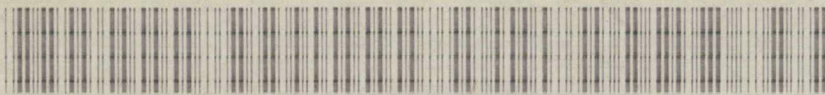


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PART B

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PART B

1987 BUDGET STATEMENTS

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PART C

FROM: F CASSELL.  
25 February 1987

SIR PETER MIDDLETON

cc Sir T Burns  
Mr Scholar  
Mr Culpin  
Mr Hudson

BUDGET SPEECH: MONEY AND BORROWING

I attach some suggestions on your draft. The two big questions it raises seem to me to be:

i. What emphasis to give to the exchange rate, in relation to MO. I would prefer to put the paragraph on the exchange rate earlier and omit the phrase "monetary operations will be guided by MO". If - which is not impossible - we face a situation after the Budget in which £ is strong, MO is at or above the top of its range and interest rates are falling the present text could be awkward.

*Yes, and it appears to contradict all we've said about taking account of all the indicators.*  
AH

ii. Do we mention the money figure for next year's PSBR? You have confined the text to ratios. This question needs to be considered in the context of the speech as a whole. Also I would have thought that some more specific explanation of why this year's PSBR is turning out so low is called for - though this will be covered in some detail in the Red Book.

*Yes.*

1. *Alex*  
*You may like to see. Some of the same suggestions as you (and me). I think the original first sentence of para 7 should go to the end, otherwise the laughing & jeering will drown the rest of the para - I suggested this to PEM.*

F CASSELL

2. PLWP

In 1979, I presented to the House the first Red Book of the newly elected Conservative Government. It revealed what happens when a Government attempts to guide the economy without the least sense of monetary strategy. Fifteen Budget packages of one sort or another in the five years up to 1979 had left inflation at 12 per cent and rising. The country was demoralised and falling steadily behind our competitors.

2. In the words of my Rt Hon friend, the 1979 Budget marked a "new beginning". Since then the financial picture has been transformed. With it has come a growing confidence in Britain. This is apart from our standing in the world today. And it is even more apart from the new approach of British management and indeed the whole British people to the future. New energies have been released. And the key which has unlocked them has been the stable framework presented by the medium term strategy.

3. This has provided a durable framework in which monetary policy has been pursued with steady persistence and a clear sense of direction. It has proved adaptable to changing circumstances both at home and beyond our shores. Above all it has proved a success.

4. We shall build on this success, as the <sup>1987</sup> 1979 Red Book shows.

5. Monetary conditions will be set so as to maintain the gradual reduction in money GDP over the medium term. This is demonstrated by the declining growth of the money supply as measured by M0 in the period up to 1991.

6. <sup>For</sup> Monetary operations will be guided by the <sup>the</sup> M0 target for 1987-88 ~~which~~ will be 2-6% - exactly as indicated in last year's MTFS.

Para 8, on <sup>the</sup> exchange rate, would ~~be~~ be better here.

7. <sup>answering</sup> ~~There is~~ <sup>no target for broad money, this year.</sup> ~~no target for broad money, this year.~~ Rapid changes in financial markets associated with wholly desirable institutional changes have affected monetary indicators throughout the world. The interpretation of particular monetary conditions has become very difficult. <sup>we will continue to refer</sup> ~~In the United States,~~ <sup>account of a wide range of other monetary aggregates. Bank here will be</sup> ~~MI has been put temporarily into cold storage.~~ <sup>MI has just abandoned targeting MI because it has ceased to be a reliable</sup> In this country rapid £M3 growth has proved consistent with monetary conditions which have demonstrably brought about lower inflation. It is too uncertain a measure to use for target purposes, as was vividly demonstrated by the Governor of the Bank of England in his Loughborough speech. We shall continue to make judgements about broad money in assessing monetary conditions. But I have selected a more reliable guide for the monetary target. i disagree.

8. The exchange rate will continue to play a significant part in monetary conditions and thus in decisions about short term interest rates. The recent agreement by the 6 major industrial nations to reduce existing imbalances and co-operate to foster the stability of exchange rates will reduce uncertainty. It is entirely consistent with our medium term objectives and has been widely welcomed.

### Public borrowing

9. A crucial part of the new beginning in 1979 was the need to reduce the burden of financing the public sector so as to leave room for industry and commerce to prosper. Here we have been completely successful. The PSBR in 1978-9 was 5¼% of GDP and rising. By contrast the PSBR in 1986-7 will be around 1½% of GDP for the second successive year and falling. Next year I expect to achieve my ultimate objective of a PSBR of no more than 1% of GDP. And I confidently expect to keep it there for the medium term.

10. There have been a number of contributory factors to this success. Much the most important has been the control of public expenditure which has been falling as a proportion of total expenditure in the economy since 1982. But the

*answering*  
*In judgment monetary conditions that we will continue to have*  
*account of a wide range of other monetary aggregates. Bank rates will be*

7. ~~There is~~ no target for broad money, ~~this year~~. Rapid changes in financial markets associated with wholly desirable institutional changes have affected monetary indicators throughout the world. The interpretation of particular monetary conditions has become very difficult. *In the United States,* ~~M1 has been put temporarily into cold storage.~~ *M1 has been just abandoned targeted by M1 because it has ceased to be a reliable* In this country rapid £M3 growth has proved consistent with monetary conditions which have demonstrably brought about lower inflation. It is too uncertain a measure to use for target purposes, as was vividly demonstrated by the Governor of the Bank of England in his Loughborough speech. We shall continue to make judgements about broad money in assessing monetary conditions. But I have selected a more reliable guide for the monetary target.

*to remain*  
*par*

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10. There have been a number of contributory factors to this success. Much the most important has been the control of public expenditure which has been falling as a proportion of total expenditure in the economy since 1982. But the

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cumulative effects of the steady increase in output and prosperity since 1981 have also been important. Companies are more profitable than they have been in living memory against the background of a reformed tax structure. Activity is booming in the financial markets, <sup>helped by</sup> following the reduction in stamp duty last year. And the population as a whole has achieved new levels of prosperity.

11. With continuing prudent policies, there is no reason why these favourable developments should not continue. This year they have enabled us to live through a near halving of oil revenues ~~without raising non oil taxes~~ - and achieve a lower borrowing requirement than we expected at this time last year. In the future they hold out the inviting prospect of both low public borrowing and lower taxes.

12. Combined with sound monetary policy in the MTFs, they offer a good basis for the further creation of wealth and as much insurance as is possible in an uncertain world from the economic shocks which beset us from time to time.

effective tax rate has gone up!

BS3  
DC

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*Plw*

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FROM: M C SCHOLAR  
DATE: 27 FEBRUARY 1987

**CHANCELLOR OF THE EXCHEQUER**

cc Principal Private Secretary  
Chief Secretary (2)  
Financial Secretary (2)  
Economic Secretary (2)  
Minister of State (2)  
Sir Peter Middleton  
Sir Terence Burns  
Sir Geoffrey Littler  
Mr F E R Butler  
Mr Wilson  
Mr Cassell  
Mr Monck  
Mr Sedgwick  
Mr Odling-Smee  
Mr Culpin  
Miss O'Mara  
Miss Sinclair  
Miss Evans  
Mr Hudson  
Mr Cropper  
Mr Tyrie  
Mr Ross Goobey  
Mr Battishill - IR  
Mr Isaac - IR  
Mr Painter - IR  
Mr Beighton - IR  
Mr McManus - IR  
Sir Angus Fraser - C&E  
Mr Knox - C&E  
Mr Wilmott - C&E  
Mr Bone - C&E

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**B.L.O.**

**BUDGET STATEMENT: SECOND DRAFT**

I enclose a second draft of the Budget Statement, put together in the light of your comments on last week's draft.

2. The passage on the economy (paragraphs 4-18) is by Sir Terence Burns. Monetary policy and public sector borrowing are by Sir Peter Middleton. Sir Terence Burns is the author of the Verdict. Mr Cassell, Mr Hudson and I have reworked the tax proposals section. The peroration is by Mr Hudson.

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3. I also attach an alternative version of monetary policy and public sector borrowing which Sir Terence Burns produced this evening (and which he has not been able to clear round the office).

4. I am afraid that all this does not add up to a coherent speech, and there is a good deal of overlapping and perhaps some inconsistency between these sections. We will have to iron this out next week.

5. Some issues which arise:

- (a) The borrowing section at present gives no money figure for the PSBR but either a ratio (Sir Peter Middleton) or words (Sir Terence Burns). That is good theatre, but it does make for problems at the end of the speech, where it would be bathetic to start up again on the higher non-oil revenues and so on, but perhaps unconvincing without this. The approach in the present draft means that we will rely on the FSBR and briefing to stand up our fiscal forecast.
- (b) There is a case for giving a more specific explanation than the present draft does of why the PSBR this year is turning out so low.
- (c) Sir Peter Middleton has made his draft deliberately upbeat, on the basis that it is easier to tone down than to lift up a draft.
- (d) I have omitted the sentence on the oil pricing and valuation changes as interrupting the flow and unnecessary (Mr Cassell and the Revenue). But your first thought on this was that it would be disingenuous to leave it out.
- (e) I have omitted the paragraph (paragraph 96 in the first draft) on the material interest test in employee share schemes in close companies. It seemed rather dull and unnecessary.
- (f) There may be a case for removing the passage on BES, company cars and training (paragraphs 74-79) to the end of the Small Business section, so that PRP stands on its own at the end of the Business and Enterprise section.

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(g) This draft places, as you suggested, the alignment of Corporation Tax payment dates in the anti-avoidance section rather than in the streamlining CT section (as in the previous draft). This perhaps gives too much weight to the anti-avoidance element in the justification of this measure: if anti-avoidance were its main motive we would be introducing a more limited measure and not one which affects all companies.

6. In length the Speech may now be a few minutes over the hour.

MLS

M C SCHOLAR

BLO enc: 53 pages

B.L.O.

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**BUDGET STATEMENT: SECOND DRAFT**

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Introduction

1. The setting for the Budget this year is more favourable than it has been for many years. We are entering our seventh year of steady growth, once again at the top of the international league table. We are entering our fourth year in which this steady growth has been combined with low inflation. And we are entering one more year in which the public finances are sound and strong.

2. These are the fruits of the Government's determination to hold to our policies of sound money and free markets. I gladly reaffirm these policies today. They provide the only sure basis for more jobs and lasting, productive, jobs.

3. I shall begin by reviewing the economic background to the Budget. I shall then deal with monetary policy and with the fiscal prospect this year and next. Finally I shall propose some changes in taxation designed to assist in achieving our economic objectives. As usual, a number of press releases, filling out the details of my proposals, will be available from the Vote Office as soon as I have sat down.



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**Economic Background**

4. The past year has been dominated by the sudden collapse of oil prices. Inevitably, the difficulties the world economy experienced in adjusting to the sharp fall in oil prices has influenced our economic performance. During the summer there were worries that the "pause" in activity was a precursor of a longer period of stagnation although I explained at the time why it was likely to be short lived. Helped by the benefits of prudent fiscal and monetary policies - and the progressive strengthening of the supply performance of the economy - those worries have now been set aside and the economy has developed broadly as I set out a year ago.

5. In 1986 as a whole output has grown by a further 2½ per cent or so. This compares well with other industrialised countries and continues the steady economic growth we have experienced since 1981. We have now had 6 years of growth at around 3 per cent a year; one of the longest and steadiest periods of expansion since the war. And it has coincided with falling inflation. For the past four years inflation has averaged less than 5 per cent.

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This is an impressive combination. For 1986 as a whole inflation averaged 3.4 per cent - the lowest annual figure since 1967.

6. Last year our growth performance was achieved against a difficult world background. Demand in the industrial economies grew rapidly but the oil producers and other developing economies cut back their imports more than expected. As a result the industrialised countries experienced weak export demand in the early months of 1986.

7. UK exports initially reflected this weakness but have grown strongly since the middle of the year. Over the last three months the volume of visible exports, excluding oil, was almost 10 per cent higher than a year earlier - a performance stronger than in any other major economy. It has been reflected in the performance of manufacturing industry; output grew rapidly in the second half of 1986 having been weak in the early months of this year.

8. The steady growth performance of the economy as a whole has contributed to a welcome fall in unemployment, although the level is still much too high. Since August unemployment has fallen by more

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than 100,000, the largest six-monthly fall since 1973. Adult unemployment, long-term unemployment and youth unemployment are all lower than a year ago. And since the early months of last year we have seen a further surge in productivity, particularly in manufacturing industry. This builds on the good productivity performance achieved by British industry since 1981. In the six years prior to 1979 UK productivity growth in manufacturing was, at  $\frac{3}{4}$  per cent, the lowest of all the Summit Seven countries. In the seven years since 1979 our annual rate of growth of output per head in manufacturing industry has been higher than any other member of that group.

9. The current account of the balance of payments showed a small deficit in 1986. This follows a cumulative current account surplus of £21 billion since 1979 which enabled the UK to build up a stock of overseas assets in excess of [£100] billion - a stock second only to that of Japan. Some deterioration in our current account is not surprising in the face of £5 billion loss on oil trade and the weaker than expected growth of some of our important markets. But the importance of this should not be exaggerated. The exchange rate adjustment that followed the fall in oil prices is

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already contributing to improved non-oil trade performance and the UK's large stock of net overseas assets will provide a lasting contribution to the current account in the future.

10. Looking ahead, I expect 1987 to be a year of steady, balanced growth with continued low inflation. Domestic demand is expected to continue to grow rapidly and combined with vigorous export growth should mean another year of 3 per cent growth. The composition of domestic demand growth is likely to be more balanced than last year when growth of consumers' expenditure was given a boost by the lower oil price and the fall in commodity prices. Next year consumer spending is likely to show slower growth but industrial surveys point to stronger growth of investment.

11. The manufacturing sector in particular faces a good year. Building on the improved performance during the second half of 1986 I expect to see continued strong growth of exports, output and productivity.

12. And with  $3\frac{1}{2}$  per cent growth in the non-oil economy in prospect there is every chance of unemployment continuing to fall throughout 1987 at

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the rate seen in the past 6 months. In last year's Budget I said that employment prospects depended on a sustained improvement in the performance of business and industry. That sustained improvement in economic performance has occurred and is continuing.

13. As anticipated in the Autumn Statement inflation may edge up for a time, perhaps to 5 per cent by the middle of the year, but should then fall back to 4 per cent by the end of the year. Since the last Election most of the short-term swings in the monthly RPI have mirrored changes in the mortgage interest rate. For example the monthly low of 3.7 per cent in 1983 and 2.4 per cent in 1986 coincided with falling mortgage rates; the monthly high of 7 per cent in 1985 reflected a rising mortgage rate. The pattern expected this year is largely the result of mortgage rate increases at the end of last year coupled with the effect on the 12-month comparison of the temporary dip in petrol prices last summer.

14. The recent and prospective performance in inflation is in historical terms a good one and one that we can point to with some satisfaction. But it is higher than in most other major industrial

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countries and it remains an important objective of the Government to keep inflation on an unambiguously downward underlying trend.

15. The growth of the UK's main overseas markets should be somewhat stronger in 1987 than in 1986. There are, however, risks that the outturn could be less favourable. It is possible that developing countries and oil producers could import less from the developed economies than we now expect. We cannot be sure that protection will be held at bay. And problems in foreign exchange markets could lead to reactions that dampen demand and output in the major economies.

16. It was for that reason that Ministers and Central Bank Governors, meeting in Paris on 21-22 February, agreed that in current circumstances a period of stability would now be desirable. Accordingly, the UK and other countries represented there agreed to co-operate closely to foster stability of exchange rates around current levels. The Plaza agreement 18 months ago succeeded in reducing dangerous protectionist pressures that were building up in the United States. This subsequent agreement is designed to give a breathing space for the benefits of past exchange rate

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adjustments to show through on trade balances. At the same time it will give the United States, Germany and Japan an opportunity to reinforce the policies already in place to improve the balance in their economies between domestic and external demand.

17. On the assumption that overseas markets will grow more quickly in 1987 than in 1986, the prospect is for continued strong growth of UK exports. But because non-oil imports have been growing rapidly at the same time as our surplus on oil account has been reduced there is likely to be a modest current account deficit of [£2 ]billion in 1987; around  $\frac{1}{2}$  per cent of GDP.

18. To summarise, British industry now has an outstanding opportunity with growing markets at home and overseas, low inflation, improved profitability and rapidly growing productivity. If industry is able to control its costs and protect its competitive advantage we can look forward to many more years of strong growth combined with low inflation.

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Monetary policy

19. In 1979, I presented to the House the first Red Book of the newly elected Conservative Government. It followed the attempt of the previous Government to guide the economy without the least sense of monetary strategy. Fifteen Budget packages of one sort or another in the five years up to 1979 had left inflation at 12 per cent and rising. The country was demoralised and falling steadily behind our competitors.

20. In the words of my Rt Hon Friend the then Chancellor, the 1979 Budget marked a "new beginning". Since then the financial picture has been transformed. With it has come a growing confidence in Britain and a transformation of our standing in the world today. It has transformed, too, the approach of British management and indeed the whole British people to the future. New energies have been released. And the key which has unlocked them has been the stable framework enshrined in the medium term strategy.

21. This has provided a durable setting in which monetary policy has been pursued with steady persistence and a clear sense of direction. It has



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proved adaptable to changing circumstances both at home and beyond our shores. Above all it has proved a success.

22. We shall build on this success, as the 1987 Red Book shows.

23. Monetary conditions will be set to continue the gradual reduction in money GDP over the medium term thus bringing about further reductions in inflation. This is demonstrated by the declining growth of the money supply as measured by M0 in the period up to 1991 and the target range for 1987-88 which will be 2-6 per cent - exactly as indicated in last year's MTFIS.

24. The exchange rate will continue to play a significant part in monetary conditions and thus in decisions about short term interest rates. [The recent agreement by the 6 major industrial nations to reduce existing imbalances and co-operate to foster the stability of exchange rates will reduce uncertainty. It is entirely consistent with our medium term objectives and has been widely welcomed.]

25. In assessing monetary conditions we shall continue to consider a wide range of information

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about the money supply. There is no target for broad money this year. Rapid changes in financial markets associated with wholly desirable institutional changes have affected monetary indicators throughout the world. The interpretation of particular monetary measures has become very difficult. In the United States, M1 has temporarily lost its target status. In this country rapid M3 growth has proved consistent with monetary conditions which have demonstrably brought about lower inflation. It is too uncertain a measure to use for target purposes, as was explained by the Governor of the Bank of England in his Loughborough lecture. We shall continue to make judgements about broad money in assessing monetary conditions. But I have selected the more reliable guide, M0, for the monetary target.

Public borrowing

B.L.O.

26. A crucial part of the new beginning in 1979 was the need to reduce the burden of financing the public sector so as to leave room for industry and commerce to prosper. Here we have been completely successful. The PSBR in 1978-79 was  $5\frac{1}{4}$  per cent of GDP and rising. By contrast the PSBR in 1986-87 will be around  $1\frac{1}{2}$  per cent of GDP for the second

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successive year and falling. Next year, in 1987-88, I expect to achieve my ultimate objective of a PSBR of no more than 1 per cent of GDP. [We inherited a PSBR of 5½ per cent of GDP. During our first Parliament it was reduced to 3 per cent; it is now down to 1½ per cent; and next year I expect to achieve my ultimate objective of a PSBR at around 1 per cent of GDP.] And I confidently expect to keep it there for the medium term.

27. There have been a number of contributory factors to this success. Much the most important has been the control of public expenditure which has been falling as a proportion of total expenditure in the economy since 1982. But the cumulative effects of the steady increase in output and prosperity since 1981 have also been important. Companies are more profitable than they have been in living memory against the background of a reformed tax structure. Activity is booming in the financial markets helped by the reduction in stamp duty last year. And the population as a whole has achieved new levels of prosperity.

28. With continuing prudent policies, there is no reason why these favourable developments should not continue. This year they have enabled us to live

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through a near halving of oil revenues - and achieve a lower borrowing requirement than we set at this time last year. In the future they hold out the inviting prospect of both low public borrowing and lower taxes.

29. Combined with sound monetary policy in the MTFs, they offer the basis for the further creation of wealth and as much insurance as is possible in an uncertain world from the economic shocks which beset us from time to time.

**The Verdict**

30. The economy is now performing as well as that of any developed nation, in marked contrast to the record of the 1970s. That improvement could not have occurred without the policies we have implemented to encourage enterprise, efficiency and flexibility. From the beginning the Government has taken action to promote competition, incentives, and freer markets and to press ahead with deregulation and privatisation. These measures are now bearing fruit and we see the proof of this in the renewed success of British industry in international markets.



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31. We are also reaping the benefits of prudent fiscal and monetary policies set in a clear medium-term framework. Over the past 7 years there has been a vigorous debate in this country about the conduct of fiscal and monetary policies - in particular whether it was possible to have a sustained recovery of output without a fiscal stimulus. The post-war neo-Keynesian approach was to try to stimulate economic performance by expansionary fiscal policy and accommodating monetary policy whenever there was any sign of weakening growth. In practice it failed to provide other than short-term gains to output and merely spelled long-term trouble; rising inflation and a succession of financial crises. We turned our back on that approach.

32. Instead we have directed monetary and fiscal policy towards steadily reducing inflation and providing a stable financial environment within which a reinvigorated economy could perform.

33. Our critics have constantly changed their ground as events have confounded their gloomy predictions. Initially they said it would not be possible to reduce inflation without incomes policy. They then said inflation was only falling

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because we were in a self-perpetuating downward spiral which meant the PSBR would get bigger rather than smaller. Then we had the question "where will the growth come from?" And the suggestion that it was impossible to have steady growth consistent with a falling budget deficit. When it became clear that the economy was growing we were warned that it was a flash in the pan and would peter out. Year after year we were told that although growth this year might be better than expected next year it would slow down. And that if we did have sustained recovery inflation would roar ahead again. I could go on.

34. But what has been the outcome? Sustained growth at near to 3 per cent a year for about 6 years against a background of falling inflation - from 16½ per cent at the end of 1980 to [4] per cent over the past 18 months.

35. More recently the nature of the debate has changed and it has been suggested we are in danger of overheating which finally will bring the recovery to an end. Again this demonstrates a lack of understanding of why this upswing is different in character from other upswings; and why it is so well based.

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36. The length of the upswing is not just a matter of chance. It reflects the soundness of the recovery; improved industrial performance; an absence of artificial fiscal stimulus; an absence of speculative build-up of stocks by industry; and an absence of inflationary pressure based on easy monetary conditions. Above all because the recovery has been at a comfortable pace it has not shown the strains and stresses that once were so familiar.

37. We have eschewed active demand management in response to expectations of short-term fluctuations; we have been prepared to take difficult action with interest rates when it was necessary to maintain sound monetary conditions; and we have made steady progress in bringing the PSBR down as a percentage of GDP. Excluding asset sales the PSBR is now a lower percentage of GDP than any year since 1969-70.

38. The debate about monetary and fiscal policy is surely now over. Given the historically low budget deficits of the past two years there can be no clearer proof than the enthusiasm with which those who accused us of starving the economy of demand now accuse us of generating excess demand and of changing the conduct of policy. They were wrong then; they are wrong now.

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39. I turn now to my proposals for changes in taxation.

Business and Enterprise

Corporation Tax

40. First, taxes affecting business and enterprise.

41. The central objective of my reforms in this area has been to remove obstacles to business success. The national insurance surcharge and the development land tax have gone altogether. The reformed system of corporation tax came fully into effect last April, and for the past year, the rate of tax on company profits has been lower in Britain than in any major industrial nation, though the Americans are now set to emulate us. The sharper incentive this gives companies to improve their performance benefits employees, customers, shareholders, and the nation as a whole.

42. During the transition to the new system, companies were given advance notice of the main rate of Corporation Tax for the year ahead. This helped them in their forward planning, and I intend, as far



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as possible, to continue the practice of fixing the rate in advance.

43. Accordingly, I can announce now that the main rate of Corporation Tax in 1987-88 will be unchanged at 35 per cent.

Company Capital Gains

44. I have a further measure of streamlining to propose. The present system of taxing companies' capital gains is complicated: gains are charged to corporation tax, but the amount of the gain is first adjusted by a certain fraction so that the effective rate of tax is the same as on individuals' capital gains. But I see much force in the view that, with the greatly reduced Corporation Tax rates, there is less justification for this difference between the tax treatment of companies' capital gains and their income from other sources.

45. I therefore propose that with effect from today, the capital gains of large and small companies will be charged at the appropriate Corporation Tax rate, without adjustment, except for the indexation which applies to all post-1982 gains.

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46. At the same time, I am proposing to enable companies to set payments of Advance Corporation Tax against their tax liability on capital gains. This remedies a longstanding complaint which has been the subject of regular representations.

47. Together, these measures are expected to yield about £60 million in 1988-89 and £100 million in a full year.

Pay and File

48. I also propose to legislate now to pave the way for a new method of collecting Corporation Tax, to be known as Pay and File. At present, many company accounts are not received in time to agree the tax liability before payment is due. So there is a laborious process of an estimated assessment from the Inland Revenue and an appeal from the company. Under Pay and File companies will estimate their tax liabilities themselves, and pay on the normal due date. Tax liabilities will be finalised once companies submit their returns and accounts. Where it turns out that the company's initial payment was too high, the Revenue will pay interest on the excess; where the initial payment was too low the company will pay interest.

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49. This new approach was set out in last December's consultative document on the recommendations in the Keith Committee Report and was generally welcomed both by business and by tax specialists.

50. As this is part of a wider programme of streamlining tax collection, including major developments in the Inland Revenue's computer systems, it will not come into force until the early 1990s. But by legislating now we are giving taxpayers and their advisers a firm basis on which to prepare for the new scheme.

Oil

51. Within the company sector, the oil industry has faced a year of adjustment following last year's sharp fall in the oil price. My Rt Hon Friend the Secretary of State for Energy and I have followed closely the effects on North Sea producers and their suppliers. The industry itself is generally confident about the longer term prospects, but companies have suggested that in the short-term the trough in activity could lead to the loss of some of the capacity, in Scotland and elsewhere, that will certainly be required in the longer run.

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52. Last autumn, with this problem in mind, I introduced legislation to bring forward the repayment of over £300 million of Advance Petroleum Revenue Tax. That has already helped many of the small companies with cash flow difficulties.

53. I now propose two new Petroleum Revenue Tax reliefs. First, with effect from today, participators may elect to have up to 10 per cent of the costs of developing new oil fields, until income from the new fields exceeds the costs incurred, set against their Petroleum Revenue Tax liabilities in other fields. Second, I am proposing a new relief for research expenditure on oil extraction that is not related to a particular field, and so is not at present allowed for Petroleum Revenue Tax.

54. Together, these changes will give a further measure of help, both to the oil companies themselves and to those for whom they generate work, that will assist them in meeting the difficulties of the next five years or so.

#### Small Businesses

55. The growth of the small business sector has been one of the most encouraging developments in the



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1980s. Between 1983 and 1985, 550 new businesses, on average, were created each week. Small businesses have a vital role to play in the economy, not least in job creation. The Government has introduced a wide range of measures to help this sector and to make it easier for small businesses to get on with the job of making profits.

56. Representations have been made to me from time to time about the difficulties some small businesses experience with VAT, both with its impact on their cash flow and with the record-keeping required. I therefore authorised Customs and Excise to issue a consultative document last autumn proposing certain changes, which have been broadly welcomed by representative bodies and individual businessmen alike.

57. One of the proposals which received a very wide welcome was that for an optional system of cash accounting for businesses with a turnover of up to £100,000. Indeed, there were many requests for this option to be available more widely.

58. In the light of this I now propose that, with effect from 1 October, companies with an annual turnover of up to £250,000 should, if they so

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choose, be able to account for VAT on the basis of cash paid and received. They will thus not have to pay VAT until they have been paid by their customers, which will ease their cash-flow problems, as well as giving them automatic relief for bad debts.

59. The proposal is subject to our obtaining the necessary derogation from the EC Sixth Directive on VAT; I am applying for this today.

60. To help small businesses with the handling of VAT, I propose an optional system of annual accounting, which will mean that businesses with an annual turnover below £250,000 will be able to make payments on account and send only one return a year to Customs. This change will come into effect in the second half of 1988.

61. I have two further changes to propose here. First, the period within which businesses must apply to be registered for VAT will be extended from ten days to thirty days.

62. Second, the rules for the special VAT schemes for retailers will be changed to make them simpler for small and medium-sized businesses.

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63. But there are two matters on which the representations have persuaded me it would not be right to proceed. I shall not be going ahead with the proposal for compulsory deregistration of traders below the VAT threshold; nor with the withdrawal of the standard method of accounting for VAT used by retailers.

64. For the coming year, I propose to increase the VAT registration threshold itself to £21,300, the maximum permitted under existing European Community law. We shall continue to argue vigorously in Brussels for flexibility to set a higher limit.

65. The proposals I have just outlined go further, in some respects, than those published in the autumn. They will help ease the burden of VAT on smaller firms - and allow more of their management energies to be concentrated on generating profits. Some controls, forms and regulations are inevitable, but we are continuing to prune this bureaucratic thicket as much as possible.

**Tax avoidance**

66. The Government is determined to make further progress in reducing the burden of taxation. But

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hand in hand with this we must ensure that tax is collected fairly and effectively, and that the law enables the right amount of tax to be collected. I have a number of proposals to make today in this regard.

67. The first of these concerns VAT, and has already been the subject of extensive consultation. Where a business' activities are in part liable to VAT and in part not, the present rules are over-generous on the amount of input tax which can be deducted, and are being exploited. We have already announced that these rules are to be revised so as to curb tax avoidance and prevent distortion of competition. There will be generous and straightforward reliefs for small businesses, and administration will be kept as simple as is consistent with the prevention of wholly unacceptable losses of revenue. The changes will come into effect on 1 April, and are estimated to prevent a revenue loss in 1987-88 of £300 million.

68. Second, I propose to take action on dual residence, so that dual resident companies in multinational groups will no longer be able to secure two tax reliefs for one and the same interest payment. Trading companies will not be affected.



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This change, which will take effect from 1 April 1987, follows on the action taken in this area by the United States last year. Indeed, this is one area where we can follow the United States, since the US tax reforms are substantially concerned with removing tax shelters which do not exist here.

69. My third proposal concerns the timing of corporation tax payments. At present companies established before 1965 may pay their corporation tax up to 21 months after the end of the period for which it is due; but companies established since 1965 must all pay their tax after nine months and some building societies pay earlier still. This difference in the treatment of companies no longer has any justification; and it is open to an abuse which could put the timing of a substantial proportion of the corporation tax yield at risk.

70. I propose, therefore, that all companies and building societies should be liable to pay Corporation Tax nine months after the end of the accounting period on which the tax is due. This will be more equitable between companies than the present regime; it will rationalise the arrangements for collecting Corporation Tax from companies; and it will smooth the flow of tax

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receipts into the Exchequer. There will be a  
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transitional period during which the change will be  
phased in.

71. Fourth, I propose to tackle the present over-generous treatment of tax credit relief for foreign withholding tax paid on interest on bank loans. In future, banks will be able to offset this tax credit only against tax on the profit on the relevant loan, and not more widely. This brings the rules here broadly into line with those in other countries. The change will apply from 1 April 1987 for new loans and from 1 April 1988 for existing loans.

72. Fifth, I propose legislation to ensure that the tax treatment of Lloyd's Reinsurance to Close is made consistent with the treatment of provisions for outstanding liabilities made by insurance companies and similar provision made by other financial traders. These proposals will first apply to premiums paid for the 1985 Lloyd's account closing at 31 December 1987.

73. I have a number of further proposals, to improve the taxation of business and enterprise.

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Business Expansion

74. Last year I was glad to confirm that, in view of its outstanding success, the Business Expansion Scheme would continue in being indefinitely. The changes I made to the Scheme in 1986 have improved its targetting. More BES money is now going into the higher risk ventures for which the Scheme was designed.

75. The scheme is now on a generally satisfactory basis. But I propose two further improvements.

76. The first is a measure to deal with the problem of end-year bunching, about which a number of people have made representations. I propose that, for investments made in the first half of the tax year, the investor will be able to claim part of the relief against income of the previous year. This measure, which will apply to investments made after 5 April 1987, should make it easier for companies to raise BES finance throughout the year.

77. The second measure is a relaxation of the rules to make it easier for independent film companies to benefit from BES investment. I hope that this will be widely welcomed in the film industry.

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78. I need to set the 1988-89 car and car fuel benefit scales for those with company cars. The car scale charges still fall well short of the true value of the benefits and as in the last three years I propose to increase them by 10 per cent. I propose no change to the car fuel benefit scales which from 6 April will also used for VAT purposes.

79. Training and retraining are vital to a dynamic, flexible economy. It is most important that there should be no disincentive for people who are likely to be changing jobs, which might hold them back from training and acquiring new work skills. At present, training of this kind provided by an employers is treated as a taxable benefit. I propose to take it out of tax.

Profit-related pay

80. I turn now to profit-related pay.

81. I suggested last year the possibility of introducing changes to the tax system which would run with the grain of, and reinforce, efforts to break up the rigidity of the pay system in this country.

82. I pointed then to two considerable advantages of arrangements which relate pay to profits. First,

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they lead to a closer identification of employees with the firms in which they work. Second, they make for more flexibility in the face of changing market conditions and hence help to make employment more stable.

83. My remarks led to a lively debate, and last July we published a Green Paper on profit related pay. I warmly welcome the discussion and responses that the document generated. Those firms which already have profit-related pay schemes generally believe they have worked well. And many other firms are considering introducing them.

84. I have therefore decided that the time is right to give a measure of tax relief for employees in qualifying profit-related pay schemes.

85. This should encourage many more firms to bring these schemes into operation. Initially, at least, these schemes will be confined to the private sector. Certain conditions will of course have to be met before tax relief is available. But firms will have as much flexibility as possible to design schemes to suit their particular needs, and the administration will be kept simple.

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86. A key issue is the level of tax relief. The Green Paper suggested that one quarter of an employee's profit-related pay might get tax relief. I have now decided to double this to a half. So for someone on average earnings receiving 5 per cent of their pay as PRP, the tax relief will be equivalent to a penny off the basic rate of income tax. That underlines the importance the Government attaches to this major new initiative. Depending on take-up the full year cost could well build up to over £100 million by the end of the decade.

87. Profit related pay is not a panacea. But I believe it will be of practical help in tackling some of the deep seated problems of the UK economy by promoting greater flexibility and enterprise, and so help further to strengthen the prospects for employment. I hope that employees and employers alike will now respond enthusiastically to this opportunity as we look forward to the 1990s.

#### Savings and Investment

88. I now turn to savings and investment

89. First, share ownership. This Government has given a major boost to wider share ownership through

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action on three fronts: employee share schemes, privatisation, and the introduction of Personal Equity Plans.

90. The growth in approved employee share schemes since 1979 has been remarkable. We started with about 30 schemes. Now there are over 1,200 open to all employees which cover some 1½ million workers in over 10,000 companies.

91. I now propose a further measure in this area. In future, employees in a company which is taken over will be able to exchange their existing share options under an approved scheme for options over shares in the acquiring company.

92. I am, further, instituting a review, with the help of outside practitioners, of the effect of Section 79 of the 1972 Finance Act which deals with the tax treatment of employee-acquired shares outside approved schemes. ♦ The aim of the review will be to suggest how to improve and simplify the rules, consistent with the underlying purpose of countering tax avoidance, so as to allow greater flexibility and encouragement to enterprise.

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93. Privatisation brings a wide range of benefits for the economy at large, as well as for the industries privatised and for their consumers. Not the least of these benefits is the breakthrough we have been able to make in wider share ownership.

94. As the House knows, the British Telecom sale in 1984 brought a step-change in the number of share-owners. Over 2 million people applied, half of whom had never owned shares before. Last year's sale of British Gas proved another landmark for wider share ownership. 4½ million applications were received on behalf of 5 million people, the largest number of applications ever received in a flotation anywhere in the world. [Plus reference to TSB? - review in the light of the results of the Treasury/Stock Exchange Survey, expected on 2 March.]

95. I am particularly glad that employees have seized the chance to become shareholders - sometimes, it must be said, against the advice of their trades unions. No fewer than 90 per cent of the employees in the privatised companies floated on the stock market have become shareholders.



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96. The success of these policies has been clear for some time, but estimates of the number of shareholders have varied. I therefore commissioned, in conjunction with the Stock Exchange, a major survey of individual shareholders and have recently received the results. The survey shows that there are now [ ] million individual shareholders in the UK. [This is fully three times the number in 1979.]

97. But we are not going to stop there. There is a great deal of scope, not only for increasing still further the number of people owning shares but also for existing shareholders to add to their portfolios. Our measures to promote employee share schemes and our plans for further privatisation sales will continue to play an important part.

98. The Personal Equity Plans announced in my last Budget came into operation on January 1st and are already beginning to show impressive results. Already over 165 banks, stockbrokers, unit trusts, building societies and investment advisers have applied to become plan managers and the investor is being offered a wide range of plans to choose from. Over 2,000 people a day are currently taking out PEPs, and there is evidence that many of these had

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not previously owned shares directly and are basic rate taxpayers.

99. PEPs are now successfully launched, and going well. In time they, with the other measures we have taken, will alter the landscape of attitudes towards saving, investment and share-ownership in this country.

Pensions

100. I turn now to pensions.

101. In my last Budget, I promised to bring forward proposals for the tax treatment of the new personal pensions which are to be introduced from 1 January 1988. Accordingly, we published a consultative document last November.

102. Personal pensions are an important development in three ways. First, they will enable employees - if they so wish - to opt out of their employers' schemes and make their own arrangements. Second, they will be a new opportunity for the millions of employees who at present do not belong to an occupational scheme. And third, people may, again if they so wish, use them to contract out of SERPS.

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103. As foreshadowed in last year's Budget, and in the consultative document, I now propose to extend to these new personal pensions broadly the same tax treatment that applies to retirement annuities.

104. I also propose to implement other reforms contained in the consultative document, which have been widely welcomed.

105. Employers will be able to set up simplified occupational schemes with the minimum of red tape. This will be particularly good news for many small employers who have been discouraged by the complexity and open-ended commitment of a full-blown final salary scheme. And there will be much greater scope for transferring between different types of pension scheme.

106. I intend to go beyond my original proposals in one further, important way. I propose new arrangements which will allow members of occupational schemes to make additional voluntary contributions with full tax relief to a separate plan of their own choice instead of, as now, being restricted to plans within their employer's schemes. They will be able to top their pensions right up to the present tax approval limits.

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107. All these proposals will make it easier for people to take their pensions with them when they change jobs, which will be good for labour mobility and independence. It will widen the range of choices people can make about their pensions; and it will mean that in future they will have more control over the way in which their pension contributions are invested.

108. But these far-reaching improvements can be justified only if they are properly used. Some new safeguards are necessary to discourage exploitation of the very generous reliefs, particularly by a few very highly paid people. I intend, therefore, to introduce some limited changes to the present rules to restrict the excessive relief which can be obtained in some circumstances. These will include, for all arrangements entered into from today, a cap on the maximum tax-free lump sum of £150,000 and stricter rules on how pension and lump-sum benefits can be calculated, including a stricter definition of final salary.

109. All these changes are set out in a further document which we are publishing today.



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110. In my 1984 Budget I reformed the limits that apply to tax exempt life assurance issued by friendly societies. I did so because certain societies had widely abused the privileges traditionally enjoyed by the friendly society movement. These societies were set up purely for commercial reasons, far removed from the mutual self-help role which the movement has sponsored for decades.

111. To improve the position of the older, long-established societies, I now propose that societies should in future be able to offer tax-exempt policies based on annual premiums of up to £100. This will enable the older societies to operate economically, without effectively changing the position of commercial societies.

112. Turning to the capital taxes I propose to increase the annual exempt amount of capital gains from £6,300 to £6,600. I am also increasing the maximum amount of capital gains relieved from tax on retirement from £100,000 to £125,000.

113. The burden of inheritance tax - which raises over £1 billion - falls disproportionately on those with relatively small estates, many of which consist

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entirely of the family house. I therefore propose a substantial increase in the threshold from £71,000 to £90,000 and a simplification of the rates structure. The effect will be to reduce the number of estates liable to the tax by about a third and to give worthwhile reductions at all levels, particularly for smaller estates.

114. Last year I removed a widely resented obstacle to lifetime giving by exempting outright gifts between individuals made more than 7 years before the donor's death. This year I can go further. I propose to extend the exemption on similar terms to gifts involving settled property in which there is an interest in possession, though this will not apply to discretionary trusts.

115. The proposed changes in rates and bands will help businesses. But I propose to go further by increasing business relief for shares in unquoted companies. The rate of relief for substantial minority holdings in such companies will be increased from 30 per cent to 50 per cent. To reflect the progress of the unlisted securities market, in future all holdings in USM companies will be treated like those with a full listing. These changes will concentrate relief on assets which do not readily provide funds to pay the tax or which could only do so at the risk of damaging the business.

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Taxes on spending

116. I turn now to taxes on spending.

117. I have no changes to announce in the rate or coverage of Value Added Tax, except for some further reliefs for charities.

118. We have a very generous tax regime for charitable giving, following the package of new reliefs I introduced last year, and in particular the payroll giving scheme which starts next month. As I announced before Christmas, I propose to increase the limit on donations under the scheme to £120 a year.

119. I know charities will not expect any major changes this year. But following representations from the Charities VAT and Tax Reform Group, I have decided to extend the VAT reliefs introduced last year to certain new areas: to installing or adapting lavatory or bathroom facilities in charity residential homes for the disabled; to certain welfare vehicles used by hospices to transport the terminally ill; to drugs and chemicals supplied to charities and directly used in medical research; to

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goods donated for export by a charity for relief of distress; and to specialised location and identification equipment used by mountain rescue and first aid services.

120. On excise duties, I announced last year that I had decided to introduce a duty differential in favour of unleaded petrol, to offset its higher production costs. I can now announce that the differential will be 5 pence. This means that unleaded petrol should be no dearer at the pump than 4 star leaded petrol. The measure will take effect from 6 o'clock this evening.

121. The gaming machine licence duty has not been changed since 1982, and I propose to increase it by about a quarter, which will restore it to its 1982 value. I propose no change in the level of duty on off-course betting, where the reforms introduced by my Rt Hon Friend the Home Secretary have done much to improve betting shops' prospects. But, mindful of the adverse effects of declining attendances at racecourses, and with a view to consoling those Hon Members who, but for my choice of Budget date, would have spent the day at Cheltenham watching the Champion Hurdle, I propose to abolish the duty on on-course betting from 29 March.



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122. Taken together, these measures are broadly revenue-neutral.

123. I propose to increase the rates of vehicle excise duty on farmers' lorries, to bring them into line with the use they make of the public roads. This change will take effect from midnight tonight. I also propose to increase the rates of duty on trade licences and to create a new taxation class for recovery vehicles. These changes will take effect from 1 January 1988.

124. [Passage on excise duties to be drafted later.]

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Income Tax

125. Finally I turn to income tax.

126. Lower rates of tax are good for incentives and a stimulus to enterprise. The best chance of increased prosperity for all will come when Britain is placed firmly in the league of countries with low taxation and high growth. Our tax reform strategy has been to move as quickly as is prudently possible in this direction.

127. We have already made a very substantial reduction in the top rate of income tax, reducing it from the penal level of 83 per cent under the previous Government to 60 per cent. We have abolished the investment income surcharge and brought the basic rate of tax down from 33 per cent to 29 per cent. The main tax thresholds are now 22 per cent higher in real terms than in 1979, taking 1.4 million people out of income tax altogether. The married man's allowance will therefore remain at its highest level in real terms since the war.

128. We now need to carry this process a step further.

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129. I propose for 1987-88 to raise the main personal allowances in line with the statutory indexation provisions.

130. The single person's allowance will therefore rise by £90 to £2,425 and the married man's allowance by £140 to £3,795.

131. The single age allowance will rise by £110 to £2,960 and the married age allowance by £170 to £4,675.

132. I propose, however, to give an extra increase in the age allowance to people aged 80 or over. For them, it will be raised by twice the amount due under indexation so that, for the very elderly, the single age allowance will be £3,070 and the married age allowance, £4,845. Around 400,000 single people and married couples will benefit from this new provision and the extra increase in the allowance will take up to 25,000 of them out of income tax altogether.

133. The blind person's allowance was last raised in 1981 when it was increased by £180 to its present level of £360. For 1987-88, I am proposing a further £180 increase, to £540.

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134. As to the higher rates of income tax, the threshold for the 40 per cent rate will be raised in line with statutory indexation to £17,900 and the threshold for the 45 per cent rate will go up by £200 to £20,400. But I have decided that the thresholds for the 50 per cent, 55 per cent and 60 per cent rates will remain at their 1986-87 levels.

135. In my Budget speech last year, I reaffirmed the aim set out by my predecessor in 1979, to reduce the basic rate of income tax to no more than 25 per cent. That remains my objective.

136. But reductions in the basic rate are expensive. It costs well over £1 billion to reduce the rate by one percentage point. Given the overriding need for prudence on public borrowing - on which I am not prepared to compromise - I cannot achieve the goal of a 25 per cent basic rate this year. But I can take a further useful step towards it. I am therefore cutting 2 pence off the basic rate for 1987-88.

137. This reduction to a rate of 27 pence in the pound brings down marginal rates for the overwhelming majority of taxpayers. It will be



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worth over £3 per week to a married man on average earnings.

138. The income tax changes I have announced today will take effect under PAYE on the first pay day after 17 May.

139. The basic rate reduction will, of course, mean a similar reduction in Advance Corporation Tax.

140. As a further measure to help small businesses, I have decided also to reduce the small companies' rate of corporation tax to 27 per cent. Following the proposals I announced earlier, this rate will also apply to small companies' capital gains, which are currently taxed at 30 per cent. The changes to income tax and corporation tax will mean a significant fall in the tax burden on small companies and the unincorporated sector. This gives the best possible incentive to small businesses, which are so crucial for future growth and employment.

141. The total cost of the income tax changes will be some £2½ billion in 1987-88. The overall cost of all the measures I have announced today will be just over £2 billion. This is consistent with my

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objective of a PSBR of no more than 1 per cent of GDP. I have accordingly set the PSBR for 1987-88 at £4 billion.

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Peroration

142. Mr Deputy Speaker, we now have a vigorous and resilient economy, entering its seventh year of steady growth. Inflation remains low; the number of people in work continues to rise; and unemployment is now on a downward trend.

143. In this Budget, I have been able to reduce public borrowing to 1 per cent of GDP, and to make a further reduction in income tax; in the next year, public spending will fall as a proportion of GDP, but spending in priority areas will increase.

144. To succeed on all these fronts together is a goal that has eluded successive Governments for decades.

145. This achievement is the direct result of the prudent economic policies pursued since 1979.

146. This Budget carries forward those policies. I commend it to the House.

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FROM: M C SCHOLAR  
DATE: 27 FEBRUARY 1987

**CHANCELLOR OF THE EXCHEQUER**

cc Principal Private Secretary  
Chief Secretary (2)  
Financial Secretary (2)  
Economic Secretary (2)  
Minister of State (2)  
Sir Peter Middleton  
Sir Terence Burns  
Sir Geoffrey Littler  
Mr F E R Butler  
Mr Wilson  
Mr Cassell  
Mr Monck  
Mr Sedgwick  
Mr Odling-Smee  
Mr Culpin  
Miss O'Mara  
Miss Sinclair  
Miss Evans  
Mr Hudson  
Mr Cropper  
Mr Tyrie  
Mr Ross Goobey  
Mr Battishill - IR  
Mr Isaac - IR  
Mr Painter - IR  
Mr Beighton - IR  
Mr McManus - IR  
Sir Angus Fraser - C&E  
Mr Knox - C&E  
Mr Wilmott - C&E  
Mr Bone - C&E

**BUDGET STATEMENT: SECOND DRAFT**

I enclose a second draft of the Budget Statement, put together in the light of your comments on last week's draft.

2. The passage on the economy (paragraphs 4-18) is by Sir Terence Burns. Monetary policy and public sector borrowing are by Sir Peter Middleton. Sir Terence Burns is the author of the Verdict. Mr Cassell, Mr Hudson and I have reworked the tax proposals section. The peroration is by Mr Hudson.

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3. I also attach an alternative version of monetary policy and public sector borrowing which Sir Terence Burns produced this evening (and which he has not been able to clear round the office).

4. I am afraid that all this does not add up to a coherent speech, and there is a good deal of overlapping and perhaps some inconsistency between these sections. We will have to iron this out next week.

5. Some issues which arise:

- (a) The borrowing section at present gives no money figure for the PSBR but either a ratio (Sir Peter Middleton) or words (Sir Terence Burns). That is good theatre, but it does make for problems at the end of the speech, where it would be bathetic to start up again on the higher non-oil revenues and so on, but perhaps unconvincing without this. The approach in the present draft means that we will rely on the FSBR and briefing to stand up our fiscal forecast.
- (b) There is a case for giving a more specific explanation than the present draft does of why the PSBR this year is turning out so low.
- (c) Sir Peter Middleton has made his draft deliberately upbeat, on the basis that it is easier to tone down than to lift up a draft.
- (d) I have omitted the sentence on the oil pricing and valuation changes as interrupting the flow and unnecessary (Mr Cassell and the Revenue). But your first thought on this was that it would be disingenuous to leave it out.
- (e) I have omitted the paragraph (paragraph 96 in the first draft) on the material interest test in employee share schemes in close companies. It seemed rather dull and unnecessary.
- (f) There may be a case for removing the passage on BES, company cars and training (paragraphs 74-79) to the end of the Small Business section, so that PRP stands on its own at the end of the Business and Enterprise section.

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(g) This draft places, as you suggested, the alignment of Corporation Tax payment dates in the anti-avoidance section rather than in the streamlining CT section (as in the previous draft). This perhaps gives too much weight to the anti-avoidance element in the justification of this measure: if anti-avoidance were its main motive we would be introducing a more limited measure and not one which affects all companies.

6. In length the Speech may now be a few minutes over the hour.

MLS

M C SCHOLAR

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**BUDGET STATEMENT: SECOND DRAFT**

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Introduction

1. The setting for the Budget this year is more favourable than it has been for many years. We are entering our seventh year of steady growth, once again at the top of the international league table. We are entering our fourth year in which this steady growth has been combined with low inflation. And we are entering one more year in which the public finances are sound and strong.

2. These are the fruits of the Government's determination to hold to our policies of sound money and free markets. I gladly reaffirm these policies today. They provide the only sure basis for more jobs and lasting, productive, jobs.

3. I shall begin by reviewing the economic background to the Budget. I shall then deal with monetary policy and with the fiscal prospect this year and next. Finally I shall propose some changes in taxation designed to assist in achieving our economic objectives. As usual, a number of press releases, filling out the details of my proposals, will be available from the Vote Office as soon as I have sat down.



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**Economic Background**

4. The past year has been dominated by the sudden collapse of oil prices. Inevitably, the difficulties the world economy experienced in adjusting to the sharp fall in oil prices has influenced our economic performance. During the summer there were worries that the "pause" in activity was a precursor of a longer period of stagnation although I explained at the time why it was likely to be short lived. Helped by the benefits of prudent fiscal and monetary policies - and the progressive strengthening of the supply performance of the economy - those worries have now been set aside and the economy has developed broadly as I set out a year ago.

5. In 1986 as a whole output has grown by a further 2½ per cent or so. This compares well with other industrialised countries and continues the steady economic growth we have experienced since 1981. We have now had 6 years of growth at around 3 per cent a year; one of the longest and steadiest periods of expansion since the war. And it has coincided with falling inflation. For the past four years inflation has averaged less than 5 per cent.

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This is an impressive combination. For 1986 as a whole inflation averaged 3.4 per cent - the lowest annual figure since 1967.

6. Last year our growth performance was achieved against a difficult world background. Demand in the industrial economies grew rapidly but the oil producers and other developing economies cut back their imports more than expected. As a result the industrialised countries experienced weak export demand in the early months of 1986.

7. UK exports initially reflected this weakness but have grown strongly since the middle of the year. Over the last three months the volume of visible exports, excluding oil, was almost 10 per cent higher than a year earlier - a performance stronger than in any other major economy. It has been reflected in the performance of manufacturing industry; output grew rapidly in the second half of 1986 having been weak in the early months of this year.

8. The steady growth performance of the economy as a whole has contributed to a welcome fall in unemployment, although the level is still much too high. Since August unemployment has fallen by more

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than 100,000, the largest six-monthly fall since 1973. Adult unemployment, long-term unemployment and youth unemployment are all lower than a year ago. And since the early months of last year we have seen a further surge in productivity, particularly in manufacturing industry. This builds on the good productivity performance achieved by British industry since 1981. In the six years prior to 1979 UK productivity growth in manufacturing was, at  $\frac{1}{4}$  per cent, the lowest of all the Summit Seven countries. In the seven years since 1979 our annual rate of growth of output per head in manufacturing industry has been higher than any other member of that group.

9. The current account of the balance of payments showed a small deficit in 1986. This follows a cumulative current account surplus of £21 billion since 1979 which enabled the UK to build up a stock of overseas assets in excess of [£100] billion - a stock second only to that of Japan. Some deterioration in our current account is not surprising in the face of £5 billion loss on oil trade and the weaker than expected growth of some of our important markets. But the importance of this should not be exaggerated. The exchange rate adjustment that followed the fall in oil prices is

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already contributing to improved non-oil trade performance and the UK's large stock of net overseas assets will provide a lasting contribution to the current account in the future.

10. Looking ahead, I expect 1987 to be a year of steady, balanced growth with continued low inflation. Domestic demand is expected to continue to grow rapidly and combined with vigorous export growth should mean another year of 3 per cent growth. The composition of domestic demand growth is likely to be more balanced than last year when growth of consumers' expenditure was given a boost by the lower oil price and the fall in commodity prices. Next year consumer spending is likely to show slower growth but industrial surveys point to stronger growth of investment.

11. The manufacturing sector in particular faces a good year. Building on the improved performance during the second half of 1986 I expect to see continued strong growth of exports, output and productivity.

12. And with 3½ per cent growth in the non-oil economy in prospect there is every chance of unemployment continuing to fall throughout 1987 at



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the rate seen in the past 6 months. In last year's Budget I said that employment prospects depended on a sustained improvement in the performance of business and industry. That sustained improvement in economic performance has occurred and is continuing.

13. As anticipated in the Autumn Statement inflation may edge up for a time, perhaps to 5 per cent by the middle of the year, but should then fall back to 4 per cent by the end of the year. Since the last Election most of the short-term swings in the monthly RPI have mirrored changes in the mortgage interest rate. For example the monthly low of 3.7 per cent in 1983 and 2.4 per cent in 1986 coincided with falling mortgage rates; the monthly high of 7 per cent in 1985 reflected a rising mortgage rate. The pattern expected this year is largely the result of mortgage rate increases at the end of last year coupled with the effect on the 12-month comparison of the temporary dip in petrol prices last summer.

14. The recent and prospective performance in inflation is in historical terms a good one and one that we can point to with some satisfaction. But it is higher than in most other major industrial

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countries and it remains an important objective of the Government to keep inflation on an unambiguously downward underlying trend.

15. The growth of the UK's main overseas markets should be somewhat stronger in 1987 than in 1986. There are, however, risks that the outturn could be less favourable. It is possible that developing countries and oil producers could import less from the developed economies than we now expect. We cannot be sure that protection will be held at bay. And problems in foreign exchange markets could lead to reactions that dampen demand and output in the major economies.

16. It was for that reason that Ministers and Central Bank Governors, meeting in Paris on 21-22 February, agreed that in current circumstances a period of stability would now be desirable. Accordingly, the UK and other countries represented there agreed to co-operate closely to foster stability of exchange rates around current levels. The Plaza agreement 18 months ago succeeded in reducing dangerous protectionist pressures that were building up in the United States. This subsequent agreement is designed to give a breathing space for the benefits of past exchange rate

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adjustments to show through on trade balances. At the same time it will give the United States, Germany and Japan an opportunity to reinforce the policies already in place to improve the balance in their economies between domestic and external demand.

17. On the assumption that overseas markets will grow more quickly in 1987 than in 1986, the prospect is for continued strong growth of UK exports. But because non-oil imports have been growing rapidly at the same time as our surplus on oil account has been reduced there is likely to be a modest current account deficit of [£2 ]billion in 1987; around  $\frac{1}{2}$  per cent of GDP.

18. To summarise, British industry now has an outstanding opportunity with growing markets at home and overseas, low inflation, improved profitability and rapidly growing productivity. If industry is able to control its costs and protect its competitive advantage we can look forward to many more years of strong growth combined with low inflation.

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Monetary policy

19. In 1979, I presented to the House the first Red Book of the newly elected Conservative Government. It followed the attempt of the previous Government to guide the economy without the least sense of monetary strategy. Fifteen Budget packages of one sort or another in the five years up to 1979 had left inflation at 12 per cent and rising. The country was demoralised and falling steadily behind our competitors.

20. In the words of my Rt Hon Friend the then Chancellor, the 1979 Budget marked a "new beginning". Since then the financial picture has been transformed. With it has come a growing confidence in Britain and a transformation of our standing in the world today. It has transformed, too, the approach of British management and indeed the whole British people to the future. New energies have been released. And the key which has unlocked them has been the stable framework enshrined in the medium term strategy.

21. This has provided a durable setting in which monetary policy has been pursued with steady persistence and a clear sense of direction. It has



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proved adaptable to changing circumstances both at home and beyond our shores. Above all it has proved a success.

22. We shall build on this success, as the 1987 Red Book shows.

23. Monetary conditions will be set to continue the gradual reduction in money GDP over the medium term thus bringing about further reductions in inflation. This is demonstrated by the declining growth of the money supply as measured by M0 in the period up to 1991 and the target range for 1987-88 which will be 2-6 per cent - exactly as indicated in last year's MTFs.

24. The exchange rate will continue to play a significant part in monetary conditions and thus in decisions about short term interest rates. [The recent agreement by the 6 major industrial nations to reduce existing imbalances and co-operate to foster the stability of exchange rates will reduce uncertainty. It is entirely consistent with our medium term objectives and has been widely welcomed.]

25. In assessing monetary conditions we shall continue to consider a wide range of information

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about the money supply. There is no target for broad money this year. Rapid changes in financial markets associated with wholly desirable institutional changes have affected monetary indicators throughout the world. The interpretation of particular monetary measures has become very difficult. In the United States, M1 has temporarily lost its target status. In this country rapid M3 growth has proved consistent with monetary conditions which have demonstrably brought about lower inflation. It is too uncertain a measure to use for target purposes, as was explained by the Governor of the Bank of England in his Loughborough lecture. We shall continue to make judgements about broad money in assessing monetary conditions. But I have selected the more reliable guide, M0, for the monetary target.

Public borrowing

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26. A crucial part of the new beginning in 1979 was the need to reduce the burden of financing the public sector so as to leave room for industry and commerce to prosper. Here we have been completely successful. The PSBR in 1978-79 was 5½ per cent of GDP and rising. By contrast the PSBR in 1986-87 will be around 1½ per cent of GDP for the second

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successive year and falling. Next year, in 1987-88, I expect to achieve my ultimate objective of a PSBR of no more than 1 per cent of GDP. [We inherited a PSBR of  $5\frac{1}{4}$  per cent of GDP. During our first Parliament it was reduced to 3 per cent; it is now down to  $1\frac{1}{2}$  per cent; and next year I expect to achieve my ultimate objective of a PSBR at around 1 per cent of GDP.] And I confidently expect to keep it there for the medium term.

27. There have been a number of contributory factors to this success. Much the most important has been the control of public expenditure which has been falling as a proportion of total expenditure in the economy since 1982. But the cumulative effects of the steady increase in output and prosperity since 1981 have also been important. Companies are more profitable than they have been in living memory against the background of a reformed tax structure. Activity is booming in the financial markets helped by the reduction in stamp duty last year. And the population as a whole has achieved new levels of prosperity.

28. With continuing prudent policies, there is no reason why these favourable developments should not continue. This year they have enabled us to live

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through a near halving of oil revenues - and achieve a lower borrowing requirement than we set at this time last year. In the future they hold out the inviting prospect of both low public borrowing and lower taxes.

29. Combined with sound monetary policy in the MTFs, they offer the basis for the further creation of wealth and as much insurance as is possible in an uncertain world from the economic shocks which beset us from time to time.

#### The Verdict

30. The economy is now performing as well as that of any developed nation, in marked contrast to the record of the 1970s. That improvement could not have occurred without the policies we have implemented to encourage enterprise, efficiency and flexibility. From the beginning the Government has taken action to promote competition, incentives, and freer markets and to press ahead with deregulation and privatisation. These measures are now bearing fruit and we see the proof of this in the renewed success of British industry in international markets.



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31. We are also reaping the benefits of prudent fiscal and monetary policies set in a clear medium-term framework. Over the past 7 years there has been a vigorous debate in this country about the conduct of fiscal and monetary policies - in particular whether it was possible to have a sustained recovery of output without a fiscal stimulus. The post-war neo-Keynesian approach was to try to stimulate economic performance by expansionary fiscal policy and accommodating monetary policy whenever there was any sign of weakening growth. In practice it failed to provide other than short-term gains to output and merely spelled long-term trouble; rising inflation and a succession of financial crises. We turned our back on that approach.

32. Instead we have directed monetary and fiscal policy towards steadily reducing inflation and providing a stable financial environment within which a reinvigorated economy could perform.

33. Our critics have constantly changed their ground as events have confounded their gloomy predictions. Initially they said it would not be possible to reduce inflation without incomes policy. They then said inflation was only falling

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because we were in a self-perpetuating downward spiral which meant the PSBR would get bigger rather than smaller. Then we had the question "where will the growth come from?" And the suggestion that it was impossible to have steady growth consistent with a falling budget deficit. When it became clear that the economy was growing we were warned that it was a flash in the pan and would peter out. Year after year we were told that although growth this year might be better than expected next year it would slow down. And that if we did have sustained recovery inflation would roar ahead again. I could go on.

34. But what has been the outcome? Sustained growth at near to 3 per cent a year for about 6 years against a background of falling inflation - from  $16\frac{1}{2}$  per cent at the end of 1980 to [4] per cent over the past 18 months.

35. More recently the nature of the debate has changed and it has been suggested we are in danger of overheating which finally will bring the recovery to an end. Again this demonstrates a lack of understanding of why this upswing is different in character from other upswings; and why it is so well based.

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36. The length of the upswing is not just a matter of chance. It reflects the soundness of the recovery; improved industrial performance; an absence of artificial fiscal stimulus; an absence of speculative build-up of stocks by industry; and an absence of inflationary pressure based on easy monetary conditions. Above all because the recovery has been at a comfortable pace it has not shown the strains and stresses that once were so familiar.

37. We have eschewed active demand management in response to expectations of short-term fluctuations; we have been prepared to take difficult action with interest rates when it was necessary to maintain sound monetary conditions; and we have made steady progress in bringing the PSBR down as a percentage of GDP. Excluding asset sales the PSBR is now a lower percentage of GDP than any year since 1969-70.

38. The debate about monetary and fiscal policy is surely now over. Given the historically low budget deficits of the past two years there can be no clearer proof than the enthusiasm with which those who accused us of starving the economy of demand now accuse us of generating excess demand and of changing the conduct of policy. They were wrong then; they are wrong now.

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39. I turn now to my proposals for changes in taxation.

Business and Enterprise

Corporation Tax

40. First, taxes affecting business and enterprise.

41. The central objective of my reforms in this area has been to remove obstacles to business success. The national insurance surcharge and the development land tax have gone altogether. The reformed system of corporation tax came fully into effect last April, and for the past year, the rate of tax on company profits has been lower in Britain than in any major industrial nation, though the Americans are now set to emulate us. The sharper incentive this gives companies to improve their performance benefits employees, customers, shareholders, and the nation as a whole.

42. During the transition to the new system, companies were given advance notice of the main rate of Corporation Tax for the year ahead. This helped them in their forward planning, and I intend, as far



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as possible, to continue the practice of fixing the rate in advance.

43. Accordingly, I can announce now that the main rate of Corporation Tax in 1987-88 will be unchanged at 35 per cent.

Company Capital Gains

44. I have a further measure of streamlining to propose. The present system of taxing companies' capital gains is complicated: gains are charged to corporation tax, but the amount of the gain is first adjusted by a certain fraction so that the effective rate of tax is the same as on individuals' capital gains. But I see much force in the view that, with the greatly reduced Corporation Tax rates, there is less justification for this difference between the tax treatment of companies' capital gains and their income from other sources.

45. I therefore propose that with effect from today, the capital gains of large and small companies will be charged at the appropriate Corporation Tax rate, without adjustment, except for the indexation which applies to all post-1982 gains.

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46. At the same time, I am proposing to enable companies to set payments of Advance Corporation Tax against their tax liability on capital gains. This remedies a longstanding complaint which has been the subject of regular representations.

47. Together, these measures are expected to yield about £60 million in 1988-89 and £100 million in a full year.

Pay and File

48. I also propose to legislate now to pave the way for a new method of collecting Corporation Tax, to be known as Pay and File. At present, many company accounts are not received in time to agree the tax liability before payment is due. So there is a laborious process of an estimated assessment from the Inland Revenue and an appeal from the company. Under Pay and File companies will estimate their tax liabilities themselves, and pay on the normal due date. Tax liabilities will be finalised once companies submit their returns and accounts. Where it turns out that the company's initial payment was too high, the Revenue will pay interest on the excess; where the initial payment was too low the company will pay interest.

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49. This new approach was set out in last December's consultative document on the recommendations in the Keith Committee Report and was generally welcomed both by business and by tax specialists.

50. As this is part of a wider programme of streamlining tax collection, including major developments in the Inland Revenue's computer systems, it will not come into force until the early 1990s. But by legislating now we are giving taxpayers and their advisers a firm basis on which to prepare for the new scheme.

Oil

51. Within the company sector, the oil industry has faced a year of adjustment following last year's sharp fall in the oil price. My Rt Hon Friend the Secretary of State for Energy and I have followed closely the effects on North Sea producers and their suppliers. The industry itself is generally confident about the longer term prospects, but companies have suggested that in the short-term the trough in activity could lead to the loss of some of the capacity, in Scotland and elsewhere, that will certainly be required in the longer run.

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52. Last autumn, with this problem in mind, I introduced legislation to bring forward the repayment of over £300 million of Advance Petroleum Revenue Tax. That has already helped many of the small companies with cash flow difficulties.

53. I now propose two new Petroleum Revenue Tax reliefs. First, with effect from today, participators may elect to have up to 10 per cent of the costs of developing new oil fields, until income from the new fields exceeds the costs incurred, set against their Petroleum Revenue Tax liabilities in other fields. Second, I am proposing a new relief for research expenditure on oil extraction that is not related to a particular field, and so is not at present allowed for Petroleum Revenue Tax.

54. Together, these changes will give a further measure of help, both to the oil companies themselves and to those for whom they generate work, that will assist them in meeting the difficulties of the next five years or so.

#### Small Businesses

55. The growth of the small business sector has been one of the most encouraging developments in the



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1980s. Between 1983 and 1985, 550 new businesses, on average, were created each week. Small businesses have a vital role to play in the economy, not least in job creation. The Government has introduced a wide range of measures to help this sector and to make it easier for small businesses to get on with the job of making profits.

56. Representations have been made to me from time to time about the difficulties some small businesses experience with VAT, both with its impact on their cash flow and with the record-keeping required. I therefore authorised Customs and Excise to issue a consultative document last autumn proposing certain changes, which have been broadly welcomed by representative bodies and individual businessmen alike.

57. One of the proposals which received a very wide welcome was that for a optional system of cash accounting for businesses with a turnover of up to £100,000. Indeed, there were many requests for this option to be available more widely.

58. In the light of this I now propose that, with effect from 1 October, companies with an annual turnover of up to £250,000 should, if they so

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choose, be able to account for VAT on the basis of cash paid and received. They will thus not have to pay VAT until they have been paid by their customers, which will ease their cash-flow problems, as well as giving them automatic relief for bad debts.

59. The proposal is subject to our obtaining the necessary derogation from the EC Sixth Directive on VAT; I am applying for this today.

60. To help small businesses with the handling of VAT, I propose an optional system of annual accounting, which will mean that businesses with an annual turnover below £250,000 will be able to make payments on account and send only one return a year to Customs. This change will come into effect in the second half of 1988.

61. I have two further changes to propose here. First, the period within which businesses must apply to be registered for VAT will be extended from ten days to thirty days.

62. Second, the rules for the special VAT schemes for retailers will be changed to make them simpler for small and medium-sized businesses.

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63. But there are two matters on which the representations have persuaded me it would not be right to proceed. I shall not be going ahead with the proposal for compulsory deregistration of traders below the VAT threshold; nor with the withdrawal of the standard method of accounting for VAT used by retailers.

64. For the coming year, I propose to increase the VAT registration threshold itself to £21,300, the maximum permitted under existing European Community law. We shall continue to argue vigorously in Brussels for flexibility to set a higher limit.

65. The proposals I have just outlined go further, in some respects, than those published in the autumn. They will help ease the burden of VAT on smaller firms - and allow more of their management energies to be concentrated on generating profits. Some controls, forms and regulations are inevitable, but we are continuing to prune this bureaucratic thicket as much as possible.

Tax avoidance

66. The Government is determined to make further progress in reducing the burden of taxation. But

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hand in hand with this we must ensure that tax is collected fairly and effectively, and that the law enables the right amount of tax to be collected. I have a number of proposals to make today in this regard.

67. The first of these concerns VAT, and has already been the subject of extensive consultation. Where a business' activities are in part liable to VAT and in part not, the present rules are over-generous on the amount of input tax which can be deducted, and are being exploited. We have already announced that these rules are to be revised so as to curb tax avoidance and prevent distortion of competition. There will be generous and straightforward reliefs for small businesses, and administration will be kept as simple as is consistent with the prevention of wholly unacceptable losses of revenue. The changes will come into effect on 1 April, and are estimated to prevent a revenue loss in 1987-88 of £300 million.

68. Second, I propose to take action on dual residence, so that dual resident companies in multinational groups will no longer be able to secure two tax reliefs for one and the same interest payment. Trading companies will not be affected.



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This change, which will take effect from 1 April 1987, follows on the action taken in this area by the United States last year. Indeed, this is one area where we can follow the United States, since the US tax reforms are substantially concerned with removing tax shelters which do not exist here.

69. My third proposal concerns the timing of corporation tax payments. At present companies established before 1965 may pay their corporation tax up to 21 months after the end of the period for which it is due; but companies established since 1965 must all pay their tax after nine months and some building societies pay earlier still. This difference in the treatment of companies no longer has any justification; and it is open to an abuse which could put the timing of a substantial proportion of the corporation tax yield at risk.

70. I propose, therefore, that all companies and building societies should be liable to pay Corporation Tax nine months after the end of the accounting period on which the tax is due. This will be more equitable between companies than the present regime; it will rationalise the arrangements for collecting Corporation Tax from companies; and it will smooth the flow of tax

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receipts into the Exchequer. There will be a  
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transitional period during which the change will be  
phased in.

71. Fourth, I propose to tackle the present over-generous treatment of tax credit relief for foreign withholding tax paid on interest on bank loans. In future, banks will be able to offset this tax credit only against tax on the profit on the relevant loan, and not more widely. This brings the rules here broadly into line with those in other countries. The change will apply from 1 April 1987 for new loans and from 1 April 1988 for existing loans.

72. Fifth, I propose legislation to ensure that the tax treatment of Lloyd's Reinsurance to Close is made consistent with the treatment of provisions for outstanding liabilities made by insurance companies and similar provision made by other financial traders. These proposals will first apply to premiums paid for the 1985 Lloyd's account closing at 31 December 1987.

73. I have a number of further proposals, to improve the taxation of business and enterprise.

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Business Expansion

74. Last year I was glad to confirm that, in view of its outstanding success, the Business Expansion Scheme would continue in being indefinitely. The changes I made to the Scheme in 1986 have improved its targetting. More BES money is now going into the higher risk ventures for which the Scheme was designed.

75. The scheme is now on a generally satisfactory basis. But I propose two further improvements.

76. The first is a measure to deal with the problem of end-year bunching, about which a number of people have made representations. I propose that, for investments made in the first half of the tax year, the investor will be able to claim part of the relief against income of the previous year. This measure, which will apply to investments made after 5 April 1987, should make it easier for companies to raise BES finance throughout the year.

77. The second measure is a relaxation of the rules to make it easier for independent film companies to benefit from BES investment. I hope that this will be widely welcomed in the film industry.

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78. I need to set the 1988-89 car and car fuel benefit scales for those with company cars. The car scale charges still fall well short of the true value of the benefits and as in the last three years I propose to increase them by 10 per cent. I propose no change to the car fuel benefit scales which from 6 April will also be used for VAT purposes.

79. Training and retraining are vital to a dynamic, flexible economy. It is most important that there should be no disincentive for people who are likely to be changing jobs, which might hold them back from training and acquiring new work skills. At present, training of this kind provided by an employer is treated as a taxable benefit. I propose to take it out of tax.

Profit-related pay

80. I turn now to profit-related pay.

81. I suggested last year the possibility of introducing changes to the tax system which would run with the grain of, and reinforce, efforts to break up the rigidity of the pay system in this country.

82. I pointed then to two considerable advantages of arrangements which relate pay to profits. First,

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they lead to a closer identification of employees with the firms in which they work. Second, they make for more flexibility in the face of changing market conditions and hence help to make employment more stable.

83. My remarks led to a lively debate, and last July we published a Green Paper on profit related pay. I warmly welcome the discussion and responses that the document generated. Those firms which already have profit-related pay schemes generally believe they have worked well. And many other firms are considering introducing them.

84. I have therefore decided that the time is right to give a measure of tax relief for employees in qualifying profit-related pay schemes.

85. This should encourage many more firms to bring these schemes into operation. Initially, at least, these schemes will be confined to the private sector. Certain conditions will of course have to be met before tax relief is available. But firms will have as much flexibility as possible to design schemes to suit their particular needs, and the administration will be kept simple.

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86. A key issue is the level of tax relief. The Green Paper suggested that one quarter of an employee's profit-related pay might get tax relief. I have now decided to double this to a half. So for someone on average earnings receiving 5 per cent of their pay as PRP, the tax relief will be equivalent to a penny off the basic rate of income tax. That underlines the importance the Government attaches to this major new initiative. Depending on take-up the full year cost could well build up to over £100 million by the end of the decade.

87. Profit related pay is not a panacea. But I believe it will be of practical help in tackling some of the deep seated problems of the UK economy by promoting greater flexibility and enterprise, and so help further to strengthen the prospects for employment. I hope that employees and employers alike will now respond enthusiastically to this opportunity as we look forward to the 1990s.

#### Savings and Investment

88. I now turn to savings and investment

89. First, share ownership. This Government has given a major boost to wider share ownership through

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action on three fronts: employee share schemes, privatisation, and the introduction of Personal Equity Plans.

90. The growth in approved employee share schemes since 1979 has been remarkable. We started with about 30 schemes. Now there are over 1,200 open to all employees which cover some 1½ million workers in over 10,000 companies.

91. I now propose a further measure in this area. In future, employees in a company which is taken over will be able to exchange their existing share options under an approved scheme for options over shares in the acquiring company.

92. I am, further, instituting a review, with the help of outside practitioners, of the effect of Section 79 of the 1972 Finance Act which deals with the tax treatment of employee-acquired shares outside approved schemes. ♦ The aim of the review will be to suggest how to improve and simplify the rules, consistent with the underlying purpose of countering tax avoidance, so as to allow greater flexibility and encouragement to enterprise.

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93. Privatisation brings a wide range of benefits for the economy at large, as well as for the industries privatised and for their consumers. Not the least of these benefits is the breakthrough we have been able to make in wider share ownership.

94. As the House knows, the British Telecom sale in 1984 brought a step-change in the number of share-owners. Over 2 million people applied, half of whom had never owned shares before. Last year's sale of British Gas proved another landmark for wider share ownership. 4½ million applications were received on behalf of 5 million people, the largest number of applications ever received in a flotation anywhere in the world. [Plus reference to TSB? - review in the light of the results of the Treasury/Stock Exchange Survey, expected on 2 March.]

95. I am particularly glad that employees have seized the chance to become shareholders - sometimes, it must be said, against the advice of their trades unions. No fewer than 90 per cent of the employees in the privatised companies floated on the stock market have become shareholders.

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96. The success of these policies has been clear for some time, but estimates of the number of shareholders have varied. I therefore commissioned, in conjunction with the Stock Exchange, a major survey of individual shareholders and have recently received the results. The survey shows that there are now [ ] million individual shareholders in the UK. [This is fully three times the number in 1979.]

97. But we are not going to stop there. There is a great deal of scope, not only for increasing still further the number of people owning shares but also for existing shareholders to add to their portfolios. Our measures to promote employee share schemes and our plans for further privatisation sales will continue to play an important part.

98. The Personal Equity Plans announced in my last Budget came into operation on January 1st and are already beginning to show impressive results. Already over 165 banks, stockbrokers, unit trusts, building societies and investment advisers have applied to become plan managers and the investor is being offered a wide range of plans to choose from. Over 2,000 people a day are currently taking out PEPs, and there is evidence that many of these had

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not previously owned shares directly and are basic rate taxpayers.

99. PEPs are now successfully launched, and going well. In time they, with the other measures we have taken, will alter the landscape of attitudes towards saving, investment and share-ownership in this country.

**Pensions**

100. I turn now to pensions.

101. In my last Budget, I promised to bring forward proposals for the tax treatment of the new personal pensions which are to be introduced from 1 January 1988. Accordingly, we published a consultative document last November.

102. Personal pensions are an important development in three ways. First, they will enable employees - if they so wish - to opt out of their employers' schemes and make their own arrangements. Second, they will be a new opportunity for the millions of employees who at present do not belong to an occupational scheme. And third, people may, again if they so wish, use them to contract out of SERPS.

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103. As foreshadowed in last year's Budget, and in the consultative document, I now propose to extend to these new personal pensions broadly the same tax treatment that applies to retirement annuities.

104. I also propose to implement other reforms contained in the consultative document, which have been widely welcomed.

105. Employers will be able to set up simplified occupational schemes with the minimum of red tape. This will be particularly good news for many small employers who have been discouraged by the complexity and open-ended commitment of a full-blown final salary scheme. And there will be much greater scope for transferring between different types of pension scheme.

106. I intend to go beyond my original proposals in one further, important way. I propose new arrangements which will allow members of occupational schemes to make additional voluntary contributions with full tax relief to a separate plan of their own choice instead of, as now, being restricted to plans within their employer's schemes. They will be able to top their pensions right up to the present tax approval limits.

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107. All these proposals will make it easier for people to take their pensions with them when they change jobs, which will be good for labour mobility and independence. It will widen the range of choices people can make about their pensions; and it will mean that in future they will have more control over the way in which their pension contributions are invested.

108. But these far-reaching improvements can be justified only if they are properly used. Some new safeguards are necessary to discourage exploitation of the very generous reliefs, particularly by a few very highly paid people. I intend, therefore, to introduce some limited changes to the present rules to restrict the excessive relief which can be obtained in some circumstances. These will include, for all arrangements entered into from today, a cap on the maximum tax-free lump sum of £150,000 and stricter rules on how pension and lump-sum benefits can be calculated, including a stricter definition of final salary.

109. All these changes are set out in a further document which we are publishing today.



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110. In my 1984 Budget I reformed the limits that apply to tax exempt life assurance issued by friendly societies. I did so because certain societies had widely abused the privileges traditionally enjoyed by the friendly society movement. These societies were set up purely for commercial reasons, far removed from the mutual self-help role which the movement has sponsored for decades.

111. To improve the position of the older, long-established societies, I now propose that societies should in future be able to offer tax-exempt policies based on annual premiums of up to £100. This will enable the older societies to operate economically, without effectively changing the position of commercial societies.

112. Turning to the capital taxes I propose to increase the annual exempt amount of capital gains from £6,300 to £6,600. I am also increasing the maximum amount of capital gains relieved from tax on retirement from £100,000 to £125,000.

113. The burden of inheritance tax - which raises over £1 billion - falls disproportionately on those with relatively small estates, many of which consist

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entirely of the family house. I therefore propose a substantial increase in the threshold from £71,000 to £90,000 and a simplification of the rates structure. The effect will be to reduce the number of estates liable to the tax by about a third and to give worthwhile reductions at all levels, particularly for smaller estates.

114. Last year I removed a widely resented obstacle to lifetime giving by exempting outright gifts between individuals made more than 7 years before the donor's death. This year I can go further. I propose to extend the exemption on similar terms to gifts involving settled property in which there is an interest in possession, though this will not apply to discretionary trusts.

115. The proposed changes in rates and bands will help businesses. But I propose to go further by increasing business relief for shares in unquoted companies. The rate of relief for substantial minority holdings in such companies will be increased from 30 per cent to 50 per cent. To reflect the progress of the unlisted securities market, in future all holdings in USM companies will be treated like those with a full listing. These changes will concentrate relief on assets which do not readily provide funds to pay the tax or which could only do so at the risk of damaging the business.

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Taxes on spending

116. I turn now to taxes on spending.

117. I have no changes to announce in the rate or coverage of Value Added Tax, except for some further reliefs for charities.

118. We have a very generous tax regime for charitable giving, following the package of new reliefs I introduced last year, and in particular the payroll giving scheme which starts next month. As I announced before Christmas, I propose to increase the limit on donations under the scheme to £120 a year.

119. I know charities will not expect any major changes this year. But following representations from the Charities VAT and Tax Reform Group, I have decided to extend the VAT reliefs introduced last year to certain new areas: to installing or adapting lavatory or bathroom facilities in charity residential homes for the disabled; to certain welfare vehicles used by hospices to transport the terminally ill; to drugs and chemicals supplied to charities and directly used in medical research; to

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goods donated for export by a charity for relief of distress; and to specialised location and identification equipment used by mountain rescue and first aid services.

120. On excise duties, I announced last year that I had decided to introduce a duty differential in favour of unleaded petrol, to offset its higher production costs. I can now announce that the differential will be 5 pence. This means that unleaded petrol should be no dearer at the pump than 4 star leaded petrol. The measure will take effect from 6 o'clock this evening.

121. The gaming machine licence duty has not been changed since 1982, and I propose to increase it by about a quarter, which will restore it to its 1982 value. I propose no change in the level of duty on off-course betting, where the reforms introduced by my Rt Hon Friend the Home Secretary have done much to improve betting shops' prospects. But, mindful of the adverse effects of declining attendances at racecourses, and with a view to consoling those Hon Members who, but for my choice of Budget date, would have spent the day at Cheltenham watching the Champion Hurdle, I propose to abolish the duty on on-course betting from 29 March.



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122. Taken together, these measures are broadly revenue-neutral.

123. I propose to increase the rates of vehicle excise duty on farmers' lorries, to bring them into line with the use they make of the public roads. This change will take effect from midnight tonight. I also propose to increase the rates of duty on trade licences and to create a new taxation class for recovery vehicles. These changes will take effect from 1 January 1988.

124. [Passage on excise duties to be drafted later.]

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Income Tax

125. Finally I turn to income tax.

126. Lower rates of tax are good for incentives and a stimulus to enterprise. The best chance of increased prosperity for all will come when Britain is placed firmly in the league of countries with low taxation and high growth. Our tax reform strategy has been to move as quickly as is prudently possible in this direction.

127. We have already made a very substantial reduction in the top rate of income tax, reducing it from the penal level of 83 per cent under the previous Government to 60 per cent. We have abolished the investment income surcharge and brought the basic rate of tax down from 33 per cent to 29 per cent. The main tax thresholds are now 22 per cent higher in real terms than in 1979, taking 1.4 million people out of income tax altogether. The married man's allowance will therefore remain at its highest level in real terms since the war.

128. We now need to carry this process a step further.

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129. I propose for 1987-88 to raise the main personal allowances in line with the statutory indexation provisions.

130. The single person's allowance will therefore rise by £90 to £2,425 and the married man's allowance by £140 to £3,795.

131. The single age allowance will rise by £110 to £2,960 and the married age allowance by £170 to £4,675.

132. I propose, however, to give an extra increase in the age allowance to people aged 80 or over. For them, it will be raised by twice the amount due under indexation so that, for the very elderly, the single age allowance will be £3,070 and the married age allowance, £4,845. Around 400,000 single people and married couples will benefit from this new provision and the extra increase in the allowance will take up to 25,000 of them out of income tax altogether.

133. The blind person's allowance was last raised in 1981 when it was increased by £180 to its present level of £360. For 1987-88, I am proposing a further £180 increase, to £540.

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134. As to the higher rates of income tax, the threshold for the 40 per cent rate will be raised in line with statutory indexation to £17,900 and the threshold for the 45 per cent rate will go up by £200 to £20,400. But I have decided that the thresholds for the 50 per cent, 55 per cent and 60 per cent rates will remain at their 1986-87 levels.

135. In my Budget speech last year, I reaffirmed the aim set out by my predecessor in 1979, to reduce the basic rate of income tax to no more than 25 per cent. That remains my objective.

136. But reductions in the basic rate are expensive. It costs well over £1 billion to reduce the rate by one percentage point. Given the overriding need for prudence on public borrowing - on which I am not prepared to compromise - I cannot achieve the goal of a 25 per cent basic rate this year. But I can take a further useful step towards it. I am therefore cutting 2 pence off the basic rate for 1987-88.

137. This reduction to a rate of 27 pence in the pound brings down marginal rates for the overwhelming majority of taxpayers. It will be



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worth over £3 per week to a married man on average earnings.

138. The income tax changes I have announced today will take effect under PAYE on the first pay day after 17 May.

139. The basic rate reduction will, of course, mean a similar reduction in Advance Corporation Tax.

140. As a further measure to help small businesses, I have decided also to reduce the small companies' rate of corporation tax to 27 per cent. Following the proposals I announced earlier, this rate will also apply to small companies' capital gains, which are currently taxed at 30 per cent. The changes to income tax and corporation tax will mean a significant fall in the tax burden on small companies and the unincorporated sector. This gives the best possible incentive to small businesses, which are so crucial for future growth and employment.

141. The total cost of the income tax changes will be some £2½ billion in 1987-88. The overall cost of all the measures I have announced today will be just over £2 billion. This is consistent with my

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objective of a PSBR of no more than 1 per cent of GDP. I have accordingly set the PSBR for 1987-88 at £4 billion.

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Peroration

142. Mr Deputy Speaker, we now have a vigorous and resilient economy, entering its seventh year of steady growth. Inflation remains low; the number of people in work continues to rise; and unemployment is now on a downward trend.

143. In this Budget, I have been able to reduce public borrowing to 1 per cent of GDP, and to make a further reduction in income tax; in the next year, public spending will fall as a proportion of GDP, but spending in priority areas will increase.

144. To succeed on all these fronts together is a goal that has eluded successive Governments for decades.

145. This achievement is the direct result of the prudent economic policies pursued since 1979.

146. This Budget carries forward those policies. I commend it to the House.

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**MONETARY POLICY**

1. For its part the Government will continue to pursue sound and prudent financial management. The framework for that policy will continue to be the Medium Term Financial Strategy, as it has been since 1980. It is designed to bring inflation down further over a period of years and ultimately to achieve price stability.
2. The MTFSS has provided a durable framework in which monetary policy has been pursued with steady persistence and a clear sense of direction. It has proved adaptable to changing circumstances both at home and beyond our shores. Above all it has proved a success. We shall build on this success.
3. Monetary conditions will be set so as to maintain the gradual reduction in money GDP over the medium term. In the short run there will be fluctuations but it is the medium term trend which is important. Experience over the past seven years shows that this policy will deliver a combination of low inflation and steady growth.
4. The achievement of a declining path for money GDP growth requires firm monetary policies supported by low public sector borrowing. Our commitment to anti-inflationary monetary policies is demonstrated by the declining path up to 1991 for growth of money supply as measured by MO.
5. Short-term interest rates remain the essential instrument of monetary policy. Changes in interest rates are made in response to changes in monetary conditions. In turn 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. There is no mechanical formula for taking these factors into account; a balance must be struck.
6. For narrow money the target range for 1987-88 will be 2-6 per cent - exactly as indicated in last year's MTFSS.



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7. There is no target for broad money this year. Rapid changes in financial markets associated with wholly desirable institutional changes have affected monetary indicators throughout the world. The interpretation of particular monetary conditions has become very difficult. In the United States, M1 has been put temporarily into cold storage. In this country rapid £M3 growth has proved consistent with monetary conditions which have demonstrably brought about lower inflation. It is too uncertain a measure to use for target purposes, as was vividly demonstrated by the Governor of the Bank of England in his Loughborough speech. We shall continue to make judgements about broad money in assessing monetary conditions. But I have selected a more reliable guide for the monetary target.

8. The exchange rate will continue to play a significant part in monetary conditions and thus in decisions about short-term interest rates. The recent agreement by the 6 major industrial nations to reduce existing imbalances and co-operate to foster the stability of exchange rates will reduce uncertainty. It is entirely consistent with our medium-term objectives and has been widely welcomed.

#### **PUBLIC SECTOR BORROWING**

9. An important component of the success of the MTF5 has been the reduction in the level of public sector borrowing.

10. Last year the Budget arithmetic was dominated by the sudden collapse of our oil revenues, which have fallen from £11 1/2 billion in 1985-86 to an estimated £4 1/2 billion in 1986-87. I introduced a cautious Budget which nevertheless left me some room to reduce taxes. The PSBR was expected to be around £7 billion in the current financial year.

11. In spite of lower oil revenues it now appears that the PSBR this year will, for the second year in succession, be lower than

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the Budget estimate. We now estimate that this year's PSBR will be £5 billion, or about 1 1/4 per cent of GDP. If privatisation proceeds are added back, it is still lower as a share of GDP than in any year since 1969-70.

12. As last year, this successful outcome is due to two factors. First, public expenditure has been held within the planning total and continues to fall as a proportion of GDP. The second factor has been a marked surge in non-oil revenues. This is not the result of a short-lived boom; the economy has performed in line with our projections. It is the consequence of higher than expected effective tax rates for a given level of economic activity.

13. This means that the PSBR this year, as a proportion of GDP, is about one quarter of the level we inherited in 1978-79. There have been two marked steps downwards. The first step brought the PSBR from 5 1/4 per cent to around 3 per cent in 1981-82. The second step brought it down from 3 per cent to 1 1/4 per cent in 1985-86.

14. Last year's MTFs indicated a PSBR for 1987-88 of £7 billion. There is a sensible presumption that I stick to the pre-announced figure. But given the outturn for this year and the buoyancy of revenues projected for next year I have decided to aim to make faster progress towards the desired low level for the PSBR. [I am not sure whether it is intended to mention the figure here or later].

15. North Sea revenues are forecast at about £5 billion, the same level as in 1986-87. In the light of the uncertainty surrounding oil prices I have stuck to the assumption made last year that oil prices will average \$15 dollars a barrel. The proceeds from the privatisation programme are expected to be £5 billion, as set out in the Autumn Statement.

16. This is a cautious and prudent policy. Unfortunately, it will not allow room for the substantial reduction in taxation to

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which this Government attaches such importance. That is regrettable, but necessary, for we are determined, as we have been for the past eight years, to take no risks with inflation, and no risks with our management of the public finances.

17. Even so I will be able to announce some reductions in taxation. It is a measure of the soundness of our policies that at the same time we shall be able to maintain public borrowing at unequivocally low levels despite the sizeable additions we have made to the level of public expenditure, and despite the slashing of our oil revenues.

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FROM: M C SCHOLAR  
DATE: 27 FEBRUARY 1987

**CHANCELLOR OF THE EXCHEQUER**

- cc Principal Private Secretary
- Chief Secretary (2)
- Financial Secretary (2)
- Economic Secretary (2)
- Minister of State (2)
- Sir Peter Middleton
- Sir Terence Burns
- Sir Geoffrey Littler
- Mr F E R Butler
- Mr Wilson
- Mr Cassell
- Mr Monck
- Mr Sedgwick
- Mr Odling-Smee
- Mr Culpin
- Miss O'Mara
- Miss Sinclair
- Miss Evans
- Mr Hudson
- Mr Cropper
- Mr Tyrie
- Mr Ross Goobey
- Mr Battishill - IR
- Mr Isaac - IR
- Mr Painter - IR
- Mr Beighton - IR
- Mr McManus - IR
- Sir Angus Fraser - C&E
- Mr Knox - C&E
- Mr Wilmott - C&E
- Mr Bone - C&E

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**SECRET**

**B.L.O.**

*Get Wilson's text.*

*Ch*

*Exclude Content Act  
para not in its version  
(Haggard took in first draft below)*

*AA*

**BUDGET STATEMENT: SECOND DRAFT**

I enclose a second draft of the Budget Statement, put together in the light of your comments on last week's draft.

2. The passage on the economy (paragraphs 4-18) is by Sir Terence Burns. Monetary policy and public sector borrowing are by Sir Peter Middleton. Sir Terence Burns is the author of the Verdict. Mr Cassell, Mr Hudson and I have reworked the tax proposals section. The peroration is by Mr Hudson.

*good, but rather long.*

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3. I also attach an alternative version of monetary policy and public sector borrowing which Sir Terence Burns produced this evening (and which he has not been able to clear round the office).

4. I am afraid that all this does not add up to a coherent speech, and there is a good deal of overlapping and perhaps some inconsistency between these sections. We will have to iron this out next week.

5. Some issues which arise:

- (a) The borrowing section at present gives no money figure for the PSBR but either a ratio (Sir Peter Middleton) or words (Sir Terence Burns). That is good theatre, but it does make for problems at the end of the speech, where it would be bathetic to start up again on the higher non-oil revenues and so on, but perhaps unconvincing without this. The approach in the present draft means that we will rely on the FSBR and briefing to stand up our fiscal forecast.
- (b) There is a case for giving a more specific explanation than the present draft does of why the PSBR this year is turning out so low.
- (c) Sir Peter Middleton has made his draft deliberately upbeat, on the basis that it is easier to tone down than to lift up a draft.
- (d) I have omitted the sentence on the oil pricing and valuation changes as interrupting the flow and unnecessary (Mr Cassell and the Revenue). But your first thought on this was that it would be disingenuous to leave it out.
- (e) I have omitted the paragraph (paragraph 96 in the first draft) on the material interest test in employee share schemes in close companies. It seemed rather dull and unnecessary.
- (f) There may be a case for removing the passage on BES, company cars and training (paragraphs 74-79) to the end of the Small Business section, so that PRP stands on its own at the end of the Business and Enterprise section.

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(g) This draft places, as you suggested, the alignment of Corporation Tax payment dates in the anti-avoidance section rather than in the streamlining CT section (as in the previous draft). This perhaps gives too much weight to the anti-avoidance element in the justification of this measure: if anti-avoidance were its main motive we would be introducing a more limited measure and not one which affects all companies.

6. In length the Speech may now be a few minutes over the hour.

**SECRET**

*MLS*

M C SCHOLAR

BLO enc: pages

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**BUDGET STATEMENT: SECOND DRAFT**

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amendments.*

*Ny 13  
B.*



COPY 1 NO 10

FROM: A C S ALLAN  
DATE: 2 March 1987

~~MR C W KELLY~~

cc: EST  
Sir P Middleton  
Sir T Burns  
Mr Cassell  
Mr Scholar  
Mr Peretz

**BUDGET SPEECH: EXCHANGE CONTROL**

... I attach the Chancellor's own draft of this section of the Budget Speech.

2. Please could I have any comments as soon as possible.

*ACSA*

A C S ALLAN

*Mr Allan  
No comments from me, thank you.*

*2.3.*

*Ch  
EST feels para X5 is too kind to  
Mr H, & could refer amendment marked  
OK?  
His amendment is good; but to avoid being  
too kind I have marked a diff  
amendment - plus two other amendments.*



X. EXCHANGE CONTROL

X1. Before I turn to my proposals for changes in taxation, I have one other important change of a specific nature to announce.

X2. In 1979, a few months after we had first taken office, my predecessor announced the abolition of exchange controls, which had been in continuous operation ever since the outbreak of war in 1939. That bold action has, over the past 7½ years, proved wholly beneficial to the British economy; and I am glad to note that other European countries are now moving in the same direction.

X3. But although the operation of exchange control has ceased, the Exchange Control Act itself remains on the Statute book. So long as it does, there is likely to persist a nagging <sup>fear</sup> ~~uncertainty~~ that, in ~~some~~ <sup>certain</sup> circumstances, exchange control might be reimposed; and such uncertainty could be damaging.

X4. I have therefore concluded that the time has come to repeal the Act. The necessary legislation will be contained in this year's Finance Bill.

(What was clearly intended for) X5. I note that, in a ~~major~~ <sup>major</sup> speech in New York ~~in~~ <sup>in</sup> September, the Deputy-Leader of the Labour Party declared that, and I quote:

"The Labour Party has no intention of reintroducing statutory exchange controls".

I am confident, therefore, that the proposal I have just made will be welcomed on all sides of the House.

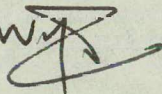
PWF

BUDGET CONFIDENTIAL

Turning now to the duties on betting and gaming, I note that the gaming machine licence duty has not been changed since 1982. I propose to increase it by about a quarter, to restore it to its 1982 value. I propose no change in the level of duty on off-course bets [where the efforts of my rt hon Friend the Home Secretary have done much to improve betting shops' prospects]. But, mindful of the adverse effects of declining attendances at racecourses (particularly on the setting of starting prices), I propose a measure that will console those hon Members who, but for my choice of Budget date, would have spent the day at Cheltenham, watching the Champion Hurdle. The duty on on-course bets will be abolished from 29 March. Taken together, these measures are broadly revenue neutral.

Mr Hudson, Chancellor's Office

We suggest the above alternative approach for the Budget Statement.

P. G. W. 

Chronics. 26.2.87

Min.

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COPY NO 3 OF 6

PWP



FROM: A P HUDSON

DATE: 2 March 1987

MR SCHOLAR

cc Mr Cassell

**BUDGET SPEECH: OIL TAXATION**

... I attach the Chancellor's own draft of the section on North Sea oil taxation.

2. The Chancellor noted that something would have to be said about the cost of the package. He also asked what the position is on oil companies' ACT. I shall minute out these questions when circulating the full draft.

A handwritten signature in black ink, appearing to be 'A P HUDSON'.

A P HUDSON

D17. While business and industry as a whole is doing well, the North Sea oil sector has inevitably been hard hit by last year's oil price collapse. My Rt Hon Friend the Secretary of State for Energy and I have followed closely the effects on North Sea producers and their suppliers. The industry itself is generally confident about the longer-term prospects; while as for the tax system, not only is it inherently price-sensitive, but the companies themselves have always stressed their desire for stability.

D18. However, in the light of the immediate problems I introduced last autumn legislation to bring forward the repayment of over £300 million of Advance Petroleum Revenue Tax. This has already helped many of the smaller companies faced with cash flow difficulties.

D19. I now propose two further Petroleum Revenue Tax reliefs. First, as from today and until such time as income from new fields exceeds the costs incurred, companies may elect to have up to 10 per cent of the costs of developing new oil fields set against their Petroleum Revenue Tax liabilities in existing fields. Second, there will be a new relief against PRT for research spending on oil extraction not related to any particular field.

D20. I hope that these carefully targeted changes will give a worthwhile measure of help to the North sea oil sector.

REF NO: F 87/5<sup>A</sup> RWF  
 COPY NO 1 OF 36 COPIES

FROM: A C S ALLAN  
 DATE: 2 March 1987

MR SCHOLAR

5288  
 WORD

cc Chief Secretary  
 Financial Secretary (2)  
 Economic Secretary (2)  
 Minister of State (2)  
 Sir P Middleton  
 Sir T Burns  
 Sir G Littler  
 Mr F E R Butler  
 Mr Wilson  
 Mr Cassell  
 Mr Monck  
 Mr Sedgwick  
 Mr Odling-Smee  
 Mr Culpin  
 Mr Miss O'Mara  
 Miss Sinclair  
 Miss Evans  
 Mr Cropper  
 Mr Tyrie  
 Mr Ross Goobey  
 Mr Battishill - IR  
 Mr Isaac - IR  
 Mr Painter - IR  
 Mr Beighton - IR  
 Mr McManus - IR  
 Sir Angus Fraser - C&E  
 Mr Knox - C&E  
 Mr Wilmott - C&E  
 Mr Bone - C&E

**BUDGET STATEMENT: TAXATION SECTION: THIRD DRAFT**

... I attach the Chancellor's own draft of the second half of the Budget Statement covering the taxation measures. He will draft Sections A-C next weekend.

2. Please could I have any comments as soon as possible.

3. There are a number of paragraphs with gaps for figures, and I should be grateful if Mr Beighton and Mr Wilmott could make sure that these are filled in.

4. The Chancellor has a number of other questions.

- (a) Paragraph D20. He notes that something will need to be said about the cost of the North Sea oil measures. He has also asked about the position on oil companies' ACT. [Action: Mr Beighton.]
- (b) Paragraph D29. He would be grateful if the Minister of State could look at the drafting of the middle sentence.
- (c) Paragraph D31. Please could Mr Wilmott check that this paragraph is accurate.
- (d) Anti-avoidance Section. The Chancellor would be grateful for advice on whether the remaining Keith measures need to be mentioned. He thinks they probably do, since they raise a significant sum (£45 million in 1988-89). If so, he would be grateful for advice on where they should be mentioned, and for a short and clear draft paragraph. [Action: Mr Scholar, Mr Isaac.]
- (e) Paragraph E15. Please could Mr Beighton make sure that the wording of this paragraph is checked carefully.
- (f) Paragraph F4. The Chancellor would be grateful if the Minister of State could look at the drafting of this paragraph, and in particular the item described as "goods donated for export by a charity for relief of distress".
- (g) Paragraph F8. Please could Mr Wilmott suggest a form of words to clarify the final sentence.

ACSA

A C S ALLAN

**D. BUSINESS AND ENTERPRISE** (2523 WORKS)

D1. I now turn to the taxation of business and enterprise.

D2. The fundamental reform of the Corporation Tax system which I introduced in 1984 came fully into effect last April. The new system has undoubtedly improved the quality of business investment decisions in Britain, and is encouraging overseas companies to set up here, thus creating more jobs.

D3. During the transition to the new system, companies were given advance notice of the main rate of Corporation Tax for the year ahead. This helped them in their forward planning, and I intend as far as possible to continue the practice of setting the rate in advance. Accordingly, I can announce now that the main rate of Corporation Tax in 1987-88 will be unchanged at 35 per cent - lower than in any other major industrial nation, though the United States is now set to emulate us.

D4. The low rate of Corporation Tax enables me to introduced a further simplification into the system.



D5. At present, while companies' capital gains are liable to Corporation Tax, the amount of such gains is first adjusted by a certain fraction so that the effective rate of tax is the same as that on capital gains made by individuals. This dates back to the time when the two rates of tax were far apart.

D6. This is no longer the case: indeed, the Corporation Tax rate for small companies is now below the Capital Gains Tax rate.

D7. I therefore propose that, from today, companies' capital gains be charged at the appropriate Corporation Tax rate, without adjustment, save for the indexation which applies to all post-1982 gains.

D8. It has, however, been argued that capital gains made by companies can in some cases be taxed twice, once in the hands of the company and once in the hands of the shareholder. I believe there is some justice in this complaint. Accordingly, I propose to remedy it by allowing companies to set payments of Advance Corporation Tax against their liability to tax on capital gains.

D9. Taken together, these changes should yield £60 million in 1988-89.

D10. I have one further simplification and rationalisation of the Corporation Tax system to announce.

D11. At present, companies established before 1965 do not have to pay their Corporation Tax until 21 months after the end of the period for which it is due, while companies established since 1965 have to pay their tax after 9 months - and some building societies have to pay sooner still.

D12. This difference in treatment of different companies cannot be justified. Moreover, it is open to an abuse which could put the timing of a substantial proportion of the total Corporation Tax yield at risk.

D13. I therefore propose that all companies and building societies should be treated the same way, with all liable to pay Corporation Tax nine months after the end of the accounting period on which the tax is due. There will be a transitional period during which the change will be phased in, but I would expect it to yield around £100 million in 1988-89.

D14. I also propose to legislate now to pave the way for a new method of collecting Corporation Tax, to be known as Pay and File. At present, many company

accounts are not received in time to agree the tax liability before payment is due. So there is a laborious process of an estimated assessment from the Inland Revenue and an appeal from the company. Under Pay and File companies will estimate their tax liabilities themselves, and pay on the normal due date. Tax liabilities will be finalised once companies submit their returns and accounts. Where it turns out that the company's initial payment was too high, the Revenue will pay interest on the excess; where the initial payment was too low the company will pay interest.

D15. This new approach was set out in last December's consultative document on the recommendations in the Keith Committee Report and was generally welcomed by the business community and their tax advisers.

D16. As this is part of a wider programme of streamlining tax collection, including major developments in the Inland Revenue's computer systems, it will not come into force until the early 1990s. But by legislating now I am giving taxpayers and their advisers a firm basis on which to prepare for the new scheme.

D17. While business and industry as a whole is doing well, the North Sea oil sector has inevitably been

hard hit by last year's oil price collapse. My Rt Hon Friend the Secretary of State for Energy and I have followed closely the effects on North Sea producers and their suppliers. The industry itself is generally confident about the longer-term prospects; while as for the tax system, not only is it inherently price-sensitive, but the companies themselves have always stressed their desire for stability.

D18. However, in the light of the immediate problems, I introduced last autumn legislation to bring forward the repayment of over £300 million of Advance Petroleum Revenue Tax. This has already helped many of the smaller companies faced with cash flow difficulties.

D19. I now propose two further Petroleum Revenue Tax reliefs. First, as from today and until such time as income from new fields exceeds the costs incurred, companies may elect to have up to 10 per cent of the costs of developing new oil fields set against their Petroleum Revenue Tax liabilities in existing fields. Second, there will be a new relief against PRT for research spending on oil extraction not related to any particular field.

D20. I hope that these carefully targeted changes will give a worthwhile measure of help to the North Sea oil sector.

D21. I have to set the 1988-89 car and car fuel benefit scales for those with company cars. The car scale charges still fall well short of the true value of the benefit, and as last year I propose to increase them by 10 per cent. There will be no change in the car fuel benefit scales which, from 6 April, will also be used for VAT purposes.

D22. Last year I put the Business Expansion Scheme onto a permanent footing. This year I have two further improvements to propose. First, the rules will be relaxed to make it easier for independent film companies to benefit from the scheme. Second, for investments made in the first half of the tax year, the investor will be able to claim part of the relief against his previous year's income. This should deal with the persistent problem of the end-year bunching of BES investment, thus making it easier for companies to raise BES finance throughout the year.

D23. [Training para: to be written when policy decision finally taken.]

D24. The past few years have seen a remarkable and most welcome growth in the number of small businesses and the self-employed. The Government has done a great deal to lighten the burdens on this vitally important sector of the economy. But I am

well aware that problems remain, not least in the field of VAT.

D25. Accordingly, I asked Customs and Excise to issue a consultative document last autumn canvassing a number of changes. In the light of the responses to that document, I have four proposals to make.

D26. Perhaps the biggest problem faced by the small businessman today is the trade customer who is late in paying his bills: so late, sometimes, that VAT becomes due before the bill has been paid. I can do nothing about late payment; but I can, I hope, do something about the VAT problem.

D27. My first and most important proposal, therefore, is that, as from 1 October, companies whose annual turnover is under £½ million will be able to choose to account for VAT on the basis of cash paid and received. In other words, they will have no liability to pay VAT until they themselves have received the money from their customers. In addition to easing the cash flow problems caused by late payers, this system will of course provide automatic VAT relief for bad debts.

D28. I have to warn the House, however, that I cannot legally introduce this change without first

obtaining a derogation from the European Community's Sixth VAT Directive. I am applying for the necessary derogation today.

D29. Second, I propose to give businesses whose annual turnover is under £¼ million the option of accounting for VAT on an annual basis. That is to say, they will be able to make payments on account and send only one return a year to the Customs and Excise. This change will come into effect next year.

D30. Third, the period within which businesses must apply to be registered for VAT will be extended from ten to thirty days.

D31. Fourth, the rules for the special VAT schemes for retailers will be changed to make them simpler for small and medium-sized businesses.

D32. I believe that the changes I have outlined, and in particular the option to move to cash accounting, will be widely welcomed by the small business community. They will cost £115 million in 1987-88 and £60 million in 1988-89.

D33. In addition, I propose to increase the VAT threshold to £21,300, the maximum permitted under existing European Community law.

D34. The House will also note that, in the light of the responses to the consultative document, I shall not be going ahead either with the withdrawal of the so-called standard method of accounting for VAT for retailers or with the compulsory deregistration of traders below the VAT threshold.

D35. I have one further measure to help the small businessman, unrelated to VAT. I propose to increase the limit for Capital Gains Tax retirement relief by 25 per cent, from £100,000 to £125,000. At the same time the annual exempt amount will be increased to £6,600, in line with statutory indexation.

D36. An essential element in any ongoing programme of tax reduction and reform must always be the elimination of unintended or unjustified tax breaks which cause rates of tax generally to be higher than they need to be. Accordingly, I have four proposals to make today to this end.

D37. The first concerns VAT, and has already been the subject of extensive consultation. The House will be aware that a business that provides a service that is exempt from VAT cannot in turn deduct input tax on its purchases. But where the activities of a business are in part liable to VAT and in part exempt, the existing rules are



excessively generous as to the amount of input tax that can be deducted; and this generosity is being exploited on a growing scale. The rules must therefore be changed, and the changes will come into effect on 1 April. There will be special arrangements to help small businesses. The yield from this, which in effect is a measure of the potential revenue loss, will be some £300 million in 1987-88 and £400 million in 1988-89.

D38. Second, I propose to change the law so that companies in multinational groups which enjoy dual residence will no longer be able to secure tax relief twice on one and the same interest payment. Genuine trading companies will not be affected. This change, which will take effect on 1 April, follows the similar action taken by the United States as part of its recently-enacted tax reform package. [The House may be interested to note that, of all the substantial tax shelters removed by the American tax reform package, this is the only one that exists in this country: the others have either never existed here or have been abolished some time ago.] The change will yield £125 million in 1988-89.

D39. Third, I propose to end the present excessively generous treatment of tax credit relief for foreign withholding tax paid on interest on bank loans. In

future, banks will be able to offset this tax credit only against tax on the profit on the relevant loan, and not more widely. This will bring our rules broadly into line with those in most other countries. The change will apply from 1 April this year for new loans and from 1 April next year for existing loans. It will yield some £20 million in 1988-89.

D40. Fourth, I propose to bring to an end the unsatisfactory tax treatment of Lloyds syndicates as it applies to the so-called Reinsurance to Close system. At present, tax relief is in effect given for provision for losses that may or may not materialise, with no subsequent adjustment when the facts are known. I therefore propose to bring the tax treatment of Lloyds into line with the tax treatment of provisions for outstanding liabilities made by ordinary insurance companies and indeed of similar provision made by other financial traders. I have asked the Inland Revenue to consult urgently with Lloyds about the details of an equitable scheme. The new rules will first apply to premiums paid for the Lloyds account which closes on 31 December this year. The yield will depend on the precise details of the new treatment.

D41. I have one further proposal to make in the broad field of the taxation of business and enterprise.

D42. In my Budget last year I suggested the possibility of introducing a measure of tax relief for profit-related pay.

D43. I pointed then to two considerable advantages that might be expected to flow from arrangements which relate pay to profits. First, the workforce would have a more direct personal interest in the profits earned by their company; and, second, there would be a greater degree of pay flexibility in the face of changing market conditions, which is absolutely essential if, as a nation, we are to defeat the scourge of unemployment.

D44. Last July my Rt Hon and Noble Friend the Secretary of State for Employment, my Rt Hon Friend the Secretary of State for Trade and Industry and I presented a Green Paper on Profit-Related Pay; and I believe the time has come to introduce a scheme of tax relief broadly along the lines floated in the Green Paper.

D45. The principal change I propose is to double the proportion of an employee's profit-related pay that is eligible for tax relief from a quarter to a half. So for someone on average earnings receiving 5 per cent of their pay in profit-related form, the tax relief will be equivalent to a penny off the basic rate of income tax. Full details of the scheme are

contained in an Inland Revenue press release published today. The cost will depend on take-up: it could be £35 million in 1988-89, rising year by year as take-up grows.

D46. Profit-related pay is no panacea. But then there are no panaceas. What it is is a tool to help British business gradually to overcome one of our biggest national handicaps: the nature and behaviour of our labour market. I am today challenging British management to take advantage of that tool and to make good use of it, for the good of their company, their workforce and their country.

**E. TAXES ON SAVING**

1309.

E1. I turn now to the taxation of savings.

E2. A central theme and purpose of the Government's policies is the creation of a genuine popular capitalism: what used to be called, when ambitions were more limited and language more inhibited, a property-owning democracy.

E3. That means wider home ownership, wider share ownership, and wider pension ownership. Over the past eight years, the Government has actively promoted the first two, and has now embarked on the third. Home ownership, above all through the council tenant's right to buy. And share ownership, through the encouragement of employee share schemes, which now involve  $1\frac{1}{2}$  million workers, compared with [40,000] in 1979; through the massively successful privatisation programme, where Britain has led the world; and most recently through the Personal Equity Plan scheme, which I announced in last year's Budget and which started up on 1 January this year. More than 2,000 people a day [UPDATE AS NECESSARY] are currently taking out Personal Equity Plans, many of them first-time investors, as I had hoped.

E4. We know that 63 per cent of households now own their own homes, compared with 55 per cent in 1979. There are, however, no official figures for the rather more explosive growth of share ownership in Britain over the past eight years. The Treasury and the Stock Exchange have therefore jointly commissioned a major independent survey of individual shareholding in Britain. The results are now available. They show that there are now some xx million individual shareholders in this country, amounting to yy per cent of the total adult population, and fully three times the number there were in 1979.

E5. And then there is wider pension ownership. This will be brought about by the introduction on 1 January next year of the new personal pensions developed by my Rt Hon Friend the Secretary of State for Social Services.

E6. Personal pensions are an important dimension of ownership in three ways. First, they will enable employees - if they so wish - to opt out of their employers' schemes and made their own arrangements. Second, they will be a new opportunity for the [ ] million employees who at present do not belong to an occupational scheme. And third, people may, again if they so wish, use them to contract out of SERPS.

E7. In my Budget last year I undertook to bring forward proposals to give personal pensions the same favourable tax treatment as is currently enjoyed by retirement annuities. These were duly contained in a consultative document published last November, and the necessary legislation will be contained in this year's Finance Bill.

E8. This will also implement other useful reforms proposed in the consultative document. In particular, employers will be permitted to set up simplified occupational schemes with the minimum of red tape. This will be particularly welcome to many small employers who have been discouraged by the complexity and open-ended commitment of a full-blown final salary scheme. And there will be much greater scope for transferring between different types of pension scheme.

E9. In addition, I have decided to go beyond the proposals set out in the consultative document in one important respect. I propose to allow members of occupational pension schemes to make additional voluntary contributions, with full tax relief, to a separate plan of their own choice instead of, as now, being restricted to plans within their employer's schemes. They will be able to top their pensions right up to the present tax approval limits.

E10. The cost of the proposed tax concessions for personal pensions and freestanding additional voluntary contributions will be £75 million in 1988-89.

E11. The proposals I have outlined will make it easier for people to take their pensions with them when they change jobs, which will be good for labour mobility and independence. It will widen the range of choices people can make about their pensions; and it will mean that in future they will have more control over the way in which their pension contributions are invested.

E12. But the generous tax treatment of pensions can be justified only if it is not abused. I propose, therefore, to introduce some limited changes to the present rules to restrict the excessive relief which can be obtained in some circumstances, particularly by a few very highly paid people. These will include, for all arrangements entered into from today, an upper limit of £150,000 on the maximum permissible tax-free lump sum, coupled with more rigorous rules on how pension and lump-sum benefits can be calculated, including a stricter definition of final salary.

E13. Details of all these changes are set out in an Inland Revenue press notice published today.



E14. In my 1984 Budget I tightened the limits that apply to tax exempt life assurance issued by friendly societies. I did so because certain new friendly societies, set up purely for commercial reasons, far removed from the mutual self-help role which the movement has sponsored for decades, were engaged in large-scale exploitation of the movement's tax privileges.

E15. To improve the position of the older, long-established societies, I now propose to permit societies to offer tax-exempt policies based on annual premiums of up to £100. This will enable the older societies to survive and flourish, without creating a new loophole for the commercial societies to exploit.

E16. Finally, in this section, I turn to Inheritance Tax.

E17. In my Budget last year I abolished the pernicious tax on lifetime gifts between individuals, which was particularly damaging to the ownership and health of family business. This year I propose to extend the same exemption from tax, on similar terms, to gifts involving settled property where there is an interest in possession. This will not, however, apply to discretionary trusts.

E18. I also propose to make two minor changes affecting business assets. First, in what is perhaps an unwanted tribute to the unlisted securities market, holdings in USM companies will henceforth be treated for Inheritance Tax purposes in precisely the same way as holdings in companies with a full Stock Exchange listing. Second, business relief for minority holdings in excess of 25 per cent in unquoted companies will be increased from 30 per cent to 50 per cent. The purpose of both these changes is to concentrate business relief more accurately on those assets which could provide funds to pay the tax only at the risk of damaging the business.

E19. I am, however, conscious that the reform I introduced last year, with the transformation of Capital Transfer Tax into Inheritance Tax by the abolition of the tax on lifetime giving, while of the first importance to family businesses, did little to help the smallest taxable estates, many of which consist almost entirely of the family home, and which can find themselves taxed more heavily than when the Rt Hon Member for Leeds East first enacted the Capital Transfer Tax in 1975.

E20. I therefore propose to make a substantial increase in the threshold for Inheritance Tax, from £71,000 to £90,000, coupled with a simplification of

the rate structure from seven rates to four. As a result of this change, the number of estates liable to Inheritance Tax will be cut by roughly a third. The cost will be £70 million in 1987-88 and £150 million in 1988-89.

E21. Despite this substantial relief, however, and all the other much-needed reliefs that my predecessor and I have introduced since 1979, the House may be interested to learn that the expected yield of Inheritance Tax in 1987-88, at over £1 billion, is three times the yield of Capital Transfer Tax in 1978-79, an increase in real terms of 22 per cent.

**F. TAXES ON SPENDING**

482

F1. I now turn to the taxation of spending.

F2. I have already announced some important changes in VAT to prevent avoidance and to help the small businessman. I have no other proposals for major changes in value added tax this year.

F3. However, in the light of representations I have received, I have decided to extend slightly the VAT reliefs I introduced last year for certain aspects of charitable work.

F4. I propose to relieve charities from VAT on certain welfare vehicles used by hospices to transport the terminally ill; on installing or adapting lavatory or bathroom facilities in charity homes for the disabled; on goods [donated for export by a charity for relief of distress]; and on drugs and chemicals supplied to a charity and used exclusively in medical research. I also propose to relieve from VAT specialised location and identification equipment used by mountain rescue and first aid services.

F5. While on the subject of charitable giving, I should remind the House that this year's Finance

Bill will increase the limit on donations to charity under the new payroll giving scheme, which starts next month, from £100 to £120 a year.

F6. Next, the excise duties. I do not believe it would be right to reduce the revenue I get from the taxation of gambling. But I do believe that some readjustment within the total is called for. I therefore propose to increase the gaming machine licence duty by about a quarter, which will restore it in real terms to its 1982 level, when it was last increased; and to offset this by abolishing, from 29 March, the tax on on-course betting. I hope this measure will be of some assistance to the racing and bloodstock industry, as well as consoling those hon Members who have complained to me about the clash this year between Budget Day and the Champion Hurdle.

F7. In my Budget Statement last year, I gave advance notice of my intention to introduce a duty differential in favour of unleaded petrol so as to offset its higher production cost. I can now announce that the differential will be 5 pence a gallon. This means that the pump price of unleaded petrol should be no higher than that of 4-star leaded petrol. The change will take effect from 6 o'clock this evening.

F8. Following on from the action I took last year, I propose to increase the rates of Vehicle Excise Duty on farmers' lorries, to bring them into line with the use they make of the public roads. This change will take effect from midnight tonight. I also propose to increase the rates of duty on trade licences and to create a new taxation class for recovery vehicles.

F9. I have no further changes to propose this year in the rates of excise duty.

**G. INCOME TAX**

760

G1. Finally, I turn to income tax.

G2. There is now a worldwide consensus on the economic desirability of tax reform and tax reduction, and in particular the reduction of income tax. This was demonstrated most recently by the various national policy declarations that emerged from last month's meeting of Finance Ministers from the major industrial nations.

G3. Lower rates of tax sharpen up incentives and stimulate enterprise, which in turn is the only route to improved economic performance. And it is only by improving our economic performance that we will be able to afford to spend more on public services; only by improving our economic performance that we will be able to create jobs on the scale we all want to see.

G4. That is why, ever since we first took office in 1979, we have consistently sought to reduce the burden of income tax. We have cut the basic rate of tax from 33 per cent to 29 per cent and sharply reduced the punitive higher rates we inherited from the Party opposite. We have increased the main tax allowances by 22 per cent more than inflation,

taking almost  $1\frac{1}{2}$  million people out of income tax altogether.

G5. Year in, year out, we must seek, step by step, to carry this process further.

G6. For 1987-88 I propose to raise all the main thresholds and allowances by the statutory indexation factor of 3.7 per cent, rounded up. Thus the single person's allowance will rise by £90 to £2,425 and the married man's allowance by £140 to £3,795. The single age allowance will rise by £110 to £2,960 and the married age allowance by £170 to £4,675. The age allowance income limit becomes £9,800. I propose to raise the first, 40 per cent, higher rate threshold by £700 to £17,900, in line with statutory indexation; but the threshold for the 45 per cent rate will go up by only £200 to £20,400. The other higher rate thresholds will remain unchanged.

G7. I have two other changes in allowances to announce. First, I propose to give an additional increase in the age allowance for those aged 80 or over. For them, the increase will be double the amount due under statutory indexation, so that, for the very elderly, the single age allowance will rise by £220 to £3,070 and the married age allowance by £340 to £4,845. Around 400,000 very elderly



taxpayers will benefit from this new concession, and up to 25,000 of them will be taken out of income tax altogether.

G8. Second, the blind person's allowance has remained unchanged since 1981, when it was increased by £180 to its present level of £360. For 1987-88 I propose to increase it by a further £180, to £540.

G9. Finally, I turn to the basic rate of income tax. This is the starting rate of income tax for everyone and the marginal rate for the overwhelming majority of taxpayers.

G10. In my Budget speech last year I reaffirmed the aim set out by my predecessor in 1979, to reduce the basic rate of income tax to no more than 25 per cent. That remains my firm objective.

G11. However, given my decision to use the greater part of the fiscal scope I now have to reduce the Public Sector Borrowing Requirement, that goal cannot be achieved in this Budget.

G12. I can, however, take a further step towards it, as I did last year. I am therefore reducing the basic rate of income tax by twopence, to 27 per cent. This reduction will be worth over £3 a week to a married man on average earnings.

G13. There will, of course, be a consequential reduction in the rate of Advance Corporation Tax, and - as last year - I also propose a corresponding cut in the small companies' rate of Corporation Tax from 29 per cent to 27 per cent.

G14. The income tax changes I have announced today will take effect under PAYE on the first pay day after 17 May. They will cost a little over £2 billion in 1987-88 over and above the cost of statutory indexation.

G15. The overall cost of all the measures in this year's Budget, again on an indexed basis, is a little over £2½ billion. This is fully consistent with my objective of a PSBR of £4 billion.

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*Comments marked.*

FROM: A C S ALLAN  
DATE: 2 March 1987

MR SCHOLAR

- cc Chief Secretary
- Financial Secretary (2)
- Economic Secretary (2)
- Minister of State (2)
- Sir P Middleton
- Sir T Burns
- Sir G Littler
- Mr F E R Butler
- Mr Wilson
- Mr Cassell
- Mr Monck
- Mr Sedgwick
- Mr Odling-Smee
- Mr Culpin
- Miss O'Mara
- Miss Sinclair
- Miss Evans
- Mr Cropper
- Mr Tyrie
- Mr Ross Goobey
- Mr Battishill - IR
- Mr Isaac - IR
- Mr Painter - IR
- Mr Beighton - IR
- Mr McManus - IR
- Sir Angus Fraser - C&E
- Mr Knox - C&E
- Mr Wilmott - C&E
- Mr Bone - C&E

*Mark Done!*  
*I hope all clear -*  
*PPM have a*  
*clean retype*  
*done ASAP.*

*STW to do:*  
*(i) Review paras*  
*Section*  
*(ii) Unimp. intaxum*  
*para (after*  
*BS in 1987*  
*half of split)*  
*(iii) Re putative*  
*521 A & 521 B*

*Oh*  
*Many of the*  
*comments are the rats*  
*trying to make speed as*  
*being as possible or can*  
*be ignored*  
*At*

*tax yields (I don't*  
*see why higher*  
*rate of*  
*IT*  
*sw*  
*now for*  
*mentioned.)*  
*Mr*

**BUDGET STATEMENT: TAXATION SECTION: THIRD DRAFT**

... I attach the Chancellor's own draft of the second half of the Budget Statement covering the taxation measures. He will draft Sections A-C next weekend.

2. Please could I have any comments as soon as possible.

3. There are a number of paragraphs with gaps for figures, and I should be grateful if Mr Beighton and Mr Wilmott could make sure that these are filled in.

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4. The Chancellor has a number of other questions.

- (a) Paragraph D20. He notes that something will need to be said about the cost of the North Sea oil measures. He has also asked about the position on oil companies' ACT. [Action: Mr Beighton.]
- (b) Paragraph D29. He would be grateful if the Minister of State could look at the drafting of the middle sentence.
- (c) Paragraph D31. Please could Mr Wilmott check that this paragraph is accurate.
- (d) Anti-avoidance Section. The Chancellor would be grateful for advice on whether the remaining Keith measures need to be mentioned. He thinks they probably do, since they raise a significant sum (£45 million in 1988-89). If so, he would be grateful for advice on where they should be mentioned, and for a short and clear draft paragraph. [Action: Mr Scholar, Mr Isaac.]
- (e) Paragraph E15. Please could Mr Beighton make sure that the wording of this paragraph is checked carefully.
- (f) Paragraph F4. The Chancellor would be grateful if the Minister of State could look at the drafting of this paragraph, and in particular the item described as "goods donated for export by a charity for relief of distress".
- (g) Paragraph F8. Please could Mr Wilmott suggest a form of words to clarify the final sentence.

ACSA

A C S ALLAN

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*E* D. BUSINESS AND ENTERPRISE

*E* D1. I now turn to ~~the~~ taxation of <sup>the taxes on</sup> business and ~~enterprise~~.  
*First, taxes affecting*

*E* D2. The fundamental reform of the Corporation Tax system which I introduced in 1984 came fully into effect last April. The new system has undoubtedly improved the quality of business investment decisions in Britain, and is <sup>also</sup> encouraging <sup>more</sup> overseas companies to set up here, ~~[thus creating more jobs]~~.

*E* D3. During the transition to the new system, companies were given advance notice of the main rate of Corporation Tax for the year ahead. This helped them in their forward planning, and I intend as far as possible to continue the practice of setting the rate in advance. Accordingly, I can announce now that the main rate of Corporation Tax in 1987-88 will be unchanged at 35 per cent - lower than in any other major industrial nation, though the United States is now set to emulate us.

*E* D4. The low rate of Corporation Tax enables me to introduce a further simplification into the system.

*MCS [We don't tax enterprise.]*

*ES7 (see minute) suggests moving 2nd sentence of D2 to end of D3, with consequential redrafting. The trouble is, that makes for a dull beginning. An alternative would be to bring the last half-sentence of D3 into D2.*

*IR minute says "impossible to disprove [but short of] evidence".*

*MCS queries evidence on overseas companies - but you mentioned one!*

*J.O.S (see minute)  
(Minute)*

*IR are content but point out this ties us down a bit. But so what?*

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E D5. At present, while companies' capital gains are liable to Corporation Tax, the amount of such gains is first adjusted by a certain fraction so that the effective rate of tax is the same as that on capital gains made by individuals. This dates back to the time when the two rates of tax were far apart.

E D6. This is no longer the case: indeed, the Corporation Tax rate for small companies is now below the Capital Gains Tax rate.

*SECRET*  
E D7. I therefore propose that, from today, companies' capital gains be charged at the appropriate Corporation Tax rate, without adjustment, save for the indexation which applies to all post-1982 gains.

*B.L.C.*  
E D8. It has, however, been argued that capital gains made by companies can in some cases be taxed twice, once in the hands of the company and once in the hands of the shareholder.  $\diamond$  I believe there is some justice in this complaint. Accordingly, I propose to remedy it by allowing companies to set payments of Advance Corporation Tax against their liability to tax on capital gains.

*SECRET*  
E D9. Taken together, these changes should yield £60 million in 1988-89.

*C.Sinclair: need we say this?  
(APH: surely yes, at £60m)*

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CECS: 2 including Pay-File.

D10. I <sup>also</sup> have <sup>some</sup> ~~one~~ further simplifications and rationalisation of the Corporation Tax system to announce.

IR

D11. At present, companies established before 1965 do not have to pay their Corporation Tax until <sup>up to</sup> 21 months after the end of the period for which it is due, ~~while~~ <sup>whereas</sup> companies established since 1965 have to pay their tax after 9 months - and some building societies have to pay sooner still.

APH

D12. This difference in treatment, ~~of different companies~~ cannot be justified. Moreover, it is open to an abuse which could put the timing of a substantial proportion of the total Corporation Tax yield at risk.

APH/MCS

See F57 suggestion which I would not take.

D13. I therefore propose that all companies and building societies should be treated the same way, with all liable to pay Corporation Tax nine months after the end of the accounting period on which the tax is due. ~~There will be a transitional period during which~~ the change will be phased in, but I would expect it to yield around £100 million in 1988-89.

APH (IR are content)

D14. I also propose to legislate now to pave the way for a new method of collecting Corporation Tax, to be known as Pay and File. At present, many company

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accounts are not received in time to agree the tax liability before payment is due. So there is a laborious process of an estimated assessment from the Inland Revenue and an appeal from the company. Under Pay and File companies will estimate their tax liabilities themselves, and pay on the normal due date. Tax liabilities will be finalised once companies submit their returns and accounts. Where

it turns out that the ~~company's~~ initial payment was too <sup>low</sup> high, the <sup>company</sup> Revenue will pay interest <sup>to the Revenue;</sup> ~~on the~~ excess, where the initial payment was too <sup>high,</sup> low the <sup>Revenue</sup> company will pay interest, <sup>to the company,</sup>

E D15. This new approach was set out in last December's consultative document on the recommendations in the Keith Committee Report, and was generally welcomed by the business community and their tax advisers.

✓ APH E D16. As this <sup>change</sup> is part of a wider programme of streamlining tax collection, including major developments in the Inland Revenue's computer systems, it will not come into force until the early 1990s. But by legislating now I am giving taxpayers and their advisers a firm basis on which to prepare for the new scheme.

E D17. While business and industry as a whole is doing well, the North Sea oil sector has inevitably been

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hard hit by last year's oil price collapse. My Rt Hon Friend the Secretary of State for Energy and I have followed closely the effects on North Sea producers and their suppliers. The industry itself is generally confident about the longer-term prospects; while as for the tax system, not only is it inherently price-sensitive, but the companies themselves have always stressed their desire for stability.

IRx  
E D18. However, in the light of the immediate problems, I introduced last autumn legislation to bring forward the repayment of over £300 million of Advance Petroleum Revenue Tax. This has already helped many of the smaller <sup>and medium-sized</sup> companies faced with cash flow difficulties.

FC redraft, which you have agreed. ✓  
E D19. I now propose two further Petroleum Revenue Tax reliefs. First, as from today and until such time as <sup>the</sup> income <sup>of those</sup> from new fields exceeds the costs incurred, companies may elect to have up to 10 per cent of the costs of developing <sup>certain</sup> new ~~oil~~ fields set against their Petroleum Revenue Tax liabilities in existing fields. Second, there will be a new relief against PRT for research spending on oil extraction not related to any particular field. ~~[The treatment of research for PRT will then be closer to the Corporation Tax regime which treats all research expenditure as allowable.]~~

[See IR minute on costs & oil companies' ACT. FC advised against mentioning costs, & I think you agreed. But FST is not convinced (see minute).]  
E D20. I hope that these carefully targeted changes will give a worthwhile measure of help to the North Sea oil sector.

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USE 2<sup>nd</sup> bit

D21. I have to set the 1988-89 car and car fuel benefit scales for those with company cars. The car scale charges still fall well short of the true value of the benefit, and as last year I propose to increase them by 10 per cent. There will be no change in the car fuel benefit scales which, from 6 April, will also be used for VAT purposes.

D22. Last year I put the Business Expansion Scheme onto a permanent footing. This year I have two further improvements to propose. First, the rules will be relaxed to make it easier for independent film companies to benefit from the scheme. Second, for investments made in the first half of the tax year, the investor will be able to claim part of the relief against his previous year's income. This should <sup>reduce</sup> deal with the persistent problem of the end-year bunching of BES investment, thus making it easier for companies to raise BES finance throughout the year.

Longer, but I think the second bit helps.

~~I propose to extend the rules to include post-production distribution activities.~~ Second, there have been complaints that the present rules produce end-year bunching of BES investments, and hence crowd out some projects and lead to ~~the~~ bad decisions on others. I propose <sup>to think</sup> to permit the investor to claim part of the relief against his previous year's income. This will make

USE FST draft as amended by me.

See draft in IR minute, and alternative proposed by FST (minute).

D23. ~~[Training para: to be written when policy decision finally taken.]~~

D24. The past few years have seen a remarkable and most welcome growth in the number of small businesses and the self-employed. The Government has done a great deal to lighten the burdens on this vitally important sector of the economy. But I am

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well aware that problems remain, not least in the field of VAT.

E D25. Accordingly, I asked Customs and Excise to issue a consultative document last autumn canvassing a number of changes. In the light of the responses to that document, I have four proposals to make.

*My first two proposals will be of interest to traders whose annual turnover is under £ 1/4 million - about half of all traders who pay VAT.*

M57/C1 E

V flat AA

*I have decided to increase this limit from the £100,000 suggested in the consultative document.*

E D26. Perhaps the biggest problem faced by the small businessman today is the trade customer who is late in paying his bills: so late, sometimes, that VAT becomes due before the bill has been paid. I can do nothing about late payment; but I can, I hope, do something about the VAT problem.

C.  
We want this point about increasing the limit in somewhere. PS/MST's minute explains why they want it at the start.

E D27. My first and most important proposal, therefore, is that, as from 1 October, <sup>those businesses</sup> companies whose annual turnover is under £ 1/4 million will be able to choose to account for VAT on the basis of cash paid and received. In other words, they will have no liability to pay VAT until they themselves have received the money from their customers. In addition to easing the cash flow problems caused by late payers, this system will of course provide automatic VAT relief for bad debts.

*which means maybe half of all traders [who pay VAT] [above the VAT threshold]*

M57 AA

Ch  
Could simply refer here to "small businesses" and then add new para

"In the consultative document proposed that this system should be restricted to companies whose annual turnover was under £100,000. I have now decided to move the limit to £ 1/4 million, so that half of all companies who pay VAT will, if they choose, be able to take advantage of it"

E D28. I have to warn the House, however, that I cannot legally introduce this change without first

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obtaining a derogation from the European Community's Sixth VAT Directive. I am applying for the necessary derogation today.

*The House will note that the upper limit of £¼ million is consistently greater than the £100,000 suggested in the Committee's documents.*

E D29. Second, I propose to give businesses whose annual turnover is under £¼ million the option of accounting for VAT on an annual basis. That is to say, they will be able to make payments on account and send only one return a year to the Customs and Excise. This change will come into effect next year.

MS7:  
Instead of making quarterly returns, they will ~~pay nine~~ <sup>regular</sup> ~~monthly instalments~~ <sup>make payments</sup> on account, and then file a single return at the end of the year. This option, which offers considerable streamlining, will be available next year.

E D30. Third, the period within which businesses must apply to be registered for VAT will be extended from ten to thirty days.

*there will be changes to*  
E D31. Fourth, the rules for the special VAT schemes for retailers <sup>in particular, the simpler schemes will be made more widely available to</sup> will be changed to make them simpler for small and medium-sized businesses. *will be able to make use of the simpler schemes.*

C+E  
(changing their mind!)  
APH?

E D32. I believe that the changes I have outlined, and in particular the option to move to cash accounting, will be widely welcomed by the small business community. *The cost will be* They will cost £115 million in 1987-88 and £60 million in 1988-89.

C+E (because Keith deferment is not mentioned here, but is part of cost.)

E D33. In addition, I propose to increase the VAT threshold to £21,300, the maximum permitted under existing European Community law.

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This is double edged.  
Some people will no doubt be  
pleased, but it looks as  
though you think your  
original proposal was draft!

be pleased to know

C2 E

OK

by which retailers  
calculate their gross  
takings ~~for~~

C2 E  
(Again, original draft was  
theirs, I think.)

£ D34. The House will also ~~note~~ that, in the light of the responses to the consultative document, I shall not be going ahead either with the withdrawal of the so-called standard method <sup>calculating gross</sup> of accounting for VAT, ~~for~~ ~~retailers~~, or with the compulsory deregistration of traders below the VAT threshold.

£ D35. I have one further measure to help the small businessman, unrelated to VAT. I propose to increase the limit for Capital Gains Tax retirement relief by 25 per cent, from £100,000 to £125,000. At the same time the annual exempt amount will be increased to £6,600, in line with statutory indexation.

£ D36. An essential element in any ongoing programme of tax reduction and reform must always be the elimination of unintended or unjustified tax breaks which cause rates of tax generally to be higher than they need to be. Accordingly, I have <sup>(five)</sup> four proposals to make today to this end. ♦

X  
IR x  
(If you include D.40 A.3;  
six if controlled  
foreign coys is included)

£ D37. The first concerns VAT, and has already been the subject of extensive consultation. The House will be aware that a business that provides a service that is exempt from VAT cannot in turn deduct input tax on its purchases. But where the activities of a business are in part liable to VAT and in part exempt, the existing rules are

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C→E  
which I announced to the House last December  
C→E

excessively generous as to the amount of input tax that can be deducted; and this generosity is being exploited on a growing scale. The rules must therefore be changed, and the changes will come into effect on 1 April. <sup>For small businesses,</sup> There will be <sup>a simpler</sup> special ~~system, for small businesses, and with special reliefs, for small businesses.~~ arrangements to help small businesses. The yield from this, which in effect is a measure of the potential revenue loss, will be some £300 million in 1987-88 and £400 million in 1988-89.

AW: US clauses not yet drafted.

D38. Second, I propose to change the law so that companies in multinational groups which enjoy dual residence will no longer be able to secure tax relief twice on one and the same interest payment. Genuine trading companies will not be affected. This change, which will take effect on 1 April, follows the similar <sup>recently</sup> action taken by the United States ~~as part of its recently-enacted tax reform package.~~ [The House may be interested to note that, of all the substantial tax shelters removed by the American tax reform package, this is the only one that exists in this country: the others have either never existed here or have been abolished some time ago.] The change will yield £125 million in 1988-89.

D39. Third, I propose to end the present excessively generous treatment of tax credit relief for foreign withholding tax paid on interest on bank loans. In

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future, banks will be able to offset this tax credit only against tax on the profit on the relevant loan, and not more widely. This will bring our rules broadly into line with those in most other countries. The change will apply from 1 April this year for new loans and from 1 April next year for existing loans. It will yield some £20 million in 1988-89.

D40. Fourth, I propose to bring to an end the unsatisfactory tax treatment of Lloyd's syndicates as it applies to the so-called Reinsurance to Close system. At present, tax relief is in effect given for provision for losses that may or may not materialise, with no subsequent adjustment when the facts are known. I therefore propose to bring the tax treatment of Lloyd's into line with the tax treatment of provisions for outstanding liabilities made by ordinary insurance companies, and, indeed, of similar provision made by other financial traders. I have asked the Inland Revenue to consult urgently with Lloyd's about the details of an equitable scheme. The new rules will first apply to premiums payable for the Lloyd's account which closes on 31 December this year. The yield will depend on the precise details of the new treatment.

E42 D41. I have one further proposal to make in the broad field of the taxation of business and enterprise.

BUDGET

D 40  
THIS INSTEAD IS NOT AN  
OWN TAX OR MY TAX  
MINUS DEDUCTIONS. ALSO, WITH  
IR / EST EST / IR PROPOSAL

under which Lloyd's syndicates provide for liabilities outstanding at the end of the year. The normal tax rules for such provision do not currently apply to Reinsurance to Close. So at present, members of Lloyd's - through their syndicates - are the only traders within our tax system who have the right to decide on the level of provision for future liabilities to be deducted from their pre-tax income, and so in effect to determine their own tax bill.

(much too long!  
AA)  
APH.

IR suggest new D40A. on Keith. See minutes new draft Plugged. You Also D 40 B on Controlled Foreign Companies

INSURE D 40 A as amended. (NOT 840B)

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E43 D42. In my Budget last year I suggested the possibility of introducing a measure of tax relief for profit-related pay.

E44 D43. I pointed then to two considerable advantages that might be expected to flow from arrangements which relate pay to profits. First, the workforce would have a more direct personal interest in the profits earned by their company; and, second, there would be a greater degree of pay flexibility in the face of changing market conditions, <sup>which is something</sup> ~~which if widespread, would make a major contribution to reducing unemployment.~~ **absolutely essential** if, as a nation, we are to defeat the scourge of unemployment. <sup>3</sup>

E45 D44. Last July <sup>in conjunction with</sup> my Rt Hon and Noble Friend the Secretary of State for Employment, <sup>and</sup> my Rt Hon Friend the Secretary of State for Trade and Industry, ~~and I~~ presented a Green Paper on Profit-Related Pay, and I believe the time has come to introduce a scheme of tax relief broadly along the lines floated in the Green Paper.

E46 D45. The principal change I propose is to double the proportion of an employee's profit-related pay that is eligible for tax relief from a quarter to a half. So for someone on average earnings receiving 5 per cent of their pay in profit-related form, the tax relief will be equivalent to a penny off the basic rate of income tax. <sup>Full details of the scheme are</sup>

BUDGET

Vital

J.O-S. suggests this ~~(draft)~~ redraft (see minute); ~~submit~~ I think we need a strong statement about pay flexibility here, though perhaps tone down "absolutely essential" to "vital" (He misses the point!)

APH: Easier to read as "I presented a G.P... in conjunction with my RHF... " ? **yes!**

AW: Who's? (Andrew tells me it's Govt's Accountants Address!)

AW: Too complicated in the drafting. (I think it's fine.)

IR suggest unnecessary, since you will refer to ~~the~~ press releases generally at the start. MCS agrees.

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~~contained in an Inland Revenue press release published today.~~ <sup>inverts</sup> The cost will depend on take-up: it could be £<sup>50</sup>35 million in 1988-89, ~~and will build up to~~ <sup>rising year by</sup> year as take-up grows. <sup>substantially more than that</sup> <sup>burying</sup>

E47

D46. Profit-related pay is no panacea. But then there are no panaceas. What it is is a tool to help British business gradually to overcome one of our biggest national handicaps: the nature and behaviour of our labour market. I am today challenging British management to take advantage of that tool and to make good use of it, for the good of their company, their workforce and their country.

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MCS/P. Gray.  
(minute of 3.)

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E. TAXES ON SAVING

F E1. I turn now to the taxation of savings.

F E2. A central theme and purpose of the Government's policies is the creation of a genuine popular capitalism: what used to be called, when ambitions were more limited and language more inhibited, a property-owning democracy.

F E3. That means wider home ownership, wider share ownership, and wider pension ownership. Over the past eight years, the Government has actively promoted the first two, and has now embarked on the third. Home ownership, above all through the council tenant's right to buy. And share ownership, through the <sup>rapid growth</sup> encouragement of employee share schemes, <sup>new</sup> which now involve 1½ million workers, compared with [40,000] in 1979; through the massively successful privatisation programme, where Britain has led the world; and most recently through the Personal Equity Plans <sup>scheme</sup>, which I announced in last year's Budget and which started up on 1 January this year. <sup>In the first month of the scheme</sup> More than 2,000 people a day <sup>a day took out</sup> ~~[UPDATE AS NECESSARY]~~ are currently taking out Personal Equity Plans, many of them first-time investors, as I had hoped.

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(covers all sorts of pub. sectors housing.)

IR say not all 1½ m involved now: some may have exercised.

involved only 200,000 people in 1979, but have now benefited 1½ million employees;

APH/MCS

IR say this info was based on a special survey - they will not be in a position to update it before the Budget. be able to go back to all Plan managers again at this stage.

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The amended version is the strictly correct one, but the original has been used before. STE7?

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APH

F4. We know that 63 per cent of <sup>homes</sup> households <sup>are</sup> now owned <sup>by their occupiers</sup> their own homes, compared with 55 per cent in 1979. There <sup>were</sup> ~~are~~, however, no official figures for the ~~[rather]~~ more explosive growth of share ownership in Britain over the past eight years. The Treasury and the Stock Exchange ~~have~~ therefore jointly commissioned a major independent survey of individual shareholding in Britain. The results are now available. They show that there are now some <sup>8 1/2</sup> ~~xx~~ million individual shareholders in this country, amounting to <sup>that is almost 20</sup> ~~yy~~ per cent <sup>amounting to only 17%</sup> of the total adult population, and <sup>roughly</sup> fully three times the number there were in 1979.

See Mr M.F. Brown's minute on "trebling".

C. See ARG's minute, with a new E5.

F5. And then there is wider pension ownership. This will be brought about by the introduction on 1 January next year of the new personal pensions developed by my Rt Hon Friend the Secretary of State for Social Services.

F6. Personal pensions are an important dimension of ownership in three ways. First, they will enable employees - if they so wish - to opt out of their employers' schemes and make <sup>k</sup> their own arrangements. Second, they will be a new opportunity for the ~~10~~ million employees who at present do not belong to an occupational scheme. And third, people may, again if they so wish, use them to contract out of SERPS.

X

IR

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F E7. In my Budget last year I undertook to bring forward proposals to give personal pensions the same favourable tax treatment as is currently enjoyed by retirement annuities. These were duly contained in a consultative document published last November, and the necessary legislation will be contained in this year's Finance Bill.

APH  
F E8. <sup>The Bill</sup> This will also implement other useful reforms proposed in the consultative document. In particular, employers will be permitted to set up simplified occupational schemes with the minimum of red tape. This will be particularly welcome to many small employers who have been discouraged by the complexity and open-ended commitment of a full-blown final salary scheme. And there will be much greater scope for transferring between different types of pension scheme.

ARG x F E9. In addition, I have decided to go beyond the proposals set out in the consultative document in one important respect. I propose to allow members of occupational pension schemes to make additional voluntary contributions, with full tax relief, to a separate plan of their own choice instead of, as now, being restricted to plans within their employer's schemes. They will be able to top their pensions right up to the present tax approval <sup>benefit</sup> limits.

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IR want to put a cost para after E12, because they say the anti-abuse package is not covered separately in the FSBR.

OK

E10. The cost of the proposed tax concessions for personal pensions and freestanding additional voluntary contributions will be £75 million in 1988-89.

F10 E11. The proposals I have outlined will make it easier for people to take their pensions with them when they change jobs, which will be good for labour mobility and independence. It will widen the range of choices people can make about their pensions; and it will mean that in future they will have more control over the way in which their pension contributions are invested.

F11 E12. But the generous tax treatment of pensions can be justified only if it is not abused. I propose, therefore, to introduce some limited changes to the present rules to restrict the excessive relief which can be obtained in some circumstances, particularly by a few very highly paid people. These will include, for all arrangements entered into from today, an upper limit of £150,000 on the maximum permissible tax-free lump sum, coupled with more rigorous rules on how pension and lump-sum benefits can be calculated, including a stricter definition of final salary.

ARG a stricter definition of final salary and

E12. The net cost of the overall package is estimated at £65 million in 1988-89, but will depend very much on take-up.

E13. Details of all these changes are set out in an Inland Revenue press notice published today.

ARG

ARG

IR.

APH: again, may not need to mention separately.

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IR  
EST (IR agree)  
BUDGET

F13 E14. In my 1984 Budget I <sup>reformed</sup> tightened the limits that apply to tax exempt life assurance issued by friendly societies. I did so because <sup>the movement's</sup> certain new tax privileges were being increasingly exploited by certain new friendly societies, set up purely for commercial reasons, <sup>Friendly Societies which had been set up for purely commercial reasons,</sup> far removed from the mutual self-help role which the movement has sponsored for decades, were engaged in <sup>blatant</sup> large-scale exploitation of the movement's tax privileges.

FR

USE REVISED Para E15 as amended + APH  
VERSION of E15A.

P1. see revised para attached to EST's comments.  
And new para suggested by EST on Trade Union sickness etc benefits.

F14 E15. To improve the position of the older, long-established societies, I now propose to permit societies to offer tax-exempt policies based on annual premiums of up to £100. This will enable the older societies to survive and flourish, without creating a new loophole for the commercial societies to exploit.

F16 E16. Finally, in this section, I turn to Inheritance Tax.

F17 E17. In my Budget last year I abolished the <sup>Capital Transfer Tax,</sup> pernicious tax on lifetime gifts between individuals, which was particularly damaging to the ownership and health of family business. This year I propose to extend the same exemption from tax, on similar terms, to gifts involving settled property where there is an interest in possession. This will not, however, apply to discretionary trusts. <sup>These</sup> changes will be of benefit to unquoted companies and to heritage properties, both of which are often held in trust.

CECS

FS7

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F E18. I also propose to make two minor changes affecting business assets. First, in what is perhaps an unwanted tribute to the unlisted securities market, holdings in USM companies will henceforth be treated for Inheritance Tax purposes in precisely the same way as holdings in companies with a full Stock Exchange listing. Second, business relief for minority holdings in excess of 25 per cent in unquoted companies will be increased from 30 per cent to 50 per cent. The purpose of both these changes is to concentrate business relief more accurately on those assets which could provide funds to pay the tax only at the risk of damaging the business.

New E 18A on Heritage →

OK as amended

~~F E19. I am, however, conscious that the reform I introduced last year, with the transformation of Capital Transfer Tax into Inheritance Tax, by the abolition of the tax on lifetime giving, while of the first importance to family businesses, did little to help the smallest taxable estates, many of which consist almost entirely of the family home, and which can find themselves taxed more heavily than when the Rt Hon Member for Leeds East first enacted the Capital Transfer Tax in 1975.~~

F E20. I therefore propose to make a substantial increase in the threshold for Inheritance Tax, from £71,000 to £90,000, coupled with a simplification of

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Some drafting suggestions of mine. MCS also points out that the original sentence is v. similar to the start of E 17. AH

But I remain conscious that it

IR  
FST prefers "house" to "home". [I don't.]  
EST would also omit last 3 lines.

That year's

where

the family home is the main asset.

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the rate structure from seven rates to four. As a result of this change, the number of estates liable to Inheritance Tax will be cut by roughly a third. The cost will be £70 million in 1987-88 and £1<sup>6</sup>/<sub>50</sub> million in 1988-89.

E21. Despite this <sup>substantial</sup> relief, <sup>however,</sup> and all the other much-needed reliefs that my predecessor and I have introduced since 1979, the House may be interested to learn that the expected yield of Inheritance Tax in 1987-88, at over £1 billion, is <sup>nearly</sup> three times the yield of Capital Transfer Tax in 1978-79, an increase in real terms of <sup>over 50</sup> 22 per cent.

SEE E21A & B on YIELDS OF TAX.

<sup>18</sup>  
E21A. ~~Thanks to the efforts of this Government, the tax regime for the heritage has been much improved. Today, I have two further changes to propose. First, I am exempting from inheritance tax settled property that is put into a heritage maintenance fund within two years of the death of a life tenant. And second, I propose to improve the arrangements for acceptance of property in lieu of tax. In future, owners will have the choice between of either the present <sup>system</sup> arrangements, or an arrangement under which no interest would be charged between [the date of] the offer and [the date of] acceptance, but the tax satisfied would be based on the market value at the date of the offer and not, as now, the date of acceptance.~~

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IR x

IR (But N.B. receipts, not accruals, basis.)

OK

New IR para on heritage.

Drafted as you asked, by Ewan Houghton. I understand where it fits in the Bill.

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F. TAXES ON SPENDING

G F1. I now turn to the taxation of spending.

G F2. I have already announced some important changes in VAT to prevent avoidance and to help the small businessman. I have no other proposals for major changes in value added tax this year.

G F3. However, in the light of representations I have received, I have decided to extend slightly the VAT reliefs I introduced last year for certain aspects of charitable work.

G F4. I propose to relieve charities from VAT on certain welfare vehicles used by hospices to transport the terminally ill; ~~on installing or adapting lavatory or bathroom facilities in charity homes for the disabled; on goods [donated for export by a charity for relief of distress]; and on drugs and chemicals supplied to a charity and used exclusively in medical research;~~ I also propose to relieve from VAT <sup>and on</sup> specialised location and identification equipment <sup>employed</sup> by mountain rescue and first aid services. ~~I also propose to relieve from VAT the installation and adaptation of lavatory or bathroom facilities in charity homes for the disabled.~~

G F5. While on the subject of charitable giving, I should remind the House that this year's Finance

stat |  
["goods donated..." deleted by C+E.]

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Bill will increase the limit on donations to charity under the new payroll giving scheme, which starts next month, from £100 to £120 a year.

*Propose to maintain*  
G F6. Next, the excise duties. I ~~do not believe it~~  
~~would be right to reduce~~ the revenue I get from the  
*but to match*  
taxation of gambling, ~~But I do believe that some~~  
~~readjustment within the total is called for.~~ I  
therefore propose to increase the gaming machine  
licence duty by about a quarter, which will restore  
it in real terms to its 1982 level, when it was last  
increased; and to offset this by abolishing, from  
29 March, the tax on on-course betting. I hope this  
measure will be of some assistance to the racing and  
bloodstock industry, as well as consoling those hon  
Members who have complained to me about the clash  
this year between Budget Day and the Champion  
Hurdle.

*C + E  
[Includes VAT as well  
as excise duty.]*  
✓ G F7. In my Budget Statement last year, I gave  
advance notice of my intention to introduce a ~~duty~~<sup>tax</sup>  
differential in favour of unleaded petrol so as to  
offset its higher production cost. I can now  
announce that the differential will be 5 pence a  
gallon. This means that the pump price of unleaded  
petrol should be no higher than that of 4-star  
leaded petrol. The change will take effect from 6  
o'clock this evening.

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G F8. Following on from the action I took last year, I propose to increase the rates of Vehicle Excise Duty on farmers' lorries, to bring them into line with the use they make of the public roads. This change will take effect from midnight tonight. I also propose to increase the rates of duty on trade licences, *and to rationalise the taxation of recovery vehicles.* ~~and to create a new taxation class for recovery vehicles.~~

Mr Romanowski:

which allow motor traders to use unlicensed vehicles temporarily in their possession. And I am creating a separate taxation class for recovery vehicles, ~~or trucks designed to recover broken-down or damaged vehicles - many of which at present use trade licences~~ which can at present be licensed in various categories. This will put them all on the same basis.

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G F9. I have no further changes to propose this year in the rates of excise duty.

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**G. INCOME TAX**

H/G1. Finally, I turn to income tax.

H/G2. There is now a worldwide consensus on the economic desirability of tax reform and tax reduction, and in particular the reduction of income tax. This was demonstrated most recently by the various national policy declarations that emerged from last month's meeting of Finance Ministers from the major industrial nations.

H/G3. Lower rates of tax sharpen up incentives and stimulate enterprise, which in turn is the only route to improved economic performance. And it is only by improving our economic performance that we will be able to afford to spend more on public services; only by improving our economic performance that we will be able to create jobs on the scale we all want to see.

H/G4. That is why, ever since we first took office in 1979, we have consistently sought to reduce the burden of income tax. We have cut the basic rate of tax from 33 per cent to 29 per cent and sharply reduced the punitive higher rates we inherited from the Party opposite. We have increased the main tax allowances by 22 per cent more than inflation,

*MCS thinks the PM might not like - "if it's a consensus, it must be wrong"! indeed.*

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taking almost 1½ million people out of income tax altogether.

IR (like the Italians) want to remove G5. They point out that it's ~~not~~ applies to the whole package, but sounds odd coming immediately before you simply announce statutory indexation.

IR would omit the figure, on the grounds that the latest inflation figure is higher. Can't do that AA

~~G5. Year in, year out, we must seek, step by step, to carry this process further.~~

<sup>H5</sup>  
G6. For 1987-88 I propose to raise all the main thresholds and allowances by ~~the~~ statutory indexation factor of 3.7 per cent, rounded up. Thus the single person's allowance will rise by £90 to £2,425 and the married man's allowance by £140 to £3,795. The single age allowance will rise by £110 to £2,960 and the married age allowance by £170 to £4,675. The age allowance income limit becomes £9,800. I propose to raise the first, 40 per cent, higher rate threshold by £700 to £17,900, in line with statutory indexation; but the threshold for the 45 per cent rate will go up by only £200 to £20,400. The other higher rate thresholds will remain unchanged.

<sup>H6</sup>  
G7. I have two other changes in allowances to announce. First, I propose to give an additional increase in the age allowance for those aged 80 or over. For them, the increase will be double the amount due under statutory indexation, so that, for the ~~very~~ elderly, the single age allowance will rise by £220 to £3,070 and the married age allowance by £340 to £4,845. Around 400,000 ~~very elderly~~

MCS reckons even over 80s don't think of themselves as 'very elderly'. But we've got to say something; I'd keep it the first time but omit the second. ✓ AA

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taxpayers will benefit from this new <sup>measure</sup> concession, and up to 25,000 of them will be taken out of income tax altogether.

H7 G8. Second, the blind person's allowance has remained unchanged since 1981, when it was increased by £180 to its present level of £360. For 1987-88 I propose to increase it by a further £180, to £540.

H8 G9. Finally, I turn to the basic rate of income tax. This is the starting rate of income tax for everyone and the ~~marginal~~ rate for the overwhelming majority of taxpayers.

ES7 suggests to "only".  
I prefer "marginal" - it's a concept that's getting more attention in the press now, is essential to our case on incentives.

Stat/

H9 G10. In my Budget speech last year I reaffirmed the aim set out by my predecessor in 1979, to reduce the basic rate of income tax to no more than 25 per cent. That remains my firm objective.

H10 G11. However, given my decision to use the greater part of the fiscal scope I now have to reduce the Public Sector Borrowing Requirement, that goal cannot be achieved in this Budget.

H11 G12. I can, however, take a further step towards it, as I did last year. I am therefore reducing the basic rate of income tax by twopence, to 27 per cent. This reduction will be worth over £3 a week to a married man on average earnings.

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H12  
G13. There will, of course, be a consequential reduction in the rate of Advance Corporation Tax, and - as last year - I also propose a corresponding cut in the small companies' rate of Corporation Tax from 29 per cent to 27 per cent.

Taken together with the income tax change, this will mean a significant reduction in the tax burden on small businesses, which are so crucial for future growth and employment.

↑ OK  
MCS/CECS: This or something to take credit for helping small firms.

H13  
G14. The income tax changes I have announced today will take effect under PAYE on the first pay day after 17 May. They will cost a little over £2 billion in 1987-88 over and above the cost of statutory indexation.

H14  
G15. The overall cost of all the measures in this year's Budget, again on an indexed basis, is a little over £2½ billion. This is fully consistent with my objective of a PSBR of £4 billion.

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MR 9/64

**BUDGET SECRET AND PERSONAL**



COPY 8 NO 10

FROM: A C S ALLAN  
DATE: 2 March 1987

MR C W KELLY

214 WTRMS

cc: EST  
Sir P Middleton  
Sir T Burns  
Mr Cassell  
Mr Scholar  
Mr Peretz

**BUDGET SPEECH: EXCHANGE CONTROL**

... I attach the Chancellor's own draft of this section of the Budget Speech.

2. Please could I have any comments as soon as possible.

*ACSA*  
A C S ALLAN

X. EXCHANGE CONTROL

X1. Before I turn to my proposals for changes in taxation, I have one other important change of a specific nature to announce.

X2. In 1979, a few months after we had first taken office, my predecessor announced the abolition of exchange controls, which had been in continuous operation ever since the outbreak of war in 1939. That bold action has, over the past 7½ years, proved wholly beneficial to the British economy; and I am glad to note that other European countries are now moving in the same direction.

X3. But although the operation of exchange control has ceased, the Exchange Control Act itself remains on the Statute book. So long as it does, there is likely to persist a nagging uncertainty that, in some circumstances, exchange control might be reimposed; and such uncertainty could be damaging.

X4. I have therefore concluded that the time has come to repeal the Act. The necessary legislation will be contained in this year's Finance Bill.

X5. I note that, in a major speech in New York in September, the Deputy-Leader of the Labour Party declared that, and I quote:

"The Labour Party has no intention of reintroducing statutory exchange controls".

I am confident, therefore, that the proposal I have just made will be welcomed on all sides of the House.

## BUDGET SECRET



FROM: S P Judge

DATE: 3 March 1987

PS/CHANCELLOR

cc PS/Chief Secretary  
 PS/Financial Secretary  
 PS/Economic Secretary  
 Sir Peter Middleton  
 Sir Terence Burns  
 Sir Geoffrey Littler  
 Mr F E R Butler  
 Mr Cassell  
 Mr Monck  
 Mr Culpin  
 Miss O'Mara  
 Miss Sinclair  
 Miss Evans  
 Mr Cropper  
 Mr Tyrie  
 Mr Ross Goobey  
 Sir Angus Fraser - C&E  
 Mr Knox - C&E  
 Mr Wilmott - C&E  
 Mr Bone - C&E

**BUDGET STATEMENT: TAXATION SECTION: THIRD DRAFT**

The Minister of State has seen your (BLO) note of 2 March to Mr Scholar. He had the following drafting suggestions.

Paragraph D25: add at end:

"My first two proposals will be of interest to traders whose annual turnover is under £¼ million - ~~about~~ [half] of all ~~VAT~~ payment traders. *who pay VAT*"

Paragraph D27: replace "companies whose annual turnover is under £¼ million" with "these companies".

Paragraph D29: replace "businesses whose annual turnover is under £¼ million" by "these businesses".

The reason for separating the quantification of those under the £¼ million threshold from the paragraph on annual accounting is that only about half of those formally eligible for it will in fact want to use it. The rest - eg retailers and builders

(D29)

✓  
 Agreed with  
 PS/MS7.



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- are already on special schemes. But the Minister thinks it is useful to indicate that the small business package does apply to a significant number of traders.

Paragraph D29: replace 2nd+3rd sentences with:

"Instead of making quarterly returns, they will pay nine monthly instalments on account, and then file a single return at the end of the year. This option, which offers considerable streamlining, will be available next year".

Paragraph F4: replace with:

"I propose to relieve charities from VAT on certain welfare vehicles used by hospices to transport the terminally ill on goods [intended] for export which are donated to a charity for the relief of distress; on drugs and chemicals used by a charity in medical research; and on specialised location and identification equipment employed by mountain rescue and first-aid services. I also propose to relieve from VAT the installation and adaptation of lavatory or bathroom facilities in charity homes for the disabled".

I have cleared these redrafts with Customs (Mr Wilmott and Ms Barrett).

On the "goods for export donated to a charity" point, it is important that the Budget speech is technically accurate. The export itself need not be for relief (it could be for fund-raising); conversely the charity must exist for relief.

(Mr Wilmott is minuting separately in reply to your other queries.)

S P J

S P JUDGE  
Private Secretary

FROM: A ROSS GOOBEY  
DATE: 3 MARCH 1987

CHANCELLOR ✓

cc Chief Secretary  
Financial Secretary  
Economic Secretary  
Minister of State  
Miss Sinclair  
Miss Noble  
Mr Cropper  
Mr Tyrie  
Mr Corlett-IR  
Mr Munro-IR

### PENSIONS PACKAGE

Messrs Corlett and Munro of Inland Revenue, Miss Noble, Miss Sinclair and I have discussed further the best way to promulgate the pensioner package both in your speech and thereafter.

2. You should be aware that Mr Fowler is making a speech to the FT Pensions Conference on 19 March at which he wishes to make announcements about the starting date for Personal Pensions and the contracted-out rebate, if this is constitutionally proper.

3. Your latest speech draft (2 March) has a much lengthened passage E5 to E13 on pensions which rightly highlights the total pensions strategy of which this Budget's announcements are only part; the ad-hoc group would make the following comments.

4. In E5, there is unease about the use of the word "ownership" in this context. Although you closely associate it with the personal pension regime, it is likely to revive the argument that the assets of occupational schemes "belong" to the members. I would suggest in E5 "And then there is the greater sense of ownership in wider pension provision. Already 11 million employees are members of occupational pension schemes and there are 5 million occupational pensions in payment. The Government has <sup>taken steps to</sup> instigated a strategy which will enable all employees to participate in a

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pension scheme, either that of their employer or one which they arrange themselves. [ This process will give added momentum to the steady improvement in the real income of pensioner households which has taken place under this Government and reduce the unfunded total reliance on the state which many of our competitor nations are faced with in the 21st century.]"

*In the House, I think this would provoke heckling & detract from the positive measures to follow.*

5. Then, subject to your discussion with Mr Fowler about announcing the starting date, you can go into E6 "The introduction of personal pensions, developed by my rt hon Friend the Secretary of State for Social Services, is an important dimension in this sense of ownership in three ways ....."

6. In E9, before "limits" in the final line, I suggest insert "benefit".

7. In E12, the definition of final salary was, I believe, intended to apply to existing arrangements. The sentence could be rearranged to read: "These will include a stricter definition of final salary and, for all arrangements entered into from today ....."

8. As to presentation, you will probably want to allow Mr Fowler sight of the draft passage and agree which of you is to make which announcement. We also suggest that DHSS, in consultation with the Inland Revenue, produce a glossy booklet drawing together all the changes in the pensions regime made over the past three years, perhaps between the Budget and the passage of the Finance Bill, perhaps after Royal Assent.

*Widier to wait until after Royal Assent, but we clearly want good publicity for the changes straight away.*

9. On Budget Day, the Inland Revenue press release will be in three sections: Headlines, detailed summary and discussion paper. This will be aimed at respectively the instant comments, the detailed "Eric Short" comment and the pensions industry.

10. The Inland Revenue is providing the Financial Secretary with a Standard Budget Brief and I intend to bring up-to-date the more political presentational paper I submitted to the Overview.

11. Does this meet with your approval?

*ARh*

CONFIDENTIAL

From: J ODLING-SMEE  
3rd March 1987

PRINCIPAL PRIVATE SECRETARY

cc Sir Terence Burns  
Mr Monck  
Mr Scholar

BUDGET STATEMENT: TAXATION SECTION: THIRD DRAFT

Two comments on this. First, paragraph D2 says that the new corporation tax system is encouraging overseas companies to set up here, thus creating more jobs. The former is probably true, but it does not necessarily follow that more jobs are created. With a floating exchange rate, it is quite likely that the jobs in the new companies displace existing jobs. It might be wise to end the paragraph at "here".

2. Secondly, two completely different conditions for a greatly improved employment situation are mentioned. In paragraph D43 a greater degree of pay flexibility is said to be absolutely essential, and in G3 it is an improvement in our economic performance which is a necessary condition. While these two are not inconsistent, it might avoid difficulties if one of them were changed. I suggest watering down D43 somewhat, for example to read:

"... changing market conditions, which is something which, if widespread, would make a major contribution to reducing unemployment."

That would leave G3 unchanged, which is appropriate since it is a more general statement and comes in the final section.

*JOL 01*

J ODLING-SMEE

*Not really.  
Pay flexibility  
is part of  
improving  
economic  
performance.*



## BUDGET CONFIDENTIAL



FROM: P D P BARNES  
 DATE: 4 March 1987

x4349

MR SCHOLAR

cc PS/Chancellor  
 PS/Chief Secretary  
 PS/Financial Secretary  
 PS/Minister of State  
 Sir P Middleton  
 Sir T Burns  
 Sir G Littler  
 Mr F E R Butler  
 Mr Wilson  
 Mr Cassell  
 Mr Monck  
 Mr Sedgwick  
 Mr Odling-Smee  
 Mr Culpin  
 Miss O'Mara  
 Miss Sinclair  
 Miss Evans  
 Mr Cropper  
 Mr Tyrie  
 Mr Ross Goobey

Mr Battishill - IR  
 Mr Isaac - IR  
 Mr Painter - IR  
 Mr Beighton - IR  
 Mr McManus - IR

Sir Angus Fraser - C & E  
 Mr Knox - C & E  
 Mr Wilmott - C & E  
 Mr Bone - C & E

<sup>A</sup>  
 BUDGET STATEMENT: TAXTION THIRD DRAFT  
<sub>L</sub>

The Economic Secretary has seen the Chancellor's draft of the Second half of the Budget Statement, attached to Mr Alan's minute of 2 March.

2. The Economic Secretary had the following comments:

D2 and 3

3. The Economic Secretary thinks that the second half of the last sentence of D2 is justified by the last sentence of D3. He

suggests transferring the second sentence of D2 to the end of D3 and phrasing it as follows: "Just as the new system has undoubtedly improved the <sup>quality</sup> ~~policy~~ of business investment decisions in Britain, so the 35 per cent rate is encouraging overseas companies to set up here, thus creating more jobs".

D14

4. In order to end the paragraph on a favourable note the Economic Secretary suggests reversing the order of the two elements of the last sentence. The last sentence might read: "Where it turns out that the initial payment was too low, the company will pay interest to the Revenue; where the initial payment was too high, the Revenue will pay interest to the company."

D40

5. Subject to the comments of the Inland Revenue, the Economic Secretary would prefer an alternative second sentence along the following lines. "At present, <sup>members of</sup> Lloyds <sup>through their</sup> syndicates are the only traders within our tax system who have ~~an absolute~~ right to decide on the level of provision for future liabilities to deduct from their pre-tax income, and so in effect to determine their own tax bill."

E14

6. The Economic Secretary would like to replace the second sentence by the following: "I did so because the movement's tax privileges were being increasingly exploited by certain new Friendly Societies which had been set up for purely commercial reasons".

E15

7. The Economic Secretary would prefer to replace the existing paragraph E15 by the following: "On the <sup>However,</sup> other hand, I am anxious that the traditional Friendly Societies, which have played a valuable part in mutual self-help for many generations, should

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be able to plan for the future with confidence. To raise the [existing tax-exempt] limits would merely invite a return to the commercial exploitation which led to the changes of 1984. [The existing tax-exempt limits, being based on <sup>the</sup> sums assured <sup>and</sup> annuity payments, tends in practice to be more restricted for the traditional societies, <sup>which</sup> because they generally offer much longer term policies.] I have therefore decided to replace the existing limits with a new limit based on annual premiums. I propose to set this at £100 per annum, which will make little difference to the commercial societies but will greatly increase the scope of the traditional societies to offer life ~~and annuity~~ policies to their members".

A

→ see later E57 comments. → "what is the proposal"

E19

8. The Economic Secretary would omit the last 3 lines

G9

The Economic Secretary suggests replacing 'marginal' by 'only'.

R<sub>B</sub>

P D P BARNES  
Private Secretary