PO/CH/NL/0018 Part A

SECRET

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PART A

PO -CH /NL/0018

PART A

1987 BUDGET FINANCIAL STATEMENT AND BUDGET REPORT AND PUBLIC SECTOR BORROWING REQUIREMENT

DD's 25 years NAZ 23-03-95.

STARTS: 20-02-87

6-3-87

CLOSED

CONTINUED ON:-

PART B

1987
Budget

FSBR

+ PSBR

TB 16/2/45

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Annex B4, note 9

Chancellor

FSBR

This is it as it went to the printers on Saturday.

Camps Evans will be reading at press from 9.00 on Monday. I hope there will be no problems but I shall be at home later on Sunday evening (690-3491).

Michael Scholar

Ch
Gone to printers, may not have back.

ps8/45A

UNCLASSIFIED

FROM: A C S ALLAN
DATE: 16 February 1987

MISS C EVANS

cc Mr Scholar

PRICE OF THE FSBR

The Chancellor was grateful for your minute of 13 February, and is content for the FSBR to cost £6.90.

ACSA

A C S ALLAN

CE46

FROM: MISS C EVANS
DATE: 13 FEBRUARY 1987

MCS 13/2

1. **MR SCHOLAR**

2. **CHANCELLOR OF THE EXCHEQUER**

OK

PRICE OF THE FSBR

We propose that this year the FSBR should cost £6.90, an increase of 4½ per cent on last year's price of £6.60. You will recall that last year the increase over 1985 was more than 23 per cent. Are you content with £6.90 please?

C Evans

MISS C EVANS

COPY NO 2 OF 28

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FROM: P N SEDGWICK
DATE: 20 FEBRUARY 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Sir G Littler
Mr F E R Butler
Mr Cassell
Mr Monck
Mr Odling-Smee
Mr Scholar
Mr Culpin
Mr S Davies
Mr Mowl
Mr Riley
Mr Cropper
Mr Tyrie
Mr Ross Goobey

Mr Battishill IR
Sir Angus Fraser C&E

THE PSBR IN 1987-88

Mr Allan's minute to Mr Mowl of February 11 (copy attached) asked for an urgent update of the prospects for public sector finances in 1987-88 and beyond in the light of the recent monthly figures on borrowing. The attached paper by Colin Mowl and me provides this reassessment for 1987-88.

2. By this stage of the budget preparations our projections of public finances are, as the note explains, on a post-budget basis. The forecast for the PSBR in 1987-88 will of course vary with any changes to the assumed package. Because we have produced this update quickly and because new information on the outturn for 1986-87 and on prospects for 1987-88 will become available between now and the completion of the FSBR we and the tax forecasters in the revenue departments will want to make further changes to the underlying forecast in the next few weeks.

3. We have included in the attached note a detailed account of the most up to date forecast for the PSBR in 1986-87. Our latest estimate is for a PSBR of £4.3b. This is identical to the forecast in Colin Mowl's note to you of February 13 covering the draft monthly note on the PSBR. We

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are likely to make some further changes to our forecast for 1986-87 in the light of the CGBR(O) figures for February which we will get on March 2. Our current estimate of the PSBR in 1987-88 is just under £3½b., assuming the package in the score card for your February 16 overview). As you will see from the attached note we have re-examined in some detail the prospects for borrowing by local authorities and public corporations. It goes without saying that predictions of behaviour in these areas have very wide error margins around them.

4. When we have your reactions to the updated projections it will be necessary to consider how you want to present the fiscal prospect for 1986-87 and 1987-88 in the FSBR. The decisions you take will affect the figures and text in parts 1, 3 and 6 of the FSBR. (Messrs Odling-Smee and Riley will let you have a further submission in due course on the presentation in part 2 of the FSBR of the fiscal numbers for the later years.)

5. You have indicated that you would like to publish an estimate of the PSBR in 1986-87 if anything a little above our central view of the likely outturn. Similarly you have indicated a desire to choose a forecast PSBR for 1987-88 - after taking account both of any changes to the package and the figure published for 1986-87 - that allows some margin for safety. We will prepare the numbers for the FSBR - and in particular the text for part 6 - in the light of your decisions on what PSBR numbers to show.

P N SEDGWICK

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FROM: A C S ALLAN

DATE: 11 February 1987

cc Sir P Middleton
Sir T Burns
Mr Cassell
Mr Peretz
Mr Sedgwick
Mr Scholar
Mr Ritchie
Mr Devereux
Dr Clark

PSBR IN JANUARY

The Chancellor was grateful for your note of 10 February. In the light of the January figures, he would like an urgent revision of the outlook for 1987-88 (and thereafter). There must be a strong presumption that the current Budget package would produce a lower PSBR than that at present projected, and he might well wish to show this.

A C S ALLAN

200/2

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THE PSBR IN 1987-88

INTRODUCTION

This paper re-assesses the prospects for public finances in 1987-88 in the light of the most recent developments.

2. The forecast reported here differs from the January forecast in that it is on a post-budget basis. The most recent forecasts for taxes provided by Inland Revenue and Customs and Excise incorporate both any changes in the underlying judgements on yields and the assumed effects of the budget package. The package used here is that described in the fifth budget scorecard (Ms Sinclair's minute of February 12: this hardly differs from the sixth scorecard, circulated by Mr Scholar on February 19). The projections of future output, incomes, etc on which the estimates for public finances are based have barely changed since the January forecast. The submission on the Draft Industry Act forecast, which we will send you on Tuesday February 24, will discuss the small changes in the economic prospect that the most recent data and developments suggest.

3. The rest of this paper is arranged as follows:

Section I summarises the latest forecast and compares it with the January exercise and the 1986 FSBR

Section II discusses CG revenues, expenditure and borrowing

Section III deals with LA's borrowing

Section IV deals with PC's borrowing

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I PSBR PROSPECTS: SUMMARY

4. Table 1 summarises the latest data and forecasts for 1986-87

Table 1: PSBR in 1986-87 - £ billion

	CGBR(O)			LABR			PCBR			PSBR		
	Budget	Jan F'st	Latest	Budget	Jan F'st	Latest	Budget	Jan F'st	Latest	Budget	Jan F'st	Latest
April to January	4.0	2.0	2.1	0.4	-0.3	-0.6	-0.2	-0.6	-1.1	4.2	1.1	0.4
1986-87	6.1	5.2	4.7	1.6	1.1	0.9	-0.6	-1.1	-1.3	7.1	5.2	4.3

The "news" in the January figures was mainly on the local authorities and public corporations. Cumulative borrowing to end-January by these two sectors taken together was £1.9 billion below the cumulative budget profiles for the first ten months of 1986-87 and £¾ billion lower than in the January Forecast. Over half of the net undershoot on the prediction in the January forecast was the result of downward revisions to the LABR and PCBR in earlier months rather than an overestimate of borrowing in January itself. The cumulative outturn for the CGBR(O) to January was slightly higher than forecast, but for other reasons the forecast CGBR(O) for the year as a whole has been revised down by £½ billion since January. This revision to the CGBR(O) was reported in the draft monthly note on the PSBR, circulated by Mr Mowl on 13 February, which included the new forecast of the PSBR in 1986-87 of £4.3 billion.

5. Table 2 compares the PSBR forecast for 1987-88 with the January forecast.

Table 2: PSBR and Fiscal Adjustment - £ billion

	Fiscal Adjustment		PSBR		Change in PSBR Prospect*
	January Forecast	Latest	January Forecast	Latest	
1986-87	-	-	5.2	4.3	-0.9
1987-88	2.9	2.1	4.3	3.4	-0.1

* equals for 1987-88 the assumed change in PSBR less any change in the fiscal adjustment

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6. The first year effect on the PSBR (from an indexed base) of the package assumed in the latest forecast is £2.1b. The effect of the cut in the basic rate is itself £2.1b. A number of small measures together offset the extra revenue from the VAT partial exemption measure.

7. The January forecast assumed cuts in income tax (achieved by raising allowances rather than cutting the basic rate) with a first year PSBR effect of £2.9b.

8. Taking account of the difference in the assumption on the fiscal adjustment plus other changes in the forecast, the PSBR forecast for 1987-88 comes out at just under £3½ billion. Table 3 shows that most of this revision occurs on central government own account borrowing. The main contributions to the reduction of £0.8 billion in the CGBR(O) are:

- 0.8 smaller fiscal adjustment allocaated to tax cuts than in the January forecast.
- 0.5 better ECGD trading performance due to refinancing of Nigerian debt.
+ 0.3 lower North Sea Revenues mainly reflecting a lower oil price
+ 0.2 changes in other receipts

- £0.8b.

9. The forecast of the LABR has been revised down slightly, in line with the revision to 1986-87, mainly the result of revised view on LA capital receipts, in part offset by a lower assumed increase in LA rates. There is a very modest reduction in the PCBR in the light of a change in view of the trading surpluses PC's are likely to achieve with the economy growing at 3 per cent or thereabouts.

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Table 3: Sectoral Components of PSBR in 1986-87 and 1987-88 - £ billion

	CGBR(O)		LABR		PCBR	
	January	Latest	January	Latest	January	Latest
1986-87	5.2	4.7	1.1	0.9	-1.1	-1.3
1987-88	3.2	2.4	1.9	1.8	-0.8	-0.9

10. Table 3 shows that even with the modest downward adjustments to the LABR and PCBR in 1987-88 the central expectation, as in the January forecast, is that both the LABR and PCBR are likely to rise in 1987-88, after falling in the two previous years, 1985-86 and 1986-87. The rise in the LABR is mainly due to a smaller LA rates increase in 1987-88 than in 1986-87, with little change in the growth of expenditure. The rise in the PCBR primarily reflects the privatisation of British Gas (ie its transfer from the PC sector). Adjusted for privatisation the PCBR is forecast to fall in 1987-88. Sections III and IV of this note consider in more detail the plausibility of this aspect of the forecast. The next section reviews the forecast of the CGBR(O).

II CGBR(O)

11. Table 4 compares the latest and January forecasts of the CGBR(O). The downward revision since January to the forecast for 1986-87 is mainly due to a reduction in supply expenditure. There is also a small upward revision to Customs & Excise taxes. The reduction for 1987-88 is mainly the result of the £¾ billion difference in the assumed Budget package.

Table 4: CGBR(O) £billion

	1985-86	1986-87	1987-88
January Forecast	4.1	5.2	3.2
Latest	4.1	4.7	2.4

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Central Government Expenditure

12. Little new information has emerged on central government expenditure. The prospect for 1987-88 remains much the same as envisaged in the January Forecast.

Central Government Revenues

13. Total central government taxes and royalties in 1986-87 are now forecast at £104.2 billion, unchanged from the January forecast. An upward revision of £350 million to the forecast of tobacco duty receipts, reflecting the evidence now emerging of much greater than expected pre-Budget forestalling, is largely offset by a downward revision of £300 million to VAT receipts, in the light of the most recent information on the inflow of tax receipts. On Customs and Excise advice, we are now attributing rather more of higher than forecast VAT receipts to a once-for-all effect from Keith changes than we did earlier.

14. As compared with the January forecast, our view of the underlying path for non-North Sea taxes in 1987-88 has not changed significantly. The revisions to the VAT and tobacco duty forecasts for 1986-87 carry through to 1987-88, but are broadly offsetting. For North Sea revenues, however, we have revised down the January forecast by £0.3 billion as a result of the lower oil price assumption.

15. Among the non-tax items which count towards central government receipts, the main change since January has been a reduction of £0.5 billion in the projected trading deficit of ECGD, as a result of recent decisions on the refinancing of Nigerian debt. This scores as an increase in other central government receipts.

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III LOCAL AUTHORITY BORROWING

16. Table 5 shows the January and latest forecasts of the LABR, together with recorded data for earlier years. The forecasts of the LABR in 1986-87 has been revised down by £0.2 billion since January as in the latest monthly note. The forecast for 1987-88 has been revised down by only £0.1 billion however because rate increases now look likely to be slightly lower than assumed in January and the estimate of current expenditure has increased a little.

Table 5 : The LABR - £ billion

	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88
January Forecast	-0.2	0.1	1.2	2.4	1.7	1.1	1.9
Latest						0.9	1.8

17. The forecast of the LABR in 1986-87 takes into account the outturn so far, but is heavily influenced by the historical record of the level of borrowing in the last two months of the financial year, and a recent DOE survey of the authorities' borrowing intentions in the last quarter of the year, the first results of which have become available since the January Forecast was completed. The forecast also produces a complete picture of local authorities' income and expenditure accounts as a cross-check. This cross-check has severe limitations however as latest data for 1986-87 covers the first half of the financial year only and is not comprehensive. For example, there are no outturn data yet on the authorities' current expenditure in 1986-87 - the quarterly figures for the first half of the year published by the CSO are based on the authorities' budgets, not on information about expenditure actually undertaken.

18. Table 6 sets out the past experience of borrowing in February and March and the forecast for the same two months this year.

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Table 6 : LABR in February and March - £ billion

	1982	1983	1984	1985	1986	Average 1982-86	1987 Forecast
Cash	0.6	1.3	1.2	1.5	1.2	1.1	1.5
1987 prices	0.8	1.5	1.3	1.6	1.2	1.3	1.5

19. The forecast for LA borrowing in February and March is slightly higher, though not by much, than the average for previous years because - faut de mieux - we have given a good deal of weight to the DOE Borrowing Survey. This survey has always overpredicted borrowing, but table 7 shows that an allowance is made in the forecast for the average bias. If the error this year were higher than average - for example at the top of the range of past errors - the LABR in 1986-87 as a whole would be £0.2 billion lower than the current forecast ie. £0.7 billion rather than £0.9 billion.

Table 7 : DOE Borrowing Intentions Survey - £ billion

	1983 Q1	1984 Q1	1985 Q1	1986 Q1	Average 1983-86	1987 Q1
1. Survey	1.8	1.6	1.5	2.0	1.7	2.1
2. Outturn	1.1	1.1	1.2	1.3	1.2	1.6*
3. Error (2-1)	-0.7	-0.5	-0.3	-0.7	-0.5	-0.5*

* Forecasts

20. The forecast of the LABR in 1987-88 is based largely on a projection of the detailed income and expenditure accounts for the LA sector. Table 8 sets out the main elements of the authorities' accounts using national income accounting concepts.

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Table 8 : Local Authorities Income Expenditure and Borrowing - £ billion (% changes in brackets)

		1985-86 Outturn	1986-87 Budget Forecast	1986-87 Latest Forecast	1987-88 Latest Forecast
1.	Rates	13.8 (6.7)	15.6 (13.8)	15.5 (12.5)	16.7 (7.5)
2.	Current grant	20.7 (1.2)	21.5 (6.7)	22.3 (7.8)	24.0 (7.6)
3.	Other current income	5.6 (5.7)	5.4 (3.7)	5.8 (3.0)	5.9 (1.9)
4.	Current expenditure	38.2 (4.9)	40.6 (7.6)	41.3 (8.1)	45.0 (9.0)
5.	GDFCF	4.0 (10.1)	3.6 (4.1)	3.7 (-6.5)	3.8 (3.0)
6.	Capital grants (net) and net lending	-0.4	-0.2	-0.3	-0.3
7.	Other	-0.1	0.1	-0.2	-0.1
8.	LABR (-1-2-3+4+5+6+7)	1.7	1.6	0.9	1.8

11. Table 8 illustrates why the LABR is forecast to rise in 1987-88. Gross current expenditure is forecast to rise at about 9 per cent per annum, a little faster than in 1986-87, but rate income is projected to increase much less than in 1986-87. Together with some rise in capital spending this pattern makes an increase in the LABR on the low 1986-87 outcome very likely indeed. The rest of this section examines the following key components in turn:

(i) rates

(ii) current expenditure and balances

(iii) GDFCF and other capital

12. The basis of the **rates** forecast for 1987-88 has changed since the January Forecast. In the January Forecast the forecast was largely determined by the projections of current expenditure and grant on the one hand and likely changes in rate fund balances on the other. While the rates forecast was influenced by anecdotal evidence on likely rate increases there was no firm information on these. In the recent past the DOE has begun to receive

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information from the local authorities on agreed rate increases. Most of the information for England is from the shire counties, with little or nothing from the metropolitan authorities. The average increase for England, based on a relatively small sample, is 7 to 8 per cent. The available figures for Wales and Scotland are higher than this. Nevertheless LG advise that, because the English metropolitan authorities and district councils are expected on average to agree lower rates increases than those for the counties (in part because a substantial proportion are rate capped), an average increase of 7 to 8 per cent for the UK as a whole is the current best estimate. This is slightly lower than in the January Forecast, and other things equal, would increase the LABR by £0.1 billion.

Table 9 : Rate Income - % change

1985-86	1986-87	1987-88	
		January Forecast	Latest
6.7	12.5	8.2	7½

13. About three quarters of **current expenditure** is on wages and salaries. The basis of the forecast is an assumption that local authority employees receive earnings increases in line with the private sector, with the exception of the teachers who are assumed to receive increases in line with the Baker proposals. Table 10 shows the forecast for average earnings. The 1985-86 increase for local authorities was artificially low because of the timing of the interim award to teachers.

Table 10 : Average Earnings - % change

	1985-86	1986-87	1987-88
Local authorities	3.0	9.8	9.6
Private sector	8.6	7.3	7.1

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۲۴. The forecast has a small rise in local authority employment of ¾ per cent a year (full time equivalents). This is in line with recent trends in 1986-87.

۲۵. Current estimates suggest little change in rate fund balances in 1986-87, when rate increases were relatively high, but the authorities are expected to run rate fund balances and special funds down in 1987-88, when rate increases are relatively low. The latest forecast of current expenditure, grant and rates implies a reduction in rate fund balances of about £½ billion (GB). DOE consider such a reduction plausible. Reductions in balances score as an increase in borrowing: a larger assumed reduction would imply a higher forecast LABR.

۲۶. The forecast of capital spending is summarised in table 11. The forecast of net capital spending (row 4) has been reduced a little since January because there are indications that recent capital receipts have been higher than assumed.

Table 11 : Local Authority Capital Expenditure* - £ billion

		1985-86	1986-87		1987-88	
			January Forecast	Latest	January Forecast	Latest
1.	GDFCF	4.0	3.6	3.7	3.9	3.8
	of which: council house sales	(-1.3)	(-1.3)	(-1.4)	(-1.4)	(-1.5)
	other	(5.3)	(4.9)	(5.1)	(5.3)	(5.3)
2.	Net lending	-0.4	-0.3	-0.5	-0.2	-0.4
3.	Capital grants	0.7	0.6	0.6	0.9	0.8
4.	Total capital (net) (=1+2+3)	4.3	3.9	3.8	4.6	4.2
5.	1987 PEWP provision for total capital (net)	-	-	-	4.3	4.2
6.	Overspend on PEWP (=4-5)	-	-	-	0.3	0.0

* national accounts definitions

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IV PUBLIC CORPORATIONS' BORROWING

27. Table 12 summarises the forecast of public corporations' borrowing

Table 12 : The PCBR - £ billion

	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87		1987-88	
							Jan F'st	Latest	Jan F'st	Latest
Actual/Forecast	1.5	2.5	1.5	0.4	1.2	0.0	-1.1	-1.3	-0.8	-0.9
Actual/Forecast Adjusted for privatisation and Coal Strike	1.6	2.0	1.9	0.9	0.4	-0.3	-0.4	-0.6	-0.8	-0.9

An increase in the PCBR in 1987-88 compared with 1986-87 is not surprising given the privatisation of British Gas. Adjusting for this a further fall in borrowing in 1987-88 is forecast. The downward revision to the PCBR forecast for 1987-88 since the January Forecast is smaller than that for 1986-87 for two reasons. First it now looks as if some industries will see their agreed nominal price increases reduced in real terms by higher inflation and secondly the benefit of net trade credit receipts to the PCBR in 1986-87 (see below) is unlikely to be repeated.

28. Cumulative borrowing by public corporations to the end of January was nearly £1 billion below both the Budget profile and borrowing in the corresponding period of 1986. Table 13 below shows which industries have contributed to the lower borrowing in 1986-87 compared with 1985-86.

Table 13 : Public Corporations Borrowing April to December 1986 less borrowing in April to December 1985

	£ billion
British Coal	+ 0.5
British Gas	- 0.4
British Steel	- 0.3
Electricity	- 0.6
Others	+ 0.1
Total PCBR	- 0.7

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The main reasons for the changes appear to be:

British Coal - a lower coal price, following the fall in oil prices;

British Gas - a large change in their net trade credit position;

British Steel - a rise in profit margins following favourable exchange rate movements - assisted by falls in raw material costs;

Electricity - the end of post-coal strike re-stocking and lower input cost.

২৯. None of these factors imply that there would be a <u>further</u> fall in borrowing in 1987-88, but by the same token with the exception of British Gas, none of them should reverse, suggesting that the lower 1986 level of borrowing could be maintained. The privatisation of British Gas, where borrowing has been negative, might be expected to increase the PCBR however.

৩০. All of the factors mentioned in paragraph ২৮ could have been anticipated by the Budget Forecast, apart from British Gas's trade credit receipts. Unfortunately the available data on 1986-87 is not yet sufficient for a proper analysis of why the Budget Forecast of the PCBR now appears too high. A feature of the Budget Forecast for Public corporations, however, was the allocation of £½ billion of the Reserve to nationalised industry external finance, compared with an estimated outturn of zero claim on the reserve.

৩১. Our current forecast for 1987-88 by contrast is for an EFL outturn broadly in line with provision in the 1987 PEWP, as shown in table ১৭. This is coincidence however as the forecast is built up largely independently of the expenditure plans through an assessment of the industries' trading prospects, given the economic prospects generally, and assumptions about capital spending.

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Table 14 : The PCBR, EFLs etc - £ billion

		1986-87	1987-88	
			1987 PEWP	Latest Forecast
1.	NIs' EFL	0.5	0.7	0.7
	Financed by:			
2.	Grant and subsidies	2.0	1.9	1.9
3.	Borrowing from CG	0.2	-0.4	-0.5
4.	Market and Overseas Borrowing	-1.7	-0.8	-0.7
5.	OPC Borrowing	0.2	N/A	0.2
6.	PCBR (=3+4+5)	-1.3	N/A	-0.9

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32. The forecast of public corporations' trading surpluses is influenced by a number of factors, the most important of which are:

(i) their output

(ii) costs and prices

(iii) productivity increases

Coal output is on a trend decline and British Rail is not likely to experience much, if any growth. The other major industries should benefit however from the steadily growing economy. Average earnings in public corporations are assumed to rise in line with those in the private sector. The industries in aggregate are assumed to achieve further productivity gains in 1987-88 but somewhat smaller than in 1986-87. Table 15 below shows the price increases assumed in the forecast. In aggregate real price falls in 1987-88 are a little larger than those in 1986-87.

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Table 15 : Nationalised Industry Prices in Real Terms* - %

	1985-86	1986-87	1987-88
Electricity			
- Industrial	- 2	- 3½	- 4½
- Domestic	- 2	- 2	- 5
Coal			
- Industrial	+ 6	- 4	- 4½
- Domestic	- 1½	- 1	- 2½
Water	+ 5½	+ 5	+ ½
British Rail (Passenger)	+ ½	+ 3	+ 1
Average, all NIs	- 1	- 2	- 3
Memo: GDP Deflator	+ 6	+ 3	+ 4½
Retail price index	+ 6	+ 3	+ 5

* Relative to the GDP deflator, except domestic prices, Water and British Rail Passengers, which are relative to the retail price index.

33. The net result of these assumptions about prices, output etc for the nationalised industries gross trading surpluses (GTS) is shown in table 16. Adjusted for privatisation the GTS is forecast to be higher in 1987-88 than 1986-87 but the same as a proportion of GDP.

Table 16 : Nationalised Industries' Gross Trading Surpluses - £ billion

	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88
Gross trading surplus	4.6	6.3	7.2	6.7	2.9	6.2	4.9	4.7
Gross trading surplus adjusted for privatisation and coal strike	1.7	3.2	2.6	2.4	2.4	4.1	4.1	4.7
(% of money GDP)	(0.7)	(1.2)	(1.1)	(0.8)	(0.7)	(1.1)	(1.1)	(1.1)

34. The other major factor which will affect borrowing is capital spending. Table 17 gives the figures in the forecast and compares them with the PEWP.

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Table 17 : Nationalised Industries Capital Spending - £ billion

	1985-86	1986-87	1987-88
1987 PEWP*	5.4	5.1	4.3
Forecast	5.4	5.0	4.2
Forecast, adjusted for privatisation	4.4	4.4	4.2
(% change)		(0.0)	(-3.8)

* fixed assets plus other capital expenditure

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by Sir T Burns

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 MTFS 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 MTFS.

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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 MTFS 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: P N SEDGWICK
DATE: 20 FEBRUARY 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Sir G Littler
Mr F E R Butler
Mr Cassell
Mr Monck
Mr Odling-Smee
Mr Scholar
Mr Culpin
Mr S Davies
Mr Mowl
Mr Riley
Mr Cropper
Mr Tyrie
Mr Ross Goobey

Mr Battishill IR
Sir Angus Fraser C&E

THE PSBR IN 1987-88

Mr Allan's minute to Mr Mowl of February 11 (copy attached) asked for an urgent update of the prospects for public sector finances in 1987-88 and beyond in the light of the recent monthly figures on borrowing. The attached paper by Colin Mowl and me provides this reassessment for 1987-88.

2. By this stage of the budget preparations our projections of public finances are, as the note explains, on a post-budget basis. The forecast for the PSBR in 1987-88 will of course vary with any changes to the assumed package. Because we have produced this update quickly and because new information on the outturn for 1986-87 and on prospects for 1987-88 will become available between now and the completion of the FSBR we and the tax forecasters in the revenue departments will want to make further changes to the underlying forecast in the next few weeks.

3. We have included in the attached note a detailed account of the most up to date forecast for the PSBR in 1986-87. Our latest estimate is for a PSBR of £4.3b. This is identical to the forecast in Colin Mowl's note to you of February 13 covering the draft monthly note on the PSBR. We

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are likely to make some further changes to our forecast for 1986-87 in the light of the CGBR(O) figures for February which we will get on March 2. Our current estimate of the PSBR in 1987-88 is just under £3½b., assuming the package in the score card for your February 16 overview). As you will see from the attached note we have re-examined in some detail the prospects for borrowing by local authorities and public corporations. It goes without saying that predictions of behaviour in these areas have very wide error margins around them.

4. When we have your reactions to the updated projections it will be necessary to consider how you want to present the fiscal prospect for 1986-87 and 1987-88 in the FSBR. The decisions you take will affect the figures and text in parts 1, 3 and 6 of the FSBR. (Messrs Odling-Smee and Riley will let you have a further submission in due course on the presentation in part 2 of the FSBR of the fiscal numbers for the later years.)

5. You have indicated that you would like to publish an estimate of the PSBR in 1986-87 if anything a little above our central view of the likely outturn. Similarly you have indicated a desire to choose a forecast PSBR for 1987-88 - after taking account both of any changes to the package and the figure published for 1986-87 - that allows some margin for safety. We will prepare the numbers for the FSBR - and in particular the text for part 6 - in the light of your decisions on what PSBR numbers to show.

P N SEDGWICK

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FROM: A C S ALLAN

DATE: 11 February 1987

MR MOWL

cc Sir P Middleton
Sir T Burns
Mr Cassell
Mr Peretz
Mr Sedgwick
Mr Scholar
Mr Ritchie
Mr Devereux
Dr Clark

PSBR IN JANUARY

The Chancellor was grateful for your note of 10 February. In the light of the January figures, he would like an urgent revision of the outlook for 1987-88 (and thereafter). There must be a strong presumption that the current Budget package would produce a lower PSBR than that at present projected, and he might well wish to show this.

A C S ALLAN

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THE PSBR IN 1987-88

INTRODUCTION

This paper re-assesses the prospects for public finances in 1987-88 in the light of the most recent developments.

2. The forecast reported here differs from the January forecast in that it is on a post-budget basis. The most recent forecasts for taxes provided by Inland Revenue and Customs and Excise incorporate both any changes in the underlying judgements on yields and the assumed effects of the budget package. The package used here is that described in the fifth budget scorecard (Ms Sinclair's minute of February 12: this hardly differs from the sixth scorecard, circulated by Mr Scholar on February 19). The projections of future output, incomes, etc on which the estimates for public finances are based have barely changed since the January forecast. The submission on the Draft Industry Act forecast, which we will send you on Tuesday February 24, will discuss the small changes in the economic prospect that the most recent data and developments suggest.

ie £2.1bn (without non-revaluation)

3. The rest of this paper is arranged as follows:

Section I summarises the latest forecast and compares it with the January exercise and the 1986 FSBR

Section II discusses CG revenues, expenditure and borrowing

Section III deals with LA's borrowing

Section IV deals with PC's borrowing

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I PSBR PROSPECTS: SUMMARY

4. Table 1 summarises the latest data and forecasts for 1986-87

Table 1: PSBR in 1986-87 - £ billion

	CGBR(O)			LABR			PCBR			PSBR		
	Budget	Jan F'st	Latest	Budget	Jan F'st	Latest	Budget	Jan F'st	Latest	Budget	Jan F'st	Latest
April to January	4.0	2.0	2.1	0.4	-0.3	-0.6	-0.2	-0.6	-1.1	4.2	1.1	0.4
1986-87	6.1	5.2	4.7	1.6	1.1	0.9	-0.6	-1.1	-1.3	7.1	5.2	4.3

The "news" in the January figures was mainly on the local authorities and public corporations. Cumulative borrowing to end-January by these two sectors taken together was £1.9 billion below the cumulative budget profiles for the first ten months of 1986-87 and £¾ billion lower than in the January Forecast. Over half of the net undershoot on the prediction in the January forecast was the result of downward revisions to the LABR and PCBR in earlier months rather than an overestimate of borrowing in January itself. The cumulative outturn for the CGBR(O) to January was slightly higher than forecast, but for other reasons the forecast CGBR(O) for the year as a whole has been revised down by £½ billion since January. This revision to the CGBR(O) was reported in the draft monthly note on the PSBR, circulated by Mr Mowl on 13 February, which included the new forecast of the PSBR in 1986-87 of £4.3 billion.

5. Table 2 compares the PSBR forecast for 1987-88 with the January forecast.

Table 2: PSBR and Fiscal Adjustment - £ billion

	Fiscal Adjustment		PSBR		Change in PSBR Prospect*
	January Forecast	Latest	January Forecast	Latest	
1986-87	-	-	5.2	4.3	-0.9
1987-88	2.9	2.1	4.3	3.4	-0.1

ie Scorecard parking

* equals for 1987-88 the assumed change in PSBR less any change in the fiscal adjustment

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6. The first year effect on the PSBR (from an indexed base) of the package assumed in the latest forecast is £2.1b. The effect of the cut in the basic rate is itself £2.1b. A number of small measures together offset the extra revenue from the VAT partial exemption measure.

7. The January forecast assumed cuts in income tax (achieved by raising allowances rather than cutting the basic rate) with a first year PSBR effect of £2.9b.

8. Taking account of the difference in the assumption on the fiscal adjustment plus other changes in the forecast, the PSBR forecast for 1987-88 comes out at just under £3½ billion. Table 3 shows that most of this revision occurs on central government own account borrowing. The main contributions to the reduction of £0.8 billion in the CGBR(O) are:

- 0.8 smaller fiscal adjustment allocaated to tax cuts than in the January forecast.
- 0.5 better ECGD trading performance due to refinancing of Nigerian debt.
+ 0.3 lower North Sea Revenues mainly reflecting a lower oil price
+ 0.2 changes in other receipts

- £0.8b.

?? surely Jan was on $15?

9. The forecast of the LABR has been revised down slightly, in line with the revision to 1986-87, mainly the result of revised view on LA capital receipts, in part offset by a lower assumed increase in LA rates. There is a very modest reduction in the PCBR in the light of a change in view of the trading surpluses PC's are likely to achieve with the economy growing at 3 per cent or thereabouts.

Consistent with what we now know about rates?

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Table 3: Sectoral Components of PSBR in 1986-87 and 1987-88 - £ billion

	CGBR(O)		LABR		PCBR	
	January	Latest	January	Latest	January	Latest
1986-87	5.2	4.7	1.1	0.9	-1.1	-1.3
1987-88	3.2	2.4	1.9	1.8	-0.8	-0.9

10. Table 3 shows that even with the modest downward adjustments to the LABR and PCBR in 1987-88 the central expectation, as in the January forecast, is that both the LABR and PCBR are likely to rise in 1987-88, after falling in the two previous years, 1985-86 and 1986-87. The rise in the LABR is mainly due to a smaller LA rates increase in 1987-88 than in 1986-87, with little change in the growth of expenditure. The rise in the PCBR primarily reflects the privatisation of British Gas (ie its transfer from the PC sector). Adjusted for privatisation the PCBR is forecast to fall in 1987-88. Sections III and IV of this note consider in more detail the plausibility of this aspect of the forecast. The next section reviews the forecast of the CGBR(O).

II CGBR(O)

11. Table 4 compares the latest and January forecasts of the CGBR(O). The downward revision since January to the forecast for 1986-87 is mainly due to a reduction in supply expenditure. There is also a small upward revision to Customs & Excise taxes. The reduction for 1987-88 is mainly the result of the £¾ billion difference in the assumed Budget package.

Table 4: CGBR(O) £billion

	1985-86	1986-87	1987-88
January Forecast	4.1	5.2	3.2
Latest	4.1	4.7	2.4

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Central Government Expenditure

12. Little new information has emerged on central government expenditure. The prospect for 1987-88 remains much the same as envisaged in the January Forecast.

Central Government Revenues

13. Total central government taxes and royalties in 1986-87 are now forecast at £104.2 billion, unchanged from the January forecast. An upward revision of £350 million to the forecast of tobacco duty receipts, reflecting the evidence now emerging of much greater than expected pre-Budget forestalling, is largely offset by a downward revision of £300 million to VAT receipts, in the light of the most recent information on the inflow of tax receipts. On Customs and Excise advice, we are now attributing rather more of higher than forecast VAT receipts to a once-for-all effect from Keith changes than we did earlier.

14. As compared with the January forecast, our view of the underlying path for non-North Sea taxes in 1987-88 has not changed significantly. The revisions to the VAT and tobacco duty forecasts for 1986-87 carry through to 1987-88, but are broadly offsetting. For North Sea revenues, however, we have revised down the January forecast by £0.3 billion as a result of the lower oil price assumption.

15. Among the non-tax items which count towards central government receipts, the main change since January has been a reduction of £0.5 billion in the projected trading deficit of ECGD, as a result of recent decisions on the refinancing of Nigerian debt. This scores as an increase in other central government receipts.

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III LOCAL AUTHORITY BORROWING

16. Table 5 shows the January and latest forecasts of the LABR, together with recorded data for earlier years. The forecasts of the LABR in 1986-87 has been revised down by £0.2 billion since January as in the latest monthly note. The forecast for 1987-88 has been revised down by only £0.1 billion however because rate increases now look likely to be slightly lower than assumed in January and the estimate of current expenditure has increased a little.

Table 5 : The LABR - £ billion

	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88
January Forecast	-0.2	0.1	1.2	2.4	1.7	1.1	1.9
Latest						0.9	1.8

17. The forecast of the LABR in 1986-87 takes into account the outturn so far, but is heavily influenced by the historical record of the level of borrowing in the last two months of the financial year, and a recent DOE survey of the authorities' borrowing intentions in the last quarter of the year, the first results of which have become available since the January Forecast was completed. The forecast also produces a complete picture of local authorities' income and expenditure accounts as a cross-check. This cross-check has severe limitations however as latest data for 1986-87 covers the first half of the financial year only and is not comprehensive. For example, there are no outturn data yet on the authorities' current expenditure in 1986-87 - the quarterly figures for the first half of the year published by the CSO are based on the authorities' budgets, not on information about expenditure actually undertaken.

18. Table 6 sets out the past experience of borrowing in February and March and the forecast for the same two months this year.

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Table 6 : LABR in February and March - £ billion

	1982	1983	1984	1985	1986	Average 1982-86	1987 Forecast
Cash	0.6	1.3	1.2	1.5	1.2	1.1	1.5
1987 prices	0.8	1.5	1.3	1.6	1.2	1.3	1.5

19. The forecast for LA borrowing in February and March is slightly higher, though not by much, than the average for previous years because - faut de mieux - we have given a good deal of weight to the DOE Borrowing Survey. This survey has always overpredicted borrowing, but table 7 shows that an allowance is made in the forecast for the average bias. If the error this year were higher than average - for example at the top of the range of past errors - the LABR in 1986-87 as a whole would be £0.2 billion lower than the current forecast ie. £0.7 billion rather than £0.9 billion.

Table 7 : DOE Borrowing Intentions Survey - £ billion

	1983 Q1	1984 Q1	1985 Q1	1986 Q1	Average 1983-86	1987 Q1
1. Survey	1.8	1.6	1.5	2.0	1.7	2.1
2. Outturn	1.1	1.1	1.2	1.3	1.2	1.6*
3. Error (2-1)	-0.7	-0.5	-0.3	-0.7	-0.5	-0.5*

* Forecasts

20. The forecast of the LABR in 1987-88 is based largely on a projection of the detailed income and expenditure accounts for the LA sector. Table 8 sets out the main elements of the authorities' accounts using national income accounting concepts.

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Table 8 : Local Authorities Income Expenditure and Borrowing - £ billion (% changes in brackets)

		1985-86 Outturn	1986-87 Budget Forecast	1986-87 Latest Forecast	1987-88 Latest Forecast
1.	Rates	13.8 (6.7)	15.6 (13.8)	15.5 (12.5)	16.7 (7.5)
2.	Current grant	20.7 (1.2)	21.5 (6.7)	22.3 (7.8)	24.0 (7.6)
3.	Other current income	5.6 (5.7)	5.4 (3.7)	5.8 (3.0)	5.9 (1.9)
4.	Current expenditure	38.2 (4.9)	40.6 (7.6)	41.3 (8.1)	45.0 (9.0)
5.	GDFCF	4.0 (10.1)	3.6 (4.1)	3.7 (-6.5)	3.8 (3.0)
6.	Capital grants (net) and net lending	-0.4	-0.2	-0.3	-0.3
7.	Other	-0.1	0.1	-0.2	-0.1
8.	LABR (-1-2-3+4+5+6+7)	1.7	1.6	0.9	1.8

11. Table 8 illustrates why the LABR is forecast to rise in 1987-88. Gross current expenditure is forecast to rise at about 9 per cent per annum, a little faster than in 1986-87, but rate income is projected to increase much less than in 1986-87. Together with some rise in capital spending this pattern makes an increase in the LABR on the low 1986-87 outcome very likely indeed. The rest of this section examines the following key components in turn:

(i) rates

(ii) current expenditure and balances

(iii) GDFCF and other capital

12. The basis of the **rates** forecast for 1987-88 has changed since the January Forecast. In the January Forecast the forecast was largely determined by the projections of current expenditure and grant on the one hand and likely changes in rate fund balances on the other. While the rates forecast was influenced by anecdotal evidence on likely rate increases there was no firm information on these. In the recent past the DOE has begun to receive

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information from the local authorities on agreed rate increases. Most of the information for England is from the shire counties, with little or nothing from the metropolitan authorities. The average increase for England, based on a relatively small sample, is 7 to 8 per cent. The available figures for Wales and Scotland are higher than this. Nevertheless LG advise that, because the English metropolitan authorities and district councils are expected on average to agree lower rates increases than those for the counties (in part because a substantial proportion are rate capped), an average increase of 7 to 8 per cent for the UK as a whole is the current best estimate. This is slightly lower than in the January Forecast, and other things equal, would increase the LABR by £0.1 billion.

Table 9 : Rate Income - % change

1985-86	1986-87	1987-88	
		January Forecast	Latest
6.7	12.5	8.2	7½

13. About three quarters of **current expenditure** is on wages and salaries. The basis of the forecast is an assumption that local authority employees receive earnings increases in line with the private sector, with the exception of the teachers who are assumed to receive increases in line with the Baker proposals. Table 10 shows the forecast for average earnings. The 1985-86 increase for local authorities was artificially low because of the timing of the interim award to teachers.

Table 10 : Average Earnings - % change

	1985-86	1986-87	1987-88
Local authorities	3.0	9.8	9.6
Private sector	8.6	7.3	7.1

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۲۴. The forecast has a small rise in local authority employment of ¾ per cent a year (full time equivalents). This is in line with recent trends in 1986-87.

۲۵. Current estimates suggest little change in rate fund balances in 1986-87, when rate increases were relatively high, but the authorities are expected to run rate fund balances and special funds down in 1987-88, when rate increases are relatively low. The latest forecast of current expenditure, grant and rates implies a reduction in rate fund balances of about £½ billion (GB). DOE consider such a reduction plausible. Reductions in balances score as an increase in borrowing: a larger assumed reduction would imply a higher forecast LABR.

۲۶. The forecast of capital spending is summarised in table 11. The forecast of net capital spending (row 4) has been reduced a little since January because there are indications that recent capital receipts have been higher than assumed.

Table 11 : Local Authority Capital Expenditure* - £ billion

		1985-86	1986-87		1987-88	
			January Forecast	Latest	January Forecast	Latest
1.	GDFCF	4.0	3.6	3.7	3.9	3.8
	of which: council house sales	(-1.3)	(-1.3)	(-1.4)	(-1.4)	(-1.5)
	other	(5.3)	(4.9)	(5.1)	(5.3)	(5.3)
2.	Net lending	-0.4	-0.3	-0.5	-0.2	-0.4
3.	Capital grants	0.7	0.6	0.6	0.9	0.8
4.	Total capital (net) (=1+2+3)	4.3	3.9	3.8	4.6	4.2
5.	1987 PEWP provision for total capital (net)	-	-	-	4.3	4.2
6.	Overspend on PEWP (=4-5)	-	-	-	0.3	0.0

* national accounts definitions

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IV PUBLIC CORPORATIONS' BORROWING

27. Table 12 summarises the forecast of public corporations' borrowing

Table 12 : The PCBR - £ billion

	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87		1987-88	
							Jan F'st	Latest	Jan F'st	Latest
Actual/Forecast	1.5	2.5	1.5	0.4	1.2	0.0	-1.1	-1.3	-0.8	-0.9
Actual/Forecast Adjusted for privatisation and Coal Strike	1.6	2.0	1.9	0.9	0.4	-0.3	-0.4	-0.6	-0.8	-0.9

An increase in the PCBR in 1987-88 compared with 1986-87 is not surprising given the privatisation of British Gas. Adjusting for this a further fall in borrowing in 1987-88 is forecast. The downward revision to the PCBR forecast for 1987-88 since the January Forecast is smaller than that for 1986-87 for two reasons. First it now looks as if some industries will see their agreed nominal price increases reduced in real terms by higher inflation and secondly the benefit of net trade credit receipts to the PCBR in 1986-87 (see below) is unlikely to be repeated.

28. Cumulative borrowing by public corporations to the end of January was nearly £1 billion below both the Budget profile and borrowing in the corresponding period of 1986. Table 13 below shows which industries have contributed to the lower borrowing in 1986-87 compared with 1985-86.

Table 13 : Public Corporations Borrowing April to December 1986 less borrowing in April to December 1985

	£ billion
British Coal	+ 0.5
British Gas	- 0.4
British Steel	- 0.3
Electricity	- 0.6
Others	+ 0.1
Total PCBR	- 0.7

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The main reasons for the changes appear to be:

British Coal - a lower coal price, following the fall in oil prices;

British Gas - a large change in their net trade credit position;

British Steel - a rise in profit margins following favourable exchange rate movements - assisted by falls in raw material costs;

Electricity - the end of post-coal strike re-stocking and lower input cost.

29. None of these factors imply that there would be a <u>further</u> fall in borrowing in 1987-88, but by the same token with the exception of British Gas, none of them should reverse, suggesting that the lower 1986 level of borrowing could be maintained. The privatisation of British Gas, where borrowing has been negative, might be expected to increase the PCBR however.

30. All of the factors mentioned in paragraph 28 could have been anticipated by the Budget Forecast, apart from British Gas's trade credit receipts. Unfortunately the available data on 1986-87 is not yet sufficient for a proper analysis of why the Budget Forecast of the PCBR now appears too high. A feature of the Budget Forecast for Public corporations, however, was the allocation of £½ billion of the Reserve to nationalised industry external finance, compared with an estimated outturn of zero claim on the reserve.

31. Our current forecast for 1987-88 by contrast is for an EFL outturn broadly in line with provision in the 1987 PEWP, as shown in table 14. This is coincidence however as the forecast is built up largely independently of the expenditure plans through an assessment of the industries' trading prospects, given the economic prospects generally, and assumptions about capital spending.

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Table 14 : The PCBR, EFLs etc - £ billion

		1986-87	1987-88	
			1987 PEWP	Latest Forecast
1.	NIs' EFL	0.5	0.7	0.7
	Financed by:			
2.	Grant and subsidies	2.0	1.9	1.9
3.	Borrowing from CG	0.2	-0.4	-0.5
4.	Market and Overseas Borrowing	-1.7	-0.8	-0.7
5.	OPC Borrowing	0.2	N/A	0.2
6.	PCBR (=3+4+5)	-1.3	N/A	-0.9

32. The forecast of public corporations' trading surpluses is influenced by a number of factors, the most important of which are:

(i) their output

(ii) costs and prices

(iii) productivity increases

Coal output is on a trend decline and British Rail is not likely to experience much, if any growth. The other major industries should benefit however from the steadily growing economy. Average earnings in public corporations are assumed to rise in line with those in the private sector. The industries in aggregate are assumed to achieve further productivity gains in 1987-88 but somewhat smaller than in 1986-87. Table 15 below shows the price increases assumed in the forecast. In aggregate real price falls in 1987-88 are a little larger than those in 1986-87.

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Table 15 : Nationalised Industry Prices in Real Terms* - %

	1985-86	1986-87	1987-88
Electricity			
- Industrial	- 2	- 3½	- 4½
- Domestic	- 2	- 2	- 5
Coal			
- Industrial	+ 6	- 4	- 4½
- Domestic	- 1½	- 1	- 2½
Water	+ 5½	+ 5	+ ½
British Rail (Passenger)	+ ½	+ 3	+ 1
Average, all NIs	- 1	- 2	- 3
Memo: GDP Deflator	+ 6	+ 3	+ 4½
Retail price index	+ 6	+ 3	+ 5

* Relative to the GDP deflator, except domestic prices, Water and British Rail Passengers, which are relative to the retail price index.

33. The net result of these assumptions about prices, output etc for the nationalised industries gross trading surpluses (GTS) is shown in table 16. Adjusted for privatisation the GTS is forecast to be higher in 1987-88 than 1986-87 but the same as a proportion of GDP.

Table 16 : Nationalised Industries' Gross Trading Surpluses - £ billion

	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88
Gross trading surplus	4.6	6.3	7.2	6.7	2.9	6.2	4.9	4.7
Gross trading surplus adjusted for privatisation and coal strike	1.7	3.2	2.6	2.4	2.4	4.1	4.1	4.7
(% of money GDP)	(0.7)	(1.2)	(1.1)	(0.8)	(0.7)	(1.1)	(1.1)	(1.1)

34. The other major factor which will affect borrowing is capital spending. Table 17 gives the figures in the forecast and compares them with the PEWP.

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Table 17 : Nationalised Industries Capital Spending - £ billion

	1985-86	1986-87	1987-88
1987 PEWP*	5.4	5.1	4.3
Forecast	5.4	5.0	4.2
Forecast, adjusted for privatisation	4.4	4.4	4.2
(% change)		(0.0)	(-3.8)

* fixed assets plus other capital expenditure

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Copy No 24 of 26

FROM: A C S ALLAN
DATE: 23 February 1987

MR SEDGWICK

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Sir G Littler
Mr F E R Butler
Mr Cassell
Mr Monck
Mr Odling-Smee
Mr Scholar
Mr Culpin
Mr S Davies
Mr Mowl
Mr Riley
Mr Cropper
Mr Tyrie
Mr Ross Goobey

Mr Battishill - IR
Sir Angus Fraser - C&E

THE PSBR IN 1987-88

The Chancellor was most grateful for your minute of 20 February.

2. He feels that the margin of safety in the published 1987-88 PSBR figures will consist of the $15 oil price assumption: no further margin is required.

3. He will take decisions on the precise numbers to publish for 1987-88 as soon as the Budget package is finalised. For 1986-87 he has not yet decided between £4¾ billion and £5 billion, though he inclines to £4.9 billion.

ACSA

A C S ALLAN

3984/025LG

RESTRICTED

Yes, it really looks it's in the gloom + doom side.

FROM: B J PORTEOUS
DATE: 23 February 1987

MR WALTERS

cc: Mr Scholar
Miss O'Mara
Mr Dyer
Miss Evans
Mr Evans
Mr Pickering
Mr Rawlings
Mr Woodall
Mr Fray
Mr Cropper

1987 BUDGET: FSBR

In the final paragraph of your minute of 9 February to Nigel Fray you asked for my comments on setting up a contingency plan for photocopying the FSBR if HMSO run into difficulties.

2. The FSBR is a sizeable document. In 1986 it was 67 pages in length and 835 copies were produced. To try and print the FSBR in-house would present us with enormous difficulties. In addition to the size of the job, the paper used for the FSBR is of a high quality and A3 size (folded into A4). It is bound in a manilla cover and each copy is saddle stitched. We simply cannot match this. We have only one machine capable of copying A3 size documents and it does so at a less than impressive speed.

3. We would also be in trouble on timing. According to the Aide Memoire, the final proof of the FSBR will not be ready until the morning of 16 March, yet the full 835 copies are needed by early morning on Budget Day itself. If we do have to try and produce the FSBR in-house, we will probably have to do so sometime between late Budget Eve/early Budget Day, when we will be at the height of producing other Budget documents. If I tell you that last year our deadline for completion was 0800 on Budget Day and we actually managed to finish at 0750, you will realise that there was no room for manoeuvre.

4. I do wonder, however, whether we really need a contingency plan. My understanding is that HMSO have contingency plans of their own. I believe that the FSBR will be printed on HMSO's secure press at Nine Elms. In the event of any failure production will be switched to the HMSO unit in the

House of Commons, where essential copies will be taken (if necessary, extra copies will be produced after the Budget speech). If another failure occurs, production will be switched to a secure outside contractor under the strict supervision of HMSO staff.

5. I must confess that this seems as much as we can hope for. I do not think we need anything else. If, despite all their plans, HMSO cannot produce the FSBR then we will, of course, have to do it in-house. But the price to pay will be markedly inferior quality and, more importantly, a virtual certainty that one or more of the other Budget documents will not be produced.

6. I am happy to discuss any of this with you if it would be helpful.

B J PORTEOUS

ps8/70A

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FROM: A C S ALLAN
DATE: 24 February 1987

MR SCHOLAR

cc Miss C Evans

1987 FSBR: CHAPTERS 4 AND 5

The Chancellor was most grateful for your minute of 23 February and the attached drafts of Chapters 4 and 5 of this year's FSBR. He had the following comments:

(i) in paragraph 4.03, we need to add the higher age allowance for the over-80s;

(ii) in paragraph 4.06, the square-bracketed sentence can be omitted;

(iii) on paragraph 4.07, he would be content for you to amend the text to refer to limits of £1,500 or 10 per cent, as you suggested in paragraph 4 of your covering note. But he noted that the treatment in paragraph 8 of the Annex to Chapter 4 used the £3,000/20 per cent presentation in a way which seemed perfectly clear to him. He would be grateful to be reminded when we decided on a £1,500 limit rather than £2,000, and why?

(iv) in the paragraphs on excise duties (4.08 to 4.12), he felt that (despite last year) there is no need to mention any that are unchanged: they are not annual taxes, and so we can simply mention the changes. This may need to include the minor changes on recovery vehicles and coolers;

(v) on paragraph 4.19, he felt we must make it clear that indexation continues for post-1982 gains. He suggests that the second sentence starts "They will be taxed without adjustment, other than the indexation that applies to post-1982 gains, at the rates applying to other profits ...";

(vi) in paragraph 4.26, he wondered whether the explanation of personal pensions was sufficiently clear;

(vii) in paragraph 4.31, he felt that we needed to expand the description of the anti-avoidance provisions;

(viii) in paragraph 4.33, he felt that the ceiling on retirement relief should be a separate paragraph;

(ix) in paragraph 4.36, "the maximum permitted under European Community law" should be deleted;

(x) in paragraph 4.38 "will" should be "would";

(xi) in paragraph 4.41, the reference to aligning UK law with the EC Sixth Directive should be omitted. The paragraph should also refer explicitly to partial exemption;

(xii) in Table 4.1, Item 31, he wondered whether the two measures (ie the ending of fractions and the allowance against ACT) should be separated out;

(xiii) in Table 4.1, he felt we needed a new sub-total under Item 77 for "total VED and other";

(xiv) in the Annex to Chapter 4, Item 4, the over-80s age allowance needs adding;

(xv) in Item 8, "highly uncertain" should be "inevitably uncertain", and "in particular" should be deleted;

(xvi) Item 14 should start "The tax treatment of Lloyds reinsurance to close will be made consistent ...";

(xvii) On Item 27, he wondered whether the description was completely accurate;

(xviii) in Item 31, he felt the first two sentences needed complete redrafting: the ACT point needs separating out and, the small companies change needs to be explained properly. The third sentence should start "The yield represents ...";

(xix) in Item 36, the first sentence needs more explanation;

(xx) he thought we had dropped the presentation "the following changes are proposed", used at the start of Items 45 and 46";

(xxi) Item 48 can be deleted;

(xxii) he would prefer Item 70 to say "abolished" rather than "reduced to nil";

(xxiii) in paragraph 5.05, he thought the description of the change between plans and estimated outturn for 1986-87 was very oddly drafted. It did not make it sufficiently clear that the increases included allocations from the Reserve, and so totalled over £5½ billion, whereas the overrun on the planning total is only £1¼ billion;

(xxiv) in paragraph 5.06, he felt the first sentence should start "Central Government spending makes up about three-quarters ..."; the fourth sentence should read "Spending by local authorities accounts for about one-quarter ..."; and the next sentence should start "Nationalised industries and other public corporations account for the remainder of the total".

ACSA

A C S ALLAN

SECRET

FROM: P N SEDGWICK
DATE: 24 FEBRUARY 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Sir G Littler
Mr F E R Butler
Mr Cassell
Mr Kemp
Mr Monck
Mr Odling-Smee
Mr Peretz
Mr Scholar
Mr Bottrill
Mr Davies
Mr Matthews
Mr Mowl
Mr Riley
Mr Cropper
Mr Tyrie
Mr Ross Goobey

DRAFT OF PART 3 OF THE FSBR (RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS TO MID 1988)

I attach

(a) a short note that assesses recent data and their implications for the economic prospect,

and (b) a draft of part 3 of the FSBR which takes account of provisional decisions reached at a meeting yesterday chaired by Sir P Middleton.

2. I attach as well as an annex an extract from the record of your meeting on the January forecast which lists the provisional decisions taken at that time on the main numbers to publish in the FSBR. In the rest of this note I discuss some of the factors you will want to consider in the presentation of economic prospects.

(i) **The order of the sections**

We spent some time agonising over the order when preparing the Autumn Statement. The order of the sections in the attached draft is close to that finally adopted in the AS, except that the section on financial conditions comes immediately after the summary. The discussion in Part 3 of the FSBR (the IAF) is now the only retrospective assessment of monetary conditions in the FSBR. (At one time there was a retrospective assessment in the MTFS section.) It is now by custom fuller than the discussion of monetary conditions in the AS IAF. It would be very odd for this section to come at the end of the short term forecast, appearing almost as an afterthought. (In the AS IAF the discussion of financial conditions was followed by one on fiscal conditions in the current financial year which the FSBR IAF does not need.) We judged that it would be better for the financial section to come before the section on the world economy, rather than - as in the FSBR last year - between the sections on the world economy and trade and the balance of payments, which should be consecutive.

We have ordered the discussion in the summary section at the beginning as in the 1986 FSBR, except that the paragraph on assumptions comes at the end.

(ii) **GDP in 1986**

We will need to decide how to present the record on GDP growth in 1986. During the next few weeks the CSO will be accumulating the material on which their estimate of the average measure of GDP will be based. They will publish this estimate on March 20, and will not have a near final estimate until near budget day. We will need to take a final decision on what to include in the FSBR in the light of the then available information from the CSO about a week before budget day.

There seems virtually no chance that the CSO will produce an estimate of GDP(A) growth in 1986 that rounds to 3 per cent. In the light of this there are two options for the treatment of GDP in the FSBR that depend on the number the CSO is likely to publish.

At the moment it looks as if the CSO will publish a figure for the growth of GDP(A) that will round to 2½ per cent - the same (when rounded) as the already published growth of GDP(O). If, when the FSBR goes to press, this still looks the most likely number for GDP(A) that the CSO will publish, our inclination is to show it in Part 3 of the FSBR (in tables 3.6, 3.13, and 3.14). The text could mention the likelihood of this estimate being revised up, given the CSO's own analysis of past revisions. It will at all events be necessary to discuss in the text the profile of growth during 1986 shown by GDP(O), which is generally considered more reliable than GDP(A) for short run movements. In this option, which we have followed in the attached draft of Part 3 of the FSBR, there is not a strong case for breaking with tradition and showing GDP(O), either as well as GDP(A) or instead of it, in tables 3.13 and 3.14, ie the main summary table and the detailed half yearly expenditure/GDP table. The table below compares the numbers for GDP(A) that we have in mind on this option with the January forecast and last year's FSBR forecast.

still seems pretty perverse.

	1986 FSBR	January Internal forecast	AS	Draft 1987 FSBR
Real GDP 1986	3	3	3	2½
Money GDP 1986-87	6¾	6½	7	6

If, on the other hand, it looked as if the CSO was going to publish a figure for growth of GDP(A) that rounded to 2 per cent we would advise including figures for GDP(O) in table 3.14. (The GDP(O) index could be a final column next to the GDP(A) index.) If necessary the summary table (3.13)

could include GDP(O) only. There could be an even fuller discussion in the text of GDP(O) behaviour in 1986 than with the first option. We would not advise publishing different growth rates for GDP(O) and GDP(A) for the future.

(iii) **The exchange rate**

Last year Part 3 of the FSBR said "...neither the sterling index nor the sterling/dollar exchange rate is assumed to change much". Following the G5/G7 meetings we have replaced the usual assumption of little change in the exchange rate with the explicit assumption that it stays at its current level. We have also removed the significant changes in other countries' exchange rates during 1987 that were in the January WEP. (The January WEP had a further substantial fall in the $.) This latter change prevents the sterling index and the £/$ rate - which is important for oil revenues - behaving differently.

If you thought that the new form of words for the exchange rate assumption might be taken to imply a greater commitment to a stable exchange rate than you want to give, we could revert to last year's words without altering any of the figures.

(iv) **Inflation** See also note re Budget Mtg.

At your meeting on the forecast in January it was realised that it would be difficult to show 4 per cent RPI inflation in 1987(4) without an assumed cut in the mortgage rate. The RPI prospect will as well depend on the precise fiscal package you choose.

It is possible that some commentators would spot an assumed cut in the mortgage rate from the behaviour of the housing component of the RPI (though in the past, eg at the time of the 1986 Autumn Statement, commentators have not always interpreted this series correctly).

(v) **The oil price**

We have assumed $15 for Brent (equivalent to about $14.5 for the world average price that the WEP use) from April 1. The assumption is described as "conventional". We assume that the real price is maintained from the beginning of 1988 onwards. This indexation assumption, which is the same as that used last year, is of negligible importance for Part 3 of the FSBR, which goes to mid 1988 only. It is, however, important for Part 2 of the FSBR (which on past precedent will give it explicitly) and for the press notice on oil revenues over the medium term which is published on budget day.

(vi) **Productivity**

You have expressed the wish to show estimates of the "underlying" growth of productivity. To do this could lead to demands for a productive potential table, involving underlying productivity, labour supply growth, and the oil contribution to GDP.

We believe that table 3.11 in the attached draft effectively meets your wish to show the strength of productivity growth without getting into the conceptual problems involved in the definition and estimation of "underlying" productivity. The figures for 1984, 1985, and 1986 in table 3.11 show that high productivity growth has continued during the period since the large employment shake out of the early 1980s.

(vii) **Exports**

We need to be careful when describing the recent excellent performance of UK visible exports. Prima facie growth in the volume of exports of manufactures of 9½ per cent during 1986 (fourth quarter on fourth quarter) while our measure of export markets grew at 4 per cent suggests a very large increase in the UK's share of world manufacturing trade. However, the denominator we have used for many years for the

UK's share of world manufacturing trade is not a measure of total world trade in manufactures. It measures the exports of manufactures of the main manufacturing countries for which data are readily available. Data simply are not available on the exports of many of the NIC's in the last few years. It is quite likely that countries such as the South East Asian NIC's were increasing their exports of manufactures at rapid rates during 1986, while the appreciating countries included in our measure - especially Germany and Japan - lost out.

We are urgently investigating alternative measures of world trade that include the increasingly important exports of the NIC s, but it is unlikely that we can produce a suitable measure quickly. In the meantime we have described the ratio we normally calculate (the ratio of UK exports of manufactures to main manufacturing countries' exports of manufactures) very precisely, so as to emphasise the UK's strong export performance relative to the other developed economies without giving a misleading impression.

(viii) **The current account**

At your January meeting on the forecast Sir T Burns said that we should wait for the January trade figures before choosing whether to publish a current account deficit for 1987 of £2 or 2½b. As you know the CSO are revising the figures for both visible and invisible trade in 1986. We ought to wait until we know what they are going to publish before taking a final decision on the number for 1987. (The numbers the CSO are to publish should be available in near final form by the end of this week.) We need to look in particular at the recorded deficit in the second half of 1986, and whether the forecast number for 1987 implies an implausible change from it.

P.N.S

P N SEDGWICK

ANNEX

EXTRACT FROM RECORD OF CHANCELLOR'S MEETING ON THE JANUARY FORECAST

PUBLISHED FIGURES

10. Oil Price Mr Sedgwick said that a note on the $18 oil price variant would be available by the end of the week. The Chancellor said that he thought it would be difficult to use an assumption very different from the prevailing market price at the time of the Budget. There were attractions in using a $15 oil price assumption, but it would not be possible to go public on that unless the markets moved in that way.

11. Balance of payments Sir T Burns commented that there had been a large error in the balance of payments forecast for 1986, and people would assume that whatever figure was published for 1987 would be an understatement. He thought the choice for publication was between £2 or £2½ billion, but he would be inclined to wait to see the January figure (due out in mid-February) before a final decision was taken.

12. Nominal GDP and GDP deflator Possibilities were 7 to 7½, and 4 to 4½ per cent respectively, with a figure around 7 for 1988-89. Mr Odling-Smee would be submitting a note shortly on the MTFS path which should help decisions.

13. RPI It was noted that the bow shape in the inflation forecast for 1987 was due almost entirely to the mortgage rate and petrol prices. A figure of 4 per cent for 1987Q4 would look reasonable if the mortgage rate were cut - but without such a cut, 4 per cent would be difficult. Most outside forecasters were expecting a figure closer to 5 per cent. The current forecast for 1988Q2 was 4.6 per cent, but it was agreed that it would be preferable to show the same figure as for 1987Q4.

14. GDP Growth for 1986 was currently estimated to have been between 2½ and 3 per cent. The situation should become clearer over the next few weeks.

15. Sir T Burns noted that he would like to see the whole range of next months statistics before final decisions on the numbers were taken. This was agreed.

CATHY RYDING
3 February 1987

Circulation:-
Those present
CST
Mr Peretz

THE IMPLICATIONS OF RECENT INFORMATION FOR ECONOMIC PROSPECTS

This note summarises the new information on the world and the UK economy that has become available since the January forecast was completed, and discusses the extent to which new information affects our view of economic prospects.

I WORLD ECONOMY

Domestic Demand

2 In Japan and Germany, recent figures on industrial activity have remained gloomy and business confidence continues to deteriorate. We have lowered our forecast of domestic demand growth (which already assumed some policy loosening this year) in 1987 by ½ per cent in both countries. In the light of recent data we have since made a small reduction in US domestic demand growth. For the major seven economies as a whole, the rate of growth of real domestic demand in 1987 has been cut from 3¼ to 3 per cent. There is thus a fall in domestic demand growth in the major 7 from our current estimate of 3 3/4 per cent for 1986. Major 7 GNP growth in 1986 at 2½ per cent was significantly below domestic demand growth. We now expect GNP growth to be 2½ per cent in 1987, about ¼ of a percentage point less than in the January forecast. There are some signs of a pick up in industrial/manufacturing output towards the end of 1986 in France, Italy, and the US.

Inflation

3. We have reduced the extent of the recovery in consumer price inflation in the US and given more weight to our now persistent tendency to be too pessimistic about US inflation. Inflation in Japan and Germany could be lower than we have been predicting and even stay negative through 1987. There have been significant upward revisions to IMF recorded figures for unit labour costs in most of the major OECD countries. The price of industrial materials in the final quarter of 1986 was slightly higher than expected in January. This has raised the forecast level of commodity prices in 1987 although the growth rate through the year has not been changed.

cm
new-info

World Trade

4. We have slightly revised up our estimate of total world visible trade in 1986 to 5½ per cent reflecting a higher imports by non-oil developing countries. A once-off surge in imports of oil, partly for stockbuilding, inflated the figure for total trade.

5. Our series for main manufacturing countries' exports of manufactures, weighted by UK markets, grew by 2½ per cent in 1986 on the basis of the limited data that is available. This is more than expected in the January WEP. Nevertheless this is almost certainly lower than the growth of total world trade in manufactures for two reasons.

First, this series does not include exports of manufactures by the NICs which almost certainly grew more quickly than the main manufacturing countries' exports of manufactures in a year when other prominent economies were adjusting to large rises in their exchange rates.

Second, the UK, along with other G5, is more heavily committed than some other industrial countries to OPEC and LDC markets which have been relatively weak.

6. Our forecast for manufacturing countries' exports, weighted by UK markets is for a rise in growth in 3½ per cent in 1987.

II THE UK ECONOMY

Current balance of payments

7. The DTI will publish revised visible trade figures and a new CSO invisibles projection for 1986 with the January trade figures on 27 February. The full Q4 balance of payments figures will be published on 5 March. The indications at the moment are that the changes to invisibles will increase the current account deficit in 1986 to at least £½ billion and possibly more.

?? figure on £360m in stuff we saw.

North Sea

8. There have been some minor changes since the January forecast.

Oil and NGL Production

(million tonnes)

	January Forecast	Now	
1986	128.3	126.9	-1.4
1987	125.6	126.0	+0.4

GDP

9. When we completed the winter forecast we felt more uncertainty over the data for the recent past than over our projection of growth for the coming year. The problems with the data for the first three quarters of 1986 are still with us; although we understand that the CSO are making revisions to the profits figures which should give higher growth in the income and average estimates of GDP in 1986.

10. The main development since the end of the Winter forecast is that the projections for the fourth quarter have become slightly firmer. When we completed the Winter forecast we expected that, given the published figures for the first three quarters of the year, 1986 GDP growth based on the output estimate would round up to 3 per cent and on the average estimate would round down to 2 per cent. The CSO's current projections for Q4 show a substantial reversal of the relative movements that occurred in the second and third quarters.

11. A preliminary figure for GDP(O) for Q4 has now been published, showing output flat at the Q3 level. By contrast, expenditure looks quite strong overall in the fourth quarter of 1986. We now have provisional figures for consumers' expenditure, industrial fixed investment and stockbuilding as well as external trade figures. Although manufacturing investment figures published last Thursday were disappointing, this is a relatively small component of total

expenditure, and the figures for those components of stockbuilding that were published at the same time were stronger than expected. The latest (still very provisional) CSO projections show GDP(E) rising by about 1½ between Q3 and Q4. We understand that the CSO are now making substantial upward revisions to profits figures for the first three quarters of 1986. This will have the effect of raising the growth of the income measure of GDP in the first three quarters of the year. GDP(I) also seems to have shown quite strong growth in the fourth quarter.

12. These changes bring the growth figures for the year as a whole more closely into line. The preliminary published figure for GDP(O) for 1986 as a whole is 2.6. The latest internal CSO projections of GDP(A) suggest that, like GDP(O), the GDP(A) figure to be published three days after the Budget may round to 2½ per cent. We will not have much firmer information until a week before budget day.

13. We of course have virtually no information on the first quarter of 1987 as yet. The only thing we know about is the provisional January retail sales figures, which shows a 2½ per cent fall compared with December. However, this does not indicate a need to call into question the consumption forecast for 1987, as retail sales were badly affected by January's exceptionally severe weather and retailers seem fairly confident that there will be a good and speedy recovery in sales. Moreover, in terms of total consumers' expenditure, low retail sales as a result of bad weather in January will have been partly offset by higher consumers' expenditure on energy during the cold weather.

Inflation

14. Since completing the Winter forecast, there have been one month's extra figures on producer price inflation, retail price inflation, and average earnings. Producer output prices were slightly lower than expected, input prices higher than expected, and retail prices pretty well in line with expectations. In no case have we felt it necessary to make significant consequential changes to the forecast.

Employment and unemployment

15. The latest labour market figures showed unemployment virtually unchanged between early December and early January, whereas the January forecast had a continuation of the roughly 20,000 a month falls of recent months; on the other hand, employment growth in the third quarter has been revised up to 80,000, and manufacturing employment is now estimated to have fallen by only 4,000 in the fourth quarter, suggesting total employment growth may possibly have reached or exceeded 100,000 in the fourth quarter.

16. January was a particularly bad month for unemployment last year, and it may well be that there are some residual seasonality problems. We are assuming for the moment that January was just a freak month and that unemployment will continue to fall in the future months at a similar trend rate to what we assumed in the winter forecast.

THE ECONOMY: RECENT DEVELOPMENTS AND PROSPECTS TO MID 1988

SUMMARY

Demand and activity

3.1 Following a slight slowdown in the second half of 1985, economic activity has been growing at around 3 per cent since last spring as exports have recovered strongly, following some months of sluggish growth. Recorded GDP growth in 1986 was about [2½] per cent. A substantial rise in investment and non-oil exports is forecast for 1987, and GDP should grow by 3 per cent. Manufacturing output growth may be slightly faster.

Labour market

3.2 In line with faster output growth, employment has been rising more quickly again since the middle of 1986. In recent months there has been a reversal of the previous upward trend in unemployment, and there are good prospects for a continuing decline this year.

Inflation

3.3 Inflation fell last year, with the retail price index (RPI) rising by just under 4 per cent in the year to January 1987, compared with 5½ per cent in the year to January 1986. During this year RPI inflation is likely to fall back to around [4] per cent in the fourth quarter following a continuation of the recent upward movement earlier in the year.

World economy

3.4 GNP in the major industrial countries has been rising by 2½-3 per cent a year since 1984, and is likely to continue at that rate in 1987. Following a period of adjustment, the imports of developing countries (other than oil exporters) should rise this year. This should benefit exports and industrial production in the developed world. Markets for UK exports of manufactures may grow a little faster in 1987 than they are estimated to have done in 1986.

fst
tbls

Trade and the current account

3.5 Following the fall in oil prices a year ago, the current account of the balance of payments was [in small deficit [of around £½ billion] in 1986.] Both export and import volumes rose sharply in the second half of last year. A [further] small current account deficit of [£2-2½ billion (around ½ per cent of GDP)] is forecast for 1987.

Assumptions

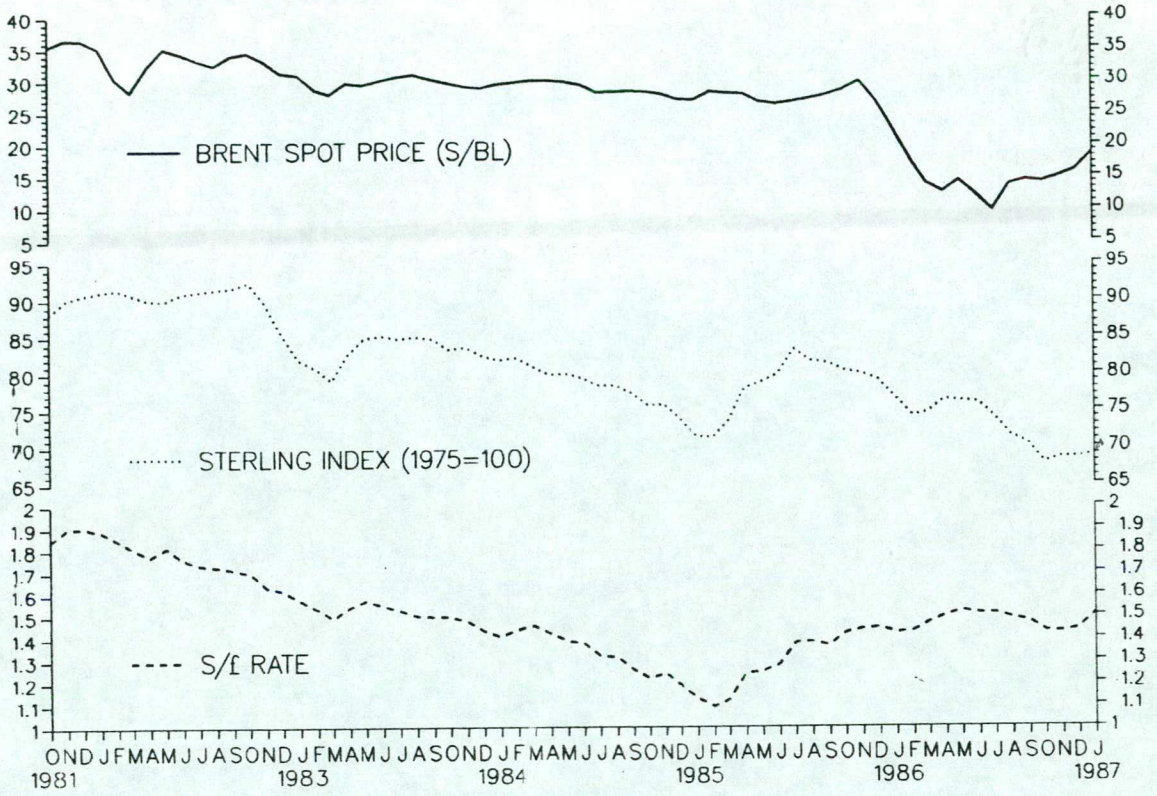
3.6 The forecast for the UK assumes that fiscal and monetary policies will be as set out in the MTFS. The exchange rate is assumed to [stay] at its present level. [The forecast has the conventional assumption of a $15 oil price as assumed in recent forecasts.]

FINANCIAL CONDITIONS

Exchange rates

3.7 The US dollar is now more than 40 per cent lower against the deutschemark and the yen than at its peak at the end of February 1985. The sterling index which rose during 1985 and then fell during 1986 in the wake of the decline in oil prices, has shown little change since November as oil prices have strengthened. Over the period, sterling has tended to rise against the dollar while falling against other major currencies.

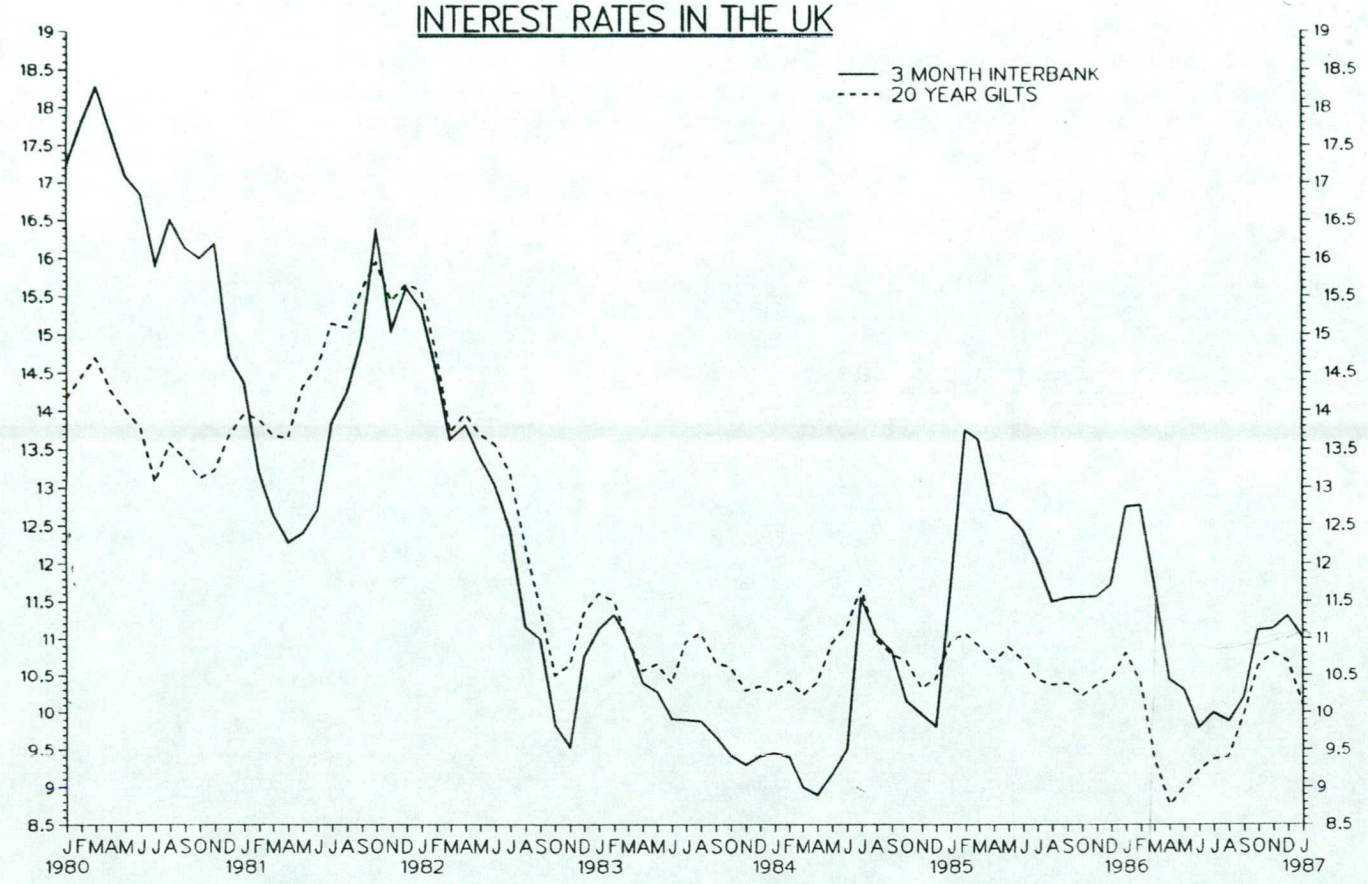
EXCHANGE RATE AND OIL PRICES



Interest rates

3.8 Short-term interest rates fell last summer but rose in the early autumn and peaked above 11 per cent. Recently interbank rates have fallen a little, but remain several points above rates in the US and most other industrialised countries. Yields on 20-year gilts also declined in the middle of last year, firmed again in the autumn, and have declined again in the most recent period.

Short-term interest rates are at about the same level as they were a year ago. They fell early in the summer, but rose again in the autumn. [They remain several points above rates in the US and other industrial countries]. Yields on 20-year gilts have followed a similar pattern.



Narrow money

3.9 M0 growth was below the centre of its target range in the early months of the 1986-87 current financial year. Growth picked up from August onwards reflecting both the decline in interest rates and the continued buoyant growth of personal incomes and in recent months it has been in the upper half of its range. The lagged effects of the action on rise in interest rates in the autumn, coupled with the continued maintenance of tight financial conditions and the prospect of a gradual slowdown in the growth of consumer spending over the year ahead should be accompanied in time by a slower 12-month growth rate of M0.

What does this mean?

"Growth is expected to slow down over the year ahead, as the effects of the rise in interest rate last autumn feed through fully and as the growth of consumer spending slows.

(or drop? see Bank's points (Chapter 2).

GROWTH RATES OF MONETARY AGGREGATES

remained at about that level since then

Broad money

3.10 The growth of £M3 has risen to [18] during 1986-87. This is above the top of the target range set in the 1986 MTFS and well above the growth of money GDP. Deposits by companies and financial institutions have grown particularly rapidly with a slower rise in persons' deposits. The wider aggregates that include building societies' liabilities have grown more slowly, although also at a rate well in excess of the growth of money GDP. The year-on-year growth of PSL2 has been about [14] per cent in recent months. Credit has continued to grow strongly reflecting at least partly the pace of financial innovation and liberalisation.

3.11 The growth of broad money must be seen in the context of the growth of private sector wealth generally which has risen strongly relative to incomes. Positive real interest rates have enhanced the attractiveness of financial assets, and increased competition in financial markets has led to simultaneous growth in both liquidity and

borrowing. The increase in liquidity since 1980, however, appears to have been willingly held and has been accompanied by lower inflation.

WORLD ECONOMY

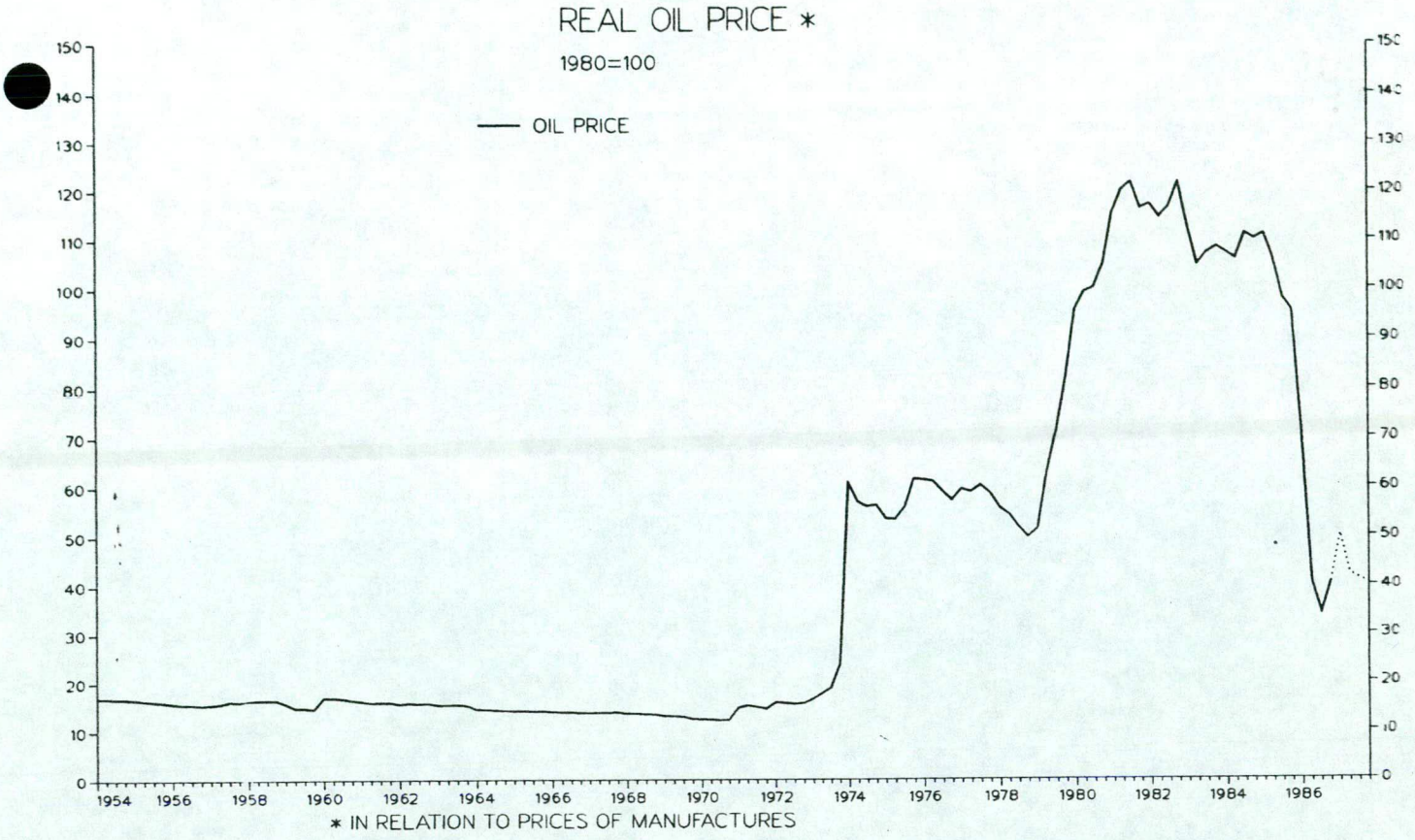
Recent developments

3.12 The world economy has been strongly influenced by the fall in oil prices, some further weakening of other commodity prices and by a substantial depreciation of the dollar, particularly against the yen and deutschemark. Lower import prices have reduced inflation in the industrialised countries and stimulated faster growth in real domestic demand. Developing countries, however, particularly oil producers, have suffered a loss of trade.

3.13 Real GNP in the major seven OECD economies grew by about 2½ per cent in 1986. Real domestic demand grew by 3½-4 per cent but exports rose slowly reflecting weak demand from developing countries and oil producers. Improved terms of trade contributed to lower inflation and boosted household incomes and expenditure. Average consumer prices are now only 1 - 1½ per cent higher than a year ago. Real household incomes rose by nearly 3½ per cent in 1986 and private consumers' expenditure by about 4 per cent.

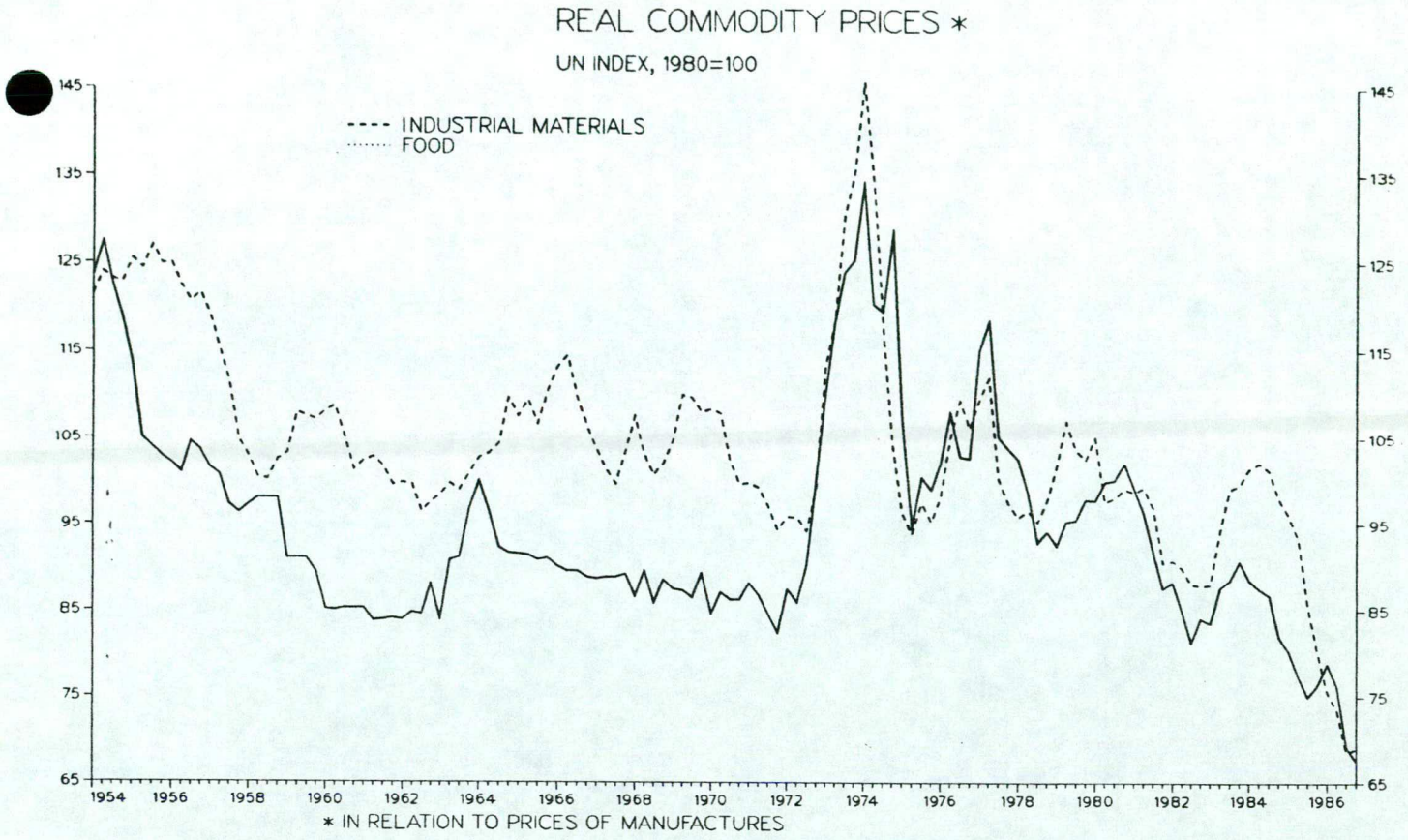
3.14 Despite the buoyancy of domestic demand in the major seven, their industrial production has grown slowly. This reflected the weakness of external demand and relatively sluggish growth in investment. In the United States, business investment, already slowing in reflection of the maturity of the business cycle, has been adversely affected by the repeal of the investment tax credit and by cutbacks in energy-related investment. Japanese business confidence has been weakened by the strength of the yen, which has led to a loss of export market share.

3.15 The increase in imports of consumer goods into the US in 1986 was accompanied by a substantial rise in oil imports to rebuild stocks. Together with "J-curve" effects as the dollar has continued to depreciate, this helps to explain the absence to date of any reduction in the US current account deficit. In Japan and Germany too, while trade volumes have started to adjust, this has been offset by terms of trade changes, so that their trade surpluses have continued to increase, albeit more slowly.



3.16 Oil prices which fell below $10 per barrel last summer, but rose in the latter part (towards the end) of the year, particularly after OPEC members agreed to try to achieve a price of $18 per barrel for the first half of 1987, by means of fixed price contracts supported by restrictions on production. More recently oil prices have eased, but slightly. Food and industrial materials prices which fell sharply through most of last year, before recovered slightly in the Autumn, but remain weak and may have continued to decline slightly in real terms. Charts [ ] and [ ] show past movements in real commodity prices, highlighting the extent of the present trough.

or the serious decline (Drecker etc)!



3.17 World import volumes appear to have grown by more than 5 per cent during 1986. This is somewhat faster than in 1985, largely because of a rise in oil trade, reflecting a rebuilding of stocks by the major oil companies. Trade in manufactured goods rose by only 3 per cent as buoyant domestic demand in industrialised countries, was offset to some extent by cuts in developing countries' imports.

Prospects

3.18 The outlook for oil prices remains uncertain. The forecast continues to make the conventional assumption that North Sea oil prices average $15 per barrel from the start of the 1987-88 financial year - as in last year's FSBR and in the Autumn Statement. Non-oil commodity prices may remain depressed, with food prices in particular held down by the surpluses generated by agricultural support policies. Rising industrial activity in the major economies should result in a strengthening of real industrial materials prices from their current extremely low levels.

Table 3.1: World economy

	Per cent changes on a year earlier			
	1985	Estimates 1986	Forecasts 1987	1988
Major seven countries[1]:				
Real GNP	3	2½	2½	3
Real domestic demand	3	3 3/4	3	3¼
Industrial production	3	1	2½	4¼
Consumer prices	4	2	2¼	2 3/4
World trade, at constant prices:				
Total imports	3½	5	3½	4½
Trade in manufactures[2]	4	2	3½	4

1 US, Japan, Germany, France, UK, Italy and Canada

2 UK-weighted

This gives quite a wobbly flavour — of inflation surges — when the forecast shows it remains @ historically low levels

3.19 Table 3.1 shows the projections for activity and inflation in the major seven industrialised countries, and for world trade. Price inflation is expected to rise slightly again during 1987 as the effects of the fall in oil prices work through are exhausted. The extent of the rise depends crucially on the response of earnings to last year's fall in inflation. The forecast assumes only a limited reduction in wage settlements and inflation is projected to rise towards 3 per cent by the first half of 1988. The fall in the dollar is likely to contribute slightly to more rapid inflation in the US, while currency appreciation could mean Japanese and German prices rising only slowly, if at all.

3.20 The rise in Rising inflation could lead to a slower growth in domestic demand in the US, offset by some improvement in net export volumes following the decline in the dollar. In Japan and Germany, a nearly stable price level will help to strengthen domestic demand. However this is likely to be offset by weak export performance. This suggests that there may be little recovery in real GNP growth, especially in Japan where growth could be below the average of the past decade.

3.21 Real domestic demand in the major seven industrial countries is forecast to increase at an annual rate of 3 - 3¼ per cent over the next eighteen months - slightly lower than in 1986. Helped by some recovery in commodity prices and by relatively buoyant OECD demand, the non-oil developing countries, should see higher export revenues during 1987 and 1988. This in turn should strengthen external demand for OECD exports. As a result real GNP growth in the major seven picks up to nearly 3 per cent in 1987 and 1988, and the growth of industrial production could pick up even more.

3.22 Total world trade growth in 1987 may be slower than in 1986, as oil trade diminishes following the rebuilding of stocks last year. By contrast world trade in manufactures is forecast to grow more quickly. There could be significant differences between countries in the pattern of imports. Import demand in the US is forecast to slow considerably. Oil producers have not completed their adjustment to lower oil price levels and are likely to reduce their imports further in 1987. Debtor countries will also have to exercise continued import restraint. On the other hand imports into Japan and Germany are expected to increase rapidly.

TRADE AND THE BALANCE OF PAYMENTS

Relative costs and prices

3.23 The UK's cost and price competitiveness improved markedly during 1986 as a consequence of the depreciation of sterling following the fall in oil prices. Productivity gains in the course of 1986 meant that the growth of unit labour costs was only a litte above those of competitors. As a result the lower exchange rate was almost entirely reflected in improved competitiveness. This pattern of unit labour costs is expected to continue so that on the assumption of not much change in the exchange rate, the gain in competitiveness seems likely to be maintained over the year ahead.

Table 3.2: The exchange rate and competitiveness

	Sterling index 1975=100	Relative unit labour costs* 1980=100	Relative export prices* 1980=100
1984Q4	75	80	87
1985Q4	80	86	93
1986Q4	68	72	85

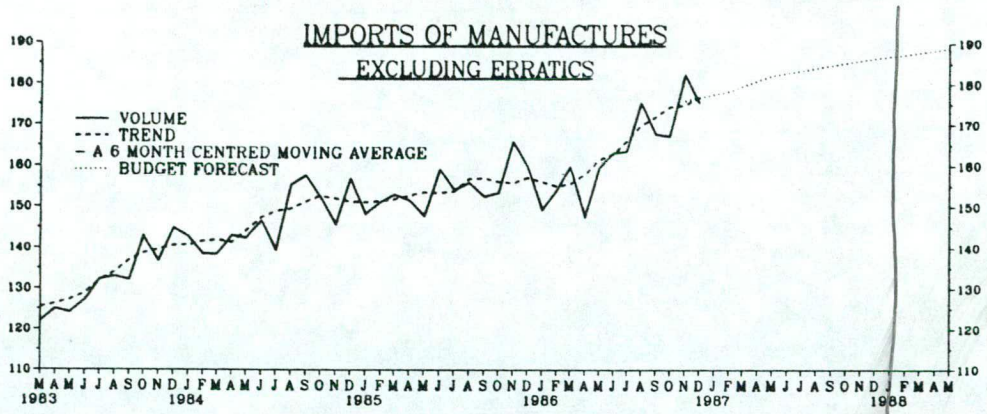
* Ratio of UK manufacturing costs/prices to those overseas

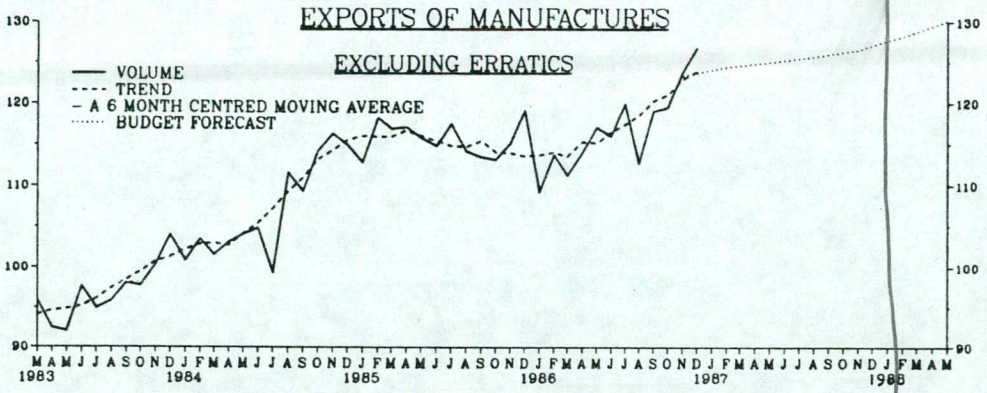
Trade prices and the terms of trade (excluding oil)

3.24 Prices of most imports rose during 1986, particularly in the latter part of the year, as the effects of the depreciation of sterling more than offset the generally weak world prices. Export prices also rose faster than prices to the domestic market as exporters took advantage of sterling's decline to improve profit margins. The terms of trade for goods excluding oil declined slightly between 1985 and 1986. A further small terms of trade decline seems likely in 1987 reflecting the delayed effects of sterling's fall and some recovery in world commodity prices.

Visible trade volumes (goods other than oil and erratics)

3.25 The volume of manufactured exports stagnated in the final months of 1985 and fell briefly in the early months of 1986 in common with exports by other main manufacturing countries. Since Spring they have recovered strongly, and in the three months to January were [10] per cent above their level a year earlier. The volume share of UK exports in the main developed countries' exports of manufactures was broadly constant between 1981 and 1985 after a long period of decline. In 1986 the UK share appears to have risen. Exports of non-manufactures also rose rapidly last year reflecting exceptionally high grain exports. With rising world trade and the continued benefits of improved competitiveness, manufactured exports should show continued strong growth and more than offset a return to more normal levels of agricultural exports. Total exports should grow by about [6] percent, compared to 2 per cent in 1986.

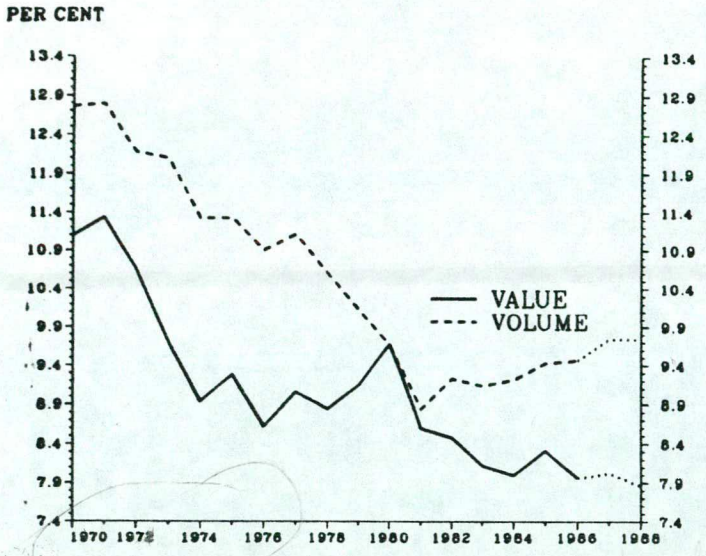




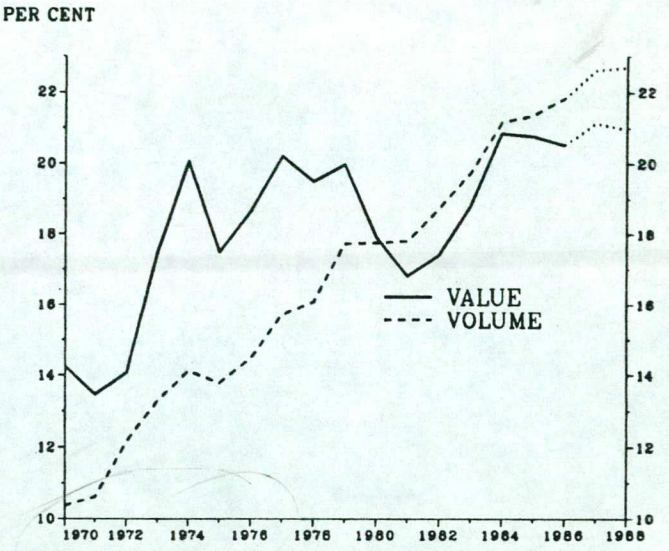
3.26 Non-oil imports were relatively flat in the early part of 1986, but then rose sharply in the third quarter, reflecting mainly the increase in domestic demand. They have continued on an upward trend - albeit less rapidly - in recent months, and despite strong growth of domestic output, import penetration has risen. Manufactured imports have grown particularly rapidly. In the second half of 1986, they were 9½ per cent higher than a year earlier. Non-manufactured imports have also risen quickly, reflecting at least partly the poor quality of the 1985 UK harvest. Imports seem likely to continue to rise strongly in 1987 as domestic activity expands, although the benefits of improved competitiveness together with a return to more normal levels of food imports, will tend to slow the rate of growth. Imports of non-oil goods are forecast to rise [4] per cent between the second halves of 1986 and 1987.

EXPORT SHARES AND IMPORT PENETRATION

U.K. MARKET SHARE , EXPORTS OF MANUFACTURES
(U.K. WEIGHTED)



SHARE OF IMPORTS OF GOODS (EXCLUDING OIL) IN DOMESTIC DEMAND



Oil trade

3.27 The surplus on oil trade fell from £8 billion in 1985 to £4 billion in 1986 following the decline in world oil prices and a fall in the volume of net oil exports. About half of this effect on the current account was offset by lower payments of interest, profits and dividends abroad from North Sea companies. Production from the North Sea in 1987 is likely to be a little lower than in 1986 and with broadly unchanged average prices the oil trade surplus will be slightly smaller.

Total visible trade

3.28 Table [ ] shows the main movements in the terms of trade and trade volumes for both total visible trade and trade excluding oil and erratics. The UK's terms of trade which declined by more than 5 per cent in 1986 mainly as a result of lower oil prices; they are forecast to show little further change in 1987. The volume of non-oil visible exports is forecast to continue the vigorous growth of recent months, although the volume of oil exports is likely to fall. The volume of visible imports which rose by 6½ per cent in 1986, is forecast to show a further similar rise in 1987.

Table 3.3: Visible trade

	Per cent changes on previous year					
	All goods			Goods less oil and erratic items		
	Export volume	Import volume	Terms of trade*	Export volume	Import volume	Terms of trade
1985	5½	3	1½	7	4	1½
1986	3½	6½	-5½	2	6	-1
1987 Forecast	4	6½	- ½	6	7½	0

Invisibles

3.29 The surplus on invisibles rose sharply in 1986. The surplus on IPD rose particularly rapidly as a result of lower payments abroad from the North Sea and an increase in the surplus on other earnings. The surplus on services fell in 1986 largely due to a fall in net tourism earnings attributable to US fears about terrorism in Europe and increased spending abroad by UK residents. The transfers deficit in 1986 was abnormally [low] small reflecting the size and timing of government transactions with the EC.

3.30 The invisible surplus is forecast to show a further strong rise in 1987 with the pound's recent depreciation helping to increase the services surplus and increase the sterling value of IPD earnings on the UK's large stock of net foreign assets. These should more than offset an increase in the transfers deficit to a more normal level.

Current account

close to balance?

3.31 The current account was in small deficit in 1986 following a £3½ billion surplus in 1985. The fall in the net oil surplus and an increased deficit on manufactures trade more than offset an improvement in invisibles. The forecast for 1987 is for a current deficit of £[2½] billion with increases in the deficit on manufactures and other goods from their levels in the second half of 1986 more than offsetting rises in the surpluses on oil trade and invisibles.

Table 3.4: Current account

£ billion

	Manufactures	Oil	Other goods	Invisibles	Current balance
1985	- 3	8	-7½	5½	3½
1986	- 6	4	-7	8½	-½
1987 Forecast	- 9	4	-7	9½	-2½

Overseas assets

3.32 The UK's stock of net overseas assets is estimated provisionally to have risen to about £[100] billion (equivalent to [25] per cent of GDP) at the end of 1986 compared to £80 billion at the end of 1985. The increase reflects an increase in the sterling value of assets as a result of the [increase in foreign securities markets] and the depreciation of sterling.

the strong growth in world stock markets

DEMAND AND ACTIVITY

3.33 Uncertainties surrounding estimates of the rate of growth of the economy last year are even greater than usual, given the large discrepancies in the first three quarters of 1986 between the three separate estimates of GDP (based on measures of expenditure, income and output).

3.34 It is generally [recognised] (accepted) that the output measure of GDP gives the most reliable indication of short term fluctuations in activity. The output figures suggest that the UK economy was sluggish in the latter part of 1985 and at the beginning of 1986 (in common with the economies of other major industrial countries), but that the non-oil economy has been growing quite strongly since then. North Sea output showed little change in 1986. The non-oil economy probably grew by around 3 per cent between the end of 1985 and the end of 1986.

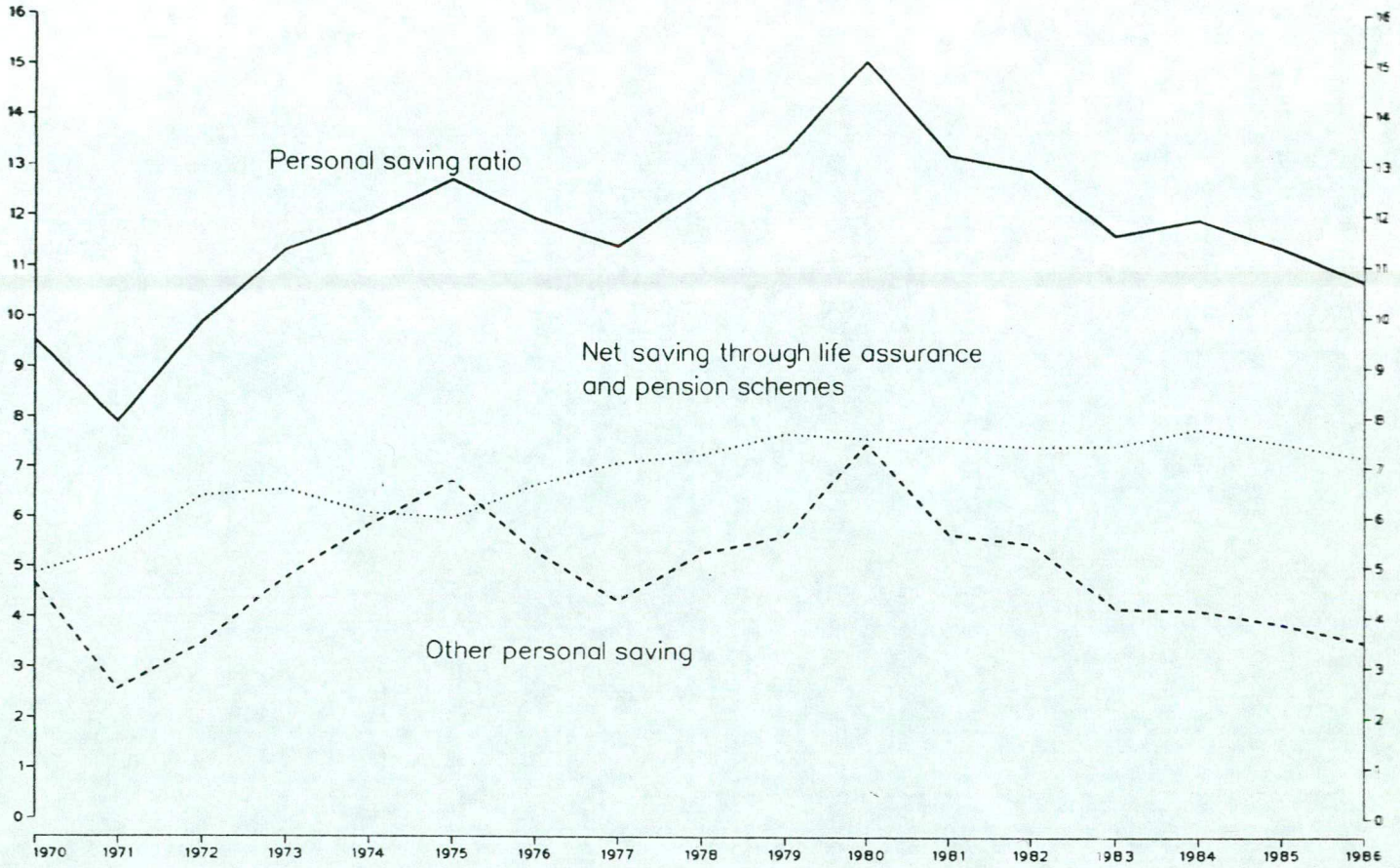
3.35 As in other industrial countries, consumers' expenditure in the UK was buoyant in 1986 [reflecting] (as a result of) the fall in inflation and fast growth in real incomes. [However for reasons already set out

UK exports were weak in the first half of 1986, but recovered strongly in the second half of the year. Imports had been unexpectedly depressed in the first half of the year but also rose sharply in the second half as the UK economy gained momentum, with particularly marked rises in imports of capital goods. Reflecting the composition of demand, output growth in the service industries exceeded growth of manufacturing output for the year as a whole; but manufacturing output rose 2 per cent between the two halves of the year as exports recovered.

Personal sector expenditure

3.36 Real personal disposable income is estimated to have risen by about 4 per cent in 1986, and consumers' expenditure by about 5 per cent. The personal saving ratio has been declining throughout most of the 1980s. One reason is that households have needed to make less provision for the erosion of their existing savings as inflation has fallen. Another factor has been a cut back in the growth of employers' contributions to pension funds in reaction to surpluses that many funds have been showing: these contributions are treated in the national accounts as a part of personal income and saving. Quite apart from this the buoyancy of consumers' spending possibly owes something to the strength of the stockmarket in recent years; in spite of the fall in saving, higher asset prices and lower inflation have contributed to a 50 per cent or so increase in persons' net holdings of financial assets since the end of 1983.

PERSONAL SAVING



3.37 Real personal disposable income is forecast to rise by a little over 3 per cent in 1987. This is rather less than in 1986 and reflects a narrowing of the gap between earnings growth and price inflation. There may be some further decline in the saving ratio, but consumers' expenditure is expected to grow more slowly than in 1986, at around 3½ per cent.

3.38 The housing market was buoyant in 1986, and private residential investment, both in new dwellings and in improvements to existing dwellings, grew strongly during the course of the year. Private housing starts were about 7½ per cent higher in 1986 than in 1985; in Greater London, where the largest increases in house prices have been recorded, private housing starts in the first three quarters of 1986 were about 60 per cent higher than a

year earlier. These higher starts should be reflected in completions and investment in new dwellings during 1987; private residential investment may rise by around 10 per cent in the year as a whole.

Company incomes and expenditure

3.39 The net real rate of return earned by industrial and commercial companies (ICCs) declined in 1986, as profits earned in the North Sea fell by more than half. The rate of return earned by non-North Sea ICCs has continued to rise although the published statistics suggest that the rate of growth of profits slowed down last year. The outlook for companies is favourable, although further substantial rises in profitability will probably have to depend less on helpful developments in the world prices of inputs of materials and fuels, and more on firms' containing the costs that are under their own control.

3.40 Company sector spending was relatively weak in 1986. North Sea investment has been falling as oil companies have retrenched in the face of sharply lower profits. Onshore business investment was affected by the bringing forward of investment from 1986 to 1985 ahead of the reduction in capital allowances announced in the 1984 Budget.

3.41 The prospects are for a much stronger investment performance this year. The DTI Investment Intentions survey published last December pointed to growth in onshore business investment of about 6 per cent, with a continuation of strong growth in investment in 1988. The latest quarterly CBI survey of industrial trends pointed to a pick up in investment in manufacturing industry, and the forecast assumes that the DTI's Intentions survey projections will be achieved. Table 3.5 provides details of the forecast for total investment and its components.

Table 3.5: Gross domestic fixed capital formation

	£ billion at 1980 prices	Per cent changes on a year earlier		
				Forecast
	1985	1985	1986	1987
Business[1]	30.5	4	- 3	3
Private dwellings[2]	9.3	- 1	5	8
General government	6.6	- 4	5	- 1
Total fixed investment		2	0	4

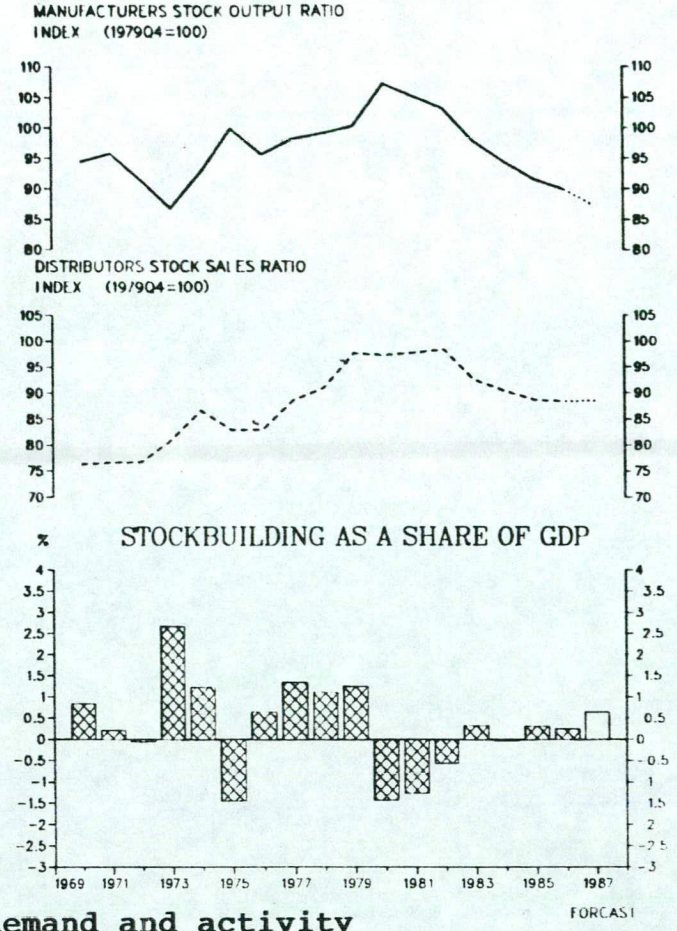
1 Includes investment by public corporations.

2 Includes purchase less sales of land by persons, companies and public corporations, other than purchases of council houses.

3.42 It appears that manufacturers ran down stocks during the course of 1986, and while distributors' stock levels rose, the increase was a small one in relation to the increase in the volume of sales. Thus the economy's stock output ratio fell for the sixth successive year. The latest quarterly CBI survey suggested that manufacturers may now be less concerned to reduce further their stocks of materials, possibly because of the firmer trend in materials prices in recent months. An additional source of destocking in 1986 was the exceptionally high exports of grain which led to a fall in the stocks held by the Intervention Board for Agricultural Produce (IBAP). Grain exports seem unlikely to persist at recent levels, and a further rundown in IBAP stocks is not expected.

3.43 Stockbuilding is thus likely to make a positive contribution to growth in 1987, although the forecast is for only a small rise in stocks by the standards of most years in the 1970s (see Chart 3. x) and implies a further fall in the stock output ratio for the whole economy.

AGGREGATE STOCK RATIOS



longer perspective here.

Prospects for demand and activity

3.44 The forecast for activity in 1987 remains much as it was at the time of the Autumn Statement: GDP is forecast to grow by 3 per cent, around the rate at which it was growing in the latter part of 1986. The sharp recovery forecast in investment and the continuation of recent growth in exports will offset a slackening in growth of consumers' spending.

slowing

Table 3.6: Domestic demand and GDP

Per cent changes on a year earlier (constant prices)

	1986	Forecasts 1987	1988H1
Domestic demand	3½	3½	2½
Exports of goods and services	2½	4	1½
Imports of goods and services	5½	6	2½
Domestic production: GDP*	2½	3	2½

* Average measure

Total North Sea output was marginally lower in 1986 than the previous year, reflecting in part the leak at the Flotta terminal which had a major impact on production in some fields during December. Little change in North Sea production is expected in 1987.

3.45 Non-North Sea output rose by over 2½ per cent in 1986, and at an annual rate of well over 3 per cent between the first and second halves of the year. Strong output growth is forecast to continue during 1987. The recovery in manufacturing output seen in the second half of 1986 is forecast to continue, helped by rising exports. Construction output also rose sharply during 1986, and should benefit further from the expected strength of private investment in dwellings and other new buildings and works during 1987.

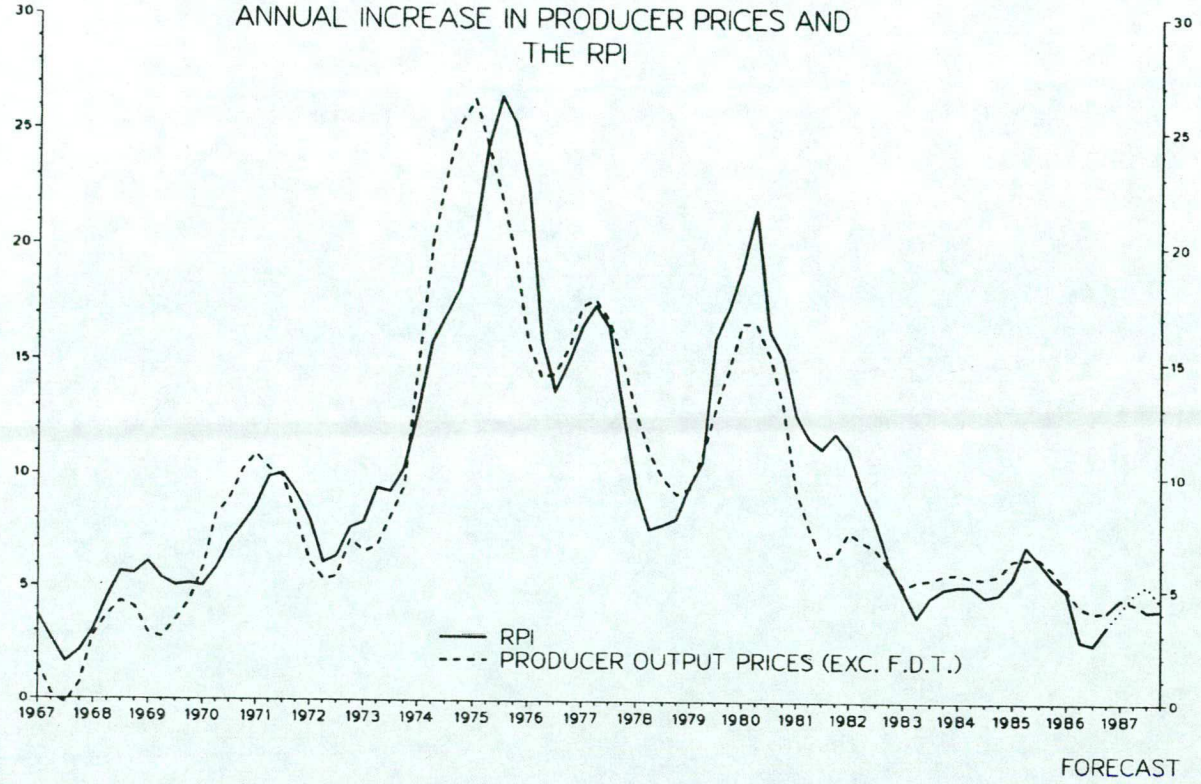
Table 3.7: Real Output

	Per cent changes on a year earlier		
		Forecasts	
	1986	1987	1988H1
GDP (output measure)	2½	3	2½
Non-North Sea output	2½	3½	3
Manufacturing output	½	4	3

INFLATION

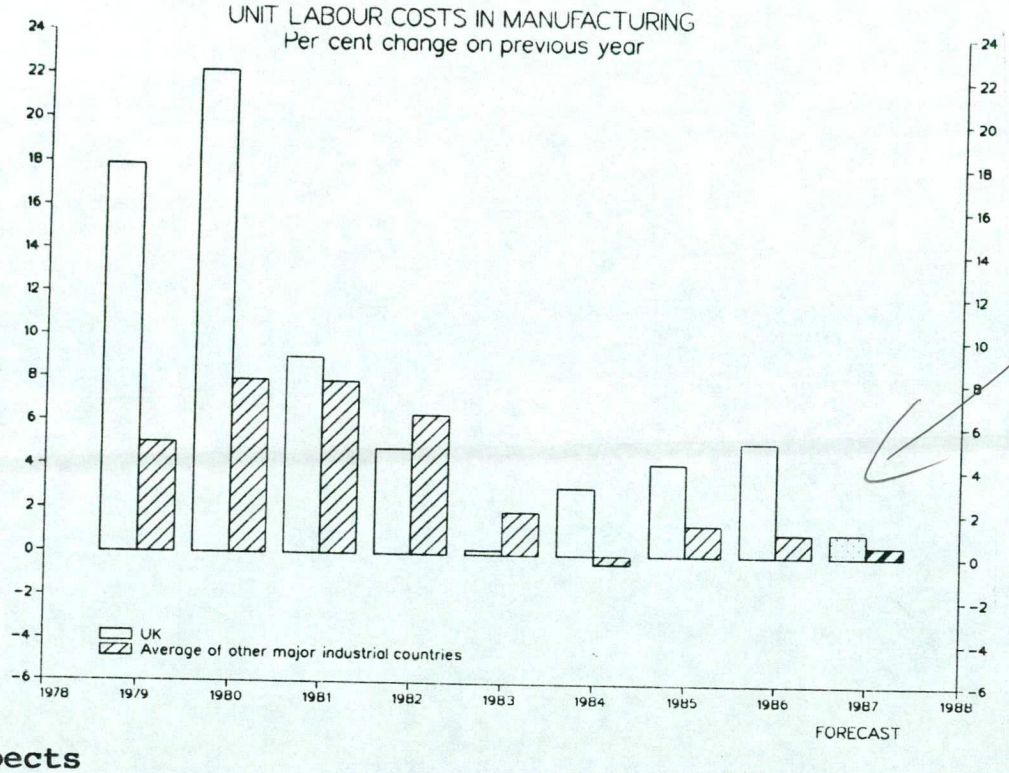
3.46 The RPI rose by just under 4 per cent in the year to January, compared with a rise of 5½ per cent in the year to January 1986. The annual inflation rate reached a low point of 2.4 per cent in July and August: most of its subsequent rise has reflected a higher contribution from the mortgage interest payments component of the RPI.

3.47 The rate of increase of producer output prices has also fallen significantly since the start of 1986, although it has started to edge up again recently, reflecting in part the fall in sterling that took place during the summer and early autumn. Both retail and producer output price inflation remain close to the lowest levels experienced since the 1960s.



3.48 Pay settlements in the private sector have fallen since the start of the current pay round. Settlements in manufacturing industry recorded by the CBI have shown a fall of about 1½ per cent over the last year, although settlements in the private sector as a whole, including those outside manufacturing, may have fallen by less than this. This decline in pay settlements has not yet been reflected in lower recorded growth in average earnings. The current annual rate of growth of earnings reflects settlements made over the whole of the last year (the majority of them still dating from the previous pay round), and is also affected by overtime working, which has risen since the second quarter of 1986.

3.49 In spite of the continuing relatively fast growth of earnings, unit labour costs in manufacturing have been almost unchanged since the first quarter of 1986 as output per man has risen sharply. Comparing 1986 with the previous year unit labour costs in manufacturing rose by about 5 per cent. Chart 3. x shows recent and forecast movements in UK labour cost in relation to those of other major industrial countries.



v striking chart.

Prospects

3.50 The lower pay settlements recorded in recent months should lead to a lower recorded growth of earnings over the remainder of this pay round. Nevertheless employees should enjoy a further substantial rise in real earnings in 1987. The high rate of productivity growth currently being recorded should contain the growth in unit labour costs to below 4 per cent for the non-oil private sector as a whole, and to around 1½ per cent for manufacturing industry.

Table 3.8: Costs in manufacturing

Per cent changes on a year earlier

	Unit labour costs	Cost of materials and fuels[1]	Estimated total costs[2]	Output prices[1]
1984	3	8½	4½	5½
1985	4	4½	4½	6½
1986	5	- 10½	0	4½
1987 Forecast	1½	1½	2	4½

[1] Producer prices excluding food, drink and tobacco.

[2] Including costs of bought in services

3.51 The figures in table 3.8 suggest that profit margins in manufacturing have widened markedly in recent years; it seems likely that industry will hold onto the gains it made last year with the help of falling input costs, and profits margins may widen further during 1987 given the forecast low growth in unit labour costs. In the longer run the higher level of profitability should lead to more investment, greater capacity, higher productivity, and hence lower inflationary pressure.

3.52 The early part of 1987 is likely to see a continuation of the recent upward movement in the rate of RPI inflation. This will mainly reflect the relative movements in 1986 and 1987 of petrol prices (which fell during the first half of 1986 to a low point in July and early August) and mortgage interest rates. RPI inflation should fall back in the second half of this year, to around 4 per cent in the fourth quarter.

Table 3.9: Retail prices index

Per cent changes on year earlier

	Weight in 1986	Forecasts		
		1986Q4	1987Q4	1988Q2
Food	18½	3¼	2 3/4	3½
Nationalised industries[1]	6	3¼	2	5
Housing	14½	7	[11]	[8]
Other	61	2½	[3½]	[3½]
Total	100	3½	[4]	[4]

[1] Includes water

3.53 The GDP deflator measures the price of domestic value added - principally unit labour costs and profits per unit of output - and excludes import prices. It is sensitive to movements in North Sea profits, which may have fallen by more than half in the current financial year: as a result the deflator for GDP at market prices may have risen by only 3 per cent in 1986-87. The forecast stabilisation of the oil price means that, with the further rise in non-North Sea profits now foreseen, the GDP deflator may rise rather faster in 1987-88 than in the previous year, perhaps by around 4½ per cent.

PRODUCTIVITY AND THE LABOUR MARKET

3.54 Results from the 1984 Census of Employment became available in December. These showed that the change in the number of employees since the last Census in 1981 had been very close to provisional estimates based on the results of successive Labour Force Surveys, and confirmed the need to allow for downward bias in the responses to the quarterly and monthly surveys of employers. Growth since March 1983 in the employed labour force in Great Britain is now estimated at 1,129,000. Table 3.10 shows changes in employment over the last three years for which statistics are available.

Table 3.10: Employment

Thousands, change in GB seasonally adjusted

	Employees in employment		Self employed	HM forces	Employed labour force
	Male	Female			
September 1983 to September 1984	- 21	+ 191	+ 233	+ 3	+ 406
September 1984 to September 1985	+ 33	+ 198	+ 112	- 2	+ 341
September 1985 to September 1986	- 41	+ 139	+ 122*	- 3	+ 216

* Figure for self-employment growth over the last year is a projection based on self-employment growth over the previous four years.

3.55 Growth in employment averaged a relatively modest 37,000 a quarter in the first half of 1986, reflecting the period of sluggish output growth at the end of 1985 and in early 1986. The third quarter saw growth in employment at more than twice this rate as the economy quickened again. Recent monthly figures for manufacturing employment point to a still larger rise in total employment in the fourth quarter.

3.56 While confirming earlier figures for the total number of employees the Census results show some differences from the previous figures in the composition of changes in employment. Full- time female employment has risen by much more, and part-time female female employment by much less than previously estimated; employment outside manufacturing has risen more than previously thought while

manufacturing employment has shown a correspondingly greater decline. The estimate of productivity growth in manufacturing since the 1979 cyclical peak has been raised by about ½ per cent a year on average. Underlying growth in manufacturing productivity now seems to be fully back to the rate experienced in the 1960s.

Table 3.11: Output per head of the employed labour force*

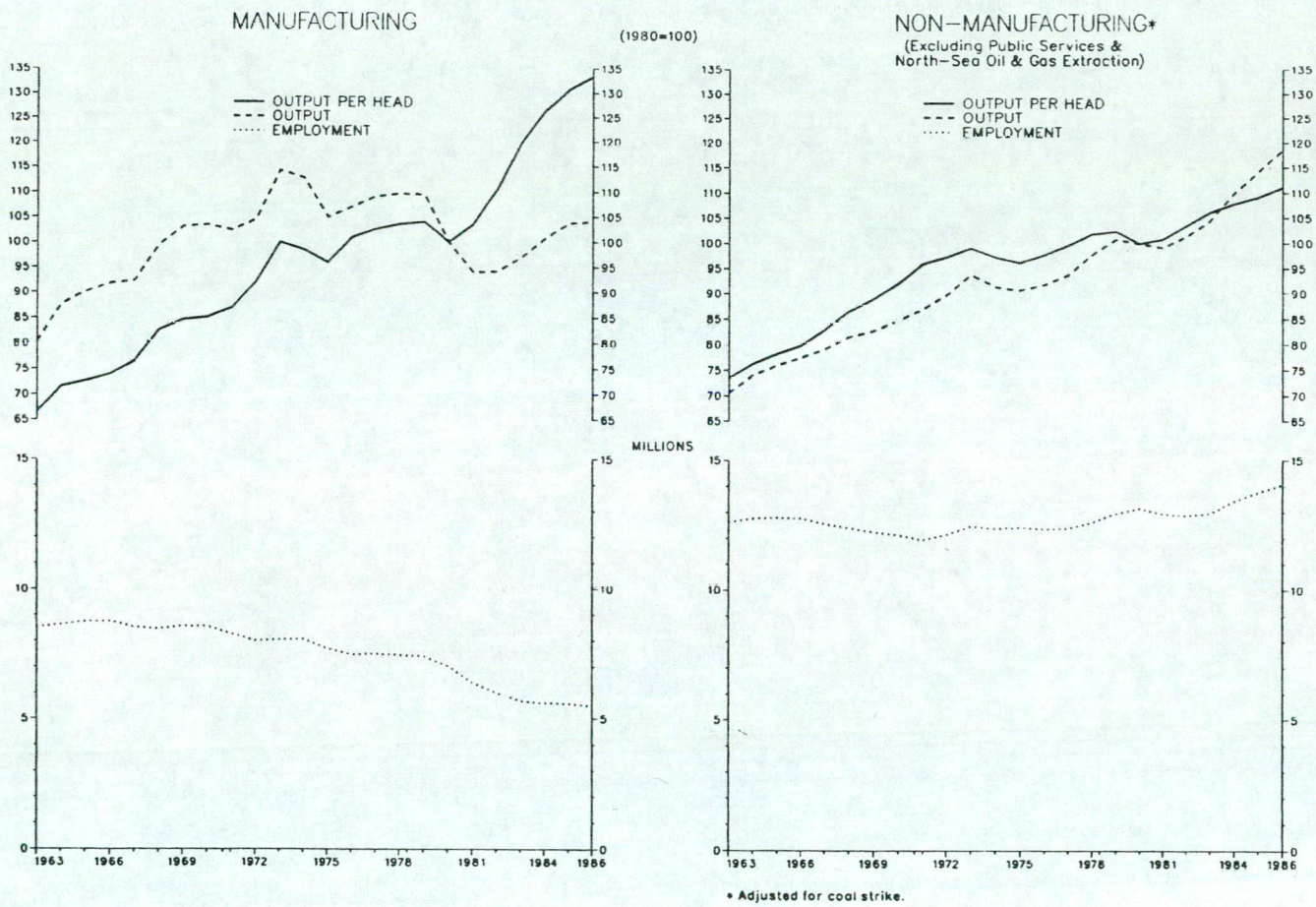
Per cent changes

	Annual averages			1983Q4 to 1984Q4	1984Q4 to 1985Q4	1985Q4 to 1986Q4
	1964-73	1973-79	1979-86			
Manufacturing	3 3/4	3/4	3½	3¼	2¼	4¼
Non-manufacturing*	3	½	1	1 3/4	1¼	1½
Whole economy	2 3/4	1¼	2	2	1	1 3/4
Non-North Sea economy	2 3/4	½	1 3/4	1 3/4	1½	2

* Figures for 1984Q4 are adjusted for the estimated effect of the coal strike.

** Includes private sector and nationalised industries other than in manufacturing and oil.

OUTPUT, EMPLOYED LABOUR FORCE AND OUTPUT PER HEAD



, the largest six months fall since [1973]

Unemployment

3.57 Seasonally adjusted adult unemployment in the United Kingdom fell by 100,000 in the six months to January. The recent and prospective strength of the UK economy means that employment growth is likely to pick up further during the next year, and the outlook for a continuation of the decline in unemployment is very promising. The training and counselling measures announced and implemented over the last year are helping in particular the longer term unemployed. A sustained major reduction in unemployment will depend, as it has always done, on moderation in pay settlements.

FORECAST AND OUTTURN

3.58 The table below compares the main elements of the forecast published in the 1986 FSBR with the outturn or latest estimate:

Table 3.12: Forecast and outturn

	1986 FSBR forecast	Latest estimate/ forecast	Average errors from past forecasts
Total gross domestic product: per cent change between 1985 and 1986	3	2½	¾
RPI: per cent increase between the fourth quarters of 1985 and 1986	3½	3½*	1½
Money GDP, per cent change between 1985-86 and 1986-87	6¾	6	1¼
Current account of the balance of payments in 1985, £ billion	3½	[-½]	3
PSBR, financial year 1986-87 £ billion	7	5	[5]

* Outturn

3.59 Inflation in the fourth quarter of 1986 turned out in line with the forecast made a year ago. Real and money GDP growth have probably turned out a little below forecast, although the data on which latest estimates for 1986 are based is still very uncertain. Unanticipated strength of non-oil revenues mean that the PSBR in 1986-87 is likely to turn out perhaps £2 billion below last year's FSBR forecast. The largest error made last year was on the current

account; the main factors here were that growth in UK export markets turned out well below what had been expected a year ago while the terms of trade declined more than forecast.

3.60 This year's forecast is summarised in Table 3.13

Risks and uncertainties

3.61 No forecast is complete without an indication of error margins. Table 3.13 sets out the average errors from past forecasts, alongside the forecasts themselves. These average errors provide an indication of possible errors in the current forecast. Those items which represent the relatively small balance between large flows in either direction are particularly subject to error. For example, the flows on either side of the PSBR, including the revenues of the public corporations, are about £200 billion; and for the current account of the balance of payments exceed £150 billion.

Table 3.13: The prospects: summary

	fore-cast	Average errors from past forecasts[1]
A. Output and expenditure at constant 1980 prices	per cent changes 1986 to 1987	
Domestic demand	3½	¾
of which:		
Consumers' expenditure	3½	1
General government consumption	2	1
Fixed investment	4	2¼
Change in stockbuilding (as per cent of level of GDP)	½	¾
Exports of goods and services	4	2½
Imports of goods and services	6	2½
Gross domestic product: total	3	¾
manufacturing	4	2
B. Inflation		
Retail prices index	per cent changes	
1986Q4 to 1987Q4	4	1½
1987Q2 to 1988Q2	4	2¼
Deflator for GDP at market prices	per cent changes on a year earlier	
Financial year 1986-87	3	¾
Financial year 1987-88	4½	1¾
C. Money GDP at market prices	per cent changes on a year earlier	
Financial year 1986-87	6	1¼
Financial year 1987-88	7½	1½
D. Balance of payments on current account	£billion	
1987	-2½	3
1988 first half (at an annual rate)	-3	3½

E. PSBR	£billion[2]	
Financial year 1986-87	5 (1¼)	[1 (¼)]
Financial year 1987-88	4½(1)	[5 (1¼)]

---

[1] The errors relate to the average differences (on either side of the central figure) between forecast and outturn. The method of calculating these errors has been explained in earlier publications and government forecasts (see Economic Progress Report June 1981). The calculations of average errors are based on forecasts made between 1975 and 1985. The errors are after adjustment for the effects of major changes in fiscal policy where excluded from the forecasts.

[2] Percent of GDP at market prices shown in brackets.

Table 3.14 Constant price forecasts of expenditure, imports and gross domestic product*
£ billion at 1980 prices, seasonally adjusted

	Consumers' expenditure	General government consumption	Total fixed investment	Exports of goods and services	Change in stocks	**Total final expenditure**	Less Imports of goods and services	Less Adjustment to factor cost	Plus Statistical adjustment	**Gross domestic product at factor cost**	GDP index (average estimate) 1980=100
1982	138.2	49.6	39.5	63.3	- 1.1	**289.3**	59.5	30.4	0.7	**200.0**	100.3
1983	143.6	50.5	41.7	64.7	0.7	**301.2**	62.8	31.5	0.0	**207.0**	103.8
1984	146.6	50.9	45.5	69.0	- 0.1	**311.9**	68.5	32.6	2.0	**212.8**	106.7
1985	152.0	50.9	46.4	73.1	0.7	**323.1**	70.6	33.7	1.3	**220.0**	110.3
1986	159.5	52.0	46.4	75.1	0.6	**333.4**	74.7	35.0	1.3	**225.0**	112.8
1987	165.0	53.0	48.4	78.1	1.3	**345.4**	79.1	36.1	2.0	**232.1**	116.3
1985 H1	75.0	25.5	23.4	36.7	0.5	**116.2**	35.2	16.7	0.5	**109.8**	110.1
H2	77.0	25.4	23.0	36.4	0.2	**161.9**	35.4	17.0	0.9	**110.3**	110.5
1986 H1	78.6	25.8	23.2	36.6	0.5	**164.6**	35.9	17.2	0.4	**111.9**	112.2
H2	81.0	26.2	23.2	38.5	0.1	**168.7**	38.8	17.8	1.0	**113.1**	113.4
1987 H1	82.0	26.4	23.9	38.9	0.7	**171.8**	39.2	18.0	0.9	**115.5**	115.8
H2	83.0	26.5	24.3	39.2	0.7	**173.6**	39.9	18.2	1.1	**116.6**	116.9
1988 H1	84.6	26.5	24.5	39.6	0.6	**175.9**	40.2	18.5	1.0	**118.3**	118.6
Per cent changes											
1984 to 1985	3½	0	2	6	-	**3½**	3	3½	-	**3½**	2½
1985 to 1986	5	2	0	3	-	**3**	5½	4	-	**2½**	2½
1986 to 1987	3½	2	4	4	-	**3½**	6	3½	-	**3**	3
1987H1 to 1988H1	3	1½	3½	1½	-	**2½**	2½	2½	-	**2½**	2½

* GDP figures in the table are based on "compromise" estimates of gross domestic product, reflecting, for the past, average movements in constant price expenditure, output and income estimates of GDP. Percentage changes are calculated from unrounded levels and then rounded to half per cent. Figures for 1987H1 and beyond are forecasts. Figures for periods up to the end of 1986 are based mainly on the national accounts published earlier (covering periods up to 1986Q3) and incorporate some revised and later data and forecasts. A full set of national accounts, to end 1986, will be published by the CSO on 21 March.

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DATE: 26 FEBRUARY 1987

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Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir Terence Burns
Mr F E R Butler
Sir Geoffrey Littler
Mr Cassell
Mr Monck
Mr A Wilson
Mr Odling-Smee
Mr Sedgwick
Mr Turnbull
Mrs R J Butler
Mr Culpin
Miss O'Mara
Mr Mowl
Miss Evans
Mr Cropper
Mr Ross Goobey
Mr Tyrie

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

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B.L.O.

FSBR: CHAPTER 1

... I attach a first draft of Chapter 1 of the FSBR. This follows last year's format and is consistent with the individual draft chapters which you have seen this week.

2. We have at this stage omitted the section in paragraph 1.04 of last year's FSBR which refers to reducing the burden of taxation and to tax and expenditure on a declining path as a percentage of GDP

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since on present estimates the scorecard package will keep taxation as a proportion of GDP constant at the 1986-87 level of 38.2 per cent.

3. We would welcome your comments on the draft before we send the FSBR to the printers on Monday.

MCS

M C SCHOLAR

BLO enc: 4 pages

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1 The Budget

1.01 The objective of the Government's economic policy is to defeat inflation and maintain a vigorous, enterprising economy which will generate sustained growth and increased employment.

1.02 The Financial Statement and Budget Report (FSBR) supplements the Chancellor's Budget Statement. It describes the Medium Term Financial Strategy (MTFS); outlines developments in the economy over the past year; provides forecasts to mid 1988; details the tax proposals in the Budget; summarises the government's spending plans and brings together the financial position of the public sector for the year ahead.

The Medium Term Financial Strategy

1.03 Chapter 2 describes the MTFS which has been in place since 1980. It provides the framework for the government's economic policies, which are designed to bring down inflation and improve the UK's economic performance. Monetary and fiscal policy is set to reduce the growth of money GDP, so bringing down inflation. It is supported by measures to encourage enterprise, efficiency and flexibility which will improve the prospect for output and jobs. The Budget is designed to strengthen these policies.

Forecast

1.04 Chapter 3 describes the main developments in the economy in 1986 and the prospect until mid-1988. A strong rise in investment and non-oil exports is forecast for 1987 and GDP should grow by 3 per cent. Manufacturing output growth may be slightly faster. Inflation is forecast to be at around [4] per cent in the fourth quarter of 1987. A current account deficit of [£2-2½ billion], around ½ per cent of GDP, is forecast. There are good prospects for a continuing decline in unemployment.

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Tax measures

1.05 Chapter 4 sets out the tax proposals in the Budget. They include a cut of 2p in the basic rate of income tax, a new incentive to encourage the growth of profit related pay, improvements in the regime for pensions, and measures to simplify tax collection and to make it more fair and effective. Table 1.1 opposite summarises the effect of all these measures.

Public expenditure

1.06 Chapter 5 summarises the government's spending plans for the next three years. The plans show a continuing fall in general government spending as a percentage of GDP. This chapter also provides the latest estimates of the outturn for the public expenditure planning total in 1986-87 and includes a comparison of outturn and plans for the different spending authorities.

Receipts and expenditure

1.07 Chapter 6 brings together the complete financial picture for the public sector. The public sector borrowing requirement (PSBR) for 1986-87 is forecast to be [just under £5 billion, over £2 billion] lower than indicated in the 1986 FSBR. The PSBR for 1987-88 is forecast to be some £[3½] billion, or [¾] per cent of GDP, £[3½] billion below the level in the MTFS last year. The Budget measures are expected to contribute £[2] billion to the borrowing requirement, over and above the cost of indexing tax rates and allowances. Table 1.2 summarises the sources of the receipts and the direction of expenditure.

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TABLE 1.1 THE BUDGET MEASURES[1]

Tax proposals	£million 1987-88 Changes from an indexed base	1987-88 Changes from a non-indexed base	yield(+)/cost(-) 1988-89 Changes from a non-indexed base
Income tax basic rate[2]	-2200	-2200	-2800
Income tax allowances and thresholds	+ 40	- 760	-1000
Excise duties			
- oils (net of bus fuel grants)	+ 90	+ 320	+ 350
- vehicle excise duty	- 85	+ 10	+ 10
- tobacco	*[3]	+ 95	+ 105
- alcohol	- 20	+ 85	+ 95
- on-course betting duty	- 20	- 20	- 20
- gaming machine licence duties	+ 20	+ 20	+ 20
VAT			
- partial exemption rules	+ 300	+ 300	+ 400
- small business package	- 115	- 115	- 35
- other	- 5	- 5	+ 20
Inheritance tax	- 70	- 85	- 200
Corporation tax	*	*	+ 235
Profit related pay	*	*	- 35
Pensions	*	*	- 65
Other tax measures	- 30	- 35	+ 25
Total tax measures	-2095	-2390	-2895

1 These measures and the basis of the costings shown, are described in detail in Chapter 4.

2 Figures include the effect of the consequential change in the rate of advance corporation tax.

3 Negligible.

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Table 1.2 The finances of the public sector

£ billion	1986-87 1986 Budget[1]	1986-87 Latest estimate	1987-88 Forecasts
RECEIPTS			
Income taxes	38.7	38.6	40.3
Corporation tax excluding North Sea[2]	9.4	11.2	3.2
Capital taxes	2.8	2.7	3.2
Expenditure taxes:			
Value added tax	20.7	21.5	23.3
Local authority rates	15.6	15.5	16.7
Petrol, derv, etc., duties	7.3	7.5	8.1
Spirits, beer, wine, etc	4.4	4.2	4.4
Cigarettes and other tobacco	4.7	5.0	5.1
Other	9.3	10.1	10.5
Total expenditure taxes	61.9	63.7	68.1
North Sea revenues:			
North Sea corporation tax[3]	2.7	2.7	1.4
Petroleum revenue tax	2.4	1.3	2.0
Oil royalties	1.0	0.9	0.8
Total North Sea	6.1	4.8	4.2
Other[4]	-1.2	-1.2	-0.8
Total taxes and royalties	117.6	119.7	128.6
National insurance and other contributions	26.2	26.4	28.5
Interest and dividend receipts	6.4	5.8	5.8
Gross trading surpluses and rent	2.7	3.3	3.3
Other	3.0	3.3	3.5
General government receipts[5]	155.9	158.6	169.7

£ billion	1986-87 1986 Budget[1]	1986-87 Latest estimate	1987-88 Forecasts
EXPENDITURE			
DHSS - Social security	42.9	44.6	46.0
Defence	18.5	18.4	18.8
DHSS - Health and personal social services	17.7	18.0	19.1
Scotland, Wales and Northern Ireland	15.0	15.5	16.0
Education and science	14.3	15.7	16.6
Other departments	31.2	32.5	33.6
Privatisation proceeds	-4.7	-4.4	-5
Reserve	4.5	-	3.5
Adjustments	-0.4	-	-
Public expenditure planning total	139.1	140.3	148.6
General government gross debt interest	18.2	17.5	18.3
less public corporations' markets and overseas borrowing	-0.4	-1.8	-0.6
Other national accounts adjustments	5.7	5.7	6.1
General government expenditure	163.4	165.3	173.7

Difference between expenditure and revenue financed by borrowing

	1986-87 1986 Budget	1986-87 Latest estimate	1987-88 Forecast
General government expenditure	163.4	165.3	173.7
General government receipts	155.9	158.6	169.7
General government borrowing requirement	7.5	6.7	4.0
Public corporations' market and overseas borrowing	-0.4	-1.8	-0.6
Public sector borrowing requirement	7.1	4.9	3.4

1 On current definitions
2 Including advance corporation tax but excluding corporation tax on capital gains
3 Before advance corporation tax set off. See footnote[3] to Table 6.B.3
4 Adjustments for advance corporation tax set off against North Sea corporation tax plus accruals adjustment
5 In these and other tables, constituent items may not add up to totals because of rounding.

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FROM : D. N. WALTERS
Date : 27 February 1987

MR STONEHOUSE

cc Mr Frey.

FSBR : DEMAND NUMBER.

For this year's FSBR - published on 17 March - the Treasury's requirement is for the following number of copies:

Chancellor's Office	:	150 copies
Committee Section (per IDT)	:	487 copies
FP division	:	15 copies
HMT Library	:	25 copies
TOTAL	:	677 copies

I would be grateful if you could arrange the necessary demand number documentation please.

D N Walters

F.P. Division.

ph1.31

BUDGET SECRET

Copy No 34 of 35

FROM: A C S ALLAN
DATE: 27 FEBRUARY 1987

MR SCHOLAR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir Peter Middleton
Sir Terence Burns
Mr F E R Butler
Sir Geoffrey Littler
Mr Cassell
Mr Monck
Mr A Wilson
Mr Odling-Smee
Mr Sedgwick
Mr Turnbull
Mrs R J Butler
Mr Culpin
Miss O'Mara
Mr Mowl
Miss Evans
Mr Cropper
Mr Ross Goobey
Mr Tyrie
Mr Battishill - IR
Mr Isaac - IR
Mr Painter - IR
Mr Calder - IR
Mr Ko - IR
Sir Angus Fraser - C&E
Mr Knox - C&E
Mr Willmott - C&E
Mr Bone - C&E

FSBR CHAPTER 1

The Chancellor was grateful for your minute of 26 February. He has the following comments to make.

i. In paragraph 1.03, the second sentence should end "designed to bring inflation down further and improve other aspects of the UK's economic performance".

ii. At the end of paragraph 1.03, delete the full-stop and add "and to reduce the role of the state in the economy. Public expenditure is on a declining part as a percentage of Gross Domestic Product (GDP) and taxes have again been reduced, as they have in each year since 1981".

iii. In paragraph 1.04, leave the first and last sentences as drafted, but amend the intervening passages to read "GDP is forecast to grow by 3% in 1987, the sixth successive year of steady growth. A strong rise is forecast in investment, in manufacturing output and in non-oil exports. Inflation is forecast to be about [4%] in the fourth quarter of 1987".

iv. In paragraph 1.05 change "cut" to "reduction" in the first line. The second sentence should end "... and to make it fairer and more effective".

v. In paragraph 1.07 the third sentence should read "... below the illustrative level in last year's MTFS". In the next sentence say "the net cost".

2. The Chancellor wishes to consider further the treatment of column 3 of Table 1.1. The numbers in paragraph 1.07 and Table 1.1 may need revision in the light of final decision on the Budget package at Monday's overview meeting.

ACSA

A C S ALLAN

COPY NO. 31 OF 31.

FROM: A C S ALLAN
DATE: 27 February 1987

MR C MOWL

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Sir G Littler
Mr F E R Butler
Mr Cassell
Mr Monck
Mr Odling-Smee
Mr Scholar
Mr Sedgwick
Mr Turnbull
Mr Culpin
Mr S Davies
Mr Riley
Mrs R Butler
Mr Ritchie
Mr Devereux
Ms Evans
Mr Cropper
Mr Tyrie
Mr Ross Goobey

Mr Battishill - IR
Mr Calder - IR
Sir Angus Fraser - C&E
Mr Wilmott - C&E

FSBR CHAPTER 6

The Chancellor was grateful for your minute of 25 February. He notes that a number of the figures will need amending as the Budget package changes or new information arrives. Otherwise, he has the following comments:

(i) in paragraph 6.06 the first sentence should start "The Autumn Statement said that general government receipts in 1986-87 were expected to be higher ...". Later in that paragraph "£1.7 billion" should be "£1¾ billion" and "£0.8 billion" should be "£¾ billion";

(ii) in paragraph 6.07 delete "mainly" in the first line and "also" in the second line. Amend the second sentence to

read "Oil revenue are now estimated to have fallen from £x billion in 1985-86 to £4¼ billion in 1986-87." In the last line change "assumed" to "forecast";

(iii) in paragraph 6.08 add "total" before "non-oil receipts" in the first line; amend the beginning of the second sentence to read "They are now estimated to have risen slightly more, by 9¾ per cent ...". Amend the third sentence to read "Corporation tax receipts in 1986-87 largely depend on profits and other income earned in the calendar year 1985". Amend the beginning of the next sentence to read "On currently recorded data, non-North Sea company incomes rose strongly ...". In the next sentence change the second "rise" to "increase". Amend the end of the last sentence to read "but probably also reflects a change in the composition of consumption towards spending on goods and services subject to VAT";

(iv) in paragraph 6.09 start the first indent "a further rise" then end the second line "corporation tax). This compares with ...". Start the third indent "an 8¼ per cent". Delete "standard rate" in the second sentence;

(v) in paragraph 6.10 is it really true that GGE is now expected to be higher than in the Autumn Statement?

(vi) in paragraph 6.11 delete "over" in the first sentence; "is" should be "are" in the last sentence;

(vii) in paragraph 6.13 amend the fourth sentence to read "And central government revenue is expected to be less than last year, with lower North Sea oil revenues as a result of the fall in oil prices, and lower receipts of building society composite rate tax as a result of the change in payment arrangements". Delete "but there remains substantial uncertainty surrounding this estimate" at the end;

(viii) in paragraph 6.14 delete everything after the first sentence. Also delete the footnote;

(ix) in paragraph 6.15 change the fifth line to read "... done since 1982-83, while general government receipts ...";

(x) in paragraph 6.16 amend the first two sentences to read "there have been significant changes in the structure of receipts over the past eight years. In particular:". In the first indent, say "financing public expenditure", and "12 per cent of expenditure". Delete the last indent;

(xi) delete Chart 6.1;

(xii) in paragraph 6.20 delete "individual" in the last line;

(xiii) in paragraph 6.21 change "still very large" to "inevitably very large" in the seventh line;

(xiv) in paragraph 6.23 the end should read "... the effect on profit margins of the decline in sterling, and a rise in net trade credit receipts";

(xv) in paragraph 6.24 the end of the third sentence should read "... shows the derivation of the public sector financial deficit". The end of the last sentence should read "... associated with Rover Group is classified as cash expenditure on company securities and appears in line 27". Something needs to be added to this paragraph to warn of the non-cash basis of PSFD;

(xvi) in Table 6.6 the presentation has been changed since last year, with taxes on income and North Sea oil royalties split into separate lines (which has thrown almost all the line number references in the Annex). The Chancellor would prefer the presentation in Table 6.6 to go back to where it was last year: it seems best to segregate either all oil revenues or none;

(xvii) in paragraph 6A.1 is the "financial deficit" referred to in the second and sixth lines the public sector financial

deficit or the general government financial deficit? The text should make this clear. The last line should say "public sector borrowing requirement";

(xviii) in paragraph 6A.5 the second sentence should read "For example, oil revenues comprise North Sea corporation tax, petroleum revenue tax and oil royalties (all included ...". (This assumes the presentation in Table 6.6 is changed back to last year's);

(xix) in Table 6.B.3, Footnote 5 should read "Includes estate duty and capital transfer tax".

ACSA

A C S ALLAN

FROM: P D P BARNES
DATE: 2 March 1987

1 MR SCHOLAR

cc 2 PPS
3 PS/Chief Secretary
4 PS/Financial Secretary
5 PS/Minister of State
6 Sir P Middleton
7 Sir G Littler
8 Sir T Burns
9 Mr F E R Butler
10 Mr Cassell
11 Mr Monck
12 Mr A Wilson
13 Mr Culpin
14 Mr Odling-Smee
15 Mr Turnbull
16 Mrs R J Butler
17 Miss O'Mara
18 Mr Mowl
19 Miss Evans
20 Mr Cropper
21 Mr Ross Goobey
22 Mr Tyrie

23 Mr Battishill - IR
24 Mr Isaac - IR
25 Mr Painter - IR
26 Mr Calder - IR
27 Mr Ko - IR

28 Sir Angus Fraser - C & E
29 Mr Knox - C & E
30 Mr Wilmott - C & E
31 Mr Bone - C & E

FSBR

The Economic Secretary has seen your submission to the Chancellor of 26 February, and those of Messrs Sedgwick and Riley of 24 February. He has the following comments:

i) Table 1.1. The Economic Secretary thinks that the contrast between the cost of the basic rate reduction and the yield from income tax allowances and thresholds looks presentationally awkward. Could it be made clear that the +40 yield of the latter in 1987-88 arises from the thresholds and not the allowances?

ii) Table 1.2. The Economic Secretary wonders whether the Corporation Tax Forecast for 1987-88 of £3.2 billion is a mistake.

iii) Paragraph 207. The Economic Secretary thinks that the phrase "to keep monetary conditions on track" is very strange.

iv) Paragraph 212. The Economic Secretary is in favour of keeping the reference to M1 in the text but he thinks it might read better as follows: "M0 remains the best choice of narrow aggregate for target purposes. In principle, there is a case for moving to a wider measure of non-interest bearing money, such as the non-interest bearing component of M1. But M1 is very sensitive to interest rate changes and its velocity exhibits considerable fluctuations, currently exacerbated by the rapid growth of interest-bearing sight deposits".

v) Chart 25. The Economic Secretary thinks it is confusing to describe financial year 1986-87 as "1986" in the table. He wonders whether this is a convention.

vi) Paragraph 222, line 6. Insert "projected" before "planning total".

vii) Paragraph 3.9. The Economic Secretary thinks the last sentence sounds a bit out of date in view of the recent improved M0 figures. Also, in the chart above, the Economic Secretary thinks it a pity not to show the present yield on gilts as below 10. He wonder whether this chart, and that on monetary aggregates on the following page, could be extended to show later figures.

PB

P D P BARNES
Private Secretary

56

BUDGET SECRET

COPY NO 2 OF 35 COPIES

From: R B SAUNDERS
Date: 2 March 1987

MISS C EVANS

cc PPS
PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir T Burns
Mr F E R Butler
Sir G Littler
Mr A Wilson
Mr Cassell
Mr Monck
Mr Odling-Smee
Mr Peretz
Mr Scholar
Mr Sedgwick
Mr Turnbull
Mrs Butler
Mr Culpin
Miss O'Mara
Mr Mowl Mr Riley
Mr Cropper
Mr Ross Goobey
Mr Tyrie

Mr Battishill)
Mr Isaac) IR
Mr Painter)
Mr Calder)

Sir A Fraser)
Mr Knox) C&E
Mr Wilmott)
Mr Bone)

FSBR

Sir Peter Middleton went through the FSBR, as it stood on Friday night, over the weekend. He has a number of comments.

Chapter 1

2. No comments, but he will wish to pick up the Chancellor's comment about column 3 of table 1.1. (There was correspondence

on this point last year.)

Chapter 2

3. A number of comments were made at Sir Peter Middleton's monetary meeting with the Bank on Thursday last week. Could you please consult Mr Peretz about them. He will be sending the Bank a revised version of this chapter tonight, with a view to clearance in the course of tomorrow and to avoiding the need for a meeting between the Chancellor and the Governor this year.

4. He thinks it is a pity to have dropped the first sentence of 2.02 "Economic policy is set in a nominal framework". He would prefer this to be reinstated.

5. On paragraph 2.10, the second and third sentences to read ... period of stability would be desirable in current circumstances. Accordingly the UK and the other countries represented agreed to co-operate closely ...". He questions the use of the words "from year to year" in the final sentence, and would suggest deletion.

6. The final sentence of 2.11 to read "M0 has proved a reliable ...".

7. He still has reservations about paragraph 2.12 as it stands, but meanwhile I give you two minor drafting points: in the second sentence insert "which are" before "currently"; and in the final sentence delete "For the present" and insert "So".

8. In paragraph 2.15, delete the "and" after the semi-colon in the second sentence. And paragraph 2.16 is to be redrafted in the light of the monetary meeting.

9. On chart 2.5, he wonders why we need to add "and privatisation proceeds" to the title. He does not like the description of the years on the scale as "1970, 1971 etc".

He thinks we should go back to last year's presentation.

10. Paragraph 2.19 to read as follows:

> "As usual, the fiscal projections for the next 4 years set out in tables 2.3-5 take account of the composition of receipts and expenditure in 1987-88. The path of the PSBR is below that shown in last year's MTFS. The buoyancy of revenues experienced in 1986-87 and projected for 1987-88 has made it possible to project a PSBR in 1987-88 which reflects the Government's long term objective for the level of public borrowing.

11. On paragraph 2.21, he would prefer to standardise on privatisation proceeds being "added back" (rather than "excluded") in the second sentence. He would make the final sentence read "These figures illustrate the desired position over a period of years; decisions about the PSBR in particular years will be taken nearer the time." if the Chancellor wants to go that far.

12. In paragraph 2.24 move the words "as a proportion of GDP" to come after "steadily". In paragraph 2.28, delete "taxation" insert "taxes". Paragraph 2A.1 delete "now" in the first sentence. He notices that the heading of table 2A.1 is right, unlike last year!

Chapter 3

13. I understand that a revised version of this is in preparation, which the Chancellor's office will be circulating.

Chapter 4

14. Nothing.

Chapter 5

15. Nothing. But he thinks it is important for somebody to read through the whole document carefully to make sure that an unemployment forecast cannot be deduced from it.

Chapter 6

16. In paragraph 6.04, delete the first "three-fold". In the fourth indent in paragraph 6.09, insert "forecast" before "increase".

17. He would like the proposition in the first sentence of paragraph 6.15 checked. He would like to see the arithmetic set out.

18. On the first indent of paragraph 6.16, he was not clear what was meant by "public expenditure". He has asked if we have standardised on GGE throughout this chapter. On this and the next indent, he has some doubts about expressing borrowing and revenues as a proportion of expenditure. He has asked whether this is new. He wonders whether it will complicate the normal practice of using GDP as the denominator.

19. Paragraph 6.24, line 6 - "transactions".

R B SAUNDERS
Private Secretary

Ok: forget manpower

Ch

I discussed manpower with Medical Schools. He felt that it would be much easier to include an extra paragraph in this minute (since the numbers this year are so small). The alternative, page below has this added

AA

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FROM: M C SCHOLAR
DATE: 4 MARCH 1987

CHANCELLOR OF THE EXCHEQUER

cc Sir Peter Middleton
Mr Cassell

BUDGET MEASURES: MINUTE TO THE PRIME MINISTER

... I attach a draft minute to the Prime Minister. I suggest that this year you send her two minutes - this one and one early next week on the MTFS and borrowing requirement.

What will be in the other one? MCS

M C SCHOLAR

BLO enc: 7 pages

Ch

Long, but wraps up in one minute what was in 2 last year.

AA

OK. After all!

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~~44.~~ I am ~~proposing~~ purpose to increase the main personal allowances by the statutory indexation factor of 3·7 per cent. As last year, I am sure our priority must be to cut the basic rate ~~&~~ the marginal tax rate for [95%] of taxpayers. ~~rather than to make any major change in allowances.~~

(4)

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DRAFT MINUTE TO PRIME MINISTER

1. This minute sets out my proposals for the Budget this year.

2. My aim, as in previous years, has been to devise a Budget which will give us a solid financial framework, with a safety margin built into it, for the year ahead; which will reduce taxation ~~as far as we prudently can~~ within the limits of prudence; and will improve incentives and encourage enterprise.

3. I will minute you separately about my proposals for monetary targets and the PSBR when the final pieces of the jigsaw are available, early next week. But it is already plain that we shall be able this year both to plan on a PSBR ~~well~~ substantially below the level envisaged in last year's MTFS and at the same time to afford a tax reduction of £2½-3 billion, in 1987-88 rising to just under £3 billion in 1988-89.

Income tax

4. ~~I am clear that we must devote the bulk of this to a further reduction in the basic rate of income tax.~~ I am therefore proposing a 2p cut, to 27 pence in the pound. This will do more than any other measure available to us to add momentum to the growth of the enterprise culture. It is ~~thus~~ desirable in itself and ~~as~~ is the best means of improving the longer term potential of the economy. It also highlights the difference between an approach based on reduction of the opposition.

5. Our presentation of ~~this cut~~ these proposals should, I suggest, follow closely the line which we got across so successfully last year: that it is aimed at the vast majority of taxpayers and will help all the sensitive groups in the middle - the nurse, the teacher married to a bank clerk and so on. To strengthen our presentation I propose, as last year, to set the higher rate bands so as to ensure that higher rate taxpayers will not benefit disproportionately from the income tax changes as a whole. ~~I am accordingly increasing the starting point for higher rate tax by the same percentage - the statutory indexation factor of 3.7 per cent - as will be applied to the main personal allowances; increasing the threshold for the~~ proposing to increase the starting point for higher rate tax by the same percentage as will be applied to the main personal allowances; increasing the threshold for the

Thus the first (40%) higher rate threshold would be fully revalorised, the second (45%) higher rate threshold partially revalorised, and the subsequent higher rate thresholds left unchanged.

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45 per cent band by £200 to £20,400; and leaving the other higher rate thresholds unchanged.

6. For two groups I propose increases in the allowances beyond simple indexation: for those over 80 the age allowance will be increased by twice that amount ie by 7.4 per cent; and the blind allowance will go up from £360 to £540.

Excise duties

7. Apart from three minor changes in Vehicle Excise Duty and an increase in gaming machine duty, I am making no increases in the excise duties this year. This means that the overall impact of the Budget on the RPI as conventionally measured will be about 0.15 per cent (entirely reflecting the effect of the basic rate cut on mortgage payments), well below last year's 0.5 per cent. Although I expect some criticism from the health lobby I am sure that public opinion will well understand why tax increases on fuel, drinks, tobacco and so on are unnecessary in this year's financial circumstances. I shall be reducing duty on unleaded petrol as I promised last year, to do, and I shall be abolishing the duty on on-course betting,

Business and enterprise

8. My other Budget proposals are designed to carry further the themes of my previous Budgets. I am again taking action to tilt the balance towards small businesses, both by cutting their tax rates and by lightening the administrative load they bear. The small companies' rate of Corporation Tax comes down to 27 per cent, in line with the basic rate cut. The self-employed will benefit from the reductions in income tax.

9. I am also legislating to ease the burden of VAT on small businesses. My proposals, which David Young supports, were well received in the consultation exercise we launched last autumn. The main change here is cash accounting, which will mean that companies with an annual turnover of up to £¼ million will not be liable to pay VAT until they have been paid by their customers. This will help their cash flow, as well as giving them automatic bad debt

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(X) I ~~have investigated~~ would possibly have also but a still
~~A~~ perhaps ~~£~~ ½m; ~~would be possible~~ but I
(on the basis of legal advice from experts) that that would
jeopardise our prospects of getting the necessary
derogation from the EC Commission

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relief, something for which they have long argued. We are also introducing annual accounting, which will enable small companies to make VAT payments on account and send only one return a year to Customs and Excise; and several other changes, including a further increase to the VAT threshold to bring it to the maximum currently possible under European Community law. This package will cost £115 million in 1987-88 and £60 million in 1988-89.

10. I am making a number of changes to streamline the taxation of the corporate sector. These changes have been made possible by, and build upon, the 1984 corporation tax reform, which is already showing even better results - in improving both the environment for business and the quality of business decisions, and, paradoxically, at the same time increasing the yield of the tax - than we dared hope three years ago.

11. At present companies pay corporation tax at different intervals depending on whether they were established before or after 1965. This difference of treatment is historical and no longer has any justification. It is also open to abuse: you will remember the Habitat case last year. I therefore propose that all companies and building societies should be treated in the same way, so that all will be liable to pay corporation tax nine months after the end of the accounting period on which the tax is due. The change will be phased in, but should yield a useful £100 million in 1988-89. For the longer term I am taking steps now to introduce a more streamlined, and fairer, method of collecting corporation tax, called Pay and File.

12. I am also making changes to the taxation of companies' capital gains. In future these will be taxed at the same rate as company income, not, as now, at 30 per cent. Companies will be allowed to offset payment of Advance Corporation Tax against their tax liability on gains, something which should be generally welcomed.

13. Peter Walker and I have been looking closely at the effect of the last year's oil price on North Sea producers and their suppliers. We have already legislated to bring forward to 1986-87 the repayment of over £300 million of Advance Petroleum Revenue Tax. I propose to introduce two further reliefs designed to

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(Y) They are to allow part of the expenditure on new fields to be set against PRT liabilities on the fields; and to allow special relief for R&D (~~not related to any individual field~~ even though it is).

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encourage research and development in the North Sea oil sector. These have been carefully aimed where they should do most good.

14. I propose that the scale charge for assessing the taxable benefit of company cars should be increased by 10 per cent. There will be no change in the car fuel benefit scales.

15. The Budget will also contain a number of measures designed to block up loopholes where substantial losses of tax are at stake. On one of these, VAT partial exemption, we have already exchanged minutes (my minute to you of 16 December and David Norgrove's reply of 18 December) and it is now clear that the scale of avoidance is larger than we at first supposed (£300 million in 1987-88 and £400 million in 1988-89). The business community accepts that we must act to stop this practice. I am also proposing action, on dual resident companies, to stop them getting tax relief twice on the same interest payment. And I am bringing to an end the present over-generous treatment of tax credit relief for foreign withholding tax paid on interest on bank loans.

16. I have one further measure in this category, which will be controversial but is essential. When the 1985 Central Lloyd's settlement was completed some £42 million of tax evaded was recovered. Lloyd's have now discovered a weakness in the law which prevents the Revenue from challenging for tax purposes syndicates' "Reinsurance to Close" - ie their provision for outstanding liabilities. I am proposing to put this right and to bring the arrangements for Lloyd's into line with the tax treatment of provisions for outstanding liabilities made by ordinary insurance companies.

17. I am convinced that, where we can, we must give a push to moves towards more flexibility on pay throughout the economy. I accordingly propose now to introduce a scheme of tax relief broadly on the lines floated in the Green Paper on Profit Related Pay which David Young, Paul Channon and I published last July. Half of profit-related pay will be relieved from income tax, subject to limits. For someone on average earnings receiving 5 per cent of

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their pay in profit-related form, the tax relief will be equivalent to a penny off the basic rate of income. The administration will be kept simple.

Savings and investment

18. I have agreed with Norman Fowler a major package of proposals on pensions which will complement the reforms in 1985 and 1986 Social Security Acts. Our aim is wider pension ownership, and to encourage people to provide for themselves in old age.

19. There are several strands to the proposals. First, I am introducing a system of tax relief for personal pensions on broadly the same lines as that now applying to retirement annuities. This ~~should encourage~~ will make it easier for employees to opt out of their employers' schemes and make their own arrangements; and it will also benefit those whose employers do not offer an occupational pension scheme. Second, I propose changes which will make it ~~easier~~ simpler for employers to set up occupational schemes with the minimum of red tape and with less of an open-ended commitment on the size of final pensions. This should encourage wider pension coverage and be of particular benefit to the 10 million or so employees who are not covered by occupational schemes.

20. Third, I am introducing arrangements to allow members of occupational schemes to make additional voluntary contributions, with full tax relief, to a plan outside their employer's scheme. They will be able to top their pension right up to the present tax approval limits. This goes well beyond what we have already announced. It will be good for choice and individual responsibility.

21. 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 by a few people, including an upper limit of £150,000 on the tax-free lump sum and more rigorous rules for calculating final salary.

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22. Last year's Budget abolished the tax on lifetime gifts between individuals. This year I propose to extend the same exemption from tax to gifts involving settled property where there is an interest in possession. ~~I am sure~~ this will be welcomed by many ~~on our side~~ of our own supporters.

23. I am also making a substantial increase in the threshold for inheritance tax, from £71,000 to £90,000 and reducing the number of tax rates from seven to four. This change will take a third of the estates currently liable to inheritance tax out of tax altogether. There will be worthwhile tax reductions at all levels, particularly for smaller estates. I also propose to increase from 30 per cent to 50 per cent business relief for inheritance tax on share-holdings of a given size in unquoted companies. This should help family firms by giving relief on assets where cash is not always available to pay the tax. ~~These changes taken together will cost £70 million in 1987-88 and £150 million in 1988-89.~~

24. Last year's ~~was a Budget for charities.~~ contains a substantial package of measures to help charities. The encouragement we give to charitable giving is now very generous; and the Payroll Giving Scheme which starts next month will give it a further boost. I therefore have no major new proposals in this field, ~~but~~ though I propose to extend slightly the VAT reliefs for charities which I introduced last year. These extensions will meet points which have been put to me by the charities lobby.

... 25. I attach a table which summarises the revenue effects of these changes. I would be grateful to know if you are content with my proposals.

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REVENUE EFFECTS OF BUDGET CHANGES

£m
(rounded to £5m)

	1987-88 (cost (-)/yield (+))	1988-89
Income tax (including higher rates)	-2160	-2740
Excise duties ~~(rate changes)~~	- 535	- 575
VAT - small business package	- 115	- 60
- change in partial exemption rules	+ 300	+ 400
Corporation tax - small companies rate	negligible	- 45
- capital gains	negligible	+ 60
- payment ~~duties~~ dates	negligible	+ 100
- dual residents	negligible	+ 125
- tax credit relief for banks	negligible	+ 20
Car and car fuel benefits	nil	+ 30
North Sea oil	- 5	- 15
Profit related pay	negligible	- 35
Pensions	negligible	- 65
Inheritance Tax	- 70	- 150
Other	- 30	+ 40
Total	**-2595**	**-2900**

Note: (All figures are net of the cost or yield of indexation or revalorisation, which is included in the base forecast)

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PMP

24. Last year's Budget contains a substantive package of measures to help charities. The encouragement we give to charitable giving is now very generous; and the Payroll Giving Scheme which starts next month will give it a further boost. I therefore have no major new proposals in this field, though I propose to extend slightly the VAT reliefs for charities which I introduced last year. These extensions will meet points which have been put to me by the charities lobby.

Manpower

25. The direct effect of these proposals would be a net increase of about 115 staff in 1987-88 and 225 in 1988-89 on the activities affected. The whole of this increase comes in the Inland Revenue (Customs have a small saving thanks to the small business package). In the Public Expenditure Survey the Chief Secretary will be carefully scrutinising the Revenue Departments' running costs.

26. I attach a table which summarises the revenue effects of these changes. I would be grateful to know if you are content with my proposals.

NB Changes in paras 17 & 24 (typn errors) & 23 (omission). NL.

N.L.
5 March 1987

BUT ~~Who~~ WHAT HAS HAPPENED TO THE CLASSIFICATION ? (SECRET – PRIME MINISTER'S EYES ONLY – DOUBLE ENVELOPES ETC NL.

3785/15

CONFIDENTIAL

prep

FROM: COLIN MOWL
DATE: 4 March 1987

CHANCELLOR

cc Chief Secretary
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Anson
Mr Monck
Mr Cassell
Mr Scholar
Mr Turnbull
Mr Odling-Smee
Mr Sedgwick
Mr Moore
Mrs R J Butler
Mrs Brown
Mr Riley
Mr Cropper
Mr Tyrie
Mr Ross Goobey

GGE IN 1986-87

You asked (Mr Allan's minute to me of 27 February) whether it was really true, as stated in paragraph 6.10 of the draft of Chapter 6 of the FSBR, that GGE in 1986-87 is now expected to be higher than in the Autumn Statement.

2. Current indications are that, even if the estimated outturn for the planning total remains much as in the Autumn Statement, GGE will be about £1 billion higher, because of changes in the various national accounts adjustments. The biggest factor is an increase of £600 million in the estimate of the repayment of market and overseas borrowing by public corporations (PCMOB) - ie. a reduction in PCMOB. This reduction reflects a switch in the composition of nationalised industry short-term borrowing (less than one year), away from market and overseas borrowing towards borrowing from the NLF and, to a lesser extent, higher subsidies. As you are aware, the Treasury does not seek to control the choice between these sources of short-term borrowing. The table below summarises the picture, using the latest estimates which are slightly different from those in the draft FSBR:-

		Autumn Statement	Latest Estimates	Change since Autumn Statement
1.	Nationalised industry EFLs	0.5	0.5	-
	Financed by:			
2.	Subsidies	1.6	1.7	+0.1
3.	NLF borrowing from CG	-0.4	0.1	+0.5
4.	Market and overseas borrowing	-1.0	-1.5	-0.5
5.	Other	0.2	0.2	-
6.	Other List I PCs market and overseas borrowing	0.1	0.0	-0.1
7.	PCMOB on public expenditure definitions (=4+6)	-0.9	-1.5	-0.6

The change in PCMOB only affects GGE because it is a change in the composition of EFL financing. A change in PCMOB which changes the EFL (and the planning total) by the same amount has no effect on GGE.

3. The remaining £300 million of the increase in GGE is mostly accounted for by revised estimates of VAT refunds and grants and loans to List III public corporations.

4. GEP will be clearing a 1986-87 planning total figure for publication in the FSBR with the Chief Secretary early next week. There may also be further changes to the national accounts adjustments, especially PCMOB which tends to be volatile both in-year and between years. However, we expect the final figures to show GGE higher than in the Autumn Statement.

Colin Mowl

COLIN MOWL

CONFIDENTIAL

F CASSELL
4 March 1987

MR RILEY

cc Sir P Middleton
Sir T Burns
Mr Peretz
Mr Scholar
Mr Allan

FSBR

I have just heard from Eddie George that he is entirely content with the drafts of the monetary section of Chapter 2 and of paragraphs 3.7-3.11 from Chapter 3. The Bank have no comments, and in putting the FSBR drafts back to the Chancellor you can record that.

You can also say that the Governor himself has not yet seen them but that Mr George is putting them to him with the recommendation that there is no need for a meeting with the Chancellor on this year's MTFS.

F CASSELL

2-17

FROM: D N WALTERS
DATE: 5 MARCH 1987

MR SKERRATT

cc Mr Fray

FINANCIAL STATEMENT AND BUDGET REPORT

Thank you for your minute of 3 March in which you advised of the Library's revised requirement for a total of 200 copies of the 1987 FSBR. This compares with the 25 copies which Nigel Fray was told earlier would meet your needs.

2. As I explained to you on the telephone, it is disappointing that this change has arisen so late in the day. Nigel Fray's earlier enquiries were both to allow us to advise HMSO of our total requirements well in advance so that they can ensure the essential early delivery and to enable us to finalise the detailed Budget day arrangements. However, I have now been able to amend the original order.

3. I note that you wish to receive your copies as early as possible on 17 March so that they can be labelled for distribution in advance of the lifting of the embargo. However, the FSBR and other related Budget documents are kept under tight security until the moment the Chancellor sits down to ensure that any chance of early leakage of the measures is kept to an absolute minimum. I am afraid, therefore, that I will not be able to release the documents to you until that time.

D N WALTERS

FROM: PW SKERRATT
DATE: 3 MARCH 1987

TO: MR D WALTERS

Financial Statement & Budget Report

1. Further to our recent telephone conversation, I would like to confirm that the Library requires a total of 200 copies of the 1987 FSBR (including the 25 copies in the figures produced by Nigel Fray).

2. Could you please arrange for us to receive them as early as possible on 17th March so that they can be labelled for distribution in advance of the lifting of the embargo.

3. Please let me know if there are likely to be problems with this.

Peter W Skerratt

Peter Skerratt
Treasury & Cabinet Office Library

4-12

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COPY NO 28 OF 30 COPIES

FROM: M C SCHOLAR
DATE: 5 MARCH 1987

CHANCELLOR OF THE EXCHEQUER

cc Principal Private Secretary
Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
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
Sir Angus Fraser - C&E
Mr Knox - C&E

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FSBR: CHAPTERS 1 AND 3

We are due to submit the first proof of the FSBR to you tomorrow. However I understand that you would find it helpful to have sight of these two chapters received early from the printer.

2. We are submitting Chapter 1 without updating the tables since these are subject to revision - in particular in the light of your decisions on the basis of the 1988-89 figure in Table 1.1, and on the PSBR forecast.

3. It would be helpful to have your response to Mr Sedgwick's minute and any other points as soon as possible on Friday.

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M C SCHOLAR

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Financial Statement and Budget Report 1987-88

Return to an Order of the House of Commons dated 17 March 1987: for

Copy of Financial Statement and Budget Report 1987-88
as laid before the House of Commons by
the Chancellor of the Exchequer when opening the Budget

Treasury Chambers
17 March 1987

Norman Lamont
~~John Moore~~

Ordered by the House of Commons to be printed 17 March 1987

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Table 1.1 The Budget measures[1]

	£ million		yield(+)/cost(−)
	1987–88		1988–89
	Changes from an indexed base	Changes from a non-indexed base	Changes from a non-indexed base
Tax proposals			
Income tax basic rate[2]			
Income tax allowances and thresholds			
Excise duties			
oils (net of bus fuel grants)			
vehicle excise duty			
tobacco			
alcohol			
on-course betting duty			
gaming machine licence duties			
VAT			
partial exemption rules			
small business package			
other			
Inheritance tax			
Corporation tax			
Profit related pay			
Pensions			
Other tax measures			
Total tax measures			

[1] *These measures and the basis of the costings shown, are described in detail in Chapters 4.*
[2] *Figures include the effect of the consequential change in the rate of advance corporation tax.*
[3] *Negligible.*

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1 The Budget

1.01 The objective of the Government's economic policy is to defeat inflation and maintain a vigorous, enterprising economy which will generate sustained growth and increased employment.

1.02 The Financial Statement and Budget Report (FSBR) supplements the Chancellor's Budget Statement. It describes the Medium Term Financial Strategy (MTFS); outlines developments in the economy over the past year; provides forecasts to mid-1988; details the tax proposals in the Budget; summarises the government's spending plans and brings together the financial position of the public sector for the year ahead.

The Medium Term Financial Strategy

1.03 Chapter 2 describes the MTFS which has been in place since 1980. It provides the framework for the government's economic policies, which are designed to bring inflation down further and improve other aspects of the UK's economic performance. Monetary and fiscal policy is set to reduce the growth of money GDP, so bringing down inflation. ~~It is supported by~~ The Budget contains new further measures to encourage enterprise, efficiency and flexibility ~~which will improve the prospect for output and jobs. The Budget is designed to strengthen these policies and to reduce the role of the state in the economy~~. | STET
Public expenditure is on a declining path as a percentage of Gross Domestic Product (GDP) and taxes have again been reduced, as they have in each year since 1981.

Forecast

1.04 Chapter 3 describes the main developments in the economy in 1986 and the prospect until mid-1988. GDP is forecast to grow by 3 per cent in 1987, the sixth successive year of steady growth. A strong rise is forecast in investment, in manufacturing output and in non-oil exports. Inflation is forecast to be about [4] per cent in the fourth quarter of 1987. There are good prospects for a continuing decline in unemployment.

Tax measures

1.05 Chapter 4 sets out the tax proposals in the Budget. They include a reduction of 2p in the basic rate of income tax, a new incentive to encourage the growth of profit related pay, improvements in the regime for pensions, and measures to simplify tax collection and to make it fairer and more effective. Table 1.1 opposite summarises the effect of all these measures.

Public expenditure

1.06 Chapter 5 summarises the government's spending plans for the next three years. The plans show a continuing fall in general government spending as a percentage of GDP. This chapter also provides the latest estimates of the outturn for the public expenditure planning total in 1986–87 and includes a comparison of outturn and plans for the different spending authorities.

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Receipts and expenditure

1.07 Chapter 6 brings together the complete financial picture for the public sector. The public sector borrowing requirement (PSBR) for 1986–87 is forecast to be [just under £5 billion, over £2 billion] lower than indicated in the 1986 FSBR. The PSBR for 1987–88 is forecast to be some £[3½] billion, or [¾] per cent of GDP, £[3½] billion below the illustrative level in last year's MTFS. The Budget measures are expected to contribute £[2] billion to the borrowing requirement, over and above the net cost of indexing tax rates and allowances. Table 1.2 summarises the sources of the receipts and the direction of expenditure.

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Table 1.2 The finances of the public sector[1]

	£ billion		
	1986–87		1987–88
	1986 Budget[2]	Latest estimate	Forecasts
RECEIPTS			
Income taxes	38·7	38·6	40·3
Corporation tax excluding North Sea[3]	9·4	11·2	13·5
Capital taxes	2·8	2·7	3·2
Expenditure taxes:			
Value added tax	20·7	21·5	23·3
Local authority rates	15·6	15·5	16·7
Petrol, derv, etc., duties	7·3	7·5	8·1
Spirits, beer, wine, etc.	4·4	4·2	4·4
Cigarettes and other tobacco	4·7	5·0	5·1
Other	9·3	10·1	10·5
Total expenditure taxes	61·9	63·7	68·1
North Sea revenues:			
North Sea corporation tax[4]	2·7	2·7	1·4
Petroleum revenue tax	2·4	1·3	2·0
Oil royalties	1·0	0·9	0·8
Total North Sea	6·1	4·8	4·2
Other[5]	−1·2	−1·2	−0·8
Total taxes and royalties	**117·6**	**119·7**	**128·6**
National insurance and other contributions	26·2	26·4	28·5
Interest and dividend receipts	6·4	5·8	5·8
Gross trading surpluses and rent	2·7	3·3	3·3
Other	3·0	3·3	3·5
General government receipts	**155·9**	**158·6**	**169·7**

	£ billion		
	1986–87		1987–88
	1986 Budget[1]	Latest estimate	Forecasts
EXPENDITURE			
DHSS—Social security	42·9	44·6	46·0
Defence	18·5	18·4	18·8
DHSS—Health and personal social services	17·7	18·0	19·1
Education and science	14·3	15·7	16·6
Home Office (including Lord Chancellor's department)	5·6	5·8	6·2
Other departments	40·7	42·2	43·4
Privatisation proceeds	−4·8	−4·4	−5·0
Reserve	4·5	—	3·5
Adjustments	−0·4	—	—
Public expenditure planning total	**139·1**	**140·3**	**148·6**
General government gross debt interest	18·2	17·5	18·3
less public corporations' markets and overseas borrowing	−0·4	−1·8	−0·6
Other national accounts adjustments	5·7	5·7	6·1
General government expenditure	**163·4**	**165·3**	**173·7**

Difference between expenditure and revenue financed by borrowing:

	1986–87		1987–88
	1986 Budget	Latest estimate	Forecast
General government expenditure	163·4	165·3	173·7
General government receipts	155·9	158·6	169·7
General government borrowing requirement	7·5	6·7	4·0
Public corporations' market and overseas borrowing	−0·4	−1·8	−0·6
Public sector borrowing requirement	**7·1**	**4·9**	**3·4**

[1] *In these and other tables, constituent items may not add up to totals because of rounding.*
[2] *On current definitions.*
[3] *Including advance corporation tax but excluding corporation tax on capital gains.*
[4] *Before advance corporation tax set off. See footnote* [3] to Table 6 B.3.
[5] *Adjustments for advance corporation tax set off against North Sea corporation tax plus accruals adjustment.*

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COPY NO 19 OF 30 COPIES

FROM: M C SCHOLAR
DATE: 5 MARCH 1987

CHANCELLOR OF THE EXCHEQUER

cc Principal Private Secretary
Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
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
Sir Angus Fraser - C&E
Mr Knox - C&E

FSBR: CHAPTERS 1 AND 3

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2. We are submitting Chapter 1 without updating the tables since these are subject to revision - in particular in the light of your decisions on the basis of the 1988-89 figure in Table 1.1, and on the PSBR forecast.

3. It would be helpful to have your response to Mr Sedgwick's minute and any other points as soon as possible on Friday.

MCS

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Financial Statement and Budget Report 1987-88

Return to an Order of the House of Commons dated 17 March 1987: for

Copy of Financial Statement and Budget Report 1987-88
as laid before the House of Commons by
the Chancellor of the Exchequer when opening the Budget

Treasury Chambers
17 March 1987

Norman Lamont
~~John Moore~~

Ordered by the House of Commons to be printed 17 March 1987

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Income tax allowances and thresholds			
Excise duties			
oils (net of bus fuel grants)			
vehicle excise duty			
tobacco			
alcohol			
on-course betting duty			
gaming machine licence duties			
VAT			
partial exemption rules			
small business package			
other			
Inheritance tax			
Corporation tax			
Profit related pay			
Pensions			
Other tax measures			
Total tax measures			

[1] *These measures and the basis of the costings shown, are described in detail in Chapters 4.*
[2] *Figures include the effect of the consequential change in the rate of advance corporation tax.*
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1 The Budget

1.01 The objective of the Government's economic policy is to defeat inflation and maintain a vigorous, enterprising economy which will generate sustained growth and increased employment.

1.02 The Financial Statement and Budget Report (FSBR) supplements the Chancellor's Budget Statement. It describes the Medium Term Financial Strategy (MTFS); outlines developments in the economy over the past year; provides forecasts to mid-1988; details the tax proposals in the Budget; summarises the government's spending plans and brings together the financial position of the public sector for the year ahead.

The Medium Term Financial Strategy

1.03 Chapter 2 describes the MTFS which has been in place since 1980. It provides the framework for the government's economic policies, which are designed to bring inflation down further and improve other aspects of the UK's economic performance. Monetary and fiscal policy is set to reduce the growth of money GDP, so bringing down inflation. ~~It is supported by~~ The Budget contains new measures to encourage enterprise, efficiency and flexibility ~~which will improve the prospect for output and jobs. The Budget is designed to strengthen these policies and to reduce the role of the state in the economy~~. Public expenditure is on a declining path as a percentage of Gross Domestic Product (GDP) and taxes have again been reduced, as they have in each year since 1981.

Forecast

1.04 Chapter 3 describes the main developments in the economy in 1986 and the prospect until mid-1988. GDP is forecast to grow by 3 per cent in 1987, the sixth successive year of steady growth. A strong rise is forecast in investment, in manufacturing output and in non-oil exports. Inflation is forecast to be about [4] per cent in the fourth quarter of 1987. There are good prospects for a continuing decline in unemployment.

Tax measures

1.05 Chapter 4 sets out the tax proposals in the Budget. They include a reduction of 2p in the basic rate of income tax, a new incentive to encourage the growth of profit related pay, improvements in the regime for pensions, and measures to simplify tax collection and to make it fairer and more effective. Table 1.1 opposite summarises the effect of all these measures.

Public expenditure

1.06 Chapter 5 summarises the government's spending plans for the next three years. The plans show a continuing fall in general government spending as a percentage of GDP. This chapter also provides the latest estimates of the outturn for the public expenditure planning total in 1986–87 and includes a comparison of outturn and plans for the different spending authorities.

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Receipts and expenditure

1.07 Chapter 6 brings together the complete financial picture for the public sector. The public sector borrowing requirement (PSBR) for 1986–87 is forecast to be [just under £5 billion, over £2 billion] lower than indicated in the 1986 FSBR. The PSBR for 1987–88 is forecast to be some £[3½] billion, or [¾] per cent of GDP, £[3½] billion below the illustrative level in last year's MTFS. The Budget measures are expected to contribute £[2] billion to the borrowing requirement, over and above the net cost of indexing tax rates and allowances. Table 1.2 summarises the sources of the receipts and the direction of expenditure.

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Table 1.2 The finances of the public sector[1]

	£ billion		
	1986–87		1987–88
RECEIPTS	1986 Budget[2]	Latest estimate	Forecasts
Income taxes	38·7	38·6	40·3
Corporation tax excluding North Sea[3]	9·4	11·2	13·5
Capital taxes	2·8	2·7	3·2
Expenditure taxes:			
Value added tax	20·7	21·5	23·3
Local authority rates	15·6	15·5	16·7
Petrol, derv, etc., duties	7·3	7·5	8·1
Spirits, beer, wine, etc.	4·4	4·2	4·4
Cigarettes and other tobacco	4·7	5·0	5·1
Other	9·3	10·1	10·5
Total expenditure taxes	61·9	63·7	68·1
North Sea revenues:			
North Sea corporation tax[4]	2·7	2·7	1·4
Petroleum revenue tax	2·4	1·3	2·0
Oil royalties	1·0	0·9	0·8
Total North Sea	6·1	4·8	4·2
Other[5]	−1·2	−1·2	−0·8
Total taxes and royalties	**117·6**	**119·7**	**128·6**
National insurance and other contributions	26·2	26·4	28·5
Interest and dividend receipts	6·4	5·8	5·8
Gross trading surpluses and rent	2·7	3·3	3·3
Other	3·0	3·3	3·5
General government receipts	**155·9**	**158·6**	**169·7**

	£ billion		
	1986–87		1987–88
EXPENDITURE	1986 Budget[1]	Latest estimate	Forecasts
DHSS—Social security	42·9	44·6	46·0
Defence	18·5	18·4	18·8
DHSS—Health and personal social services	17·7	18·0	19·1
Education and science	14·3	15·7	16·6
Home Office (including Lord Chancellor's department)	5·6	5·8	6·2
Other departments	40·7	42·2	43·4
Privatisation proceeds	−4·8	−4·4	−5·0
Reserve	4·5	—	3·5
Adjustments	−0·4	—	—
Public expenditure planning total	**139·1**	**140·3**	**148·6**
General government gross debt interest	18·2	17·5	18·3
less public corporations' markets and overseas borrowing	−0·4	−1·8	−0·6
Other national accounts adjustments	5·7	5·7	6·1
General government expenditure	**163·4**	**165·3**	**173·7**

Difference between expenditure and revenue financed by borrowing:

	1986–87		1987–88
	1986 Budget	Latest estimate	Forecast
General government expenditure	163·4	165·3	173·7
General government receipts	155·9	158·6	169·7
General government borrowing requirement	7·5	6·7	4·0
Public corporations' market and overseas borrowing	−0·4	−1·8	−0·6
Public sector borrowing requirement	**7·1**	**4·9**	**3·4**

[1] *In these and other tables, constituent items may not add up to totals because of rounding.*
[2] *On current definitions.*
[3] *Including advance corporation tax but excluding corporation tax on capital gains.*
[4] *Before advance corporation tax set off. See footnote* [3] to Table 6 B.3.
[5] *Adjustments for advance corporation tax set off against North Sea corporation tax plus accruals adjustment.*

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FROM: **P N SEDGWICK**
DATE: 5 MARCH 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Sir G Littler
Mr F E R Butler
Mr Cassell
Mr Kemp
Mr Monck
Mr Odling-Smee
Mr Peretz
Mr Scholar
Mr Bottrill
Mr S Davies
Mr Matthews
Mr Mowl
Mr Riley
Ms Evans
Mr Cropper
Mr Tyrie
Mr Ross Goobey

FSBR CHAPTER 3

The version of Chapter 3 that incorporates your drafting changes (reported in Mr Allan's note to me of March 2, copy attached) has come back from the printers . The version going to you tonight includes further suggested changes in manuscript, a number of which reflect changes in the recorded numbers and their implications for the period to mid-1988. We have also taken account of Sir Peter Middleton's comments (Mr Saunder's minute to me of March 2). Mr George of the Bank has seen the section on financial conditions and does not want to suggest any changes.

2. In the rest of this note I discuss the outstanding issues (other than the PSBR about which I will be minuting you separately) on which we need to have decisions on the presentation &/or numbers.

(i) **The current account**

The CSO's latest revisions to the current account have produced deficits of £1.1b. in 1986 as a whole, and £3.4b. at

an annual rate in the second half of the year. A forecast deficit of £2½b. in 1987 would be more plausible than a lower figure, which would imply a very sharp turn round during 1987 from the second half of 1986. The text and the detailed figures in the tables in the attached draft show forecast deficits of £2½b. in 1987 and £2b. at an annual rate in the first half of 1988. The figure for the first half of 1988 comes by tradition in table 3.13 only. There is no material on the first half of 1988 in tables 3.3 and 3.4.

(ii) **The exchange rate**

The initial section on assumptions now says that the forecast "assumes that the exchange rate will remain around its current level". We will of course not divulge the precise assumptions we have made on exchange rates, but it might be helpful if I summarise them here as they influence the RPI prospect.

In constructing the forecast we will assume the average sterling index prevailing in the fortnight following the Louvre agreement. Though the text of Part 3 does not say so, we also assume - following the Louvre agreement - no changes in the other major countries' exchange rates.

Compared with the January internal forecast that gives us over the period to mid-1988

- a rather higher sterling index, at just over 70:

- slightly lower £/$ rate (because we have removed the large fall in the $ that the January WEP assumed): this produces a higher sterling oil price than assumed in January for a Brent price of $15.

(iii) **The RPI**

Taking account of the effects of the package and the exchange rate assumptions set out in (ii) only half a percentage point cut in the mortgage rate - which in turn could occur with a ¾

of a percentage point fall in base rates - is needed to achieve RPI inflation of 4 per cent in the fourth quarter of 1987. It will not be easy for commentators to deduce with confidence a small mortgage rate cut such as this from the housing component of the RPI in table 3.9. Even though we assume - probably unrealistically - that the mortgage rate cut occurs no sooner than July, and therefore that it is still depressing RPI inflation in the first half of 1988, it is still difficult to achieve a figure of 4 per cent RPI inflation in 1988(2). The text and tables in the attached draft nevertheless has 4 per cent inflation in both 1987(4) and 1988(2).

(iv) **Self employment**

We have received data from Department of Employment which show a considerably smaller increase in the numbers self-employed in the twelve months to September 1986. This is to some extent consistent with our current view that growth slackened somewhat between mid-1985 and mid-1986. In the normal course of events DE would probably have published the revised figures in the next package of labour market statistics, two days after the Budget. However, they are amenable to publishing the figures earlier, to allow us to use the revised estimates in the FSBR. We have thus incorporated revised numbers (still subject to further minor changes) into table 3.11 and amended the text in the light of them.

(v) **Charts**

Mr Allan's minute of March 3 (paragraph 5(iii)) reported your comment that we do not draw charts for the future. It has in fact been the recent practice to have charts with the forecasts for the current calendar year in Part 3 of the FSBR and Chapter 1 (the IAF) of the Autumn Statement. (Chapter 2 of the FSBR does not have charts that show the medium term projections or assumptions that that particular section presents in tables.) Some of the charts in the draft

Chapter 3 attached to my minute to you of February 24 did, however, show the forecasts for the first half of 1988 as well. It might look odd if all the charts in Chapter 3 ceased altogether to show future values. Our preference would be to revert to last year's practice and show forecasts in the charts, where it has been the practice to include these, to the end of 1987 only.

We have left out the charts for imports and exports of manufactures.

3. We have made a few other drafting changes, a few of which require comment.

(a) Paragraph 3.09

The February MO figure is published two days after the budget. We have therefore deleted the specific reference to the February figure.

(b) Table 3.1

You commented on this. Apart from footnote 2 this is exactly the same form as last year, with figures to 1988 1st half only.

(c) Table 3.2

The text discussing this table concentrates on the determinants of labour cost competitiveness. I would prefer to delete the third column of this table (relative export prices). This shows competitiveness little better in 1986(4) than in 1984(4), something which I personally believe to be manifestly not true.

(d) Paragraph 3.24

We have not changed this paragraph much, but it might help to set out our thoughts about the numbers. The growth in exports of manufactures in the three months to January 1987 over the same period a year earlier was 6 per cent - similar to the growth rate through the year to Q4. The volume of exports of total non-oil visible exports (less erratics) were 9 per cent higher in the three months to January compared with a year earlier, but these were heavily influenced by exceptionally high - and in our view unsustainable - exports of food and basic materials which we do not expect to continue. The manufactured export comparison, therefore, gives a better growth to the underlying trend. (It is worth noting that paragraph 7 of the last full version of the budget speech refers to the higher growth rate.

(e) Paragraph 3.31

We are still discussing with the CSO what is the best estimate of the stock of foreign assets at the end of 1986. We have included higher figures in the latest draft - £110b., 28 per cent of GDP. We want, if possible, to avoid highlighting a number - as in the FSBR last year - which the CSO revise down a month or so later.

(f) RPI/TPI

This draft includes in paragraph 3.50 in the text the reference requested in Mr Allan's note to Mr Davies of March 4.

E. Hall Sedgwick

PP **P N SEDGWICK**

3 The economy: recent developments and prospects to mid 1988

Summary

Demand and activity

3.01 The economy has been growing at around 3 per cent since last spring as exports recovered strongly. For 1986 as a whole, recorded GDP growth was about 2½ per cent. A substantial rise in investment and non-oil exports is forecast for 1987, and GDP is expected to grow by 3 per cent, with manufacturing output rising slightly faster.

Labour market

3.02 Employment has continued to grow, particularly since the middle of 1986. There has been a reversal of the previous rising trend in unemployment, and there are good prospects for a continuing decline this year.

Inflation

3.03 Inflation fell last year, to 3½ per cent, its lowest level for nearly 20 years. During 1987, inflation may rise temporarily to 5 per cent by the summer, as last year's movements in petrol prices and in mortgage interest rates affect the year-on-year comparisons. But it is then expected to fall back to around 4 per cent by the fourth quarter.

World economy

3.04 Output in the major industrial countries has been rising by 2½–3 per cent a year since 1984, and is likely to continue at that rate in 1987. Imports by developing countries (other than oil exporters) should rise this year. Markets for UK exports of manufactures may grow a little faster in 1987 than in 1986.

UK trade and the current account

3.05 Following the fall in oil prices a year ago, the current account of the balance of payments was in deficit of around £1 billion in 1986. Both export and import volumes rose sharply in the second half of last year. A further relatively modest current account deficit of £2½ billion (some ½ per cent of GDP) is forecast for 1987.

Assumptions

3.06 The forecast for the UK assumes that fiscal and monetary policies are set within the framework of the MTFS. It makes the conventional assumption of a $15 oil price, as in last year's forecast, and assumes that the exchange rate will remain around its current level.

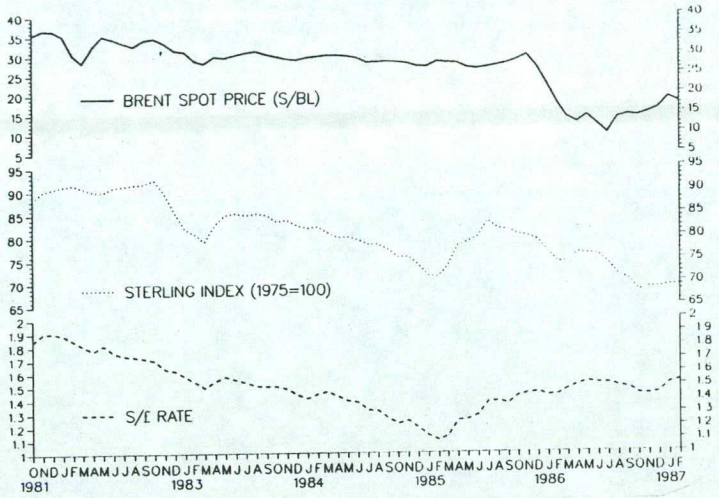
Financial conditions

Exchange rates

3.07 The **dollar** fell further during 1986, particularly against the deutschemark and the yen. These changes will, over time, help to reduce the size of the US current account deficit and the Japanese and German surpluses. As paragraph [2.10] above explained, Finance Ministers of six of the leading industrialised nations agreed last month to seek a period of stability in exchange rates. **Sterling** fell in 1986, in the wake of the fall in the oil price. It has remained steady since November and the most recent period, during which it has tended to rise a little.

CHART 3.1

EXCHANGE RATE AND OIL PRICES

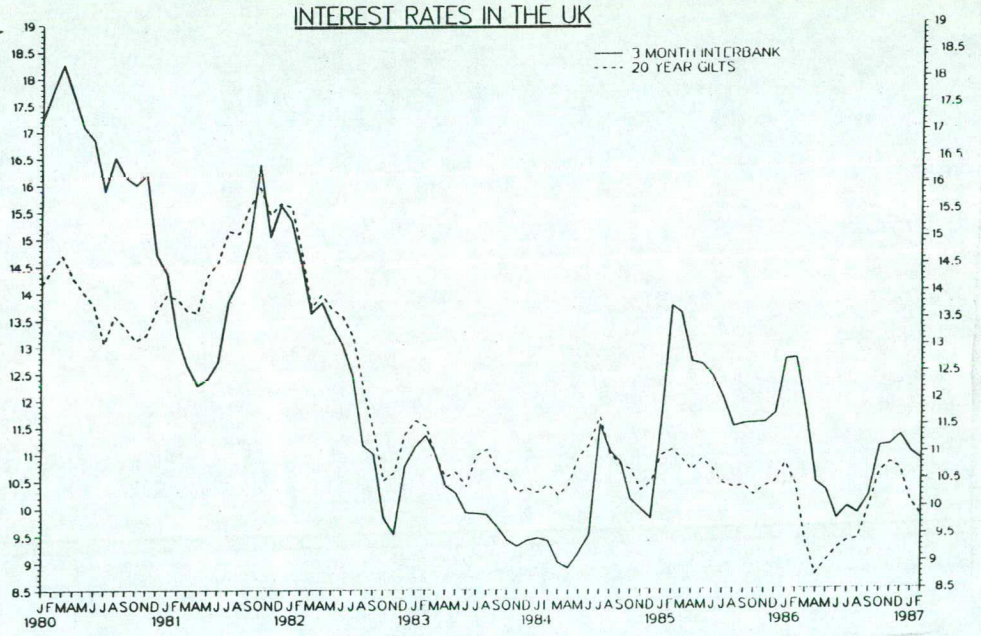


Interest rates

3.08 Short-term interest rates in the UK, which rose to nearly 13 per cent in January 1986, fell last spring to around 10 per cent. But with sterling weakening in the autumn and M0 also indicating an easing of monetary conditions they were raised to 11 per cent in October and have remained around that level since, though inter-bank rates have recently fallen a little. Rates in several overseas countries have been reduced in recent months. Longer-term rates in the UK followed the same broad profile as short-term rates, falling sharply in the spring and rising in the autumn. In recent weeks they have fallen again—to below 10 per cent.

CHART 3.2

INTEREST RATES IN THE UK



Narrow money

3.09 M0 growth was below the centre of its 2–6 per cent target range in the early months of 1986–87. Its growth quickened from August onwards, reflecting both the falls in interest rates in the spring and the buoyant growth

there have been signs that its growth has been easing

of personal incomes, and moved into the upper half of its target range. More recently its growth has eased, following the rise in interest rates last Autumn. By February 1987 M0 growth was back to around towards the middle of its target range.

l/c

CHART 3

3.3 GROWTH RATES OF MONETARY AGGREGATES

Broad money

3.10 The growth of £M3 rose to 18 per cent in the early months of 1986–87 and has since remained at about that level. This is some 3 points above the top of its target range and well above the growth of money GDP. Holdings of bank deposits by companies and financial institutions have grown particularly rapidly. The wider aggregates that include building societies' liabilities have grown more slowly, although also at a rate well in excess of the growth of money GDP: the year-on-year growth of PSL2 has been about 14 per cent in recent months. Credit has continued to grow strongly, reflecting at least partly the pace of financial innovation and liberalisation.

13-14

3.11 The growth of broad money must be seen in the context of the strong growth of private sector wealth and positive real interest rates that have made financial assets attractive to hold. Increased competition in financial markets has narrowed the margins between borrowing and lending rates and this has led to persons and companies building up both their liquidity and their borrowing. The considerable increase in liquidity since 1980 appears to have been willingly held, and has been accompanied by lower inflation.

World economy

Recent developments

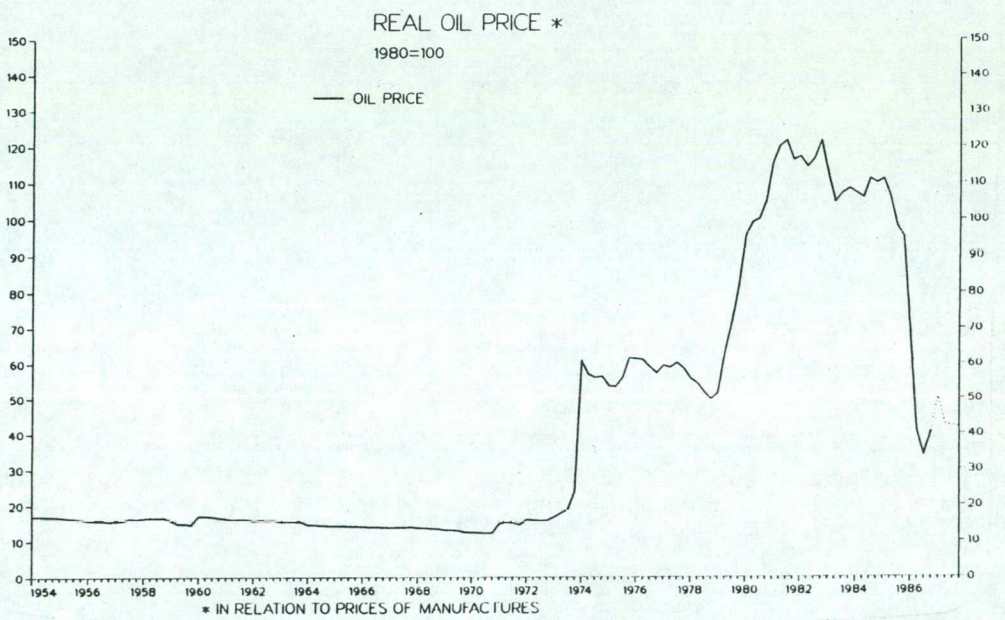
3.12 The world economy has been strongly influenced by the fall in oil and other commodity prices, and by the substantial depreciation of the dollar. Lower import prices have helped to reduce inflation in the industrialised countries and stimulated faster growth in real domestic demand. But developing countries—and oil producers in particular—have suffered a sharp deterioration in their terms of trade.

3.13 Real GNP in the seven largest OECD countries grew by about 2½ per cent in 1986. Domestic demand grew rather faster, at 3½–4 per cent, with large rises in household incomes and consumers' expenditure. Inflation fell further; average consumer prices in the seven major countries increased by only 2 per cent in 1986.

3.14 Despite the buoyancy of domestic demand in these countries, industrial production has grown only slowly. This has been largely a result of weak export demand, particularly from developing countries, and relatively sluggish growth in investment.

3.15 The changes in exchange rates over the last two years are already beginning to have significant effects on trade volumes; but these have not yet been enough to overcome the terms of trade effects (the "J-curve"). As a result, the trade imbalances between the major countries remain large. The surpluses in Japan and Germany have continued to grow, though more slowly; and there has been little sign yet of any substantial reduction in the US current account deficit.

R/C
CHART 4
3.4

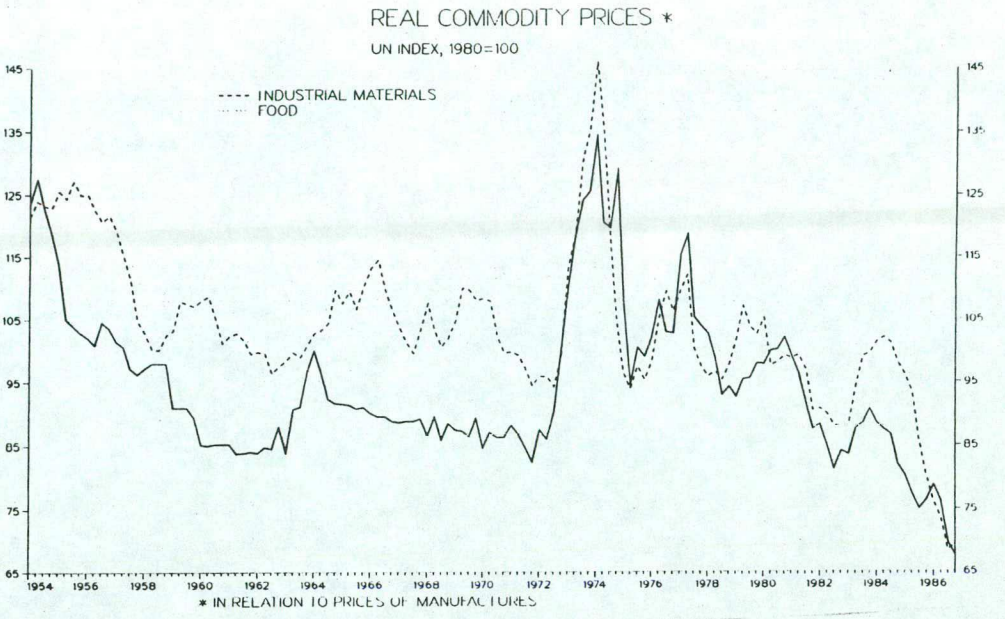


3.16 Oil prices fell below $10 per barrel last Summer, but rose in the second half of the year following the OPEC meeting in December. They have recently traded in a range of $15–$18 a barrel. Food and industrial materials prices also fell sharply through most of last year, although they recovered slightly in the Autumn. Charts 4 and 5 show past movements in real commodity prices, highlighting the extent of the recent falls.

3.4 I.C. 3.5

l/c

CHART 3 5



3.17 World import volumes are thought to have grown by more than 5 per cent during 1986. This is somewhat faster than in 1985, largely because of a rise in oil trade as the major oil companies rebuilt their stocks. Developed countries' exports of manufactures rose by only 3 per cent as buoyant domestic demand in industrialised countries, was partially offset by cuts in developing countries' imports.

Prospects

3.18 The outlook for oil prices remains uncertain. The forecast below is based on the conventional assumption that North Sea oil prices average $15 per barrel in the 1987–88 financial year. Non-oil commodity prices may remain low, with food prices held down by the large surpluses of agricultural production. With rising activity in the major economies, industrial material prices may recover slightly from their current low levels.

Table 3.1 World economy

	Per cent changes on a year earlier			
		Estimates	Forecasts	
	1985	1986	1987	1988 H1
Major Seven countries[1]:				
Real GNP	3	2½	2½	3
Real domestic demand	3	3¾	3	3¼
Industrial production	3	1	2½	4¼
Consumer prices	4	2	2¼	2¾
World trade, at constant prices				
Total imports	3½	5½	3½	4½
Trade in manufactures[2]	4	2½	3½	4

[1] *US, Japan, Germany, France, UK, Italy and Canada.*

[2] *Developed countries' exports weighted by UK markets.*

3.19 Table 3.1 shows the projections for activity and inflation in the major seven industrialised countries, and for world trade. Inflation is expected to remain low, though it may rise a little from last year's level. In the US inflation may increase slightly as the effects of the fall in the dollar feed through, but the corresponding appreciation of the yen and deutschemark should mean that prices in Japan and Germany rise only very slowly, if at all.

3.20 These changes in exchange rates and inflation will affect domestic demand and output. In Japan and Germany they are likely to strengthen domestic demand but weaken export demand; in the US, the opposite effects are likely. In aggregate, domestic demand in the major industrial countries is likely to grow less strongly than in 1986. But GNP growth should be much the same, and industrial production should grow rather faster, helped by a recovery in exports.

3.21 World trade in manufactures is forecast to grow rather more quickly in 1987 than in 1986, though the pattern may be uneven. Import demand in the US is likely to slow down considerably, and oil producers are likely to cut back their imports further. But imports by Japan and Germany are expected to increase rapidly. Growth in total world trade in 1987 is likely to be slower than in 1986, largely because the rebuilding of oil stocks is not expected to continue.

UK trade and the balance of payments

Relative costs and prices

3.22 The UK's ~~cost and price~~ competitiveness improved markedly during 1986. Productivity rose fast and the growth of unit labour costs was only a little above that of our main competitors. As a result, the lower exchange rate was almost entirely reflected in improved competitiveness. The gain in competitiveness seems likely to be maintained over the year ahead.

Table 3.2 The exchange rate and competitiveness

	Sterling Index (1975 = 100)	Relative unit labour costs* (1980 = 100)	Relative export prices* (1980 = 100)
1984 Q4	75	80	87
1985 Q4	80	86	93
1986 Q4	68	72	85

* *Ratio of UK manufacturing costs/~~prices~~ to those overseas.*

Trade prices and the terms of trade (excluding oil)

3.23 Prices of most imports rose during 1986, as the effects of the depreciation of sterling more than offset generally weak world prices. Export prices also rose, as exporters took advantage of sterling's decline to improve profit margins. Excluding oil, terms of trade for goods worsened slightly between 1985 and 1986. ~~A further small deterioration~~ seems likely in 1987, ~~reflecting the delayed effects of sterling's fall and some increase in world commodity prices.~~

Little further change

Visible trade volumes (goods other than oil and erratics)

3.24 Exports of manufactures have been growing strongly in recent months. Growth had flattened in the final months of 1985 and exports fell briefly in early 1986, in common with those of other main manufacturing countries. But since then they have recovered strongly, and in the three months to January were 6½ per cent above their level a year earlier. With rising world trade and the continued benefits of improved competitiveness, manufactured exports should show further strong growth in 1987. Exports of non-manufactures rose rapidly last year, mainly as a result of exceptionally high grain exports ~~(the UK harvest was of poor quality and less suitable for domestic use)~~; they are unlikely to continue at these levels in 1987. Total exports should grow by about 6 per cent, compared with 2½ per cent in 1986.

manufactured export volumes in line with

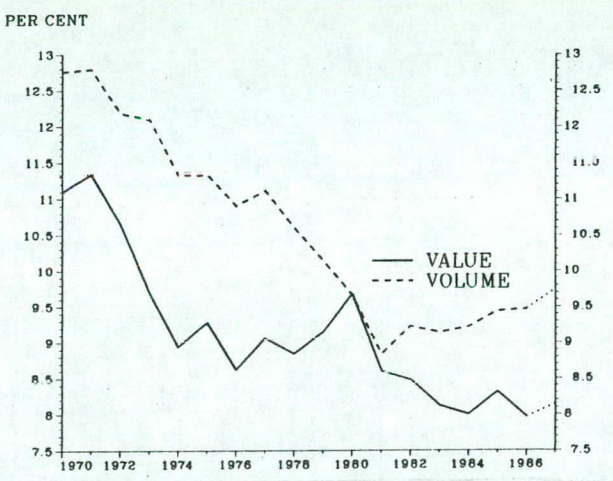
3.25 ~~The~~ UK appears to have increased ~~its volume share of~~ developed countries' exports ~~of manufactures~~ in 1986. This reinforces the previous evidence that the declining trend over the years up to 1981 has ended.

3.26 Non-oil imports were flat in the early part of 1986, but then rose sharply in the second half of the year. More recently, the rate of growth has moderated. Imports are likely to continue to rise in 1987 as domestic activity expands, though improved competitiveness should slow the rate of growth. Non-manufactured imports rose rapidly in 1986, ~~again~~ partly the result of the poor quality of the 1985 UK harvest; this effect is unlikely to continue in 1987. In total, imports of goods other than oil are forecast to rise by ~~4½~~ 5 per cent between the second halves of 1986 and 1987.

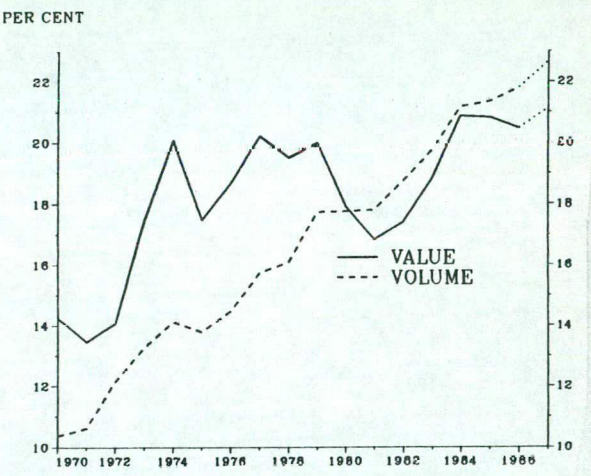
R/C 3.6
~~CHART 6~~

EXPORT SHARES AND IMPORT PENETRATION

U.K. MARKET SHARE , EXPORTS OF MANUFACTURES
(U.K. WEIGHTED)



SHARE OF IMPORTS OF GOODS (EXCLUDING OIL) IN DOMESTIC DEMAND



Oil trade

3.27 Britain's surplus on oil trade halved from £8 billion in 1985 to £4 billion in 1986, reflecting the sharp fall in world oil prices and some decline in the volume of net oil exports. A fall in North Sea companies' payments abroad, which was only partly matched by lower overseas earnings by UK oil companies, helped to offset the reduction in the oil visible trade surplus. North Sea production in 1987 is likely to be a little lower than in 1986 and the oil trade surplus slightly smaller.

Table 3.3 Visible trade

	Per cent changes on previous year					
	All goods			Goods less oil and erratic items		
	Export volume	Import volume	Terms of trade*	Export volume	Import volume	Terms of trade
1985	5½	3½	1½	7	4	1½
1986	4	6½	−5½	2½	6	−1
1987 Forecast	3½	7½	ø½	6	8½	1

* The ratio of UK export average values to import average values

3.28 The surplus on invisibles rose in 1986. Net receipts of interest, profits and dividends (IPD) rose particularly rapidly as a result of the lower payments abroad by North Sea companies and an increase in the surplus on other earnings. The surplus on services fell in 1986, largely due to lower net earnings from tourism. The deficit on transfers was abnormally low last year, reflecting the size and timing of government transactions with the European Community.

3.29 The surplus on invisibles is forecast to show a further rise in 1987 with the pound's depreciation during last year helping to increase the sterling value of the earnings on the UK's large stock of foreign assets. The surpluses on services should also benefit from the improvement in UK competitiveness. These higher earnings should more than offset an increase in the transfers deficit to a more normal level.

Current account

3.30 The current account recorded a £1 billion deficit in 1986 following a surplus of £3 billion in 1985. Lower net oil earnings and an increased deficit on manufactures trade more than offset an improvement in invisibles. The forecast for 1987 is for a current deficit of £2½ billion.

Table 3.4 Current account

	£ billion				
	Manufactures	Oil	Other goods	Invisibles	Current balance
1985	−3	8	−7½	5	3
1986	−5½	4	−7	7	−1
1987 Forecast	−8½	[illegible]	−7	ø8½	−2½

3.31 The UK's stock of net overseas assets is provisionally estimated to have risen by the end of 1986 to about £[100] billion (equivalent to [25] per cent of GDP: its highest level for over 30 years) compared with £80 billion at the end of 1985. The increase in the sterling value of assets reflects both the strength of world stock markets and the depreciation of sterling last year.

Demand and activity

3.32 The UK economy continued its steady growth in 1986. But there are considerable uncertainties over the precise estimates of the rate of growth, given the large differences between the three separate estimates of GDP (based on measures of expenditure, income and output). The output

figures—generally recognised as the most reliable short-term indication—showed non-oil growth of around 3 per cent between the end of 1985 and the end of 1986, following a brief pause in late 1985.

3.33 As in other industrial countries, consumers' expenditure in the UK grew strongly in 1986 as inflation fell and real incomes rose. UK exports were weak in the first half of the year, but recovered strongly in the second half. Imports had been depressed in the first half of the year but also rose sharply in the second half as the economy gained momentum, with particularly marked rises in imports of capital goods. Output growth in the service industries exceeded growth of manufacturing output for the year as a whole; but manufacturing output rose 2 per cent between the two halves of the year as exports recovered.

Personal sector expenditure

3.34 Real personal disposable income is estimated to have risen by about 4 per cent in 1986, and consumers' expenditure by about 5 per cent. This implies some further fall in the personal saving ratio which has been declining throughout most of the 1980s. One reason is that with lower inflation households have needed to make less provision for the erosion of their past savings. Another factor ~~affecting this ratio~~ has been a ~~cut back~~ decline in the growth of employers' contributions to pension funds as a result of the surpluses that many funds have been showing, reinforced by the provisions of the 1986 Finance Act: these contributions are treated in the national accounts as a part of personal income and saving. The buoyancy of consumers' spending may also owe something to the strength of the stock market. In spite of the fall in the saving ratio, higher asset prices and lower inflation have contributed to an increase of over 50 per cent in persons' net holdings of financial assets since the end of 1983.

~~HC~~
~~CHART 7 XXXXXXXXXX~~

Chart deleted

3.35 Real personal disposable income is forecast to rise by a little over 3 per cent in 1987. This is rather less than in 1986 and reflects a narrowing of the gap between earnings growth and price inflation. ~~There~~ Though there may be some further decline in the saving ratio, ~~but~~ consumers' expenditure is expected to grow more slowly than in 1986, at around 3½ per cent.

3.36 The housing market was buoyant in 1986, and private residential investment, both in new dwellings and in improvements to existing dwellings, grew strongly during the course of the year. Private housing starts were about 7½ per cent higher than in 1985; in Greater London, where the largest increases in house prices have been recorded, private housing starts in the first three quarters of 1986 were about 60 per cent up on a year earlier. These higher starts should be reflected in completions and investment in new dwellings during 1987; private residential investment may rise by around 10 per cent in the year as a whole.

Company incomes and expenditure

3.37 The rate of return earned by non-North Sea industrial and commercial companies (ICCs) continued to rise last year; profits earned in the North Sea fell by more than half. The outlook for companies is favourable, ~~though~~ but further substantial rises in profitability will probably have to depend less on depressed world prices of inputs of materials and fuels, and more on firms' containing the costs that are under their own control.

3.38 Company sector spending was relatively weak in 1986. North Sea investment has been falling in the face of sharply lower profits. Onshore business investment was adversely affected by the bringing forward of capital spending into 1985 ahead of the final stage of the reduction in capital allowances announced in the 1984 Budget.

3.39 The prospects are for investment to grow rapidly this year. The DTI Investment Intentions survey published last December pointed to growth in non-North Sea business investment of about 6 per cent, continuing into 1988. The latest quarterly CBI survey of industrial trends indicated a pick up in investment in manufacturing industry, and the forecast assumes that the DTI's Intentions survey projections will be ~~achieved~~ broadly realised. Table 3.5 provides details of the forecast for total investment and its components.

Table 3.5 Gross fixed domestic capital formation

	£ billion at 1980 prices	Per cent changes on a year earlier		
	1985	1985	1986	Forecast 1987
Business[1]	30·5	4	−3	~~3~~ 4
Private dwellings[2]	9·3	−1	5	8
General government	6·6	−4	5	−1
Total fixed investment	46·4	**2**	**0**	**4**

not italics

[1] *Includes investment by public corporations*

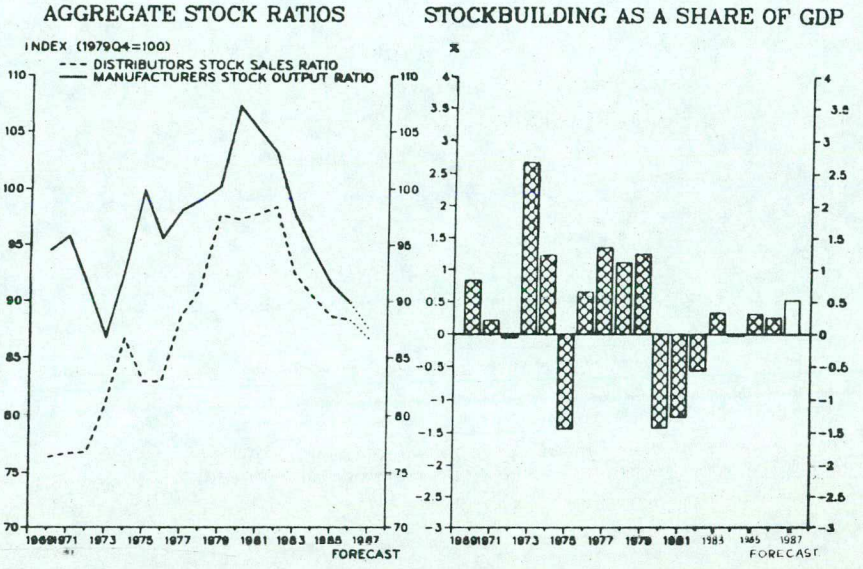
[2] *Includes purchase less sales of land by persons, companies and public corporations, other than purchases of council houses.*

3.40 The economy's stock/output ratio fell in 1986 for the sixth successive year. It appears that manufacturers ran down stocks and though distributors' stock levels rose, the increase was a small one in relation to the increase in the volume of sales. The latest quarterly CBI survey suggested that manufacturers may not now be intending to reduce their stocks of raw materials further, possibly because of the firmer trend in raw material prices in recent months. An additional source of destocking in 1986 was the

0029

exceptionally high exports of grain which led to a fall in the stocks held by the Intervention Board for Agricultural Produce (IBAP). Grain exports seem unlikely to persist at recent levels, and a further rundown in IBAP stocks is not expected.

3.41 Stockbuilding is thus likely to make a positive contribution to growth in 1987, although the forecast is for only a small rise in stocks by the standards of most years in the 1970s (see Chart 3.X), and there is likely to be a further fall in the stock output ratio for the whole economy.



Prospects for demand and activity

3.42 The forecast is for a further year of steady growth in 1987. GDP is expected to grow by 3 per cent, around the rate at which it was growing in the latter part of 1986. Exports and investment are forecast to grow strongly, offsetting some slowing down in consumer spending.

Table 3.6 Domestic demand and GDP

	Per cent changes on a year earlier (constant prices)		
		Forecasts	
	1986	1987	1988 H1
Domestic demand	3½	3½	2½
Exports of goods and services	2½	4	1½
Imports of goods and services	5½	6½	2½
Domestic production: GDP*	2½	3	2½

* *Average measure.*

3.43 The recovery in manufacturing output seen in the second half of 1986 is forecast to continue, helped by rising exports. Construction output also rose sharply during 1986, and should benefit further from the expected strength of private investment in dwellings and other new buildings and works during 1987.

Table 3.7 Real output

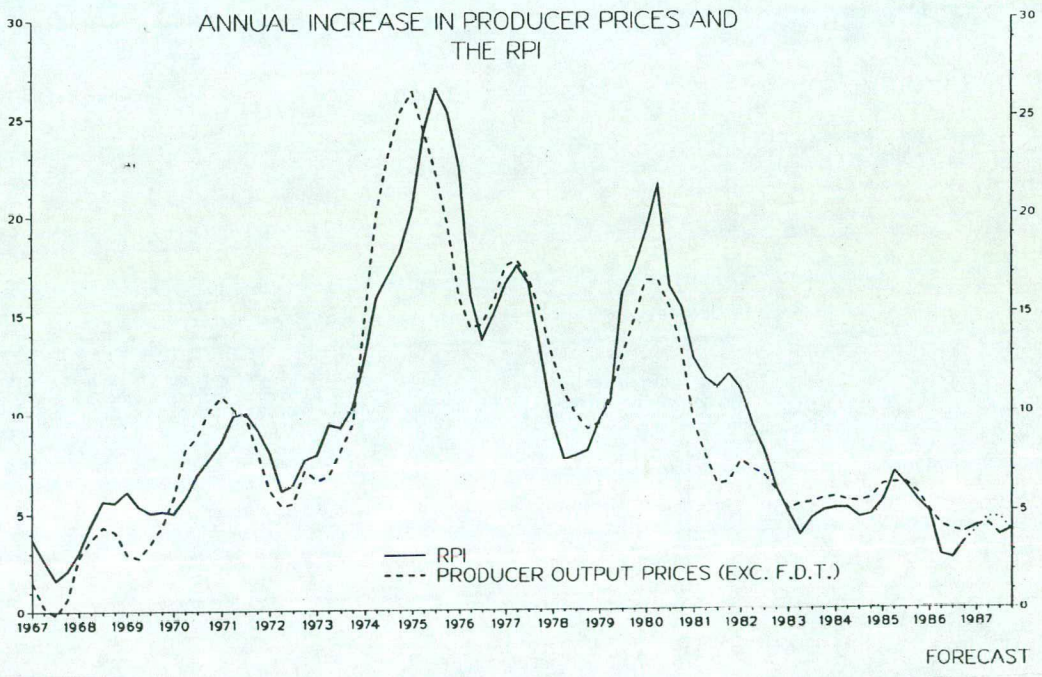
	Per cent changes on a year earlier		
		Forecasts	
	1986	1987	1988 H1
GDP (output measure)	2½	3	2½
Non-North Sea output	2½	3½	3
Manufacturing output	½	4	3

Inflation

3.44 Both retail and producer output price inflation remain close to the lowest levels experienced since the 1960s. The RPI rose by 3½ per cent in 1986, compared to a rise of 6 per cent in 1985. The annual inflation rate reached a low point of 2·4 per cent in July and August: most of its subsequent rise has reflected higher ~~contribution from the~~ mortgage interest payments ~~component of the RPI~~.

3.45 The rate of increase of producer output prices has also fallen significantly since the start of 1986, although it has started to edge up again recently, reflecting in part the fall in sterling that took place during the summer and early autumn.

~~CHART~~ 3.8

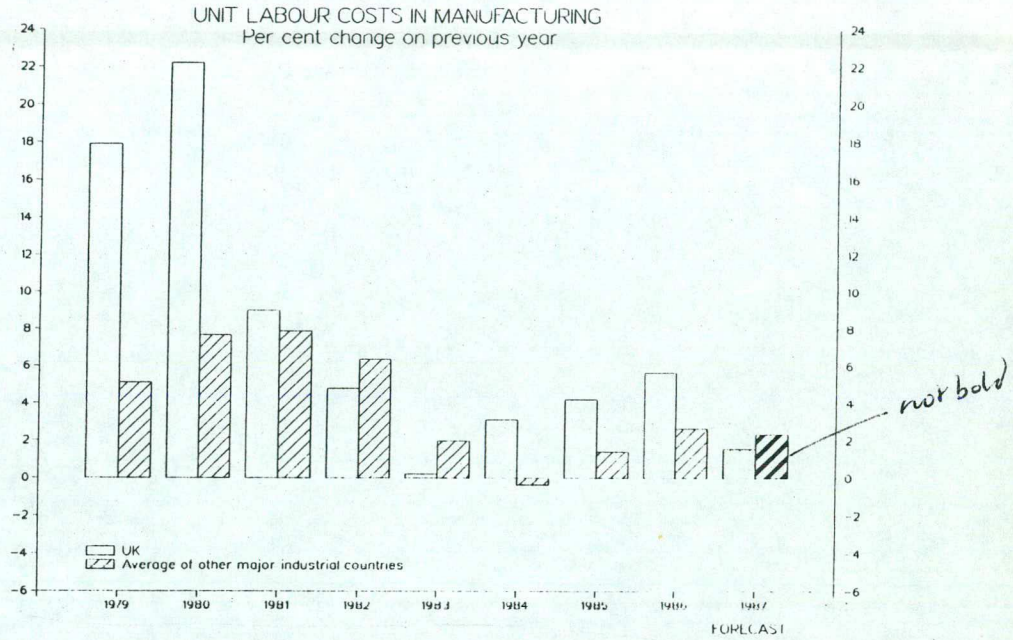


3.46 Pay increases in the private sector have fallen slightly in recent months ~~since the start of the current pay round~~. Settlements in manufacturing industry recorded by the CBI have shown a fall of about 1½ per cent since 1985, although settlements in the private sector as a whole, including those outside manufacturing, may have fallen by less than this. This decline in pay settlements has not yet been reflected in lower recorded growth in average earnings. The current annual rate of growth of earnings reflects settlements made over the whole of the last year (the majority of them still dating from ~~the previous pay round~~), and is also affected by overtime working, which has risen since the second quarter of 1986.

the period when settlements were running at a higher rate than they now are

3.47 In spite of the continuing relatively fast growth of earnings, unit labour costs in manufacturing have changed only a little since the first quarter of 1986 as productivity has risen sharply. Between 1985 and 1986 unit labour costs in manufacturing rose by about 5 per cent. Chart 3.9 shows recent and forecast movements in UK labour costs in relation to those of other major industrial countries.

CHART 3.9



Prospects

3.48 The lower pay settlements recorded in recent months should lead to a lower recorded growth of earnings over the remainder of this pay round. Nevertheless employees should enjoy a further substantial rise in real earnings in 1987. The high rate of productivity growth currently being recorded should contain the growth in unit labour costs to below 4 per cent for the non-oil private sector as a whole, and to around 1½ per cent for manufacturing industry.

Table 3.8 Costs in manufacturing

	Per cent changes on a year earlier			
	Unit labour costs	Cost of materials and fuels[1]	Estimated total costs[2]	Output prices[1]
1984	3	8½	4½	5½
1985	4	4½	4½	6½
1986	5	−10½	0	4½
1987 Forecast	1½	3½	2	4½

[1] *Producer prices excluding food, drink and tobacco.*

[2] *Including costs of bought in services.*

3.49 The figures in Table 3.8 suggest that profit margins in manufacturing have widened markedly in recent years; it seems likely that industry will hold on to the gains it made last year with the help of falling input costs, and profits margins may widen further during 1987 given the forecast low growth in unit labour costs. In the longer run the higher level of profitability should lead to more investment, greater capacity, higher productivity, and hence lower inflationary pressure.

3.50 The year-on-year rate of inflation is likely to continue to edge up over the next few months, reaching a peak of about 5 per cent by the Summer. This will mainly reflect the relative movements in 1986 and 1987 of petrol prices (which fell during the first half of 1986 to a low point in July and early August) and mortgage interest rates. But inflation should then fall back in the second half of the year, to around 4 per cent in the fourth quarter.

Table 3.9 Retail prices index

	Weight in 1986	Per cent changes on a year earlier		
		1986 Q4	Forecasts 1987 Q4	1988 Q2
Food	18½	3¼	2¾	3½
Nationalised industries[1]	6	3¼	2	5
Housing	14½	7	[9]	[6]
Other	61	2½	[3½]	[3½]
Total	**100**	**3½**	**[4]**	**[4]**

[1] *Includes water.*

3.51 The GDP deflator measures the price of domestic value added—principally unit labour costs and profits per unit of output—and excludes import prices. It is sensitive to movements in North Sea profits, which may have fallen by more than half in the current financial year: as a result the deflator for GDP at market prices may have risen by only 3 per cent in 1986–87. Given the assumption of a $15 oil price from now on, and with the further rise in non-North Sea profits now foreseen, the GDP deflator may rise rather faster in 1987–88 than in the previous year, perhaps by around 4½ per cent.

Productivity and the labour market

3.52 Results from the 1984 Census of Employment became available in December. These showed that the change in the number of employees since the last Census in 1981 had been very close to provisional estimates based on the results of successive Labour Force Surveys. Growth since March 1983 in the employed labour force in Great Britain is now estimated at 1,~~120,000~~ 040,000. Table 3.10 shows changes in employment over the last three years for which figures are available.

Table 3.10 Employment

	Thousands, change in GB seasonally adjusted				
	Employees in employment		Self-employed	HM Forces	Total in employment
	Male	Female			
September 1983 to September 1984	−21	+191	+233	+3	+406
September 1984 to September 1985	+~~39~~	+~~198~~ 204	+~~112~~ 86	−2	+~~34~~ 27
September 1985 to September 1986	−41	+139	+~~122~~* 38	−3	+~~216~~ 133

* *Figure for self-employment growth ~~over the last year~~ is a projection based on self-employment growth over the previous ~~four~~ five years.*

SECRET

3.53 Growth in employment averaged ~~a relatively modest~~ only about 20 ~~37~~,000 a quarter in the first half of 1986, reflecting the period of sluggish output growth at the end of 1985 and in early 1986. The third quarter saw employment growing at almost three times ~~more than twice~~ this rate as the economy quickened again. Recent monthly figures for manufacturing employment point to a ~~still further larger rise~~ growth pick up in total employment in the fourth quarter.

3.54 While confirming earlier figures for the total number of employees the Census results show some differences from the previous figures in the composition of changes in employment. Full-time female employment has risen by much more, and part-time female employment by much less than previously estimated; employment outside manufacturing has risen more than previously thought while manufacturing employment has shown a corresponding greater decline. The estimate of productivity growth in manufacturing since the 1979 cyclical peak has been raised by about ½ per cent a year on average. Underlying growth in manufacturing productivity now seems to be ~~fully~~ back to the rate experienced in the 1960s.

Table 3.11 Output per head of the employed labour force

Per cent changes

	Annual averages			1983 Q4 to 1984 Q4*	1984 Q4* to 1985 Q4	1985 Q4 to 1986 Q4
	1964–73	1973–79	1979–86			
Manufacturing	3¾	¾	3½	3¼	2¼	4¼
Non-manufacturing**	3	½	1	1¾	1¼	1½
Whole economy	2¾	1¼	2	2	1	1¾
Non-North Sea economy	2¾	½	1¾	1¾	1½	2

**Figures for 1984 Q4 are adjusted for the estimated effect of the coal strike.*

***Includes private sector and nationalised industries other than manufacturing and oil.*

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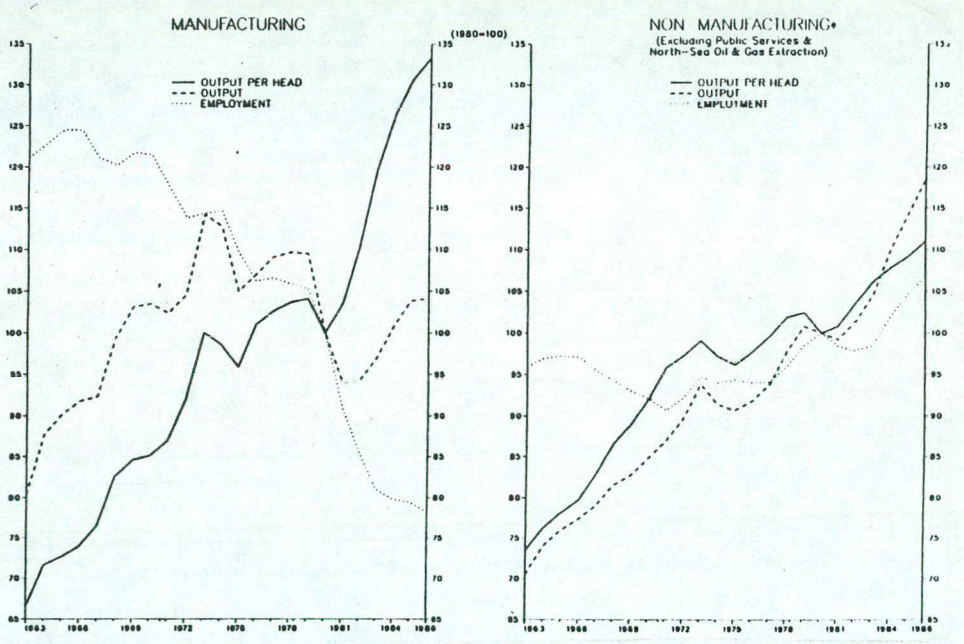
~~CHART 11~~ 3.10

OUTPUT, EMPLOYED LABOUR FORCE AND OUTPUT PER HEAD



Unemployment **3.55** Seasonally adjusted adult unemployment in the United Kingdom fell over 100,000 in the six months to January, the largest six month fall since 1973. The continued strength of the UK economy means that employment

growth is likely to pick up further during the next year, and the outlook for a continuation of the decline in unemployment is promising. The training and counselling measures announced and implemented over the past year are helping in particular the long term unemployed. A sustained major reduction in unemployment will depend, as it has always done, on moderation in pay settlements.

Forecast and outturn

3.56 The table below compares the main elements of the forecast published in the 1986 FSBR with the outturn or latest estimate:

Table 3.12 Forecast and outturn

	1986 FSBR forecast	Latest estimate/ forecast	Average errors from past forecasts
Total gross domestic product; per cent change between 1985 and 1986	3	2½	¾
RPI: per cent increase between the fourth quarters of 1985 and 1986	3½	3½*	1½
Money GDP, per cent change between 1985–86 and 1986–87	6¾	6	1¼
Current account of the balance of payments in 1986, £ billion	3½	−1	3
PSBR, financial year 1986–87, £ billion	7	[5]	[4]

* *Outturn*

3.57 Inflation in the fourth quarter of 1986 was in line with the forecast made a year ago. GDP growth has probably been a little below forecast, although the data on which latest estimates for 1986 are based is still very uncertain. Non-oil tax revenues have grown faster than forecast, and the PSBR in 1986–87 is likely to turn out about £2 billion below last year's forecast. The largest error made last year was on the current account; the main factors here were that growth in UK export markets turned out well below what had been expected a year ago while the terms of trade worsened more than forecast.

3.58 This year's forecast is summarised in Table 3.13.

Risks and uncertainties

3.59 No forecast is complete without an indication of error margins. Table 3.13 sets out the average errors from past forecasts, alongside the forecasts themselves. These average errors provide an indication of possible errors in the current forecast. Those items which represent the relatively small balance between large flows in either direction are particularly subject to error. For example, the flows on either side of the PSBR, including the revenues of the public corporations, are about £200 billion; and for the current account of the balance of payments exceed £150 billion.

Table 3.13 The prospects: summary

	forecast	Average errors from past forecasts[1]
A. Output and expenditure at constant 1980 prices	per cent changes 1986 to 1987	
Domestic demand	3½	¾
of which:		
Consumers' expenditure	3½	1
General government consumption	2	1
Fixed investment	4	2¼
Change in stockbuilding (as per cent of level of GDP)	½	¾
Exports of goods and services	4	2½
Imports of goods and services	6½	2½
Gross domestic product: total	3	¾
manufacturing	4	2
B. Inflation		
Retail prices index	per cent changes	
1986Q4 to 1987Q4	4	1½
1987Q2 to 1988Q2	4	2¼
Deflator for GDP at market prices	per cent changes on a year earlier	
Financial year 1986–87	3	¾
Financial year 1987–88	4½	1¾
C. Money GDP at market prices	per cent changes on a year earlier	
Financial year 1986–87	6	1¼
Financial year 1987–88	7½	1½
D. Balance of payments on current account	£billion	
1987	−2½	3
1988 first half (at an annual rate)	−1½	3½
E. PSBR	£ billion[2]	
Financial year 1986–87	[5 (1¼)]	[1½ (¼)]
Financial year 1987–88	[4 − 4½ (1)]	[5 (1½)]

[1] *The errors relate to the average differences (on either side of the central figure) between forecast and outturn. The method of calculating these errors has been explained in earlier publications and government forecasts (see Economic Progress Report June 1981). The calculations of average errors are based on forecasts made between 1975 and 1985. The errors are after adjustment for the effects of major changes in fiscal policy where excluded from the forecasts.*

[2] *Per cent of GDP at market prices shown in brackets.*

Table 3.14 Constant price forecasts of expenditure, imports and gross domestic product*

£ billion at 1980 prices, seasonally adjusted

	Consumers' expenditure	General government consumption	Total fixed investment	Exports of goods and services	Change in stocks	**Total final expenditure**	*Less* Imports of goods and services	*Less* Adjustment to factor cost	*Plus* Statistical adjustment	**Gross domestic product at factor cost**	GDP index (average estimate) 1980 = 100
1982	138·2	49·6	39·5	63·3	−1·1	**289·3**	59·5	30·4	0·7	**200·1**	100·3
1983	143·6	50·5	41·7	64·7	0·7	**301·2**	62·8	31·5	0·0	**207·0**	103·8
1984	146·6	50·9	45·5	69·1	−0·1	**312·0**	68·6	32·6	2·0	**212·8**	106·7
1985	152·0	50·9	46·4	73·1	0·7	**323·1**	70·7	33·7	1·5	**220·1**	110·3
1986	159·4	51·9	46·3	75·3	0·6	**333·6**	74·8	35·0	2·0	**225·7**	113·1
1987	165·3	53·1	48·2	78·4	1·5	**346·5**	79·5	36·3	2·1	**232·7**	116·6
1985 H1	75·1	25·5	23·4	36·7	0·5	**161·2**	35·2	16·7	0·5	**109·8**	110·1
H2	77·0	25·4	23·0	36·4	0·2	**161·9**	35·5	17·0	1·0	**110·3**	110·6
1986 H1	78·6	25·8	23·2	36·7	0·5	**164·8**	35·9	17·2	0·5	**112·2**	112·4
H2	80·8	26·1	23·2	38·7	0·1	**168·8**	39·0	17·8	1·5	**113·6**	113·8
1987 H1	81·9	26·5	23·9	39·0	0·8	**172·1**	39·3	18·0	0·8	**115·6**	115·9
H2	83·4	26·6	24·3	39·3	0·7	**174·3**	40·2	18·3	1·2	**117·1**	117·4
1988 H1	85	26·5	24·4	39·6	0·8	**176·3**	40·2	18·5	1·0	**118·6**	118·8
	Per cent changes										
1984 to 1985	3½	0	2	6	—	**3½**	3	3½	—	3½	3½
1985 to 1986	5	2	0	3	—	**3**	6	4	—	2½	2½
1986 to 1987	3½	2	4	4	—	**4**	6½	3½	—	3	3
1987 H1 to 1988 H1	3½	0	2	1½	—	2½	2½	3	—	2½	2½

* *GDP figures in the table are based on "compromise" estimates of gross domestic product, reflecting, for the past, average movements in constant price expenditure, output and income estimates of GDP. Percentage changes are calculated from unrounded levels and then rounded to half per cent. Figures for 1987 H1 and beyond are forecasts. Figures for periods up to the end of 1986 are based mainly on the national accounts published earlier (covering periods up to 1986 Q3) and incorporate some revised and later data and forecasts. A full set of national accounts, to end 1986, will be published by the CSO on 21 March.*

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Date	CHX diary & Parliament	FSBR and Budget	External Events
Monday 9 February	ECOFIN	Chancellor's meeting on MTFS issues etc Overview 3. Paper for EcoCab circulated	ECOFIN
Tuesday 10 February		Briefing for EcoCab to Chancellor Chancellor's meeting on Budget broadcast charts	Jan PSBR (internal)
Wednesday 11 February			RPI (internal)
Thursday 12 February		EcoCab Papers for Overview 4	Unemployment figures
Friday 13 February	TCSC report on PEWP published	Revised Budget statement outline to Chancellor	RPI published provisional money (internal)
Monday 16 February		Overview 4	
Tuesday 17 February		First draft of MTFS (early sections) to Chancellor	Jan PSBR published
Wednesday 18 February	PEWP debate	Chancellor's meeting on MTFS draft (and target ranges)	GDP(O)
Thursday 19 February		Papers for Overview 5	Provisional money published
Friday 20 February		First draft of Budget statement to Chancellor 1st drafts of chapters 4, 5 and 6 to Chancellor	

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Date	CHX diary & Parliament	FSBR and Budget	External Events
Monday 23 February		Chancellor comments on Chapters 4,5,6 by noon Overview 5 Chancellor's comments on statement circulated	Trade figures
Tuesday 24 February		Full drafts of chapters 2 and 3 (MTFS/IAF) to Chancellor	
Wednesday 25 February		Chancellor to comment on chapters 2 and 3 by 10am Submission to Chancellor on revised MTFS assumptions. Draft of chapter 1 to Chancellor last date for decisions on VED	
Thursday 26 February	1st Order	Chancellor to comment on chapter 1 by 10am Papers for Overview 6	
Friday 27 February		Second draft of Budget statement to Chancellor 1st draft of FSBR (all chapters, typescript) to Chancellor [last date for VAT, excise duties changes]	
Saturday/Sunday 28 February/1 March		Chancellor works on Budget Statement	

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Date	CHX diary & Parliament	FSBR and Budget	External Events
Monday 2 March		Chancellor to comment on draft FSBR by 10am Overview 6 FSBR to printer, incorporating Chancellor's amendments. Submission to Chancellor on post-Budget fiscal projections Chancellor's office circulate revised version of Budget statement [Last for income tax changes]	Full money
Tuesday 3 March		Draft Budget broadcast circulated	Feb CGBR 1st estimate
Wednesday 4 March	NEDC	Chancellor meetings with HMT and (separately) Bank on MTFS	Reserves
Thursday 5 March		Papers for Overview 7	
Friday 6 March		Chancellor's office submit third draft of statement to Chancellor 1st proof of FSBR (all chapters) to Chancellor	
Saturday/Sunday 7-8 March		Chancellor works on Budget statement	

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Date	CHX diary & Parliament	FSBR and Budget	External Events
Monday 9 March	ECOFIN	Chancellor to comment on 1st proof of FSBR by 10am Overview 7 FSBR to printers incorporating Chancellor's comments Chancellor's office circulate revised version of Budget statement	
Tuesday 10 March		Draft EPR supplement to Chancellor Draft notes for Queen and overseas posts to Chancellor	PSBR (internal)
Wednesday 11 March		Chancellor comments on EPR, notes for Queen and overseas posts by 10am 2nd proof of FSBR to Chancellor List and presentation of press notices to Chancellor	RPI (internal)
Thursday 12 March		Chancellor comments on FSBR proof by 10am EPR supplement to printer Final proof of FSBR to printer (last opportunity for substantive changes)	
Friday 13 March		Final draft of statement to Chancellor EPR proof to Chancellor Copy of Budget statement to Prime Minister Telegram for overseas posts: final draft to Chancellor Note for Queen: final draft to Chancellor Final version of Budget broadcast to Chancellor PS/Chancellor sends copy of statement section on oil taxation to PS/Mr Walker (if necessary)	RPI published prov money (internal)
Saturday 14 March		am FSBR proofs checked in HMT am EPR proof with Chancellor's comments to printer pm FSBR proofs returned to printer, copy to Chancellor	
Saturday/Sunday 14/15 March	Chancellor finalises Budget statement		

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Date	CHX diary & Parliament	FSBR and Budget	External Events
Monday 16 March	Audience with Queen	Budget Cabinet Budget statement finalised (am) Read at press (FSBR and EPR)	
Tuesday 17 March	Budget Day	FSBR and EPR published	FSBR published
Wednesday 18 March	Budget debate		
Thursday 19 March	Budget debate		prov money unemployment
Friday 20 March			
Monday 23 March	Budget debate concluding day	Finance Bill 1st Reading	
Tuesday 24 March	TCSC (officials)		
Wednesday 25 March	TCSC		

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FROM: M C SCHOLAR
DATE: 6 MARCH 1987

CHANCELLOR OF THE EXCHEQUER

cc Principal Private Secretary
Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
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
Mr Mowl
Miss Evans
Mr Hudson
Mr Cropper
Mr Tyrie
Mr Ross Goobey

Mr Battishill - IR
Mr Isaac - IR
Mr Painter - IR
Sir Angus Fraser - C&E
Mr Knox - C&E

FSBR: CHAPTERS 4, 5 AND 6

... I attach first proofs of these Chapters. We are due to return them to the printer by close on Monday night and would therefore appreciate your comments on Monday. We will submit the second proofs to you on Wednesday night.

CHAPTER 4

2. This Chapter takes account of your amendments and views on the presentation of Lloyd's and the second year effects of the Budget measures.

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CHAPTER 5

3. Table 5.1 has been amended to show figures for Home Office in place of those for the territories as requested by the Chief Secretary. A reference to the Rover payment is included in paragraph 5.06.

CHAPTER 6

4. You will receive the forecasters' final assessment of the prospects for the PSBR in 1986-87 and 1987-88 by the middle of next week. In the meantime the draft of the FSBR uses:

- for 1986-87 a PSBR of £4.9 billion, which was obtained, as you suggested, from our last central estimate of £4.3 billion plus a safety margin of £0.6 billion;
- for 1987-88 a PSBR of £4 billion. The last central forecast of £3.4 billion was based on a package which assumed revalorisation of excise duties. In view of the decision not to revalorise, which adds £0.6 billion to the PSBR, the draft assumes for the time being a PSBR of £4 billion.

The text does however anticipate some of the changes which the forecasters expect to include in next week's assessment, for example the prospect of higher local authority rates increases than expected earlier.

5. All of your comments on the first draft of Chapter 6 (Mr Allan's minute to Mr Mowl of 27 February) have been incorporated except for a minor one on the annex. You will recall that the two-page table (now table 6.7) just before the annex included oil royalties as a separate line. This was a mistake and as you requested, we have now included "oil royalties" with taxes on income as in last year's FSBR. The commentary in the penultimate sentence of paragraph 6A.5 however was the same as last year's FSBR and does not, we think, need changing.

6. The major changes, suggested by Mr Mowl, since the last draft are:

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(i) paragraph 6.07: the first sentence has been amended to include a reference to lower than expected oil production. The explanation of the fall in oil revenues in 1987-88 has also been amended;

(ii) the addition of paragraph 6.10 and table 6.2 on the burden of tax as agreed following Mr Sedgwick's minute to you of 5 March;

(iii) the omission of references to the Local Authority Borrowing Intentions Survey. We have discussed the paragraphs on local authorities with the DoE. They would like us to delete references to the survey as the figure we are likely to publish for the LABR in 1986-87 is lower than could be justified by it. Last year was the first time the survey was mentioned in the FSBR;

(iv) at your request we have added a reference to the non-cash basis of the PSFD in paragraph 6.25.

(v) paragraph 6.17 contains some observations about the shares of different taxes etc in the financing of total general government expenditure. We see no harm in this (novel) presentation but we could, if you prefer, turn the paragraph into one about the structure of taxation, and express the shares of the taxes in relation to total taxes and NICS.

7. You asked whether 'financial deficit' in paragraph 6A.1 is the public sector or general government financial deficit. The term is intended to apply to the entries in this line in each of the 10 columns in table 6.7: we have changed the drafting to make this clearer.

... 8. The proof omits the chart on the structure of receipts and expenditure which you asked us to drop from the previous draft. We wonder whether you would be willing to consider restoring this chart (copy attached) - it was part of our attempt to improve Chapter 6. Although Chapter 6 is, properly, concerned with bringing together receipts and expenditure, the expenditure element in this chart will clearly not do in its present form since the

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expenditure table is inconsistent with the Chief Secretary's wishes on the structure of the expenditure tables in Chapters 1 and 5. If you were content in principle to restore the chart we would agree its detailed content with the Chief Secretary.

... 9. I also attach, for information, the first proof of Chapter 2 in the form agreed at your meeting on this yesterday.

... 10. You asked that the Guinness chart (2.5) be redrawn, to make the froth look like froth. I attach a new version, by Mr Cavanagh of the CSO. Is this OK now?

11. In Chapter 1, which you have already seen in its first proof form, we will amend Table 1 to show the separate components of corporation tax as you suggested (Mr Allan's minute of today). After discussion with Mr Corlett, I suggest that in the text we refer to "improvements in the tax régime for pensions" not "for personal pensions", since the changes go a good deal wider than personal pensions (AVCs affect occupational pensions; then there are the abuse provisions) and we are presenting the package as a fairly wide reform. A further point is that the package is not really an improvement in the tax régime for personal pensions - but the introduction of such a régime. Do you agree?

MCS

M C SCHOLAR

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Chart ● The structure of receipts and expenditure[1]

Receipts and borrowing	1978-79 %	1987-88 %
Income taxes	25	23
Corporation tax (excl. North Sea)	5	8
Capital taxes	1	2
Local authority rates	8	10
Central government expenditure taxes	24	30
North Sea revenues	1	2
National Insurance Contributions	14	16
Interest and dividends	4	3
Other receipts	6	4
Borrowing[2]	12	2
TOTAL RECEIPTS AND BORROWING	100	100

Expenditure	1978-79 %	1987-88 %
DHSS - Social security	22	26
Defence	10	11
DHSS - Health and personal social services	10	11
Scotland, Wales, N. Ireland	10	9
Education and science	10	10
Other Departments	26	18
Interest	10	10
Other adjustments	2	5
TOTAL EXPENDITURE	100	100

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1 This table is based on the presentation in table 1.2. For 1987-88 the cash totals of receipts and borrowing and expenditure are £[ ] billion.

2 By general government

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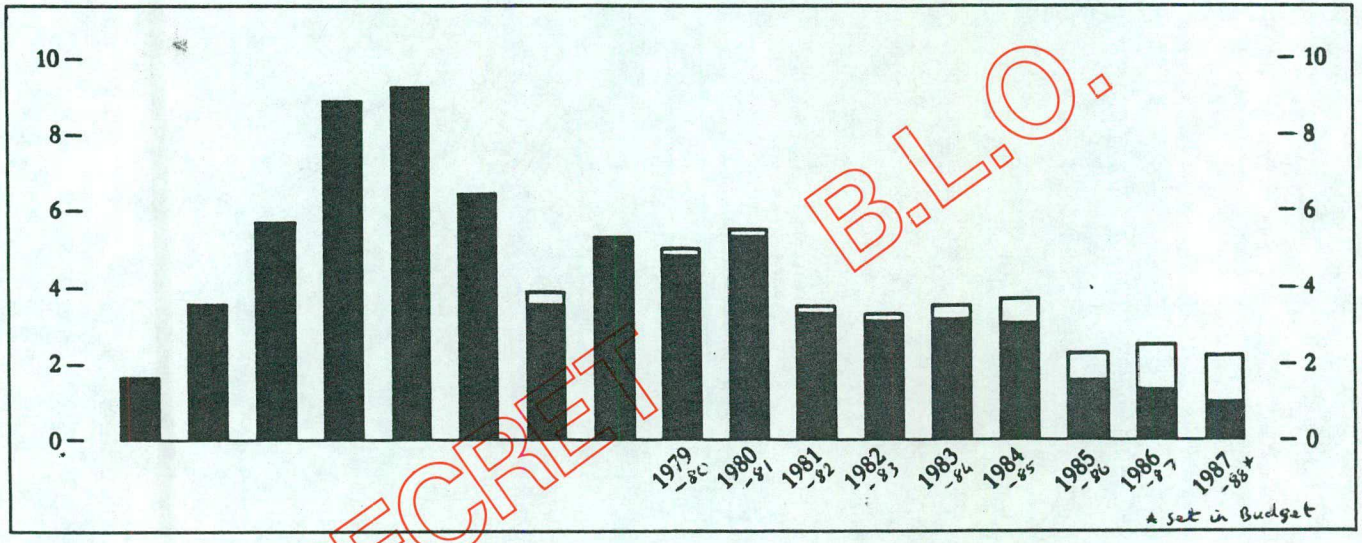
Chart 2.5 Public sector borrowing requirement and privatisation proceeds



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2 Medium Term Financial Strategy

2.01 The Medium Term Financial Strategy (MTFS) continues to provide the framework for the Government's economic policy, as it has done since 1980. It is intended to bring inflation down further over a period of years, and ultimately to achieve price stability. It is complemented by policies designed further to improve other aspects of the UK's economic performance.

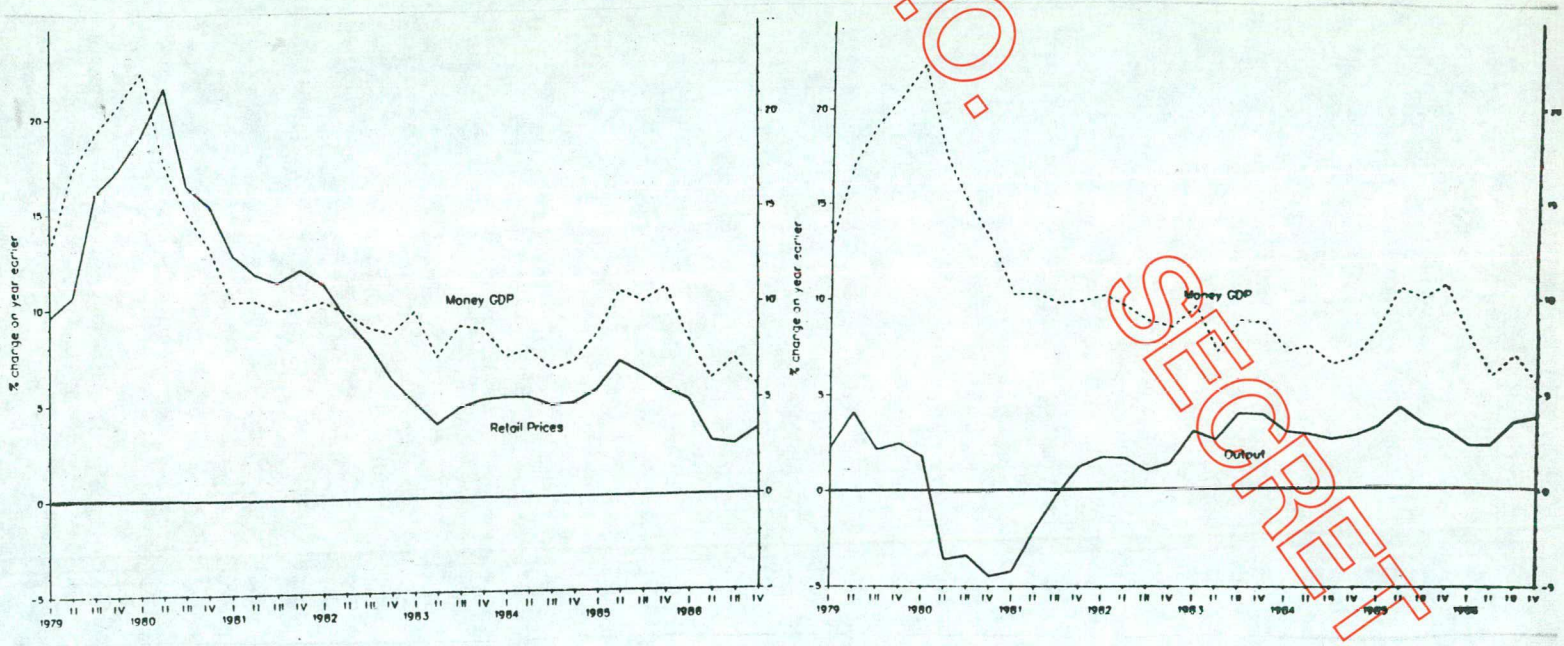
Economic policy is set in a nominal framework

2.02 Monetary and fiscal policies are designed to reduce the growth of money GDP, so bringing down inflation. They are complemented by policies to encourage enterprise, efficiency and flexibility. These policies improve the division of money GDP growth between output growth and inflation, and help the creation of jobs.

Over the past seven years, money GDP growth has come down from over 20 percent to around 6 percent. But in real terms,

2.03 Since 1981, the economy has grown at ~~around~~ approaching 3 per cent a year on average, with little variation in the growth rate from year to year. This is the longest period of steady expansion since ~~the 1960s~~ before 1973, and it has been achieved while inflation has come down sharply—from a peak of over 20 per cent in 1980 to 4 per cent now. Productivity is rising rapidly, at a rate which compares very favourably with our major competitors. The economy has weathered the fall in oil prices last year without disruption, and is about to embark on a seventh year of steady growth, combined with low inflation.

Chart 2.1 Money GDP output and inflation



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Objectives and the framework of policy

Money GDP

2.04 Policy is directed at maintaining monetary conditions that will bring about a gradual reduction in the growth of money GDP over the medium term. In the short term there will be fluctuations, but it is the medium term trend which is important. The government will aim to avoid substantial departures in the medium term from the path set out in table 2.1

Table 2.1 Money GDP and Monetary Growth[1]

	1986–87	1987–88	1988–89	1989–90	1990–91
Money GDP[1]	6	7½	6½	6	5½
M0[2]	2½	2–6	1–5	1–5	0–4

[1] *Per cent change on previous financial year. See table 2.2 for assumptions on output and inflation. The figure for 1987–88 is a forecast; and in subsequent years the figures describe the Government's broad medium term objectives.*

[1] *1986–87: per cent change on previous financial year.*
1987–88: target range.
1988–89 onwards: illustrative ranges.

2.05 The growth of money GDP in 1986–87 is expected to be somewhat below the 6¾ per cent forecast at the time of the last Budget. The forecast for 1987–88, described in Chapter 3, is higher than the 6½ per cent indicated last year. Over the two years to 1987–88 the growth rate is little changed. In the later years the growth of money GDP declines at the same rate as in last year's MTFS.

Instruments of policy

2.06 The Government sets monetary and fiscal policies to achieve monetary conditions which will deliver its objectives for money GDP. A declining path for money GDP growth, as in Table 2.1, requires firm monetary policies supported by low public sector borrowing.

2.07 Fiscal policy is reviewed each year at Budget time. Short-term interest rates, which can be varied more frequently, are the essential instrument of monetary policy. They will continue to be maintained at levels necessary to keep monetary conditions on track.

2.08 The authorities seek to fund the PSBR fully, and no more, over each financial year by sales of debt outside the monetary sector. This will continue to be the basis for funding policy.

Monetary policy

2.09 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 between the exchange rate and domestic monetary growth consistent with the Government's aims for money GDP and inflation.

2.10 Over the past two years, the dollar has depreciated substantially against most other major currencies. At a meeting of Finance Ministers and Central Bank Governors of six major industrial nations in Paris on 21/22 February, it was concluded that a period of stability would 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 MTFS projections assume that there is no major change in either the sterling exchange rate index or the sterling/dollar exchange rate from year to year.

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Narrow money

2.11 Last year's MTFS set out the properties desired of a target aggregate for narrow money. In particular it should have a stable relationship with money GDP. As Chart 2.2 shows, the velocity of M0 has grown relatively steadily over a long period of time. M0 has proved a reliable indicator of monetary conditions.

Chart 2.2 Velocity of monetary aggregates

2.12 In principle there is a case for moving to a wider measure of non-interest bearing money, such as the non-interest bearing component of M1. But the velocity of this aggregate exhibits considerable fluctuations which are currently exacerbated by the rapid growth of interest bearing sight deposits, and it is ultra-sensitive to interest rate changes. In these circumstances M0 remains the best choice of narrow aggregate for target purposes.

Chart 2.3 Growth of M0 and money GDP

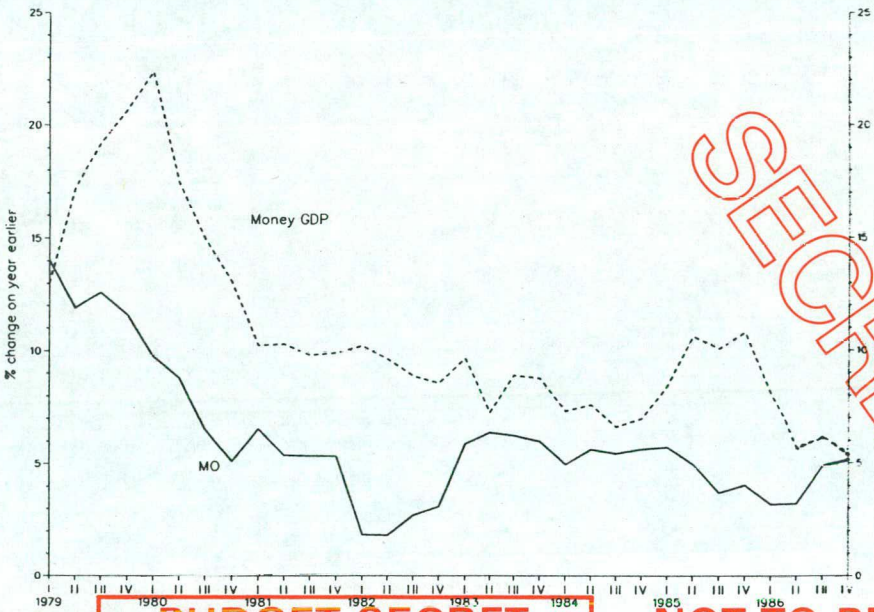

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Table 2.2 Growth of M0

1986–87	1987–88	1988–89	1989–90	1990–91
4	2–6	1–5	1–5	0–4

2.13 The target range for M0 growth in 1987–88 is 2–6 per cent, unchanged from the range indicated in last year's MTFS. Ranges for the later years are illustrative, but have a downward profile consistent with the declining path for money GDP growth.

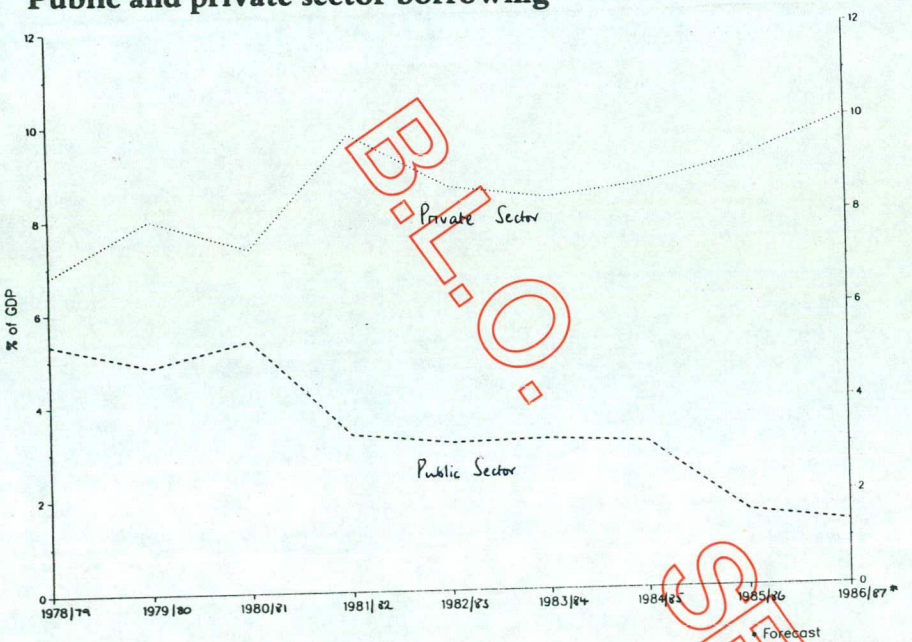
Table 2.2 to go here, with footnote →

2.14 If the underlying growth of M0 threatens to move significantly outside its target range in 1987–88 there is a presumption that the Government will take action on interest rates unless other indicators suggest that monetary conditions remain satisfactory.

Broad money

2.15 Broad money has been growing considerably faster than money GDP in recent years. In part this has reflected high real interest rates, which have added to the attractiveness of financial assets in general; the end of overfunding in 1985 has also contributed. But perhaps most important, the increasing competition in financial markets in recent years has led to rapid growth of private sector liquidity and borrowing. Private sector borrowing has been rising and is now ~~over~~ 10 per cent of GDP (Chart 2.4). It has contributed more than public borrowing to upward pressure on real interest rates. These trends are likely to persist, so that broad money growth may continue at around its recent rate, well in excess of the growth rate of money GDP.

Chart 2.4 Public and private sector borrowing



2.16 The 1986 Building Societies Act marks a further step in the evolving status of building societies. As their behaviour becomes closer to that of banks, wider aggregates which include building society liabilities are likely to continue to be less erratic than £M3.

2.17 Both the Chancellor and the Governor of the Bank of England have drawn attention to the increasing difficulties in interpreting changes in broad money. With rapid and pervasive changes in financial practices, there is no simple relationship between broad money growth and money GDP. For this reason, the Government has decided that there should be no formal target

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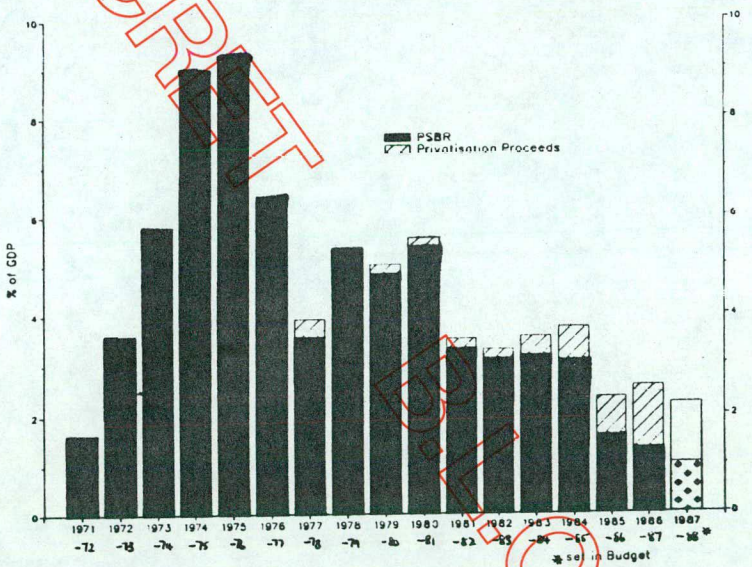
for broad money in 1987–88. But the rate of growth of broad money cannot be ignored, and the Government will continue to take it into account in assessing monetary conditions.

Fiscal policy

2.18 The PSBR in 1986–87 is expected to be about 1¼ per cent of GDP. This is ~~somewhat lower than~~ ~~in last year's projection~~, in spite of lower oil revenues. After remaining at about 3¼ per cent of GDP between 1981–82 and 1984–85, the PSBR ~~has now come down in each of the last two years~~. As Chart 2.5 shows, if privatisation proceeds are added back, it has been lower as a share of GDP in ~~1985–86 and 1986–87~~ the past two years than ~~in~~ at any ~~year~~ time since 1971–72.

Chart 2.5 Public sector borrowing requirement and privatisation proceeds



The PSBR path

2.19 The fiscal projections for the next four years are set out in Tables 2.4–6. The path of the PSBR is below that shown in last year's MTFS. The buoyancy of revenues experienced in 1986–87 and projected for 1987–88 has made it possible to ~~aim to achieve the desired low level of the PSBR as a percentage of GDP by 1987–88. As usual, account has been taken of the composition of receipts and expenditure~~.

2.20 The PSBR for 1987–88 is thus set at £4 billion, or 1 per cent of GDP. North Sea revenues in 1987–88 are forecast at about £4 billion, ~~the same level as~~ slightly lower than in 1986–87. The proceeds from the Government's privatisation programme are expected to be £5 billion, as set out in the Autumn Statement.

2.21 The PSBR is projected to remain at 1 per cent of GDP ~~after 1987–88~~ thereafter. If privatisation proceeds are added back the ratio gradually falls from 2¼ per cent in 1987–88 to 2 per cent in the final year. ~~These figures illustrate the desired position over a period of years; decisions about the PSBR in particular years will be taken nearer the time~~.

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Assumptions

2.22 For the period to 1989–90, the public expenditure projections in Table 2.4 follow the plans set out in the Public Expenditure White Paper (Cm 56). It is assumed that the planning total will grow by 1 per cent in real terms in 1990–91. Decisions on the planning total for that year will be taken in the 1987 Survey. The revenue projections in Table 2.5 are based on the conventional assumptions of constant 1987–88 tax and national insurance contribution rates, and allowances and thresholds indexed from the proposed 1987–88 levels. All changes proposed in the Budget are taken into account.

2.23 The assumptions about output growth and inflation that underlie the revenue projections are shown in Table 2.3. They are consistent with the figures for money GDP growth in Table 2.1. As last year, oil prices are assumed to average $15 a barrel in 1987, and thereafter to remain broadly unchanged in real terms.

Table 2.3 Output and inflation assumptions

	Percentage change on previous financial year				
	1986–87	1987–88	1988–89	1989–90	1990–91
Real GDP					
Non-North Sea	3	3½	2¾	2¾	2¾
Total	3	3	2½	2½	2½
Inflation					
GDP deflator	3	4½	4	3½	3

Public expenditure

2.24 Continued restraint in public spending is a vital element of the Government's economic strategy. General government expenditure has fallen steadily as a proportion of GDP from its peak of over 46 per cent in 1982–83. Given the path for money GDP, the plans in the White Paper imply a continuing fall. This will enable a low level of borrowing to be combined with reductions in the burden of taxation, so improving motivation, efficiency and employment. Public expenditure is discussed more fully in Chapter 5.

Table 2.4 General government expenditure

	£ billion, cash					
	1985–86	1986–87	1987–88	1988–89	1989–90	1990–91
Public expenditure planning total[1]	133·6	140	149	154	161	168
Gross debt interest	17·7	18	18	18	19	19
Other adjustments[2]	7·2	7	7	8	8	8
General government expenditure[3]	158·5	165	174	180	188	196
of which						
Privatisation proceeds[4]	2·7	4½	5	5	5	5

[1] *For 1985–86 to 1989–90, the figures are taken from Table 5.1. The planning total is assumed to grow by 1% in real terms in 1990–91.*
[2] *See paragraph 5.04.*
[3] *General government expenditure, and its components, are rounded to the nearest £1 billion from 1986–87 onwards.*
[4] *See the Public Expenditure White Paper (Cm 56), Table 1.4. Proceeds are assumed to be the same in cash terms in 1990–91 as in 1989–90.*

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Revenue

2.25 The growth in government revenues in cash terms over the medium term will depend on the growth of incomes, spending and prices, as well as on policy decisions. On the policy assumptions set out above, general government receipts are expected to increase somewhat less than money GDP. Government revenues from the North Sea are however expected projected to remain more or less unchanged in cash terms, having fallen sharply in 1986–87. Over the period as a whole, non-North Sea revenues are projected to grow broadly in line with money GDP. non-North Sea assumed

Thus total general government receipts are projected to increase somewhat less than money GDP.

Table 2.4 General government receipts

£ billion, cash

	1985–86	1986–87	1987–88	1988–89	1989–90	1990–91
Taxes on incomes, expenditure and capital	114.4	120	128	136	145	153
National insurance and other contributions	24.7	26	29	30	32	34
Interest and dividends	6.5	6	6	6	6	6
Other receipts	6.4	6	7	6	6	6
Accruals adjustment	−0.5	-	-	-	−1	−1
General government receipts [1]	151.5	159	169	178	188	198
of which						
North Sea tax [2]						

[1] *General government receipts, and its components, are rounded to the nearest £1 billion from 1986–87 onwards.*

[2] *Royalties, petroleum revenue tax (including advance payments), and corporation tax from North Sea oil and gas production (before advance corporation tax set-off). This does not correspond exactly to tax receipts in the same financial year in respect of North Sea production. See footnote [3] to Table 6.B.3.*

Public sector borrowing

2.26 The projections of government expenditure and receipts are brought together in Table 2.3 6 to provide projections of the general government borrowing requirement (GGBR), and the PSBR (and the fiscal adjustment). The size of the fiscal adjustment depends upon the estimates of revenues and expenditure. The projections of yields from a given set of tax rates are subject to considerable margins of error, as witnessed by the unexpectedly strong rise in non-oil tax receipts in 1986–87. On the expenditure side, the planning total for the final year has yet to be agreed.

2.27 Changes since the 1986 MTFS are discussed in the Annex to this Chapter.

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Table 2.6 Public sector borrowing[1]

	£ billion, cash					
	1985–86	1986–87	1987–88	1988–89	1989–90	1990–91
General government expenditure	158·5	165	174	180	188	196
General government receipts	151·5	159	169	178	188	198
Fiscal adjustment from previous years[2]	-	-	-	-	3	5
Annual fiscal adjustment[2]	-	-	-	3	2	2
GGBR	6·9	6	5	5	6	6
Public corporations' market and overseas borrowing	−1·1	−2	−1	−1	−1	−1
PSBR	5·8	5	4	4	5	5
Money GDP at market prices	361	382	412	439	466	491
PSBR as per cent of GDP	1·6	1¼	1	1	1	1

[1] *Rounded to the nearest £1 billion from 1986–87 onwards. Further details for 1986–87 and 1987–88 are provided in Tables 1.2 and 6.6.*

[2] *Means lower taxes or higher expenditure than is assumed in lines 1 and 2.*

Conclusion **2.28** Events both at home and abroad may modify some of the assumptions on which the projections have been based. But the Government is committed to maintaining progress towards lower inflation, lower public expenditure as a share of GDP and lower taxes in the medium term. The MTFS provides the framework within which the financial policies to achieve this are set.

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Annex to Chapter 2

Changes since the 1986 MTFS

Money GDP

2A.1 The growth rate of money GDP in 1986–87 is expected to be somewhat lower than envisaged in last year's MTFS, with ~~faster growth of output but a~~ a smaller increase in the GDP deflator. A bounce-back is projected in 1987–88 leaving money GDP growth over the two years to 1987–88 much as projected last year. After 1987–88, inflation and money GDP growth are ½ point higher than assumed last year, though declining at the same rate. The projection of output growth is unchanged.

Table 2A.1 Money GDP Growth

Per cent changes from 1985 MTFS projections

1986–87	1987–88	1988–89	1989–90
−1¾	+1	+½	+½

Monetary aggregates

2A.2 The growth of M0 in 1986–87 is expected to be ~~slightly above~~ at the centre of its target range. The target range for 1987–88 is the same as the illustrative range given last year. The illustrative ranges for subsequent years are also the same.

Table 2A.2 The Growth of M0

	Per cent changes on a year earlier			
	1986–87	1987–88	1988–89	1989–90
1987 MTFS	4	2–6	1–5	1–5
1986 MTFS	2–6	2–6	1–5	1–5

Fiscal projections

2A.3 Table 2A.3 shows changes in the fiscal projections since the 1986 FSBR, after allowance for classification changes.

Expenditure

2A.4 The expected overspend on the planning total in 1986–87 is referred to in Chapter 5. The planning totals for 1987–88 onwards are as in the Public Expenditure White Paper (Cm 56), which incorporate higher figures than assumed last year. General government expenditure is rather higher in 1986–87 than projected last year, partly because of the higher planning total and partly because of a change in the level and pattern of public corporations' borrowing. Within a reduced level of total borrowing, they borrowed more from ~~general~~ government and less from the market and overseas than projected last year. From 1987–88 onwards, the higher levels of general government expenditure are due to higher planning totals ~~offset by slight reductions in gross debt interest [and other adjustments].~~

Receipts

2A.5 The reduction in North Sea revenues in 1986–87 is due to last summer's fall in dollar oil prices. Little change on last year's projections is expected in later years. Other taxes ~~, especially corporation tax and VAT,~~ are higher throughout the period.

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Table 2A.3 Revenue and expenditure[1]

	← Changes from 1986 MTFS projections £ billion				
	1985–86	1986–87	1987–88	1988–89	1989–90
Expenditure					
1 Planning total	−0·2	+1	+4½	+5½	+8
2 Other[2,5]	+0·4	+½	−½	+½	+½
3 General government expenditure	(+0·1)	+1½	+4	+6	+8½
Receipts[3]					
4 North Sea taxes	−0·1	−1½	-	−½	-
5 Other taxes and contributions	+1·8	+3½	+4½	+5½	+7
6 Other[2]	+0·3	+½	-	−½	−1
7 General government receipts	+2·0	+3	+4½	+4½	+6½
8 Implied cumulative fiscal adjustment[4]	-	-	−2½	−3	−4
9 Public Corporations' market and overseas borrowing[5]	+0·1	−1	-	−½	−½
10 PSBR	−1·1	−2	−3	−2½	−2½

[1] *Classification changes since the 1986 FSBR.*

The main changes are:

[2] *Includes changes in debt interest and other items.*

[3] *The allocation of tax receipts between North Sea and other is affected by the treatment of advance corporation tax set-off. See footnote (3) to Table 6B.3.*

[4] *Line 8 = lines 10 − 9 − 3 + 7.*

[5] *Public corporations' market and overseas borrowing is included in the planning total and in the PSBR, but not in general government expenditure. Changes in it are therefore deducted in line 2 and added back in line 9.*

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4 The Budget tax proposals

4.01 The main tax changes proposed in the Budget are summarised below. A full list of changes is given in Table 4.1

Income tax

4.02 The basic rate of income tax will be reduced to 27 per cent.

4.03 The main income tax personal allowances will be increased in line with the statutory indexation provisions (based on the increase of 3.7 per cent in the RPI in the year to December 1986). This will mean that:

- the single person's and wife's earned income allowances will rise from £2,335 to £2,425.
- the married allowance will rise from £3,655 to £3,795.
- the age allowance will rise from £2,850 to £2,960 (single) and from £4,505 to £4,675 (married) and the income limit from £9,400 to £9,800.
- the additional personal allowance and widow's bereavement allowance will rise from £1,320 to £1,370.

4.04 For those aged 80 and over the age allowance will be further increased to £3,070 (single) and £4,845 (married)

4.05 The allowance for the blind will be increased from £360 to £540.

4.06 Thresholds for the higher rates of income tax will be charged as follows:

Tax rate per cent	Taxable income £
27	0-17,900
40	17,901–20,400
45	20,401–25,400
50	25,401–33,300
55	33,301–41,200
60	over 41,200

4.07 Car benefit scale charges will be increased by 10 per cent from 6 April 1988.

Profit related pay

4.08 An income tax relief will be introduced for employees in profit-related pay (PRP) schemes which meet certain conditions, and which have been registered with the Inland Revenue. The maximum amount of PRP eligible for relief will be £3,000, or 20 per cent of total PAYE pay, whichever is lower. Relief will be given on half the eligible amount.

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Excise duties

4.09 A duty differential will be created for unleaded petrol, equivalent to 5p a gallon less than for leaded petrol.

4.10 Duty will no longer be levied on on-course betting. The ~~duties~~ rates of duty on gaming machine licences will be increased by between 25 and 28 per cent.

Vehicle excise duty

4.11 The rates of duty on farmers' heavy goods vehicles over 7.5 tonnes will be increased by between 5 and 34 per cent. The rates of duty for trade licences will be increased to £85 for cars and £17 for motor cycles. A new taxation class will be created for recovery vehicles. The duty rate will be £50.

Inheritance tax

4.12 From Budget Day the threshold will be increased from £71,000 to £90,000 and the number of chargeable bands reduced from seven to four. The new scale will be as follows:

Rate on death per cent	Bands of chargeable value £000
0	0–90
30	90–140
40	140–220
50	220–330
60	Over 330

4.13 Lifetime gifts of "interests in possession" in settled property will be exempt from Inheritance Tax (IHT) if the donor survives for seven years. Measures against abuse will be incorporated.

4.14 Trust property in which there is an interest in possession will not be taxed on the death of a life tenant if the property is put into a heritage maintenance fund not later than two years after the death.

4.15 Property accepted in lieu of tax will be valued at the date of the offer, and interest will cease to accrue on that date, at the option of the offeror.

4.15 From Budget Day, the rate of business relief on transfers of holdings of more than 25 per cent (other than control holdings) in unquoted companies will be increased from 30 to 50 per cent. Companies dealt in on the Unlisted Securities Market will from Budget Day be treated for IHT purposes in the same way as companies with a full listing on the Stock Exchange.

Corporation tax

4.16 The main rate of corporation tax for the financial year 1987 will be 35 per cent. The small companies' rate of corporation tax will be reduced to 27 per cent. The rate of advance corporation tax (ACT) will go down automatically to 27/73rds as a consequence of the reduction in the basic rate of income tax.

4.17 All companies ~~and~~ building societies and other bodies chargeable to corporation tax will become liable, after a phasing-in period, to pay ~~corporation~~ tax nine months after the end of the accounting period for which tax is due.

4.18 From Budget Day there will be changes in the tax treatment of companies' capital gains. They will be taxed without adjustment, other than the indexation that applies to post–1982 gains, at the rates applying to other profits (including, where appropriate, the small companies' rate) and credit for payment of ACT will be allowed against liability to tax on them.

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4.19 From 1 April 1987, credit for any foreign withholding tax actually paid or deemed to be paid on interest received by banks on any new loan made by them to a non–resident will be allowed only against corporation tax due on the profit from that loan. This rule will apply to existing loans with effect from 1 April 1988.

4.20 From 1 April 1987, dual resident companies will not be allowed a double deduction for interest payments. This change will not apply to trading companies.

4.21 Legislation will be introduced for a new scheme, known as Pay and File, to streamline the assessment and collection of corporation tax. The scheme will be implemented when the necessary computerisation is complete.

Oil taxation

4.22 Two relaxations to the expenditure relief rules are proposed:

(a) to allow a proportion of the costs up to payback of developing certain new fields against petroleum revenue tax (PRT) liabilities in another field; and

(b) to allow certain research expenditure which is not specifically for the purpose of any determined oil field to be set against PRT liabilities in any field after three years.

A minor technical change is also proposed to the rules for allocating oil allowance.

4.23 It is [also] proposed to restrict the set-off against ring fence profits of ACT paid by an oil extraction company in respect of certain dividends on preference shares where the capital raised has not been used for oil extraction purposes.

[4.24 It is proposed to mitigate the effects of Section 16 of the Oil Taxation Act 1975, which restricts set–off of ACT against ring fence profits, by allowing limited carryback of surrendered ACT and by allowing surrender of ACT to a ring fence company by a 50/50 joint venture owning that company.]

Business Expansion Schemes

4.25 Two amendments will be made to the Business Expansion Scheme:

(a) for investments made in the first half of the tax year, the investor will be able to opt for part of the relief to be given for the previous year; and

(b) the rules governing the special relief for film production will be relaxed.

Pensions

4.26 **Personal Pensions:** In the light of the reform of Social Security, a new tax regime for personal pensions (ie pensions taken out by an individual independently of his employer) will be introduced, to replace and extend the present arrangements [1 January 1988]. The new regime will include the present retirement annuities. The main features will be:

(a) benefits based on the actual return from invested contributions ('money purchase');

(b) no limits on pension benefits;

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—a tax-free lump sum, subject to a limit;

—annual contributions limited to 17.5 per cent of earnings (more for people over 50) with employers free to contribute within the limit; and

—tax relief for contributions, tax exemption for fund income and gains.

4.27 Employees will be able to "contract-out" of the State Earnings Related Pension Scheme (SERPS) by joining a personal pension scheme, to which the DHSS will pay a "minimum contribution".

4.28 **"No frills" occupational schemes:** Employers will be able to establish simplified "no frills" occupational schemes which may be "final salary" or "defined contribution". Under the new Social Security rules, the latter may be "contracted out money purchase" schemes.

4.29 There will be greater transferability between different types of pension arrangements.

4.30 Additional voluntary contributions (AVCs): Members of occupational pension schemes will be able to pay AVCs—on which tax relief will be available—to arrangements outside their employer's scheme. As with in-scheme AVCs, contributions will be subject to existing limits on contributions and benefits.

4.31 **Exploitation of tax reliefs:** A number of changes in current pensions law and practice will be made, to counter certain types of exploitation particularly by high earners. These include:

- a "cap" on lump sums above £150,000;
- changes in the rules on "final salary" for pension purposes; and
- changes in the rules relating to accelerated accrual of benefits.

Employee share schemes

4.32 The rules for the 1980 and 1984 employee share option schemes will be changed to make it possible, in the event of a takeover, for participants to exchange their existing share options for options over shares in the acquiring company.

Capital gains tax

4.33 The capital gains tax annual exempt amount is to be increased in accordance with the statutory indexation provisions from £6,300 to £6,600 in the case of individuals, and from £3,150 to £3,300 in the case of most trusts.

4.34 The ceiling for retirement relief will be raised from £100,000 to £125,000.

Lloyd's: reinsurance to close

4.35 Legislation is proposed on the taxation of members of Lloyd's to ensure that the normal tax treatment of provisions is applied to them as to insurance companies and other traders. These proposals will affect the tax treatment of Lloyd's reinsurance to close and will first apply to premiums for the 1985 Lloyd's account closing at 31 December 1987.

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PAYE and subcontractor schemes

4.36 Changes will be made to the PAYE and subcontractor deduction schemes, including the charging of interest where formal assessments have had to be made of tax deducted under these schemes. This follows recommendations of the Keith Committee.

VAT

4.37 From 18 March 1987 the registration limits will become £21,300 per annum and £7,250 per quarter.

4.38 Subject to the Government's obtaining the necessary derogation from ~~the Commission of~~ the European Community, businesses with annual turnover below £250,000 are to be given the option of accounting for VAT on the basis of payments received and made. This optional system of cash accounting is intended to come into effect on 1 October 1987.

4.39 An optional system of annual accounting for VAT is to be introduced with advance payments based normally on the previous year's tax so that businesses with annual turnover below £250,000 would need to send only one return to Customs each year.

4.40 The period within which businesses must notify and be registered for VAT will be extended to 30 days.

4.41 The ~~special~~ simpler VAT schemes for retailers will be made available for use by ~~are to be improved and simplified in a number of ways~~. many more small & medium-sized businesses.

4.42 The rules on VAT input tax deduction by partly exempt traders are to be revised so as to curb tax avoidance and to prevent distortion of competition.

4.43 VAT relief for charities will be extended to certain welfare vehicles used by hospices to transport the terminally ill; to specialised location and identification equipment used by mountain rescue and first aid services; to the goods donated for export by a charity for relief of distress or animal welfare; to installing or adapting lavatory or bathroom facilities for the handicapped in charity residential homes ~~for the disabled;~~ and to drugs and chemicals ~~supplied to charities and~~ directly used by charity in medical care or research.

washroom or lavatory

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Table 4.1 Direct effects of changes in taxation

£ million

		Estimated effect on receipts in: 1987-88		1988-89
	See Annex 1 Paragraph numbers	Changes from a non-indexed base	Changes from an indexed base	Changes from an indexed base
	INLAND REVENUE			
	Income tax			
1	Reduction of 2p in basic rate	-1910	-1910	-2690
2	Increase in single allowance of £190 and married allowance of £140	-610	-	-
3	Increase in additional personal allowance and widow's bereavement allowance of £50	-5	-	-
4	Increase in age allowance of £110 (single) and £170 (married) and income limit of £400	-80	-	-
5	Further increase in age allowance of £[ ] (single) and £170 (married) for those aged 80 and over	-10	-10	-10
6	Increase in blind allowance of £130	*	*	*
7	Increase in basic rate limit of £700 to £17,300	-60	-	-
8	Changes to further higher rate thresholds	-5	+40	+80
9	Profit Related Pay	*	*	+35
10	Fringe benefits - car scale	-	-	+30
11	[Fringe benefits - official rate of interest	-	-	*]
12	Income support paid to the unemployed and to strikers	-	-	*
13	Approved employee share schemes - takeovers	*	*	*
14	Payroll giving to charities - increase in donation limit to £120 a year	*	*	*
15	Legislation on Lloyd's reinsurance to close	-	-	†
16	Apportionment of income etc of close companies	*	*	*
17	Foreign partnerships - removal of possible anomaly	-	-	-
	Income tax and capital gains tax			
18	Business Expansion Scheme changes	-5	-5	-5
19	Amendment to offshore fund rules	*	*	*
	Income tax and corporation tax			
20	Personal pensions	[-]	[-]	-25
21	Changes in pensions law and practice	[-]	[-]	-40
22	Friendly societies	*	*	*
23	Keith Committee - PAYE and subcontractors	+5	+5	+45
24	Interest payments between related companies	*	*	*
25	Increase in exemption limits for trade union provident funds	*	*	*
26	Capital allowances - extension of assured tenancies relief	*	*	*
27	Relief for the costs of training	*	*	*
	Income tax, corporation tax and capital gains tax			
28	Securities - Financial Services Act consequentials	-	-	-
	Income tax, corporation tax, capital gains tax, inheritance tax and stamp duties			
29	Unit trusts - Financial Services Act consequentials	-	-	-

* = Negligible - = Nil

† Details of measure subject to consultation, so no estimate possible at present.

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Table 4.1 Direct effects of changes in taxation

£ million

See Annex 4 Paragraph numbers		Estimated effect on receipts in: 1987-88		1988-89
		Changes from a non-indexed base	Changes from an indexed base	Changes from an indexed base
	Corporation tax			
30	Reduction in rate of ACT to 22/33 rds of the amount of the distribution	-290	-290	-130
31	Reduction in small companies' rate to 27 per cent	*	*	-45
32	Harmonisation of payment dates for corporation tax	*	*	+100
33	Taxation of indexed gains in full at normal corporation tax rates	*	*	+80
34	ACT set-off against tax on companies' gains	*	*	-20
35	Dual resident companies - non-allowance of double deduction	*	*	+125
36	Foreign withholding tax on interest received by banks	*	*	+20
37	[Relaxation of set-off of surrendered ACT against ring fence profits	-20	-20	-20]
38	ACT set-off against ring fence profits (certain preference share dividends)	[-]	[-]	[+15]
39	Building societies - groups of companies and capital gains	*	*	*
40	Pay and file	-	-	-
41	[Amendment to controlled foreign companies legislation	+10	+10	+10]
	Corporation tax and capital gains tax			
42	Financial futures and traded options	-		*
	Oil taxation			
43	10 per cent cross field allowance	-5	-5	-15
44	Petroleum revenue tax relief for certain research expenditure	-	-	-
45	Oil allowance - final adjustments	*	*	*
	Capital gains tax			
46	Indexation of annual exempt amount	-		-
47	Retirement relief	-	-	*
	Inheritance tax			
48	Changes to rates and bands	-90	-75	-170
49	Business relief and Unlisted Securities Market	*	*	*
50	Abolition of lifetime charge on interest in possession trust property	*	*	*
51	Heritage maintenance funds	*	*	*
52	Property accepted in lieu of tax	*	*	*
	Stamp duties			
53	Changes to stamp duties and the reserve tax	*		*
	TOTAL INLAND REVENUE	-3080	-2265	-2705

* = Negligible - = Nil

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Table 4.1 Direct effects of changes in taxation

£ million

See Annex 4 Paragraph numbers		Estimated effect on receipts in: 1987-88 Changes from a non-indexed base	Changes from an indexed base	1988-89 Changes from an indexed base
	CUSTOMS AND EXCISE			
	Value added tax			
54	Revised treatment of tour operators' margins	-	-	+20
55	New rules on deduction of input tax by partly exempt traders	+300	+300	+400
56	Cash accounting for small businesses	-100	-100	-10
57	Increase in registration limits	*	-	*
58	Revised registration requirements	-15	-15	-25
59	Annual accounting for small businesses	-	-	-25
60	Simplified retail schemes	-	-	-
61	Removal of loophole on imported services	*	*	+5
62	Relief for charities	-5	-5	-5
	Excise duties			
63	No change in rate of spirits duty	-	-25	-25
64	No change in rate of beer duty	-	-60	-65
65	No change in rate of duty on cider and perry	-	*	*
66	No change in rates of wine and made-wine duties	-	-20	-20
67	No change in rates of duty on petrol etc	-	-190	-210
68	No change in rate of duty on derv	-	-50	-50
69	No change in rates of minor oil duties	-	-5	-5
70	No change in rate of tobacco products duties	-	-105	-110
71	Duty differential in favour of unleaded petrol	*	*	*
72	Abolition of on-course betting duty	-20	-20	-20
73	Increase in rates of gaming machine license duties	+20	+20	+20
	TOTAL CUSTOMS AND EXCISE	+180	-275	-125
	Vehicle excise duty			
74	No change in VED on car, light van and main lorry rates	-	-95	-100
75	Increase in other VED rates	+5	+5	+5
76	Recovery vehicles	*	*	*
77	VED back orders	*	*	+5
	Other			
78	Bus fuel grants	-	+5	+5
	TOTAL VED AND OTHER	+5	-90	-85
	TOTAL CHANGES IN TAXATION	-2895	-2625	-2315

* = Negligible - = Nil

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Annex to Chapter 4

How the figures in Table 4.1 have been calculated

Table 4.1 gives the direct effects of changes in taxation. Estimates are rounded to the nearest £5 million. "Negligible" means less than £3 million.

The **direct** effect of a tax change is the difference between the yield of the tax which would arise on the basis of the rates of tax, allowances, etc prevailing before the Budget (the pre-Budget regime) and the yield after the changes proposed in the Budget (the post-Budget regime).

For **Inland Revenue** taxes (and VED) the difference in yield for each tax is generally calculated by applying the pre- and post-Budget tax regimes to the same tax base. This base is the post-Budget base—that is the levels of income, profits etc forecast for future years on the assumption that all the measures proposed in the Budget take effect. In certain cases, however, the difference in yield also takes account of changes in taxpayers' behaviour arising from the tax change where these behavioural changes can be directly attributed to the change in tax. For example, the estimate of the direct cost of the cut in stamp duty rate in last year's FSBR allowed for the expected increase in chargeable transactions.

For **Customs and Excise** taxes and duties, the calculation takes into account, where possible, the effect of the tax change on the pattern of consumers' expenditure and the resulting impact on other expenditure taxes but makes no allowance for secondary effects: in particular, it is assumed that total consumers' expenditure does not change. A fuller description of the methodology is in Economic Trends, March 1980.

Table 4.1 shows the expected change in **receipts** of tax resulting from the Budget proposals. Additional information is provided in the commentary below for those proposals where the effect on tax **liabilities** in the first complete year to which the change applies (full year effect) is substantially different from the effect on **receipts** in either 1987–88 or 1988–89; or where the impact of the proposal is expected to build up over a period of years.

The direct effects shown in the third column of Table 4.1 assume that the levels of allowances, rates of duty etc proposed in the Budget for 1987–88 continue to apply for 1988–89 and compare the effect on receipts in that year with allowances and rates of duty unchanged from their money levels in 1986–87 (the unindexed base).

The estimates shown in Table 4.1 do not reflect changes in the tax base arising from changes in money incomes and in the general level of prices and other economic variables which may result from the proposed tax change. These secondary effects are, of course, taken into account in estimating the impact of the tax change on the PSBR. The base for the post-Budget forecast of each tax (given in Table 6.B.3) takes account of the effects, direct and secondary, of all the measures announced in the Budget.

Table 4.1 does not include certain measures announced and implemented before Budget day. These are the amendment of the material interest test for approved employee share schemes and other purposes, tax relief for the cost of seconding

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Insertion A: (to second para of Annex introduction)

The estimates in the first column of table 4.1 show the direct effect of the Budget measures on receipts in 1987-88. The comparison is with the non-indexed base - that is the pre-Budget regime of allowances, thresholds and rates of duty at their 1986-87 money levels. The estimates in the second and third columns assume indexation of both the pre- and post-Budget regimes as appropriate. The changes are therefore measured from an indexed base and, for 1988-89, assume the tax rates and indexation of the allowances, thresholds and rates of duty proposed in the Budget for 1987-88.

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employees to educational bodies, the tax treatment of invalid care allowance paid to married women, and changes in the pricing and valuation rules for petroleum revenue tax. These measures are reflected in the baseline for costing the effect of tax changes in the Budget.

The remainder of this annex provides a commentary on the Budget proposals in Table 4.1. The paragraph numbers refer to the lines in this table.

Income tax

1 The basic rate will be reduced from 29 per cent to 27 per cent. The cost figures in the table for this item assume that the changes in items [2–7] have been made first. They include the saving in public expenditure on mortgage interest relief to those below the tax threshold. The effect of the consequential change in the rate of advance corporation tax (ACT) is shown in line [29] of Table 4.1.

2 The single person's allowance and the wife's maximum earned income relief will be increased from £2,335 to £2,425 and the married allowance from £3,655 to £3,795.

3 The additional personal allowance and widow's bereavement allowance will be increased from £1,320 to £1,370.

4 The age allowance will be increased for the single person from £2,850 to £2,960 and for the married from £4,505 to £4,675; the age allowance income limit will be increased from £9,400 to £9,800.

5 There will be a new, higher level of age allowance for those aged 80 or over. The allowance will be £3,070 for the single person and £4,845 for the married.

6 The blind allowance will be increased from £360 to £540. This will cost about £2 million per year.

7 The basic rate limit will be increased to £17,900.

8 The threshold for the 45 per cent higher rate will be raised by £200 to £20,400. The thresholds for the 50 per cent, 55 per cent and 60 per cent rates will remain at £25,400, £33,300 and £41,200 respectively.

9 One half of profit related pay (PRP) paid to an employee under a registered scheme will be relieved from income tax, subject to the lower of two annual limits: where the total PRP exceeds 20 per cent of total PAYE pay, PRP will be regarded for tax relief purposes as limited to that amount, and the maximum annual amount of PRP which may be taken into account will be £3,000. The build-up of costs for the proposed income tax relief is inevitably uncertain, but is expected to exceed £100 million in later years. It will depend upon the number of PRP schemes introduced by employers and registered by the Inland Revenue, the numbers of employees covered by them, the amount of PRP in question, and employers' arrangements for the timing of PRP payments.

10 For 1988–89, the scale for taxing car benefits in respect of company cars provided for directors, and for employees whose remuneration is at a rate of £8,500 a year or more, will be increased by 10 per cent. No change is proposed for 1988–89 to the scale charges for car fuel benefit, also—from 6 April 1987—used for VAT purposes.

11 With effect from 6 April 1987 the official rate of interest for taxing cheap or interest-free loans provided for directors, and for employees whose remuneration is at a rate of £8,500 a year or more will follow more closely movements in banks' base rates.

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12 Legislation providing for the taxation of supplementary benefit paid to the unemployed and to strikers will be amended to reflect the replacement in 1988 of supplementary benefit by income support.

or discretionary

13 Approved savings-related ~~share options and approved share option schemes~~ will be permitted to enable directors and employees, when their company is taken over, to exchange their existing options for options over shares in the acquiring company.

14 The limit on charitable donations qualifying for relief under payroll deduction schemes will be increased to £120 from April 1987.

which closes at the end of 1987

15 The tax treatment of Lloyd's reinsurance to close will be made consistent with the treatment of provisions for outstanding liabilities made by insurance companies and similar provisions made by other financial traders. The legislation will first take effect for the Lloyd's 1985 Account. This is assessable for the year 1985–86, the tax for which does not become payable until 1 January and 1 July 1989. The estimate of receipts ~~in 1988–89 is subject to a considerable degree of uncertainty. So is the estimate of the rate at which receipts will build-up in subsequent years, but they may reach £60 million in 1991–92 and subsequently stabilise at about £30 million.~~

depends on the details of the new arrangements, which are still to be established.

16 The Inland Revenue's powers to apportion the income and annual payments of a close company to its participators will be made obligatory (a recent Court case held that they were discretionary).

17 A possible anomaly in the law relating to the taxation of foreign partnerships will be removed to prevent substantial potential revenue loss.

Income tax and capital gains tax

18 Relief under the Business Expansion Scheme for investments made in the first half of the tax year will, in part, be able to be claimed against the income of the previous tax year. The special relief for film production, which requires the company to be producing films throughout the three year qualifying period, will be relaxed so that the requirement can be satisfied by the distribution of films produced in this period.

19 The Revenue will be given a limited discretion in certifying offshore funds as distributing funds.

Income tax and corporation tax

20 A new tax regime for personal pensions will be introduced to replace and extend the present, broadly similar, legislation for retirement annuities. The estimated cost assumes an initial take-up of 200,000 rising to 400,000 by April 1989.

21 The changes proposed for pensions include some tightening up to guard against exploitation of the tax reliefs and some relaxations, in particular to allow members of occupational schemes to pay additional voluntary contributions to pension plans outside their employer's scheme ("freestanding AVCs"). The estimated overall cost of the package assumes an initial take-up of "freestanding AVCs" of 250,000 and includes a modest yield from the tightening up measures.

22 A change is proposed in the limit applicable to tax exempt life or endowment business carried on by friendly societies. The present limit of £750 gross sum assured will be changed to £100 annual premium.

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Insertion B: Income tax, corporation tax, capital gains tax, inheritance tax and stamp duties.

29. Changes in the tax rules for unit trusts are necessary to cater for the definitional and ~~regulatory changes relating~~ to unit trusts introduced in the Financial Services Act.

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23 The PAYE and subcontractor deduction schemes will be slightly amended. In particular, there will be an interest charge where PAYE tax, or an amount that should have been paid under deduction by a contractor, has to be formally determined.

24 Where certain interest is paid between companies which are members of a group or under common control, it will be treated in all cases as being paid and received on the same day. Without this measure there could have been widespread avoidance.

25 The exemption limits for trade union provident funds will be increased from £2,400 to £3,000 (for lump sums) and from £500 to £625 (for annuities).

26 Capital allowances for construction costs of properties provided for letting on assured tenancy terms by "approved bodies" were introduced in 1982 for a period of five years ending 31 March 1987. ~~It is proposed to extend~~ that period by a further five years ending 31 March 1992.

27 With effect from 6 April 1987, training costs borne by an employer to equip with new work skills a worker who is to ~~be made redundant~~ will no longer be treated as a taxable benefit received by the employee and such costs will be allowed in computing the employer's taxable profits.

Income tax, corporation tax and capital gains tax

28 Legislation will enable securities quoted on new Recognised Investment Exchanges to be treated in the same way as comparable securities quoted on the Stock Exchange.

Corporation tax

29 As a consequence of the reduction in the basic rate, the rate of ACT for 1987–88 will be 27/73rds of the amount of the distribution. This reduction in ACT will be balanced by an increase in subsequent liability to mainstream corporation tax.

30 The small companies' rate of corporation tax for the financial year 1987 will be reduced to 27 per cent.

31 All companies ~~and~~ building societies will be liable to pay ~~corporation~~ tax nine months after the end of each accounting period. For individual companies ~~and building societies~~ the change will be phased in over a period of up to three years.

32 Under present law capital gains by companies are reduced by one-seventh before being charged to corporation tax at 35 per cent. Gains realised from Budget Day will cease to be reduced. Instead they will be taxed in full (with indexation allowance) at normal corporation tax rates. For small companies, the small companies' rate will apply to gains. The yield represents the difference between receipts at the level of capital gains before the change and receipts at the level of capital gains expected as a result of the change.

33 Credit for the payment of ACT will be allowed against liability for tax on gains realised from Budget Day. The cost shown against this measure is extremely tentative.

34 Dual resident companies are companies which are simultaneously resident in two countries. It is proposed that, unless they are trading companies, they should no longer enjoy a deduction in both countries for the interest which they pay.

35 The rules for calculating banks' taxable income from making a loan to a non-resident will be changed so that any tax credit for foreign withholding tax paid or deemed to be paid on the interest they receive may be offset only against UK tax due on the turn on that loan. The yield will build up over time to about £60 million by 1990–91.

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[36 Effects of Section 16 of the Oil Taxation Act 1975 will be mitigated by allowing limited carry back of ACT surrendered to a ring fence subsidiary by its parent (initially restricted by a monetary ceiling of £10 million per company), or, in the case of a company owned by a consortium which is a 50/50 joint venture, by allowing surrender of ACT to the ring fence consortium company.]

37 ACT in respect of dividends paid on or after Budget Day on preference shares where the capital raised has not been used for ring fence purposes will no longer be available for set-off against corporation tax on ring fence profits. Without this measure, there could have been widespread avoidance of the ring fence provisions, possibly costing tens of £million.

38 The capital gains provisions for groups of companies will be amended to include building societies.

39 Under Pay and File companies will estimate and pay their corporation tax on the normal due date without the need for the Inland Revenue to make estimated assessments. Interest will run from the normal due date on tax paid late by the company and on tax repaid to the company. Returns will be due twelve months after the accounting period with automatic penalties for delay. This measure will not be implemented ~~for some years.~~

40 [The legislation affecting controlled foreign companies is to be amended to prevent avoidance of a UK tax charge on dividends. Without this provision, there could be a significant loss of tax.]

Corporation tax and capital gains tax

41 The provisions concerning financial futures dealt in on Recognised Futures Exchanges and with traded options will be amended.

Oil taxation

42 Up to 10 per cent of expenditure incurred in developing new oil fields will be allowed against a participator's PRT liability in another field. The cost builds up to £40 million in 1989–90, and to £80 million in 1990–91.

43 Research expenditure will be allowed against a participator's PRT liability in any field if, three years after it is incurred, it has not yet become allowable for any field. No cost therefore arises until 1990–91, when it will amount to about £30 million, and £25 million thereafter (taking account of CT clawback).

44 The scope for redistributing oil allowance amongst participators, in order to correct imbalances, will be extended. The cumulative total of oil allowance will be unchanged.

Capital gains tax

45 The capital gains tax annual exempt amount is to be increased in accordance with the statutory indexation provisions from £6,300 to £6,600 in the case of individuals, and from £3,150 to £3,300 in the case of most trusts.

46 The limit for retirement relief will be increased from £100,000 to £125,000.

Inheritance tax

47 The estimated full year cost for the proposed rate structure in paragraph [4.18] attributable to transfers in 1987–88 is £210 million, measured against the indexed base.

48 The rate of relief on transfers of holdings of more than 25 per cent and up to 50 per cent in unquoted companies is to be increased from 30 to 50 per cent from Budget Day. Minority holdings in USM companies will no longer qualify for business relief, but shares in such companies will be treated for all IHT purposes like shares in companies with a full listing. The revenue effects of these changes is likely to be broadly neutral.

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50 **(a)** The charge on transfers made by individuals to interest in possession trusts on or after 17 March 1987 and more than seven years before the death of the transferor will be abolished.

(b) The charge on termination of an interest in possession in settled property in favour of another individual on or after 17 March 1987 and more than seven years before the death of the person beneficially entitled to the interest will be abolished.

(c) An alternative basis will be provided for determining the rate of charge on the termination of an interest in possession in settled property in favour of a discretionary trust on or after 17 March 1987.

51 **(a)** IHT will not be payable in respect of settled property on the death on or after 17 March 1987 of a person beneficially entitled to an interest in possession in that property if the property becomes subject to the trusts of a qualifying heritage maintenance fund within two years (or if a Court Order is needed, within three years) after the death.

(b) The charge where property formerly subject to an interest in possession leaves a heritage maintenance fund will be altered: if the tax given up when the property entered the maintenance fund was tax on the termination of an interest in possession, the exit charge will be based on the cumulated chargeable transfers of the person whose interest was terminated.

Insert © here

52 Changes in the tax rules for unit trusts are necessary to cater for the definitional and regulatory changes relating to unit trusts introduced in the Financial Services Act.

Stamp duties

53 Certain technical changes are proposed to the legislation governing stamp duties and the reserve tax.

Value Added Tax

54 The gross margins earned by tour operators on sales of tours within the European Community will be brought within the scope for VAT with effect from 1 April 1988.

55 The law will be changed to strengthen the rules relating to the deduction of input tax by partly exempt traders, and to exempt the underwriting of, and making of arrangements for, capital issues.

56 Businesses with annual turnover below £250,000 will have the option of accounting for VAT on the basis of payments made and received. It is intended that this system should be introduced on 1 October 1987.

57 The registration limit will be increased to £21,300 per annum and £7,250 per quarter.

58 The time allowed to notify for registration will be extended to 30 days, and it will be made easier to deregister.

59 Businesses with annual turnover below £250,000 will have the option of making a single VAT return each year (instead of the present four) with nine advance payments based on the VAT paid in the previous year. This system will be introduced in the second half of 1988. Certain recommendations of the Keith Committee which were due to be implemented in 1988 will, as a result, be deferred until 1989. The cost of deferral will be £25 million in 1988–89 and some £50 million to £75 million in 1989–90.

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Insertion C: (under inheritance tax items)

52. (a) The tax satisfied by acceptance of pre-eminent heritage property in lieu of IHT will be calculated, at the option of the offeror, by reference to the value of the property at the date of the offer instead of the value at the date of acceptance.

(b) Where this option is selected, the tax will be regarded as having been paid on the date of the offer and so will not bear interest after that date.

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59 Simplified special schemes for retailers will be made available for use by many more small and medium-sized businesses.

60 The law will be changed to prevent the avoidance of tax on imported services by exempt businesses.

61 VAT relief will be extended to certain welfare vehicles used by hospices to transport the terminally ill; to specialised location and identification equipment used by mountain rescue and first aid services; to goods donated for export by a charity for relief of distress or animal welfare; to installing or adapting lavatory or bathroom facilities in charity residential homes for the disabled; and to drugs and chemicals supplied to charities and **directly** used in medical care or research.

Excise duties

62-69 There will be no changes in the duties on alcoholic drinks, tobacco products and most hydrocarbon oils.

70 The duty on unleaded petrol will be increased by 2p a gallon (inclusive of consequential VAT).

71 The duty on bets placed on-course at horse and greyhound racetracks will be abolished.

72 The rate of gaming machine licence duty will be increased as follows:

for 5p "amusement with prizes" machines by £30
for 10p "amusement with prizes" machines by £75
for 5p jackpot machines by £75
for 10p jackpot machines by £210

The amount of refund on surrender of a licence will be increased and the arrangements for collecting the duty will be changed.

Vehicle excise duties

73 There will be no change in the duties on cars, light vans, taxis, buses, coaches, motor cycles and most lorries.

74 The concessionary rates of duty for farmers' heavy goods vehicles over 7·5 tonnes will be increased by varying amounts as the final stage in the process of bringing them into line with the proportion of average mileage covered by these vehicles on public roads. From 1 January 1988 the rate of duty for trade licences will be increased to £85 for cars and £17 for motor cycles, as the second stage in the process of increasing these rates to the rates for ordinary licences for cars and motor cycles between 150 and 250cc, respectively.

75 From 1 January 1988 a new taxation class will be created for recovery vehicles. The rate of duty will be set at £50.

76 The law will be amended so that, on conviction for VED evasion, the Courts will be required to order payment of all back duty from the expiry of the last licence or date of acquisition of the vehicle, without regard for any non-use of the vehicle during the period.

77 There will be no change in bus fuel grant.

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5 Public Expenditure

Public spending plans **5.01** The 1987 public expenditure White Paper (Cm 56-I and II) set out plans for public spending for the next three years and provided the basis for the more detailed Supply Estimates, cash limits and other spending controls for 1987–88. These plans are summarised in Table 5.1.

Changes since previous Budget **5.02** Since the last FSBR, extra funds have been allocated to priority services including education, health and law and order. The estimated costs of some demand-led programmes, such as social security, have also risen.

Table 5.1 Public expenditure

£ billion

	1985–86 Outturn	1986–87 Estimated Outturn	1987–88 Plans	1988–89 Plans	1989–90 Plans
Department					
DHSS – Social security	41·5	[44·6]	46·0	47·5	49·3
Defence	18·0	[18·4]	18·8	19·0	19·5
DHSS – Health and personal social services	16·6	[18·0]	19·1	19·9	20·8
~~Scotland, Wales and Northern Ireland~~	~~14·3~~	~~[15·5]~~	~~16·0~~	~~16·5~~	~~16·8~~
Education and science	14·5	[15·7]	16·6	17·4	17·8
Other departments	~~31·4~~ 40·5	~~[32·5]~~ [42·2]	~~33·6~~ 43·4	~~33·6~~ 43·6	~~34·8~~ 45·0
Privatisation proceeds	−2·7	[−4·4]	−5·0	−5·0	−5·0
Reserve			3·5	5·5	7·5
Adjustments[1]		[ ]			
Public expenditure planning total	**133·6**	**[140·3]**	**148·6**	**154·2**	**161·5**
General government gross debt interest[2]	17·7	[17·5]	[18·0]	[18]	[19]
Other adjustments[2]	7·2	[7·3]	[6·8] 7·0	8 [7½]	8 [7½]
General government expenditure[2]	**158·5**	**[165·3]**	**[173·7]**	**[180]**	**[188]**
Planning total in real terms (base year 1985–86)	**133·6**	**[136·3]**	**[139·3]** 138·0	**[139·7]** 137·7	**[142·1]** 139·2
General government expenditure as a percentage of GDP	**44**	**[43¼]**	**[42¼]**	**[41¼]**	**[41¼]** 40½

[1] [Comments on adjustment line if required]

[2] [Comments on rounding conventions] 1988-89 and 1989-90 figures rounded to nearest £1 billion

Home Office (and including Law Officers' Department)	5·3	[5·8]	6·2	6·4	6·6

Public spending trends **5.03** The plans show a further fall in general government spending as a percentage of GDP over the next three years (see Table 5.1); this is the case with or without any proceeds from privatisation. By 1989–90, the

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percentage should be back to the level of the early seventies. This reflects the Government's continued objective of reducing steadily the State's share of the nation's income.

5.04 General government expenditure covers spending by central government and local authorities. It is the ~~definition of government spending~~ used in the ~~national accounts, forecasts of the economy and the MTFS~~. The main difference between general government expenditure and the planning total is the inclusion in the former of general government gross debt interest, amounting to some [£18] billion in 1987–88. There are also a number of other definitional differences and adjustments, which are described in the Annex to Part 2 of the 1987 public expenditure White Paper. In 1987–88, these adjustments account for a further £7 billion.

key public expenditure aggregate

Medium Term Financial Strategy where public expenditure is set into the context of the economy as a whole.

1986–87 outturn

5.05 The latest estimates, which still remain subject to some uncertainty, suggest that the planning total outturn in 1986–87 is likely to be about [£140.3 billion], [£1.2] billion above the plans shown in the 1986 public expenditure White Paper and the 1986 Budget. [This is very close to the estimated outturn figure shown in the Autumn Statement and this year's White Paper.] The details are shown in Table 5.2.

Table 5.2 Comparison of plans and estimated outturn for 1986–87

	£ billion 1986–87		
	Plans [1]	Estimated outturn	Outturn minus plans
Central government	102·6	[105·2]	[+2·5]
Local authority	35·2	[38·2]	[+3·1]
of which			
Relevant expenditure	27·0	[29·5]	[+2·5]
Other current	4·5	[4·8]	(+0·3]
Capital	3·7	[3·9]	[+0·3]
Nationalised industries and other public corporations	1·6	[1·4]	[−0·2]
Privatisation proceeds	−4·8	[−4·4]	[+0·4]
Reserve	4·5	/	[−4·5]
Adjustment [2]		[ ]	[ ]
Public expenditure planning total	**139·1**	**[140·3]**	**[+1·2]**

[1] Plans from The Government's Expenditure Plans 1986–87 to 1988–89, Cmnd 9702, adjusted for classification changes.

[2] [ ].

The major changes between plans and estimated outturn are:—

i. an increase of [£3 billion] in local authority expenditure including an overrun of [£2½] billion on expenditure relevant for Aggregate Exchequer Grant (relevant expenditure);

ii. an increase in social security expenditure of [£1½] billion;

iii. ~~a payment of [£650] million [comment on nature of payment to Rover]~~ additional equity of £680 million in Rover Group to meet debt and restructuring costs associated with disposal of their Trucks and Bus businesses

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Additions to programmes amount to some [£5.3] billion and, after allowing for a shortfall of £400m on privatisation proceeds and allocation of the Reserve of £4.5 billion, the overrun on the planning total amounts to about [£1.2] billion.

Table 5.3 Public expenditure by spending authority

£ billion

	1985–86 Outturn	1986–87 Estimated Outturn	1987–88 Plans	1988–89 Plans	1989–90 Plans
Central government[1]	98·5	[105·1]	108·3	111·2	115·7
of which Voted in Estimates	71·3	[74·7]	76·3	78·7	81·1
Other	27·1	[30·4]	32·0	32·5	34·6
Local authorities[1]	35·2	[38·2]	40·2	41·1	42·4
of which Relevant expenditure	26·9	[29·5]	31·0	32·2	33·1
Other current	4·5	[4·8]	4·9	4·9	5·2
Capital	3·9	[3·9]	4·3	4·0	4·1
Nationalised industries	1·7	[0·5]	0·7	0·3	−0·1
Other public corporations	0·9	[0·5]	1·0	1·0	1·1
Privatisation proceeds	−2·7	[−4·4]	−5·0	−5·0	−5·0
Reserve			3·5	5·5	7·5
Adjustments[2]		[ ]			
Public expenditure planning total	**133·6**	**[140·3]**	**148·6**	**154·2**	**161·5**

[1] Excluding finance for public corporations (including nationalised industries).
[2] [ ].

Public expenditure by spending authority

5.06 Central government spending makes up about three quarters of the planning total. About 70 per cent of this is voted by Parliament through the annual Supply Estimates and covers the expenditure of government departments for their own activities as well as their funding of other bodies such as the National Health Service. Most of the remainder consists of social security payments paid out of the National Insurance Fund. Spending by local authorities accounts for about one quarter of public expenditure. Nationalised industries and other public corporations account for the remainder of the total. Table 5.3 gives outturn figures for the last two years and the plans as published in the public expenditure White Paper.

Supply Estimates

5.07 For 1987–88, the plans set out in the public expenditure White Paper have now been translated, where appropriate, into detailed control totals in Supply Estimates. The total Estimates provision for 1987–88 for which the Government is seeking Parliamentary approval is shown in Table 5.4. The main Estimates for 1987–88 are published in a series of booklets on 17 March 1987 with a Summary and Guide (Cm [94]) which explains the Supply procedure and summarises the Estimates. It also explains how they relate to the public expenditure planning total.

5.08 Of the £[105.0] billion included in the Supply Estimates, £[78.8] billion is direct public expenditure. The remaining £[26.3]m does not feature directly as public expenditure because it consists of grants to local authorities and finance for other bodies whose spending is counted as public

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expenditure. ~~Nearly [59]~~ per cent of the money voted in Estimates is subject to cash limits, which provide the Government with greater control over its cash expenditure during the financial year.

Table 5.4 Supply expenditure

	£ billion			
	1985–86		1986–87	1987–88
	Expected outturn in 1986 Budget	Final outturn	Expected outturn	Provision
Main Supply Estimates	96·0	~~[96·0]~~	~~[99·0]~~ 1	~~[105·0]~~ 104·5
Supplementaries and net under-spending	2·0	~~[2·1]~~	~~[2·9]~~ 2·8	
Total Supply expenditure	**98·1**	**~~[98·1]~~**	**~~[102·0]~~** 101·9	
(public expenditure element)	(74·9)	~~[75·0]~~	~~[77·5]~~ 77·4	

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6 The public sector's finances

The scope of this chapter

6.01 This Chapter brings together revenue (discussed in Chapter 4) and spending (in Chapter 5), and provides an analysis and forecast of the public sector's finances in 1987–88, together with new estimates of outturn in 1986–87. It also comments on the main features of the public sector's finances in those two years, including the most important changes that have taken place since last year's projections. Table 6.1 is a summary.

Table 6.1 Public Expenditure, Receipts and Borrowing

£ billion

	1985–86	1986–87		1987–88
	Outturn	1986 Budget	Latest estimate	Forecast
General government expenditure	158·5	163·4	165·~~3~~1	173·~~7~~5
General government receipts	151·6	155·9	158·~~6~~7	~~169·7~~ 168.7
General government borrowing requirement	6·9	7·5	6·~~7~~4	4·~~1~~8
Public corporations' market and overseas borrowing	−1·1	−0·4	−1·~~8~~5	−0·~~6~~8
Public sector borrowing requirement	**5·8**	**7·1**	**4·9**	~~5·1~~ 4.0

6.02 The PSBR is now estimated to be just under £5 billion in 1986–87, compared with the forecast of £7 billion made a year ago. The PSBR is forecast to be about £3¼ billion in 1987–88.

Public sector's finances: three-fold analysis

6.03 The public sector's finances can be analysed in a number of different ways:

- by type or activity, showing on the one hand the different types of receipts (income taxes, corporation taxes, capital taxes, expenditure taxes, North Sea revenues, and so on); and on the other hand the spending (on social security, defence, health, education and so on) financed by those receipts and by borrowing;

- by sector, showing the authority which undertakes the financing or spending: central government, local authorities or public corporations;

- by economic category, showing, for example, whether the receipts and spending are current or capital transactions and whether current spending is on goods and services or transfer payments.

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6.04 This three-fold analysis of the public sector's finances is analogous to the three-fold presentation of public spending that has become an established feature of the Public Expenditure White Paper: see paragraph 13 of Cm 56-I. The rest of this Chapter sets out these three analyses in detail.

Analysis by type or activity

6.05 Table 1.2 analyses the public sector's finances by type or activity. The main receipts of general government (ie central plus local government) are grouped according to the kind of activity which gives rise to them, while spending is shown, by department, as in Chapter 5 and in the Public Expenditure White Paper. Its bottom line, the public sector borrowing requirement, is derived from those two totals. This derivation is repeated in Table 6.1.

Receipts

6.06 The Autumn Statement said that general government receipts in 1986–87 were likely to be higher than forecast in the 1986 Budget. The size of the overshoot now appears to be ~~rather bigger~~ than envisaged then. Total general government receipts are now estimated to be over ~~£2½~~ billion higher than the 1986 Budget forecast, despite a shortfall of £1¼ billion in oil receipts. As Table 1.2 shows non-North Sea corporation tax (£1¾ billion) and VAT (£¾ billion) account for most of the additional receipts. Stamp duty, included in "other" expenditure taxes in Table 1.2, accounts for nearly a further £½ billion.

6.07 The shortfall in **oil revenues** reflects lower than assumed oil prices ~~in the first half of~~ 1986 ~~87~~ and ~~also~~ the £0·3 billion repayment of advanced petroleum revenue tax announced in the Autumn Statement. Oil revenues are now estimated to have fallen from £11½ billion in 1985–86 to £4¾ billion in 1986–87. They are forecast to fall ~~a little further in 1987–88~~, to £4¼ billion, ~~because of~~ lower receipts of North Sea corporation tax. This reflects the fall in oil prices in 1986, as corporation tax is paid with a lag. ~~Other oil revenues in 1987–88, determined mainly by oil prices and production in 1987, are forecast to increase.~~ The sterling oil price is assumed to be somewhat higher in 1987 than 1986 and oil production is forecast to fall slightly.

6.08 The 1986 Budget expected total **non-oil receipts** to rise a little less than the projected rise in non-oil money GDP. They are now estimated to have risen slightly more, by 9¾ per cent, compared with an estimated 9 per cent rise in non-oil money GDP. Corporation tax receipts in 1986–87 largely depend on profits and other income earned in calendar year 1985. On currently recorded data non-North Sea company incomes rose strongly in 1985. The rise, however, is insufficient to explain the whole of the increase in corporation tax receipts. One possibility is that the recorded data understate the full rise in company income. Another possibility is that the distribution of total income growth among individual companies was such that less use was made of capital allowances and other tax offsets than the forecast implied. The greater than expected buoyancy of VAT is partly attributable to total consumer spending rising a little faster than forecast, but probably also reflects a change in the composition of consumption towards spending on goods and services subject to VAT.

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6.09 In 1987–88 both total and non-oil money GDP are forecast to increase at much the same rate, about 7½ per cent. Non-oil receipts are ~~also~~ forecast to rise by 7½ per cent, after taking account of the Budget proposals. As Table 1.2 shows there is within this overall increase:

- ~~a~~ a further rise, of 21 per cent, in receipts of **corporation tax** (excluding North Sea mainstream corporation tax). This reflects continued growth of company incomes in 1986.
- ~~a~~ a 4½ per cent increase in receipts from **income taxes**—lower than the increase in personal incomes, reflecting the income tax reductions announced in the Budget.
- ~~an~~ an 8½ per cent increase in **VAT** receipts, following an 11 per cent increase in 1986–87. The rate of increase in consumer spending on goods and services subject to VAT is forecast to be lower in 1987–88 than in 1986–87.
- ~~a~~ a 7½ per cent increase in net **local authority rates**, a ~~much~~ smaller increase than in 1986–87.
- ~~a~~ a 5½ per cent increase in revenue from excise duties, ~~other expenditure taxes~~.

Expenditure

6.10 Total **general government expenditure** is expected to have been £165½ billion in 1986–87, a little higher than in the Autumn Statement and Public Expenditure White Paper, and ~~nearly~~ £7 billion higher than in the 1986 Budget forecast. There are two main reasons for the overspend compared with the Budget forecast. First, as explained in Chapter 5, the planning total is expected to be £1¼ billion higher than planned. Secondly within public corporations' external financing requirement, a component of the planning total, public corporations have met a higher proportion by general government finance and a smaller proportion by market and overseas borrowing. Partially offsetting these factors is an estimated £¾ billion reduction in general government **debt interest payments**.

6.11 General government expenditure is expected to rise by 5 per cent in 1987–88, to £173½ billion. The planning total, at £148·6 billion, is the same as in the Public Expenditure White Paper. General government gross debt interest payments are forecast to rise from £17½ billion in 1986–87 to nearly £18¼ billion in 1987–88.

Borrowing

6.12 The difference between general government receipts and expenditure is the general government borrowing requirement (GGBR), as shown in Table 6.1. As general government lending to public corporations is included in general government expenditure, the GGBR together with public corporations' market and overseas borrowing, gives the ~~public sector borrowing requirement (PSBR).~~ PSBR.

6.13 A year ago the PSBR in 1986–87 was forecast at £7·1 billion. Borrowing in the eleven months to February is provisionally estimated to have been £[1·6] billion. Borrowing in March is always relatively high. Central government expenditure is likely to be unusually high this March as a result of transactions related to the Rover Group, ~~And central government~~ while receipts from the revenue is expected to be less than last year, with lower North Sea ~~oil~~ revenues as a result of the fall in oil prices, ~~and lower receipts of building society composite rate tax as a result of the change in payments.~~

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Taxes in relation to GDP

6.10 Table 6.2 shows taxes (including rates) and national insurance contributions as a percentage of GDP. While, overall, the percentage is estimated to have fallen in 1986-87 and is forecast to fall further in 1987-88, non-oil taxes are estimated to have risen in 1986-87 as a percentage of non-oil GDP, and are likely to stay much the same in 1987-88.

Table 6.2: Taxes and National Insurance Contributions (NICs) Relative to GDP - %

	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87 Estimated Outturn	1987-88 Forecast
Total taxes and NICs as a share of total GDP	39.4	39.2	38.6	39.1	38.6	38.3	38.1
Non-oil taxes and NICs as a share of non-oil money GDP	38.8	38.4	37.9	37.8	37.1	37.8	37.8

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~~arrangements~~. Local authority borrowing is always high in the closing weeks of the financial year, ~~and could be higher than usual this year.~~ The latest estimate of the outturn for the PSBR in 1986–87 as a whole is £~~4·9~~ billion, or ~~1·3~~ per cent of money GDP.

6.14 The PSBR in 1987–88 is forecast to be about £~~3~~ billion, or ~~1~~ per cent of money GDP.

~~Earlier years~~ **6.15** Both general government expenditure and receipts are estimated to have fallen as a proportion of money GDP in 1986–87, the latter because of the fall in oil revenues. In 1987–88 expenditure is projected to fall again as a proportion of money GDP, as it has done since 1982–83, while general government receipts are forecast to be the same as a proportion of money GDP as in 1986–87.

6.16 There have been significant changes in the ~~structure of receipts~~ financing of expenditure over the past eight years. In particular:

- ~~—~~ borrowing has become a much less important means of financing public expenditure, its share falling from 12 per cent of expenditure in 1978–79 to ~~1~~ 3 per cent in 1987–88.
- ~~—~~ North Sea revenues have grown, but in 1987–88 they are expected to finance only 2 per cent of expenditure compared with 8 per cent at their peak in 1984–85.
- ~~—~~ there has been a switch away from direct to indirect taxation; expenditure taxes, including rates, financed 28 per cent of expenditure in 1978–79 but are expected to finance ~~40~~ 39 per cent in 1986–87 8.
- ~~—~~ the contribution of income tax has fallen from 25 per cent to 23 per cent.

— the contribution of national insurance contributions has risen but this is broadly offset by the fall in the contribution of the national insurance surcharge (counted as a tax on expenditure)

Analysis by sector

6.17 The PSBR may also be analysed by the authority or sector which will be undertaking (or repaying) the borrowing: central government, local authorities and public corporations. Table 6.2 shows the sectoral composition of the PSBR in 1986–87, in summary form.

Table 6.2 Public sector borrowing requirement

	£ billion	
	1985–86 outturn	1986–87 Latest estimate
1 Central government on own account	4·1	~~5·7~~ 4
2 Local authority borrowing from central government	5·7	4·9
3 Local authority borrowing from market and overseas	−4·1	−4·~~0~~ 1
4 Total local authority borrowing	1·7	0·~~8~~ 3
5 Public corporations' borrowing from central government	1·1	0·~~3~~ 2
6 Public corporations' borrowing from market and overseas	−1·1	−1·~~8~~ 5
7 Total public corporations' borrowing	0·0	−1·3
8 Public sector borrowing requirement	**5·8**	~~4·9~~
Memorandum item:—		
Central government borrowing requirement (lines 1+2+5)	10·9	10·~~6~~ 5

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6.18 Tables 6.3 to 6.5 show estimated outturns and forecasts of receipts and expenditure in 1986–87 and 1987–88 for each of the three sectors. These tables include some of the analysis by economic category in paragraph 6.27 and Table 6.6. Expenditure in 1987–88 does not include the Reserve, which has not been allocated. The forecast of the PSBR assumes however that the Reserve is fully spent.

6.19 Central government spending includes grants and subsidies to local authorities and public corporations (including nationalised industries), which are included in the receipts of those sectors, shown in Tables 6.4 and 6.5.

Table 6.3 Central government transactions

	£ billion		
	1985–86 Outturn	1986–87 Latest estimate	1987–88 Forecasts
Receipts			
Taxes and royalties	100·6	104·3	111·8
National insurance and other contributions	24·7	26·3	28·6
Other	10·5	10·7	9·3
Total receipts	**135·8**	~~140·9~~ 141.0	~~150·4~~ 149.7
Expenditure			
Current expenditure on goods and services	46·6	49·2	52·0
Current grants and subsidies	72·2	76·9	79·0
Interest	16·1	16·6	17·6
Net lending and capital expenditure, excluding on-lending to local authorities and public corporations	4·2	3·5	2·3
Total expenditure	**139·1**	**146·2**	~~150·9~~* 151.1

**Excluding any allocation from the Reserve*

6.20 Local authority receipts consist primarily of the rate income plus grant from central government. The forecast increase in net rate income between 1986–87 and 1987–88 takes account of ~~recent~~ available information about rate decisions by ~~a sample of~~ local authorities.

6.21 The local authority borrowing requirement (LABR) in the first eleven months of 1986–87 is provisionally estimated to have been a surplus of £[0·4] billion. The estimated outturn for the year as a whole is borrowing of £0·9 billion. This estimate takes account of the ~~Borrowing Intentions Survey of a sample of local authorities~~. If the estimated outturn is correct, and the margin of error surrounding the forecast is inevitably very large, the LABR in 1986–87 will be £1 billion lower than in 1985–86. This fall in borrowing appears to have been the result of current receipts rising more than current expenditure and a small fall in net capital spending. In 1986–87, as in 1985–86, local authorities replaced substantial amounts of market and overseas borrowing by borrowing from the central government.

usual high level of borrowing in March.

nearly £1

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Table 6.4 Local authority transactions

	£ billion		
	1985–86 Outturn	1986–87 Latest estimate	1987–88 Forecasts
Receipts			
Rates (net of rate rebates)[1]	13·8	15·5	17·0
Rate support grant	11·3	11·8	13·0
Other grants from central government	10·0	11·4	11·8
Other	5·6	5·6	5·5
Total receipts	**40·7**	**44·3**	**47·3**
Expenditure			
Current expenditure on goods and services	28·5	31·5	33·3
Current grants and subsidies	5·3	5·8	5.6
Interest	3·7	4·4	4·6
Net lending and capital expenditure	4·2	3·8	4·0
Total expenditure	**41·7**	**45·2**	**47·5**[2]
[1] *Memo: Rate rebates*	*1·6*	*1·7*	*1·9*

[2] *Excluding any allocation from the Reserve*

6.22 Table 6.5 shows public corporations' transactions. The public corporations' receipts include subsidies and capital grants from central and local government. For the nationalised industries (and the majority of other public corporations) their net external finance, ie their borrowing plus subsidies and grants, is included in the planning total. Changes from one year to another are affected by privatisations. During the course of 1986–87 British Gas and British Airways were privatised and ceased to be classified as public corporations.

Table 6.5 Public corporations' transactions

	£ billion		
	1985–86 Outturn	1986–87 Latest estimate	1987–88 Forecasts
Receipts			
Gross trading surplus (including subsidies)	8·1	7·0	7·0
Other	1·8	3·2	2·4
Total receipts	**9·9**	**10·2**	**9·4**
Expenditure			
Interest, dividends and taxes on income	4·3	3·7	3·8
Net lending and capital expenditure	5·6	5·3	4·8
Total expenditure	**9·9**	**8·9**	**8·6**[1]

[1] *Excluding any allocation from the Reserve*

6.23 Public corporations' borrowing requirement in the first eleven months of 1986–87 is provisionally estimated at a net repayment of £[1·1] billion. The estimated outturn for the year as a whole is a net repayment of £1·3 billion, compared with a zero borrowing requirement in 1985–86.

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The reduction in borrowing appears to have been due to a number of factors including rising output, further improvements in productivity, the effect on profit margins of the decline in sterling and ~~a rise in~~ higher net trade credit receipts.

Analysis by economic category

6.24 The transactions leading up to the PSBR may also be analysed by economic category (some details of which are given in Tables 6.3 to 6.5 above). This analysis is shown in Table 6.6, with a breakdown between central government, local authorities and public corporations. This analysis, which distinguishes between current and capital transactions (and within the latter between physical and financial investment) shows the derivation of the public sector financial deficit. The ~~public sector~~ financial deficit, unlike the PSBR, is not wholly a measure of ~~actual~~ cash transactions because certain taxes included in lines 1 and 2 of Table 6.6 are measured on an accruals basis. An accruals adjustment is made in line 28 before the PSBR is derived.

6.25 The unallocated Reserve is assumed to be used up by spending on current items or physical capital formation—ie in transactions that fall above the financial surplus/deficit line. In practice allocations from the Reserve can affect financial transactions (lines 25 to 29). For example expenditure in 1986–87 associated with Rover Group is classified as cash expenditure on company securities and appears in line 26.

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Table 6.6 Public sector transactions by sub-sector and economic category

£ billion[1]

	Line[2]	1986–87 Latest estimate: General government: Central government	General government: Local authorities	General government: Total	Public corporations	Public sector
Current and capital receipts						
Taxes on income, and oil royalties	1	53·4	—	53·4	−0·1	53·3
Taxes on expenditure	2	48·2 1	15·5	63·7 6	—	63·7 6
Taxes on capital	3	2·7	—	2·7	—	2·7
National insurance and other contributions	4	26·4	—	26·5	—	26·5
Gross trading surplus	5	−0·3	0·4	0·1	7·0	7·1
Rent and miscellaneous current transfers	6	0·2	3·1	3·3	0·5	3·8
Interest and dividends from private sector and abroad	7	2·7	0·7	3·4 3	1·0.9	4·3 2
Interest and dividends within public sector	8	5·7	−3·3	2·4	−2·4	—
Imputed charge for non-trading capital consumption	9	1·0	1·4	2·4	—	2·4
Capital transfers from private sector	10	—	—	—	0·1 2	0·1 2
Total	11	**140·0**	**17·8**	**157·8**	**6·2 0**	**164·0** 163.8
Current and capital expenditure						
Current expenditure on goods and services	12	−49·2 5	−31·2 5	−80·4 -81.0	—	−80·4 -81.0
Subsidies	13	−5·1	−1·3	−6·4	—	−6·4
Current grants to personal sector	14	−46·6 2	−4·5	−51·1 -50.8	—	−51·1 -50.8
Current grants paid abroad	15	−2·9 -3.2	—	−2·9 -3.2	—	−2·9 -3.2
Current grants within public sector	16	−22·3	22·3	—	—	—
Debt interest	17	−16·6 5	−0·9	−17·5	−0·8	−18·3
Gross domestic fixed capital formation	18	−3·4	−3·7	−7·1	−5·3	−12·4
Increase in stocks	19	0·1	—	0·1	0·1	0·1
Capital grants to private sector	20	−2·2	−0·6	−2·8	−0·1	−2·9
Capital grants within public sector	21	−1·3 6	0·9	−0·6 7	0·6 7	—
Total	22	−149·6 -150.3	−19·1 3	−168·7 -169.3	−5·6 5	−174·3 8
Unallocated Reserve	23	—	—	—	—	—
Financial surplus/deficit	24	−9·6 -10.3	−1·2 5	−10·8 -11.5	0·6 5	−10·2 -11.0
Financial transactions						
Net lending to private sector and abroad	25	−0·2	0·5	0·3	−0·2	0·3 −
Cash expenditure on company securities (net) (including privatisation proceeds)	26	3·7 9	—	3·7 9	—	3·7 9
Transactions concerning certain public sector pension schemes	27	0·8	—	0·8	—	0·8
Accruals adjustments	28	−0·1	−0·3 −	−0·4 −	—	−0·3 −
Miscellaneous financial transactions	29	0·2	0·1 2	0·3 4	0·7 1.0	1·0 4
Borrowing requirement	30	**5·3 4**	**0·9 8**	**6·2**	**−1·3**	**4·9**

[1] *Sign convention: receipts positive, payments negative.*

[2] *Relationship between lines: (24) = (11) + (22) + (23) — (25) to (30)*
(30) = −(24 to 29)

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£ billion[1]

Line[2]	General government: Central government	General government: Local authorities	General government: Total	Public corporations	Public sector	
						Current and capital receipts
1	57·34	—	57·34	−0·1	57·23	Taxes on income and oil royalties
2	51·35	16·7 17.0	68·05	—	68·05	Taxes on expenditure
3	3·2	—	3·2	—	3·2	Taxes on capital
4	28·36	—	28·36	—	28·36	National insurance and other contributions
5	−0·3	0·5	0·2	6·9 7.0	7·1	Gross trading surplus
6	0·23	3·1	3·34	0·5	3·89	Rent and miscellaneous current transfers
7	2·98	0·7	3·65	0·87	4·42	Interest and dividends from private sector and abroad
8	5·9	−3·7	2·2	−2·2	—	Interest and dividends within public sector
9	1·0	1·5	2·5		2·5	Imputed charge for non-trading capital consumption
10	—	—	—	0·13	0·13	Capital transfers from private sector
11	**150·04**	**18·7 19.0**	**168·7 169.4**	**6·61**	**174·7 175.4**	**Total**
					−85.4	*Current and capital expenditure*
12	−52·01	−32·9 −33.3	−84·9 −85.4	—	−84·9	Current expenditure on goods and services
13	−4·5 −5.1	−1·0	−5·5 −6.1	—	−5·5 −6.1	Subsidies
14	−47·8	−4·6	−52·4	—	−52·4	Current grants to personal sector
15	−2·79	—	−2·79	—	−2·79	Current grants paid abroad
16	−24·0 −23.6	24·0 23.6	—	—	—	Current grants within public sector
17	−17·63	−0·7	−18·30	−1·1 −0.9	−19·4 −18.9	Debt interest
18	−3·5	−3·36	−7·0	−4·6	−11·76	Gross domestic fixed capital formation
19	−0·2	—	−0·2	−0·1	−0·3	Increase in stocks
20	−2·0	−0·7	−2·7	−0·1	−2·8	Capital grants to private sector
21	−1·48	0·8 1.1	−0·67	0·67	—	Capital grants within public sector
22	**−155·7 −156.2**	**−18·7 −19.2**	**−174·4 −175.5**	**−5·30**	**−179·7 −180.5**	**Total**
23					−3·5	Unallocated Reserve
24	**−5·7**	—	**−5·7**	**0·7**	**−8·5**	**Financial surplus/deficit**
						Financial transactions
25	−0·2	0·4	0·2	−0·12	—	Net lending to private sector and abroad
26	5·0	—	5·0	—	5·0	Cash expenditure on company securities (net) (including privatisation proceeds)
27	0·75	—	0·75	—	0·5	Transactions concerning certain public sector pension schemes
28	−0·23	−0.1	−0·2	—	−0·2	Accruals adjustments
29	−0·16	— −0.1	−0·18	0·3	0·2 0.8	Miscellaneous financial transactions
30					3·4 4.0	**Borrowing requirement**

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Annex to Chapter 6

Part A: Relationship between tables in Chapter 6, and with Table 1.2; and outturn data

Relationship between tables

6A.1 Table 6.6 is based on the definitions used to compile the national accounts. In order to show the financial deficit for each sector, lending and other financial transactions are separated from the analysis of receipts and expenditure in lines 1–23 and shown in lines 25–29. These lines show the relationship between the financial deficit (line 24) and the borrowing requirement for each sector (line 30).

6A.2 Tables 6.3–6.5 are summary versions of the sectoral columns of Table 6.6. The information in Table 6.6 is rearranged so that, for example, central government grants to local authorities (which appear as negative expenditure in the local authorities column of Table 6.6, lines 16 and 21) appear as receipts in Table 6.4. Interest paid by local authorities to central government (which appears as negative receipts in the local authorities column of Table 6.6, line 8) appears as expenditure in Table 6.4. Finally, lending and other financial transactions (lines 25–29 of Table 6.6) are included in the receipts and expenditure of Tables 6.3–6.5.

6A.3 Table 1.2 in Chapter 1 uses the same information as Table 6.6, but again rearranges it. To derive general government expenditure, it starts by giving a functional breakdown of the public expenditure planning total: that includes not only general government expenditure items in the third column of Table 6.6 (including the "financial transactions" in lines 25–26), but also borrowing or capital expenditure by public corporations in the fourth column. General government expenditure as shown in Table 1.2 is then obtained by adding general government debt interest from the third column of Table 6.6 and the national accounts adjustments already included in Table 6.6, and deducting public corporations' borrowing from the market and from overseas.

6A.4 Alternatively, general government expenditure in Table 1.2 (and Table [2.3]) can be obtained as the sum of lines 22, 23, 25 and 26 (third column) in Table 6.6 and on-lending to public corporations in Table 6.2.

6A.5 To derive general government receipts, Table 1.2 takes the receipts shown in the third column of Table 6.6 (lines 11, 27, 28 and 29) and rearranges them according to the type of activity which gives rise to them. For example, oil revenues comprise North Sea corporation tax and petroleum revenue tax (included in "taxes on income" in Table 6.6) plus oil royalties. The sub total "total taxes and royalties" is the same as the first line of Table [2.4] in Chapter 2.

Outturn data

6A.6 Outturns for the PSBR and the statutory central government accounts (as in Tables 6.B.1–4 in Part B of the Annex) are compiled monthly and published by press notice 12 working days after the end of the month and then in more detail in Tables 2.5 and 3.12 to 3.16 of the following issue of Financial Statistics. ~~Outturn for the~~ details of the PSBR on national accounts definitions, as in Table 6.6, are compiled quarterly and published in sections 2 to 5 of Financial Statistics three months after the end of the quarter.

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6A.7 The first outturn for the PSBR in 1986–87 will accordingly be published on April 16. The first national accounts outturns for 1986–87 will appear in the June issue of Financial Statistics, including supplementary Table 13 which is based on Table 6.6.

Part B: Central government transactions

Commentary on the tables

6B.1 The tables in Part B of this Annex are confined to central government transactions only, and are based on the statutory funds and accounts. Their relationship to the accounts of central government on a national accounts basis (as in Table 6.3) is described in the Financial Statistics Explanatory Handbook (1987 edition, p38). The receipts and payments in the Part B tables are all shown on a cash basis, not accrued. Table 1.2, however, shows the main categories of taxes on an accrued basis as in the national accounts: for instance the item "income taxes" in Table 1.2 differs slightly from "income tax" in Table 6.B.3.

Table 6.B.1 Summary of central government transactions

	£ billion 1986–87 latest estimate
Consolidated Fund	
Revenue (Table 6.B.3)	111·4
Expenditure (Table 6.B.2)	−116·1
Deficit met from National Loans Fund	−4·8
National Loans Fund (Table 6.B.4)	
Receipts	15·6
Payments	−25·4
Total net borrowing by the National Loans Fund	**−9·8**
Other funds and accounts (net)	−0·2
Central government borrowing requirement[1] (Table 6.1)	**−10·0**

[1] Including borrowing for on-lending to local authorities and public corporations)

Table 6.B.2 Consolidated Fund expenditure

	£ million 1986–87 latest estimate
Supply issues[1]	102 000
Standing services	
Payment to the National Loans Fund in respect of service of the national debt	8 900
Northern Ireland—share of taxes etc.	2 000
Payments to the European Communities[2]	3 000
Other services	100
Total standing services	**14 100**
Total Consolidated Fund expenditure	**116 100**

[1] *Supply Issues are monies paid from the Consolidated Fund to Departments' cash accounts with the Paymaster General for spending on Supply. Supply Expenditure (see Table 5.1) equates closely to total Supply Issues in most years, although there may sometimes be slight timing differences between the two.*

[2] *£499 million was paid to the European Communities from Supply Issues instead of Standing Services.*

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Table 6.B.3 Consolidated Fund revenue

	£ million		
	1986–87		1987–88
	Budget	Latest estimate	Forecast ~~estimate~~
Inland Revenue			
Income tax[1]	38 500	38 300	~~40 000~~ 39 900
Corporation tax[2] [3]	11 700	13 300	15 000
Petroleum revenue tax[4]	2 400	~~1 350~~ 1 290	~~2 000~~ 1 690
Capital gains tax	1 050	1 050	1 250
Development land tax	35	55	20
Inheritance tax[5]	910	990	1 060
Stamp duties	1 430	~~1 810~~ 1 840	2 000
Total Inland Revenue	**56 000**	**56 900**	~~61 300~~ 60 900
Customs and Excise			
Value added tax	20 700	21 600	23 500
Petrol, derv etc. duties	7 300	7 500	~~8 100~~ 7 800
Cigarettes and other tobacco	4 700	~~4 900~~ 5 000	5 100
Spirits, beer, wine, cider and perry	4 400	4 200	4 400
Betting and gaming	800	760	800
Car tax	980	980	~~1 090~~ 1 110
Other excise duties	20	~~10~~ 5	~~5~~ 20
EC own resources[6]	1 300	1 290	1 360
Customs duties, etc.			
Agricultural levies	160	220	230
Total Customs and Excise	**40 400**	**41 400**	~~44 400~~ 43 9
Vehicle excise duties[7]	2 500	2 500	2 600
~~National Insurance surcharge~~			
Gas levy	500	~~500~~ 520	490
Broadcasting receiving licences	1 000	1 010	1 030
Interest and dividends	840	880	1 020
Other[8]	7 400	8 200	7 400
Total Consolidated Fund revenue	**108 600**	**111 400**	~~119 000~~ 117 50

[1] *See paragraph 6.B.1.*
[2] *Includes advance corporation tax (net of repayments)* — 4 100 | 4 400 | ~~4 800~~ 4 800
[3] *North Sea corporation tax* — 2 700 | ~~2 530~~ 2 670 | ~~1 610~~ 1 410
of which satisfied by setting off ACT — 1 200 | 1 100 | 800
Liability to corporation tax arising in respect of North Sea production may be satisfied by setting off ACT arising on dividends paid in previous periods in respect of both onshore and offshore activities. Dividends and ACT associated with North Sea activities alone cannot be identified.
[4] *Includes advance payments of petroleum revenue tax.*
[5] *Includes estate duty and capital transfer tax.*
[6] *Customs duties and agricultural levies are accountable to the European Communities as 'own resources'; actual payments to the Communities are recorded in Table 6.B.2.*
[7] *Includes driving licence receipts.*
[8] *Includes the 10 per cent of 'own resources' refunded by the European Communities to meet the costs of collection, privatisation proceeds and oil royalties (see Table 1.2).*

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Table 6.B.4 National Loans Fund receipts and payments

	£ million 1986–87 Latest estimate
Receipts	
Interest on loans, profits of the Issue Department of the Bank of England, etc.	6 700
Service of the National Debt—balance met from the Consolidated Fund	8 900
Total receipts	**15 600**
Payments	
Service of the National Debt	
Interest	15 400
Management and expenses	170
Total Service of the National Debt	*15 600*
Loans to:	
Nationalised industries	~~-100~~ -390
Other public corporations	~~210~~ 170
Local authorities	4 900
Private sector and within central government	100
Total National Loans Fund lending[1]	~~5 100~~ 4 70
Consolidated Fund deficit	4 800
Total payments	~~25 400~~ 25 2

[1] *On-lending to local authorities and public corporations in Table 6.3 includes, in addition to National Loans Fund lending, net lending from other funds and accounts (mainly Supply Issues in Table 6.B.2).*

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MR 9/71

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COPY NO 19 OF 31

PWP

FROM: A C S ALLAN
DATE: 6 March 1987

MR SCHOLAR

cc: CST
FST
EST
MST
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 Hudson
Mr Cropper
Mr Tyrie
Mr Ross Goobey

Mr Battishill - IR
Mr Isaac - IR
Mr Painter - IR
Sir Angus Fraser - C&E
Mr Knox - C&E

6.3.

FSBR: CHAPTER 1

The Chancellor was grateful for your minute of 5 March. He had the following comments

(i) In Table 1.1 he felt that we could not split out the separate components of income tax, VAT and excise duties but have a single line for corporation tax. He feels that we should either split corporation tax (into small companies, capital gains, dual resident companies and other); or - if there is no room for that - consolidate throughout.

(ii) In paragraph 1.05 the Chancellor felt the end of the second sentence should read "...improvements in the tax regime for personal pensions, and measures to help small businesses." [Is it legitimate to restrict the reference to personal pensions? The difficulty is that leaving the reference simply to "pensions" makes it sound potentially very wide].

(iii) He has not, at this stage, commented on paragraph 1.07, where the numbers are likely to change.

ACSA

A C S ALLAN

MR 9/70

BUDGET SECRET COPY NO 21 OF 23

FROM: A C S ALLAN
DATE: 6 March 1987

MR SEDGWICK

cc: CST
FST
EST
MST
Sir P Middleton
Sir T Burns
Sir G Littler
Mr F E R Butler
Mr Cassell
Mr Monck
Mr Odling-Smee
Mr Scholar
Mr Culpin
Mr Mowl
Mr Riley
Ms Evans
Mr Cropper
Mr Tyrie
Mr Ross Goobey

THE TAX BURDEN: PRESENTATION IN THE FSBR

The Chancellor was most grateful for your minute of 5 March. He agrees that Chapter 6 is the right place, with both a table and text. The table and side-heading should both say "in relation to" not "relative". And the text should read as follows

> "Table 6.2 shows taxes (including rates) and national insurance contributions as a percentage of GDP. While, overall, the percentage is estimated to have fallen in 1986-87 and is forecast to fall further in 1987-88, non-oil taxes are estimated to have risen in 1986-87 as a percentage of non-oil GDP, and are likely to stay much the same in 1987-88."

2. This may need revision in the light of the latest figures.

ACSA

A C S ALLAN

Ch 6 is right place.

Pete was talk, and was follow text (subject brackets right figs):-

Table 6.2 shows taxes (including rates) and national contributions as a percentage of GDP. While, overall, the percentage is estimated to fall in 1988-89 as is forecast to fall further in 1989-90, non-oil taxes are estimated to rise in 1988-89 as a percentage of non-oil GDP, and are likely to stay much the same in 1989-90.

BUDGET SECRET COPY NO 1 OF 21

FROM: **P N SEDGWICK**
DATE: 5 MARCH 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Sir G Littler
Mr F E R Butler
Mr Cassell
Mr Monck
Mr Odling-Smee
Mr Scholar
Mr Culpin
Mr Mowl
Mr Riley
Ms Evans
Mr Cropper
Mr Tyrie
Mr Ross Goobey

Ch
I think it is probably right to have this in Chapter 6 not Chapter 3 (or Chapter 1). I suggest a note shorter bit of text. AA

THE TAX BURDEN : PRESENTATION IN THE FSBR

Mr Allan's minute to me of March 2 (paragraphs 3 and 4) reported your request for some material on taxes as a percentage of GDP. You wanted to show in particular "that in one economic sense, taxes are not being cut at all" because the share of non-North Sea taxes in non-North Sea GDP does not fall in 1987-88 even after taking account of the budget measures. You also mentioned that the Budget measures "in practice do no more than offset real fiscal drag". You felt that material on the tax burden could be in Chapters 3 or 1 of the FSBR. I have discussed how to meet your request with, amongst others, Mr Scholar.

2. The Industry Act Forecast (Chapter 3 of the FSBR) does not at budget time have any material on fiscal conditions other than the numbers for the PSBR in table 3.13. (At the time of the Autumn Statement the IAF has an extended section on fiscal conditions in the current year.) The most natural place therefore for material on the tax burden is Chapter 6, which inter alia discusses the buoyancy of certain taxes. It would be possible to summarise as well the main points in a sentence or two in Chapter 1.

3. I attach a draft section for Chapter 6 which includes a table that shows the figures for the share of taxes in GDP - both including and

excluding the North Sea - since 1981-82. (Because the Revenue Departments have not yet finalised their post-Budget forecasts of taxes the numbers in the table for both 1986-87 and 1987-88 may change a little. It is still possible that there could be a small increase in the non-oil tax burden in 1987-88.) The draft material could come after the discussion in paragraph 6.09 of the present draft of Chapter 6 which discusses the forecast of non-oil tax receipts in 1987-88.

4. I have included two sentences in square brackets that point out that the share of non-North Sea taxes in non-North Sea GDP (i) rose in 1986-87, and (ii) is likely to be the same in 1987-88 - after taking account of the current package . While these make the point you requested, they do not sit too happily with other aspects of the presentation of the budget that emphasise that as a result of a consistent application of prudent policies it has been possible to reduce both borrowing and taxes. Mr Scholar feels that the upbeat character of Chapter 1 of the FSBR would be spoiled by the inclusion of any sober material on the tax burden. He would also prefer to omit the sentences in square brackets from Chapter 6. I have not included a reference to fiscal drag since one reason for the non-North Sea tax burden (post package) remaining flat in 1987-88 is the further rise in the effective CT rate (on a payments basis) and in any case the budget package allows real fiscal drag to operate on personal taxes.

P.N.S

P N SEDGWICK

4/1770

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DRAFT SECTION ON TAXES AS A SHARE OF GDP

Taxes relative to GDP

As table [6.2] shows [total] taxes and national insurance contributions as a share of money GDP [- the burden of tax - fell between 1981-82 and 1985-86. It is estimated to have fallen a little further in 1986-87. [Non-oil taxes and national insurance contributions as a share of non-oil money GDP are estimated to have risen in 1986-87.] After allowing for the tax cuts announced in the Budget the total burden of tax is forecast to fall slightly in 1987-88. [Excluding oil revenues however the tax burden in 1987-88 is expected to be the same as in 1986-87.]]

Table [6.2]: Taxes and National Insurance Contributions (NICs) ~~Relative~~ to GDP - %

	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87 Estimated Outturn	1987-88 Forecast
Total taxes and NICs as a share of total GDP	39.4	39.2	38.6	39.1	38.6	38.3	38.1
Non-oil taxes and NICs as a share of non-oil money GDP	38.8	38.4	37.9	37.8	37.1	37.8	37.8

The share has fallen since 1981-82, though the year to year changes are affected by shifts in oil revenues in particular. The recent buoyancy of non-oil revenues means that, even after the tax cuts in this year's Budget, the share in 1987-88 is likely to be very close to that in 1986-87.

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EXTRACT FROM MR. ALLAN'S NOTE OF 2.III.87 ON PART 3 OF THE FSBR

3. He feels there is one important point that it is nowhere in the FSBR or Budget Speech at all. This is that in one important economic sense, taxes are not being cut at all. As a percentage of GDP, they fall (just) from 38.2 per cent to 38.1 per cent; but that is entirely due to oil revenues: non-North Sea tax as a percentage of non-North Sea GDP actually rises slightly, from 37.7 per cent in 1986/87 to 37.8 per cent in 1987/88. In other words, the Budget measures in practice do no more than offset real fiscal drag. This point is part of the defense to claims of "irresponsible over-heating".

4. The Chancellor feels this point is probably best placed in Chapter 3 (though there may also be a case for Chapter 1). The best bet is probably to use Table 1 of Annex 3 to his Cabinet Paper, starting with 1981-82 and updated to 1987-88, with an appropriate deadpan sentence or two.

4-12.

DC

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FROM: M C SCHOLAR
DATE: 6 MARCH 1987

CHANCELLOR OF THE EXCHEQUER

cc Principal Private Secretary
Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
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
Mr Mowl
Miss Evans
Mr Hudson
Mr Cropper
Mr Tyrie
Mr Ross Goobey

Mr Battishill - IR
Mr Isaac - IR
Mr Painter - IR
Sir Angus Fraser - C&E
Mr Knox - C&E

FSBR: CHAPTERS 4, 5 AND 6

... I attach first proofs of these Chapters. We are due to return them to the printer by close on Monday night and would therefore appreciate your comments on Monday. We will submit the second proofs to you on Wednesday night.

CHAPTER 4

2. This Chapter takes account of your amendments and views on the presentation of Lloyd's and the second year effects of the Budget measures.

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CHAPTER 5

3. Table 5.1 has been amended to show figures for Home Office in place of those for the territories as requested by the Chief Secretary. A reference to the Rover payment is included in paragraph 5.06.

CHAPTER 6

4. You will receive the forecasters' final assessment of the prospects for the PSBR in 1986-87 and 1987-88 by the middle of next week. In the meantime the draft of the FSBR uses:

- for 1986-87 a PSBR of £4.9 billion, which was obtained, as you suggested, from our last central estimate of £4.3 billion plus a safety margin of £0.6 billion;
- for 1987-88 a PSBR of £4 billion. The last central forecast of £3.4 billion was based on a package which assumed revalorisation of excise duties. In view of the decision not to revalorise, which adds £0.6 billion to the PSBR, the draft assumes for the time being a PSBR of £4 billion.

The text does however anticipate some of the changes which the forecasters expect to include in next week's assessment, for example the prospect of higher local authority rates increases than expected earlier.

5. All of your comments on the first draft of Chapter 6 (Mr Allan's minute to Mr Mowl of 27 February) have been incorporated except for a minor one on the annex. You will recall that the two-page table (now table 6.7) just before the annex included oil royalties as a separate line. This was a mistake and as you requested, we have now included "oil royalties" with taxes on income as in last year's FSBR. The commentary in the penultimate sentence of paragraph 6A.5 however was the same as last year's FSBR and does not, we think, need changing.

6. The major changes, suggested by Mr Mowl, since the last draft are:

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(i) paragraph 6.07: the first sentence has been amended to include a reference to lower than expected oil production. The explanation of the fall in oil revenues in 1987-88 has also been amended;

(ii) the addition of paragraph 6.10 and table 6.2 on the burden of tax as agreed following Mr Sedgwick's minute to you of 5 March;

(iii) the omission of references to the Local Authority Borrowing Intentions Survey. We have discussed the paragraphs on local authorities with the DoE. They would like us to delete references to the survey as the figure we are likely to publish for the LABR in 1986-87 is lower than could be justified by it. Last year was the first time the survey was mentioned in the FSBR;

(iv) at your request we have added a reference to the non-cash basis of the PSFD in paragraph 6.25.

(v) paragraph 6.17 contains some observations about the shares of different taxes etc in the financing of total general government expenditure. We see no harm in this (novel) presentation but we could, if you prefer, turn the paragraph into one about the structure of taxation, and express the shares of the taxes in relation to total taxes and NICS.

7. You asked whether 'financial deficit' in paragraph 6A.1 is the public sector or general government financial deficit. The term is intended to apply to the entries in this line in each of the 10 columns in table 6.7: we have changed the drafting to make this clearer.

... 8. The proof omits the chart on the structure of receipts and expenditure which you asked us to drop from the previous draft. We wonder whether you would be willing to consider restoring this chart (copy attached) - it was part of our attempt to improve Chapter 6. Although Chapter 6 is, properly, concerned with bringing together receipts and expenditure, the expenditure element in this chart will clearly not do in its present form since the

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expenditure table is inconsistent with the Chief Secretary's wishes on the structure of the expenditure tables in Chapters 1 and 5. If you were content in principle to restore the chart we would agree its detailed content with the Chief Secretary.

... 9. I also attach, for information, the first proof of Chapter 2 in the form agreed at your meeting on this yesterday.

... 10. You asked that the Guinness chart (2.5) be redrawn, to make the froth look like froth. I attach a new version, by Mr Cavanagh of the CSO. Is this OK now?

11. In Chapter 1, which you have already seen in its first proof form, we will amend Table 1 to show the separate components of corporation tax as you suggested (Mr Allan's minute of today). After discussion with Mr Corlett, I suggest that in the text we refer to "improvements in the tax régime for pensions" not "for personal pensions", since the changes go a good deal wider than personal pensions (AVCs affect occupational pensions; then there are the abuse provisions) and we are presenting the package as a fairly wide reform. A further point is that the package is not really an improvement in the tax régime for personal pensions - but the introduction of such a régime. Do you agree?

M C SCHOLAR

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