specialists offices. Finally there are a number of regional offices and our head office based in Somerset House in London. The total cost of this in 1985/86 was [ ].

Managing the department is therefore a substantial responsibility in itself. The Board perform this management function within a framework laid down by Ministers. The Government determines the resources - manpower and finance - available for the Department. It also lays down the principles of personnel and management policy which we have to follow (e.g. open and fair recruitment is safeguarded and monitored by the Civil Service Commission).

Control of resources

The Department's management work, like its policy work, is governed by an annual cycle - in this case the annual Public Expenditure and Estimates cycle. This starts, as for other Departments, with the Public Expenditure survey which sets resources for a three year forward period, and is published in detail in the Public Expenditure White Paper around January. This sets the resources for the Department in both manpower and money terms. The overall allocation for the next financial year is converted into more detailed Estimates presented to Parliament in the Spring. At any time, we are working within limits set by the government on the total cash we can spend in the financial year, limits on our running costs (i.e. all costs other than capital costs) and to targets for our manpower at the end of the financial year. The cycle is closed by the publication of an annual Report to Parliament recording the Board's stewardship of its resources for the preceding year. A recent study by the National Audit Office showed that the Inland Revenue and Customs and Excise were unique in publishing comprehensive retrospective reports on the whole of the Department's activities.

Internally, as part of the Civil Service Financial Management Initiative we have embarked on a major exercise to decentralise control of these resources and to improve accountability for the use of resources. At the top level we have set up a "Senior Management System" under which the Divisions report to the Board on their objectives for the forthcoming year and their performance against their objectives for the previous year. These reports are reviewed at a series of Board meetings with Divisions in December/January and the reports are published the following Spring or Summer. At the same time we are setting up a line management budgeting system which allocates resources to individual line managers down to the local office level, gives them greater freedom in how they allocate their resources within the budget and hold them accountable for performance against the budget. Management information systems are being improved in conjunction with this. This system at present covers 75% of the department and will be extended to the remaining 25% next year. This is not just a change in accounting procedures: it accounts to significant change in management style to use the new freedom effectively and adopt to different controls from the past. Fuller descriptions of the Senior Management System and our line management budgeting system can be found in articles by M Symons and P Willingham.

Improvements in efficiency

Over the last few years the department has taken a number of important measures to improve efficiency. The total number of staff employed has been reduced by nearly 20% since April 1979. Of the 15,000 staff saved about [4000] are due to legislative changes; the rest are due to managerial improvements in efficiency. There are a number of strands to this in addition to the changes in financial management described above.

Computerisation

One of the most important of these is harnessing the potential of information technology. We started converting PAYE to computers in the 1960's and for employers in Scotland PAYE was centralised at a computer centre in East Kilbride as long ago as 1968. Further work was, however, suspended in the 1970 when the incoming Government decided to review the future of the PAYE system. This led to the proposed tax credit system which in turn was suspended by the new Government in 1974. Planning switched back to computerising PAYE but in the meantime technology had moved on and trials proved that rather than a batch processing system centralised at a few centres like East Kilbride, a distributed on line system with local offices linked to the computer centres would provide a better solution and be more efficient. It would also be more convenient for staff and taxpayers alike. Plans for a system on these lines were approved by Ministers in 1980. During the development phase it was decided to broaden the programme to include Schedule D assessing as well as PAYE, making this perhaps the largest computer application of its kind in Europe. We are on course to complete the conversion of Schedule D and PAYE to computers by the end of 1988 [without cost over-run].

The project involves [ ] mainframe computers and [ ] visual display units linked in. An independent team of researchers said of it "In short, COP [computerisation of PAYE] has displayed a thrusting, prudent management strategy which has not only ensured the development of the system on schedule, but has actively sought ways to enhance the programme to the benefit of the Inland Revenue, the taxpayer and the British computer industry". In no small part this success has been due to the effective use of outside expertise - harnessing the skill and experience of private sector consultants with the Department's own operational and IT expertise and our appreciation of he policy considerations.

This is not our only computer system in existence or planned. During the 1970's while the future of PAYE was under review, we pushed ahead with the computerisation of the collection of tax and corporation tax assessing. We now have plans to convert these systems onto more flexible and up to date technology and improve the level of service to the public over the next few years. And we have used computer systems for many years on statistics, pay and personnel matters. A fuller account of the Department's plans for the future can be found in "The Direction of Change" which we published in April 1985.

Network reorganisation

At the same time we have been slimming down our networks of local offices. The number of local offices in our networks will be reduced by over a quarter: the reorganisation of our tax office and collection network should be complete by 1988/89 (saving annual accommodation costs of £8m at 1986/87 prices) and that of our valuation office network sometime after 1990.

Better investigation methods

A rather different type of measure to improve efficiency has been in our investigation work. Since the late 1970's we have made considerable improvements in the cost-effective deployment of our trained Inspector resources. We have monitored in greater detail adjustments made to accounts, introduced a more systematic method of allocating resources and set targets for the numbers of cases to be investigated. A chain of special offices has been set up to handle problems of avoidance, evasion and particularly complex cases. And in 1985 we reorganised our Enquiry Branch and other head office investigations sections. As a result the yield of our investigation and audit work has increased by 25% a year on average over the last decade in real terms and is now 6 times what it was in 1976.

Manpower planning

The rundown in staff numbers has not been easy to manage and we have devoted considerable attention to effective manpower planning. We have worked very closely with the Institute of Manpower Studies in developing effective planning techniques. And we have met our challenging targets for reductions with no compulsory redundancies.

Changes in management style

This does not mean that there have been no problems. Last year our arrears rose to historically unprecedented levels as a result of the pressures caused by office reorganisations and preparatory work for computerisation, growth of work greater than forecast, and high levels of resignation and resulting inexperience among clerical staff (particularly in London and the South East). In November last year a major effort was launched with the backing of Ministers and Unions to tackle the backlog. There were three specific changes: authorisation (with trade union cooperation) and funding of substantial overtime working; an increase in our manpower targets to cope with the extra work volumes; and a number of functional changes (mostly of a temporary nature) in lower priority work. But as important has been the less tangible change in management style arising from the clear commitment throughout the department with better communication and more active targeting on priority jobs. This fits in with a longer term programme to improve communications by way of attitude surveys, a regular house journal and newsletters from the chairman and regional seminars with local management.

Measurement of output

Unlike a private sector business the Revenue has no simple measure of improved profit to show from its efficiency measures. There are a variety of indicators which can be used in the Revenue. Each tells part of the story but each, if pursued as the sole measure of performance could be misleading. The problems can be seen by considering two in a little detail.

An important indicator is the relation between the amount of tax we collect and the cost of doing so. We have been publishing cost/yield ratios in our annual Report for many years. Last year at 1 2/3p for every £ collected this reached the lowest level since the ratio started to be calculated on the present basis in 1974/75. We publish cost/yield ratios for the individual taxes in the Board's Report and also for our main forms of investigation work. But there are real snags with this as a measure of performance: changes in tax law (e.g. a change in the basic rate of tax) can affect the yield without any alteration in the real burden of work. And while the effect on cost/yield is one aspect of policy change to be taken into account it is by no means a decisive one. In order to secure their economic and social objectives Ministers may very reasonably decide to introduce reliefs which add to our staffing needs while reducing the yield.

Another indicator which has been suggested is the average number of assessments made per member of staff. But this can actually be a perverse measure of our Departmental performance. As PAYE attempts to collect the right amount of tax from employees during the year about 4 in every 5 Schedule E taxpayers do not need an assessment at the end of the year. We have taken efficiency measures to cut down the number of assessments required in recent years to reduce the Department's workload. But Schedule E taxpayers still need their records kept up to date during the year. So any increase in the figures of assessments would tend to reflect a failure in performance rather than the reverse.

We believe the sensible approach is to use a variety of indicators of performance. A number of these have been developed and are in active use as management tools. Some of them are set out in the Revenue section of the Public Expenditure White Paper including targets on progress of line management budgeting, milestones for reorganisations, progress in reducing arrears, proportion of accounts investigated, and number of cases handled per professional Valuer. The Board's annual Reports publish a wider range of statistics of our performance. Work is continuing in this area.

Interaction between management and policy

The Revenue is sometimes asked whether it has a policy view "of its own". It cannot, and does not have a policy view - above all not one at variance with that of the Government of the day. But inevitably policy decisions put constraints on management decisions and vice versa. Administrative considerations point in the direction of a relatively simple, broad-based, system with the minimum of distortions requiring the policing of difficult border lines between forms of income and category of taxpayer. But administration is only one of the ten criteria listed above which need to be taken into account for tax policy. Some legislative changes like Mortgage Interest Relief at Source (MIRAS) have been of major assistance in keeping down the cost yield ratio. Others inevitably pull in the opposite direction because of wider economic, social, or political considerations.

There has to be a general election every five years and, if this results in a change of Government (and we had three in the 1970's), the overall thrust of our activities may change markedly. But today major changes take ever longer to plan as we seek to take advantage of the latest technological developments. So our Departmental Development Plan (a very brief outline of which was published in July) displays the intended progress of each of our major activities over the next ten years - and the interactions between them - while retaining the flexibility to adjust to any changes there may be in the political scene, in technology and in society. More generally the objectives the Board have set out for themselves have one eye firmly on the sort of conditions in which we may perhaps be working by the middle of the 1990's.

Conversely the methods of assessing and collecting taxes and the timetable for changes (eg computerisation) also affects policy decisions and can put real constraints on the feasibility or extent of particular policy changes, at least in the short term. For example, transferable personal allowances would have been extremely difficult under the old manual system of PAYE and Schedule D. To try to introduce a change like this involving major new procedures at the same time as we were also computerising PAYE and Schedule D would simply not have been possible. So the introduction of transferable allowances is only really practical after the COP and CODA (computerisation of Schedule D assessing) programmes are complete. If transferable allowances are introduced there will be a similar need to keep within the strict bounds other organisational changes at the same time. There is a similar interaction between the introduction and improved online computer system for the collection of tax and some of the policy changes in the compliance field which are being considered following the report of the Keith Committee on the enforcement powers of the Revenue departments.

Conclusion

A great deal is happening in the Inland Revenue and the pace of change is accumulating. A lot remains to be done. On policy it will be Ministers who determine what they want done and how. On management too, they set the framework. Within this there are many things we have to do - to improve our measurement and targets for performance, constantly to improve our efficiency, to establish budgeting as a way of life among our line managers and to recruit, retain and not waste a professional workforce so that we and give a high level of service to the public, exploit to the full the potential of information technology. We therefore welcome debate on how outsiders see the direction for the Revenue. We try to be open to ideas; it is important that these ideas should be based on the facts. I hope this article and the other publications I have referred to in it will help to provide the facts to inform the debate.

ARTICLE FOR "FISCAL STUDIES"

3214/15

CONFIDENTIAL

Ch and FST
Peter Cropper may raise this. You were proposing to devote an "extended Prayers" (with one or two relevant officials) to this area in due course. If you wish we could slot this in post-Prayers next Monday. Meanwhile, the article for Fiscal Studies needs to be considered more urgently because of IFS printing deadlines.
AWK 21/11

FROM: P J CROPPER
DATE: 21 NOVEMBER 1986

FINANCIAL SECRETARY

cc Chancellor
Chief Secretary
Economic Secretary
Minister of State
Sir P Middleton
Mr Scholar
Mr Ross Goobey
Mr Tyrie
Mr Battishill IR
Mr Beighton IR

ARTICLE FOR "FISCAL STUDIES"

Mr Beighton's draft for Fiscal Studies is a very readable and comprehensive description of what the Inland Revenue is and does.

2. I do not think it will be seen as an adequate response to Kay. Kay's article was an attack on the Conservative Government, dressed up in the guise of an attack on the Inland Revenue. Only a political response will be seen as an effective answer.

not v good

3. It may or may not be worth putting this article in the next edition of "Fiscal Studies" but it will not impress the taxpayer/professional adviser who is unable to get an answer to the letters he writes to his Inspector.

P J CROPPER

I have made a few amendments & comments in pencil. I wd also like FP to have a look @ this. Then, subject to FST's views, OK for article to appear in Fiscal Studies.
N

318/14

CONFIDENTIAL

PS

FROM: A W KUCZYS
DATE: 24 November 1986

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Mr Scholar
Mr Cropper
Mr Ross Goobey
Mr Tyrie
Mr Beighton IR
PS/IR

ARTICLE FOR "FISCAL STUDIES"

The Chancellor has seen Mr Beighton's minute of 21 November. He has a few comments on the draft article:

(i) Page 3, the description of FP towards the top of the page ("The Treasury has a Fiscal Policy Division...Vehicle Excise Duty") is inadequate.

(ii) Page 5, the Chancellor is not sure that the percentages in the passage in square brackets("It is not always easy...Revenue Officials.") mean very much, given the widely differing nature and importance of the various proposals.

(iii) Page 6, last paragraph: delete "and it is for this reason that we have been pleased to play", substitute "we have played"; delete "Lord Young's", sustitute "the Government's".

2. The Chancellor would also like FP to have a look at the article. Then, subject to the Financial Secretary's views, the Chancellor is content for the article to appear in "Fiscal Studies".

AWK

A W KUCZYS

PMP

CHANCELLOR OF THE EXCHEQUER

[illegible]

Ch/

1. Pl see Leonard Beighton's note below, and Andrew's comment. — I agree.

2. Do you still want an "extended Prayers" to discuss John Kay + the Inland Revenue? It might seem unnecessary now. But there is still the question of Ministerial involvement, eg in a speech. And I think Peter Cropper is feeling a bit sensitive about the reception his note received. So a short discussion, perhaps after Prayers next Monday, might serve a useful role. (Frank Cassell & Michael Scholar might usefully join in).

Waste of time.

3. If you do have a meeting,

PTO

perhaps the Revenue's clerical work measurement report cd also be on the agenda? (See Max Felstead's note in separate folder: CST wants to raise at Prayers, but cd just as well be at this meeting.)

AWK

24/11

RPS

INLAND REVENUE
CENTRAL DIVISION
SOMERSET HOUSE

FROM: L J H Beighton
DATE: 24 November 1986

1. MR ISAAC 24.11

2. FINANCIAL SECRETARY

ARTICLE FOR "FISCAL STUDIES"

I have seen Mr Cropper's note to you of 21 November. I think we must be careful to get the target here in focus.

Mr Cropper is absolutely correct in saying that part of John Kay's purpose was to attack the Government through attacking the Inland Revenue. To that extent Ministers have already seen that a two-pronged response is necessary - by Ministers in their speeches and from the Inland Revenue. We can only ourselves go so far by removing some of the worse sillinesses and misconceptions in his address - and elsewhere - on which so much of the criticism is based.

C. If you do make a speech on tax reform, we ~~could~~ should certainly make a ref to the IR. AH

Fiscal Studies is a serious academic work of considerable standing and it is for that context that the draft is aimed. At the very least it should ensure that people are more aware of the substantial steps we have taken and where we are going. And while it is not directed at the immediate problem of arrears it does cast some light on it.

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cc Chancellor of the Exchequer
Chief Secretary
Economic Secretary
Minister of State
Sir P Middleton
Mr Scholar
Mr Cropper
Mr Ross-Goobey
Mr Tyrie

Mr Battishill
Mr Isaac
Mr Painter
Mr Pollard
Mr Rogers
Mr Beighton
Mr Cherry
Mr Crawley
Mr Jones
Mr Matheson
Mr Muir
Mr Johns
Ms Tyrrell
Mr Walker
PS/IR

There are no easy answers to the problem of defending the Revenue against unfair attacks, but surely we have got to try to take every opportunity which is open to do so, and to build on the work of our Press Office in presenting our role in as positive and constructive a way as possible.

LJHB

L J H BEIGHTON

As I understand it, everyone is agreed that a response is needed **both** at the official "technical" level (with which Mr Beighton's draft is concerned) **and** at the Ministerial level (whose importance Mr Cropper rightly emphasises).

CHG.

AJGI

4366/003

CONFIDENTIAL

FINANCIAL SECRETARY TO THE TREASURY

FROM: J J HEYWOOD

DATE: 27 November 1986

MR BEIGHTON - IR

cc PS/Chancellor
PS/Chief Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Mr Scholar
Mr Cropper
Mr Tyrie
Mr Ross Goobey
PS/IR

ARTICLE FOR "FISCAL STUDIES"

The Financial Secretary has seen Mr Kuczys' minute of 24 November and your minutes of 24 November and 21 November.

2. On the Chancellor's point (i), the Financial Secretary has spoken to Mr Scholar and has asked for his comments on the article and particularly on the description of FP.

3. The Financial Secretary has also asked who is going to sign the article?

JJH

JEREMY HEYWOOD
Private Secretary

Where are Rev? pse let him see Rev.

INLAND REVENUE
CENTRAL DIVISION
SOMERSET HOUSE

FROM: L J H Beighton
DATE: 5 December 1986

FINANCIAL SECRETARY

ARTICLE FOR "FISCAL STUDIES"

I sent a copy of the first draft of the article for "Fiscal Studies" to the editor and he has confirmed that it will be published in the next issue which is due in February.

I now attach a final draft and I should be grateful to know whether you are content that it should go forward: they want it not later than next Friday, 12 December. As you will see - to answer one of the questions you put to me - we propose that the article should be put forward in my name.

The final draft takes account of all the comments which have been put to us, and in particular we have reflected Mr Scholar's comments.

Since my previous minute John Kay's valedictory address has been printed in the November issue of "Fiscal Studies". Since our article will be appearing in the very next issue it would look very odd indeed if we made no reference whatsoever to what John Kay said, but we have drafted it as far as possible in an uncritical tone so that it appears to be only indirectly related to it.

LJHB

L J H BEIGHTON

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cc PS/Chancellor of the Exchequer
PS/Chief Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Mr Scholar
Mr Cropper
Mr Ross-Goobey
Mr Tyrie

Mr Battishill
Mr Isaac
Mr Painter
Mr Pollard
Mr Rogers
Mr Beighton
Mr Cherry
Mr Crawley
Mr Jones
Mr Matheson
Mr Muir
Mr Johns
Ms Tyrrell
Mr Walker
PS/IR

TAX POLICY AND MANAGEMENT
- THE ROLE OF THE INLAND REVENUE

L J H BEIGHTON*

There has been some public debate in recent months about the approach of the Inland Revenue both to giving advice on tax policy to Government Ministers and to management of the tax system (e.g. John Kay's valedictory address to the Institute for Fiscal Studies)[1]. Some of these comments appear to be based on a misunderstanding of the Inland Revenue's role. In the hope that it will help to inform the debate I explain in this article what we are trying to do in the Inland Revenue and how we see our function.

THE BOARD OF INLAND REVENUE

The Board of Inland Revenue is responsible for advising the Chancellor of the Exchequer on questions involving policy on direct taxation (and the stamp duties). After the Chancellor has decided those questions and Parliament has enacted legislation giving them effect, the Board is responsible for implementing them as part of their statutory responsibility for the care and management of the direct taxes (Section 1 of the Taxes Management Act 1970 as far as income tax, corporation tax and capital gains tax are concerned).† They are accountable in general terms to Treasury Ministers for their stewardship, but Ministers do not get involved in the day to day business of running the Department. In particular Ministers do not have access to information about people's confidential tax affairs (without their consent) or intervene in how they are to be taxed.

Board members are formally appointed by the Crown. But they are civil servants and in all other respects they are in an identical position to civil servants in other departments. The Chairman, Tony Battishill, is a permanent secretary; five of the other six members of the Board are deputy secretaries and the seventh is an under secretary. The Chairman, both Deputy Chairmen and one other Board member have had extensive experience in other departments, and the other three have spent much of their career in a wide range of operational offices of the Department responsible for the day to day contact with taxpayers and the handling of their affairs.

REVENUE ADVICE ON TAX POLICY

One respect in which the Board of Inland Revenue is on all fours with civil servants in other departments is in relation to the advice given on tax policy. Treasury Ministers are responsible

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*Leonard Beighton is the Director, Central Division, Inland Revenue.

†The Inland Revenue is also responsible for the provision of rating and valuation services, but this aspect of our duties is not covered in this article.

for taking decisions on what the tax law should be subject always to Parliamentary approval. In taking their decisions it is first to the Inland Revenue to which they turn for advice as far as the direct taxes are concerned: the conventions governing this advice are exactly the same as in other departments. Ministers take the decisions and are responsible for them to Parliament and the advice they receive from their officials prior to taking the decisions is confidential. Officials are then responsible for ensuring that the decisions of Ministers and Parliament are properly implemented.

Policy advice is provided by six Policy Divisions in the Inland Revenue's Head Office who report to the two Deputy Chairmen of the Board. One division provides advice on personal taxation, another on business taxation, another on the capital taxes, and so on. Like the Board, these divisions are manned by people with a variety of experience. At a recent count some two-thirds of senior policy staff (Principal grade and above) had worked for part of their career in various operational units of the Revenue, nearly half had spent some of their career in other Government departments (or quasi Governmental bodies) and one-fifth had experience of employment outside the Civil Service. Moreover Policy Division staff are in daily touch with their colleagues in the Technical and Management Divisions to ensure that Ministers have the best technical advice possible and are able to take full account of the staffing and operational implications before decisions are taken.

There is also close liaison with the Treasury's Fiscal Policy Division which is concerned with tax issues across the board in relation to the Government's wider economic and financial objectives, and has a general coordinating role. In addition, the Treasury have a considerably larger cadre of professional economists than we do and our statisticians and economists work closely with them in order to ensure that Ministers are fully advised on the macro and micro economic implications of tax changes and have as accurate forecasts of future tax yields as possible. Where the interests of another department are closely involved - for example the Department of Energy on North Sea taxation, and the Department of Health and Social Security on the interaction between tax and benefits - those Departments as well as the Treasury are consulted. The same is true of the Bank of England on matters affecting financial institutions.

This means that Ministers get detailed professional advice on the effects of different courses of action on tax yield, economic behaviour, distributional implications and so forth. Most of the analytical work by the department's economists and statisticians is unpublished because it is intimately bound up with the process of policy advice. Some is published each year in the Financial Statement and Budget Report and the Autumn Statement[2], both of which contain estimates of tax yields or costs resulting from legislative changes. We publish annually a volume of "Inland Revenue Statistics"[2]; and information from the Survey of Personal Incomes[2] is available both in tabular form and as an anonymised data tape of individual records.

Occasional background papers and articles have been published such as the Revenue paper "Cost of Tax Relief for Pension Schemes: Appropriate Statistical Approach"[3]. Analytical work may also be published in general Government documents. For example, last year the Green Paper on the Reform of Personal Taxation[4] contained a detailed analysis of the distributional implications of the introduction of transferable allowances, not only taken on their own but also when resulting changes in entitlement to social security benefits were taken into account. The 1982 Green Paper on Corporation Tax[5] provided substantial background statistical information on the corporation tax system and analysed the effects of the options considered in the paper.

In addition to the research work which the Revenue carries out itself it sponsors with the Treasury independent research on taxation. Apart from one-off consultancy exercises like the Business Expansion Scheme study mentioned below, we have together formed a consortium with the Economic and Social Research Council which has financed independent research. This has included a number of recent projects on personal and corporate taxation from the IFS, personal taxation studies at the LSE, and research into the compliance costs of taxation at Bath University[6]. The Treasury has also sponsored research directly, such as Professor Brown's project at Stirling University on direct taxation and labour supply in which we take a close interest. In this way the Department does much to support independent research. The Revenue makes increasing use of private sector consultants in this whole area, including the interaction of policy and management considerations. Close touch is also kept with economists outside the Government service, so as to ensure that we are able to benefit from the latest academic thinking. In our work leading up to the 1984 business tax reforms, for example, we drew on the seminal work of King and Fullerton even though it had not been published by the time of the Budget[7].

Policy evaluation

Policy advice to Ministers can be divided into two main groups. First it may be concerned with the broad strategy of the tax system - for example, together with the Treasury we looked at the whole field of savings and investment, focussing in particular on tax neutrality, before work on the 1984 tax reforms was set in hand. Second it may be concerned with consideration of more detailed issues which fall within the broad strategic approach which has been settled by Ministers.

In either event any consideration of proposals has to be evaluated against many, sometimes conflicting, criteria. It is hardly possible to prescribe an exhaustive list of all the considerations that may be relevant in considering a possible initiative in tax policy, but the 1985 Public Expenditure White Paper[8] contained a check list of the more important ones.

These were:

i. the cost or yield to the Exchequer and the distribution of gainers and losers among different categories of taxpayer;

ii. the economic effects of the proposals and any behavioural changes they would be likely to induce;

iii. the consistency of the proposals with the general thrust of the Government's tax policy, and its broader economic, financial and social policies;

iv. the implications for other parts of the tax system, for the social security system, or for other proposals which Ministers may be considering;

v. the likely effect on the perceived fairness and general acceptability of the tax system;

vi. the effect of the proposals in increasing or reducing the complexity of the tax system;

vii. the administrative implications, including effects on public expenditure and the use of public service manpower,

viii. the compliance burden on employers, businesses and other taxpayers;

ix. any views bearing on the proposals expressed in Parliament, or by representative bodies or by individual taxpayers;

x. any relevant international obligations arising from, for example, double taxation agreements or European Community obligations.

The relative weight given to these various factors will differ according to circumstances and the nature of the proposal being considered.

Our job is to ensure that Ministers are made aware of the relevant considerations, and receive the best advice possible on the likely effects of measures they have in mind. Once changes have been made, or new measures introduced, it is also our job to see whether the intended results are being achieved and, if they are not, to consider whether some further action should be taken and if so what. Let me give an example.

The Business Expansion Scheme was designed to encourage a greater supply of outside equity capital for risky small businesses. Officials worked up a detailed scheme under Ministerial guidance, based on the Business Start-up Scheme, and the legislation was introduced in 1983. This, however, was not the end of the story. We also needed to monitor whether the new scheme was meeting its objectives. Consultants (Messrs Peat Marwick Mitchell) were employed to examine how far the BES was in fact providing additional risk capital for small businesses. Their report[9] suggested that by and large the scheme was generating additional equity capital as intended, but that not all the projects were of the risky type originally envisaged. So this year's Finance Act made permanent the original temporary scheme, but it narrowed the scope of qualifying investment so as to target the relief more accurately. It was unusual for a proposal to stem from an external survey of this type, but a substantial proportion of tax changes derive from studies made within the Revenue of how far tax reliefs or rules are fulfilling the intentions behind them. No scheme is likely to be free of deadweight, but it is important with tax provisions - just as with public expenditure - to keep the accuracy of targeting under review. It is not simply a matter of tax avoidance but of ensuring that tax reliefs are cost effective and are doing the job which Parliament intended.

Where proposals for tax change come from

There are many other sources of tax changes. Naturally many stem from Ministers' own political aims and obviously all have to be consistent with their objectives. Others come from representations by the various representative bodies and interest groups. A third source is Ministers and officials in other Government departments and public committees and commissions of enquiry (such as the Keith Committee on the enforcement powers of the Revenue departments)[10]. Lastly some proposals for change originate within the Revenue itself.

Given the widely differing nature and importance of the various proposals it is not always easy to separate out the different sources of a particular proposal or to measure the weight of proposals from a particular source. All sources are significant: for example, just counting separate proposals without any weighting for their importance, in a recent year of the proposals initially considered in detail (a tithe of those put forward), about a tenth were provisions which had to be considered each year (like the rate of income tax which has to be fixed annually), about a fifth derived directly from Ministerial initiatives, and another fifth from private sector representations. Three tenths came from other Government departments and committees and the remaining fifth came from Revenue officials. But wherever the ideas originated, it is the Chancellor of the Exchequer who decides, giving such weight as he thinks fit to our advice.

The cycle of policy work

The annual cycle in which officials draw together the various sources of advice and information, assess them against these criteria, discuss them with Ministers, convert Ministerial decisions into instructions for Parliamentary Counsel to draft into legislation, and assist Ministers in piloting the legislation through the House of Commons, is described in detail in Chapter 7 of the Board's annual Report for 1983[11]. There is not room to repeat the description here. But two aspects stand out.

First is the growing importance of direct consultation to supplement full Parliamentary scrutiny of tax proposals. There are regular discussions between the leading representative bodies and senior Revenue officials; and ad hoc discussions are held with interested parties on specific proposals. These vary in formality from the full scale type of consultation such as that on the recent Green Paper on the Reform of Personal Taxation[4] with a published paper, a timetable of several months for comments and a full-scale review by Ministers, to a quick discussion during the course of a Finance Bill with interested parties about a problem they have identified in legislation to be debated in the House of Commons perhaps in a couple of days time.

Second is that - as society becomes increasingly complex - so time scales lengthen. Representative bodies who want their views to influence thinking must let us have them earlier and earlier. November is nowadays none too early for the following Budget.

THE REVENUE AND THE INDIVIDUAL TAXPAYER

Turning from policy to implementation, it is in relation to its dealings with individual taxpayers that the Revenue's statutory independence is most significant. As a rule, we do not, as explained above, involve Ministers in individual decisions. But we are tightly bound by the general law on what we can do. Taxpayers can appeal to an independent tribunal (the General or or Special Commissioners) if they are dissatisfied with their assessments. On points of law there is a right to appeal to the Courts. If they are dissatisfied with the way their case has been handled in other respects, they can get help from their MP or Ministers. MPs can call on the Parliamentary Commissioner for Administration (the Ombudsman) to investigate a case of alleged maladministration and he will examine our papers and can interrogate officials during his investigation.

Last July the Board issued a Taxpayer's Charter[12] setting out the principles of service to taxpayers which for many years we have aimed to achieve. The rights which this identified for taxpayers were the rights to help and information, to courtesy and consideration, to fairness, to privacy and confidentiality, and to expect the Revenue to have regard to taxpayers' costs in complying with the law. These are general aspirations which guide our dealings with taxpayers and, with a Department of nearly 70,000 staff and a taxpayer population approaching 30 million, it is not always easy to achieve them to our complete satisfaction in every case. But the Department is concerned to try to provide this level of service in as high a proportion of cases as we can consistent with the resources available to us.

In fulfilling our statutory tasks of assessing and collecting tax, we have to be - and are - fully aware of the impact of the tax code on our consumers - individuals and businesses alike. We are also conscious of our responsibilities towards taxpayers, both in our day to day dealings with them, and within the broader policy context. We have played a very positive and constructive role within the Government's wider deregulation initiative in attempting to reduce the burdens which the tax system places on the taxpayer. This is a good example of the very careful balance we have to draw at all times between getting tax receipts to flow into the Exchequer and our wider responsibilities to taxpayers - a balance which also lay at the root of the recommendations of the Keith Committee[10].

DEPARTMENTAL MANAGEMENT

The Revenue is a large and decentralised organisation employing nearly 70,000 staff in over 900 offices up and down the country. There are three main networks of local offices - tax offices assessing tax, collection offices collecting the tax, and valuation offices valuing property. There are a number of operational offices not linked to the main networks including the Capital Taxes Offices (administering Inheritance Tax and its predecessors) and Stamp Offices (administering stamp duties) and a number of specialist offices. Finally there are a number of regional offices and our head office based in Somerset House in London. The total cost of running the Department in 1985/86 was a little over £1 billion.

Managing the department is therefore a substantial responsibility in itself. The Board perform this management function within a framework laid down by Ministers. The Government determines the resources - manpower and finance - available for the Department. It also lays down the principles of personnel and management policy which we have to follow (e.g. open and fair recruitment is safeguarded and monitored by the Civil Service Commission) and the levels of pay we can offer.

Departmental staff

By far the most important resource of the Department is the people who work in it. Staff related costs account for nearly 90% of our total costs. We need staff with a wide range of skills in view of the diversity of the work we do. Although we employ many people with a wide range of professional training and experience, nearly two-thirds of our staff are in the two most junior clerical grades where the salary ranges run from around £3,000 to a little over £7,000. The Department is getting younger - most of the staff are under 35 with almost a fifth, the biggest single age group, being between 21 and 25. For a long time many of the staff in the Department have been women - the proportion is now about three-fifths and is still increasing. In response to this trend we have been doing a great deal to make patterns of work more flexible and responsive to women's needs. In the 1970s we took the lead in the Civil Service in introducing flexible working hours. More recently we have greatly expanded the opportunities for part-time working.

The skills we need are ones that are in high demand by other employers too. We have suffered a marked increase in resignations in recent years, particularly in some key grades and areas. Since 1982 there has been a fourfold increase in the number of resignations of fully trained Inspectors of Taxes, reflecting in particular the sharp increase in the remuneration of accountancy skills in the private sector. 1986 saw, however, a welcome if only small reduction in the number of resignations following the steps which we have taken to stem the flow. Resignations of professional valuers, examiners from the Capital Taxes Offices, and of clerical and executive staff, particularly in London and the South East, have also increased sharply. These losses put a considerable burden on our training effort - for example it costs some £40,000 to train a fully trained Inspector of Taxes (so that he can carry out the full range of work on examining business accounts) - and the proportion of our staff in local offices who are trainees and lack experience is rising rapidly. We are therefore having to develop a strategy for improving recruitment and retention of staff and for using as productively as we can the skills of the staff we have. Over the years we have had major programmes to move clerical work to areas of the country where recruitment and retention is easier and we are currently looking to see if we can do the same for some of our trained Inspector jobs.

Control of resources

The Department's management work, like its policy work, is governed by an annual cycle - in this case the annual public expenditure and estimates cycle. This starts, as for other Departments, with the Public Expenditure Survey which sets resources for a three year forward period, and is published in detail in the Public Expenditure White Paper around January. This sets the resources for the Department in both manpower and money terms. The overall allocation for the next financial year is converted into more detailed estimates presented to Parliament in the spring. At any time, we are working within limits set by the Government on the total cash we can spend in the financial year, limits on our running costs (i.e. all costs other than capital costs) and to targets for our manpower at the end of the financial year. The cycle is closed by the publication of an annual report[13] to Parliament recording the Board's stewardship of its resources for the preceding year. A recent study by the National Audit Office[15] showed that the Inland Revenue and Customs and Excise were unique in publishing comprehensive retrospective reports on the whole of the Department's activities.

Internally, as part of the Civil Service Financial Management Initiative, we have embarked on a major exercise to decentralise control of these resources and to improve accountability for their use. At the top level we have set up a Senior Management System under which each Division reports to the Board on its performance against its objectives for the previous year and on its objectives for the following year. These reports are reviewed at a series of Board meetings with Divisions in December and January which set the direction for the department for the year ahead. The reports are published the following spring or summer.

At the same time we are setting up a line management budgeting system which allocates resources to individual line managers down to local office level, gives them greater freedom in allocating their resources within their budget, and holds them accountable for their performance against their budget. Management information systems are being improved in conjunction with this. This system at present covers 75% of the Department and will be extended to the remaining 25% next year. This is not just a change in accounting procedures: it requires a significant change in management style to use the new freedom effectively and to adapt to different controls from the past. Fuller descriptions of the Senior Management System and our line management budgeting system can be found in articles by

M Symons[15] and P Willingham[16].

Improvements in efficiency

Over the last few years the Department has taken a number of important measures to improve efficiency. The total number of staff employed has been reduced by nearly 20% since April 1979. (Chart 1 attached). Of the 15,000 staff saved, about 5000 are due to legislative changes; the rest are due to managerial improvements in efficiency. There are a number of strands to this in addition to the changes in financial management I described above.

Computerisation

One of the most important of these involves our harnessing the potential of information technology. We started converting PAYE to computers in the 1960s, and in Scotland PAYE was centralised at a computer centre in East Kilbride as long ago as 1968. Further work was however suspended in 1970 when the incoming Government decided to review the future of PAYE. This led to the proposed tax credit system, which in turn was suspended by the new Government in 1974. Planning switched back to computerising PAYE, but in the meantime technology had moved on and trials proved that, rather than a batch processing system centralised at a few centres like East Kilbride, a distributed on-line system with local offices linked to the computer centres would provide a better solution and be more efficient. It would also be more convenient for staff and taxpayers alike. Plans for a system on these lines were reviewed again on the change of Government in 1979 and a revised plan was approved by Ministers in 1980. During the development phase it was decided to broaden the programme to include Schedule D assessing as well as PAYE, making this one of the largest computer applications of its kind in Europe.

The project involves 12 mainframe computers and some 25000 visual display units linked in. An independent team of researchers said of it "In short, COP [computerisation of PAYE] has displayed a thrusting, prudent management strategy which has not only ensured the development of the system on schedule, but has actively sought ways to enhance the programme to the benefit of the Inland Revenue, the taxpayer and the British computer industry"[17]. In no small part this success has been due to the effective use of outside expertise - harnessing the skill and experience of private sector consultants with the Department's own operational and IT expertise.

This is not our only computer system in existence or planned. During the 1970s while the future of PAYE was under review, we pushed ahead with the computerisation of the collection of tax and corporation tax assessing. We now have plans to convert these systems on to more flexible and up to date technology and this will improve our level of service to the public over the next few years. And we have used computer systems for many years on statistics, pay and personnel matters. A fuller account of the Department's plans for the future can be found in "The Direction of Change" which we published in April 1985[18].

Network reorganisation

At the same time we have been slimming down our networks of local offices. The number of local offices in our networks will be reduced by over a quarter: the reorganisation of our tax office and collection network should be complete by 1988/89 (saving annual accommodation costs of £8m at 1986/87 prices) and that of our valuation office network sometime after 1990.

Better investigation methods

A rather different type of measure to improve efficiency has been in our investigation work. Since the late 1970s we have made considerable improvements in the cost-effective deployment of our trained Inspector resources. We have monitored in greater detail adjustments made to accounts, introduced a more systematic method of allocating resources, and set targets for the numbers of cases to be investigated. A chain of special offices has been set up to handle some particularly complex cases and problems of avoidance and evasion. And in 1985 we reorganised our Enquiry Branch and other head office investigation sections. As a result the yield of our investigation and audit work has increased by 25% a year on average over the last decade in real terms and is now six times what it was in 1976. (Chart 2 attached).

Manpower planning

The rundown in staff numbers has not been easy to manage and we have devoted considerable attention to effective manpower planning. We have worked very closely with the Institute of Manpower Studies in developing effective planning techniques. And we have met our challenging targets for reductions with minimal compulsory redundancies.

Changes in management style

This does not mean that there have been no problems. During 1985 our arrears rose to historically unprecedented levels as a result of the pressures caused by office reorganisations and preparatory work for computerisation, growth of work greater than forecast, and the high levels of resignation and resulting inexperience among clerical staff (particularly in London and the South East). In November 1985 a major effort to tackle the backlog was launched with the backing of Ministers and Unions. There were three specific changes: authorisation (with trade union cooperation) and funding of substantial overtime working; an increase in our manpower targets to cope with the extra work volumes; and a number of functional changes (mostly of a temporary nature) in lower priority work.

The result has been a major turn around, with work on hand down by more than a third, arrears over a fortnight old down by over two thirds, outstanding repayment claims fewer than for several years, and routine cyclical work more advanced. But as important has been the less tangible change in management style arising from the clear commitment throughout the Department with better communication and more active targeting on priority jobs. This fits in with a longer term programme to improve communications by way of attitude surveys, a regular house journal, newsletters from the Chairman, and regional seminars with local management.

Measurement of performance

Unlike a private sector business the Revenue has no simple measure of improved profit to show from its efficiency measures. Our job is not to maximise the revenue, but to ensure that the correct amount of tax is assessed and collected. There are a variety of indicators which can be used. Each tells part of the story but each, if pursued as the sole measure of performance, could be misleading. The problems can be seen by considering two in a little detail.

An important indicator is the relation between the amount of tax we collect and the cost of doing so. We have been publishing cost/yield ratios in our annual Report for many years. Last year at 1 2/3p for every £ collected the ratio reached the lowest level since we started to calculate it on the present basis in 1974/75 (Chart 3 attached). We publish cost/yield ratios for the individual taxes in the Board's Report and also for our main forms of investigation work. But there are real snags with this as a measure of performance: changes in tax law (e.g. a change in the basic rate of tax) can affect the yield without any alteration in the real burden of work. And while the effect on cost/yield is one aspect of policy change to be taken into account, it is by no means a decisive one. In order to secure their economic and social objectives Ministers may very reasonably decide to introduce reliefs which add to our staffing needs while reducing the yield.

Another indicator, employed by John Kay in his valedictory lecture is the average number of assessments made per member of staff.[19] But this can actually be a perverse measure of our Departmental performance. As we attempt under PAYE to collect the right amount of tax from employees during the year, about four in every five Schedule E taxpayers do not need an assessment at the end of it. In recent years we have taken efficiency measures to cut down the number of assessments required to reduce the Department's workload. But Schedule E taxpayers still need their records kept up to date during the year. So any increase in the figures of assessments would tend to reflect a failure in performance rather than the reverse.

We believe the sensible approach is to use a variety of performance indicators. A number of these have been developed and are in active use as management tools. Some of them are set out in the Revenue section of the Public Expenditure White Paper, including targets on progress of line management budgeting, milestones for reorganisations, progress in reducing arrears, proportion of accounts investigated, and number of cases handled per professional Valuer. The Board's annual Reports publish a wider range of statistics of our performance. Work is continuing in this area.

INTERACTION BETWEEN MANAGEMENT AND POLICY

The Revenue is sometimes asked whether it has a policy view "of its own". It cannot, and does not, have a policy view - above all not one at variance with that of the Government of the day. But inevitably policy decisions put constraints on management decisions and vice versa. Administrative considerations point in the direction of a relatively simple, broad-based, system with the minimum of distortions requiring the policing of difficult border lines between forms of income or category of taxpayer. But administration is only one of the ten criteria listed above which need to be taken into account for tax policy. Some legislative changes like Mortgage Interest Relief at Source (MIRAS) have been of major assistance in keeping down the cost/yield ratio. Others inevitably pull in the opposite direction because of wider economic, social, or political considerations.

Changes of Government (and we had three in the 1970s) do of course alter the overall thrust of our activities. But today major changes take ever longer to plan as we seek to take advantage of the latest technological developments. So our Departmental Development Plan (a very brief and general outline of which was published in July)[20] displays the intended progress of each of our major activities over the next ten years - and the interactions between them - while retaining the flexibility to adjust to any changes there may be in the political scene, in technology and in society. More generally the objectives the Board have set out for themselves have one eye firmly on the sort of conditions in which we may perhaps be working by the middle of the 1990s.

Conversely the methods of assessing and collecting taxes and the timetable for changes (eg computerisation) also affect policy decisions and can put real constraints on the feasibility or extent of particular policy changes, at least in the short term. For example, transferable personal allowances would hardly have been feasible under the old manual system of PAYE and Schedule D and their introduction will only really be practicable after the COP and CODA (computerisation of Schedule D assessing) programmes are complete and an integrated departmental data network is in place.

If transferable allowances are introduced there will be a need to keep within strict bounds other organisational changes at the same time. There is a similar interaction between the introduction and improved on-line computer system for the collection of tax and some of the policy changes in the compliance field which are being considered following the report of the Keith Committee[10].

CONCLUSION

A great deal is happening in the Inland Revenue and the pace of change is accelerating. A lot remains to be done. On policy it will be Ministers who determine what they want done and how. On management too, they set the framework. Within this there are many things we have to do - to improve our measurement and targets for performance, constantly to improve our efficiency, to establish budgeting as a way of life among our line managers, and to recruit, retain and motivate a professional workforce so that we can give a high level of service to the public. We have to develop the skills of our staff to the full, increase their job satisfaction and exploit the potential of information technology.

We therefore welcome debate, and are interested to learn how outsiders see the direction in which the Revenue should go. We try to be open to ideas, but it is important that they should be based on the facts. I hope this article and the publications I have referred to in it will help to provide the factual background for that debate.

References:

1. J A Kay "Tax Reform in Context: A Strategy for the 1990's" Fiscal Studies, November 1986.

2. Published HMSO.

3. Published Inland Revenue Background Paper 1983.

4. Cmnd 9756

5. Cmnd 8456

6. Financial Times, 28 November 1986.

7. M A King and D Fullerton, Eds.,"The Taxation of Income from Capital", National Bureau of Economic Research and the University of Chicago Press, Chicago.

8. The Government's Expenditure Plans 1986/87 - 1988/89 (Cmnd 9702).

9. Peat, Marwick, Mitchell "Business Expansion Scheme". Published 18 March 1986, available from Inland Revenue Reference Room, New Wing, Somerset House, London WC2R 1LB

10. Cmnd 8822, Cmnd 9120 and Cmnd 9440.

11. Cmnd 9305.

12. Published in Board of Inland Revenue Report for the year ended 31 December 1985 (Cmnd 9831) page 3.

13. Latest annual report Cmnd 9831.

14. "Report on Financial Reporting to Parliament", pub NAO 24 July 1986.

15. M Symons "The Inland Revenue's Senior Management System" Bulletin for International Fiscal Documentation, Vol 39, 1985 (No.8/9) p.363.

16. P Willingham "The Inland Revenue's response to the FMI" Public Finance and Accountancy, 17 October 1986

17. Peter W G Morris and George H Hough "Preconditions of Success and Failure in Major Projects", Major Projects Association Technical Paper 3, pub Templeton College, Oxford Centre for Management Studies, September 1986.

18. Published with Report of Inland Revenue Senior Management System. Available from Inland Revenue Reference Room.

19. Kay, op cit, page 13.

20. Paragraph 11 Report of Inland Revenue Senior Management System 1985. Available from Inland Revenue Reference Room.

COST/YIELD RATIO : DIRECT TAXES

For Financial Years 1975 to 1986

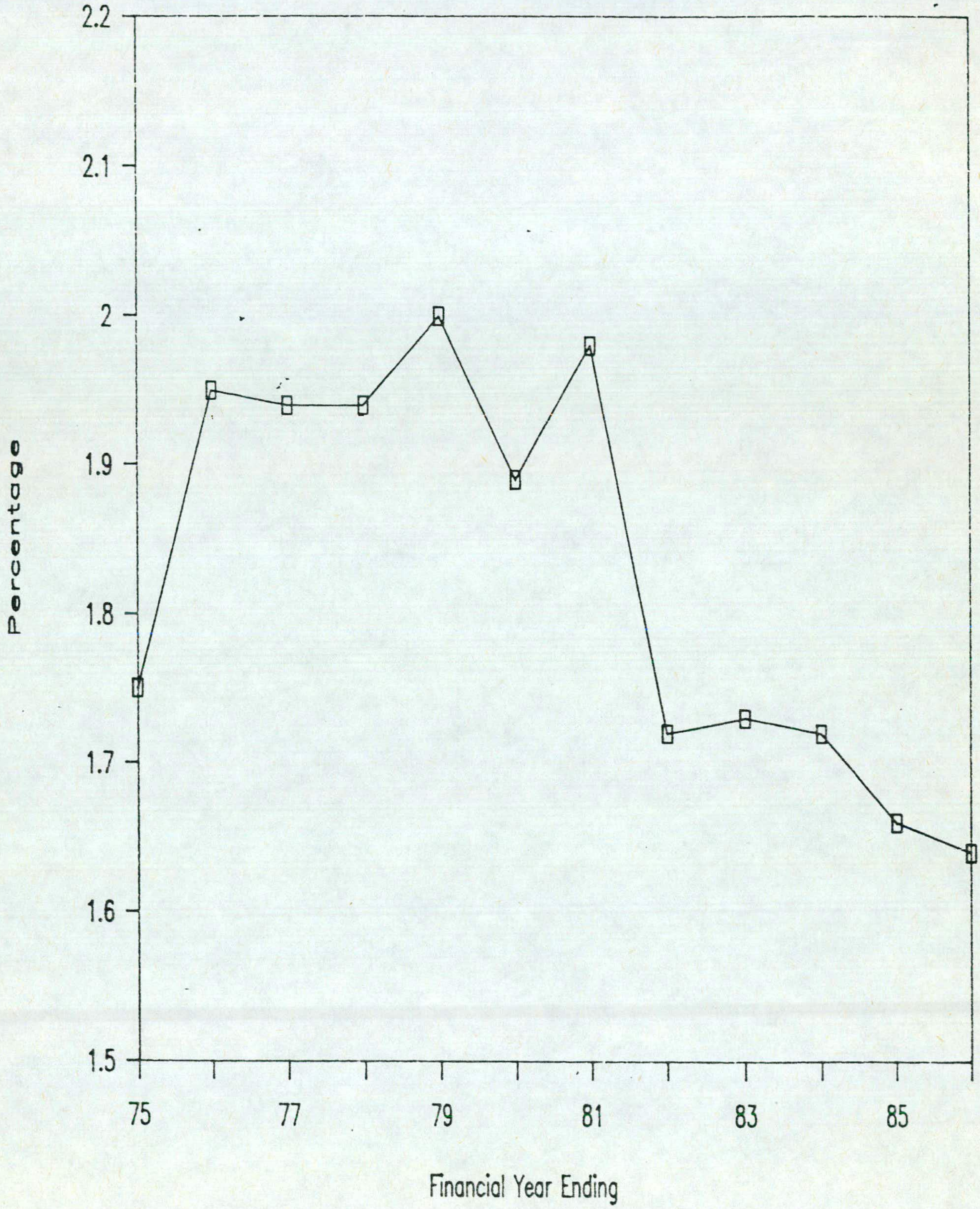


DIAGRAM 1
Inland Revenue Staff Numbers
1976/77 to 1985/86

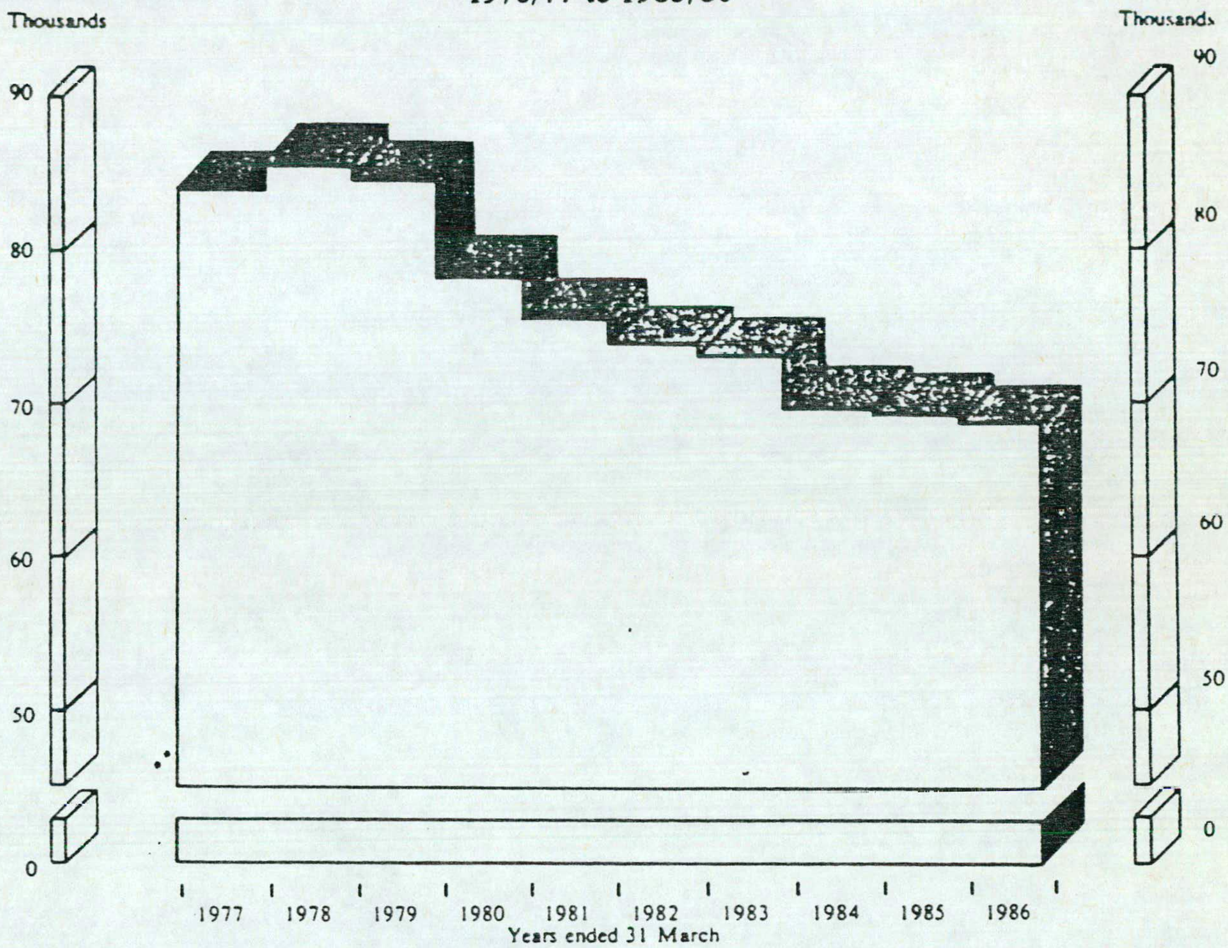
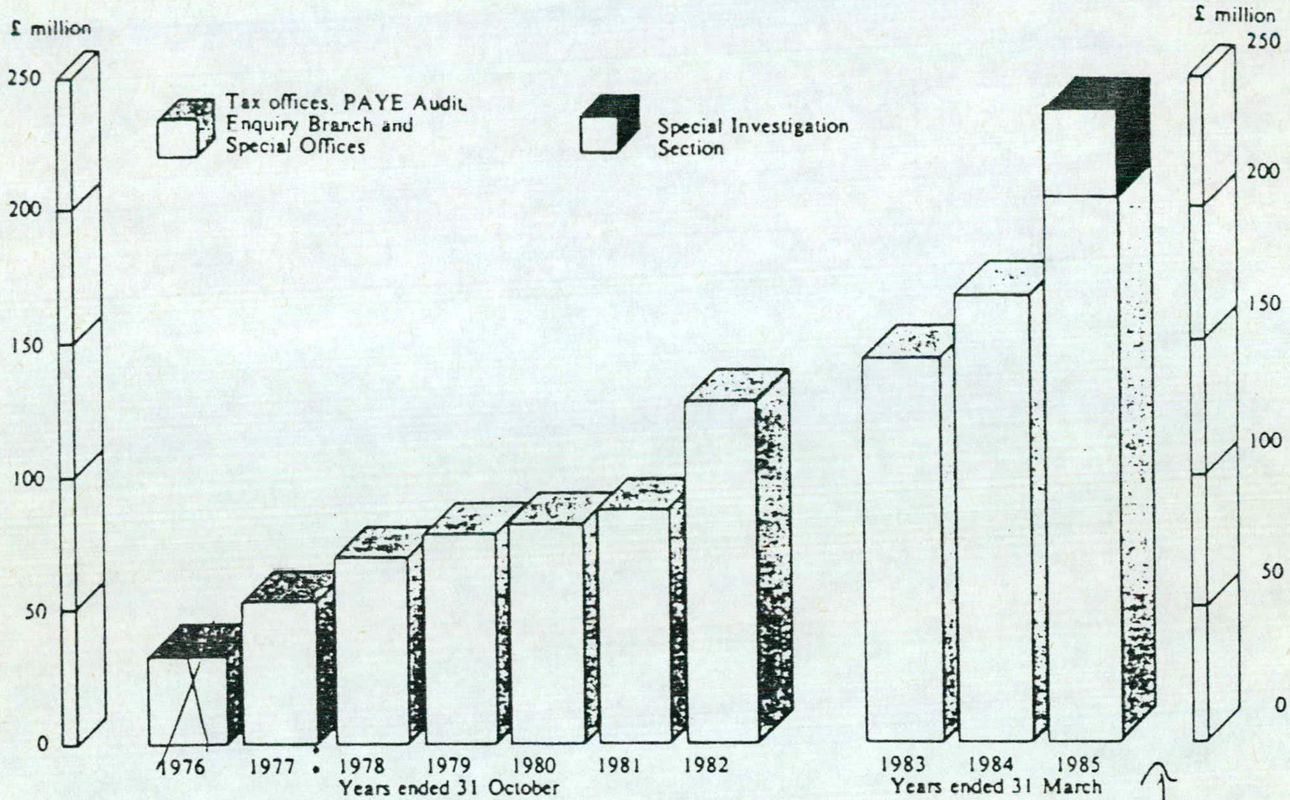


DIAGRAM 15
Yield of Investigation Work 1975/76 to 1984/85 at constant (1975/76) prices



See the footnote to Diagram 4 for the calculation of constant price figures.
For 1984 and earlier years, figures for the yield from Special Investigation work are not available.

add in 31/3/86.

4-28

CONFIDENTIAL

Rmw

c/ You asked to see Mr Scholar's comments on the earlier draft

Ms Ryding CE 8/12

H M Treasury

Parliament Street London SW1P 3AG

Switchboard 01-233 3000

Direct Dialling 01-233 ....

You asked to see this.

The latest draft is, in my view, still very dull, and I do not think it will do the Revenue any positive good. (I have not said that to them, for morale reasons).

But it is now acceptable to us, although one or two sentences (eg the first full sentence on p2) still stick in our gullet to a degree.

MCS 8/12

M C SCHOLAR
Under Secretary

L J H Beighton Esq
Inland Revenue
Central Division
Somerset House
LONDON WC2

28 November 1986

Dear Leonard,

ARTICLE FOR "FISCAL STUDIES"

As you know, Treasury Ministers have asked me to agree with you the text of your article for "Fiscal Studies". In the main, I have few comments on this. But there are one or two places where I believe changes need to be made:

(i) On page 2 I think it would better counter criticism of the John Kay variety if you gave more prominence to what is often seen as the more pure "policy" kind of advice, and less to technical and management issues. It might also focus the reader's mind on your article's objective if - given John Kay's obituary of FP - you mentioned earlier your liaison with the Treasury and the ghost of FP division. Would you, therefore, include in the third paragraph of page 2, after the first sentence

"... isolation. There is close liaison with the Treasury's Fiscal Policy Division which is concerned with tax issues across the board in relation to the Government's wider economic and financial objectives, and has a general co-ordinating role. Treasury economists specialising in tax issues work closely with the Revenue's own team of 30 statisticians and economists. Where the interests of another department are closely involved - for example the Department of Energy on North Sea taxation, Department of Health and Social Security for tax/benefit interaction, those Departments as well as the Treasury are consulted. The same is true of the Bank of England on matters affecting financial institutions."

(ii) as a consequential, the succeeding paragraph might start

"As already noted, Policy Divisions draw on the support of our statisticians and economists for advice ...".

(iii) I wonder about the wisdom of mentioning, in the first paragraph of "Policy evaluation" on p3, the "wide-ranging review with the Treasury of the whole field of savings and investment". Won't we be asked to publish this, and wouldn't it be impossible to do so, given what the review would reveal about our thinking then and what we have not done about some of it since?

May I also suggest the following changes:

(i) bottom of p3, first check-list item to read "the cost or yield to the Exchequer and the distributional effects"

(ii) p11 delete "above all not one at variance with that of the Government of the day" and substitute "as explained above"

(iii) p11 begin third paragraph "Changes of Government do of course alter the overall thrust of our activities"

(iv) second line of final paragraph (p12) substitute "accelerating" for "accumulating"?

- eight lines from the bottom delete "and not waste" and insert "and" between "recruit" and "retain"

- seven lines from the bottom substitute "can" for "and", and insert "and" before "explicit".

I hope these suggestions will give you no problems.

Yours sincerely

Michael Scholar

M C SCHOLAR

27:2

PERSONAL AND CONFIDENTIAL
Until 11.30am on Thursday 15 January

FROM: G. HACCHE
DATE: 14 January 1987
cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Monck
Mr Sedgwick
Mr Scholar
Mr Culpin
Mr S Davies
Mr Dyer (+1 for No.10)
Mr Hudson
Mr Hunt
Mr MacAuslan
Mr Cropper
Mr Ross Goobey
Mr Tyrie
HB/01

1. ~~MISS~~ O'MARA
2. CHANCELLOR

More good news on unemployment which does not seem to be wholly attributable to the employment measures – and the North/South pattern over the last year is generally helpful. The pick-up in employment growth in Q3 is also encouraging.

MOM 14/1

Thanks! I look forward to it.

COMBINED RELEASE OF LABOUR MARKET STATISTICS ON 14 JANUARY

Summary Statistics (seasonally adjusted unless otherwise stated)

	Level	Change on previous period
	Thousands	
Unemployment		
Total (excl. school leavers) December	3,116	-28
Total (not seasonally adjusted) December: 'Headline Total'	3,229	+12
Vacancies December	210	- 5
Employed Labour Force 1986Q2	24,117	+71
Manufacturing employment November 1986	5,128	- 34

	Percentage change on previous year
Index of average earnings	
Whole economy November, underlying (actual)	7½ (8.1)
Wage and salary costs per unit of output	
Whole economy 1986Q3	4.9
Manufacturing 3 months to October	3.8
Output per head	
Whole economy 1986Q3	2.4
Manufacturing 3 months to October	3.6

PERSONAL AND CONFIDENTIAL
Until 11.30am on Thursday 15 January

Unemployment

2. Seasonally-adjusted adult unemployment (excluding school leavers) fell sharply again, by 28,000, in December - the largest monthly fall since unemployment began falling in August. The level is now 3,116,000 or 11.3 per cent of the working population. Over the past six months the seasonally adjusted total has fallen on average by 17,000 a month, and over the last three months it has fallen on average by over 25,000 a month.

3. The headline total rose by 12,000 to 3,229,000, 11.7 per cent of the working population. (You will remember from last month that the changes to reduce overcounting have resulted in an unusual seasonal increase between November and December.) There was an increase of 22,000 among adults, while unemployed school leavers fell by over 9,000, little different from the fall last year.

4. The stock of vacancies at Jobcentres (seasonally adjusted) fell by 5,000 in December to 210,000, following 10 successive monthly increases.

5. Points of interest:

(a) Seasonally adjusted total lower than a year ago (December 1985: 3,132,500) for the first time since February 1980. Lowest figure since November 1985.

(b) Fall over past three months largest 3 monthly fall since March 1973. Fall over last six months largest 6 monthly fall since December 1973.

(c) Fifth consecutive monthly fall - first time since 5 months to September 1979.

(d) Fall in December largest monthly fall since April 1979.

(e) The DE press notice states that the latest figures continue to show a downward trend. DE will be saying in their press briefing that the current trend in the series is a fall of the order of 20,000 a month - the first time they have been prepared to quantify the fall.

(f) Male unemployment (seasonally adjusted, adult) has fallen in each of the last 6 months by 62,000 in total. Female unemployment has fallen in each of the last four months by 48,000 in total.

(g) The headline total in January is likely to rise, even if the current downward trend in seasonally adjusted adult unemployment continues. The seasonal influences on unemployment in December will be upward, provisionally estimated at around 70,000.

The seasonal rise will be mostly confined to adults, with little change among school leavers.

(h) The falls in unemployment over the past few months have been spread across most regions with the exception of Scotland. Northern Ireland was also an exception until recently but unemployment has now fallen there for two months following previous sharp rises. Over the past year unemployment has fallen in the North, Wales, the North West and the West Midlands.

(i) The estimated effect of employment measures on the count has been rising by about 5,000 month for more than a year. [UNPUBLISHED, NOT FOR USE; Employment measures are estimated to have reduced the adult count by about 297,000 in December.]

(j) The fall in the stock of vacancies in December was due to a reduction in the inflow of notified vacancies; the outflows continued to rise. Nevertheless in the last three months the average level of vacancies has still been the highest since the end of 1979.

(k) [NOT FOR USE: DE's assessment is that Restart has so far reduced the claimant count by around 50,000 in total ie. around 10,000 per month over the past five months. Availability testing seems to have had some impact in December as indicated by the reduced inflow into unemployment. However, DE are currently unable to quantify the effects.]

Assessment

[6. NOT FOR USE. You will have seen DE's assessment in briefing for the Prime Minister that without Restart, availability testing, and employment measures it seems likely that the previous upward trend in unemployment would have been halted and possibly marginally reversed. EA will be providing you with their own assessment]

Employment

7. This month we have figures for total employment in the third quarter, when the GB employed labour force increased by 71,000, the largest quarterly increase since 1985Q1, an encouraging reversal of the recent tailing off in employment growth. This rise was the result of an increase of 41,000 in employees in employment and an assumed increase of 30,000 in the self-employed. The number of employees in services increased by 81,000 but

this was partly offset by decreases of 34,000 in manufacturing industries and 11,000 in energy and water supply industries. The increase in total employment in the year to September 1986 was 207,000, compared with 341,000 in the year to September 1985 and 406,000 in the year to September 1984.

8. Employment, including the self employed, has risen in all regions in Great Britain, except Wales and Scotland, in the last year. The increase in the 'South' (South East, South West, East Anglia) was 172,000 and in the 'North' 37,000.

9. The rise in total employment in the second quarter was the fourteenth successive quarterly increase, again the longest period of continuous employment growth for almost 30 years. The increase in total employment since June 1983 is now over 1 million made up as follows:

<u>Employees in Employment</u>

Self employment	Males	Females Full time	Females Part time	Employed Labour Force	thousand
+536	-48	+351	+239	+1,079	

10. Later information is available for employees in employment in manufacturing. The average decrease of 7,000 per month in the three months to November was the smallest three monthly fall since January 1986.

OTHER FEATURES

Productivity and unit wage costs

11. Whole economy productivity rose by 1 per cent in 1986Q3, following growth of ¾ per cent in 1986Q2. The year on year change was 2.4 per cent in 1986Q3, up from 1.4 per cent in 1986Q2.

12. Whole economy wage and salary costs rose by 4.9 per cent in the year to 1986Q3, compared with 6 per cent in the year to 1986Q2, largely reflecting the improvement in whole economy productivity.

13. Figures for manufacturing for November are not being published until Monday 19 January, and are not yet available internally.

Gwyn Hacche

GWYN HACCHE

psl/64A

CONFIDENTIAL

pmj

FROM: A C S ALLAN
DATE: 15 January 1987

MR HACCHE

cc Mr S Davies
Miss O'Mara
Mr Hunt

COMBINED RELEASE OF LABOUR MARKET STATISTICS ON 14 JANUARY

The Chancellor was grateful for your minute of 14 January, and looks forward to seeing the further assessment from EA.

ACSA

A C S ALLAN

4114/043

CONFIDENTIAL

FROM: L C HUNT

DATE: 16 January 1987

1. MR S J DAVIES
2. CHANCELLOR OF THE EXCHEQUER

cc PS/Chief Secretary
Sir P Middleton
Sir T Burns
Mr Monck
Mr Sedgwick
Mr Scholar
Mr Culpin
Mr Gray
Miss O'Mara
Mr Deaton
Mr Hacche
Mr MacAuslan
Mr Stern
Mr Tyrie

MONTHLY NOTE ON UNEMPLOYMENT TRENDS

The numbers covered by special employment measures that are currently affecting the unemployment count are given below with our estimate of their direct effect on the December adult unemployment count:

		Numbers covered	Effect on the count
Job Release Scheme	(JRS)	28,000	25,000
Job Start	(JOB)	2,000	1,000
New Workers Scheme	(NWS)	28,000	7,000
Community Programme	(CP)	254,000	236,000
Community Industry	(CI)	10,000	4,000
Enterprise Allowance Scheme	(EAS)	74,000	25,000
Young Workers Scheme	(YWS)	6,000	1,000
TOTAL		402,000	299,000

2. The estimated number covered by the Youth Training Scheme (YTS) is 404,000 which is estimated to have reduced the adult unemployment count by 118,000 in December 1986, making such allowances as we can for seasonal factors.

3. The numbers contacted by the end of November under the national Restart Scheme is 730,000. This is estimated by the Department of Employment to have reduced adult unemployment by broadly 50,000. Our estimate is 46,000.

4. The unemployment figures are now being affected by the introduction of availability testing; the Department of Employment say that the effect cannot be quantified. Our tentative estimate of its effect on the December adult unemployment count is 6,000.

5. Table 1 shows the monthly changes in adult unemployment, and the effects on the adult count of SEMS, YTS, Restart and Availability Testing. Estimates are given to the nearest thousand; but it should be clear that they cannot be regarded as accurate to the nearest thousand.

6. Table 2 shows the trends in adult unemployment before and after SEMS, YTS, Restart and Availability Testing. It can be seen that on this analysis the trend excluding all effects has continued to decline and is in fact negative for the three months ending October, November and December 1986 and for the six months ending December 1986. It should be stressed once again that this analysis depends crucially on the estimated effects of Restart and Availability Testing and the seasonal adjustment of YTS.

X

Lester Hunt

LESTER HUNT
EA1

TABLE 1

MONTHLY CHANGES IN ADULT UNEMPLOYMENT EMPLOYMENT AND TRAINING MEASURES, RESTART AND AVAILABILITY TESTING[1]

(000s, seasonally adjusted)

	UK adult employment	SEMS and YTS effect on adult unemployment[2]	RESTART and AVAILABILITY effect on adult unemployment[3]	Net
1986 January	21	- 5	0	26
February	8	- 8	0	16
March	38	- 8	0	46
April	2	- 6	0	8
May	5	- 8	0	13
June	14	- 8	0	22
July	4	- 7	0	11
August	- 4	- 4	- 10	10
September	- 26	- 7	- 11	-8
October	- 26	- 10	- 6	-10
November	- 21	- 7	- 9	-5
December	- 28	-8 say	- 16	-4

1. A negative sign reflects an increasing impact of a scheme on the unemployment count and a positive sign a declining impact of a scheme on the unemployment count.

2. These figures refer to the <u>end</u> of each month so it is assumed that the effect is on the following months count.

3. It is assumed that all of the effects of Restart and Availability Testing is on adult unemployment. However a small proportion may in fact affect school leavers.

TABLE 2

CONFIDENTIAL

UNEMPLOYMENT TREND (000s)

	Average change in UK adult unemployment	Average change excluding SEMS and YTS	Average change excluding SEMS, YTS, Restart and Availability
Over 3 months ended:			
1986 January	11	17	17
February	16	22	22
March	22	29	29
April	16	23	23
May	15	22	22
June	7	14	14
July	8	15	15
August	5	13	16
September	- 9	- 3	4
October	-19	-13	- 4
November	-25	-18	- 9
December	-25	-17	- 7
Over 6 months ended:			
1986 January	5	11	11
February	6	12	12
March	13	19	19
April	13	20	20
May	15	22	22
June	15	22	22
July	12	19	19
August	10	18	20
September	- 1	6	10
October	- 6	1	6
November	-10	- 3	3
December	-17	-10	-1

CONFIDENTIAL.

RC6.55

Pse chase

BIF 22/1

FROM: CATHY RYDING

DATE: 19 January 1987

Thanks

AH

Cathy

John MacAuslan is now dealing with this and is aware that a draft is to be with us today

MR HUNT

OK hold on to this until it arrives or BIF 23/1

cc PS/Chief Secretary
Sir P Middleton
Sir T Burns
Mr Monck
Mr Sedgwick
Mr Scholar
Mr Culpin
Mr S J Davies
Mr P Gray
Miss O'Mara
Mr Deaton
Mr Hacche
Mr MacAuslan
Mr Stern
Mr Tyrie

MONTHLY NOTE ON UNEMPLOYMENT TRENDS

The Chancellor was grateful for your minute of 16 January.

2. The Chancellor has commented that the second sentence of paragraph 6 is the key point. He thinks that it is important that Ministers (including the Prime Minister) should not give the impression that the current decline in unemployment is solely the result of special measures. I should be grateful if you could provide me with a draft letter to David Norgrove at No.10 making this point.

CR

CATHY RYDING

C/officials unhappy about referred directly to the fact that unemp excl SEMs is now falling. Given this I'm not sure there is much point in sending attached reply.

CONFIDENTIAL

from: J MACAUSLAN
date: 21 JANUARY 1987

CR 22/1

CR
I agree M..

PS/CHANCELLOR

cc PS/Chief Secretary
Sir P Middleton
Sir T Burns
Mr Monck
Mr Burgner
Mr Sedgwick
Mr Scholar
Mr Culpin
Mr Gray
Mr SJ Davies
Miss O'Mara
Mr Deaton
Mr Hunt
Mr Hacche
Mr Stern
Mr Cropper
Mr Tyrie
Mr Ross Goobey

MONTHLY NOTE ON UNEMPLOYMENT TRENDS

I attach a draft letter to David Norgrove (No 10) as requested in Cathy Ryding's note to Lester Hunt of 19 January.

2. The draft focusses on the strongest point for the Government: that the main factor in the fall in unemployment is the UK's strong record of output and employment growth, without which reductions in unemployment could not be sustained. This presentation raises the question why unemployment had not fallen earlier. But that is good debating ground for the Government: the answer lies in growth in the labour force and in claimants who are not unemployed on the Labour Force Survey definition.

3. The Chancellor highlighted the fact that on the EA analysis, unemployment would probably be falling even without the measures. It would be possible to include in the letter a bald assertion to that effect. But there are four reasons <u>not</u> to focus on the question what would be happening to unemployment without the special measures:

(a) EA stress the uncertainties in their analysis

(b) that analysis suggests that unemployment would be falling <u>only by a little</u> without the measures: we do not want to encourage requests for quantification of the claim

(c) any such quantification would direct attention to the effect of Restart on the count; but DE do not want to do that, as it would show that the main effect of Restart is to <u>frighten</u> people off the count

(d) such a focus would tend to support the (false) view that the main purpose of the measures is to reduce the count (the draft sets out the true purpose)

4. The presentation suggested here is the one favoured by DE officials. This submission also reflects discussion with EA, EI and EB.

5. You may want to consider the circulation of the letter. I have suggested that you send it to the private secretaries of all E(A) Ministers and of Sir Robert Armstrong.

J MacAuslan

J MACAUSLAN

CONFIDENTIAL

DRAFT LETTER TO MR NORGROVE

The latest unemployment figures published last Thursday were a further encouraging indication that the trend is now firmly downwards.

2. The Prime Minister will have seen the tendency in the press to attribute ~~much of~~ the improvement to employment measures, Restart, and availability testing. Of course these are playing ~~a~~ an important role; but the Chancellor feels it is most important that Ministers should avoid supporting the false impression that the fall is solely the result of those measures. ~~The Government should seek to put the fall in proper perspective along the following lines.~~

3. The substantial fall in unemployment reflects the success of the Government's sound financial and economic policies, which have contributed to the creation of over 1 million new jobs since 1983. Employment measures including Restart are designed to help particular groups back towards work, and are playing their part. But our excellent record of sustained growth in output and employment depends above all on maintaining the Government's overall economic policy. That is the only way to ensure that reductions in unemployment are sustained.

4. I am copying this letter to the private secretaries of other members of E(A) and of Sir Robert Armstrong.

[NL]

MR 11/43

CONFIDENTIAL

FROM: CATHY RYDING

DATE: 26 January 1987

RW

MR MACAUSLAN

cc: PS/Chief Secretary
Sir P Middleton
Sir T Burns
Mr Monck
Mr Burgner
Mr Sedgwick
Mr Scholar
Mr Culpin
Mr Gray
Mr S J Davies
Miss O'Mara
Mr Deaton
Mr Hunt
Mr Hacche
Mr Stern
Mr Cropper
Mr Tyrie
Mr Ross Goobey

MONTHLY NOTE ON UNEMPLOYMENT TRENDS

The Chancellor was grateful for your minute of 21 January.

2. Given the reasons in your paragraph 3 not to focus on the question of what would be happening to unemployment without the special measures, the Chancellor thinks there is little point in writing to No.10.

CR

CAHTY RYDING

1255/15

CONFIDENTIAL

30/3

→ 6. For Prayers Monday A

Nigel — one of yr Alex Tayeh Harps...

FROM: A ROSS GOOBEY
DATE: 23 MARCH 1987

CHANCELLOR'S MORNING MEETING

49TH MEETING

NOTE FOR THE RECORD

Present: Chancellor
Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Mr Neubert, MP
Mr Lilley, MP
Mr Cropper
Mr Tyrie
Mr Ross Goobey

Cathy
What is happening about 'X'?
T
Thanks
after prayers on monday
CR

NOTE OF PRAYERS 23/3

1. BUDGET DEBATE

Mr Neubert reported that among those hoping to speak are Terence Higgins, Cranley Onslow, William Clark, John Maple, John Townend, Richard Ottaway and Richard Hickmet. Ted Heath and Enoch Powell are also likely speakers and, from the Opposition, Brian Sedgemore and Eric Heffer. Matthew Taylor expected to make his maiden speech. **Mr Neubert** will ascertain later how many votes are likely.

2. CONSOLIDATED FUND BILL

Entries are closed; Treasury participation will be modified later.

3. FINANCE BILL

X Ministers will need a meeting to decide which clauses to take in Committee and which on the floor of the House. The **Chief**

Secretary is then forearmed for his meeting with Mr Gould et al. The Opposition have already indicated that they wish to take the Exchange Control repeal on the floor.

Tactics were discussed if Labour press ahead with their threat to block the income tax cut in the event of an early dissolution. It was agreed to press ahead with the Committee Stage as soon as possible.

4. **WIND-UP**

The **Financial Secretary** suggested using Mr Kinnock's "jam today" jibe back at him as a description of selling BP. This had more substance in 1977 than in 1987.

Mr Tyrie would attempt to find any points arising out of a Labour/TUC document which is to be published today.

5. **ATTACKS ON ALLIANCE**

The strategy was discussed.

ARG

A ROSS GOOBEY

RD

CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

Discussed. The Cost,
I will probably do
22 myself, & possibly
159.

011/2982

Post Prayers.

FROM: JILL RUTTER

DATE: 27 March 1987

PS/FINANCIAL SECRETARY

cc:
Principal Private Secretary
PS/Economic Secretary
PS/Minister of State
Sir Peter Middleton
Mr Cassell
Mr Scholar
Miss Sinclair
Miss C Evans
Mr Walters
Mr Haigh
Mr Romanski
Mr Cropper
Mr Tyrie
Mr Ross Goobey

PS/IR
PS/C & E

Mr Graham - Parliamentary Counsel
Mr Neubert MP

c/ You might like to consider whether to take any clauses yourself — maybe income tax or exchange control act

CR 27/3

PS See X below - the CST is to hold a meeting later in the week. But ARG says you wanted to briefly run over the ground beforehand to feed in your views

FINANCE BILL: PROVISIONAL ALLOCATION OF CLAUSES

I have discussed with the Chief Secretary a provisional allocation of clauses for the Finance Bill and possible candidates to be taken on the floor of the House. The Chief Secretary will wish to discuss at a meeting with your Minister, officials, Parliamentary Counsel and Mr Neubert next week.

X

PS/CST TO PS/FST 27/3

Allocation of clauses

2 This is based on the Ministers most likely to take the clauses through Committee. In some cases it will be necessary to arrange for relief where one Minister has too many clauses in a row. The allocation does not take account of the need to ensure that every Minister takes a clause on the floor of the House and therefore may need to be adjusted since we have decided on the split.

Clauses 1 - 9 - Minister of State

Clauses 10 - 21 - Minister of State

Clauses 22 - 25 - Chief Secretary

Clauses 26 - 31 -Financial Secretary, though the Chief Secretary would be happy to take one or two of these clauses on to help the Financial Secretary.

Clause 32 - Economic Secretary

Clause 33 - Financial Secretary (though the Financial Secretary and the Economic Secretary might like to consider whether it would be better for the Economic Secretary to take this on)

Clause 34 - Economic Secretary

Clauses 35 - 38 - Financial Secretary, though the Chief Secretary would be willing to do either or both of clauses 37 and 38.

Clauses 39 - 42 - Financial Secretary

Clauses 43 - 46 - Financial Secretary

Clauses 47 - 48 - these fall to the Financial Secretary, but the Chief Secretary thought it might be useful if he could take them on in view of the larger number of clauses (35 - 59 - which the Financial Secretary will be taking on)

Clauses 49 - 55 - Financial Secretary, though the Economic Secretary might like to consider whether he could take one of these on.

Clauses 56 - 58 - Financial Secretary

Clause 59 - Financial Secretary

Clause 60 - Economic Secretary

Clause 61 - Chief Secretary

Clause 62 - Financial Secretary

Clause 63 - spare

Clauses 63 - 71 - the Chief Secretary would be happy to take these on, with possible assistance from the Economic Secretary, if necessary, on 69.

Clauses 72 - 106 - Financial Secretary

Clauses 107 - 116 (117 -121 spare) - Minister of State.

Clauses 122 - 136 - Economic Secretary.

Clauses 137 - 146 - Economic Secretary

Clauses 147 - 152 - Financial Secretary.

Clauses 153 - 158 - Financial Secretary.

Clause 159 - Abolition of Exchange Control - the Opposition have given notice that this is to be taken on the floor of the House. It taken in Committe, Economic Secretary.

Clause 160 - Economic Secretary

Clause 161 - Financial Secretary

Clause 162 - Financial Secretary.

Clauses 163 - Chief Secretary.

All references are to the print of the Bill ~~were~~, circulated earlier this week.

Candidates for the Committe of the Whole House

3 The Chief Secretary thinks that the following are candidates for CWH, noting the Opposition's desire to debate Clause 159 on the floor of the House.

(a) - Clauses 22 and 24 - charge of income tax for 1987-88, Corporation Tax - Small Companies. The Chief Secretary would envisage doing these.

(b) - Profit related pay - could the Minister of State think of which clause/group of clauses would be suitable

(c) - Personal pensions - could the Financial Secretary think which clause/group of clauses might be suitable

(d) - Reduced rates of inheritace tax (clause 147)

(e) - Cash accounting for VAT (? clause 10).

4 Once the final selection is known, he will ensure that each Minister takes a clause on the floor of the House.

Clause 10 more important than clause 24

clause 147 not willing to risk - & Oppn will have Rees - I may want to do 22 (IT) under Sgn 159.

Jill Rutter

JILL RUTTER
Private Secretary

4077/11

CHANCELLOR OF THE EXCHEQUER

FROM: B O DYER
DATE: 1 April 1987

1. Catts
2. TD 1/01

01-270 4520

MISS EVANS - FP

cc PPS
PS/Chief Secretary
Mr Scholar
PS/IR
PS/C&E

FINANCE BILL : QUEEN'S CONSENT

Notwithstanding the Chancellor's comment regarding Clause 135 (recorded in Mr Allan's minute of today's date), you may think it prudent to check, with the instructing lawyers or Parliamentary Counsel, there is nothing in the Bill that requires the Queen's Consent. I cannot readily identify anything, but this question is not always straightforward (eg although a Bill is regarded as binding the Crown if it is binding on Government departments, this does not require The Queen's Consent to be signified).

2. For the record, if a Bill (or any provision therein) affects the prerogative, hereditary revenues, personal property or interests of the Crown or the interests of the Duchy of Cornwall, the Consent of The Queen or, as regards the Duchy of Cornwall, of the Prince of Wales must be signified in both Houses before the Bill is passed. This is usually done at Third Reading so that account may be taken of any amendments accepted at earlier stages. If formal Consent is required a letter needs to be drafted for the Minister's office to send to the Palace explaining the purpose of the relevant provision in the Bill and the way in which it affects the Crown, and asking for Consent.

B. Dyer

B O DYER
Parliamentary Clerk

RA3.11

UNCLASSIFIED

PWP

FROM: A C S ALLAN
DATE: 1 April 1987

PS/CHIEF SECRETARY

cc PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Sir T Burns
Sir G Littler
Mr F E R Butler
Mr Cassell
Mr Monck
Mr Scholar
Miss C Evans
Mr Cropper
Mr Ross Goobey
Mr Tyrie
Mr Dyer
PS/IR
PS/C&E

FINANCE BILL: CLAUSE 135

The Chancellor thinks the new offence described in the designation of clause 135 is a very important one. He feels in retrospect he should have mentioned it in his Budget Statement. He may well want to take this clause himself on the floor of the House.

2. He presumes there is no question of Crown exemption applying, and that this new offence will apply to officials in the Treasury and the Revenue Departments.

ACSA

A C S ALLAN

Chapter V

Taxes Management Provisions

Company returns

022/2763

CONFIDENTIAL

RWP

CHIEF SECRETARY TO THE TREASURY

FROM: M C FELSTEAD
DATE: 1 April 1987

MR K E BRADLEY

cc:
Chancellor
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Mr F E R Butler
Mr Wilson
Mr Anson
Mr Judd
Mr Gilmore
Mr Burgner
Mr Scholar
Mr Turnbull
Mr Mason
Mr Revolta
Miss Sinclair
Mr Bonney
Mr Waller
Mr Walters

FEES AND CHARGES AND VIRES: FINANCE BILL

The Chief Secretary has seen your submission of 31 March proposing a form of words for a Lobby Note on the provisions to deal with defective fees and charges legislation to be introduced at the Committee Stage of the Finance Bill.

2 The Chief Secretary has asked whether we have announced our plans to Parliament. He does not think we can indicate our plans for a Committee Stage amendment simply by means of a Lobby Note. He feels it would be better to announce our plans either through an arranged PQ and Answer, at the time of publication of the Finance Bill, or perhaps through a reference in his Second Reading speech.

3 The Chief Secretary would be grateful if you could consider this urgently in consultation with Miss Sinclair.

M C Felstead

M C FELSTEAD
Assistant Private Secretary

013/2763

1. Tony
2. PWP

FROM: JILL RUTTER

DATE: 2 April 1987

PS/FINANCIAL SECRETARY

CC:
Principal Private Secretary /2
PS/Economic Secretary
PS/Minister of State
Sir Peter Middleton
Mr Cassell
Mr Scholar
Miss Sinclair
Miss C Evans
Mr Walters
Mr Haigh
Mr Dyer
Mr Romanski
Mr Cropper
Mr Tyrie
Mr Ross Goobey

PS/IR
PS/C & E

Mr Graham - Parliamentary Counsel
Mr Neubert MP

PS/CST TO PS/FST 2/4

FINANCE BILL: ALLOCATION OF CLAUSES

The Chief Secretary discussed this with his Ministerial colleagues on 1 April. All references are to the print of the Bill circulated on 31 March.

Clauses 1 - 5: Duties of excise - Minister of State

Clauses 6 - 10: Amendments of the Management Act - Minister of State

Clauses 11 - 19: Value Added Tax - Minister of State

Clause 20 - Charge of income tax
To be taken on the floor of the House - Chancellor (probably)

Clauses 21 - 23 - Chief Secretary

Clauses 24 - 29: **Personal reliefs etc** - Financial Secretary, with the Chief Secretary taking **Clause 26 - Over 80's relief**.

Clause 30 - 32: Friendly societies, trade unions and charities - Economic Secretary

Clauses 33 - 36: Employees - Financial Secretary, with the Chief Secretary taking **Clause 35 - Employees seconded to education bodies**

Clauses 37 - 40: **Companies** - Financial Secretary

Clauses 41 - 44: Unit Trust and Investment Companies - Economic Secretary

Clauses 45 - 46: Business Expansion Scheme - Financial Secretar

Clauses 47 - 53: Provisions having an overseas element - 47 - 51 - Financial Secretary, **Clauses 52 - 53** - Economic Secretar

Clauses 54 - 56: Oil industry: ACT - Financial Secretary

Clause 57: Disclosure of employment information - Financial Secretar

Clause 58: Lloyds - Economic Secretary

Clause 59: **Allowances for dwelling houses** - Chief Secretary

Clause 60: Recognised investmentexchanges - Financial Secretary

Clause 61 - 68: **Capital Gains Tax** - Chief Secretary

Clause 69 - 106: Personal Pension Schemes - Financial Secretar

Clauses 107 - 121A: Profit related pay - Minister of State

Clauses 122 - 136: Taxes Management Provisions - Economic Secretary

Clauses 137 - 146: Stamp Duty - Economic Secretary

Clauses 147 - 152: Inheritance Tax - Financial Secretary

Clauses 153 - 159; Oil Taxation - Financial Secretary

Clause 160: Abolition of Exchange Control - likely to be taken on the floor of the House - EST/Chancellor

Clause 161 - Economic Secretary

Clause 162 - 163 - Financial Secretary

Clause 164 - Chief Secretary

2 The Chief Secretary noted that the Government's priorities for the clauses on the floor of the House were 20 (Income Tax) and No. 11 (cash accounting).

3 He noted that a very fast timetable was intended this year. It was therefore absolutely imperative that amendments and new Clauses at Committee Stage were kept to the absolute minimum. Notice was given of Committee Stage amendments on the legal equery on fees and charges, and Klondykers. The Economic Secretary warned that he was consulting on the Lloyds provisions. It was agreed that this was not a problem since advance notice had been given of that.

4 The Chief Secretary would try to speak to Mr Gould within the next couple of days to arrange an meeting next week.

Jill Rutter

JILL RUTTER
Private Secretary

CECS

SECRET

Papers PS2

FROM: MISS C E C SINCLAIR
DATE: 1 APRIL 1987

12/2

CHIEF SECRETARY

cc Principal Private Secretary
Financial Secretary
Economic Secretary
Minister of State
Mr Scholar
Miss Evans
Mr Dyer
Mr P Graham - Parliamentar Counsel
Mr P Wilmott - C&E
Mr M Johns

FINANCE BILL: SPLIT OF THE BILL AND POSSIBLE EARLY ELECTION

When deciding on the split of the Bill between Committee of the Whole House (CWH) and Standing Committee, you will want to be aware of the implications of an election in May or June.

2. If an early election were called, there are a number of clauses which you would want to get into a short pre-election Finance Act. The obvious one is income tax. Some of the others are less obvious. The need to get them into legislation arises because they are either in force already, or will be by the time of CWH, on the basis of PCTA Resolutions. If there is no legislation, the resulting situation will be messy.

SINCLAIR TO CST 1/4

3. The clauses are:

1	Unleaded petrol	
2	Vehicle Excise Duty	
3	Abolition of on-course betting duty	
4	Gaming machine licence duty: rates	
12	VAT: Credit for input tax	)These are all
15	VAT: Supplies to groups	)concerned with
17	VAT: Valuation of supplies at less than market value	)partial exemption)
18	VAT: Issue of securities	)
20	Charge of income tax for 1987-88	
24	Personal reliefs: operative date for PAYE	
25	Relief for interest (MIR)	
26	Increased personal relief for those aged eighty or over	
28	Increased relief for blind persons	
32	Increase in limit for payroll giving	

4. It would not be feasible for the Government to propose to take all these clauses in CWH plus the others which you have in mind. In any case it is not necessary. Parliamentary Counsel advise that if an election were announced when the Bill had reached Standing Committee it would simply return to the floor of the House and the government would need to decide what outstanding clauses it wanted to try to include in a truncated pre-election Finance Bill. With the earlier timetable set out in Mr Savage's minute of 31 March, it is possible that the excise duty and VAT changes might have got through Standing Committee before any announcement of an election.

5. In short, therefore, you do not need to take account of a possible early election when deciding on the split of the Bill. On the other hand, you might want to take one or two of the clauses listed in paragraph 3 to make it slightly easier to deal with a short pre-election Finance Bill. Obvious candidates are clauses 26 and 28 on the blind allowance and over 80 allowance. Clause 12, 15, 17 and 18 (VAT partial exemption) are important and might not have been reached in Standing Committee if an election is announced early in May.

6. Of the clauses listed in paragraph 3 above, only clause 20 (income tax rates) is likely to be contentious with the Opposition. They should support the VAT partial exemption changes since this was a problem to which Mr Blair drew attention in Committee Stage last year.

MISS C E C SINCLAIR

RP

H.M. CUSTOMS AND EXCISE
KING'S BEAM HOUSE, MARK LANE
LONDON EC3R 7HE

Please Dial my Extension Direct:
Use Code (01)-382 followed by
Extension Number 5.028......

From: J P BONE

Date: 2 April 1987

1. MR WILMOTT DD 2.4
2. MINISTER OF STATE

cc PS/Chancellor
PS/Chief Secretary
Miss Sinclair
Mr Culpin
Mr Walters
Mr Cropper

FINANCE BILL 1987: LOBBY NOTES

Mr Walters' note of 25 March commissioned lobby notes, including those on any Government New Clause to be moved at Committee Stage, and asked for them to be cleared with appropriate Ministers.

2. I attach the Customs & Excise contribution for your approval. These are for Clauses 1, 3 to 19 and for Schedule 2. (As you know, we are still pursuing the Question of Klondykers with Parliamentary Counsel, with a view to having a New Clause at Committee Stage. However, certain details have yet to be ironed out; and, in the circumstances, it does not seem appropriate to issue a lobby note.) As usual, the notes go into very little detail. Although the commissioning note originally asked for a package on manpower effects of the Finance Bill, I understand that since then the official Treasury have decided that it was not necessary.

Internal distribution: CPS, Mr Knox, Solicitor, Mr Jefferson Smith, Mr Howard, Mr Nash, Mr Wilmott, Mr Fisher

3. To meet the FP/IDT deadline for final copy, we should be grateful for your comments and/or clearance by mid-morning on Monday 6 April.

JPB

J P BONE

FINANCE BILL 1987: BACKGROUND NOTES

Clause 1 provides for the introduction of a duty differential (5p per gallon including VAT) in favour of unleaded petrol with effect from 6 pm on 17 March 1987. Further details are given in Customs and Excise News Release 22/87.

Clause 3 abolishes the duty on on-course betting with effect from 29 March 1987 and provides for the continuation of existing Customs and Excise control powers.

Clause 4 increases the rates of gaming machine licence duty with effect from 1 June 1987. The new rates of duty are also given in Customs and Excise News Release 23/87.

Clause 5 provides for changes with effect from 1 October 1987 in the arrangements for collection and repayment of gaming machine licence duty. Further information is given in Customs and Excise News Release 23/87. The Clause also enables regulations to be made permitting spare gaming machines to be kept unlicensed in certain circumstances for use in the case of breakdown of other, licensed, machines.

Clause 6 amends the Customs and Excise Management Act 1979 to enable officers of Customs and Excise to enter and search premises and goods at approved wharves and transit sheds.

Clause 7 amends the Customs and Excise Management Act 1979 to extend Customs and Excise officers' powers of search of vessels and aircraft to include other vehicles within Customs-controlled zones and installations. These changes will assist action against drug smuggling.

Clause 8 amends the Customs and Excise Management Act to provide exporters of goods within the EC Common Agricultural Policy with greater flexibility as to the date on which they may bring such goods under Customs control at their premises. Under EC legislation this date determines the rate of any refund or charge applicable, so that the provision will enable exporters to take advantage of beneficial rates.

Clause 9 introduces a new section in the Customs and Excise Management Act 1979 to require records to be kept by persons concerned in the importation or exportation of goods. This will facilitate trade by permitting the acceptance in certain circumstances of electronically transmitted customs freight declarations without any supporting paper documentation. The 'paperless entry' facility will be subject to approval, and one of the conditions will be the requirement for importers and exporters to retain, as part of their business records, any necessary supporting documents.

Clause 10 introduces a new section in the Customs and Excise Management Act 1979 to enable the Commissioners to specify the way in which records relating to imports and exports should be provided. It also gives authority for the inspection of such records at the premises of importers and exporters. The aim of the Clause is to provide for the examination of records in cases where freight declarations have been made electronically.

Clause 11 enables regulations to be made permitting schemes for cash accounting and annual accounting by certain businesses. Cash accounting will be introduced on 1 October 1987 (subject to EC approval) and annual accounting in the summer of 1988. Further details are given in Customs and Excise News Release 16/87.

Clause 12 amends the Value Added Tax Act 1983 so as to restrict deductible input tax and to counter tax avoidance. It also enables regulations to be made to secure a fair and reasonable attribution of input tax to taxable supplies and to adjust input tax which has been incorrectly attributed. These measures came into effect on 1 April 1987. Further information is contained in Customs and Excise News Release 17/87.

Clause 13 introduces new provisions allowing the registration for VAT of businesses established in the UK which make no taxable supplies within the UK and of businesses which make only supplies of goods in warehouse. Further details are contained in Customs and Excise News Release 17/87.

Clause 14 amends Schedule 1 to the Value Added Tax Act 1983 to make changes in general registration and deregistration requirements. In particular, it extends the time to notify liability to be registered to 30 days. Further information is given in Customs and Excise News Release 16/87.

Clause 15 introduces a new provision with effect from 1 April 1987 whereby, in certain circumstances, partly-exempt VAT groups will be required to account for VAT on the acquisition of business assets on the transfer of a business (or part of a business) as a going concern. Further details are contained in Customs and Excise News Release 17/87.

Clause 16 gives the Treasury powers to provide by Order for a special scheme applying VAT to tour operators' services. The scheme is intended to take effect from 1 April 1988. The intention to legislate in 1987 was announced on Budget day 1986. Further information is given in Customs and Excise News Release 21/87.

Clause 17 extends the provisions of the Value Added Tax Act 1983 to enable the special valuation rules for taxable supplies between connected persons to apply also to exempt supplies with effect from 1 April 1987. Further information is given in Customs and Excise News Release 17/87.

Clause 18 exempts, with effect from 1 April 1987, the underwriting of and making arrangements for capital issues. This is also mentioned in Customs and Excise News Release 17/87.

Clause 19 deals with the interpretation of chapter II of the Bill and introduces the amendments in Schedule 2.

Schedule 2 has 4 paragraphs

Paragraph 1 amends the VAT Act 1983 with effect from 1 April 1987 to prevent tax avoidance of VAT on imported services by exempt businesses. Further details of the changes are given in Customs and Excise News Release 18/87.

Paragraph 2 extends the provisions of section 23 of the Value Added Tax Act 1983, concerning repayment of tax on supplies made in the UK to those in business overseas, to include goods imported by them into the UK.

Paragraph 3 provides for the immediate VAT registration of the transferee when a registrable business is transferred as a going concern. The transferee will have 30 days in which to notify his liability to be registered.

Paragraph 4 provides for partly-exempt businesses to have a right of appeal to a VAT tribunal about the use of the new partial exemption method.

013/2763

PW/P

FROM: JILL RUTTER

DATE: 2 April 1987

PS/FINANCIAL SECRETARY

CHIEF SECRETARY TO THE TREASURY

cc:
Principal Private Secretary
PS/Economic Secretary
PS/Minister of State
Sir Peter Middleton
Mr Cassell
Mr Scholar
Miss Sinclair
Miss C Evans
Mr Walters
Mr Haigh
Mr Dyer
Mr Romanski
Mr Cropper
Mr Tyrie
Mr Ross Goobey

PS/IR
PS/C & E

Mr Graham - Parliamentary Counsel
Mr Neubert MP

FINANCE BILL: ALLOCATION OF CLAUSES

The Chief Secretary discussed this with his Ministerial colleagues on 1 April. All references are to the print of the Bill circulated on 31 March.

Clauses 1 - 5: Duties of excise - Minister of State

Clauses 6 - 10: Amendments of the Management Act - Minister of State

Clauses 11 - 19: Value Added Tax - Minister of State

Clause 20 - Change of income tax
To be taken on the floor of the House - Chancellor (probably)

Clauses 21 - 23 - Chief Secretary

Clauses 24 - 29: Personal reliefs etc - Financial Secretary, with the Chief Secretary taking **Clause 26 - Over 80's relief**.

Clause 30 - 32: Friendly societies, trade unions and charities - Economic Secretary

Clauses 33 - 36: Employees - Financial Secretary, with the Chief Secretary taking **Clause 35 - Employees seconded to education bodies**

Clauses 37 - 40: Companies - Financial Secretary

Clauses 41 - 44: Unit Trust and Investment Companies - Economic Secretary

Clauses 45 - 46: Business Expansion Scheme - Financial Secretar

Clauses 47 - 53: Provisions having an overseas element - 47 - 51 - Financial Secretary, **Clauses 52 - 53** - Economic Secretar

Clauses 54 - 56: Oil industry: ACT - Financial Secretary

Clause 57: Disclosure of employment information - Financial Secretar

Clause 58: Lloyds - Economic Secretary

Clause 59: Allowances for dwelling houses - Chief Secretary

Clause 60: Recognised investmentexchanges - Financial Secretary

Clause 61 - 68: Capital Gains Tax - Chief Secretary

Clause 69 - 106: Personal Pension Schemes - Financial Secretar

Clauses 107 - 121A: Profit related pay - Minister of State

Clauses 122 - 136: Taxes Management Provisions - Economic Secretary

Clauses 137 - 146: Stamp Duty - Economic Secretary

Clauses 147 - 152: Inheritance Tax - Financial Secretary

Clauses 153 - 159; Oil Taxation - Financial Secretary

Clause 160: Abolition of Exchange Control - likely to be taken on the floor of the House - EST/Chancellor

Clause 161 - Economic Secretary

Clause 162 - 163 - Financial Secretary

Clause 164 - Chief Secretary

2 The Chief Secretary noted that the Government's priorities for the clauses on the floor of the House were 20 (Income Tax) and No. 11 (cash accounting).

3 He noted that a very fast timetable was intended this year. It was therefore absolutely imperative that amendments and new Clauses at Committee Stage were kept to the absolute minimum. Notice was given of Committee Stage amendments on the legal equery on fees and charges, and Klondykers. The Economic Secretary warned that he was consulting on the Lloyds provisions. It was agreed that this was not a problem since advance notice had been given of that.

4 The Chief Secretary would try to speak to Mr Gould within the next couple of days to arrange an meeting next week.

Jill Rutter

JILL RUTTER
Private Secretary

Mr Allan

As requested I have obtained this informally from the Clerk. I understand that the Committee may decide not to publish memoranda from their adviser with their report this year.

Caigs G

3.4.87.

TR 306

cc Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Sedgwick
Mr Scholar
Mr Odling-Smee
Mr Turnbull

NOTES ON THE 1987 BUDGET

Terry Ward

Specialist Adviser

1. The effect of the Budget measures on the economy has to be considered in conjunction with the public expenditure plans for 1987-88 announced in the Autumn Statement in November last year. Then the Government added £4.5 billion to the cash plans formulated the previous year. Now the Government has cut taxes by almost £3 billion (£2.6 billion relative to an indexed base). A total of £7.5 billion has therefore seemingly been injected into the economy. This, however, is in relation to the Government doing nothing at all on either the public expenditure or the tax front, which is a somewhat artificial basis for concluding anything about the stance of fiscal policy. More relevantly the PSBR for 1987-88 has been reduced by £3 billion in relation to the previously announced target. But most significantly of all perhaps, the PSBR adjusted for asset sales is planned to remain at more or less the same level now estimated for 1986-87 (there is still considerable uncertainty about the outcome). So in relation to the fiscal stance this year, the Budget involves little change one way or the other.

2. Nevertheless the scale of the adjustments to taxation and borrowing which have been made do indicate how much projections of expenditure and receipts have been revised since last year. In total over the year as a whole, the Chancellor has had some £10.5 billion more to allocate to spending increases, tax reductions or cuts in the PSBR than was estimated this time last year. This is illustrated in Table 1 which shows the projections for 1987-88 made in the March 1986 Budget documents and compares these with the figures which the Chancellor had before him when he made his Budget judgement - ie the estimates before the Budget changes. Thus although £4.5 had already been added to public expenditure in November, the Chancellor still had £6 billion to give away in tax cuts or further expenditure increases in March (as shown by the fiscal adjustment) without exceeding his PSBR target.

3. The reasons for the upward revision in the figures are not altogether clear. Much of it seems to have occurred, probably at least £3-4 billion, since the Autumn Statement and finalisation of the expenditure plans in November. Most of it is the result of tax revenue being far more buoyant than forecast, at £7.5 billion more than the 1986 Budget projection, but few details are available as to why this should have increased so much. A large part seems to be due to a big rise in Corporation Tax because of higher than expected profits. A significant part, however, appears to be attributable to a higher than projected level of

Table 1 Estimates of Government Expenditure and Receipts for 1987-88

£billion

	March 1986 Budget	March 1987 pre-Budget changes	Difference
Planning Total	144.5	149.0	4.5
Other Expenditure	26.0	25.0	-1.0
Total Expenditure	170.5	174.0	3.5
Total Receipts	164.5	172.0	7.5
Fiscal Adjustment	2.0	6.0	4.0
GGBR	8.0	8.0	-
PC Market Borrowing	-1.0	-1.0	-
PSBR	7.0	7.0	-

GDP and therefore to a larger tax base than previously thought likely. The upward revision since November seems to result to a large extent from an increased projection of inflation, which is now forecast to be almost 1 per cent higher in 1987-88 than the figure in the Autumn Statement. This in itself has probably added at least £1 billion to tax yield next year.

Public Expenditure after the Budget

4. The upward revision in the forecast of inflation, however, has also affected the real value of the public expenditure plans presented in the Autumn Statement. The £4.5 billion that was then added to the existing planning total has been offset to a significant extent by a general erosion in what authorities are capable of purchasing with the cash budgets allocated to them. This is indicated in Table 2 which shows the revisions to real expenditure since the plans were first presented. Thus the planning total, before the deduction of asset sales, has been reduced in real terms by around £1.5 billion, at 1985-86 prices in 1987-88 as a result of increased inflation. The rate of growth in expenditure, which was to be about 2 per cent between this year and next, is now forecast to be 1.5 per cent in the case of the planning total and 1.1 per cent if debt interest is included. Both figures are below the average rate experienced since 1978-79.

Table 2 **Revisions to Real Public Expenditure in the Budget**

	1986-87	1987-88	1988-89	1989-90
		(£billion at 1985-6 Prices)		
White Paper Planning Total	136.5	139.3	139.7	142.1
Budget Planning Total	135.9	137.9	137.6	139.2
Difference	-0.6	-1.4	-2.1	-2.4
Wh.Paper Adj.Planning Total	143.3	146.0	146.1	148.4
Budget Adj.Planning Total	142.4	144.5	143.9	145.3
Difference	-0.9	-1.5	-2.2	-3.0
White Paper Total Expenditure	160.3	162.9	162.4	165.1
Budget Total Expenditure	159.4	161.2	160.0	161.7
Difference	-1.0	-1.6	-2.4	-3.4
		(Annual per cent changes)		
White Paper Planning Total	2.2	2.1	0.3	1.7
Budget Planning Total	1.7	1.5	-0.2	1.2
Wh.Paper Adj.Planning Total	3.6	1.9	0.1	1.5
Budget Adj.Planning Total	2.9	1.5	-0.4	1.0
White Paper Total Expenditure	2.8	1.6	-0.3	1.6
Budget Total Expenditure	2.1	1.1	-0.8	1.1

Note: Adjusted Planning Total is expenditure before deducting receipts from asset sales, including sales less purchases of land and buildings.

5. For the later years of the planning period, the effective reduction in expenditure caused by the higher inflation projected is even greater. In 1988-89, over £2 billion at 1985-86 prices has been cut from real spending, which is equivalent to almost 40 per cent of what was added in November. The effect is that the adjusted planning total is now projected to decline by 0.4 per cent between 1987-88 and 1989-90. In 1989-90, the reduction to the adjusted planning total in real terms is £3 billion. Figure 1 shows the extent to which these developments have pushed planned spending below the real levels which would have been expected on the basis of the trend rate of expenditure growth (1.8 per cent a year) which has obtained since 1978-79.

6. The increase in inflation and its effect on real expenditure plans give rise to two questions in particular. The first is why the incease should have occurred at all. The Budget documents say very little about the reasons for the upward revision in the Treasury forecast. The second is why the additional revenue which higher inflation will cause has not been used to make good the erosion in the Government's expenditure plans, but has instead been allocated to funding tax cuts. In effect, the Chancellor has altered the decision made in the Autumn and reduced the addition to spending then intended. It is unclear in what respects circumstances have changed in the interim to warrant a smaller increase, especially when revenue is turning out to be far more buoyant than expected when the plans were prepared.

Economic Prospects

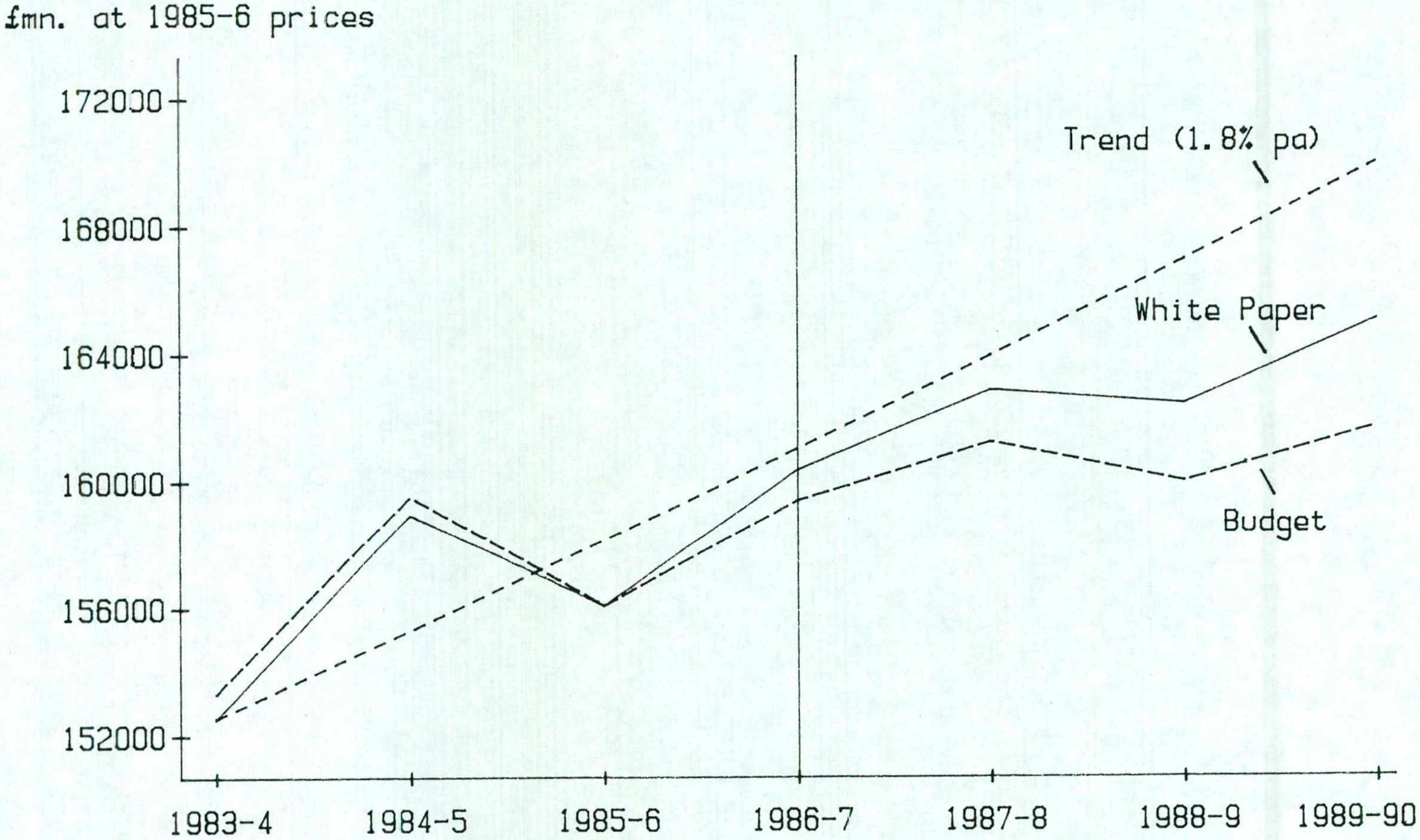
7. Despite the Chancellor's praise for the performance of the British economy in recent years and his optimism about future prospects, one aspect of the Budget forecasts ought to be a cause for concern. The balance of payments in 1987 is projected to deteriorate further, with the deficit forecast to rise to £2.5 billion. Most significantly for longer term economic prospects, the deficit in trade in manufactures is forecast to increase from £5.5 billion in 1986 to £8 billion in 1987. Yet this comes after a year when sterling depreciated substantially and cost competitiveness improved markedly - by 16 per cent between the fourth quarters of 1985 and 1986. This improvement ought presumably to be having its maximum beneficial effect on UK trade performance during the course of 1987, especially since according to the Treasury "most of the gain in competitiveness seems likely to be maintained over the year ahead." (Financial Statement, para. 3.22.) The forecast, however, is for exports to lag behind the increase in imports, despite the relatively modest growth of GDP.

8. This raise two questions. First, if the balance of payments deteriorates in such apparently favourable circumstances, how will it be possible to sustain the present rate of growth in the longer term? Secondly, if, on the other hand, 1987 is not the year when the effect of the recent large gain in cost competitiveness comes through, when does the Treasury expect it to occur on its calculations?

Cambridge

21 March 1987

Figure 1 Total Government Expenditure



Note: Expenditure measured before deducting receipts from asset sales and inclusive of debt interest.

Phillips & Drew
ECONOMICS UNIT

THE 1987 BUDGET

An assessment for the House of Commons Select
Committee on the Treasury and Civil Service
submitted by
Bill Martin, Specialist Adviser to the Committee
on 30 March 1987

The paper expresses the personal views of the
author and not necessarily those of Phillips & Drew

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BUDGET 1987

An assessment for the House of Commons Select Committee
on the Treasury and Civil Service
by Bill Martin, Specialist Adviser to the Committee

The main question now is how the Chancellor should deploy the benefits of his prudence. The welcome reduction in the target for the public sector borrowing requirement announced in the Budget could pave the way to lower interest rates and a more competitive exchange rate. This is industry's preference. The alternative is to let sterling ride high in order to damp down inflation. This may well be the Chancellor's preference. In this brief we argue that:

* There are clear signs of a pick-up in inflationary pressure; this argues for a firm sterling strategy.

* But there is also a pressing need to bring about a better balance between fiscal policy and monetary policy; this argues for lower interest rates and cheaper sterling.

* We can see no ready solution to this dilemma. If the Chancellor wants 4% inflation next year, he needs sterling at 72 to 75 on the index this year.

* The next version of the MTFS should re-affirm a commitment to cut the PSBR progressively as a proportion of GDP, even if this means running surpluses on this measure. The aim should be to bring down real interest rates until they are more in line with the economy's productive potential.

! [illegible] PSBR [illegible]

* PSBR cuts should continue to take precedence over tax cuts.

The Options

The Chancellor has lopped £3bn off the PSBR figures laid down in last year's Medium Term Financial Strategy for 1987 and 1988. There is a further £2bn reduction in 1989. With little stretch of the imagination, the reduction in the PSBR target can be thought of as forgone income tax cuts, equivalent to nearly 3p off the basic rate of income tax in 1987-88. The effect on the economy of this unexpected prudence depends on what the Chancellor regards as his priorities. We can illustrate the options by looking at the effect of forgoing a 3p tax cut using the Treasury model simulations provided to the Committee by the Parliamentary Unit.

Table 1: The Pay-off to Prudence

Option:	1) Cheap Sterling			2) Stable Sterling			3) Firm Sterling		
Year	1	2	3	1	2	3	1	2	3
Growth (%points)	0.0	0.3	0.0	-0.3	0.3	0.0	-0.3	-0.3	0.0
Inflation(%points)	0.0	0.0	0.0	-0.3	-0.3	-0.3	-0.3	-0.6	-0.9
Sterling index (%)	-1.2	-1.8	-1.2	0.0	0.0	0.0	0.6	1.8	2.7
Competitiveness (%)	1.5	2.1	1.5	0.3	0.6	0.9	-0.6	-1.2	-1.2
Current account £bn	0.6	0.9	1.5	0.9	1.2	1.2	0.9	1.5	1.8
Base rates (%points)	-1.2	-1.5	-1.2	-0.6	-0.9	-0.9	0.0	0.0	0.0

The simulations show the impact of forgoing a 3p basic rate tax cut. Cheap sterling refers to a strategy of keeping money supply growth on target. Stable sterling means keeping sterling at a given level. Firm sterling means keeping interest rates unchanged. The figures refer to changes compared to a forecast base. For example, under stable sterling, growth is 0.3% points lower but inflation is 0.3% points better than it would otherwise be in the first year of the simulation.

Under Option 1, "Cheap Sterling"; the Chancellor lets interest rates fall. Sterling declines, competitiveness improves and so, to a small extent, does growth despite the fact that the tax burden is higher than it would otherwise have been. Inflation, as measured by consumer prices, is unchanged according to these results.

Under Option 2,"stable sterling",the Chancellor keeps sterling at a fixed level. In contrast to Option 1, inflation falls a little and the current account of the balance of payments improves initially by more. Growth falters, however. To resist upward pressure on sterling, interest rates have to fall but the fall is less marked than under Option 1.

Under Option 3, "firm sterling", the Chancellor holds out against any cut in interest rates and takes the benefit of his fiscal prudence in the form of currency appreciation. This option delivers the greatest inflation gains and the greatest growth losses.

These results, taken with an appropriate pinch of salt, highlight the Chancellor's dilemma. The greater his concern about inflation, the more he will incline towards firm sterling. But in doing so, he forgoes the benefits of improved competitiveness and lower real interest rates available under a cheap sterling strategy.

Inflation worries

The Chancellor's evident worries about inflation are well-founded. Even the Treasury forecast admits to an inflation outlook which is significantly worse than projected in last year's Budget or in the Autumn Statement. For example, the 1986 Budget forecast retail price inflation of only 3 1/2% in 1987 Q2. In this year's Budget speech, the Chancellor speaks of inflation "perhaps exceeding 4 1/2% by the summer" despite his decision to leave specific duties unchanged (thereby cutting 0.3% off inflation at a stroke).

The Treasury's forecasts of money GDP growth and the split between real growth and inflation in 1987 have also taken a turn for the worse (Table 2). And perhaps most interesting of all the Treasury has radically altered its view of profit margins in manufacturing industry. In the Autumn Statement, the increase in unit costs and of product prices (excluding food, drink and tobacco) were each forecast at 3 1/2% in 1987. In the latest forecast, however, unit costs are forecast to rise by only 2% while output prices rise by 4%. The projected boost to margins occurs in spite of a 7-8% upward revision, between the two forecasts, in the assumed level of sterling. Strong profits growth and higher inflation could be taken as classic indications of economic overheating.

Table 2 Money GDP split - Treasury Forecasts

	% Growth in 1987/88	
	Before	Now
Real Growth	2 1/2	3
Inflation	3 3/4	4 1/2
Money GDP	6 1/2	7 1/2

Before (Nov)=1986 (1987) Budget estimate. Subject to rounding error.

On one interpretation, the pick up in inflation this year is the inevitable consequence of the one-off fall in oil prices last year. The fall in the oil price depressed the price <u>level</u> but not, except temporarily, the rate of inflation. This interpretation of events is too fatalistic to our mind. The fall in the oil price provided an opportunity, which was missed, to get inflation on to a permanently lower path. Instead the decision was taken last year to relax policies. The reason involves a little history. In 1985, following a long period of policy easing in the Government's second term of office, sterling collapsed and inflation took off (Table 3). Policies were duly tightened - 1985 became the year of firm sterling and firm Budget strategy. As a result, inflation was heading lower well before the oil price fell.

Table 3: Money GDP growth and inflation %

FY	1980	1981	1982	1983	1984	1985	1986	1987 f
Money GDP	14	10	9	8	9*	8 1/2*	6	7 1/2
Inflation	18 1/2	10	7	4 1/2	4 1/2	6 1/2	3	4 1/2

f: Treasury Forecast * Adjusted for coal strike

With the Chancellor feeling more relaxed about inflation in 1986, he decided to loosen his grip. Adjusted for the cycle, the public sector financial deficit may have risen by 1% of GDP in 1986. Sterling fell through the summer and autumn and interest rates were nudged down until last year's currency crisis forced them back up again (Table 4). The overall aim of this easing was to generate more growth and so falling unemployment in the run up to the election, even though it meant taking risks with inflation. This is what we said in our submission on the 1986 Budget. And we warned: "The Treasury expectation of 3 1/2% or so inflation must surely owe a great deal to an assumed reduction in pay inflation - possibly to 5-5 1/2% in the course of 1987. Low inflation may encourage wage moderation. But there are very powerful upward pressures on pay now in the system: robust company profits, a weaker exchange rate, a growing economy, a tightening labour market, ample supplies of bank credit. While we welcome the Chancellor's intention to encourage profit-sharing schemes as a means of promoting greater pay flexibility, we fear it will be too little, too late. 1987 may well be the year when the economy begins to overheat". It is therefore only mildly comforting that the Chancellor rejected the advice he received from some quarters to relax his grip even more last year.

Table 4: Policy Indicators

FY	1982	1983	1984	1985	1986	1987 f
Short term interest rates						
nominal	11 1/2	9 1/2	11	12	10 1/2	10
real @	6	3 1/2	5 1/2	7 1/2	6 1/2	6
Sterling Index	88	83 1/2	76	79	71 1/2	72
Competitiveness #	90	86 1/2	82 1/2	89 1/2	80 1/2	80 1/2
Adjusted PSBR/GDP ratio*	4	4	4 1/2	3	2 1/2	2 1/2
Change in cyclically adjusted PSFD (%GDP)+	+1/2	+1	+1	-1 1/2	+1	0

@ nominal rate less next year's inflation rate of producer prices
# unit labour cost competitiveness index; a lower figure indicates improved competitiveness
* adjusted for asset sales including council house sales
+ cycle adjustment based on Phillips and Drew's economic model and assumes 2% trend GDP growth f: our estimate of 1987 FSBR projections where appropriate. Figures are heavily rounded.

The Treasury's new forecast of 4% retail price inflation by 1988 Q2 also rests on the assumption of a lower growth in earnings. This we question for precisely the same reasons as last year. Although settlements have slipped a little, they are now more likely to rise than fall. Inflation is picking up, not slowing down; job vacancies are approaching a cyclical peak (though, interestingly, skill shortages are not so evident) and company profits remain buoyant even on the Treasury's forecast. In manufacturing, we would be surprised to see earnings growth significantly different from the current 7 3/4%.

Of course, pay increases could be offset by sharp productivity rises keeping down unit labour costs. Thanks to the cyclical pick up in output, manufacturing productivity is now rising strongly at well above its underlying trend. It is, however, the underlying trend growth - adjusted for the cycle - which is relevant for inflation. Cyclically boosted productivity growth, which is being misrepresented in the media as a productivity miracle, feeds higher profits, not lower inflation.

The FSBR states (para 3.55): "Underlying growth in manufacturing productivity now seems to be back to the rate experienced in the late 1960s". The accompanying table shows that manufacturing productivity growth between 1979 and 1986 averaged 3 1/2% pa in contrast with 3 3/4% pa between 1964 and 1973. This comparison is highly misleading, however. Our estimates of cycle-adjusted productivity indicate a large once-off step improvement in productivity in 1980-81. Thereafter, trend productivity growth averages some 3% pa. The number can be raised to the "1960s" level only if the step-improvement is included in the figuring. Overall, and bearing in mind the worse productivity trend in the non-manufacturing sector, underlying unit wage costs economy-wide still appear to be running at around 5% pa.

What the Chancellor will have to rely on to deliver his 4% inflation forecast next year is tight policies - and probably tighter than those assumed in the FSBR. Judged by its forecast of the housing element of the RPI, the Treasury is assuming base rates of around 10% in fiscal 1987 - implying yields of something like 6% in real terms. (Real interest rates are difficult to measure but, for simplicity, our preference is to deduct next year's inflation rate from this year's nominal interest rate). Real yields of this magnitude are probably necssary to justify the Treasury's assumption that sterling remains stable at around 72 on the index. The fiscal stance remains broadly neutral - staying flat on a cycle-adjusted basis (Table 4).

In terms of the Chancellor's options outlined at the beginning, we conclude that 4% inflation might prove deliverable if he now adopts a stable sterling strategy at 72 on the index. More assuredly he will get 4% next year if he allows sterling to appreciate towards the 75 region - and holds it there. The danger of both options is that they will impair the economy's longer term growth prospects by damaging productive potential.

The Case for Cheap Sterling

On productive potential grounds, we conclude that there is a pressing need to bring about lower real interest rates and a more competitive exchange rate. Since 1980, real short term interest rates (on our forward looking measure) have averaged a pretty steady 5-6%: well above any comparable period since the 1960s. And despite an improvement since 1981, manufacturers have not regained the level of price and cost competitiveness which existed through most of the 1970s. Indeed on the measure of competitiveness based on labour costs shown in the graph, the average level enjoyed over the last 3 years was rather worse than that seen in the unhappy years running up to the 1967 devaluation. (Note that an upward movement in the competitiveness index denotes a deterioration).

The consequences have been two-fold. First, it appears that without the benefit of large oil surpluses, Britain has entered a period of sustained weakness on the current account of the balance of payments.

Table 5 Current Account £bn

1979	1980	1981	1982	1983	1984	1985	1986	1987f	1988f
-1/2	3	6	4	3	1 1/2 (4)	3 (4 1/2)	-1 (-1 1/2)	-2 1/2	-2

f: Treasury Forecast. 1988 is first half at an annual rate. Figures in brackets are after adjustment for the coal strike and the timing of EC rebates.

After adjustments for distortions to the figures, the current account balance fell from a surplus of £4 1/2bn in 1985 to a prospective deficit of £2-2 1/2 bn a year on Treasury forecasts for this year and next (Table 5).

These deficits come despite earnings on Britain's overseas assets, now put at £110bn at the end of last year. Britain's invisible surplus generally does not appear to be saving the day despite hopes to the contrary. In our submission on last year's Autumn Statement, we commented: "The official projection on invisibles is now £600mn a month indicating a figure for the full year (1986) of under £8bn. The Treasury forecasts £8 1/2bn this year rising to £9bn in 1987. This looks pretty optimistic on the basis of current estimates."

Table 6: Treasury Current Account Forecasts

	Non-oil Visible			Oil Account			Invisibles		
	B86	A86	B87	B86	A86	B87	B86	A86	B87
1985	-10	-10 1/2	-10 1/2	8	8	8	5	5 1/2	5
1986	-9 1/2	-12 1/2	-12 1/2	5	4	4	8	8 1/2	7
1987	-	-14	-15	-	3 1/2	4	-	9	8 1/2

B86(87): Budget 1986 (1987) estimates
A86: Autumn Statement 1986 estimates

Mr Lawson clearly took exception to these remarks. In his robust defence of the Autumn Statement, he is reported as saying in Hansard: "And the latest estimate that the surplus on invisibles was some £750mn a month in the third quarter of this year, with a still larger surplus likely in the fourth quarter, puts into perspective the advice confidently given to the Select Committee by one of its specialist advisers that the earlier projection of £600mn a month was "particularly optimistic" ".

It was, of course, the Treasury's forecast rather than the official £600mn a month estimate that this specialist adviser was challenging. As it turns out, the latest official guess is that invisibles are indeed running at £600mn a month. The Treasury has had to revise its 1986 number from £8 1/2bn to £7bn

(Table 6). It has, however, conceded only a £1/2bn downward revision to the Autumn Statement projection of invisibles for 1987.

At the same time, the Treasury has raised by £1bn its forecast deficit on the non-oil visible balance this year. Behind this revision lies a 1 1/2% point increase in the projected growth in import volume (to 8% non-oil, excluding erratics) and a smaller 1/2% point increase in the projected growth in the volume of exports (to 6%). The non-oil terms of trade are now shown to improve by 1/2% rather than to deteriorate by 1/2%.

This worsening in the relationship between export and import volumes, non-oil, is explained by a downward revision to the Treasury's forecast of world trade growth and by the higher assumed level of sterling. The slightly encouraging trade figures for January and February suggest that the Treasury may have been overcautious on its visibles forecast so balancing the risks taken with the invisibles number. It would be churlish to quibble with the Treasury's overall current account forecast for this year and next especially in the light of an average forecast error for the year ahead of £3bn! The persistence of the deficits is a worrying feature of the forecast.

The other worrying feature is the weakness of investment. In last year's Budget, the Treasury forecast a rise in business investment of 5% in 1986. The provisional outturn was a fall of 3%. North Sea investment fell because of the collapse in oil prices. But non-oil investment was also weak. In manufacturing and services, it fell 2%. It is not known what proportion of this decline is due to the Chancellor's 1984 reform of the corporation tax system. The final stages of the transition to lower capital allowances and a lower corporate tax rate were achieved last year. It is possible that some investment was brought forward to benefit from the comparatively favourable tax treatment available in 1985. This forestalling would have depressed artificially the 1986 investment figure.

It is all too likely, however, that the same reforms which scooped the Chancellor lots of company tax revenue, which went to finance cuts in personal tax, have also knocked industrial investment for a six. On our calculations, the effect of the new corporate tax system as compared with the old is to add the equivalent of 1 1/2-2 percentage points to the hurdle rate of return which investment projects have to earn to be worth undertaking. This is a stiff increase and on some estimates of the relevant elasticities would easily account for the slump in investment last year.

For 1987, as for 1986, the Treasury is basing its investment forecast heavily on the DTI investment intentions survey. Last year, the survey pointed to a 1% rise in manufacturing and service investment; this year, it suggest a 6% rise. Such optimism could be easily overturned if the Chancellor does revert to a firm sterling strategy, thereby confounding expectations which were prevalent at the time of the December survey.

A further year of low investment would be unwelcome. The growth in the economy's capital stock has probably fallen since 1979 to around 2% pa, significantly below the previous trend (Table 7). In manufacturing, the slowdown is more marked even though official statistics probably under-record the scrapping of equipment in the 1980-81 recession. A crude adjustment for under-recording suggests a fall not a rise in manufacturers' capital stock over the period.

Table 7: Growth of capital stock* %pa

	1951 - 73	1973 - 79	1979 86
Whole economy	3.3	2.9	2.1
Manufacturing	3.5	2.5	1.0 (-3.3)

*gross capital stock at 1980 prices. The figure in brackets shows the effect of adjusting the manufacturing capital stock figure so that it is in keeping with the evidence of capacity utilisation given in CBI surveys. Official statistics on capital stock are not particularly reliable.

The concern is that the economy is suffering from a deficiency of physical investment. If so, it will take many years to put right. The impact of investment on the capital stock in any one year is pretty trivial. Even if manufacturing investment had risen by 100% last year, the capital stock would have been only 4% higher. The Treasury hopes that higher profits will do the trick eventually. In the context of its forecast of wider manufacturing profit margins, it argues: "In the longer run the higher level of profitability should lead to more investment, greater capacity, higher productivity, and hence lower inflationary pressure".

This exceptionally important argument receives not a trace of supporting evidence in the Red Book. If the Treasury now believes that cash flow determines investment it is hardly consistent with its traditional belief in the efficiency of capital markets. In any case, the evidence suggests that profits and investment have parted company in recent years. As the second graph shows, profits in manufacturing have risen sharply against their previous downward trend while investment has fallen sharply against its previous upward trend.

This disparity between profits and investment is precisely what one would expect in an economy where the real level of interest rates is held persistently well above the economy's growth rate. In these circumstances, businesses aim to squeeze higher profits out of a falling, or more slowly growing, capital stock. To an extent, this could lead to a welcome improvement in the efficiency of investment decisions. But the clear danger is that growth itself will be stunted in the longer term by the cutting out of innovative investment programmes. The Treasury's virtuous circle linking extra investment with lower inflationary pressure would become a vicious spiral.

Tax Objectives

In summary, we find that the Chancellor has exercised welcome caution in cutting his PSBR target; that there is however evidence of upward inflationary pressure; that this pressure stems from a pro-cyclical easing of policy; that there is nevertheless a good case for lower interest rates and lower sterling;

that, in the long run, this combination might improve the economy's supply performance and reduce inflationary pressure but that, in the short run and in current circumstances, it will undoubtedly increase it.

The conclusion we reach is that the reduction in the PSBR, welcome and large though it is, has not gone far enough. Some commentators have argued that the PSBR is now at its long run desired level: at 1% of GDP it happens to be consistent with a stable public debt to GDP ratio if inflation is nil and growth is 2% pa. We find "stable debtist" rules particularly unhelpful. Apart from problems of measurement it is well-nigh impossible to calculate the magic number for the desired debt ratio. We would want to argue that with real interest rates at 6% and economic growth on the Treasury's medium term projections at only 2 1/2% the current debt to GDP ratio is far too high. This, however, is not a fruitful line of discussion. More revealing is the simple point that if the Chancellor wants to raise the level of investment by cutting real interest rates, he must at the same time tighten his budgetary stance in order to keep money GDP growth on target.

Can the Chancellor reduce the PSBR target further and stick to his commitment to reduce income tax rates? The answer is: no one really knows. In past Treasury forecasts, the average error in the PSBR projection for just the year ahead has been a cool £5bn - in excess of the current target. Matters have not improved this year. As we argued in our submission on the 1986 Autumn Statement, the risk of a substantial overshoot on public expenditure in 1988 has not fallen despite the apparent generosity of the latest plans.

In addition, the Treasury forecast of non-oil tax receipts can be little more than a shot in the dark. The forecast starts from a poorly understood and poorly estimated base figure for 1986. On the Treasury's estimates, non-oil receipts including interest and dividends were some £4bn higher in 1986 than projected in last year's Budget. But nearly £1 1/2bn of this underestimate is attributed to a miscellaneous tax category ("other" in Table 1.2 of the Red Book) which includes a balancing item for statistical error! (Table 8).

Another £1 3/4bn of the underestimate is put down to non-oil corporation taxes. One reason for this surge could simply be late payment of corporation tax which would normally have been paid in 1985. Another reason is that the Chancellor's 1984 reforms have had the effect of widening the tax base. Previously tax exhausted companies lost their allowances and were drawn into the tax net. This could help to explain why the rise in non-oil corporation tax payments in 1986 of over 40% greatly exceeded the relevant growth in company profits. (Fiscal 1986 tax payments largely reflect profits made in calendar 1985). The big unknown is whether this gain from a wider tax base has now run its course.

Table 8: Sources of extra tax in 1986 £bn

Non-oil taxes	+3.1	Oil taxes	-1.3
of which:		Interest etc	-0.6
non-oil corp. tax	+1.8	Trading surp. etc	+0.3
VAT	+0.8	Other	+1.3
Stamp duty	+0.4	Total	+2.8

All this leaves the Treasury tax forecasters in an unenviable position. The Chancellor is reported to have described the official PSBR forecast at the time of the Autumn Statement as "completely ridiculous " and his forecasters as "up the pole". If true, it is conceivable that blushing officials have felt bound to add a face-saving safety margin for Lawson's Luck to their latest forecasts. What they have assumed in effect is that the source of windfall tax gain in 1986 - whatever it was - bestows a similar bounty on the Chancellor in 1987. With the Budget tax cuts stripped out, the Treasury's numbers for 1987 indicate around a 9 1/2% rise in non-oil tax take including national insurance. This exceeds the growth in non-oil money GDP (growing by 7 1/2% in 1987) by a margin similar to that estimated for 1986.

In later years, however, non-oil taxes are probably rising no faster than non-oil GDP on the Treasury's computer. This is quite a conservative assumption. The tax system, being slightly progressive when considered as a whole, will usually produce a rise in tax revenues somewhat in excess of the rise in incomes and expenditure. Consequently for any given structure of tax rates, the share of tax in income will tend to rise. Table 9 illustrates the point by showing what the non-oil tax burden would have been given the tax rates prevailing in 1981.

Table 9: Non-oil tax burden

Non-oil taxes as % of non-oil GDP

FY	1982	1983	1984	1985	1986	1987f	1988f	1989f
Unadjusted	38.4	37.9	37.8	37.2	37.7	37.8	37.8	37.7
Adjusted	38.8	39.2	39.4	39.2	39.9	40.6	40.5	40.3

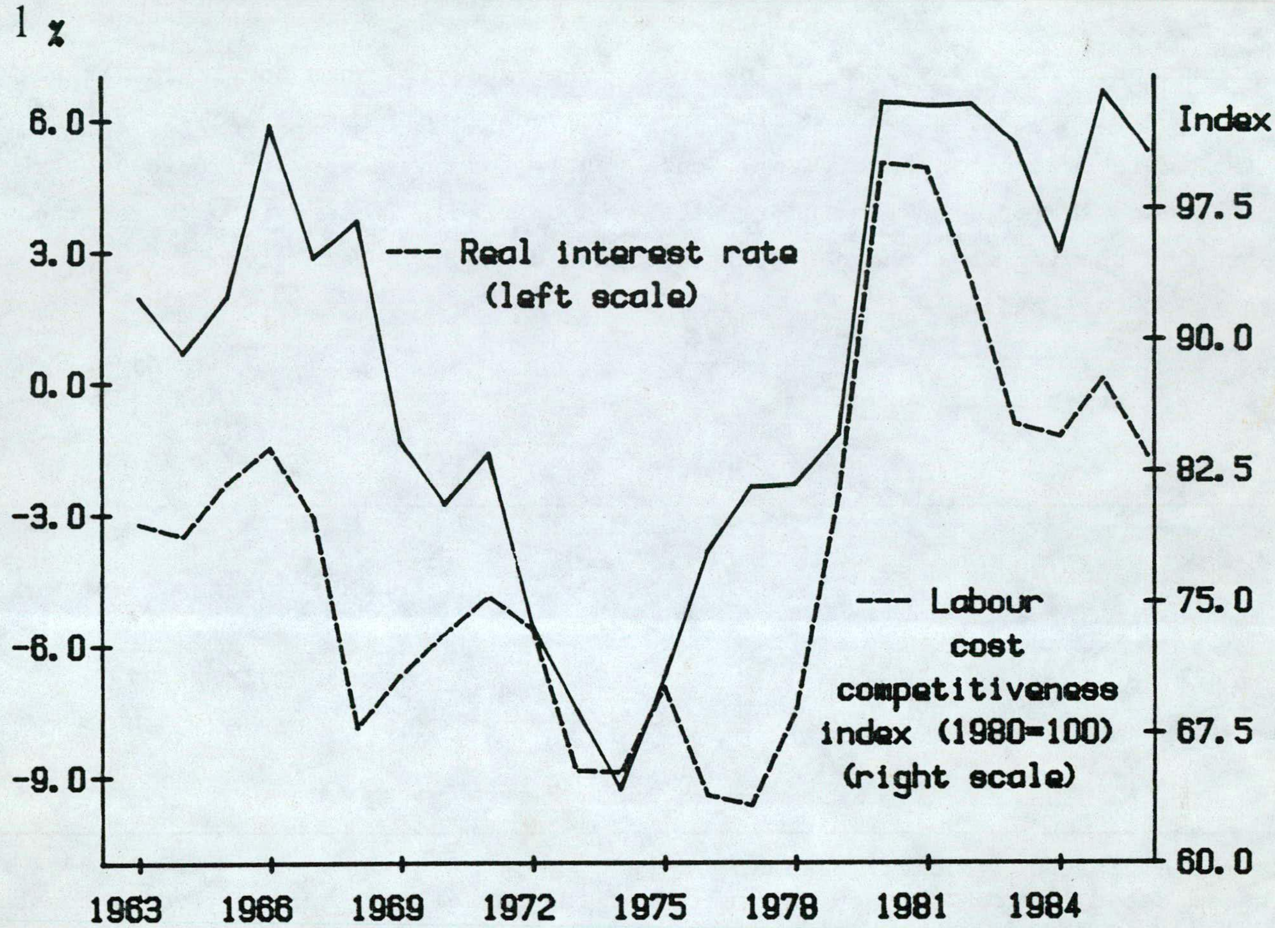
f: our estimate of Budget Forecast
The adjusted figures show our estimates of the non-oil tax burden given a constant 1981/82 tax structure.

For 1988 and 1989, then, the forecast may be trying to err on the side of caution to disguise the size of the fiscal adjustment. In 1987, however, the forecast assumes a repeat performance of 1986. If that proves incorrect, revenues in 1987 will undershoot. The 1988 forecast will then appear reasonable rather than cautious. If public expenditure does explode at that time, the Chancellor will be in difficulty with his sums.

The conclusion is that the Chancellor should soft peddle on his commitment to cut tax rates. If his luck holds, tax cuts will be affordable. Economic strategy needs firmer foundations however. The long-term objective of policy should be to reduce the PSBR as a proportion of GDP - even if this means running surpluses on this measure - until real interest rates fall more in line with the economy's productive potential. PSBR cuts, not tax cuts - that's the message for the next version of the MTFS.

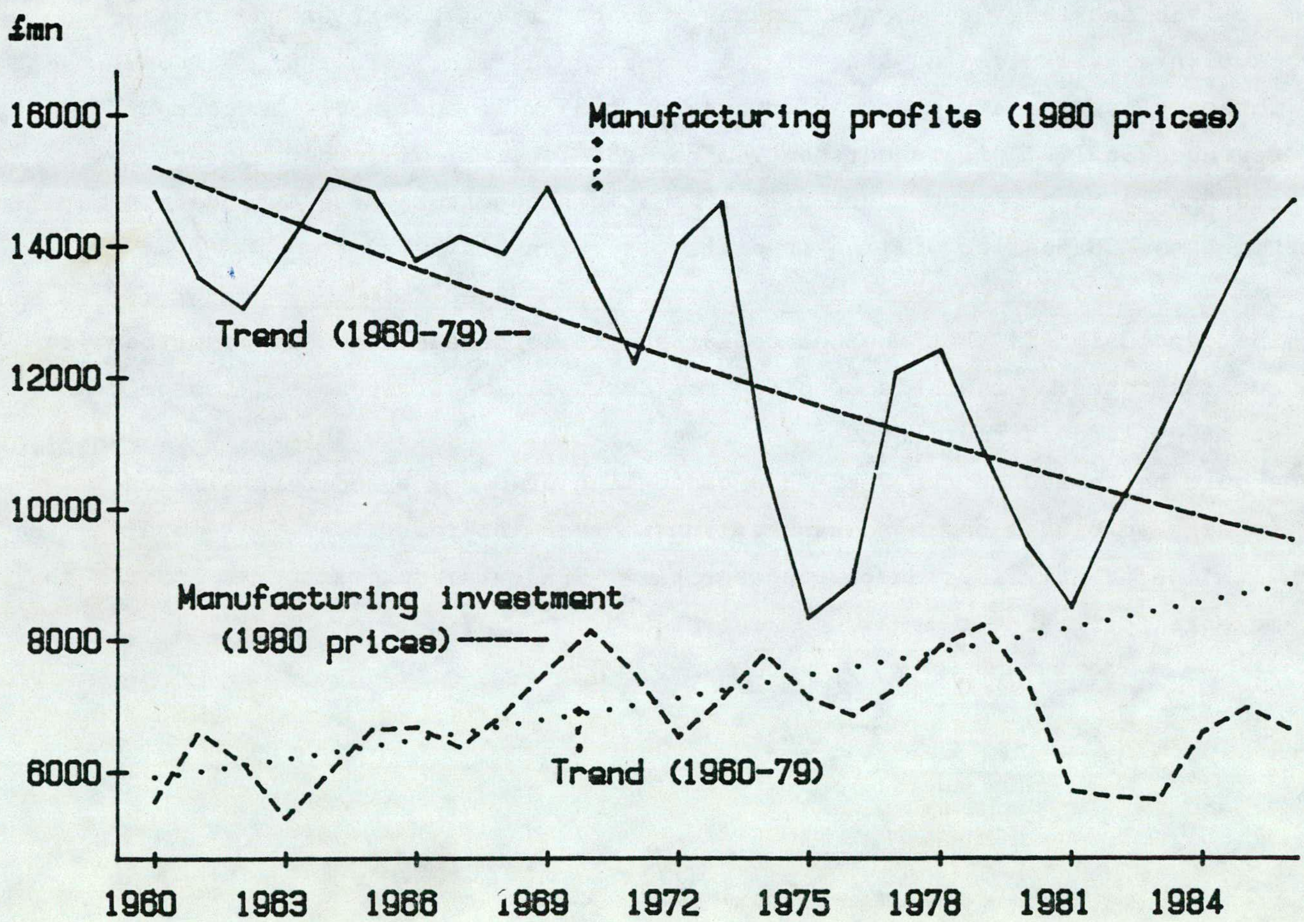
REAL INTEREST RATES & COMPETITIVENESS

1



MANUFACTURING PROFITS AND INVESTMENT

2



CHANCELLOR OF THE EXCHEQUER

HONI SOIT QUI MAL Y PENSE

Ch

Brian Dyer says

150 pages new-style

Finance Bill equals

200 pages old-style.

AA

INLAND REVENUE
CENTRAL DIVISION
SOMERSET HOUSE

1. Cotty
2. RP

FROM: A J WALKER
3 APRIL 1987

PS/FINANCIAL SECRETARY

FINANCE BILL : LOBBY NOTES

... I attach the Inland Revenue contribution to this year's lobby notes, which I understand Ministers wish to clear before they go to IDT next week. The numbering follows what I understand it will be in the Bill as published (ie the same as in the second print of the Bill, but with clauses 121A becoming 122, and clauses 122 to 141 moving up one. The earlier clause 142 - exemption for off-market dealers - has been dropped).

I should be grateful if you would let me know if the Financial Secretary is content with the notes on clauses for which he is responsible. I should likewise be grateful if PS/Economic Secretary and PS/Minister of State would let me know if their Ministers are content with the notes on their clauses.

A J WALKER

cc PS/Chancellor
PS/Chief Secretary
PS/Economic Secretary
PS/Minister of State
Mr Walters
Mr Isaac
Mr Painter
Mr Beighton
Mr Cleave
Policy Directors
Mr Walker
Mrs Weddle
PS/IR

INLAND REVENUE LOBBY NOTES

* indicates Inland Revenue press notice issued on Budget Day
+ indicates Inland Revenue press notice to be issued on 8 April

*Clause 20 sets the charge and rates of income tax for 1987-88, including the new basic rate of 27 per cent. It also provides for changes to the thresholds for the higher rates of tax.

*Clause 21 sets the main rate of corporation tax for the Financial year 1987 at 35 per cent (unchanged).

*Clause 22 reduces the rate of corporation tax for small companies for the Financial Year 1987 from 29 per cent to 27 per cent.

*Clause 23 fixes at 27 per cent the rate at which deductions are to be made from payments to subcontractors in the construction industry who do not hold exemption certificates. The change takes effect from 2 November 1987.

*Clause 24 amends, for 1987-88, the date from which the new tax allowances will be put into operation for PAYE. (There is no provision specifying the main personal allowances for 1987-88, since these are automatically increased under the statutory indexation provisions of the 1980 Finance Act.)

*Clause 25 sets the 1987-88 mortgage interest relief limit at £30,000 (unchanged).

*Clause 26 introduces a new higher level of age allowance for elderly people aged 80 and over on modest incomes. This will be available for the first time in the 1987-88 tax year.

Clause 27 ensures that invalid care allowance payable to married women is regarded as their earned income for the purposes of the wife's earned income allowance and wife's earnings election. The provision applies from 1984-85. Unemployment benefit paid to a married woman is to be treated as her earned income for wife's earnings election purposes with effect from 1987-88. Inland Revenue press notice 25 July 1986.

*Clause 28 provides for the blind person's allowance to be increased for 1987-88 and subsequent years from £360 to £540, and from £720 to £1,080 for a married couple where both are blind.

Clause 29 and Schedule 3 amend the legislation which provides for the taxation of supplementary benefit paid to the unemployed and to strikers to reflect the replacement in 1988 of supplementary benefit by income support.

*Clause 30 changes the limit on tax-exempt life or endowment assurance business carried on by friendly societies, with effect from 1 September 1987. The new limit is annual premiums of £100, instead of gross sums assured of £750. The Clause also rectifies a minor loophole in the existing friendly society tax legislation.

*Clause 31 increases the limits relating to the tax exemption given to trade unions on their income and capital gains which are used to pay provident benefits to their members. The qualifying limits go up to £3,000 (from £2,400) for lump sum benefits, and to £625 (from £500) for annuities. The new limits apply from 17 March 1987.

Clause 32 increases the limit on charitable donations eligible for relief under the new payroll giving scheme from £100 to £120 a year. It applies from 6 April 1987. Treasury Press Notice 16 December 1986.

*Clause 33 and Schedule 4 enable companies to include in approved share option scheme rules an additional provision in the event of a takeover to permit scheme participants to exchange existing share options for options over shares in the acquiring company. This will operate in respect of takeovers after Budget Day where a change in the scheme rules is approved following Royal Assent. There are also minor technical changes to the "material interest" provisions which govern whether directors and employees qualify to participate in approved share schemes and for interest relief on loans for share purchases. The changes will help the smooth running of the three types of approved share scheme and are already operative.

*Clause 34and Schedule 5 makes various amendments to the legislation in the 1970 Finance Act concerning occupational pension schemes, to implement the anti-exploitation measures concerning eg excessive lump sums announced on Budget Day, and applying to arrangements entered into on or after that day. Other measures enable occupational scheme members to obtain full tax relief for additional voluntary contributions (AVCs) paid to a separate pension plan, from October 1987.

Clause 35 provides, with effect from 26 November 1986, relief from tax on business profits for the costs on seconding employees to local education authorities and certain other educational institutions.

+*Clause 36 and Schedule 6 give tax relief for the cost of retraining in new job skills provided by an employer for employees who are to leave or former employees. The provisions apply to retraining costs incurred on or after 6 April 1987 and ensure that, subject to certain conditions, these costs are deductible in calculating the employer's taxable profits and that the employee is not taxed on them.

*Clause 37 and Schedule 7 standardises the date on which corporation tax is payable at nine months after the end of a company's accounting period. Where the interval is longer, there will be transitional arrangements to make the reduction in three equal stages over three years. These will start with the first accounting period beginning on or after 17 March 1987. For certain building societies which at present pay corporation tax less than nine months after the end of the accounting period, the transition will be spread over two years starting with accounting periods ending in the 1989-90 tax year.

*Clause 38 aligns the date on which certain interest and other payments are treated as paid and received for tax purposes where the payment is between companies within a group or otherwise under common control. The new rule applies to payments made on or after 17 March 1987.

*Clause 39 modifies the definition of the meaning of "associate" in Section 303 of the Taxes Act, principally to help maintain the smooth running of approved employee share schemes. It takes effect from 6 April 1986. A consequential change for interest relief on loans for purchasing the company's shares takes effect for loans made after 13 November 1986.

*Clause 40 makes it obligatory, where the statutory conditions are satisfied, for the Inspector to apportion the income of a close company to its shareholders. Apportionment of covenanted payments to charity (and other annual payments) will also be made obligatory. (The Inland Revenue had believed that the existing legislation had this effect but the Court of Appeal said in 1986 that the Inspector's powers were discretionary.) The apportionment changes apply to accounting periods beginning on or after 17 March 1987.

*Clauses 41-43 deal with the tax treatment of the income and capital gains of unit trusts. The changes adjust the tax rules to fit the new regime for unit trusts introduced by the Financial Services Act 1986. The substance of the present tax treatment is unchanged. The new provisions first take effect for distribution periods beginning on or after 1 April 1987 (authorised unit trusts) and 6 April 1987 (other unit trusts).

*Clause 44 makes a minor technical change in the tax treatment of management expenses of investment companies and authorised unit trusts.

*Clause 45 introduces an option for an investor under the Business Expansion Scheme to claim up to one-half of his relief against income of the previous tax year subject to a limit of £5,000 carry back for any year. The relief is available for investments made between 6 April and 5 October inclusive in any tax year from 1987-88 onwards.

*Clause 46 relaxes the conditions for eligibility under the Business Expansion Scheme of a film production company whose income is expected to derive from royalties or licence fees. To qualify the company must either be engaged throughout the three-year qualifying period in the production of films (the previous condition), or in the distribution of films produced in the period. Will apply to shares issued on or after 17 March 1987.

*Clause 47 ensures that a UK resident partner in a foreign partnership is fully chargeable to tax in the UK on his share of the profits of the partnership. It will apply so as to prevent claims to relief from tax for past years.

+Clauses 48-49 and Schedule 8 prohibit dual resident companies, other than certain trading companies, from surrendering their losses after 1 April 1987 to other members of a UK group under the UK group relief rules. They also limit the application of certain other reliefs where a dual resident investing company is involved in intra-group transactions.

*Clause 50 amends the legislation concerning controlled foreign companies (in Schedule 17 Finance Act 1984). With effect from Budget Day, in addition to the existing conditions, an acceptable distribution policy will be satisfied only if a dividend is paid at a time when the company is not resident in the UK.

Clause 51 introduces a degree of flexibility in applying the conditions which an offshore fund must satisfy to qualify as a distributing fund. For account periods which end after Royal Assent, the Inland Revenue will be able to extend the time limit for making distributions and disregard a failure to comply with the investment conditions in Section 95(3), Finance Act 1984 where the Board are satisfied that the failure was inadvertent and was remedied without unreasonable delay.

*Clause 52 changes the rules for calculating banks' taxable income from making a loan to a non-resident. Under the new rules any tax credit for foreign withholding tax paid, or deemed to be paid, on the interest they receive may in future be offset only against the UK tax due on the net profit from that loan. The change applies to interest payable on new loans made on or after 1 April 1987. For existing loans, the new rules apply to interest arising on or after 1 April 1988.

*Clause 53 imposes restrictions on double taxation relief, which parallel those imposed by Clause 52, for underlying tax on dividends in circumstances where loan interest is effectively remitted as a dividend to a bank operating from the UK. The change applies to interest payable on new loans made on or after 1 April 1987. For existing loans the new rules apply to interest arising on or after 1 April 1988.

*Clause 54 permits, subject to conditions including a monetary limit, a company carrying on oil extraction activities in the United Kingdom or on the United Kingdom Continental Shelf (UKCS) to carry back Advance Corporation Tax (ACT) surrendered to it, if the ACT relates to a dividend paid by the surrendering company on or after 17 March 1987. The company to which the surrender is made may carry back the ACT for set off against the corporation tax liability on its oil extraction activities in the previous six years.

*Clause 55 enables a member of a 50/50 consortium to surrender ACT to a company with UK or UKCS oil extraction activities which is owned by the consortium. The new rule applies to ACT in respect of dividends paid on or after 17 March 1987.

*Clause 56 prevents ACT in respect of certain preference share dividends paid on or after 17 March 1987 being set off against the corporation tax liability on profits from UK or UKCS oil extraction activities. The rule applies to redeemable preference share capital issued by a company which is under the control of another UK resident company, except where the proceeds of the issued share capital is used by the issuing company in carrying on its UK or UKCS oil extraction activities.

Clause 57 permits the Department of Employment to pass on information provided to it by the Inland Revenue under Section 58 Finance Act 1969 to local authorities for use in formulating local employment policy. The information consists of employer's names and addresses and the numbers of employees they have under PAYE.

*Clause 58 applies to Lloyd's reinsurance to close (RIC) arrangements the normal criteria for the tax deductibility of provisions for outstanding liabilities. The Clause will first take effect for RIC payments in the Lloyd's 1985 account, which closes at the end of 1987.

*Clause 59 extends by five years from 31 March 1987 to 31 March 1992 the period during which capital allowances are available to companies for costs of construction of properties for letting on assured tenancy terms. It also makes provision for effect to be given to certain initial allowances whose benefit might otherwise have been lost.

*Clause 60 deals with the tax treatment of securities traded on new recognised investment exchanges (RIEs) which may be established under the Financial Services Act 1986. The clause provides an enabling power for regulations to be made (after Royal Assent) which will allow securities traded on a new RIE to be treated in the same way for tax purposes as securities traded on the existing Stock Exchange.

+*Clause 61 and Schedule 9 amend the rules for taxing companies' capital gains so that they are taxed at the same rates as companies' income instead of the present 30% effective rate. For small companies the rate will thus be cut to 29% from 17 March 1987 and again to the new 27% small companies rate from 1 april. Companies will be able to set advance corporation tax against corporation tax on gains as well as on income. These changes apply to disposals on or after 17 March 1987. There are transitional arrangements for accounting periods straddling that date.

Clause 62 makes a corresponding change to the special provisions for life assurance companies, so that their gains will be taxed at the normal corporation tax rate of 35%.

Clause 63 makes technical changes to the provisions relating to the set-off of advance corporation tax against corporation tax on income from oil extraction activities. These changes are consequential on the extension to capital gains of the set-off for advance corporation tax and ensure that from 17 March 1987 farmout gains will be included with oil extraction income and for the purposes of the restrictions on ACT set-off.

Clause 64 makes minor technical amendments to the provisions relating to the interaction of advance corporation tax and double taxation relief. The amendments reflect the extension to capital gains of the set-off for advance corporation tax.

Clause 65 makes it explicit that established tax law will continue to apply where an investor in a multi-portfolio unit trust switches from one portfolio to another. It prevents doubts about the tax position arising because of a detailed provision in the Financial Services Act.

Clause 66 brings Building Societies within the capital gains regime for groups of companies.

*Clause 67 increases from £100,000 to £125,000 the ceiling for capital gains tax retirement relief, with effect from 6 April 1987.

*Clause 68 brings, subject to certain conditions, the treatment of over-the-counter futures and options in line with that of traded options and of transactions on recognised exchanges. The main effects are that profits on over-the-counter transactions will always be treated as capital gains unless they arise in the course of trading, and that a capital loss will arise when an over-the-counter options expires without being exercised.

*Clauses 69 to 106 and Schedule 10 introduce the new tax regime for personal pension schemes, to apply with effect from 4 January 1988. The new legislation replaces and extends the existing retirement annuity provisions in S.226 et seq of the 1970 Taxes Act, which will cease to have effect for such arrangements made after 4 January 1988. The main provisions are:

*Clause 69 defines various terms used in the legislation.

*Clause 70 enables the Inland Revenue to approve personal pension schemes subject to certain conditions.

*Clause 71 to 77 set out the pension and lump sum benefits which may be provided by approved schemes.

*Clauses 78 to 81 outline certain administrative requirements which approved schemes must satisfy.

*Clauses 82 to 88 set out the rules governing tax relief for contributions by individual members (whether employed or self-employed) of personal pension schemes.

*Clause 89 gives tax relief for any contributions to a personal pension scheme by an employer, in respect of any employee of his who is a member of that scheme.

*Clause 90 provides a tax exemption for schemes' investment income and gains.

*Clause 91 concerns the tax treatment of annuities paid to members of personal pension schemes.

*Clause 92 concerns the 'minimum contributions' which the Secretary of State for Social Services will pay to personal pension schemes which are 'contracted-out' of the State Earnings Related Pension Scheme (SERPS).

*Clause 93 enables the Inland Revenue to withdraw approval from personal pension schemes or arrangements in certain circumstances.

*Clause 94 imposes a tax charge on certain unauthorised payments to scheme members.

*Clause 95 and 96 concern tax relief for contributions to a personal pension scheme. Such contributions by employees will qualify for basic rate tax relief at source.

*Clause 97 concerns appeals procedures.

*Clauses 98, 99 and 103 cover procedural matters relevant to tax relief for an individual's contributions.

*Clauses 100 and 101 concern the Inland Revenue's powers to obtain information about contributions to, and payments by, personal pension schemes.

*Clause 102 enables Government Ministers and MPs who are not members of the Parliamentary Pension Scheme to join a personal pension scheme.

*Clause 104 introduces transitional provisions for retirement annuity contracts made before 4 January 1988.

*Clause 105 concerns applications for approval of personal pension schemes before 4 January 1988.

*Clause 106 and Schedule 10 make minor consequential amendments to the Taxes Act.

+*Clauses 107-122 and Schedule 11 introduce the new income tax relief for employees who receive profit-related pay (PRP) under registered schemes which link part of their pay to the profits of the business in which they work. Half of PRP will be eligible for tax relief (to be given by the employer through PAYE) up to the point where PRP is the lower of 20 per cent of the employee's total pay or £3,000. These provisions establish the tax relief and the conditions for its operation, define the employers eligible to introduce a registered PRP scheme, stipulate the conditions to be met by such schemes, and prescribe the method by which schemes may be registered. Employers' applications to the Inland Revenue for registration of PRP schemes will be dealt with after the Finance Bill receives Royal Assent.

*Clauses 123-133, 137 introduce a new system for the collection of corporation tax known as Pay and File. This will come into effect from a date, not before 31 March 1992, which will be announced nearer the time. Under Pay and File a company will make its own estimate of its corporation tax liability and pay this by its normal due date. It will then have until one year after its accounting date to make its return with automatic penalties if it is late. Where the estimate turns out to be too low, interest will be charged, and where the estimate was too high, interest will be paid on the tax outstanding after the due date.

*Clause 123 allows a new style of company return to be introduced for Pay and File and sets a one year time limit for its completion.

*Clauses 124-126 set automatic penalties for returns not made within the time limit and provide a right of appeal against the penalty.

*Clauses 127-131 provide for interest to be charged on overdue corporation tax and on recoveries of overpayments, for interest to be paid on repayments of corporation tax, income tax and tax credit, and for interest rates to be altered where necessary.

*Clause 132 provides for corporation tax to be payable without assessment.

*Clause 133 makes the amendments needed to the tax on loans to participators in close companies for Pay and File.

*Clause 134 provides enabling powers to introduce regulations applying an interest charge on PAYE paid late in circumstances where the Inspector has formally to determine the amount due; and clarifying the meaning of 'payment' for PAYE purposes.

*Clause 135 provides enabling powers to introduce regulations requiring the Inland Revenue to be informed of the change of control of a company holding a '714C' subcontractor certificate; giving the taxpayer a right of appeal against cancellation of a subcontractor certificate; and requiring the production to the Revenue of contractors' records.

Clause 136 improves the drafting of the present S.118(2) Taxes Management Act (which provides that a person's failure to do something, such as render a tax return, shall be ignored when there was reasonable excuse for failure) for cases for continuing reasonable excuse.

*Clause 137 provides for Pay and File to come into effect on an appointed day which will not be before 31 March 1992.

+Clause 138 adjusts the definition of a "unit trust scheme" that applies for stamp duty to match the new Financial Services Act definition. The change takes effect from Royal Assent.

+Clause 139 provides for the repeal of the statutory requirement on brokers to issue contract notes. A code governing the issue of contract notes is provided for in the Financial Services Act. The repeal will take effect from a day to be fixed by the Treasury.

+Clause 140 extends the stamp duty exemptions that apply to gilt-edged securities and to most categories of loan stock to options to acquire such stock. The change takes effect from 1 August.

+Clause 141 The clause redefines foreign currency for the purposes of S.30 Finance Act 1967 (and its Northern Ireland equivalent) which exempts from bearer duty stock expressed in a currency of a territory outside the scheduled territories. The change takes effect from Royal Assent.

+Clause 142 makes a technical modification to S.70 Finance Act 1986 which imposed a higher rate of stamp duty on shares transferred to nominee companies acting for clearance systems. The change has a 1 August start date.

+Clause 143 corrects a subsection reference in S.82 Finance Act 1986 (stamp duty relief for stock borrowed by market makers). The change takes effect from Royal Assent.

+Clause 144 amends S.97 Finance Act 1980 and S.108 Finance Act 1981 which limit the duty payable on a shared ownership lease to take account of recent changes to the shared ownership scheme. The amendments take effect on 1 August.

+Clause 145 replaces exemptions from stamp duty granted to the Secretaries of State for the Environment and Transport with a general exemption for all Government Departments. The change takes effect from 1 August.

+Clause 146 introduces Schedule 12 which contains a number of technical changes to the 1986 stamp duty reserve tax legislation. Most of the changes are deemed always to have had effect. A change which affects the date on which reserve tax is payable on purchases of renounceable letters of allotment takes effect from 1 August.

*Clause 147 applies the higher starting point (£90,000) and simplified rate scale for inheritance tax to transfers made on or after 17 March 1987.

*Clause 148 abolishes the existing inheritance tax charge on certain transfers made more than seven years before death involving interest in possession trusts (IIP trusts). Transfers to and from IIP trusts will be potentially exempt transfers (PETs) on the same basis as transfers of properly owned absolutely. Schedule 13 imposes, in certain circumstances, a special rate of charge where property that has been the subject of a PET on its transfer into an IIP trust becomes held on discretionary trusts in the next seven years and the person who made the PET is still alive. The special rate takes account of any chargeable transfers made by that person in the seven years before he made the PET. The changes apply to transfers made on or after 17 March 1987.

*Clause 149 and Schedule 14 also apply to transfers made on or after 17 March 1987. Shares in companies dealt in on the Unlisted Securities Market will be treated for all inheritance tax purposes like shares in companies with a full listing on the Stock Exchange. Business relief is to be increased from 30 to 50 per cent for transfers out of shareholdings of more than 25 per cent in unquoted companies, if the transferor has had that minimum level of holding for at least 2 years. There are also minor changes to the details of the reliefs for business and agricultural property, and the arrangements for paying inheritance tax by instalments.

*Clause 150 and Schedule 15 exempt settled property from inheritance tax on the death (on or after 17 March 1987) of a person who has an interest in possession in the property - for example, a life tenant - if the terms on which the property is held are altered after the death so that it goes into a heritage maintenance fund within two years (or three years if a Court Order is needed). The rules for charges when property leaves a maintenance fund for non-heritage purposes are altered so that the charge on property formerly held in an interest in possession trust may be based on the cumulated chargeable giving of the former life tenant. This alteration applies to charges arising on or after 17 March 1987.

+*Clause 151 provides that if property is accepted on or after 17 March 1987 in satisfaction of inheritance tax on terms that the value of the property for that purpose is determined as at a date earlier than that of the acceptance, the terms may provide that the tax satisfied will not carry interest from the earlier date.

Clause 152 extends to personal pension schemes the existing inheritance tax reliefs for pension schemes and retirement annuities.

Clause 153 and Schedule 16 enable a company proposing to sell (or appropriate) oil it has produced itself to nominate the proposed transaction to the Inland Revenue within a specified time limit. Where the nominated transaction is in the event fulfilled with the company's own equity production PRT will be based, as at present, on actual sale proceeds (or market value). In other cases, PRT will be calculated by taking account of both nominated prices and the - different - prices the company actually received from the sale of its equity production (and also, where appropriate, market value). These rules apply in respect of deliveries from 1 March 1987).

Clause 154 and Schedule 17 amend the rules, with effect from 1 January 1987, for valuing non-arm's length disposals of oil to reflect market conditions. Monthly market value will be based on the price the oil might have been expected to fetch had it been sold at arm's length for delivery in the relevant month. To obtain this monthly market value, the Schedule provides for an average to be determined by reference to prices obtained in actual arm's length sales. It also applies where market conditions make it inappropriate or impracticable to determine such an average. Inland Revenue press notice 9 February 1987.

Clause 155 and Schedule 18 contain technical provisions, which apply where oil from one field is blended with oil from other fields before being disposed of or appropriated. In such cases, a participator's share of the oil won from the field is taken to be that share of the blend which was allocated to him under an approved allocation system covering that field. This provision will have effect from 1 January 1987.

*Clause 156 and Schedule 19 provide for Petroleum Revenue Tax (PRT) relief for certain expenditure on research related to UK or UK Continental Shelf oil extraction activities incurred on or after 17 March 1987, which has not become allowable in a particular field within three years of being incurred. The new relief will be allowed against a participator's PRT liability in the field of his choice.

*Clause 157 and Schedule 20 introduce a new PRT cross field allowance. It allows a participator in certain new oil fields to set off against his PRT liabilities in existing fields up to 10 per cent of his qualifying expenditure incurred on or after 17 March 1987 in developing the new field.

*Clause 158 has the effect of extending the provision in S.8(6) Oil Taxation Act 1975 which allows participators in oil fields to re-allocate the PRT oil allowance in the final period of utilisation in order to correct imbalance. Where the final period of oil allowance utilisation ends on or after 30 June 1987, participators will have further scope to balance their shares of oil allowance in both the final and penultimate periods.

*Clause 159 remedies a defect in the rules for putting matters right where either too much or too little exploration and appraisal expenditure has been allowed for PRT. The provision applies to notices of decisions on expenditure claims given on or after 17 March 1987.

160 - not IR.

161 - not IR.

Clause 162 amends the statutory provisions under which double taxation conventions are made in respect of income tax, corporation tax, capital gains tax and inheritance tax. The amendment meets representations made to the Government by the Select Committee on Statutory Instruments about an apparent mismatch between the wording of the titles, preambles and certain articles in the Statutory Instruments embodying double taxation conventions and the enabling provisions contained in the Taxes Act. By incorporating into the statute a form of words borrowed from the OECD Model Double Taxation Convention, exchange of information between the treaty partners (for the purpose, inter alia, of the prevention of fiscal evasion) is now made explicit.

Clause 163 and Schedule 21 make amendments clarifying points of detail and drafting which are necessary to facilitate the consolidation of income tax and corporation tax legislation.

021/2763

Rur

CHIEF SECRETARY TO THE TREASURY

FROM: M C FELSTEAD

DATE: 3 April 1987

PS/MINISTER OF STATE

cc:
PS/Chancellor
PS/Financial Secretary
PS/Economic Secretary
Miss Sinclair
Mr Culpin
Miss C Evans
Mr Dyer
Mr Walters
Mr Cropper

PS/IR

Mr Wilmott - C & E
Mr Bone - C & E

FINANCE BILL 1987: LOBBY NOTES

I spoke to you this morning about Mr Bone's note of 2 April to the Minister of State covering Lobby Notes on various Customs and Excise clauses.

2 The Chief Secretary had noted that a new clause on the question of Klondykers would need to be laid at Committee Stage. He was concerned to ensure that the announcement of this should be made to Parliament first, rather than by means of a Lobby Note. You will recall that in my minute of 1 April to Mr Bradley (Fees and Charges and Vires: Finance Bill) I recorded the Chief Secretary's preference for informing Parliament first of our intention to lay new ~~caluses~~ clauses at Committee Stage to deal with this matter, and he now plans to make an announcement in his Second Reading speech. He has offered to refer also to this new clause, if the Minister of State is content.

3 More generally, could officials please note the Chief Secretary's wish that any plans to lay new clauses at Committee Stage should be announced first to the House, and only after publicised by way of Lobby Notes.

M C Felstead

M C FELSTEAD
Assistant Private Secretary

CE31

FROM: MISS C EVANS
DATE: 3 APRIL 1987

MR ALLAN

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir Terence Burns
Mr F E R Butler
Sir Geoffrey Littler 11/12
Mr Cassell
Mr Lavelle
Mr Monck
Mr Odling-Smee
Mr Peretz
Mr Scholar
Mr Sedgwick
Mr Turnbull
Mrs Lomax
Mr Culpin
Miss O'Mara
Mr Cropper
Mr Ross Goobey
Mr Tyrie

TCSC DRAFT REPORT ON THE BUDGET

... I attach a draft of the TCSC's report on the Budget. The Clerk has asked for our corrections in time for the Committee's meeting on Monday afternoon. The deadline for our response is 12 noon on Monday so could all corrections reach me by 10am on that day please.

2. If copy recipients wish to suggest any amendments which are more than straightforward factual points could they please minute you today so that the Chancellor has an opportunity to consider the point over the weekend.

Carys Evans

MISS C EVANS

Mr Allan

The whole of pages 23-27 is unhelpful. It is rest a question of tinkering with the draft. We shall just have to rubbish it when public.

[signature] 3/4

IN CONFIDENCE

TR315

FOR THE USE OF THE COMMITTEE ONLY

CHAIRMAN'S DRAFT REPORT

THE 1987 BUDGET

IN CONFIDENCE

FOR THE USE OF THE COMMITTEE ONLY

THE 1987 BUDGET

INTRODUCTION

1. Before preparing this report, we took evidence from the Chancellor of the Exchequer, Treasury officials, the Governor of the Bank of England and Bank officials. The oral evidence and a number of detailed written submissions from the Treasury and the Bank are appended to this report.

2. As in previous years, we have been supplied with a set of alternative forecasts, in order to make an independent assessment of the Treasury's Industry Act forecasts. Teams from the Henley Centre, the London Business School, the National Institute for Economic and Social Research and Phillips and Drew submitted two sets of forecasts. The first reflects their own assumptions about major future developments, the second a set of what we believe may be the latest Treasury assumptions.

3. Our advisers were Mr Gavyn Davies, Mr Christopher Johnson, Mr Bill Martin and Mr Terry Ward, to all of whom we are most grateful. The texts of the written papers which they prepared for us are set out in appendices to the Report. We also had before us two papers prepared for Members at large by the

Parliamentary Unit of the University of Warwick. Those comprised an evolution of alternative fiscal measures on the econometric models of the Treasury, the London Business School, the National Institute for Economic and Social Research, and the Bank of England; and results from the Treasury model on fiscal policy and exchange rate targets.

BUDGET DOCUMENTS

4. In our report on the 1986 Budget, we expressed the opinion that there was a substantial demand for clear, if semi-technical, presentation of Budget details which at present commercial productions meet to some extent, but which might be of interest to HMSO. Such a development would be particularly appropriate following the substantial and very welcome improvements of recent years in the form and presentation of all the Budget papers. We therefore recommended that the Treasury, together with HMSO, should look into the possibility of further promotion of the Financial Statement and Budget Report (the Red Book) and perhaps a revised Budget Supplement to the Economic Progress Report; and that the list of contents should once more appear on the front of the Budget day press releases.[1]

5. We must record our satisfaction with the Treasury's

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1. Fourth Report, 1985-86 (HC313) paras 7-9

response. The contents list of press releases duly appeared. Perhaps more significantly, HMSO sent out 19000 promotional leaflets and order forms for the Red Book as "essential reading for businesses of all kinds, students of economics and the well-informed layman." Thirdly, a version of the EPR Budget in Brief was put on sale at one of the main London railway stations at a very reasonable price. This was an experiment to test the market, at a modest total cost. The income from sales turned out to be greater than the expenditure:[2] we very much hope that the Treasury and HMSO will feel encouraged to repeat the experiment on a wider scale next year. We look forward to hearing the outcome of HMSO's promotion of the current Red Book and (in due course) of the results of the marketing of next year's Budget in Brief.

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2. HC Deb(1986-87) vol 113, c. 398

MONETARY POLICY

6.The latest statement of the Government's monetary policy is contained in paragraphs 2.04-2.17 of the Red Book. The underlying aim of policy remains the same as that articulated in previous versions of the MTFS. Paragraph 2.04 states that, "policy is directed at maintaining monetary conditions that will bring about a gradual reduction in the growth of money GDP over the medium term." These will be achieved through the setting of "monetary and fiscal policies to achieve monetary conditions which will deliver [the Government's] objectives for money GDP".[3] Short-term interest rates remain "the essential instrument of monetary policy"[4] and will continue "to be maintained at levels necessary to keep monetary conditions on track."[5] Paragraph 2.09 explains that "monetary conditions are assessed in the light of movements in narrow and broad money, and the behaviour of other financial indicators, in particular the exchange rate".

7.While the Government has again stated a target range for narrow money MO for 1987-88 it has refrained from setting a target range for £M3. Paragraph 2.17 of the Red Book states that "both the Chancellor and the Governor of the Bank of England have drawn attention to the increasing difficulties in interpreting changes in broad money. With rapid and pervasive changes in financial practices there is no simple relationship between broad money growth and money

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3. para 2.06
4. para 2.07
5. para 2.07

GDP." The target range for MO growth in 1987-88 is 2-6%, unchanged from the range indicated in last year's MTFS.

8.The Red Book is more explicit than usual about the role of the exchange rate in monetary policy. Paragraph 2.10 notes that, "at a meeting of Finance Ministers and Central Bank Governors of six major industrial nations in Paris on 22 February, it was concluded that a period of stability would be desirable. Accordingly the UK and other countries represented there agreed to cooperate closely to that end. The MTFS projections assume that there is no major change in either the sterling exchange rate index on the sterling/dollar exchange rate from year to year." While the latter assumption always accompanies each new version of the MTFS, given the Chancellor's post-Budget comments[6] there now seems to be a better justification for assuming that the Government has a more explicit, although unstated, exchange rate target. We return to this question in para ...

9.In seeking guidance on changes in ~~the~~ monetary conditions, the Government continues to place the main emphasis on narrow money. Paragraph 2.14 explains that, "if the underlying growth of MO threatens to move significantly outside its target range in 1987-88 there is a presumption that the Government will take action on interest rates unless other indicators clearly suggest that monetary conditions remain satisfactory". We expressed

"[our emphasis]"

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6. Financial Times, 19 March 1987

interest in the "other indicators" used to assess monetary policy and their role relative to MO in determining possible changes in short term interest rates. Treasury officials told us that in addition to narrow money, broad money and the exchange rate

> "we look at quite a range of evidence, movements in asset prices, house prices, stock-exchange prices can produce valuable evidence about monetary positions, most up-to-date information about inflation itself which includes producer prices as well as consumer prices, movements in the oil price which is clearly one of the important factors which affect the exchange rate, appropriate movements in the exchange rate and to some extent movmeents in the rates themselves, how our rates compare with rates abroad and differentials."[7]

They went on to say that:

> "MO has proved quite a reliable indicator in a number of years, so we would need some persuading that it was telling us wrong things but, if the range of other evidence said it was giving us a misleading message, then we would do precisely what it says in that paragraph." [2.14]."[8]

10.In previous reports we have expressed doubts about the

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7. Q11
8. ibid

suitability of MO as a leading indicator since there have been occasions on which it appeared to respond to money GDP changes with a lag, rather than leading changes in nominal income. Although in oral evidence the Treasury attempted to refute this claim, referring us to published research which seemed to show that ~~if anything~~ "the evidence is that money GDP follows MO",[9] we are relieved to find that in assessing monetary conditions MO is supplemented by such a range of other indicators.

11.Nonetheless we feel we must continue to exhibit concern about the recent behaviour of some of the indicators used to assess monetary conditions. Our concern is heightened by the fact that there seems to be a distinct divergence of views about their behaviour on the part of the authorities.

12.In our reports both on the 1986 Budget and the Chancellor's Autumn Statement we expressed concern at the build up of personal liquidity, graphically described by the Governor of the Bank of England as an "overhanging glacier of liquidity." The Red Book alludes to the continuing build up of private sector liquidity but gives the impression that the Government felt no particular anxiety about this, together with any future consequences that such a build up might have on the economy. Paragraph 2.15 tells us that:

"Private sector borrowing has been rising and is now

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9. Q3

over 10% of GDP. It has clearly contributed more than public borrowing to upward pressure on real interest rates. These trends are likely to persist, so that broad money growth may continue at around its recent rate, well in excess of the growth rate of money GDP."

13. In oral evidence, however, the Chancellor seemed to argue that the growth in personal bank lending and the upward pressure on interest rates was in some sense a reflection of Government policy in other areas:

ie add square brackets

"... if you look at the figures, the growth [of private borrowing] as a share of GDP, ~~it~~ is entirely attributable ~~entirely as a share of GDP~~ to the ~~great~~ growth of mortgage~~s~~ borrowing. ~~primarily~~, Although there is no doubt some equity withdrawal, this borrowing is primarily for the purpose of house-purchase and home improvement. ~~Of course,~~ It is part of the Government's policy to encourage home ownership, including the purchase by council tenants of the homes in which they live. therefore, That leads to more mortgages being ~~granted~~ taken out. ~~Therefore,~~ Provided that we can contain the monetary consequences of that, which we are doing, and have done - then I do not regard that as a matter of concern."[10]

Amend to correspond with corrected transcript ✓

However house prices have continued to rise, and they are one of the Government's "other indicators".

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10. Q187

14.When we questioned the Governor about the growth of personal credit he was less sanguine. He told us that, "we are concerned that we have a monthly increase of £2.5 billion in bank lending."[11] On prudential grounds the Bank of England has

> ""seen fit to make observations before now to the retail banks above all - indeed, to all providers of credit - that they should think very carefully about the level of personal borrowing..."[12]

15.When asked if the point had been reached where direct volume controls should be imposed on the supply of personal credit, the Governor told us that:

> "I would not be at all averse to those if they can be effected. They are a form of direct control or physical control against which in some respects we set our face at the moment, but if they could be effected I think it would be a not inappropriate instrument."[13]

But added wouldn't work

16.As regards the effective means of controlling the build up of liquidity in the economy, the Red Book places the onus on short-term interest rates. The primacy of interest rates as a policy instrument was robustly defended by both the Chancellor and his officials. When asked if, in the determination of the appropriate policy, it was important to distinguish between the various factors responsible for

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11. Q122
12. Q123
13. Q138

growth of the money supply, such as an unfunded PSBR or an autonomous increase in the demand for consumer credit, the Chancellor told us that:

> "I do not think it is very necessary to distinguish between them, since what matters is ~~the~~ overall monetary growth... Whatever the cause of ~~excessive monetary growth or~~ monetary growth which one might consider to be excessive, the only ~~real~~ instrument one has to deal with it is the level of interest rates, particularly short term interest rates".14

Sir Peter Middleton concurred that:

> "given the fiscal policy, since we abolished exchange controls and the corset came to an end, the only instrument is interest rates; there is not another one."15

We assume from this that the Government bases its approach on funding the PSBR completely, and uses short-term interest rates to control any increase which may take place in the growth of credit.

17. There seems however to be considerable uncertainty about the extent to which bank lending and the demand for credit generally respond to changes in short-term interest rates. The view was put to our predecessor Committee in 1980-81, by Professor Friedman that:

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14. Q184
15. Q187

"Manipulating interest rates ... has a highly erratic and undependable influence on the quantity of money demanded over the kind of short periods which .. are crucial for monetary control (period of a few months up to a year or more.)"[16]

A different view was taken by the Governor of the Bank of England in our current inquiry who put it to us that while mortgage borrowing may be more sensitive to the rate of interest,[17] ordinary private borrowing is not very responsive to such changes.[18] As the Bank has reminded us on a number of occasions, lending to the private sector - whether personal consumer credit or mortgages - has increased significantly in the past, irrespective of the rate of interest. Moreover, most of the previous discussion on the control of monetary growth by the use of short-term interest rates has taken place against a different background from that of today. Even if Professor Friedman is wrong, and even if only a proportion of borrowing is interest-rate sensitive, the Government's task in restraining overall monetary growth - stopping the overhanging glacier from expanding still further - will be doubly difficult at a time of falling interest rates.

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16. Third Report, 1980-81) (HC163-I) para 6.8
17. Q151
18. Q119 and 120

PUBLIC EXPENDITURE AFTER THE BUDGET

18. We welcome the increased emphasis given this year to a discussion of the relative advantages of increases in public expenditure, cuts in taxation, and changes in government borrowing. We now turn to consider public expenditure, the PSBR, and the forecasting of the fiscal adjustment.

RPI

19. The upward revision in the estimate of inflation from 3 3/4% at the time of the Autumn Statement to 4% in the latest Industry Act forecast will affect the real value of the public expenditure plans represented in the Autumn Statement. The £4.5 billion then added to the existing planning total has since been offset to a significant extent by a general erosion in what authorities are capable of purchasing with the cash budgets allocated to them. When adjusted to take account of the forecast rise in inflation, the planning total for 1987-88 has been reduced in real terms by around £1.5 billion at 1985-86 prices. The rate of growth in expenditure, which was to be about 2% between this year and next, is now estimated to be 1.5% in the case of the planning total and 1.1% if debt interest is included.[19] Both figures are below the average rate experienced since 1978-79.

level

GDP deflator

20. We asked Treasury officials if, given the forecast

This is a poor precis of Terry Ward (& I don't fully understand his numbers * anyway). (a) the "forecast rise in inflation" refers to inflation being 1/2 higher in 1987-88 than in the AS (3 3/4 ⇒ 4 1/2 looking @ GDP deflator & unrounded difference). (b) £1·5 billion refers to "the planning total before the deduction of asset sales", which in Terry Ward's arithmetic includes council house sales. Should be £1·4 billion.

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19. See Appendix ... (Terry Ward) — attached.

(* Andrew Turnbull says OK)

I don't think it matters that the TCSC are confused: this can be used in RO's with press.

increase in inflation together with the unrevised planning totals, the spending plans announced at the time of the Autumn Statement could be met. We were told that, "the Government will be seeking to hold those totals."[20] It was pointed out however that the Planning Total might not now be so sensitive to changes in the rate of inflation.

> "One factor to bear in mind is that when inflation is rising one major source of risk is the fact that social security benefits are linked to inflation. Now, what we have is that the timing of the upratings is such that if the infaltion rate is taken in the year to September that applies from April, so for the coming year the social security benefits have an uprating that has been tackled and whatever is happening to inflation in the current months will not affect the rate of expenditure during 1987-88. That is a very lärge chunk which, in effect, is immune from the current movement of inflation".[21]

Nonetheless past experience suggests that spending is likely to overshoot the Planning Total.

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20. Q99
21. Q100

THE PSBR

21. As discussed in para ..., the expected outturn for the PSBR in 1986-87 is £4 billion, or about 1% of GDP, and the Chancellor announced a similar target for 1987-88. In announcing the PSBR target for 1987-88 the Chancellor said:

> "Since its inception in 1980, the MTFS has indicated a steadily declining path for the PSBR expressed as a percentage of GDP. We have now reached what I judge to be its appropriate destination - a PSBR of 1% of GDP. My aim will be to keep it there over the years ahead. This will maintain a degree of fiscal prudence that, until this year, has been achieved on only two occasions since 1950."[22]

22. We have for some time discussed in evidence with the Treasury the relevance of the PSBR as a measure of the Government's underlying need to borrow when privatisation proceeds are a significant source of finance. In 1987-88, the PSBR target is £4 billion, and privatisation proceeds are expected to total £5 billion. Although the Government continues to frame its fiscal policy in terms of the PSBR, we welcome the fact that they have effectively acknowledged our previous arguments. For example, Chart 2.5 of the Red Book shows the evolution of the PSBR including privatisation proceeds as a percentage of GDP. While we do not wish to pursue this particular issue further with the

NO

"with privatisation proceeds added back in."

22. HC Deb (1986-87) vol ..., c 818

It shows both PSBR & privatisation proceeds, & the sum of the 2.

Government, we note that the Public Sector Financial Deficit, which measures the Government's underlying need to borrow <u>before</u> privatisation proceeds are subtracted from expenditure, is forecast to remain about the same, at 2% of GDP. It is not clear to us why the Government has not reduced the PSBR still further, to below 1%, when the underlying need to borrow exceeds the long run target of 1%. We note the Chancellor's argument[23] that holding the PSBR steady at 1% is the modern equivalent of the balanced budget doctrine. So far as the argument is soundly based, however, we believe it should relate to the larger figure, the Public Sector Financial Deficit and not the PSBR.

!
Will this really survive to final version
[illegible]!

23.We are in any case unclear why a PSBR of 1% of GDP is regarded as an "appropriate destination". Officials from the Treasury suggested a number of reasons for maintaining a positive PSBR, principally the contribution which a declining PSBR could make to the Government's money GDP objective:

> "There is clearly a demand for public sector debt and, as long as the economy is growing, there will be some interest in holding debt. That is one argument. Another is that it would be quite consistent with the growth of money GDP that the Government is seeking, and in the very long term of course that is a growth which is equal to the rate of growth or productive potential, and the Government sees no difficulty about

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23. Q172

seeking an extra amount of debt which would match the accumulation of assets to some extent. I do not mean exactly match but taking place in a world where there is also some accumulation of assets this would be a stable and sustainable situation"[24]

and

"The objective of every fiscal policy since the first MTFS in 1980 has been to keep public sector borrowing at a level, and if necessary on a declining trend, which will support the monetary policy and the role of monetary policy has been to create monetary confidence which will bring about the desired growth of money GDP and in early days put heavy downward pressure on inflation. We are now saying that the illustrative path of the PSBR over the medium term of 1% of GDP is fully consistent with these broad objectives".[25]

24. The Chancellor gave primacy to the desirability of preventing the ratio of debt to real GDP from rising:

"It has been clear to me throughout my time as Chancellor that 1% of GDP would be an appropriate destination. This was implicit, for example, in the Green Paper "The Next Ten Years: Public Expenditure and Taxation into the 1990s", which I published simultaneously with my first Budget in 1984. If you

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24. Q69
25. Q73

turn to paragraph 55 of that Green Paper, you will see it stated that, "In the period to 1988-89, the PSBR is assumed to follow the illustrative path set out in the MTFS. Thereafter it is assumed to fall further as a share of GDP from 1 3/4% in 1988-89 to 1% in 1993-94". The reasoning behind the 1% equilibrium level implicit in the Green Paper was made rather more explicit in my Lombard Association speech last April; ~~and~~ let me quote from that: 'There is, of course, no scientific formula for determining the 'right' size of of the PSBR ... But, over the medium and longer term, it is clearly important that the amount of public debt, and the burden this imposes, should not rise as a proportion of GDP'.

Over the medium and longer term the Government's objective is zero inflation. It follows that money GDP will then grow at the real rate of growth of the economy, perhaps an underlying 2½% a year, to be on the safe side. Against that background a 1% PSBR will ensure that public debt does not rise as a share of GDP. This is the modern equivalent of the balanced budget doctrine. By contrast, to allow the debt/GDP ratio to remain constant on anything other than a zero inflation basis is simply a recipe for accelerating inflation."[26]

25. With a PSBR at 1% of GDP, the public debt ratio may be

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26. Q172

stable; but the Chancellor has not offered any arguments in favour of this or any other ratio. He has simply stated that he does not want it to continue increasing. The Chancellor acknowledged that this target has been achieved more quickly than anticipated due to two factors, the unexpectedly strong revenue outturn and the contribution of asset sales. However, no reasons have been given why the current debt/GDP ratio is preferable to that which would have obtained if the economy have evolved in line with the 1984 Green Paper, which did not envisage the fall to 1 per cent until 1993-94.

26.Officials from the Treasury admitted a connection between the accumulation of new public assets and the level of borrowing. The Chancellor rejected a more formal analysis of public finances in terms of a government or national balance sheet which considered both public sector assets and liabilities and incorporated the notion of the net worth of the government sector:

> "I do not think it is possible in practical terms to know what the net worth is, whereas you do know what public sector debt is.[27]"

27.We conclude that the framework for determining the PSBR in the long term is little more than a rule of thumb. The Chancellor, quite rightly, wishes to avoid a situation in which public debt grows uncontrollably. But beyond that he

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27. Q213

has given no compelling reason for one level of debt rather than another. Indeed, if the Government believe that past borrowing was excessive, it might even be argued that a case existed for reducing overall public debt by the creation of fiscal surpluses. We urge the Treasury to address this issue more fully in future versions of the MTFS.

Two figures

FORECASTING

28. When announcing the planning total increases in the Autumn Statement, the Chancellor implied strongly that the scope for tax cuts was substantially reduced. Indeed, a target for the PSBR of 1 3/4% of GDP without any tax cuts then seemed to be the best the Chancellor was hoping for. He told us that:

> "As I said in the House in the questioning that followed the Autumn Statement, a pound used in additional public expenditure is a pound which is not available for reductions in taxation, unless you are prepared to expand the borrowing requirement, and I have made it clear and explicit that that I will not do[28]

29. The difference between the situation anticipated in October and that which occurred is due almost entirely to the fact that Government revenue was substantially higher than expected. Non-oil receipts (including interest and dividents) were about £4 billion higher in 1986 than those projected in last year's Budget. £1 3/4 billion of this is due to higher than expected corporation receipts. We asked Treasury officials the reasons for this large forecasting error. There were two reasons:

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28. Second Report, 1986-87 (HC27) para 21

"One is that, I think, we underestimated the profits base in the previous year, particularly for financial companies. The other is that following a period when there have been substantial profits growths for a number of years, and large profit growths in every year, it is very difficult to estimate the extent to which previously tax exhausted companies key into tax pay, and I think that is probably one of the most important reasons - or the main reason - why this time last year we underestimated onshore (which is what we are talking about here) Corporation Tax receipts in 1986-87.[29]

30. So far as concerns the movement of companies into tax-paying positions officials said that:

"a good deal of this information becomes available on an aggregate basis, which is what one needs here for doing forecasts of total Corporation Tax receipts somewhat in arrears".[30]

31. The Inland Revenue explained their forecasting methods for Corporation Tax.

32. The increase in Corporation Tax receipts is expected to continue in 1987-88. Another £1½ billion of the higher tax take in 1986-87 is attributed to a

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29. Q104
30. Q108

miscellaneous category including a statistical balancing item.

33. We note that the significant and unexpected reductions in taxation and the PSBR target announced for 1987-88 have been made possible only because the original forecasts proved inaccurate. The fiscal environment has changed in only a few months. We believe that sufficient information exists within the Inland Revenue to improve this aspect of tax forecasting and we urge the Treasury to endeavour to improve its forecasting performance in this area so that such surprises, even pleasant ones, are less likely in future.

THE LOUVRE ACCORD

34. The agreement reached in Paris between the group of 6 major industrial nations on exchange rate intervention represents a significant advance on the Plaza Agreement of September 1985. The Governor told us that:

> "The understanding which emerged from the Louvre Accord was that the exchange rate parities that prevailed at that time were considered satisfactory, and that if there were divergences in that, the central banks of the countries present would concert any action to correct the diveregneces... If I might say that, Mr Chairman, the experience of both the Louvre Accord and the Plaza eighteeen months before that, in September 1985, show that there is actually a very effective role for the central banks where we can really be sure that the banks, the five or six or seven, are operating together, and operating in circumstances in which the overall market situation is receptive to that concerted action"[31]

35. The Governor's statement suggests very strongly to us that target ranges for the G6 currencies have been established, if only informally or implicitly. . However, the Chancellor would not admit that any target bands existed. He told us that:

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31. Q143

"I am saying that we did go into the question of currency fluctuations very thoroughly. We did go into the nuts and bolts, but we agreed we would not reveal those to the market"[32]

"I am not saying whether [target bands] exist or not. What I am saying is, we do not publish the nuts and bolts of the Paris ~~A~~accord."[33]

X

36. The Governor said that specific ranges were not even discussed:

"... quite honestly, very little is said between us central bankers, actually, about figures, numbers and money. We have an understanding"[34]

This reads very badly out of context!

37. We cannot see how the G6 can conclude that existing parities are "about right" without also having in mind bands around these parities which they regard as acceptable. Our scepticism is reinforced by reports that the Japanese Prime Minister has admitted that a target rate of Y150 to the dollar was discussed and agreed by all parties in Paris.[35] Secondly, if central banks do not discuss "figures and numbers" it is difficult to see how they could agree on concerted action when these "acceptable parities" are breached.

38. The Chancellor's reason for not making public the

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32. Q257
33. Q256
34. Q14~~4~~5 X
35. <u>Daily Telegraph</u> 31 March 1987 p 19

"nuts and bolts" of the G6 meeting, including whether or not target ranges exist was:

> "The advantage of that is so as not to make it easy for the operators on the foreign exchange market to speculate or deal successfully against the policy of the countries represented at the Louvre"[36]

We find this explanation unconvincing too. Having agreed and announced publicly that existing parities are satisfactory, the authorities in the G6 countries have effectively told the markets that they will resist substantial movements away from the parities. All that remains is for the markets to test the bounds of the central banks' tolerance. It is unlikely to take long for them to do so.

39. The Governor admitted that in operational terms, the Accord and membership of the ERM (Exchange Rate Mechanism) of the EMS are very similar:

> "I would readily concede that perhaps since the Louvre Accord we are operating as though we are in something"[37]

40. The two are not, however, completely equivalent. The advantages which might occur from joining the ERM -

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36. Q258
37. Q159

improved business confidence, a lower risk premium in UK interest rates, and a guarantee of assistance in difficulties from fellow members - do not seem to flow from the Accord. On the other hand, the presumption which now exists that the Bank of England will defend existing parities involves a loss of that flexibility and tactical advantage over the markets which the Chancellor commended. In some respects the Government appears to have the worst of both worlds.

41. The action that would be taken under the Accord if the underlying fundamentals in any of the G6 diverged from their present states is also unclear. The Governor told us that a major structural change in one of the economies could release it from its obligations under the Accord. The Chancellor, on the other hand, took the view that:

This is misleading: Gov was asked (Q144) about price of oil. You were asked about currency divergence.

> "If domestic action is needed, then there is the presumption that that would be taken by the country that needs to take the action"[38]

Finally, we note that the basis of the Accord, the view that existing parities are about right, is contradicted by the Chancellor's statement in his Budget speech that

has to be seen against

Nonsense

> "There are still serious imbalances afflicting the

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38. Q219

three major economies - the United States on the one hand, and Japan and Germany on the other - which if not handled properly, could lead to a simultaneous downturn in all three"[39]

It will be surprising, therefore, is some of the G6 currencies do not come under renewed pressure.

39. HC Deb (1986-87) vol ... c. 817

BALANCE OF PAYMENTS

42. The forecast for the current account of the Balance of Payments has been revised substantially downwards since the Autumn Statement. The Balance of Payments deficit for 1987 is now forecast at £2.5 billion as compared with the Autumn Statement figure of £1.5 billion. More significantly, for longer term economic prospects, the deficit in trade in manufactures is forecast to increase from £5.5 billion in 1986 to £8 billion in 1987.

43. We believe that assessment is too pessimistic. In the first place, the economy achieved a real improvement in competitivensss in 1986. Moreover, para 3.22 of the Red Book points out that "most of the gain in competitiveness seems likely to be maintained over the year ahead." The January and February 1987 Balance of Payments figures suggest that the 'J-curve effect' is beginning to show. Secondly, the forecast assumes an oil price of US$15 a barrel, which is likely to be low. The price of oil has firmed, and since the UK is an important exporter of oil, there should be a favourable consequence for the Balance of Payments. We are therefore less concerned about the Balance of Payments than a number of other commentators.

FROM: D N WALTERS
DATE: 3 APRIL 1987

PS/CHIEF SECRETARY

cc PS/Chancellor
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Mr Scholar
Miss Sinclair
Miss Evans
Mr Dyer

Mr Bone - C&E
Mr Walker - I/R

WALTERS TO PS/CST 3/4

1987 FINANCE BILL

Enclosed is a typed version of the list of clauses to appear in the 1987 Finance Bill. I am assured by Mr Graham that this will not change further and can be considered as "final" for the published Bill.

D N WALTERS

1987 FINANCE BILL: ARRANGEMENT OF CLAUSES

Miscellaneous

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CE31

A few Observations passim.

FROM: MISS C EVANS
DATE: 3 APRIL 1987

MR ALLAN

Ch

(1) A few changes to line up quotes with revised transcript

(2) Para 19 is not a good precis of the Terry Ward piece, but it does not seem worthwhile challenging it ourselves.

(3) Other points covered in David Peretz's note.

AA

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir Terence Burns
Mr F E R Butler
Sir Geoffrey Littler
Mr Cassell
Mr Lavelle
Mr Monck
Mr Odling-Smee
Mr Peretz
Mr Scholar
Mr Sedgwick
Mr Turnbull
Mrs Lomax
Mr Culpin
Miss O'Mara
Mr Cropper
Mr Ross Goobey
Mr Tyrie

TCSC DRAFT REPORT ON THE BUDGET

... I attach a draft of the TCSC's report on the Budget. The Clerk has asked for our corrections in time for the Committee's meeting on Monday afternoon. The deadline for our response is 12 noon on Monday so could all corrections reach me by 10am on that day please.

2. If copy recipients wish to suggest any amendments which are more than straightforward factual points could they please minute you today so that the Chancellor has an opportunity to consider the point over the weekend.

Catyys Evans

MISS C EVANS

3/3070

FROM: DAVID PERETZ
3 April 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir Terence Burns
Mr F E R Butler
Sir Geoffrey Littler
Mr Cassell
Mr Lavelle
Mr Monck
Mr Odling-Smee
Mr Scholar
Mr Sedgwick
Mr Turnbull
Mrs Lomax
Mr Culpin
Miss O'Mara
Mr Cropper
Mr Ross Goobey
Mr Tyrie

Ch
Some v blatant attempts to drive a wedge between you and Gov. I think it probably is worth writing.
AA

On Salaries, pub yours with the minor changes you suggest, [illegible] [illegible] further [illegible] [illegible]

TCSC DRAFT REPORT ON THE BUDGET

There are two important problems with this draft (circulated with Miss Evans' minute of earlier today). Mr Scholar and I have discussed these, and how best to handle them. Since they are both to do with the monetary and exchange rate sections, we have agreed that I should put a note to you suggesting what we should do.

2. The first difficulty is the Committee's persistent misunderstanding about the relationship between interest rate policy and the growth of broad money and credit. This is encapsulated in the second half of the last sentence of paragraph 16 - which says that the Committee assumes that the Government "uses short term interest rates to control any increase which may take place in the growth of credit."

3. Although it would rather raise the profile of the way we normally comment on these drafts (which is by telephone), my advice is that in this instance it is worth writing to the Committee, in a final attempt to clear up this misunderstanding:

to explain that we take account of the growth of broad money in setting interest rates, but do not try to use rates to control lending to any particular level.

4. The second important worry is the draft's attempt to drive wedges between what you said and what the Governor said. Some of the quotes we cannot quarrel with, but when I came to look at others it became apparent that the authors have been highly selective in choosing quotes to try to highlight differences.

5. Michael Scholar and I have discussed how best to handle this. Again, we concluded that it would be worth departing from precedent by sending in some written comments. We considered whether, instead of writing, it would be sensible for you to have a word with Mr Higgins on all this: but our advice is that raising our profile to the extent of sending a letter ought to be sufficient.

6. I attach a draft, which if you agree Michael Scholar could send to the Clerk to the Committee on Monday morning.

7. You will see I have suggested attaching to the letter a list of relatively minor comments, of the kind that we might normally have telephoned. You will want to glance at the comment on paragraph 41.

DLCP

D L C PERETZ

37/3070

CONTRIBUTION TO DRAFT LETTER ON DRAFT REPORT ON THE BUDGET

From: Mr Scholar

To: Clerk to the TCSC

W A Mackay
H/C

<u>Interest rates and credit growth</u>

You asked for quick factual comments from us on the draft report you sent to Carys Evans on Friday morning. I thought it right to write to you with my comments on this occasion, because your draft contains an important misunderstanding about the way that monetary policy is operated. The misunderstanding arises in the final sentence of paragraph 16, and in paragraph 17.

3. The draft appears to assume, as stated at the end of paragraph 16, that the Government uses short term interest rates to <u>control</u> the growth of credit. This is not, however, the position. Short term interest rates are set after taking account of an assessment of all the indicators of monetary conditions, of which the growth of credit and broad money is only one. Moreover the aim is not to seek to use interest rates to control the growth of lending or broad money to any particular rate. The aim is to keep monetary conditions, judged as a whole, on track. Changes in interest rates have a wider effect on monetary conditions and on the economy, beyond their effect on the demand for credit. ~~They can be expected, for example, to have a relatively early impact on the growth of MO.~~

4. The point was addressed by the Chancellor, the Governor and by officials in answer to questions 199, 136 and 18. It was also covered in the 1986 MTFS, in which as the Committee will recall a target was set for the growth of £M3. Paragraph 2.18 explained

that "Experience has shown that a change in short term interest rates is unlikely to alter the growth of £M3 significantly" within the financial year; but such action "clearly affects the tightness of monetary conditions, which is what matters, and this will be likely to show up in the behaviour of MO and the exchange rate."

5. There are a number of other points which we should make. These are set out below, or (the more detailed points) in the annex to this letter.

<u>Volume controls on credit</u>

6. Paragraphs 15 and 16 of the draft report seem to contrast the Governor's statement that he "would not be averse" to such controls, with the statements by the Chancellor and officials that with a given fiscal policy, interest rates are the main instrument. In the sentence following the passage from the Governor's evidence quoted in paragraph 15 he made it clear that he did not think that such controls could be made to work, or be policed - a point also made by officials in their evidence.

<u>Louvre Accord</u>

7. Paragraphs 35-41 contain a number of alleged differences between the Governor's view and the Chancellor's view, which do not seem to be supported by the transcripts of their evidence:-

(i) Paragraph 35 says that the Governor's statement suggests very strongly that target ranges for the G6 currencies have been established. The exchange in answer to question 145 was as follows:-

"Do you think it would have been helpful if explicit target ranges for the currencies had been set at the G6 meeting and published?

Answer: I do not think so, no."

(ii) Paragraph 38 says the Committee find the Chancellor's explanation of why he preferred not to comment on whether or not target ranges exist was "unconvincing". The draft does not mention that the Governor gave the same explanation (answer to question 145 again):-

"I think we are more effective in our concerted intervention if we can leave the market guessing about at what moment we come in and out."

(iii) Paragraph 39 says the Governor admitted that in operational terms the Louvre Accord and membership of the ERM are very similar. In fact he made it clear in answer to question 159 that he saw important differences.

(iv) Paragraph 41 suggests a difference between the Governor's and Chancellor's views on what would happen if there were a major structural change in one of the G6 economies. It says that "The Governor told us that a major structural change in one of the economies could release it from its obligations." In fact he said "It would be understood that they would either be released to a degree, or there would be a different reaction from them." (Q.~~159~~ 144). The quote from the Chancellor given in this paragraph was in answer to a different question (Q.219): not a question about the conditions in which a country might be released from its obligations under the Accord.

Take in A ~~I would add in point here from~~ more ~~detailed comment below~~

Nigel

PS take a copy, & pass this to Alastair T.

1234/1

FROM: A ROSS GOOBEY
DATE: 3 APRIL 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Mr Cropper
Mr Tyrie

Mr Neubert, MP H/C
Mr Lilley, MP H/C

<u>Inland Revenue</u>
Mr Cayley
Mr Shepherd
Mr McGivern
Mr Munro

PST give this to Mr R-G (for his scrubbing) ~

POST-BUDGET LOBBYING - COUNTER BRIEFS

I attach short counter-briefing points to make on the four issues which have been subject to some press comment or lobbying.

2. They have been discussed with Inland Revenue officials.

ARG

A ROSS GOOBEY

ENCS

1. LLOYD'S REINSURANCE TO CLOSE

Is the Revenue being unfair to Lloyd's? Not at all. The point at issue is whether the Revenue should be able to review Lloyd's RIC and apply the normal tax criteria for determining how much should be deductible for tax purposes, or whether Lloyd's figure must be accepted without enquiry. Syndicates should not find it difficult to agree their tax liability with the Revenue if their RIC calculations are based on specific evidence and/or recognised statistical techniques. But it must be right for the Revenue to be able to review, and where necessary adjust, what is currently in effect a self-assessment.

Is this merely a Revenue initiative? No. Ministers firmly believe that it is unacceptable for any taxpayer to be able to determine the amount of a tax deduction without review by the Revenue. They have therefore proposed legislation so that Parliament can vote on the matter. That is the proper democratic process.

Lloyd's syndicates are different in kind from insurance companies. In some respects yes. But the effect of RIC is in substance very similar to the provisions which general insurance companies make for their outstanding liabilities and to the provisions made by Lloyd's syndicates which are "running off". And in each case the methods of calculating residual risk on similar business are comparable. So the tax criteria should also be the same.

Current position Lloyd's and Inland Revenue have already begun the consultative process in a constructive manner. One possibility being considered is the preparation of guidelines to assist syndicates in calculating the tax deduction in respect of RIC. Mr Alan Lord, Lloyd's Chief Executive, was quoted in the Financial Times of 3 April, as saying he believed that Lloyd's "can reach a satisfactory agreement with the Inland Revenue" and that "it would be quite wrong for Lloyd's to mobilise any lobbying campaign over the issue while talks were in progress".

2. LIFE ASSURANCE TAXATION

Retrospection? No. All CGT changes could be so described, but the event which crystalises the liability is prospective, not retrospective.

Unfair treatment against unit trusts? No. It is open to the life assurance companies to package their product so that the life cover is separate from the unit-linked element (sold as authorised unit trusts) and the individual might benefit from the annual CGT exemption. For operational reasons, the life offices choose not to do this.

Destroys the investment bond market? Not necessarily. Although the potential gains tax liability rises, holders of bonds linked to units still have the option of switching between different funds free of CGT liability and the higher rate taxpayer only pays his higher rate liability on income on encashment.

Affects bonuses of with-profits policies? A very small effect. Policy holders' funds of life assurance companies probably total over £50 billion, of which at least 30% is in gilts, leaving £35 billion in property and equities. If this portion stood at 25% over indexed book cost and was all realised over 5 years, the cost on all life companies would be an additional £70 million a year or 0.14% of their taxable funds. In fact, most companies offset management expenses against their capital gains which are therefore largely sheltered from Corporation Tax.

3. PENSIONS PACKAGE

Explain why done.

Will the package obstruct labour mobility? No. It is true that the change in the "uplift" rules will restrict the ability of new members of schemes in the earning of maximum benefit to 20 years instead of the current 10 years. However, this ignores the preserved benefit an individual may have from his previous employment which, for uplift purposes, must be taken into account. In any case, the basic rules for occupational pensions envisage that pension benefits are earned over the working life of the employee, not simply to facilitate a few years of tax-relieved payments into a scheme to produce a tax-advantaged payment out on retirement. While some relaxation in the basic rules is appropriate, the ability to fund - with full tax - for a maximum pension after only ten years' service is excessively generous. Most people will move jobs for a number of reasons of which pension benefit is only a part.

Overall package, with Action

~~Moreover, other pensions changes~~) personal pensions, AVCs, transfers, DHSS changes on the revaluation of deferred pension rights - will help mobility.

Why limit the benefit on freestanding AVCs? If the benefit limit on AVCs was not maintained, it would be possible for an individual in a non-contributory scheme to invest in AVCs and receive substantially more than 2/3 final salary as a benefit - perhaps even more than his final salary. Pension contribution relief was never intended as a tax shelter for investment generally.

Does not the commutation of "added years" AVCs within occupational schemes give an unfair advantage to the public sector? No. Public sector schemes provide for lump sum and pension benefits in fixed proportion; and any AVCs paid to buy added years increase both benefits. Private sector schemes have much greater flexibility: lump sums are based on final salary and the number of years of service, and the AVC benefit can be (and normally is) taken wholly in lump sum form. It is open to the private sector to provide benefits in a fixed proportion or to allow the purchase of added years' through their AVC schemes.

[Although the public service schemes do have index-linking (a much reduced advantage in periods of low inflation) and "added years", the death in service and other benefits are usually substantially inferior to the private sector.) In any case, this Budget also introduces PRP, which is not available in the public sector (nor are share options.]

4. BANK TAX RELIEF ON FOREIGN INTEREST

Explain

Why act now? Relief has been available, against bank profits as a whole including domestic profits, of withholding tax on the interest earned by UK-resident banks' lending to foreign borrowers. As a result, some banks have effectively received an interest rate subsidy on overseas loans from the UK Exchequer. The amount of overseas lending undertaken from the UK has been growing.

Weakens London's competitive position? The lending involved is to off-shore borrowers and the funds are usually provided from off-shore sources. The UK-resident bank has merely had a tax incentive to arrange the loan through London rather than elsewhere. After this measure, the London-based bank will not be at a positive disadvantage to other financial centres.

Who is affected?

The overseas borrower may have previously agreed to a clause which enables the bank to increase the interest rate he pays should this measure be introduced. The major London-based banks affected include the Japanese who are the source of over 25% of foreign currency loans to foreign borrowers.

Other countries?