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PART B

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PART B

1986 BUDGET FINANCIAL
STATEMENT AND BUDGET
REPORT AND MEDIUM TERM
FINANCIAL STRATEGY

DD'S 25 years 26-01-95 NA323

PO -CH /NL/0044
PART B

STARTS:- 28-02-86
ENDS:- 10-03-86

CLOSED

CONTINUED ON:-

PART ...C...

1986 Budget
Financial Statement
+ Budget Report.
+ MTFS papers.

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Ch/

For Monday's meeting, we leave Parts 2+3 to one side, + focus on Parts 1, 4, 5, and 6. The CST hasn't finished with Part 5 yet, so you won't want to discuss it in detail.

You have 2 versions of Part I.

- a new look version, which Michael has persisted with, despite your cool reception of the idea.

- the traditional version.

Suspect the drafting points + the

deleting the ~~chapter~~ change on "The Budget Process" which puts entirely the wrong date (& the death & dance shown upon the date day!) – I think it has quite a lot to be said for it.

You'll want to look carefully at Table 1.1 which goes into quite a bit more detail on individual measures than in previous years. The charities & pensions packages are a definite innovation.

The question is: Do you want to persevere with how book Part I or reverse to old style. Say now, before more time is wasted

CHANCELLOR OF THE EXCHEQUER

Part 4

Again – old style and new style.

New style is an improvement for most part, though I think the first page is overambitious and should be drastically cut down (or even eliminated). But the plain speak tax changes is an advance. Some of the more interpretative passages (eg on pension fund surpluses) could be pruned. The aim should be a clean, neutral, factual

Presentation.

Again, do you want to persevere with new style as against the old style (which would anyhow appear as an Annex)?

Part 5

Detailed consideration for CDT. What are we going to say about the 1985-86 planning total (see para 5.06). You have expressed worries about the teachers pay ~~emphasis~~ angle already (whereas it's 1985-86 Reserve)

Part 6.

This is where the crunch

CHANCELLOR OF THE EXCHEQUER

I understand the Reserve comes up; you wanted to discuss Margaret Pearson's note, which is in your meeting folder. (The key table is 6.5)

The other major issue is what we publish for the PSBR in 85/86, + 86/87.

Again - this is a more ambitious presentation than usual. What do you think? (Again - I prefer it: Part 6 was always rather mysterious, but this is a bit elaborate)

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FROM: M C SCHOLAR
DATE: 28 February 1986

CHANCELLOR OF THE EXCHEQUER

cc: Principal Private Secretary
Chief Secretary (2)
Financial Secretary (2)
Economic Secretary (2)
Minister of State (2)
Sir P Middleton
Sir Terence Burns
Mr F E R Butler
Sir Geoffrey Littler
Mr Cassell
Mr Monck
Mr A Wilson
Mr H P Evans
Mr Monger
Mr Odling-Smee
Mr Culpin
Miss O'Mara
Mr Pratt
Mr Cropper
Mr H J Davies
Mr Lord

Sir Lawrence Airey-IR
Mr Battishill-IR
Mr Isaac-IR

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

* 'Historical' num (structure 1982-85)

Removal of "a mistake"

1986 FSBR

I attach, at Appendix A, the first complete draft of this year's FSBR. This draft is, as usual at this point in the timetable, at a fairly preliminary stage, and will require considerable amendment and editing before you see the next complete draft next weekend.

2. The FSBR has changed a good deal in recent years. This year we are, as you know, trying to make further improvements, aiming to produce a more attractive, intelligible and integrated publication.

3. On the substance, we are suggesting some reshaping of Chapters (formerly 'Parts') 1 and 4 (Budget measures etc); little

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change to Chapters 2 and 3 (MTFS and forecast); and a re-think of Chapter 6 (public sector finances).

4. Chapter 4 now attempts, as you have suggested, to describe the tax changes in the Budget in more intelligible and accessible language than in the past, relegating the more technical material to an annex, introducing a little more tax policy, and retaining the traditional Table 4.2 which lists the tax changes in great detail (with apologies for the poor quality of the reproduction).

5. We have also put quite a bit of work into improving Chapter 6, which used to be little more than a collection of tables whose relationship and import was baffling to all but the real cognoscenti. This chapter now explains itself - that it is an analysis of and commentary on public sector financing - and fits together more coherently; some of the material is removed into annexes. A note at Appendix B describes the changes more fully.

6. Chapters 2, 3 and 5 are much as before. Chapter 2 is essentially the same as the draft submitted to you on Tuesday, but with some manuscript amendments. The attached version of Chapter 3 has been amended (again, partly in manuscript) to take account of the points agreed at your meeting this morning. The Chief Secretary has not yet had an opportunity to consider Chapter 5 in its present form and context; I understand that he will be doing so early next week.

7. We suggest that Chapter 1, which has traditionally consisted of a definition of the Budget together with an aggregated list of the measures in it, should be developed to be both a succinct but comprehensive summary of the changes in the Budget (rather like the front page of yesterday's scorecard) and a guide to, and summary of, the whole FSBR. A chapter of this kind would, I believe, help with the presentation of the Budget, and would help, too, to pull together the FSBR into a coherent whole. The attached draft therefore points the reader forward to each

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of the succeeding chapters, and at the same time attempts to give a very brief summary of the government's economic policies, the MTFS, the forecast, the tax and expenditure changes in the Budget, and the overall fiscal picture.

8. If Chapter 1 succeeds in this it will meet several other objectives: it will be an answer to the TCSC's wish for an accessible summary of the Budget, published on Budget Day (see their Second and Seventh Reports of 1984-85; extracts at flag A). And, if combined with, say, some of the material (charts, particularly) in your Budget broadcast, it could without too much further work form the basis for the EPR article whose publication you would like brought forward to Budget Day. Mr Culpin and I are investigating the practicalities here, and have so far concluded that we could produce a limited number (say, 10,000 copies) of such an article on Budget Day; that it could be published as a self-contained EPR supplement (but not a regular EPR), either as a pull-out in the FSBR or as a wholly separate document; but that, because the security printer could not cope with more than 10,000 copies without putting the FSBR, the Budget Resolutions etc at risk, the remaining print-run of the EPR (55,000 further copies) would have to be despatched later in the week.

9. If you do not like this new chapter, I attach, at Appendix C, an alternative version of Chapter 1, on traditional lines.

10. We are also suggesting some changes (which you discussed with me yesterday) in the appearance of the document, to keep it in step with recent developments to the Treasury's House style:

(a) We have either copied what seem to be the most effective of the stylistic and presentational developments in the Public Expenditure White Paper; or adapted them to the rather different character of the FSBR. So, the quality of the paper is improved; a new print-face, clearer, more attractive

in itself and more suited to the new printing technology we are now for the first time using is adopted; we are taking a bit more space for the tables and charts; and we are generally trying to make more use of the space on the page in order to make the overall effect less busy and fussy.

(b) We have not introduced a second colour, as in the White Paper - mainly because it would complicate the production process, and make it more risky to introduce changes at the last moment (we could think again about this next year).

(c) There are no changes to the front cover. But the frontispiece is modernised.

11. I hope to have a printed version of the FSBR, in the style we discussed yesterday, by next weekend.

MCS

M C SCHOLAR

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FLAG. A

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6. A number of proposals intended to improve further the clarity and presentation of Public Expenditure White Papers were made in our report on the 1985 White Paper.[1] We hope they will be included in the detailed proposals on the new format, which we look forward to receiving from the Treasury.

7. It appeared to us in our Second Report that information on the progress of the *Financial Management Initiative* should be regularly made available at Budget time, possibly in Departmental Reports. We regret that the government do not envisage an annual series of financial management reports. Leaving each department to provide information about its management systems "in the most appropriate way" will—we feel certain—mean that little information will be published. We hope that on reflection the government will be prepared to adopt a more comprehensive approach.

THE BUDGET PAPERS AND SUPPLY ESTIMATES

8. We turn now to consideration of the government's response to our Second Report in respect of those recommendations which bear on the formal papers published in association with or at the time of the Chancellor's recent Budget Statement.

9. The reply to our Second Report does not address itself to our proposals for an *integrated UK Budget document*, to replace, in part, the Financial Statement and Budget Report (The Red Book). The 1985 Red Book remains very difficult to follow, and while no doubt it contains much critical information, it cannot be said to be an instant key to the UK's present economic position and future prospects. Our case for a paper which could fulfil such a role remains unanswered.

10. Nor does the form of the *Supply Estimates* for 1985–86 reveal significant changes from that of previous years. On the other hand, progress has been made in the direction of distinguishing between the information content of the Estimates and their role as instruments for operating parliamentary supply procedures.

11. We had recommended the suppression of the Chief Secretary's Memorandum but were anxious to see some reconciliation between and explanation of Estimates provision and public expenditure planning totals. The new *Summary and Guide* to the Estimates replaces the Memorandum to admirable effect. The use of type, colour and graphics in the Summary and Guide will help to illuminate the complexities of the figures. Further thought might be given to the nature and reactions of the target audience (including some kind of response from Members) and to the means of publicising the document. But on balance we regard the Summary and Guide as an important contribution to the generally agreed aim of producing understandable background to the most vital of economic decisions.

CONCLUSION

12. We intend to keep the format and presentation of financial documents under review, commenting on this aspect of the major sets of documents in successive substantive reports. We look forward to hearing further from the Treasury on a number of topics, as they propose; and we will continue to encourage improvements in presentation.

3 April, 1985

[1] Sixth Report, 1984–85 (HC (1984–85) 213).

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timing of the eventual debate on the floor of the House on the basis of a Report from this Committee.

(ii) *The Public Expenditure White Paper*

10. The Survey recommends that the Public Expenditure White Paper should no longer be produced as at present in early February or thereabouts, and that in effect the relevant material in Volume I should be included in the proposed new "UK Budget" document and that most of the material in Volume II should be included in a comprehensive set of Departmental Reports. The first of these documents would appear on Budget Day and the second series shortly thereafter.[1]

11. Although we support the introduction of new documents at Budget time (see paragraphs 17 and 24–25 below), we do not believe it would be right to postpone the presentation of important public expenditure information for a period which could be as long as two months (indeed, we would like to see some of the information brought forward to the Autumn Statement).

12. We are however interested in the Treasury's suggestion that future White Papers after 1985 should be presented primarily on a departmental basis (although still supported by relevant functional analysis).[2] Although we believe that this would be the most sensible way to proceed in the immediate future, we do not rule out the possibility that if Departmental Reports became established (as we hope they will (see paragraph 25)), much of the material now in Volume II of the White Paper could eventually be included in those Reports.

13. We also believe there is a case for clearer and more consistent treatment of the geographical coverage of expenditure within the UK.[3]

14. We recommend that all these changes should be made in 1986 and look forward to receiving detailed proposals from the Treasury.

15. Even though we wish to see all the relevant expenditure information published at the earliest possible date, we think the House should consider whether the period immediately preceding the Budget is the best possible time for holding a debate in the House on public expenditure, as happens under present practice. In our view it is not. The debate is overshadowed by the immediately impending Budget and is rarely a distinguished occasion in the parliamentary calendar. In our view, it might be better to concentrate on debating expenditure for the forthcoming financial year at the same time as the Budget measures. This is already done to some extent and is an added reason for the unsatisfactory nature of the preceding public expenditure debate.

16. A separate public expenditure debate, concentrating on future years and based on reports from select committees, could then be held in June—which would be a much more opportune moment in terms of seeking to influence the Government's own forthcoming annual review of expenditure plans. We would like to see an experiment on these lines.

[1]Survey, p 16.
[2]Evidence, p 2.
[3]Survey, p 26.

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(iii) *The Financial Statement and Budget Report*

17. We support the proposition that Parliament should be enabled to debate expenditure planning and taxation as a whole in a wide perspective and believe that new documents should replace the present Financial Statement and Budget Report.[1] The first of these would be the proposed "UK Budget". It will however be clear from what we have said under the heading of the Public Expenditure White Paper that we do not wish to see such a document including all the material at present contained in Volume I of the Public Expenditure White Paper (see paragraph 11). In our view the way forward is to improve and expand—and to place at a focal point in the new budget document—the kind of information at present contained in Chapter 5 of the FSBR (especially Table 5.6).

18. We accept that as changes are worked out in detail, a case may emerge for producing in addition a second document in the form of a technical special analysis volume.[2] This might reproduce some of the information set out in Press Notices at the time of the Budget, as well as incorporating some of the more technical information at present included in some of the principal documents.

(iv) *The Supply Estimates and the Chief Secretary's Memorandum on the Estimates*

19. The recommendations on the Supply Estimates are, for Parliament, the most far-reaching in the Survey. But we believe that the reasons underlying the proposals are compelling ones. At present the Estimates volumes have a very low readership. Likierman and Vass found this "surprising, since the amount of detailed information can be generous almost to the point of being overwhelming".[3] We believe the weaknesses lie in the fact that the Estimates are at the same time an instrument for operating parliamentary Supply procedures and also an important information document. Successive reforms, made on the recommendation of our predecessor committee and outside committees as accepted by the Treasury, have not in their cumulative effect paid sufficient heed to this distinction and so have failed in their overall purpose.

20. We consider that the Estimates themselves should be redesigned and should become documents mainly for parliamentary use perhaps available only in type-written form[4] (we hope it would not be necessary in addition to go in for a summary document of the kind described on page 31 of the Survey). But this would depend entirely on the successful compilation and publication of expenditure information linked to the Estimates and the Public Expenditure White Paper.[5] This could be done either centrally or in Departmental Reports (see paragraph 26). It would be this presentation which would be most likely to be the starting point for work on expenditure by select committees.

21. It would not be possible to apply these reforms fully to the procedures for dealing with Supplementary Estimates—which often afford select committees with a useful opportunity to exercise control over expenditure. It would remain essential for full explanations of the need for all Supplementary Estimates to be

[1] Survey, p 17, 20.
[2] Survey, p 17, 20.
[3] Survey, p 12.
[4] Survey, p 22.
[5] Survey, p 21.

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in this direction, although some of the resulting documents go well beyond the concept of what we would regard as a Plain Man's Guide.[1] We believe that in the interests of informed public debate a popular-form document should be made widely available.

CONCLUSION AND RECOMMENDATIONS

32. Despite our dissatisfaction with much of the existing financial documentation, we hold the view that the Government (and especially the Treasury) have been moving in the right direction. Indeed, there have been many improvements in recent years. But we consider that the case has been made out for a comprehensive programme of reforms which should proceed on agreed lines. We therefore propose that a package of proposals should be drawn up by the Treasury, with a view to its being worked out in detail in consultation with Parliament and implemented in the next three years.

33. We would like to see a programme for re-structuring the documents on roughly the following time-table:

1985 — Consultation and agreement on the main lines of the reforms. Extension of time-scale of the Autumn Statement.

1986 — Conversion of the Public Expenditure White Paper on to a departmental basis.

— Introduction of a new Budget document. Reform of the Estimates and production of a linked expenditure document.

1987 — A common system of annual Reports to Parliament from all departments.

34. We invite the Treasury as a first step to bring forward detailed proposals for the reform of the Public Expenditure White Paper and an outline programme for further progress in re-structuring the remaining documents.

35. We are not certain that any of the reforms we have suggested would of themselves necessitate changes in the form of the Appropriation Accounts. But we hope that the Committee of Public Accounts will be ready to play its part in the process of change, as recommended by the Select Committee on Procedure (Finance) in the last Parliament.

[1] Q. 38.

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CH/EX → PM
1986 BUDGET : MTFS

BR/45

Ref 47J
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cc CST
EST
Sir P. Middleton
Mr F. Butler
Sir T. Burns
Mr Cassell
Mr Scholar

NL/44
13

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? After 5 March

PRIME MINISTER

1986 BUDGET: MTFS

My two previous minutes set out my Budget tax proposals with the exception of those for income tax, which we agreed at our meeting on 5 March.

I have since agreed a package of employment measures with David Young, on which I have minuted you separately.

This leaves the question of the PSBR and monetary targets for 1986-87.

Public Sector Borrowing

The latest indications are that this year's PSBR will come out slightly below the £7 billion forecast in the last Budget (and still more below the figure forecast last Autumn). A substantial shortfall on oil revenues has been more than made up by the buoyancy of other tax revenues and an expected small underspending of the Reserve. We have thus achieved this year a significant step down in the PSBR, the first since 1981-82, reducing the PSBR as a proportion of GDP from over 3 per cent to just 2 per cent.

Last year's MTFS envisaged a PSBR of £7½ billion for 1986-87 (after allowing for a "fiscal adjustment" of £3½ billion). Since then we have added £2½ billion to expected receipts from privatisation, offsetting a similar addition to gross expenditure plans. We have had to revise down our forecast of oil revenues by over £5 billion (on an assumed oil price averaging $15 a barrel for the financial year 1986-87). But other tax receipts are forecast to be significantly higher than was expected a year ago. So the reduction in total government tax revenues is rather less than £3 billion.

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At unchanged tax rates, therefore, we would foresee a PSBR of around £6 billion. The Budget package that we have agreed would come to just under £1 billion, raising the PSBR to £7 billion or 1¾ per cent of GDP.

In view of all the uncertainties I think it is wise to err on the side of caution and aim for a borrowing figure below the £7½ billion envisaged a year ago. It is important that the Budget should be seen by the markets as sound and responsible. I think that a PSBR of £7 billion would be so regarded, and indeed should leave us with some room for manoeuvre if, for example, there were a further weakening in oil prices later in the year.

For the remaining years of the MTFS period, I plan to show a path in which the PSBR falls slightly further to 1½ per cent of GDP by 1988-89. (Each ¼ per cent of GDP is approximately £1 billion.)

Monetary Targets

For the monetary targets in 1986-87 I intend to stick to MO and £M3. In view of its past behaviour, a case can be made for dropping £M3 altogether. As you know, £M3 has for some years shown a tendency to grow more rapidly than money GDP, partly in response to financial liberalisation, and partly because high real interest rates have increased the demand for broad money as a medium for saving. £M3 growth has regularly exceeded our expectations, without adverse consequences for inflation. This year has been no exception. A year ago we set a range of 5 to 9 per cent growth for 1985-86; in the 12 months to February the actual growth of £M3 has been nearly 15 per cent. And yet all the indications are that inflation is set to fall further over the coming year.

After careful consideration, however, I have concluded that dropping £M3 would risk giving the wrong signal about our attitude to liquidity. But I cannot risk a repetition of this year's experience.

We must set a range for 1986-87 that is both credible and achievable. I have decided that this should be 11-15 per cent, to allow for a continuation of the recent velocity trend. In view of all the uncertainties about broad money, however, I do not propose to show ranges of £M3 growth for the years beyond 1986-87.

The choice of target range for MO has been much easier. Its growth over the past 12 months has been 3½ per cent, towards the bottom of the 3-7 per cent range set a year ago, and I am reaffirming for 1986-87 the 2-6 per cent range indicated in last year's MTFS. As in the last two years, I shall be publishing illustrative ranges for MO for the whole MTFS period.

The presentation of monetary policy has undoubtedly suffered from the continuing problems with £M3, and the market's reluctance to accept MO as a substitute. I have sought to re-establish the credibility of the MTFS by giving a slightly more prominent role to money GDP in explaining the Government's strategy. This has no real operational significance, but it is a useful way of making the point that, whatever the problems with particular monetary aggregates, the Government remains committed to reducing the growth in money incomes, as a means of achieving a further reduction in inflation.

This approach has been fully discussed with the Bank who support these recommendations.

NL

N.L.

Financial Statement and Budget Report

Chapter 1: The Budget

1.01 The objective of the Government's economic policy is to defeat inflation, and to create the conditions for the steady growth of output and employment. The Financial Statement and Budget Report supplements the Chancellor's Budget Statement by describing in more detail the Medium Term Financial Strategy and the specific measures in the Budget. It also sets out the Government's revenue, expenditure and borrowing policies and its financial and economic forecasts for the year ahead.

The Government's Strategy

Medium Term Financial Strategy

1.02. The Government's economic policy consists of two main elements - the Medium Term Financial Strategy (MTFS) designed to bring down inflation, and a supply side policy, whose aim is to improve the efficiency of the economy.

1.03 To achieve the objectives of the MTFS, which is set out in detail in Chapter 2, it is vital to maintain monetary conditions consistent with a declining growth of money GDP and inflation. Short-term interest rates will be held at the levels needed to achieve this. Declining growth will be supported by lower public sector borrowing.

1.04 The Government also intends that the burden of taxation and the role of the State in the economy should be reduced. The MTFS accordingly provides for a further decline in taxation and public expenditure as a proportion of GDP.

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Supply Side

1.05 The MTFS is complemented by the Government's supply side policies. Their intention is to improve incentives, remove unnecessary controls, and to liberate the operation of markets. Free markets encourage enterprise and initiative; improve the efficiency and adaptability of the economy; and enhance the prospects for output and employment growth. This Budget includes a number of measures - both tax and public expenditure changes - to strengthen these policies.

Expenditure, Revenue and Borrowing

1.6 To support both the MTFS and its supply side measures, the Government's intention is to reduce over the medium term the proportion of national income that is pre-empted by the State. The path of expenditure, revenue and borrowing over the next four years is set out in Chapter 2.

The Year Ahead

The Forecast

1.07 The big fall in oil prices should sustain growth and reduce inflation in the world economy. For the UK, the forecast is for a further decline in inflation, to 4 per cent by the end of 1986, combined with output growth of 3 per cent. Investment and exports are expected to grow rather more rapidly than this, and a surplus of £4 billion on the current account of the balance of payments is forecast for 1986. Chapter 3 describes the prospects in detail, including the impact of changing oil prices on the world and domestic economy.

The Fiscal Prospects

1.08 The PSBR in 1986-87 has been set at [ ] or 1¾ per cent of GDP. This leaves room for a fiscal adjustment of [ ].

Taxation and National Insurance Contributions

1.09 Given the limited scope for overall tax reductions, the Government has concentrated its tax proposals on measures designed to improve the climate for enterprise and employment; to encourage savings, investment and wider share ownership; and to provide further incentives for charitable giving. Income tax thresholds and allowances are raised in line with inflation. The increases in petrol, derv and tobacco duties are offset by the costs of leaving unchanged car and lorry VED rates and alcohol duties respectively.

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1.10 In addition, the Government have reduced by 1 per cent national insurance contributions for all employees earning less than £140 per week.

1.11 The changes to tax and national insurance contributions will cost [£185m] in 1986-87 and [£340m] in 1987-88. They are set out summarily in Table 1.1 and in detail in Chapter 4.

Public Expenditure

1.12 Table 1.1 also includes higher spending on enterprise and employment. The new pilot schemes for the long term unemployed (in depth interviews and the Jobstart scheme) will be extended nationwide. The rate of entry into the Enterprise Allowance Scheme will also be increased. A new scheme - the New Workers Scheme - will be introduced, providing for payments to employers of 17-20 year olds where the wages are below specified limits. The Community Programme will be expanded by [ ] places. These and other changes, which are described in full in Chapter 5, will have a net public expenditure cost (after taking account of social security benefit and other savings) of £110m in 1986-87 and £205m in 1987-88. The measures will be charged to the Reserve.

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The Budget Proposals Summary

1.13 The impact of the Budget changes is shown in Table 1.1.

Table 1.1

Budget Measures: Summary of Direct Effects

£ million at current prices

	1986-87 Changes from an indexed base	1986-87 Changes from an non-indexed base	1987-88 Changes from an indexed base	1987-88 Changes from a non-indexed base
				(yield(+)/cost(-))
Tax Proposals:				
Income tax allowances & thresholds	Nil	-1135	Nil	-2405
Excise duties - petrol/derv	+135	+465	+145	+725
- VED	-135	+5	-140	+90
- tobacco	+175	+315	+180	+435
- alcohol	-175	Nil	-190	+110
- gas oil	+25	+30	+25	+35
- other minor oil duties	-25	-20	-25	-15
Stamp duty - cut in rate	-70	-70	-110	-110
- extension of base	+70	+70	+120	+120
Capital Transfer Tax	-35	-55	-55	-120
Charities - package of reliefs	Neg	Neg	-50	-50
- anti-abuse measures	Neg	Neg	+20	+20
Pension Fund Surpluses	+20	+20	+120	+120
Other tax changes	-20	-20	+20	+20
National Insurance contributions	-150	-150	-400	-400
Total tax and national insurance contributions	-185	-545	-340	-1425
Expenditure Measures:				(cost(+)/saving(-))
Enterprise Allowance	+20	+20	+90	+90
Loan Guarantee Scheme	Nil	Nil	+10	+10
New Workers Scheme	+25	+25	+50	+50
Counselling Initiative	+85	+85	+45	+45
Jobstart	+25	+25	+50	+50
Community Programme	+45	+45	+90	+90
Fraud abuse	Neg	Neg	+5	+5
Northern Ireland	+5	+5	+10	+10
Total expenditure increases	+205	+205	+350	+350
Offsetting reductions in social security benefits	-95	-95	-145	-145
Net call on the Reserve	+110	+110	+205	+205

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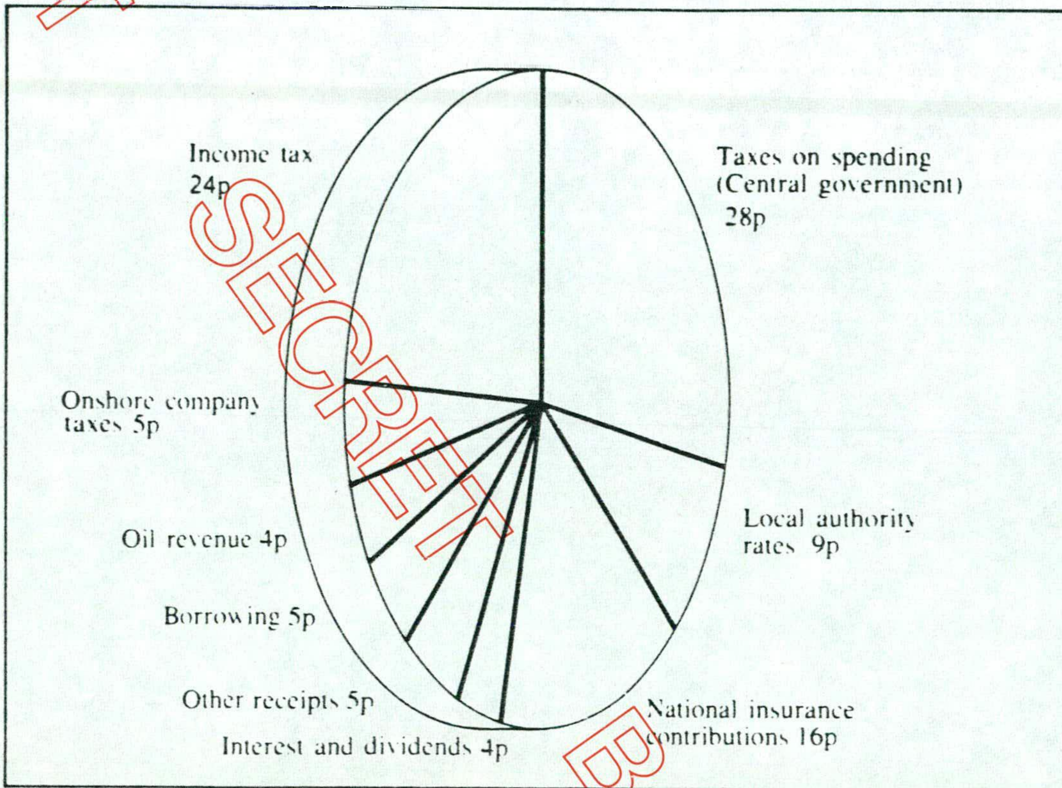
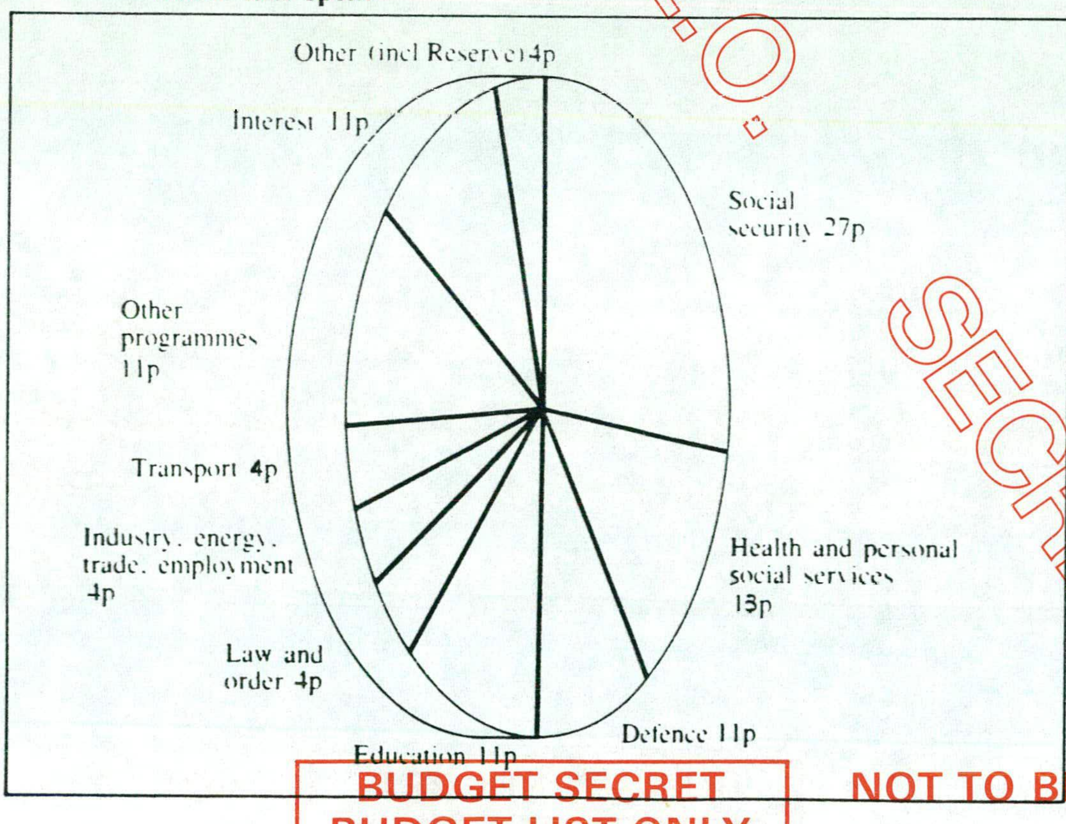
1.14 The Budget provides in 1986-87 for expenditure plans of [ ]; forecast receipts of [ ] and a forecast PSBR of [ ]. Chart 1.1 below shows the source of receipts and the direction of expenditure. These are described in more detail in Chapter 6.

THE BUDGET POUND, 1986-87

Chart 1.1 Where it comes from



Where it is spent



MEDIUM-TERM FINANCIAL STRATEGY

2.01 The Medium Term Financial Strategy (MTFS) provides the framework for macro-economic policy, as it has since 1980. It is intended to bring inflation down further over a period of years, and ultimately to achieve price stability.

2.02 It does this by setting economic policy in a nominal framework in which public expenditure is controlled in cash terms and money GDP is gradually reduced by appropriate fiscal and monetary policies.

2.03 As the growth of money GDP declines, inflation is squeezed out of the system. The division between output growth and inflation is thereby improved. The MTFS is complemented by micro-economic policies that encourage enterprise, efficiency and flexibility, enhancing the growth of output and the creation of jobs.

2.04 The success of the MTFS since its introduction can be gauged from the paths of money GDP and inflation. Over the past six years, money GDP growth has declined from nearly 20% to around 8%, broadly in line with the assumptions underlying successive versions of the MTFS. The division of money GDP between output growth and inflation has improved considerably over this period. Inflation has come down to 5% and is set to fall further. The economy is about to embark on its sixth successive year of

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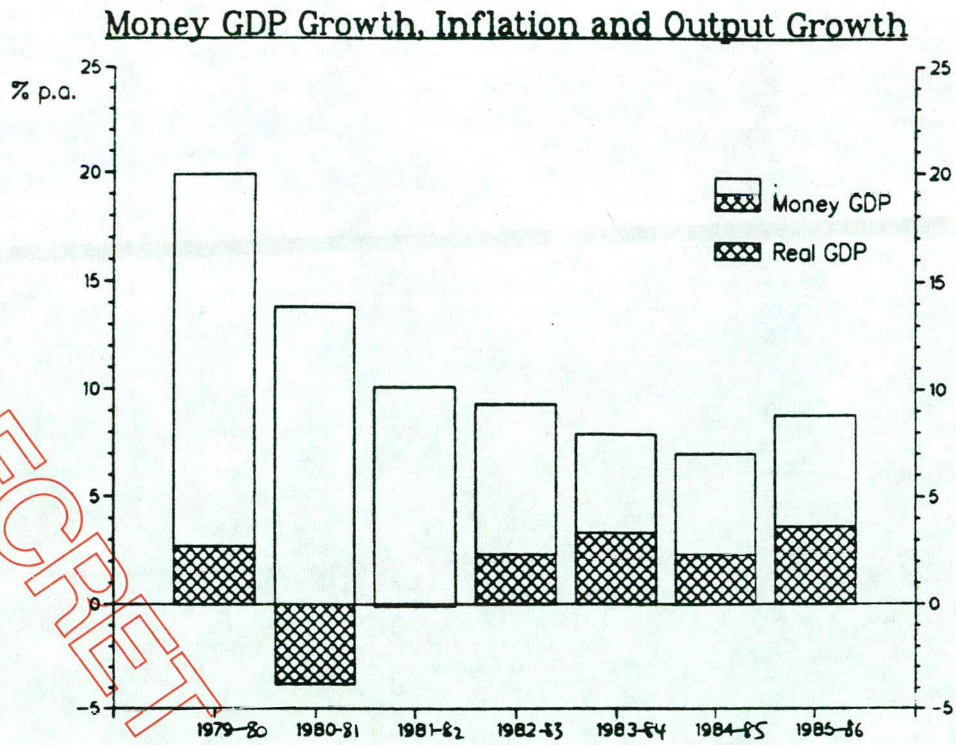
growth, the longest period of growth since the 1973 oil crisis.



2.05 Numbers in work are up by around 600 thousand since mid-1983, and productivity has improved markedly. However the growth in new jobs has failed to match the growth in the labour force, and unemployment has remained high. Moderation in pay increases is the only way of ensuring that rising prosperity is reflected in lower unemployment as well as in higher productivity and higher living standards for those in work.

Objectives and the Framework of Policy

The money GDP path

2.06 The path set out for money GDP in table 2.1 reflects the objective of a further reduction in inflation and continued growth of output at a rate which is sustainable in the medium

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term. It's achievement should ensure that the growth of nominal demand is neither excessive nor deficient.

2.07 The money GDP figures indicate broad medium term objectives; they are not targets. Fluctuations around the path shown will inevitably occur; the financial policies which support the MTFS are designed to bring it back on track over time. [If the Government's estimate of potential output changes, it may be appropriate to review the money GDP path.]

Table 2.1 Growth of the Money Supply and Money GDP

	1985-86	1986-87	1987-88	1988-89	1989-90
Money GDP (1)(2)	$9(7\frac{3}{4})$	$6\frac{1}{2}$	$6\frac{1}{4}$	6	$5\frac{1}{2}$
M0(3)	$3\frac{3}{4}$	2-6	2-6	1-5	1-5
£M3(3)	15	11-15			

(1) The money GDP figure for 1986-87 is a forecast; and in subsequent years the figures describe the government's broad medium term objective.

(2) Percentage change on previous financial year. See Table 2.4 for further detail. The figure in brackets for 1985-86 is adjusted for the coal strike.

(3) 1985-86: percentage change from mid-February to mid-February.
1986-87: target ranges.

Monetary and Fiscal Policy

2.08 Monetary and fiscal policies together affect money GDP. There is some scope for varying the balance between them, consistent with any given money GDP path. The Budget provides the main opportunity to review fiscal policy. Interest rates can be changed more frequently in order to maintain monetary conditions consistent with the desired GDP path.

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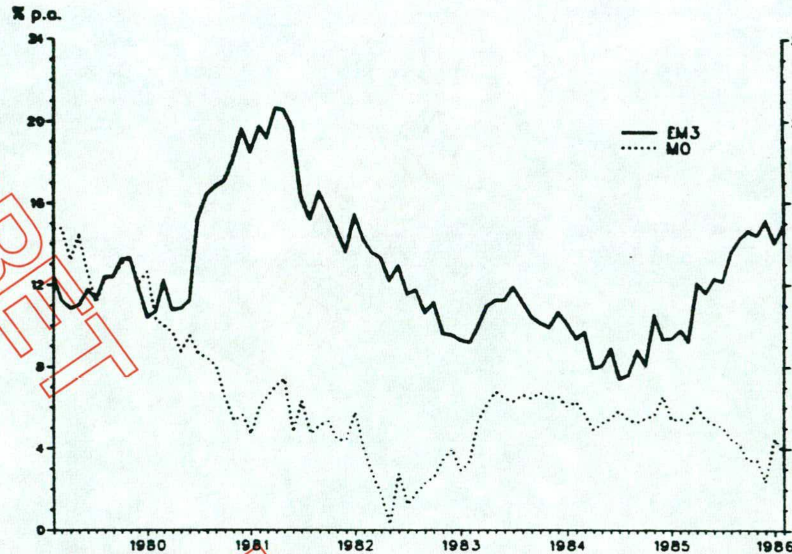
Monetary Policy

2.09 Monetary conditions are assessed in the light of movements in broad and narrow money and the behaviour of other financial indicators, particularly the exchange rate.

Monetary Growth



Note : based on banking months

Interest Rates

2.10 In recent years the authorities have attempted to restrain the expansion of broad money by heavy funding. This has involved selling more debt than is needed to fund Government borrowing. The result has been a progressive distortion of financial markets, including a rising stock of commercial bills held by the Bank of England. Such systematic overfunding makes monetary policy harder to operate, and is not sustainable. The Chancellor therefore announced in October 1985 that sales of debt outside the banking system would be limited to the amount needed to fund the PSBR.

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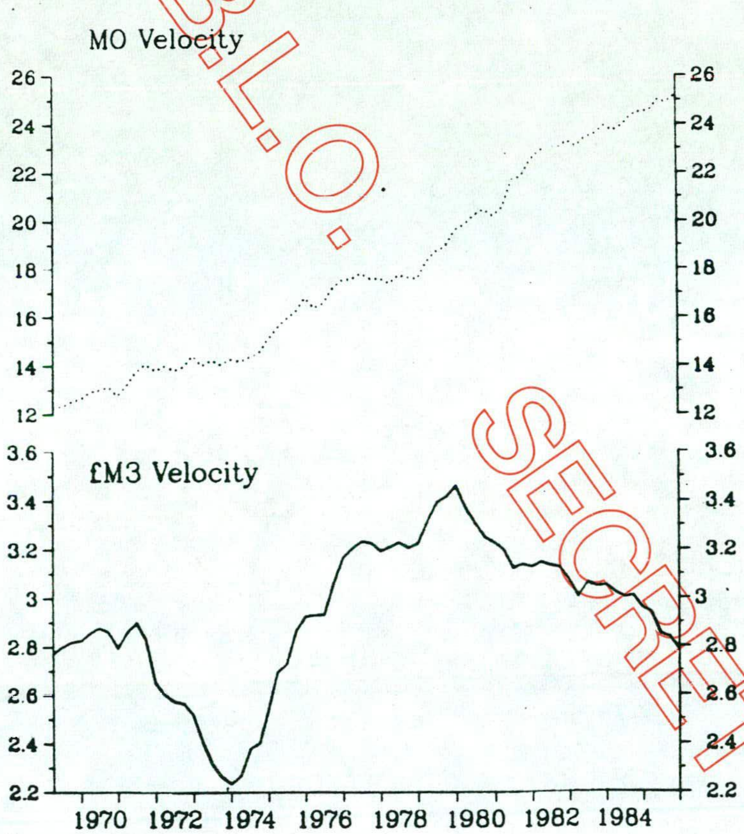
2.11 With funding thus constrained, short term interest rates are now the principal instrument for achieving appropriate monetary conditions during the year. They are currently high and positive in real terms throughout the world.

Broad Money

2.12 Measures of broad money have persistently grown faster than money GDP over the last six years, unlike the experience of the 1970s. High real interest rates have increased the relative attractiveness of financial assets; and financial liberalisation and increased competition between banks and building societies have led to a rapid build up of both liquidity and debt. This has proved consistent with declining inflation and money GDP growth. At the same time the high proportion of interest bearing deposits within broad money has meant that the immediate response of aggregates such as £M3 to changes in short term interest rates is uncertain.

Monetary Velocity



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Narrow Money

2.13 Financial innovation is also having a considerable impact on some measures of narrow money. The growth of M1 has fluctuated greatly, in part due to interest rate changes. But in recent years it has been inflated by the rapid growth of its interest bearing component, as in the United States; and the boundary between interest bearing and non-interest bearing accounts has been subject to considerable short term variation. The growth of M2 has been more stable, but data has been available only since late 1981 and the figures are subject to frequent sizeable revisions.

2.14 M0 has behaved in a much more stable fashion than the other narrow aggregates. Since it is wholly non-interest bearing it responds in an unambiguous manner to changes in short term interest rates, though by rather less than non-interest bearing M1. Its velocity has been on a rising trend as institutional change and technological improvements lead to a progressive reduction in the use of cash. But the upward trend has been very steady, and not subject to wide variation. Although it contains only a small proportion of total non-interest bearing transactions balances, it has proved a good indicator of monetary conditions in recent years. It remains the government's preferred measure of narrow money.

Monetary targets

2.15 The government is setting targets in 1986-87 for M0, as a measure of narrow money, and £M3 as a measure of broad money. The ranges are shown in Table 2.1.

2.16 For M0 the target range of 2-6% is the same as indicated in last year's MTFS. Illustrative ranges are also given for M0 in later years.

2.17 For £M3, the target range has been raised to 11-15% reflecting the rapid fall in velocity observed during the last six years and the end of overfunding. Illustrative ranges for future years are not given for £M3 on this occasion because the uncertainties surrounding its velocity trend are at present too great.

Interpretation of Monetary Conditions

2.18 In implementing policy and making decisions about monetary conditions and interest rates, the Government has to make a careful assessment of the behaviour of the monetary aggregates in relation to their targets, and other indicators especially the exchange rate.

2.19 If the underlying growth of M0 were to move significantly outside its target range, the government would take action designed to bring it back inside unless other indicators suggested clearly that monetary conditions remained satisfactory. If £M3 were to move outside its target range, more convincing evidence would be required from other indicators before deciding whether action was needed. Changes in interest rates triggered by £M3 moving outside its range are unlikely to bring it back inside the range very quickly, probably not within the target period. Such action clearly affects the tightness of monetary conditions, but is more likely to affect M0 growth than £M3 growth in the short term.

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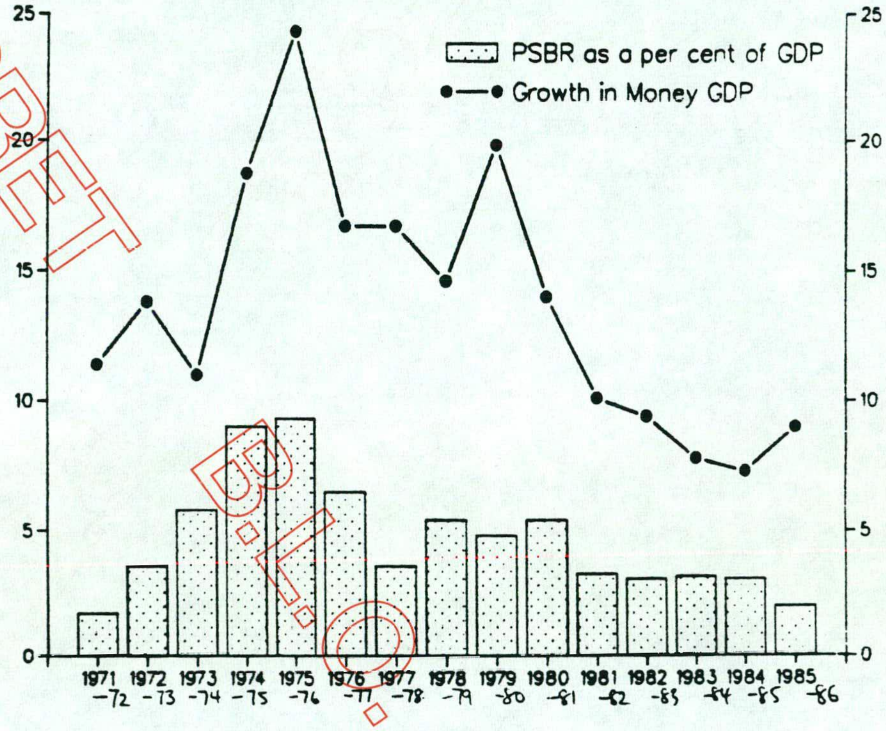
Fiscal Policy

2.20 Last year's MTFS indicated a sharp reduction in the PSBR for 1985-86. Current estimates suggest this has been achieved. The outturn is expected to be about 2% of GDP, in line with last year's projection. This follows three years when the PSBR remained at about $3\frac{1}{4}$% per cent of GDP. This year's figure is the lowest recorded since 1971-72 even if central privatisation proceeds are excluded.

Public Sector Borrowing and the Growth in Money GDP



The PSBR Path

2.21 Last year's MTFS also indicated the path of the PSBR which the Government considered appropriate over the medium term. The path indicated this year is essentially the same. In assessing the appropriate PSBR path the composition of receipts and expenditure have been taken into account.

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2.22 The PSBR for 1986-87 is forecast to be £7 billion or 2 per cent of GDP. The scale of the central privatisation programme is planned to rise from £2½ billion in 1985-86 to £4¾ billion; but North Sea revenues are projected to decline from £12 billion in 1985-86 to about £6 billion. The situation in the oil market is very uncertain, and this points to a cautious assessment of future revenue growth.

2.23 The fiscal projections summarised in table 2.4 show a further small reduction in the PSBR to 1½% of GDP in 1988-89 and 1989-90. The figures after 1986-87 are illustrative, and decisions about the appropriate PSBR in particular years will be taken nearer the time.

Assumptions

2.24 For the period to 1988-89, the expenditure projection in Table 2.2 incorporates the public expenditure plans set out in the Public Expenditure White Paper (Cmnd 9702). For 1989-90 it is assumed that the planning total will increase in line with inflation. The revenue projections in Table 2.3 are based on the conventional assumption of constant 1986-87 tax and contribution rates, and allowances and thresholds indexed from the proposed 1986-87 levels. All changes proposed in the Budget are taken into account.

2.25 Output is assumed to grow by about 2½% per annum over the four years to 1989-90, with growth of 2¾% per annum in non-North Sea GDP offset by a decline in North Sea output. Inflation as measured by the GDP deflator is expected to fall to 3¾% in 1986-87, following the sharp reduction in oil prices. After marking time in 1987-88 as the oil market

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stabilises, a steady decline in inflation to 3% in 1989-90 is projected. It is assumed that there is no major change in the sterling exchange rate index from year to year. These assumptions are consistent with the broad medium term objective for money GDP set out in Table 2.1

Public Expenditure

2.26 Continued restraint in public spending plays a vital role in the Government's economic strategy. The cash planning totals set by the Government in the White Paper are designed to hold total spending broadly level in real terms. The projection given in Table 2.2 extends to 1989-90, one year longer than the plans. The assumption for the final year means that the planning total remains broadly constant in real terms over the whole MTFS period.

2.27 As a proportion of GDP, general government expenditure has already fallen significantly from its peak of over 46% in 1982-83. Given the assumed growth of output, it is projected to decline further from over 44 per cent in 1985-86 to less than 40 per cent in 1989-90. This will enable a continued decline in borrowing to be combined with reductions in the burden of taxation, so improving motivation, efficiency and employment. The existing plans for public expenditure are discussed more fully in Part 5.

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Table 2.2 General Government Expenditure

£billion, cash

	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90
Public expenditure planning total (1)	129.6	134	139	144	148½	153
Interest payments	16.1	17½				
Other adjustments (2)	4.2	6				
General government expenditure	**150.0**	**157½**				
of which						
Central privatisaction proceeds(3)	2.1	2½	4¾	4¾	4¾	4¾

(1) For 1984-85 to 1988-89, the figures are as in Table [5.2]. Assumed to be the same in real terms in 1989-90 as in 1988-89.

(2) See Table [5.2] and paragraph [5.13]. The purpose of these adjustments is to convert the planning total into general government expenditure.

(3) See Cmnd 9702, Table 1.4. Assumed to be the same in cash terms in 1989-90 as in 1988-89

Revenue

2.28 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 unchanged policy assumptions set out above, general government receipts are expected to increase broadly in line with money GDP. Government revenues from the North Sea are projected to fall sharply in 1986-87 from the peak levels of 1984-85 and 1985-86 -the result of the projected decline in output and of the drop in real oil prices [which has already occurred.] But the decline

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in revenues from this source is offset by buoyant non-North Sea revenues.

Table 2.3 General Government Receipts

£billion, cash

	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90
Taxes on incomes, expenditure and capital	105.5	113½				
National Insurance and other contributions	22.9	24½				
Interest and dividends		6½				
Other receipts		5½				
Accruals adjustment	1.1	-½				
General government receipts	**140.8**	**149½**				
North Sea tax (1)	12.0	12	6	4	4½	4½

(1) 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 2 to Table [ ].

Public Sector Borrowing

2.29 The projections of Government expenditure and receipts are brought together in Table 2.4 to provide projections of the general government borrowing requirement (GGBR) and of the PSBR. The size of the fiscal adjustment depends upon the estimates of revenues and expenditure. As always, these are subject to major uncertainties. Apart from the general difficulty of projecting the yield from a given set of tax rates, recent events in world oil

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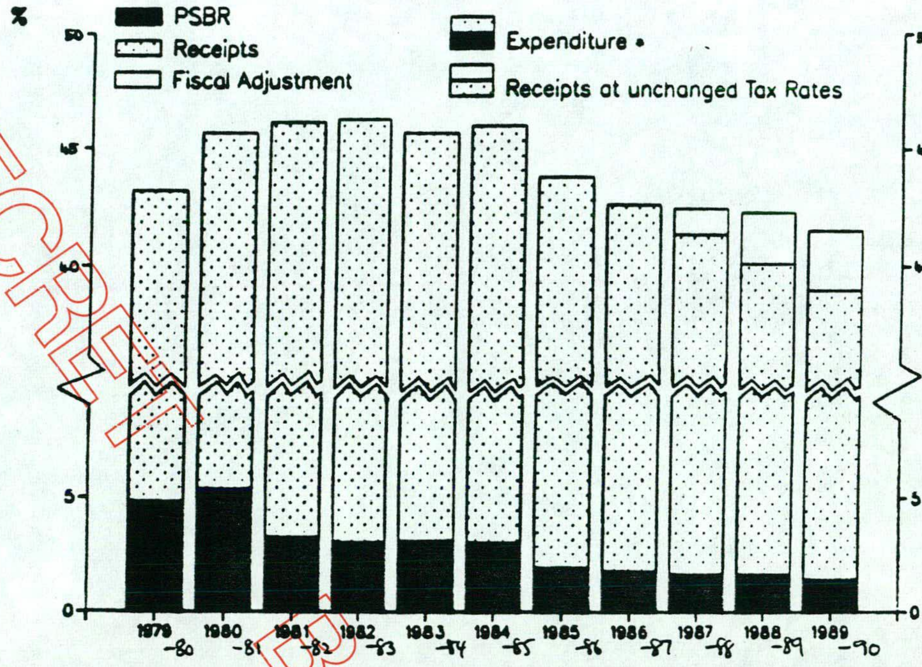
markets make the projection of oil revenues particularly uncertain. On the expenditure side, the planning total for the final year has yet to be agreed.

Expenditure, Receipts and Borrowing

as a % of GDP



* General Government Expenditure plus Public Corporations Market and Overseas Borrowing

2.30 Changes since the 1985 MTFS are discussed in the Annex.

Table 2.4 Public Sector Borrowing (1)

£billion, cash

	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90
General government expenditure	150.0	157½	164	169½	175	179½
General government receipts	140.9	149½				
Fiscal adjustment from previous years (2)	-	-	-			
Annual Fiscal adjustment (2)	-	-				
GGBR	**9.1**	**8½**				
Public corporations' market and overseas borrowing	1.0	-1½				
PSBR	10.0	7				
Money GDP at market prices (3)	327	357	380	404	428	452
PSBR as % of GDP		2	1¾	1¾	1½	1½

Constituent items may not sum to totals due to rounding.

(1) Further details for 1985-86 and 1986-87 are provided in Table [6.5].

(2) Means lower taxes or higher expenditure than assumed in lines 1 and 2.

(3) The assumed paths for prices and output are as follows:

Percentage change on previous financial year

	1985-86	1986-87	1987-88	1988-89	1989-90
Real GDP					
Non-North Sea	3¾	3	2¾	2¾	2¾
Total	3½	2¾	2½	2½	2½
Inflation					
GDP deflator	5¾	3¾	3¾	3½	3

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Conclusion

2.32 [Events in the oil market may make it necessary to revise the assumptions on which the projections have been based. But the Government is committed to maintain progress to lower inflation in the medium term, secured by appropriate financial policies. This provides the framework within which the Government will pursue its micro-economic policies.]

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THE ECONOMY: RECENT DEVELOPMENTS AND PROSPECTS TO MID-1987

Summary

Demand and Activity

3.01 1985 saw further big increases in both exports and business investment. For the forecast period substantial growth is likely not only in most areas of domestic spending but also in exports. Total domestic production and manufacturing output are both expected to record further growth in the range 2-3 per cent.

Labour Market

3.02 Employment has continued to rise, with an estimated extra 219 thousand jobs in the year to September 1985. In spite of this there has been some further rise in unemployment over the last year. However, with labour force growth now likely to fall, prospects for unemployment are better than for some years.

Inflation

3.03 After rising in the early months of 1985, inflation has been on a downward path since June and in January 1986 the RPI increase was 5½ per cent. The inflation rate is expected to be at or below 4 per cent for most of the forecast period.

Assumptions

3.04 The UK forecast is based on the assumption that fiscal and monetary policies are set within the framework of the MTFS.

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North Sea oil prices are assumed to average $15 in 1986-87. Neither the sterling index nor the sterling dollar exchange rate are assumed to change much.

World Economy

3.05 Output in the world economy has now been rising since early 1983, and inflation has been coming down since 1980. The recent large fall in oil prices will be of particular help to oil importing countries both in the developed and developing world. Assisted by further moves to lower interest rates, a period of low inflation and good growth in output and trade is in prospect. Many of the problems arising from payments imbalances and debt repayments will remain. But the benefits to trade, output and inflation from the fall in oil prices should prove substantial.

Trade and the current account

3.06 Exports have grown strongly over the last two years: in 1985 manufactured exports grew twice as much as world trade. The current account of the balance of payments is expected to remain in sizeable surplus despite the big fall in oil prices. Offsets include higher export earnings on other goods - with most overseas markets benefit ing from the fall in oil prices - lower profits earned by foreign oil companies in the North Sea, and higher earnings from the UK's stock of overseas assets.

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WORLD ECONOMY

Recent developments

3.07 After a spurt in 1983 and the first half of 1984, US economic growth has slowed down sharply. By the final quarter of 1985 real GNP was 2½ per cent higher than a year earlier. The performance of the US economy has strongly influenced the pattern of economic growth in other major industrialised countries. In Japan and Germany, in particular, output grew significantly faster than domestic demand in both 1984 and 1985, thanks to the substantial external contribution to demand, stemming in large part from the US. More recently the recovery in Europe has strengthened and growth has become less dependent on exports to the United States. In Japan growth has shown some signs of slackening, although remaining high by European standards.

3.08 Domestic demand is now growing at similar rates in the United States and other major industrialised countries. But the effect of much faster growth between 1982 and 1984 in the US, together with the effects of the rise - still only partially reversed - in the dollar, are seen in the pattern of current account balances: a large deficit in the US and large surpluses in Germany and Japan. There have, though, been a number of helpful steps toward reducing these imbalances over the past year. Slower growth in the US has not only reduced the increase in US imports, but also contributed to lower interest rates and a fall in the dollar. The latter was helped by the Plaza Agreement of 22 September between the Finance Ministers of the Group of Five. Nevertheless, a period in which US domestic demand growth is significantly slower than that in Europe and Japan is likely to prove necessary if current account surpluses and deficits are to be reduced.

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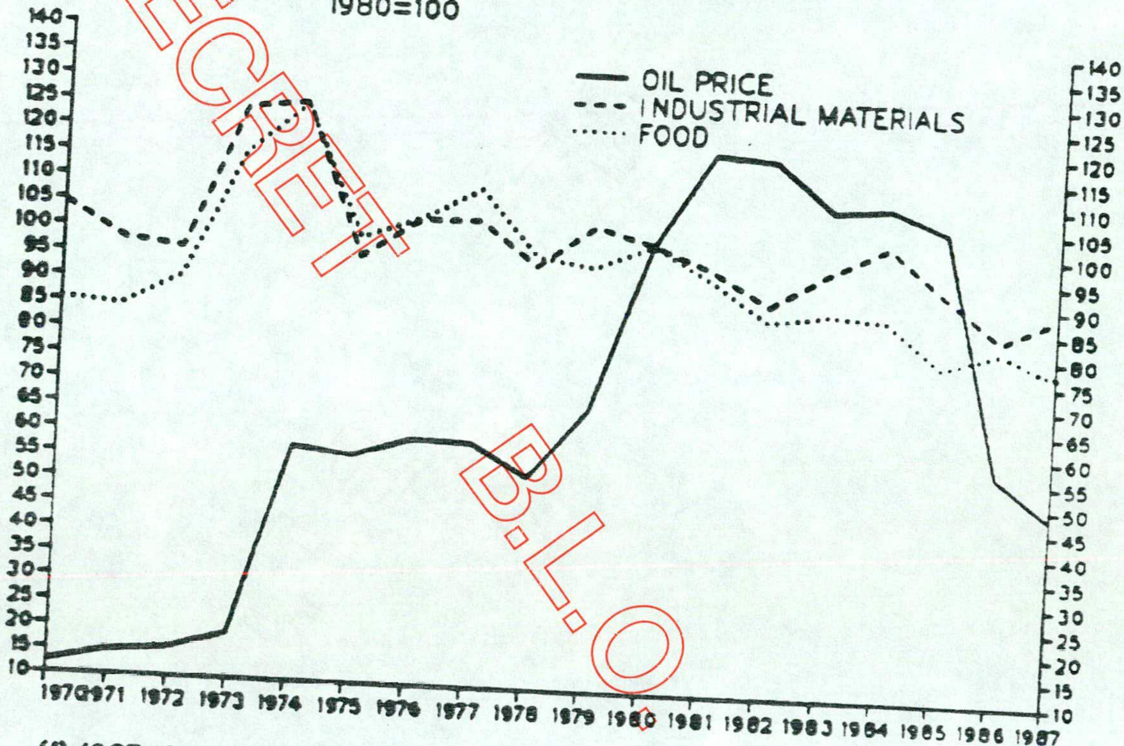
3.09 The rate of inflation fell further in 1985: consumer prices in the major industrialised countries increased on average by about 4 per cent, compared with over 4½ per cent in 1984. This partly reflects the weakness of primary product prices, (see chart 3.1).

CHART 3.1 (1987 to be removed and industrial materials and food to be combined).

REAL COMMODITY PRICES *

1980=100



(1) 1987 1ST HALF-YEAR

* IN RELATION TO PRICES OF MANUFACTURES

3.10 Since December 1985, oil prices have fallen sharply. The background to these oil price developments is set out in chart 3.2. Before the first oil price shock the non-communist world demand for oil was around 48 million barrels per day, and about 30 mbd of this was produced by OPEC members. Despite the 1973-74 increase in oil prices OPEC managed to maintain roughly this level of production throughout the 1970's. After falling in 1974 and 1975 total demand for oil rose again during the rest of the decade, while non-OPEC supply grew by roughly the same amount in absolute terms.

CHART 3.2 Oil supply (to be revised)

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3.11 Experience since the second sharp increase in oil prices in 1979 has been very different. Demand for oil has fallen and non-OPEC supplies have continued to rise sharply. OPEC's pricing policy made it effectively the residual source of supply and demand for OPEC oil nearly halved: from about 30 mbd in 1979 to less than 17½ mbd on average in 1985. A large share of the production cuts fell on Saudi Arabia.

3.12 Towards the end of 1985 Saudi Arabia indicated that it was no longer prepared to maintain its own production at very low levels in order to maintain the existing level of prices. The resulting increase in supply, combined with no sign that other producers were prepared to make offsetting cuts in their production, has produced a sharp fall in prices.

Prospects

3.13 Total demand and supply for oil may well respond only slowly to the large fall in price, and so excess capacity is likely to be present for some time. This forecast assumes that prices will settle at around $15 per barrel - rather below, in real terms, the level between 1974 and 1979.

3.14 The prices of most other primary products are also unlikely to strengthen significantly over the next year or so, since with some exceptions (for example a temporary shortfall in the coffee crop), supplies are abundant and stocks relatively high. The industrial countries can therefore expect further improvements in their terms of trade, raising real incomes and enabling inflation to fall further (see table 3.1).

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Table 3.1: World economy

	1984	1985	1986	1987 first half
	percentage change on a year earlier			
Major Seven countries*:				
Real GNP	4½	2½	3½	4
Consumer prices	4½	4	2½	1½
World trade, at constant prices				
Total imports	10	3	6	5½
Trade in manufactures (UK weighted)	8½	4	5	5

* USA, Japan, Germany, France, UK, Canada and Italy.

3.15 The growth of real GNP in the **United States** should pick up in 1986, benefiting from lower oil prices and from the effect of the lower dollar on trade. Consumers' expenditure, while growing more slowly than in recent years, should be helped by the lagged effects of lower interest rates, lower oil prices, and rises in asset prices.

3.16 Growth in **Japan** may be a little weaker in 1986 as the expansion of domestic demand may not be sufficient to compensate for a slowdown in the growth of exports. In most **European countries** the economic recovery should strengthen in 1986, with the rate of growth increasing, particularly in Germany.

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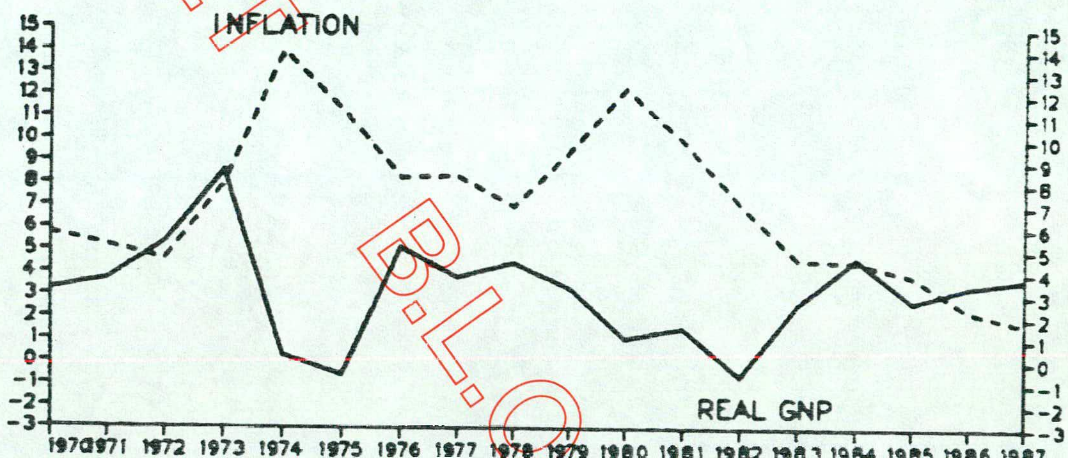
3.17 Overall the major industrialised countries may grow by about 3½-4 per cent over the next year. Together with lower inflation and interest rates in the major countries and the reduced cost of their oil imports, this should provide a better prospect for the non-oil developing countries, despite weak commodity prices. Oil producing countries, on the other hand, particularly those already heavily indebted, face severe difficulties and will have to cut their imports further.

CHART 3.3 (1987 to be deleted)

MAJOR 7 ECONOMIES REAL GNP AND INFLATION

ANNUAL % CHANGE



(1) 1987 1ST HALF-YEAR ON 1986 1ST HALF YEAR

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Table 3.2: World import volumes, annual growth rates

	USA	Japan	Europe*	OPEC	Developing countries	Other	Total
Weights in 1984	19	8	31	7	14	22	100
1984	24	11	6	- 10	8	10	10
1985	3	1	5	8	1	6	3
1986	9	8	7	- 16	7	5	6

* Germany, France, UK, Italy, Netherlands and Belgium

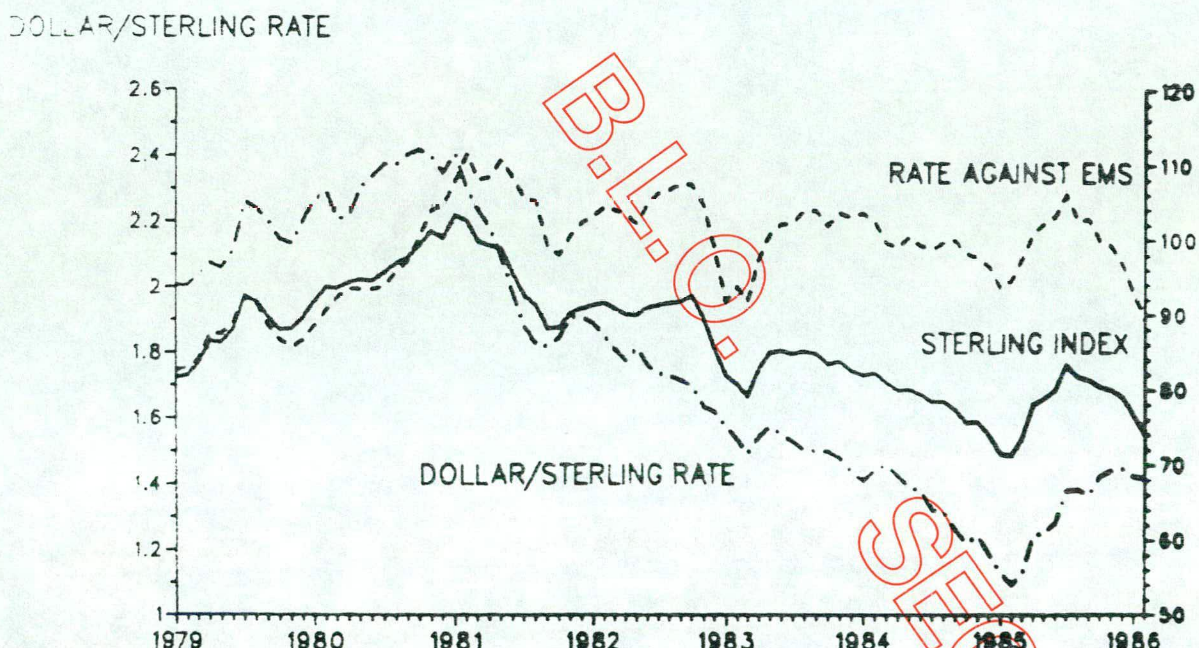
3.18 This picture of world activity is reflected in the pattern of world trade growth. Import growth is likely to be strongest in oil-importing countries and in those whose exchange rates have appreciated most over the past year. This points to rapid growth of imports into Europe, Japan and many developing countries, but to large falls in oil producers' imports. Overall import growth in 1986 should be well above that of 1985.

FINANCIAL CONDITIONS

Exchange Rates

3.19. The dollar has declined substantially (by over 20 per cent against a basket of other currencies) since its peak in early 1985. In 1985 as a whole the sterling index was little different from 1984. There were however some sizeable swings during the course of the year. The index rose from a lowpoint of 70½ in January to a high of 84½ in July, before declining to 78 in December. The index has fallen a little further this year as a result of the fall in oil prices. Over the past year sterling has risen by about 30 per cent against the dollar, but fallen against most other currencies.

Chart 3.5: Exchange rates for sterling



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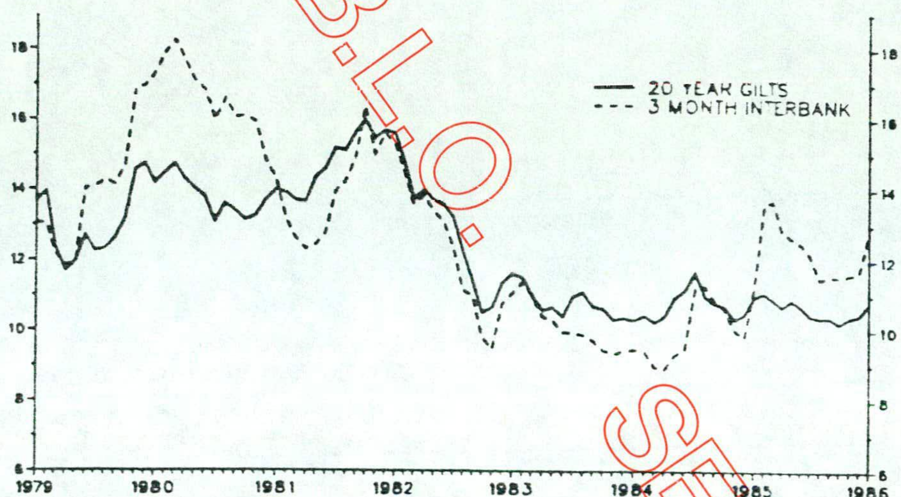
3.20 The forecast assumes that sterling will not change much from its present level either in dollar, or effective terms.

Interest Rates

3.21 Short-term interest rates fell during much of 1985 from the peak levels reached in February and March. They rose again in January this year as sterling weakened but in 1986 so far they have been a little below levels a year earlier. However in 1985-86 short rates, at 12 per cent, have on average been a point or so above the levels of 1984-85 and several points above levels in the US, and most other industrialised countries. Long rates have been much more stable. Yields on 20 year gilts have been within the 10-11 per cent range for almost all of the last three years, but in recent weeks have been at the bottom of this range. Real yields on index-linked gilts have also been relatively stable.

Chart 3.4: Interest rates in the UK



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Narrow Money

3.22 M0 was near the centre of its target range in the early months of 1985-86, but growth slowed during the course of the year, in response to the increase in interest rates last winter. In recent months M0 growth has generally been just above the bottom of its target range. The annual increase in M0 velocity has been stable for many years now, and is expected to remain so.

3.23 Growth in the non-interest bearing component of M1, 3 per cent over the last year, has also slowed. This has been in response to higher interest rates and the increased availability of high interest cheque accounts which are in M1, contributing to an acceleration in M1 in total.

Broad Money

3.24 The rate of growth of £M3 has risen during the course of 1985-86 and has been well above both the target range set in the 1985 MTFS and the growth of money GDP. With the funding objective now set at the level needed to cover the PSBR, £M3 growth (at 14-15 per cent on a year earlier in recent months) has reflected a continued strong expansion of bank credit. Other broad aggregates have grown at much the same rate.

3.25 The rapid expansion of broad money and credit reflects to a large extent the pace of financial innovation and liberalisation. In addition, since over two-thirds of £M3 bears interest and is now an attractive means of holding financial wealth, the high level of real interest rates may have contributed to higher bank deposits. The higher levels of financial wealth and debt in relation to incomes probably reflect a permanent shift in the private sector's portfolio which is not likely to be reversed through higher spending. They are therefore expected to be consistent with the slower growth of nominal incomes and the fall in inflation in this forecast.

TRADE AND THE BALANCE OF PAYMENTS

Relative costs and prices

3.26 The last two to three years as a whole have exhibited relatively little change in most measures of cost and price competitiveness, although there have been large short-term swings associated with movements in the nominal exchange rate. As table 3.3 shows, the effects of a lower nominal exchange rate have been broadly offset by unit labour cost increases at home above those in the UK's main overseas competitors, despite a good UK productivity performance. Assuming an unchanged exchange rate, the UK's cost and price competitiveness may be little different from the average of the last three years.

Table 3.3: The nominal exchange rate and relative costs and prices in manufacturing.*

	Sterling Index (1975=100)	Relative actual unit labour costs	Relative export prices (1980=100)	Import Price Competitiveness
1983	83½	85	89	94½
1984	78½	83½	87½	92
1985 Estimate	78	87½	89½	91½

* Ratio of UK to overseas costs/prices

Trade prices and the terms of trade

3.27 Prices of most categories of imports fell during the course of 1985. The exchange rate appreciated during the course of the year, inflation in the developed world was low and commodity prices were weak. By the final quarter of 1985 import prices of all goods and services were 5 per cent lower than a year earlier. For 1985 as a whole, the terms of trade were 1 per cent above those in 1984 because of the weakness of commodity prices. But some decline in the terms of trade is likely in 1986 because the price of oil has fallen relative to other goods and services. As oil has a greater share in UK exports than in imports, a fall in its price reduces export prices relative to import prices. The forecast deterioration in the terms of trade means that the UK will have to export more in volume terms to purchase a given volume of imports, if the current account is not to worsen.

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Table 3.4: Trade in goods - balance of payments basis

per cent changes on a year earlier

All goods

	Export Volume	Import Volume	Terms of Trade*
1983	2	8	½ (½)
1984	8½	11	- 2 (-1)
1985	5½	3	1½ (3½)
1986(Forecast)	5½	6½	- 2½ (1)

* The terms of trade are the ratio of UK export to import prices (average values); the figures in brackets exclude oil and are on an OTS basis.

Trade volumes (goods other than oil)

3.28 As shown in chart 3.7 UK exporters of manufactures improved their share of world trade in volume terms in 1984 and may also have done so in 1985. The value share has however declined slightly as UK export prices have fallen relative to those of our competitors. The forecast of exports of manufactures (excluding erratics) in volume terms is for further growth of 5 per cent in 1986. This is the same as to the rise in world trade, but less than in 1985.

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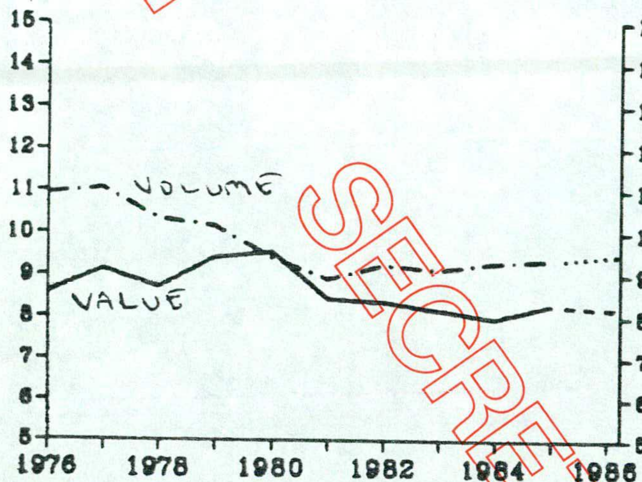
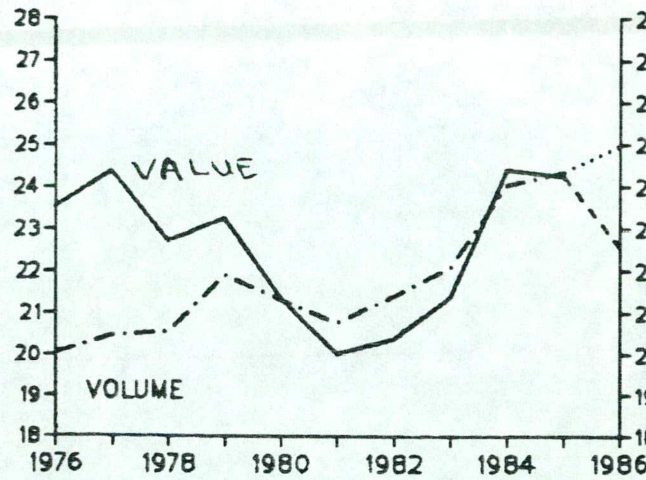
Chart 3.7: Export shares and import penetration

Share of UK exports in main manufacturing countries exports of manufactures



Share of imports in total domestic expenditure (excluding oil)



3.29 Between 1982 and 1985 the growth in domestic demand for manufactures (5½ per cent at an annual rate) has been shared by importers and domestic producers, with importers continuing to increase their share. Domestic demand for manufactures is expected to grow in 1986, because of further growth in investment and consumer durables in particular. Growth in imports of manufactures in 1986 is forecast to be around 7 per cent, twice as fast as domestic demand growth, a relationship similar to that between 1982 and 1985.

Trade in oil

3.30 The prospect is for a substantial fall in the balance of trade in oil in 1986 as a result of lower oil prices, partly offset in the current account as a whole by reduced invisible earnings of foreign owned companies operating in the North Sea. Little change in oil production in 1986 is expected and domestic demand for oil will be below the 1985 level which was boosted by the coal strike.

Invisibles

3.31 The balance of trade in **services** has more than doubled since 1982. 1985 was an exceptionally good year, with large gains in earnings from financial services, tourism and travel. With imports of services, particularly tourism, likely to grow faster, the balance on services may show only a modest gain in 1986.

3.32 The profile of the **transfers** balance is affected by the timing of official transactions with the European Community. As the bulk of the UK's rebate on its 1984 contribution was delayed into 1986 the transfers balance was unusually low in 1985, by about £½ billion. A correspondingly high figure is projected for 1986.

3.33 The surplus on **interest, profits and dividends** (IPD) fell slightly in 1985. A rise in the non-oil IPD balance was more than offset by a deterioration on oil OPD which largely reflected a once-for-all write off of losses on BP's Sohio subsidiary. Lower oil prices in 1986 will reduce the profits of foreign oil companies operating in the North Sea more than they reduce the profits of UK oil companies' overseas operations. There should be a rise in the non-oil IPD balance as a result of a further increase in the UK's net overseas assets.

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Current Account

Table 3.5: Current account of the balance of payments, £billion

	Oil	Other Goods**	Invisibles	Total: Actual and forecast	Total: After allowing for special factors*
1983	7	- 8 (-2½)	4	3	3
1984	7	- 11 (-4)	5	1	4
1985	8	- 10 (-3)	6	4	5½
1986 (Forecast)	5½	- 10 (-3½)	8½	4	3½

* The timing of EC rebates and the effect of the coal strike.

** The balance on manufactures is in brackets.

3.34 Table 3.5 summarises the current account and its main components. Allowing for the effects of the coal strike the current account was in sizeable surplus in each of the last three years and a substantial surplus is again forecast for 1986. On an underlying basis, the surplus in 1986 is expected to be lower than in 1985, as a result of the big fall in oil prices. The contribution of North Sea oil to the current account - ie the balance of trade in oil less foreign companies' North Sea profits - is forecast to fall from a strike-adjusted £6½ billion in 1985 to £3½ billion in 1986. Chart 3.8 shows the components of the account over a longer period, relative to GDP.

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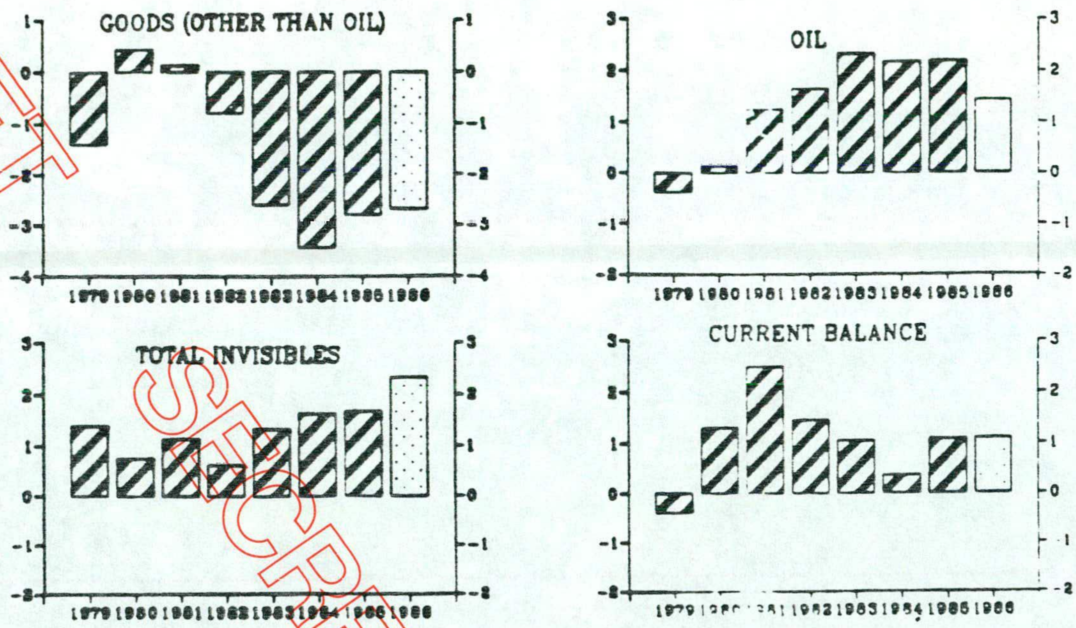
Chart 3.8: Trade balances as a percentage share of GDP



Overseas Assets

3.35 The UK's stock of net overseas assets is estimated to have been 24 per cent of GDP (£85 billion) at the end of 1985, compared with 6 per cent of GDP in 1979.

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INFLATION

Inflation and Costs in 1985

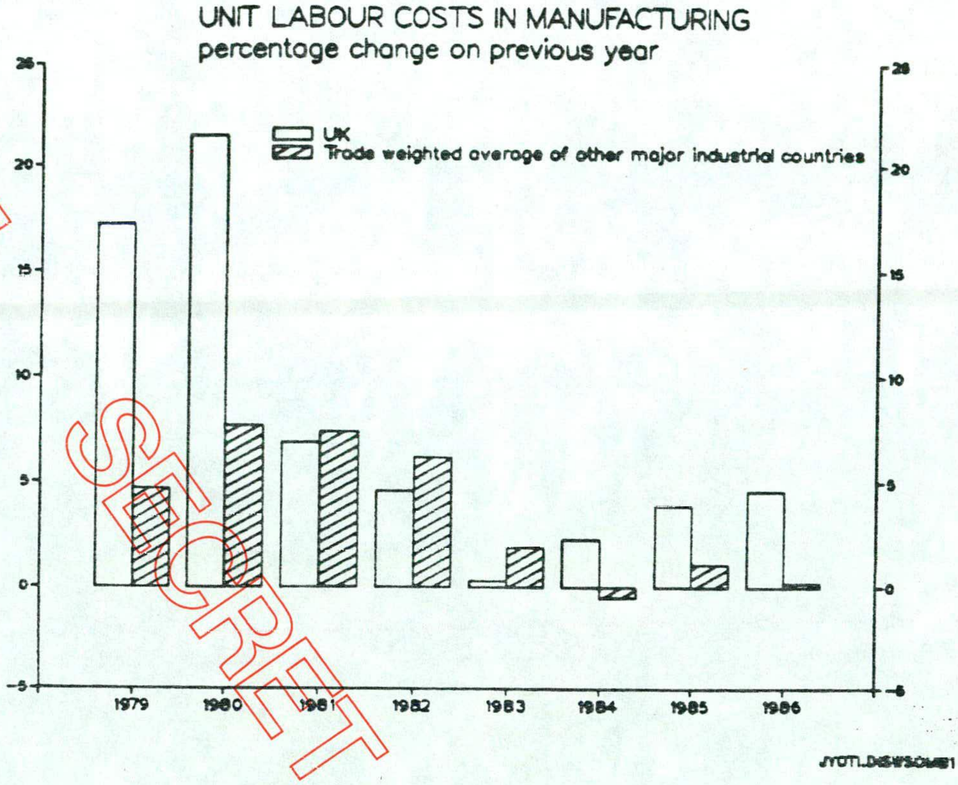
3.36. In the year to 1985Q4 the RPI increased by 5½ per cent, a little more than forecast in last year's FSBR. In the middle of the year retail price inflation touched 7 per cent reflecting in particular increases in mortgage interest rates in February and April 1985 and the weakness of sterling in late 1984 and early 1985. Between May and January retail prices rose by only 1.1 per cent in total, helped by a fall in mortgage rates; by lower petrol prices, and a general easing of cost pressures.

3.37. Import prices declined during 1985 and in the final quarter were about 5 per cent lower than in 1984Q4; the prices of imported fuels fell 14 per cent over the same period. Prices of the manufacturing sector's imported inputs fell rapidly from their peak in February and by the end of the year were 6 per cent below their December 1984 level. The rate of increase in manufacturing output prices started to slow down in the second half of 1985.

3.38. The underlying growth of average earnings (that is, abstracting from the effects of strikes, delayed settlements and other temporary factors) continued at about 7½ per cent in 1985 - little changed from 1984. With output per head growing at about 2 per cent (after allowing for the effects of the coal strike) the growth in unit wage costs was about 5½ per cent in 1985. Unit labour costs rose by about 1 per cent less mainly because of the abolition of NIS in October 1984.

In the manufacturing sector, average earnings increased by 8½-9 per cent and unit labour costs by 4 per cent. This was much faster than in most other major industrial countries. Pre-tax real earnings of employees increased by an average of almost 2½ per cent a year between 1982 and 1985.

CHART 3.9



Prospects

3.39. So far the current pay round is showing little sign of any significant change in the level of pay settlements or in the underlying rate of growth of average earnings in the private sector. Unit labour costs for the economy as a whole may rise by 5 per cent in 1986, and unit labour costs in manufacturing may rise slightly less than this. World commodity prices are likely to remain weak in 1986. With oil prices in sterling terms almost halving between 1985 and 1986, the overall cost of manufacturers' material and fuel inputs should fall quite sharply between the two years. The prospects are for very modest growth in manufacturers' total costs and a widening of profit margins for a time.

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Table 3.6: Costs in manufacturing (percentage changes on a year earlier)

	Unit Labour Costs in Manufacturing	Materials and fuels purchased by manufacturing industry(1)	Estimated Total Costs	Output Prices(1)
1983	½	8	2½	5½
1984	2½	8½	4½	5½
1985	4	4	4	6½
1986 (forecast)	4½	-11	½	4½

(1) Excluding food, drink and tobacco

3.40. The fall in import prices since the spring of 1985 has contributed to the recent low monthly growth in retail prices, and will continue to contribute to low increases in prices over the coming months. The annual rate of inflation will fall quite sharply in the months after January 1986. In the last quarter of the year RPI inflation may be about 4 per cent, with little change likely in the first half of 1987. The fall in oil prices is expected to work its way fully through to petrol prices in the course of 1986. The forecast increase in the housing component of the RPI (which covers mortgage payments, rents, rates, and other housing costs) mainly reflects the prospects for local authority rates in 1986-87.

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Table 3.7: **Retail prices index**

Per cent changes on a year earlier

	Weights in 1985	1984 Q4	1985 Q4	Forecast 1986 Q4	Forecast 1987 Q2
Food	19	3½	3	3	3½
Nationalised Industries (including water)	9	4	5½	4½	3
Housing	15	10½	9½	9½	3½
Other	57	4	5½	3	4
Total	100	5	5½	4	3¾

3.41. Other price indices sometimes move differently from the RPI because of differences in coverage. In particular they vary in the degree to which they are affected by movements in import prices; and the housing component of the RPI includes a direct effect from interest rate changes which is absent from other price indices.

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3.42. The GDP deflator measures the price of domestic value added - principally unit labour costs and profits per unit of output - and excludes imports altogether. The GDP deflator covers all sectors of the economy, including oil output in the North Sea, and so is highly sensitive to the fall in world oil prices. This contributes to a marked slowdown in the growth of GDP deflator over the ~~next~~ coming year. The deflator for GDP at market prices is estimated to have increased by 5½ per cent in 1985-86, about one per cent faster than in 1984-85. In 1986-87, inflation on this measure is expected to fall back to about [3¾] per cent. With no further benefit from lower oil prices assumed after 1986, the GDP deflator is not expected to show any further decline in 1987-88.

DEMAND AND ACTIVITY

3.43. Latest estimates suggest that GDP rose by about 3½ per cent in 1985, or 2½ per cent after making allowance for the effect of the recovery from the coal strike. Over the year to the first quarter of 1985, GDP is estimated to have risen by almost 4 per cent in strike adjusted terms: this was the period which saw the most rapid growth in the world economy. Since then the path of GDP has been flatter. The rise in GDP between the first and third quarters of the year was more than accounted for by recovery from the coal strike, but growth seems to have picked up again in the fourth quarter: the preliminary estimate of the output measure of GDP showed growth at annual rate of 2½ per cent between the third and fourth quarters of the year. The flattening out of strike adjusted GDP during the middle of 1985 reflected in part the high level of business investment and North Sea output in the first quarter of the year. Output in most sectors of the economy, including manufacturing, continued on an upward trend throughout 1985.

3.52. Table 3.8 provides details of the forecast for total investment and its major components. Overall in 1986, fixed investment is expected to show a further year of good growth. North Sea investment is expected to recover this year to a similar level to that in 1984, mainly reflecting increases in expenditures on oil fields already under development and on gas fields due for development.

Table 3.8: **Gross Fixed Domestic Capital Formation**

(at constant prices)

	1984 £ billion at 1980 prices	**Per cent change on previous year**		
			Forecasts	
		1984	**1985**	**1986**
Business(1)	29.0	10	4	4
Private dwellings(4)	9.5	4	- 1	5
General government	6.9	5	- 4	1
Total fixed investment	45.4	8	1	4½

(1) Including investment by public corporations

(2) Figures for manufacturing include assets leased from finance lessors, figures for other industries exclude these assets.

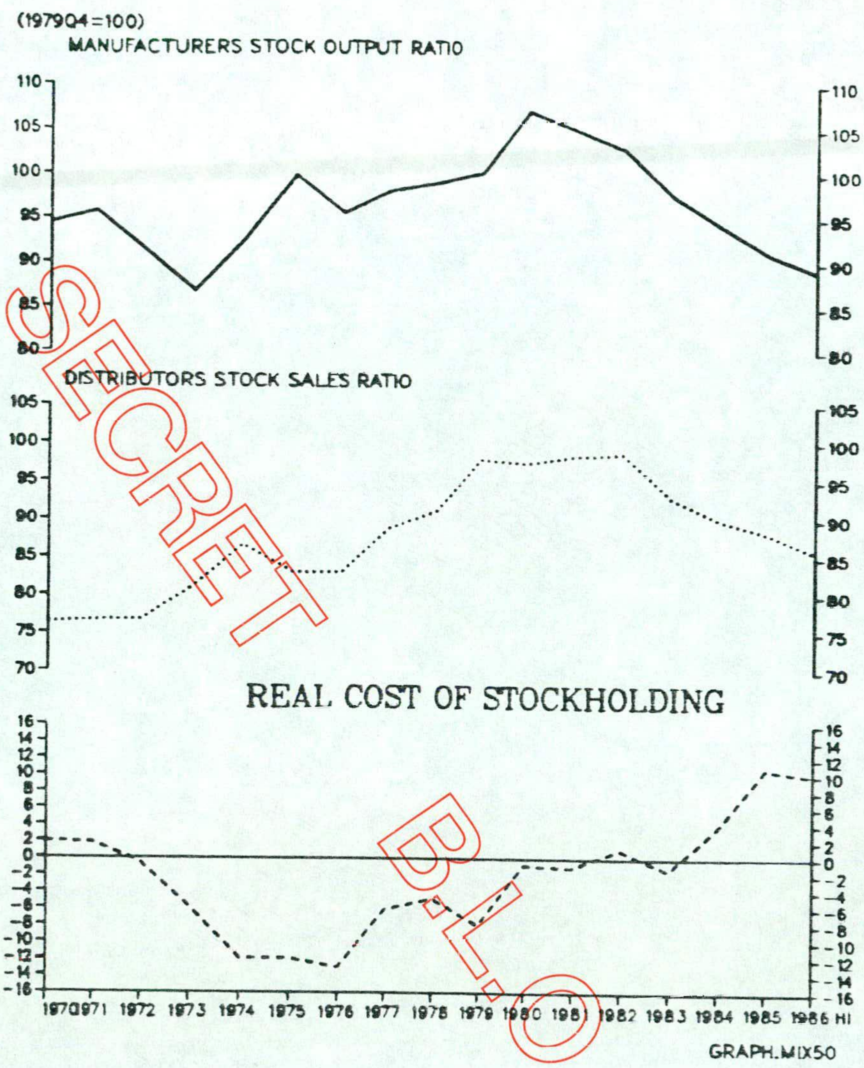
(3) Figures are for industry class 13 (1980 SIC)

(4) Includes purchases less sales of land and existing buildings by persons, companies and public corporations, other than purchases of council houses.

Stockbuilding

3.53. Survey evidence suggests that despite the low expenditure on stock building in 1985, most companies still regard their current stock levels as more than adequate in relation to output and sales. The fall in stock ratios in recent years may reflect in part cautious behaviour by companies after the last recession. Another factor has been the high cost of holding stocks as a result of the high level of real interest rates and the abolition of stock relief in the 1984 Budget. Stock ratios and the estimated real cost of holding stocks are illustrated in Chart 3.12.

CHART 3.12 AGGREGATE STOCK RATIOS



Prospects for Demand and Activity

3.54. Strong growth in exports has made an important contribution to GDP growth over the last two years. In 1985 the increase in manufactured exports was twice the estimated increase in world trade in manufactures, while UK imports of manufactures grew less in relation to the growth in demand than has normally been the case in recent years.

exchange rate

3.55. The fall in oil prices has improved the prospects for world trade, and the adjustment of the to lower oil prices has made British manufactures more competitive. As in most other industrial higher domestic demand (stimulated by lower inflation) is expected to make an important contribution to growth in 1986, but exports should also show substantial growth. The slowdown forecast for export growth in the first half of 1987 reflects the path of North Sea oil output and hence oil exports.

Table 3.9: **Domestic Demand and Trade at constant prices**

per cent changes on a year earlier

	1985	1986	1987 First half
Domestic demand	2	3½	2½
Exports of goods and services	6½	5	3
Imports of goods and services	3½	6	4½

3.56. Total domestic production is expected to increase by 3 per cent in 1986, following 3½ per cent growth in 1985. After allowance for the coal strike, growth is close to 2½ per cent in both years as shown in table 3.10. The average level of oil production in 1986 is likely to be close to its level in 1985 and 1984, but the fall forecast for oil output between the first half of 1986 and the first half of 1987 may cut total GDP growth by over ½ per cent. Output growth in the non-oil economy in 1986 and the first half of 1987 is expected to be comparable to that seen in 1985. Manufacturing output has grown slightly faster than GDP since 1983. The composition of demand growth in the forecast suggests that growth in manufacturing output may continue at around the underlying rate of growth of GDP.

Table 3.10: GDP and Manufacturing Output

	Per cent changes on year earlier		
	1985	1986	1987 First half
GDP (average measure)	3½	3	2
GDP, adjusted for coal strike (*)	2½	2½	2
GDP, adjusted for coal strike and excluding oil output	2½	2½	2½
Manufacturing output	3	2½	2

PRODUCTIVITY AND THE LABOUR MARKET

3.57. Total employment in Great Britain is estimated to have grown by about 220,000 over the year ending September 1985, giving a total increase since March 1983 of over 700,000.

3.58. The published figures show an increase of 12,000 in the number of employees in employment during the first nine months of 1985: a further rise in the number of employees in the service industries was largely offset by falls in the production and construction industries. Self employment is assumed to have risen by about 31,000 a quarter since the middle of 1984, the same as the estimated quarterly increase over the previous three years. This compares with an increase of about 68,000 a quarter recorded between the middle of 1983 and the middle of 1984. The estimates of growth in employment over the recent past shown in Table 3.11 are subject to revision whem the Census of Employment for 1984 and the Labour Force Survey for 1985 become available.

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Table 3.11: Employment (GB, seasonally adjusted)

	Employees in Employment			Self employed	HM Forces	Employed labour force
	Male	Female full-time	Female part-time			
September 1983 to September 1984	- 84	+ 19	+ 174	+ 237	+ 3	+ 349
September 1984 to September 1985	- 105	+ 20	+ 181	+ 125	- 2	+ 219

3.59. Following upward revisions to the estimates of manufacturing output, output per head in manufacturing now appears to have risen by about 3¾ per cent in 1985, close to the annual average of 3½ per cent for the period 1979-85. This marks a major improvement on the productivity performance recorded between 1973 and 1979: the trend growth in productivity in manufacturing now appears to be close to the rate achieved during the sixties (see table 3.12.) Non-manufacturing productivity has also been rising faster of late than in the 1973 to 1979 period. Growth in output per man hour has been rising at about 2 per cent per annum since 1979. However, the rise in part-time employment

is currently bringing down growth in output per head in non-manufacturing, to about 1 per cent a year.

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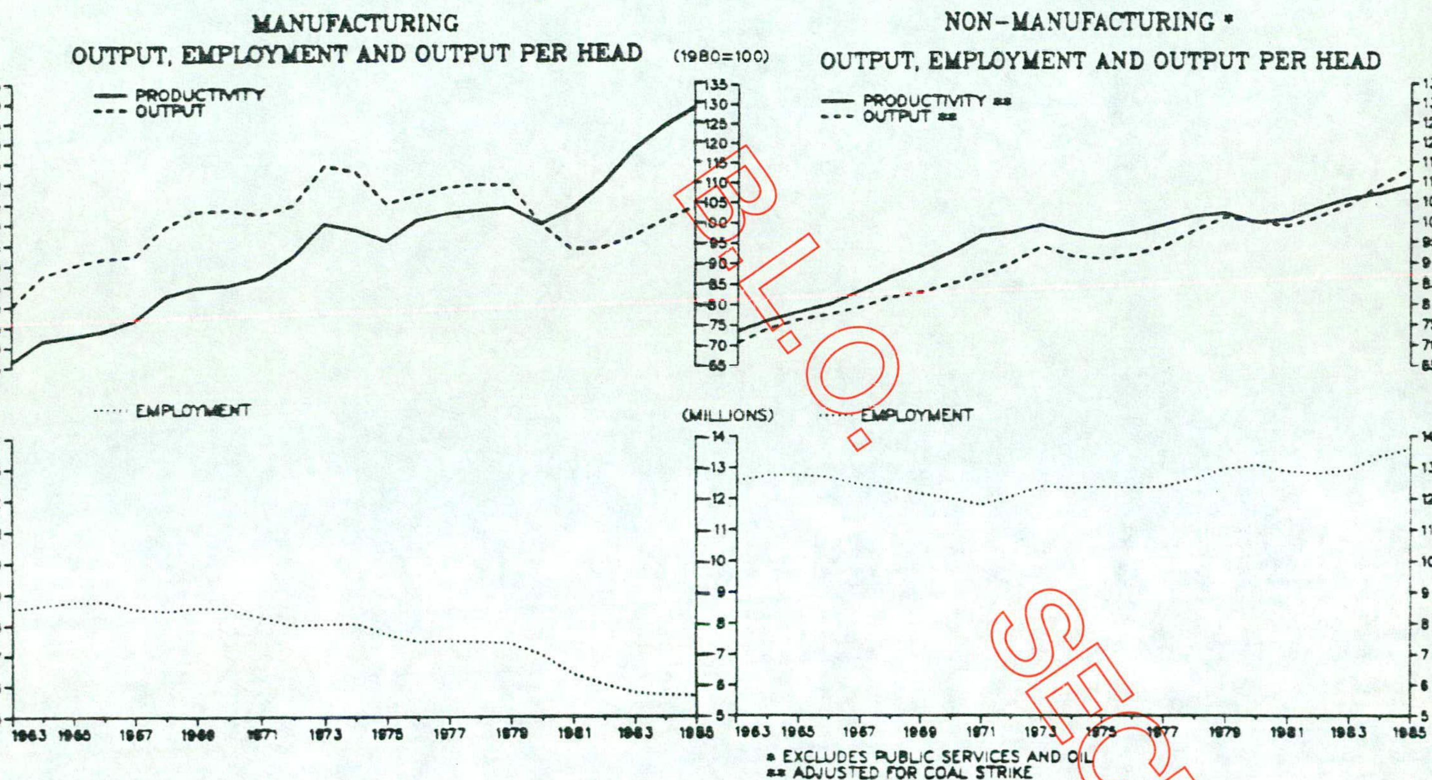
Table 3.12: Output per head of the employed labour force

	Employed Labour Force in 1984 (millions)	Percentage change in output per head (annual averages) 1964-73	1973-79	1979-85
Manufacturing	5½	3¾	¾	3½
Non-manufacturing*	13½	3	½	1

* Excludes public services and oil, and includes nationalised industries except steel.

CHART 3.13



Unemployment

3.60. With output and employment continuing to grow quite strongly, and growth in the labour force starting to slow down, the prospects for unemployment are better than they have been for some years.

FORECAST AND OUTTURN

3.61. The table below compares the main elements of the forecast published in the 1985 FSBR with outturn or latest estimate:

Table 3.13: Forecast and Outturn

	Forecast	Outturn	Average error from past forecasts
RPI: per cent increase between the fourth quarters of 1984 and 1985	5	5½.	2

	Forecast	Latest estimate/ forecast	Average errors from past forecasts
Total output: per cent change between 1984 and 1985	3½	3½	1
Current account of the balance of payments in 1985, £ billion	3	4	2½
PSBR, financial year 1985-1986 £ billion	7	6¼	4½
Money GDP, per cent change between 1984-85 and 1985-86.	8½	9	2

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3.62. Inflation in the fourth quarter of 1985 turned out a little higher than forecast a year ago. The forecasts made at the time of the last Budget for output growth and the current balance in 1985, and for the PSBR in 1985-86, are all very close to the latest estimates for these variables. In each case such error as there appears to have been is considerably smaller than the average error from past forecasts.

Table 3.14: The Prospects: Summary

	Forecast	Average errors from past forecasts*
A. Output and expenditure at constant 1980 prices; per cent changes between 1985 and 1986.		
Domestic demand	3½	[ ]
of which:		
Consumers' expenditure	3½	[1]
General Government consumption	1	[1½]
Fixed investment	4½	[2]
Change in stockbuilding (as per cent of level of GDP)	0	[¾]
Exports of goods and services	5	[2½]
Imports of goods and services	6	[2½]
Gross domestic product: total	3	[1]
manufacturing	2½	[3¼]
B. Inflation		
Retail prices index, per cent change on a year earlier		
1985Q4 to 1986Q4	4	[2]
1986Q2 to 1987Q2	3¾	[3½]
Deflator for GDP at market prices, per cent change on previous year		
Financial year 1985-86	5½	[ ]
Financial year 1986-87	3½	[ ]

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C. Balance of payments on current account

£billion:

1986	4	[2½]
1987 first half (at an annual rate)	2	[4]

D. Money GDP at market prices, per cent change

Financial year 1985-86	9	[ ]
Financial year 1986-87	6½	[ ]

E. PSBR

£billion (in brackets, per cent of GDP at market prices):

Financial year 1985-86	6¼ (1¾)	[1 (¼)]
Financial year 1986-87	7 (1¾)	[4½(1½)]

---

* 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 for the constant price variables [and the GDP deflator] are derived from forecasts made during the period between June 1965 and October 1983. For the current balance and the retail prices index, forecasts made between June 1970 and October 1983 are used. For the PSBR, Budget forecasts since 1967 are used. The errors are after adjustment for the effects of major changes in fiscal policy where excluded from the forecasts.

RISKS AND UNCERTAINTIES

3.63. No forecast is complete without an indication of error margins. Table 3.14 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 approach £200 billion; and for the current account of the balance of payments exceed £150 billion.

3.64. While the size of errors will change over time as the economy fluctuates, and as forecasting techniques change, in many cases the averages have not shifted very much since 1976. For the RPI, however, average errors are derived from a period of high and fluctuating inflation, averaging 12 per cent, and overstate likely errors at current rates of inflation. The average error in the last three Budget forecasts looking ahead to the end of the year was ½ per cent.

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Table 3.15: 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 1980 = 100
1981	136.5	48.9	37.7	62.0	-2.5	282.7	55.9	30.2	-0.3	196.3	98.5
1982	137.6	49.4	40.1	62.8	-1.1	288.7	58.7	30.6	0.7	200.1	100.4
1983	142.9	50.2	41.9	64.4	0.7	300.1	62.1	31.6	0.2	206.7	103.7
1984	145.5	50.9	45.4	69.0	-0.1	310.6	67.9	32.9	1.9	211.7	106.2
1985	149.3	51.2	45.9	73.4	0.5	320.3	70.3	33.0	1.9	218.8	109.8
1986	154.9	51.6	48.1	77.0	0.8	332.5	74.6	34.4	1.9	225.4	113.1
1984 H1	72.5	25.2	22.5	33.8	-0.4	153.7	33.0	16.3	0.5	105.0	105.3
H2	72.9	25.7	22.8	35.2	0.2	156.8	34.9	16.5	1.3	106.7	107.1
1985 H1	73.9	25.6	23.2	37.0	0.1	159.8	35.4	16.2	0.8	109.0	109.4
H2	75.4	25.6	22.7	36.4	0.4	160.5	34.9	16.8	1.1	109.9	110.3
1986 H1	76.8	25.8	24.2	38.2	0.2	165.2	36.9	17.1	0.9	112.1	112.5
H2	78.1	25.8	23.9	38.8	0.6	167.2	37.6	17.3	1.0	113.3	113.7
1987 H1	79.3	25.9	24.2	39.4	0.5	169.4	38.4	17.5	0.8	114.3	114.7
% changes											
1983 to 1984	2	1½	8	7	-	3½	9½	4	-	-	2½
1984 to 1985	2½	½	1	6½	-	3	3½	½	-	-	3½
1985 to 1986	3½	1	4½	5	-	4	6	4	-	-	3
1986H1-1987H1	3	½	0	3	-	2½	4	2½	-	-	2

* 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. Totals in £ billion may not add due to rounding. Figures for 1986 H1 and beyond are forecasts. Figures for periods up to the end of 1985 are based mainly on the national accounts published earlier this year (covering periods up to 1985 Q3) and incorporate some revised and later data and forecasts. A full set of national accounts, to end 1985, will be published by CSO on 21 March.

Chapter 4

4. The Budget Tax and National Insurance Proposals

The Government's approach to taxation

4.01 The Government's aim is to reduce the burden of taxation as a proportion of Gross Domestic Product, within the overall financial framework of the Medium Term Financial Strategy. The Green Paper "The Next Ten Years: Public Expenditure and Taxation into the 1990s" (Cmnd 9189) outlined the framework within which the discussion of fiscal plans over the longer term could take place. The size and shape of tax changes in any year depend on many factors: they must above all ensure that the nation's finances are maintained on a sound footing. What is important is that annual changes should be part of a coherent approach to taxation over the longer term, designed to complement the Government's policies in other fields.

4.02 The Government has a number of objectives which influence its approach to taxation. These include stimulating enterprise and wealth creation; more freedom for individuals to decide how to spend money which they have earned; the encouragement of personal independence and of the voluntary sector; and the reform and rationalisation of the tax system.

Achievements

4.03 Considerable progress has already been made. Basic personal allowances have been increased by about 20 per cent in real terms since 1978-79. The top rate of income tax on earned income has been reduced from 83 per cent to 60 per cent; while the basic rate has been reduced from 33 to 30 per cent.

4.04 The Government initiated in 1984 a radical reform of business taxation. Corporation Tax was reduced from 52 per cent to 35 per cent for the financial year 1986. This is the lowest rate of any major industrialised country. The reform included the abolition of stock relief and phasing out of first year allowances for plant and machinery and initial allowances for industrial buildings. The burden of capital taxation has also been reduced.

4.05 Three taxes have been abolished: Investment Income Surcharge; Development Land Tax and National Insurance Surcharge.

1986 Budget

4.06 The need to adopt a cautious and prudent approach, in the light of lower oil prices and revenues, and uncertainty about the future, has limited the scope for overall tax reductions. Nevertheless, the tax proposals in this year's Budget represent a firm continuation of the Government's policies. The main changes in tax and national insurance contributions proposed in the Budget are summarised below. A full list of changes is given in the Annex to this Chapter.

Income Tax

4.07 Income tax personal allowances and higher rate thresholds will be increased by 5.7 per cent (the year on year increase in the RPI to December 1985, in line with the statutory indexation provisions). This will mean that

the single persons and wife's earned income allowances will rise from £2205 to £2335

the married allowance will rise from £3455 to £3655

the additional personal allowance and widow's bereavement allowance will rise from £1250 to £1320

the basic rate limit will rise from £16,200 to £17,200

National Insurance Contributions

4.08 From 5 October 1986, changes are proposed to national insurance contribution rates for certain low paid employees [and for the self employed]. Unless otherwise stated, the decisions announced on 12 November 1985 and taking effect on 6 April 1986 will continue to apply.

- The existing reduced rates of Class 1 employees contributions of 5 per cent and 7 per cent will be cut by 1 percentage point to 4 per cent and 6 per cent respectively and a new reduced rate band of 8 per cent introduced for employees earning from £95 a week up to £140 a week. The full graduated structure of Class 1 rates will then be as follows:

Earnings £pw	Employer (no change) Rate payable on all earnings %	Employee Rate payable on all earnings %
38 to 59.99	5	4
60 to 94.99	7	6
95 to 139.99	9	8
140 to 285	10.45	9
285 and over	10.45	9% of 285

- [The flat rate Class 2 contributions for the self employed will be reduced from £3.80 to £3.40 a week from 5 October 1986]

- [The Class 3 voluntary contributions will be reduced from £3.70 to £3.30 a week]

Excise duties

4.09 The duties on cigarettes and hand rolling tobacco will rise by 13.6 per cent, equivalent to just over 11p on a packet of 20 cigarettes. Those on pipe tobacco and cigars will remain unchanged, as will all duties on alcoholic drinks.

4.10 Duties on road fuels will go up by a little more than 8 per cent or approximately 7.5p on a gallon of petrol and 6.5p on a gallon on derv.

Business Expansion Scheme

Encouragement of Enterprise

4.11 The Business Expansion Scheme has made a valuable contribution to the growth of risk investment and employment. It is therefore proposed to continue it after 1 April 1987 and to exempt new BES shares from CGT on first sale. Proposals to modify the scheme are being made to ensure that it provides effective encouragement to high risk investment. Some asset based activities are to be excluded.

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Capital Transfer Tax

4.12 In order to remove obstacles to outright giving, the lifetime CTT charge is to be abolished for gifts between individuals made on or after Budget Day. A charge will however be maintained on transfers involving trusts. Provision will be made to charge gifts in relation to which the donor may continue to enjoy a benefit. To reflect its new structure, the tax will be known as the Inheritance Tax.

4.13 Under the new arrangements, the yield from Inheritance Tax on deaths is to be protected by charging gifts within 7 years of death at taper rates. The exempt amount and rate bands of the tax will be increased by 5.7% under the statutory indexation provisions.

Encouragement of Wider Share Ownership

4.14 The Government propose to introduce a new tax scheme, as from 1 January 1987, specifically designed for individuals who invest directly in equities. Shares held in specially designated accounts will be free of any tax on both capital gains and dividend income, provided that such gains and income are reinvested within the account. Investment of up to £2,400 will be permitted each year and the shares will have to be held for a minimum period.

Stamp Duty

4.15 It is proposed that the rate of Stamp Duty should be reduced from 1 per cent to ½ per cent on share transactions. Since it is not proposed to reduce the overall amount of tax paid on financial transactions, the rate cut will be offset by widening the scope of duty to cover the following transactions (currently exempt):

	Rate %
American Depository Receipts (ADRs)	3
Intra-account dealing	½
Takeovers including mergers	½
Loan Stock	½
Renounceable letters	½
Company purchase of own shares	½

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Employee Share Schemes

4.16 To build on the progress already made in recent years, the following measures are proposed to encourage the spread of approved employee share schemes:

- the extension of the present tax relief to shares subject to a restriction requiring disposal when employment ends;

- easier access for employee controlled companies (and worker co-operatives);

- easier conditions on exercise of savings-related share options.

Pension Fund Surpluses

4.17 The Budget proposals tackle two problems relating to occupational pension schemes which have recently caused concern. It has been suggested that a number of pension schemes now have assets greatly exceeding the cost of their projected liabilities. But there is an undesirable degree of uncertainty about the options open to trustees of schemes when seeking to reduce such surpluses. It is proposed to clarify and reform the present rules as follows:

- pension funds assets and liabilities will be valued, for these purposes only on standard assumptions provided by the Government Actuary;

- where such valuation shows an actuarial surplus of assets over liabilities of over 5%, the trustees will be required to reduce it to not more than 5%:

- the reduction can be made by (i) an increase in pension benefits (within existing limits), (ii) a contribution reduction or holiday by either employer or employee or (iii) a refund to the employer; or by any combination of these measures (but no refund will be permitted below 5 per cent);

- where a refund is made, it will be subject to a recovery charge in the employer's hands at a rate of 40%.

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Charitable giving

4.18 Four new types of tax relief are proposed:

- Companies - other than close companies - will for the first time be able to claim tax relief for single gifts to charity. The relief will be on single gifts up to a maximum equal to [2] per cent of the ordinary dividends paid by the company in an accounting period.

- To encourage charitable giving by other companies and individuals, the Government will remove the present annual limit of £10,000 on the amount of charitable giving through deeds of covenant for which an individual taxpayer may claim higher rate relief.

- There will be a new scheme to encourage individuals to make donations to charity through deductions from their wages and salaries. Employees whose employers participate in the scheme will be able to get tax relief on donations of up to £100 a year.

- VAT relief will be available on installation of distress alarms and lifts for the handicapped, most press advertising by charities, medicinal products, video and refrigeration equipment supplied to certain charities, recording equipment used by charities for the blind, and welfare vehicles used by charities to transport the deaf, blind or mentally handicapped.

4.19 Measures are also to be taken to prevent charitable status being abused by a minority of unscrupulous operators who are manipulating, for personal gain, the present rules for charitable relief.

Business taxation

4.20 The final stage in the business tax reforms introduced in 1984 will take effect on 1 April 1986 with the reduction in the main corporation tax rate to 35% and (with a few mainly transitional exceptions) the disappearance of first year and initial capital allowances. It is proposed to complete these reforms by updating the mines and oil wells capital allowances code, and adapting the system of allowances for agricultural buildings. In order to provide a full measure of tax depreciation for agricultural buildings and works with

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a short life, balancing adjustments will be available on their disposal or destruction if the taxpayer chooses.

Capital gains tax

4.21 To maintain its value, the CGT annual exempt amount is to be increased in accordance with the statutory indexation provisions by 5.7% from £5,900 to £6,300 in the case of individuals, and from £2,950 to £3,150 in the case of most trusts.

Oil taxation

4.22 No other changes are being proposed to oil taxation apart from technical changes to remove some anomalies.

Car and car fuel benefits

4.23 The scales which determine the cash equivalents of car and car fuel benefits received by directors and employees earning £8,500 or more are to be changed from 6 April 1987. The present 1300cc and 1800cc engine-size break points are to be aligned, on a revenue-neutral basis, with those - 1400cc-2000cc - for the EC Directive on exhaust emissions. The resulting scale charges for car benefits will be increased by 10 per cent. From April 1987 the same fuel benefit scales will be used both for income tax purposes and to assess the VAT chargeable on fuel used for private journeys in business cars.

Value Added Tax

4.24 From 19 March 1986 the registration limits will become £20,500 per annum and £7,000 per quarter.

Vehicle Excise Duty

4.25 The duty on most cars, light vans, lorries and motor cycles will remain unchanged. The duty rates on buses, coaches, taxis will rise by 5%.

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Table 4.2 Direct effects of changes in taxation measured against an indexed base.

£million

	Estimated effect on receipts in 1986-87 (a)	Estimated effect on receipts in 1987-88 (a)
INLAND REVENUE		
Income tax		
Increase in single allowance of £130 and married allowance of £200	Nil	Nil (b)
Increase in additional personal allowance and widow's bereavement allowance of £70	Nil	Nil (b)
Increase in age allowance of £160 (single) and £250 (married) and income limit of £600	Nil	Nil (b)
Increase in basic rate limit of £1000 to £17,200	Nil	Nil (b)
Increase in further higher rate thresholds	Nil	Nil (b)
Abolition of higher rate relief limit for charitable covenants	Negligible	-5
Relief for charitable donations through payroll deduction schemes	Nil	-20 (d)
Fringe benefits - car and car fuel scales	Nil	+15
Changes to relief for overseas travel expenses	-10	-5 (e)
Changes in taxation of employee share acquisitions	Negligible	Negligible (f)
Use of restricted shares in approved employee share schemes	Negligible	Negligible (g)
Use of shares providing employee control in approved employee share schemes	Negligible	Negligible
Exercise of options granted under approved savings-related share option schemes	Negligible	Negligible
[Co-operatives' use of redeemable shares in approved profit-sharing schemes	Negligible	Negligible]
[Change in basis of assessment of enterprise allowance	Negligible	-5]
Exemption of pensions paid to victims of Nazi persecution	Negligible	Negligible
Relief for dividends paid into recognised clearing systems	Nil	Nil
Extension of disclosure of information to local authorities	Nil	Nil
Income tax and capital gains tax		
Business Expansion Scheme- continuation beyond April 1987 and changes in coverage	Negligible	+10 (h)
Tax relief for equity savings scheme	Negligible	-25 (i)
Income tax and corporation tax		
Mines and oil wells capital allowances	Negligible	+45 (j)
Changes in agricultural buildings allowance rules	Negligible	Negligible (k)
Changes in capital allowance rules for leased assets	Negligible	Negligible
Changes in capital allowance rules for fixtures	Nil	Nil
VAT penalties, interest, surcharges and repayment supplement	Nil	Negligible (l)
[Relief for expenditure on research and development	?	?]
Income tax, corporation tax and capital gains tax		
Charities: anti-avoidance measures	Negligible	+20
Limiting scope of anti-bondwashing provisions	Negligible	Negligible
Amendments to Accrued Income Scheme	Negligible	Negligible

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Income tax, corporation tax, capital gains tax and capital transfer tax		
Changes in relation to securities	Negligible	Negligible
Income tax, corporation tax and recovery charge		
Refunds by occupational pension schemes	+20	+120 (m)
Corporation tax		
Relief for single donations to charity by companies	Negligible	-25 (n)
Loans by close companies	(o)	(o)
Transfer of losses on company reconstruction	Nil	+5 (p)
Definition of associated company for ring fence ACT set-off	Nil	Nil (q)
Corporation tax and capital gains tax		
Options and contracts for gilt-edged securities etc	Nil	Negligible
[Small part disposals of land	Nil	-5
Oil taxation		
Fields in common ownership, shared use of assets	Nil	Nil
[Disposal receipts in exempt gas fields	Negligible	Negligible]
Onshore/offshore boundary line	Negligible	Negligible [(r)]
Alternative gas valuation rules	Nil	Nil
Capital gains tax		
Indexation of annual exempt amount	Nil	Nil (b)
Restriction of holdover relief for dual resident trusts	Nil	+5
Capital transfer tax and inheritance tax		
Abolition of lifetime charge on transfers between individuals	-35	-55 (s)
Indexation of chargeable rate bands	Nil	Nil (b)
Partially exempt estates	Negligible	Negligible
[Extension of exemption for share transfers to employee trusts	Negligible	Negligible]
Stamp duties		
Reduction in rate on shares to 0.5 per cent from Autumn 1986	-70	-75 (t)
Extension of duty to takeovers etc	+20	+20
Withdrawal of exemption for loan stock and purchases of own shares	+20	+20
Duty on conversion to depositary receipts	[+10]	[+10]
Other changes	+20	+35
TOTAL INLAND REVENUE	[-25]	[- 5]

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CUSTOMS AND EXCISE

Value added tax		
Increase in registration limits	Nil	Nil
Revised treatment of motoring expenses	Nil	+40]
New rules on disaggregation of registrations	Negligible	+20
Long term lettings of accommodation	Nil	+10
Reliefs for charities and the handicapped	-10	-10
Excise duties		
No change in rate of spirits duty	-45	-45 (c)
No change in rate of beer duty	-95	-105 (c)
No change in rate of duty on cider and perry	-5	-5 (c)
No changes in rates of wine and made wine duties	-30	-35 (c)
Increases in rates of duty on light oil etc	+110	+120 (c)
Increase in rate of duty on heavy oil for use in road vehicles	+30	+30 (c)
No change in rate of fuel oil duty	-5	-5 (c)
Abolition of duty on lubricating oils	-10	-10 (c)
Abolition of duty on AVTUR	-10	-10 (c)
Increase in rate of duty on gas oil	+25	+25 (c)
Increases in rates of tobacco products duties	+175	+180 (c)
TOTAL CUSTOMS AND EXCISE	+130	+200
Vehicle excise duty		
No change in VED on cars and lorries	-135	-140]
Increased penalties for VED evasion	Neg	+10
Other		
Bus fuel grants	-5	-5
TOTAL CHANGES IN TAXATION	[-35]	[+60]
National Insurance Contributions reduction in rate for earnings below £140 pw	-150	-400
Total changes in taxation in National Insurance contributions	-185	-340

a. Estimates are rounded to the nearest £5million. 'Negligible' means less than £3million. Components may not sum to totals because of rounding. A detailed list of the proposals is contained in Annex [ ] with a description of the method of estimating the direct effects on revenue.

b. Taxes subject to statutory indexation. The table below shows the direct revenue effects of indexing the income tax main allowances and thresholds (which are shown as the first five lines in Table 4.2 above), the capital gains tax exempt amount and the capital transfer tax threshold and bands.
Indexation in 1986-87 is by reference to the increase in the general index of retail prices between December 1984 and December 1985 (5.7per cent), rounded in accordance with the statutory provisions. For 1987-88 further indexation of [3.6]per cent is assumed (in line with the MTFS).

Direct Revenue effects

£million

	Indexation		Effect of proposed Budget 1986 changes compared with indexation		Total	
	1986-87	1987-88	1986-87	1987-88	1986-87	1987-88
Income tax						
Main allowances	-1020	-1995	Nil	Nil	-1020	-1995
Basic rate limit	-70	-205	Nil	Nil	-70	-205
Further higher rate thresholds	-50	-100	Nil	Nil	-50	-100
Total income tax	-1140	-2300	Nil	Nil	-1140	-2300
Capital gains tax						
Exempt amount	Nil	-5	Nil	Nil	Nil	-5
Capital transfer tax						
Thresholds and bands	-20	-60	Nil	Nil	-20	-60

c. The table below shows the direct revenue effects of indexing the excise duties by reference to the increase in the general index of retail prices between December 1984 and December 1985 (5.7 per cent) and the forecast increase between December 1985 and December 1986 ([3.6]per cent).

Direct Revenue effects

£million

	Indexation		Effect of proposed Budget 1986 changes compared with indexation		Total	
	1986-87	1987-88	1986-87	1987-88	1986-87	1987-88
Commodity						
Beer, cider and perry	+100	+170	-100	-110	Nil	+60
Wine	+30	+55	-30	-35	Nil	+20
Spirits	+45	+75	-45	-45	Nil	+30
Tobacco	+140	+255	+175	+180	+315	+435
Petrol	+270	+470	+110	+120	+380	+590
Derv	+65	+120	+30	+30	+95	+150
VED	+140	+230	-135	-140	+5	+90
Minor duties	+10	+20	Nil	Nil	+10	+20
Bus fuel grants	-5	-10	-5	-5	-10	-15
Total	+795	+1385	Nil	-5	+795	+1380

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d. This estimate is highly uncertain and depends on take-up.

e. The higher first year cost arises from the proposal to apply these improvements with effect from 6 April 1984.

f. Full year yield at 1986-87 income levels, £5million. This estimate is highly uncertain.

g. Full year cost at 1986-87 income levels, £10million. This estimate is highly uncertain.

h. The scheme has a full year cost at current levels of investment of about £100million. The 1987-88 figure includes a small first year cost for continuing the scheme after April 1987.

i. The cost will build up over a period and will depend on take-up. This estimate is highly uncertain.

j. The cost will decline gradually in later years.

k. Cost will not exceed £5million in early 1990's. Long term cost not exceeding £20million.

l. The yield will build up over time to about [£40million] by 1991-92.

m. The figure for 1987-88 includes a yield of £[70]million in corporation tax and income tax reflecting changed levels of contributions to or benefits paid from pension funds. [The overall yield including recovery charge may be about £[250]million in each of the following three years. These estimates are highly uncertain.

n. Rising to about £70million, depending on take-up.

o. Without this measure the anomaly in the treatment of loans to participators in close companies could have led to widespread avoidance, costing tens of £million.

p. Rising to an eventual yield of about £50million a year.

q. Without this measure it might be possible to breach the ring fence which could result in a loss of tax.

[r. These figures cannot be directly compared with those of the yield from the removal of immediate PRT exploration and appraisal relief for onshore fields given in the 1985-86 FSBR. In the light of revised forecasts of exploration and appraisal expenditure, the yield from withdrawing this relief from areas within the UK coastline is now estimated to be [£ million] in a full year.]

s. The estimated eventual effect attributable to transfers in 1986-87 is £70million. If increased lifetime giving reduces the amounts in the death estates of donors, the CTT yield from those death estates will be reduced. But the effects are long-term and uncertain.

t. Duty on additional transactions expected to follow from the reduction in the rate is taken into account. The estimate is subject to a wide margin of error. The figure for 1987-88 takes account of a yield of £35million capital gains tax arising on the additional transactions.

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5. PUBLIC EXPENDITURE

The Government's strategy

5.01 The Government's expenditure plans are drawn up within the framework of the Green Paper, The Next Ten Years (Cmnd 9189) published in 1984, and the medium term financial strategy (MTFS). Spending must be contained within the available financial resources, and directed to where it will achieve the best value for money.

5.02 The 1985 Public Expenditure Survey took as its starting point the 1985 MTFS published a year ago. The Survey was successfully completed within that framework. The broad results were set out in the the 1985 Autumn Statement and full details were given in the 1986 public expenditure White Paper (Cmnd 9702) published on 15 January. This described the public spending plans for the period up to 1988-89.

Public expenditure planning total and general government expenditure

5.03 The public expenditure planning total is the measure on which Government spending controls are based. General government expenditure covers spending by central government and local authorities. It is the definition of government spending used in the national accounts and forecasts and the MTFS.

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5.04 The main difference between general government expenditure and the planning total is general government gross debt interest, amounting to some £18.5 billion in 1986-87. There are also a number of other definitional differences and adjustments which are described in Part 7 of Cmnd 9702 (paragraph 42). In 1986-87, these adjustments are expected to add a further £[6] billion to the planning total.

Public spending trends

5.05 Chart 5.2 shows the path of the planning total in cash and in real terms ie after adjusting for the rate of inflation as measured by the GDP deflator. It also shows general government expenditure as a percentage of GDP. (The updated GDP deflator assumptions and money GDP figures are given in part 2).

5.06 The latest estimates suggest that the planning total outturn in 1985-86 is likely to be £[ ] below the figure set at the time of the 1985 Budget. [Comment on latest view including teachers' pay.] In real terms spending in 1985-86 should be below the level of 1984-85 even after allowing for the effects of the miners' strike, the first time since 1977-78 that the upward trend in public expenditure has been halted. For the three following years the expenditure plans in cash terms are as set out in Cmnd 9702. In real terms the planning total is expected to fall slightly in 1986-87, and then to remain broadly constant over the period to 1988-89.

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Table 5.1 The public expenditure planning total and general government expenditure

£ billion

	1984-85	1985-86	1986-87	1987-88	1988-89
Department					
DHSS - Social security	38.1	41.2	42.9	44.4	45.9
Defence	17.2	18.2	18.5	18.8	19.0
DHSS - Health and personal social services	15.8	16.7	17.7	18.5	19.1
Scotland, Wales and Northern Ireland	13.7	14.4	15.0	15.0	15.2
Education and science	14.0	14.5	14.3	14.4	14.5
Other	33.0	32.0	31.2	31.3	31.7
Central privatisation proceeds	-2.1	-2.6	-4.8	-4.8	-4.8
Reserve			4.5	6.3	8.0
Adjustments(1)		-0.2	-0.4		
Public expenditure planning total(2)	**129.6**	**134.2**	**139.1**	**143.9**	**148.7**
General government gross debt interest	16.1	18.0	18.5	18.5	19.0
Other adjustments	4.3	6.2	6.2	6.4	6.8
General government expenditure	**150.0**	**158.2**	**163.6**	**168.9**	**174.7**
Planning total in real terms (base year 1984-85)	**129.6**	**127.8**	**126.7**	**126.7**	**127.1**
General government expenditure as percentage of GDP	**45½**	**44½**	**43**	**41½**	**41**

(1)[Estimated outturn in 1985-86 includes a general allowance for shortfall and] the 1986-87 planned figure includes external finance of -£400m for nationalised industries to be privatised in that year.

(2)The Treasury's latest estimate of outturn.

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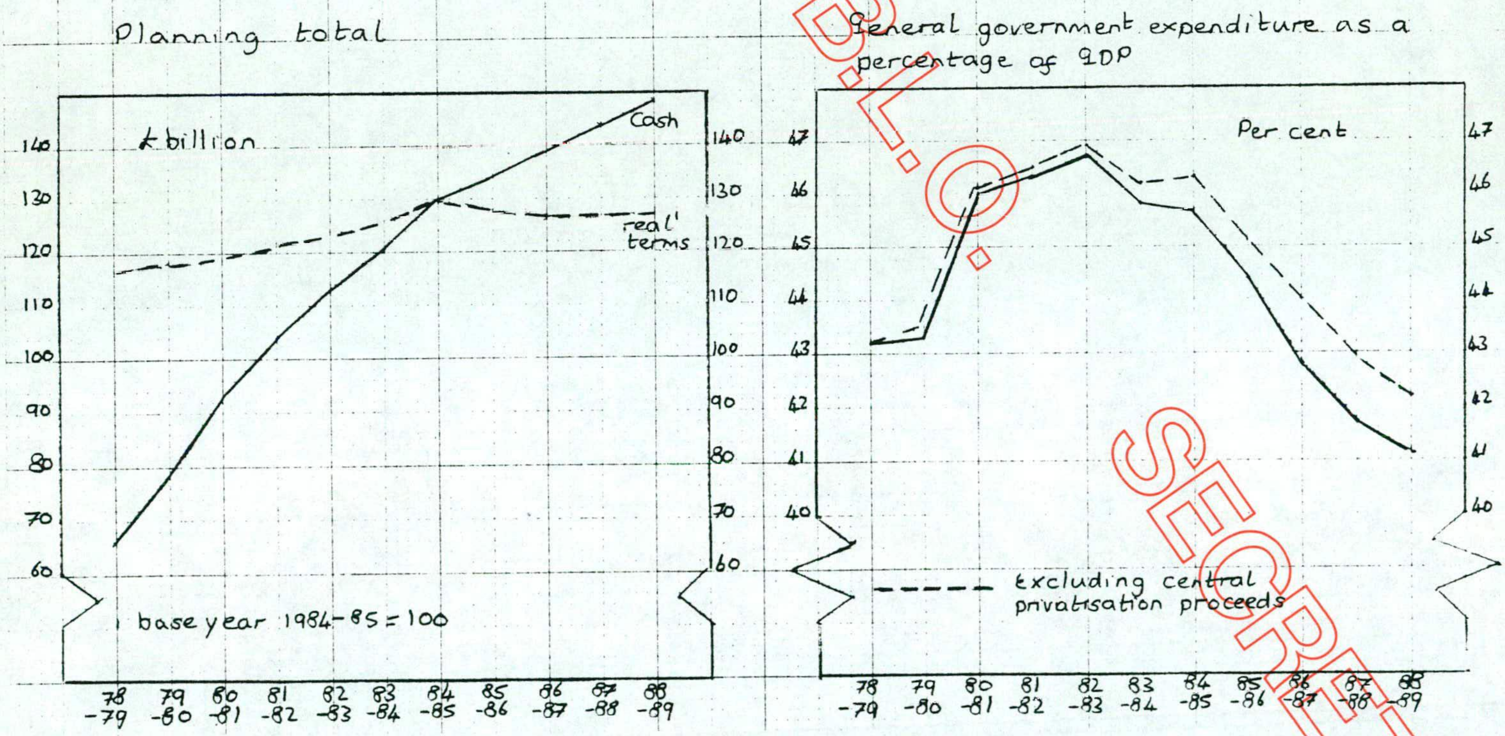
5.07 General government expenditure as a percentage of GDP is projected to continue the downward trend established since 1982-83, with a substantial further fall over the next three years. By 1988-89 the percentage is expected to be the lowest since 1972-73. These trends remain valid however one treats privatisation proceeds. This will free an increasing share of the nation's resources to the private sector, and provide the basis for further reductions in the tax burden.

Charts 5.1 Trends in Public expenditure 1978-79 to 1988-89



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Enterprise and employment measures

5.08 Included in the announcements in the Budget speech was provision for further enterprise and employment measures. The gross cost of these measures will be £205m in 1986-87 and £350m in 1987-88. The net public expenditure cost after allowing for reduced expenditure on unemployment and supplementary benefit will be £110m in 1986-87 and £206m in 1987-88 as shown in Table 1.1. The net cost to public expenditure of these measures will be charged against the Reserves provided in Cmnd 9702, and thereby met within unchanged planning totals. Summer Supplementary Estimates will be presented to Parliament in due course for the extra resources required by the Department of Employment and the Manpower Services Commission in 1986-87.

5.09 Two pilot schemes to help the long term unemployed were introduced in January 1986. The aim of the counselling scheme has been to help the long term unemployed through an in-depth interview. Interviewees may for instance be submitted for jobs, offered places on employment or training schemes or in a Jobclub, offered a specially designed Restart training course, as appropriate. The Job Start scheme provides an allowance of £20 per week to long term unemployed people who take a full-time job earning less than £80 per week. The schemes will be extended nationwide as soon as possible. [An intensive programme of counselling, offering interviews to a significant proportion of the long term unemployed, will be carried out in 1986-87.] The costs of this extension will be

£110 million in 1986-87 [and £95 million in 1987-88.]

5.10 The number of places on the Community Programme, which is targetted at long term unemployed adults, is being increased to 250,000 from the existing level of nearly 200,000 places. The cost of this will be £ million in 1986-87 and £ million in 1987-88. The programme offers jobs to the long term unemployed for up to a year on projects of benefit to the community. When the expansion is complete, the scheme will be helping over 330,000 of the long term unemployed every year.

5.11 The Enterprise Allowance Scheme is to be expanded to allow for 130,000 entrants a year [by 1987], as against 80,000 previously provided for. This scheme is intended to encourage enterprise and self-employment amongst those previously unemployed. Another scheme to help small business and enterprise is the loan guarantee scheme, under which the Government guarantees 70 per cent of qualifying loans to small businesses with effect from [ ]. The rules of the scheme will be revised, with the premium reduced from 5 per cent to 3 per cent, and a ceiling on the portfolio of loans covered of £90m in 1986-87 and £130m in the two subsequent years. These two measures together will cost about £20 million in 198687 and £100 million in 1987-88.

5.12 A new scheme has been announced to help 18-20 year olds to find jobs. This scheme, the New Workers Scheme, will provide for an allowance of £15 per week for employers taking on 18 or 19 year olds on earnings

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of £55 per week or less and 20 year olds on earnings of £65 per week or less. The cost of this scheme, [along with other minor changes to Department of Employment programmes [including any offsetting savings]] is expected to be £25 million in 1986-87 and £50 million in 1987-88.

Supply Estimates

5.13 For 1986-87, plans have now been translated into detailed spending control totals. The Supply Estimates set out the sums that the Government asks Parliament to vote for most expenditure by Government departments and certain other bodies. The main Estimates for 1986-87, are published on 18 March 1986 with a Summary and Guide (Cmnd 9742) which summarises the Estimates and explains how they relate to the public expenditure planning total. Of the £99 billion included in the Supply Estimates, £74.6 billion is direct public expenditure in line with the plans published in Cmnd 9702 for public expenditure to be voted in Estimates. Nearly [60] 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.

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Table 5.1 Supply expenditure

£ billion

	1984-85 Expected outturn in 1985 Budget	1984-85 Final outturn	1985-86 Expected outturn	1986-87 Provision
Main Supply Estimates	90.4[1]	90.4[1]	96.0	98.9
Supplementaries and net underspending	3.4	3.2	2.2	
TOTAL SUPPLY EXPENDITURE	93.8	93.6	98.2	
(public expenditure element)	(70.6)	(70.6)	(75.0)	

[1] Adjusted for abolition of NIS.

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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 1986-87, together with new estimates of outturn in 1985-86. It also provides a commentary on the main features of the public sector's finances in those two years, including the most important changes which have taken place since last year's projections.

Public sector's finances: three-fold analysis

6.02 The public sector's finances may be analysed in a number of different ways:

- on a functional basis, showing on the one hand the receipts (North Sea revenues, other company taxes, income taxes, expenditure taxes, and so on); and on the other the spending (on social security, health, defence, education and so on), financed by those receipts and by borrowing;

- by sector, ie by the authority which undertakes the financing or spending: central government, local authorities or public corporations;

- by economic category: capital and current, grants and spending on goods and services, and so on.

6.03 This threefold analysis of the public sector's finances is analogous to the threefold presentation of public spending which has become an established feature of Part I of the Public Expenditure White Paper: see paragraphs 14 and 15 of Cmnd 9702-I. The rest of this Chapter sets out these three analyses in detail.

Analysis by function

6.04 Table 6.1 and Chart 6.8 at the end of this chapter gives a functional analysis of the public sector's finances. Table 6.1 itemises the main receipts of "general government" (ie central plus local government), grouping them according to the type of activity which gives rise to them. It also sets out the various kinds of general government spending, by department, as in Chapter 5 and in the

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Pubic Expenditure White Paper. Finally, it shows how its bottom line, the public sector borrowing requirement, is derived from those two totals.

6.05 Thus, for 1986-87, general government receipts are forecast to be £[157] billion; general government expenditure is put at £[163½] billion; and, after taking account of public corporations' expected repayments of £[½] billion of borrowing from the market and overseas, the forecast public sector borrowing requirement comes out at £[6½] billion.

[Insert table 6.1 attached]

Receipts

6.06 Expected general government receipts have changed little overall in 1985-86 since the 1985 Budget forecast, being still some £[150] billion. However, within the total there have been substantial changes, lower oil revenues [being broadly offset by] an increase in other revenues. There are similarly large changes in 1986-87.

6.07 Oil revenues in 1985-86 are expected to be some £1½ billion lower than in the 1985 Budget forecast, at £11¾ billion. The reduction, which is much as forecast in the Autumn Statement, is mainly because the $/£ exchange rate has turned out higher than assumed in the 1985 Budget. (The sharp drop in the $ oil price since December has had little effect on revenues in 1985-86, because of the lags in payments.)

6.08 In 1986-87 oil revenues are now forecast at around £[6] billion, compared with £11½ billion projected in the 1985 FSBR, because of the lower $ oil price (and higher $/£ exchange rate) than earlier assumed. The forecast depends heavily on the future course of oil prices: the price of North Sea crude is assumed to be $[15] per barrel for the rest of 1986. (If prices were $1 per barrel lower on average in 1986, but other things - including the exchange rate - were unchanged, North Sea revenues would be around £½ billion lower in 1986-87.) The forecast also depends on the exchange rate: the $/£ exchange rate is assumed not to change very much.

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Table 6.1 The public sector's finances analysed by function

£ billion

	1985-86 1985 Budget	1985-86 Latest estimate	1986-87 Forecast
Receipts			
Corporation tax excl. North Sea(1)	8.2	8.4	9.6
Other taxes on income	35.2	35.1	39.3
Taxes on capital	1.9	2.4	2.7
Expenditure taxes:			
Value added tax	18.3	19.3	20.7
Local authorities rates	13.6	13.7	15.8
Petrol, derv etc. duties	6.5	6.5	7.3
Cigarettes and tobacco	4.3	4.3	4.8
Spirits, beer, wine, etc.	4.2	4.2	4.4
Other	8.6	8.6	8.9
Total expenditure taxes	55.5	56.5	62.0
North Sea revenues:			
North Sea corporation tax	2.8	3.0	2.6
Petroleum revenue tax	8.2	6.6	2.5
Oil royalties	2.5	2.1	1.0
Total North Sea	13.5	11.8	6.1
Other(2)	-0.8	-0.8	-0.7
Total taxes and royalties	**113.5**	**113.4**	**119.0**
National Insurance and other contributions	24.6	24.3	25.9
Interest and dividend receipts	6.4	6.6	6.4
Other			
Gross trading surpluses and rent	3.1	2.8	2.7
Miscellaneous	2.1	3.1	2.9
Accruals adjustments	0.2	-0.4	-0.1
General government receipts	**150.1**	**149.8**	**156.9**

	1985-86 1985 Budget	1985-86 Latest estimate	1986-87 Forecast
Expenditure			
DHSS - Social security	40.1	41.2	42.9
Defence	18.1	18.2	18.5
DHSS - Health and personal social services	16.5	16.7	17.7
Scotland, Wales and Northern Ireland	13.9	14.4	15.0
Education and science	13.6	14.5	14.3
Other	29.4	31.1	31.5
Central privatisation proceeds	-2.5	-2.6	-4.8
Reserve	5.0	-	4.5
Adjustments	0.1	-0.2	-0.4
Public expenditure planning total	**134.2**	**133.4**	**139.3**
General government debt interest	18.0	17.7	18.2
less public corporations' net market and overseas borrowing	-2.3	-1.3	-0.6
Other national accounts adjustments	5.0	5.1	5.6
General government expenditure	**159.5**	**157.5**	**163.8**
Difference between expenditure and revenue financed by borrowing:-			
General government expenditure	159.5	157.5	163.8
General government receipts	150.1	149.8	156.9
General government borrowing requirement	9.4	7.7	6.9
Public corporations market and overseas borrowing	-2.3	-1.3	-0.6
Public sector borrowing requirement	**7.1**	**6.3**	**6.3**

(1) Excluding corporation tax on capital gains

(2) Adjustments for advanced corporation tax set off against North Sea corporation tax plus accruals adjustments

Centre

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6.09 The forecast drop in oil revenues between 1985-86 and 1986-87 results mainly from the drop in the $ oil price, but partly from the higher $/£ exchange rate.

6.10 Other revenues however are proving more buoyant than earlier expected. In particular, VAT receipts are expected to be some £[1] billion higher in 1985-86 than forecast in the 1985 Budget, mainly reflecting some increase in the proportion of consumers' spending on goods subject to VAT. Receipts of capital taxes are likely to be some £[½] billion higher, because of a greater number of estates subject to capital transfer tax, and higher capital gains tax receipts.

6.11 Between 1985-86 and 1986-87, non-oil revenues are forecast to rise by [10]%. This is faster than the [9½]% rise in non-oil incomes, because of three main factors:

- onshore company tax receipts are expected to rise by [14]% between the two years, reflecting the estimated rise of around 18% in onshore company incomes between 1984 and 1985;

- income tax receipts are forecast to rise by [12]%, reflecting mainly the expected real growth in earnings;

- expenditure tax receipts are forecast to rise by [9½]%, partly because of continuing growth in consumers' expenditure and the sharp rises in rates expected from many local authorities.

Expenditure

6.12 Total general government expenditure is now expected to be around £[157½] billion in 1985-86, some £[2] billion lower than forecast in the 1985 Budget, for two main reasons.

6.13 First, as explained in Chapter 5, the planning total outturn is now expected to be £[½] billion below the figure set in the 1985 FSBR. The delay in ratification of the teachers' pay settlement for 1985 reduces local authorities' cash spending in the current year by around £400 million.

6.14 Secondly, within the planning total the nationalised industries have been borrowing less from central government and hence repaying less (net) to the market than forecast in the 1985 Budget. Therefore general government expenditure, which excludes their borrowing from the market and overseas, is less than forecast a year ago.

6.15 General government gross debt interest payments in 1985-86 are expected to total about £[17¾] billion, [close to the] forecast in the 1985 Budget. The rise in interest rates two months ago will have had little effect in 1985-86.

6.16 In 1986-87, general government expenditure is forecast at £[163½] billion, [a little lower than] indicated in the 1985 FSBR. The planning total remains the same, as £139 billion; but within it (as in 1985-86) the forecast of nationalised industries' net repayments to the market [is a little lower]. Debt interest payments are forecast at about £[18] billion, [as] in the 1985 FSBR. The rise in interest payments between 1985-86 and 1986-87 is due to the net increase in debt, partially offset by an assumed decline in interest rates from present levels and by lower inflation affecting index-linked instruments.

Borrowing

6.17 The difference between general government receipts and expenditure gives the general government borrowing requirement, as shown in Table 6.1. Together with public corporations' market and overseas borrowing, that gives the public sector borrowing requirement (PSBR).

6.18 The PSBR, shown at the bottom of Table 6.1, is forecast to be around £[6¼] billion in 1985-86, or [1¾]% of GDP, compared with £7.1 billion (2% of GDP) in the 1985 Budget forecast. [Net revenues are broadly unchanged,] as discussed above, and the reduction in the PSBR results mainly from the expectation that the planning total outturn will be below plans.

6.19 However, borrowing in March is always high and unpredictable, with high expenditure and in some cases low income (eg the local authorities, which have low rate incomes in that month). On past

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experience there is still a likely margin of error of at least £1 billion either way in the present estimate of the PSBR in 1985-86.

6.20 In 1986-87 the PSBR is forecast at £[6¼] billion, or [1½]% of GDP. However, the flows of receipts and expenditure are very large: indeed, including the revenues and expenditure of the public corporations, the PSBR represents the difference between flows of around £200 billion on each side. A small error in forecasting either flow will result in a large error in the PSBR forecast. Hence the average margin of error in the forecast of the PSBR in 1986-87 is very large, at around £[5] billion either way.

Earlier years

6.21 The changes between 1985-86 and 1986-87 imply that general government receipts and expenditure are both expected to fall relative to money GDP: from [ ]% to [ ]% in the case of expenditure. Next year will be the second successive year in which receipts have fallen sharply in relation to GDP, and the fourth successive year in which expenditure has done so (allowing for the coal strike). The upward trend in the tax burden and public expenditure until the early 1980s has now been clearly reversed (Chart [2.5]).

6.22 There have also been changes in the structure of receipts and expenditure. Comparing 19878-89 with the forecast for 1986-87, Chart [6.8] shows the following main developments:

- borrowing has become a much less important means of financing expenditure, its share falling from 12% in 1978-79 to 5% in 1986-87

- North Sea revenues have grown, but in 1986-87 they are expected to finance only [4%] of expenditure compared with 8% at their peak in 1984-85

- there has been a switch away from direct to indirect taxation; expenditure taxes, including rates, financed 31% of expenditure in 1978-79 but are expected to finance 38% in 1986-87

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- the contribution of income tax has fallen from 26% to 24%

- some expenditure programmes, notably defence, health and personal social services, and social security, have increased their shares of total expenditure, while the shares taken by housing, trade and industry, and contributions to the European Community have fallen.

Analysis by sector

6.23 The bottom line of Table 6.1 - the public sector borrowing requirement - may also be analysed by the authority or sector which will be undertaking (or, as the case may be, repaying) the borrowing: central government, local authorities and public corporations.

6.24 This analysis is shown in summary form in Table 6.2 (and in chart 6.9 at the end of the Chapter). It is also shown in the tables for each of the three sectors (Tables 6.3, 6.4 and 6.5): these tables include some of the analysis by economic category discussed further below.

Table 6.2 **Public Sector Borrowing Requirement, analysed by sector**

£ billion

	1985-86 Latest estimate	1986-87 Forecast
Central government on own account[*]	4.6	5.3
Local authorities	1.9	1.8
Public corporations	-0.2	-0.8
Public sector borrowing requirement	**6.3**	**6.3**

[*]Central government borrowing less on-lending to local authorities and public corporations.

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Central government finances

6.25 The receipts and expenditure which lead to the central government borrowing requirements shown above are:-

Table 6.3 Central Government borrowing requirement

£ billion

	1985-86 Latest estimate	1986-87 Forecast
Receipts		
Taxes and royalties	99.7	103.2
National Insurance and other contributions	24.3	25.9
Other	9.9	10.1
Total	**133.9**	**139.2**
Expenditure		
Current expenditure on goods and services	46.4	49.6
Current grants and subsidies	71.5	75.7
Interest	16.1	17.0
Net lending and capital expenditure, excluding on-lending to local authorities and public corporations	4.5	2.3
Total	**138.5**	**144.6**
Central Government Borrowing Requirement on own account	**4.6**	**5.3**
On-lending to local authorities and public corporations	5.6	3.8
Central government borrowing requirement	**10.2**	**9.1**

6.26 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 also shows central government onlending to local authorities and public corporations, giving the whole CGBR, but the forecasts of onlending are particularly uncertain (since the local authorities and public corporations may instead choose to borrow more from, or repay less to, the market and overseas).

Local authority finances

6.27 The receipts and expenditure which lead to the local authority borrowing requirements shown in Table 6.2 overleaf:-

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Table 6.4 Local authority borrowing requirement

£ billion

	1985-86 Latest estimate	1986-87 Forecast
Receipts		
Rates (net of rate rebates)(*)	13.7	15.8
Rate support grant	11.2	11.8
Other grants from central government	9.7	10.5
Other	5.0	5.0
Total	**39.6**	**43.1**
Expenditure		
Current expenditure on goods and services	28.0	30.7
Current grants and subsidies	5.2	5.7
Interest	4.3	4.5
Net lending and capital expenditure	3.9	4.1
Total	**41.5**	**44.9**
Local Authority Borrowing Requirement	**1.9**	**1.8**
of which:		
Borrowing from central government	4.4	4.0
Other borrowing	-2.5	-2.2
(*) Memo: Rate rebates	1.7	1.7

6.28 Local authority receipts consist primarily of rate income plus grant from central government. The increase forecast in net rate income between 1985-86 and 1986-87 is based on recent information about rate decisions by individual local authorities. The main change in local authority expenditure since the Public Expenditure White Paper is the delay in ratification of the teachers' pay settlement, referred to above.

6.29 The latest estimate of local authority borrowing in 1985-86 takes account of the Borrowing Intentions Survey of a sample of authorities. However, borrowing in the last month of the financial year is always very high and the margin of error is correspondingly great. The forecast of borrowing in 1986-87 is still more uncertain, as is the source of their borrowing: in 1985-86 they are expected to have borrowed [much more] from central government than forecast in the 1985 Budget, and to have repaid correspondingly more to the market, but in 1984-85 it was the other way round.

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Public corporations' finances

6.30 The receipts and expenditure which lead to the public corporations' borrowing requirements shown in Table 6.2 are:-

Table 6.5 **Public Corporations' borrowing requirement**

£ billion

	1985-86 Latest estimate	1986-87 Forecast
Receipts		
Gross trading surplus (including subsidies)	7.4	7.7
Other	3.2	2.7
Total	**10.6**	**10.4**
Expenditure		
Interest, dividends and taxes on income	4.1	3.6
Net lending and capital expenditure	6.4	6.0
Total	**10.5**	**9.6**
Public Corporations' Borrowing Requirement	**-0.2**	**-0.8**
of which:		
Borrowing from central government	1.2	-0.2
Other borrowing	-1.3	-0.6

6.31 The main public corporations are the nationalised industries. Their receipts include subsidies from central government. Their net external finance, ie their borrowing plus those subsidies, is included in the planning total. The effects of the coal strike have continued in 1985-86, adding about £1 billion to the industries' financing needs, eg for coal stock rebuilding by the Electricity Supply Industry.

Analysis by economic category

6.32 The bottom line of Table 6.1 - the public sector borrowing requirement - may also be analysed by economic category (some details of which are given in Tables 6.3-6.5 above). This analysis is shown below, first in summary form (Table 6.6 - see also chart 6.9), giving prominence to the distinction between current and capital expenditure and receipts, and to the current surplus. Table 6.6 also shows how gross capital spending is financed in terms of the current surplus, asset sales and borrowing.

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6.33 The analysis by economic category is shown more fully in Table 6.7, with a breakdown by borrowing authority or sector, and giving the derivation of the financial deficit. Table 6.7 is in the format which has become familiar in successive versions of the FSBR.

[Insert Table 6.6 attached.]

[Insert Table 6.7 attached.]

Outturn data

6.34 Outturns for the PSBR 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 issues of Financial Statistics. Outturns for the details of the PSBR on national accounts definitions, as in Table 6.7, are compiled quarterly and published in sections 2 to 5 of Financial Statistics three months after the end of the quarter.

6.35 The first outturn for the PSBR in 1985-86 will accordingly be published on April 16. The first national accounts outturns for 1985-86 will appear in the June issue of Financial Statistics, including Supplementary Table 13 which is based on Table 6.7.

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Table 6.6 **Public Sector current and capital transactions**

£ billion

	1985-86 Latest estimate	1986-87 Forecast
Current expenditure		
Current expenditure on goods and services	68.8	74.6
Current grants and subsidies	56.5	59.9
Debt interest	18.2	18.6
Total current expenditure	143.5	153.2
Capital expenditure		
Gross domestic fixed capital formation	20.1	19.9
Increase in stocks	0.7	0.4
Capital grants (net)	2.8	2.7
Total capital expenditure	23.6	23.1

	1985-86 Latest estimate	1986-87 Forecast
Current receipts		
Taxes and royalties	113.2	118.9
National Insurance contributions	24.3	25.9
Trading surpluses, rent, interest etc.	18.1	18.4
Total current receipts	155.5	163.2
Current surplus	**12.0**	**10.1**
Capital expenditure financed by:		
Current surplus	12.0	10.1
Central privatisation proceeds	2.6	4.8
Council house and other net sales	2.0	1.8
Other financial transactions (net)	0.6	0.1
Borrowing requirement	**6.3**	**6.3**
Total capital expenditure	23.6	23.1

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Table 6.7 The Public Sector's Finances Analysed by Sector and Economic Category

£ billion[1]

1985-86 Latest estimate

	Line[2]	General government: Central government	Local authorities	Total	Public corporations	Public sector
Current and capital receipts						
Taxes on income	1	52.3	-	52.3	-0.3	52.1
Taxes on expenditure	2	43.0	13.7	56.7	-	56.7
Taxes on capital	3	2.4	-	2.4	-	2.4
North Sea oil royalties	4	2.0	-	2.0	-	2.0
National Insurance and other contributions	5	24.3	-	24.3	-	24.3
Gross trading surplus	6	-0.3	0.3	-0.1	7.4	7.4
Rent and miscellaneous current transfers	7	0.3	2.8	3.1	0.5	3.6
Interest and dividends from private sector and abroad	8	3.0	0.6	3.6	1.1	4.8
Interest and dividends within public sector	9	5.5	-2.6	2.9	-2.9	-
Imputed charge for non-trading capital consumption	10	0.9	1.4	2.3	-	2.3
Capital transfers from private sector	11	-	-	-	0.2	0.2
Total	**12**	**133.4**	**16.2**	**149.6**	**6.1**	**155.8**
Current and capital expenditure						
Current expenditure on goods and services	13	-46.4	-28.0	-74.4	-	-74.4
Subsidies	14	-5.6	-1.2	-6.8	-	-6.8
Current grants to personal sector	15	-43.1	-4.1	-47.1	-	-47.1
Current grants paid abroad	16	-2.6	-	-2.6	-	-2.6
Current grants within public sector	17	-20.2	20.2	-	-	-
Debt interest	18	-16.1	-1.5	-17.7	-0.6	-18.2
Gross domestic fixed capital formation	19	-3.1	-3.4	-6.5	-6.0	-12.5
Increase in stocks	20	-0.6	-	-0.6	-0.1	-0.7
Capital grants to private sector	21	-2.2	-0.7	-2.9	-0.1	-3.0
Capital grants within public sector	22	-1.2	0.7	-0.6	0.6	-
Total	**23**	**-141.1**	**-18.0**	**-159.1**	**-6.2**	**-165.3**
Financial surplus/deficit	**24**	**-7.6**	**-1.8**	**-9.5**	**-0.1**	**-9.6**
Financial transactions						
Net lending to private sector and abroad	25	-0.1	0.2	0.1	-0.1	-
Cash expenditure on company securities (net) (including central privatisation proceeds)	26	2.7	-	2.7	-	2.7
Transactions concerning certain public sector pension schemes	27	0.5	-	0.5	-	0.5
Accruals adjustments	28	-0.4	0.1	-0.4	0.4	0.1
Miscellaneous financial transactions	29	0.4	-0.4	0.1	-	0.1
Borrowing requirement	**30**	**4.6**	**1.9**	**6.5**	**-0.2**	**6.3**

(1) Sign convention : receipts positive, payments negative.
(2) Relationship between lines : (24) = (12) + (23) = - {(25) to (30)}

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Table 6.7 continued

£ billion[1]

	Line[2]	1986-87 Forecast: General government: Central government	Local authorities	Total	Public corporations	Public sector
Current and capital receipts						
Taxes on income	*1*	53.1	-	53.1	-0.2	52.9
Taxes on expenditure	*2*	46.3	15.8	62.2	-	62.2
Taxes on capital	*3*	2.7	-	2.7	-	2.7
North Sea oil royalties	*4*	1.0	-	1.0	-	1.0
National Insurance and other contributions	*5*	25.9	-	25.9	-	25.9
Gross trading surplus	*6*	-0.6	0.3	-0.3	7.7	7.4
Rent and miscellaneous current transfers	*7*	0.3	2.9	3.3	0.5	3.8
Interest and dividends from private sector and abroad	*8*	3.2	0.6	3.8	1.0	4.8
Interest and dividends within public sector	*9*	5.7	-3.1	2.6	-2.6	-
Imputed charge for non-trading capital consumption	*10*	1.0	1.4	2.4	-	2.4
Capital transfers from private sector	*11*	-	-	-	0.2	0.2
Total	*12*	**138.7**	**18.0**	**156.8**	**6.7**	**163.5**
Current and capital expenditure						
Current expenditure on goods and services	*13*	-49.6	-30.7	-80.3	-	-80.3
Subsidies	*14*	-5.9	-1.2	-7.0	-	-7.0
Current grants to personal sector	*15*	-45.8	-4.5	-50.3	-	-50.3
Current grants paid abroad	*16*	-2.5	-	-2.5	-	-2.5
Current grants within public sector	*17*	-21.5	21.5	-	-	-
Debt interest	*18*	-17.0	-1.2	-18.2	-0.5	-18.6
Gross domestic fixed capital formation	*19*	-3.3	-3.6	-6.9	-5.6	-12.5
Increase in stocks	*20*	-0.2	-	-0.2	-0.2	-0.4
Capital grants to private sector	*21*	-2.1	-0.7	-2.8	-0.1	-2.9
Capital grants within public sector	*22*	-1.4	0.8	-0.6	0.6	-
Total	*23*	**-149.2**	**-19.7**	**-168.8**	**-5.8**	**-174.7**
Financial surplus/deficit	*24*	**-10.5**	**-1.6**	**-12.1**	**0.9**	**-11.2**
Financial transactions						
Net lending to private sector and abroad	*25*	-0.2	0.3	-	-0.1	-0.1
Cash expenditure on company securities (net) (including central privatisation proceeds)	*26*	4.8	-	4.8	-	4.8
Transactions concerning certain public sector pension schemes	*27*	0.6	-	0.6	-	0.6
Accruals adjustments	*28*	-0.2	-	-0.1	-	-0.1
Miscellaneous financial transactions	*29*	0.1	-0.5	-0.4	-	-0.4
Borrowing requirement	*30*	**5.3**	**1.8**	**7.1**	**-0.8**	**6.3**

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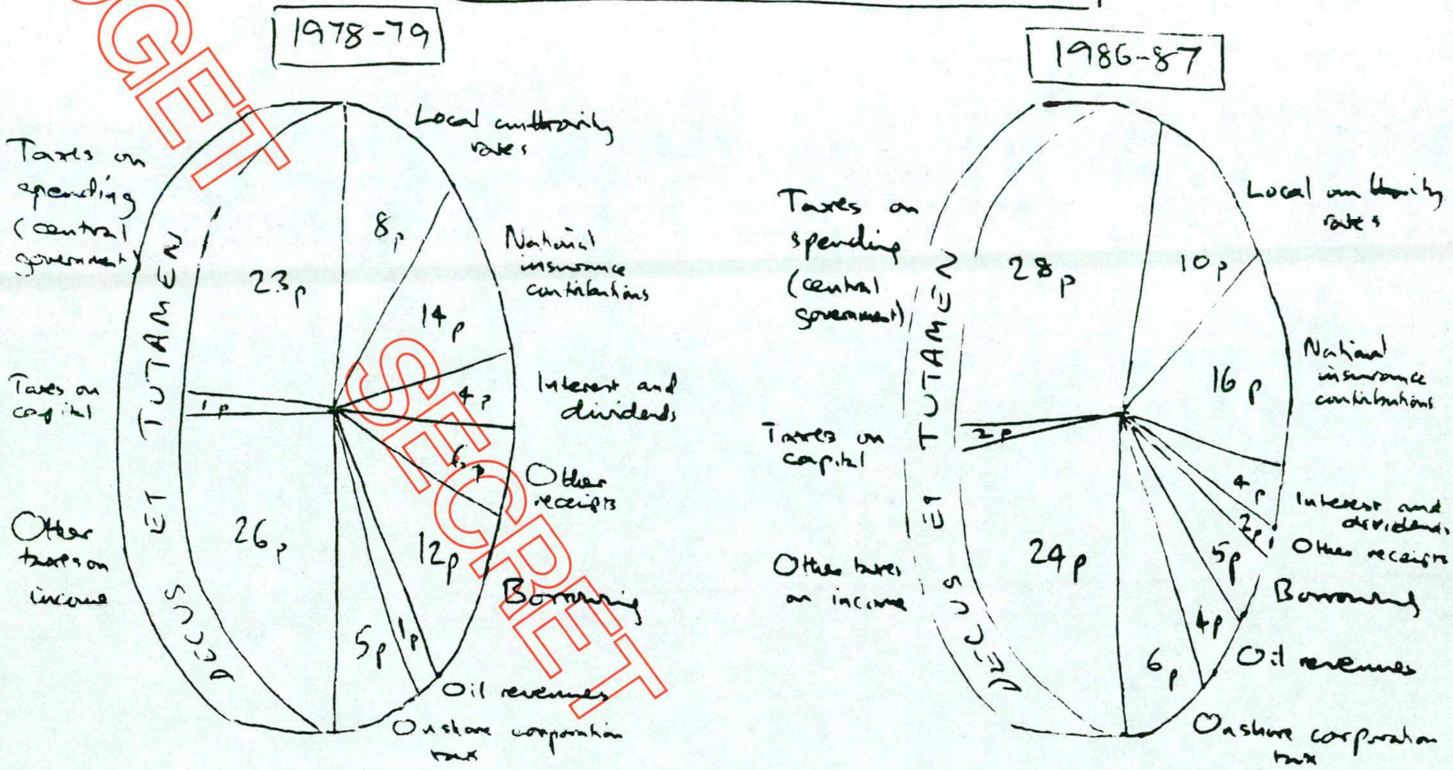
Chart 6.8

THE BUDGET POUND

WHERE IT COMES FROM



WHERE IT IS SPENT

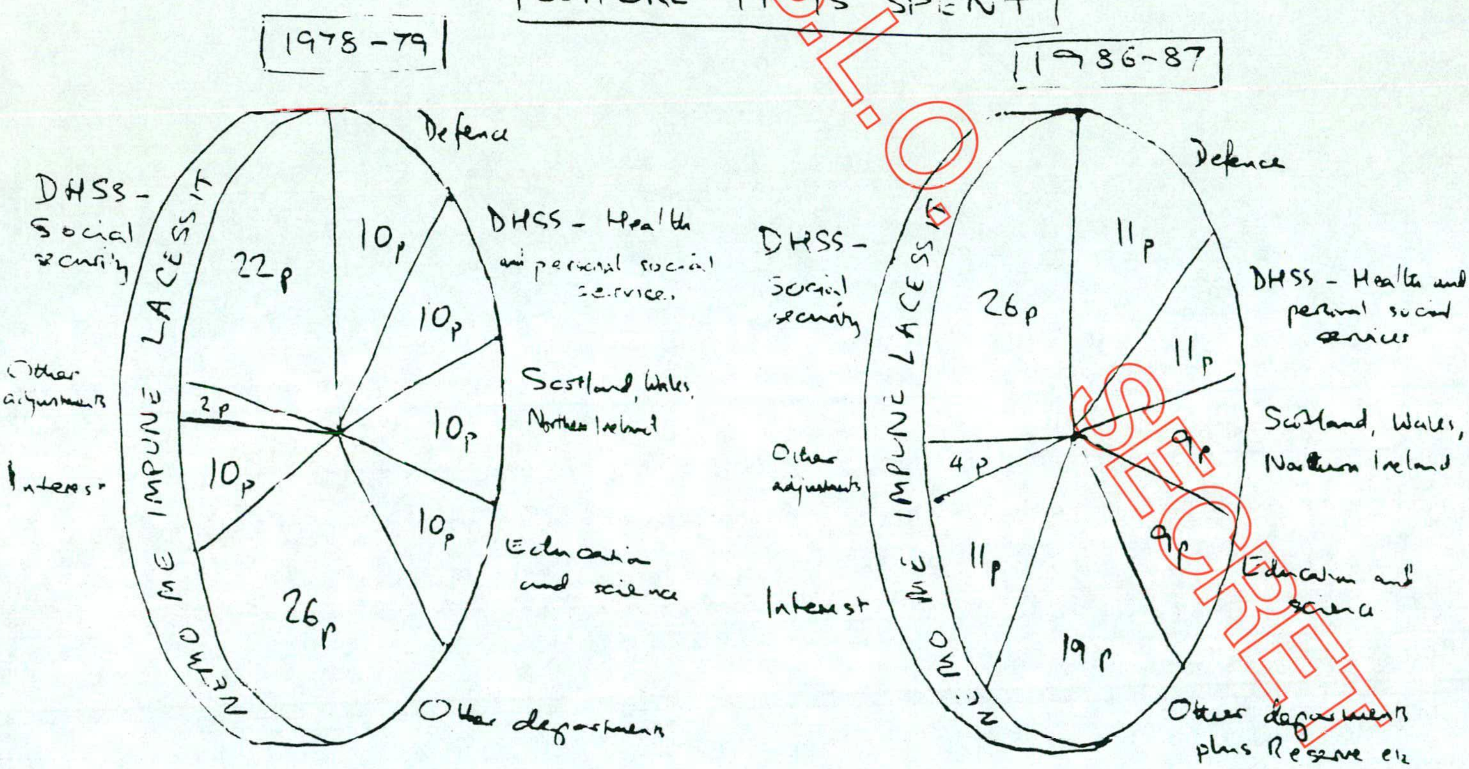


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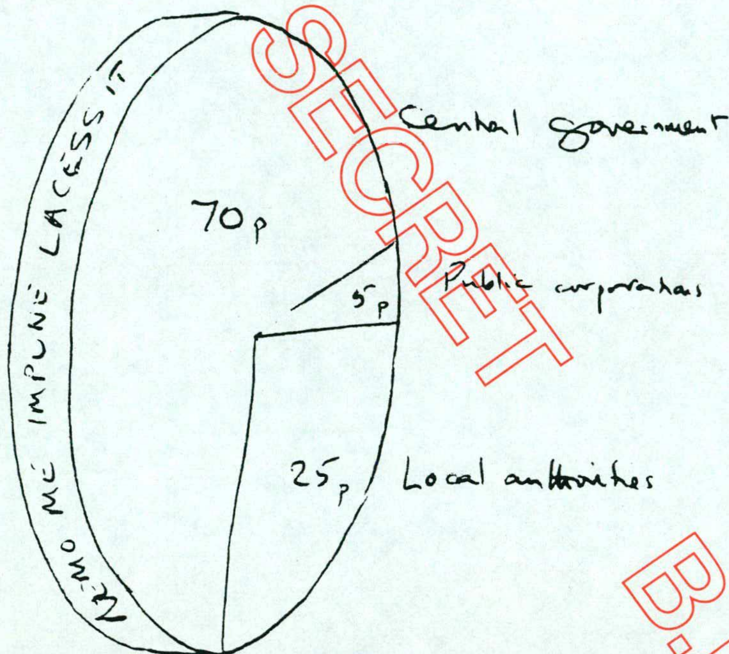
Chart 6.9

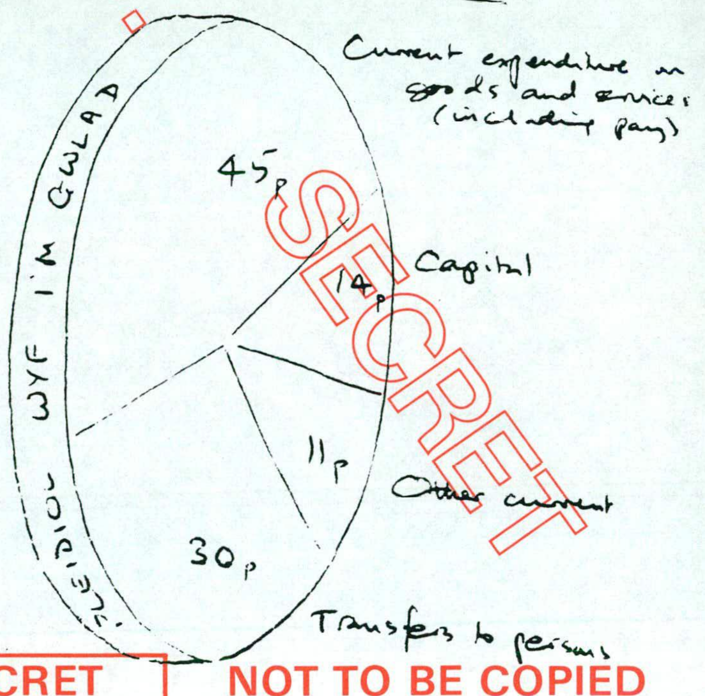
THE BUDGET POUND
(continued)

1986-87

WHO SPENDS IT



WHAT IT IS SPENT ON



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Annexes to the Financial Statement and Budget Report

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Annex to Chapter 2

: CHANGES SINCE THE 1985 FSBR

Money GDP

2A.1 The level of money GDP in 1985-86 is now expected to be higher than was projected in last year's MTFS, reflecting both higher output and a higher deflator. The path from 1986-87 is also now put higher than last year. Faster growth of onshore output is partly offset by a faster decline in North Sea output. The GDP deflator is projected to grow more slowly in 1986-87, but very slightly faster in the subsequent years than assumed last year.

Table 2.5 Money GDP per cent changes from 1985 MTFS projections

1985-86	1986-87	1987-88	1988-89
+1¾	+2	+2¾	+3¼

Monetary aggregates

2A.2 The growth of MO is expected to be in the lower half of its target range for 1985-86. The target range for 1986-87 is the same as the illustrative range given last year. But the illustrative ranges for subsequent years decline less rapidly, reflecting the slower decline in money GDP growth. The growth of £M3 in 1985-86 is well above the target range originally set last year, and the range set for 1986-87 is higher than the illustrative range in last year's MTFS.

Table 2.6 Monetary Aggregates

% change	1985-86	1986-87	1987-88	1988-89
MO - 1986 MTFS	3¾	2-6	2-6	1-5
1985 MTFS	3-7	2-6	1-5	0-4
£M3 - 1986 MTFS	15	11-15		
1985 MTFS	5-9	4-8	3-7	2-6

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Fiscal projections

2A.3 Table 2.5 shows changes in the revenue and expenditure projections.

Table 2.5 Revenue and expenditure £billion, cash

	Changes from 1985 MTFS projections				
	1984-85	1985-86	1986-87	1987-88	1988-89
Expenditure					
1. Planning total	-	- ½	-	-	+ ½
2. Interest payments(1)	- 0.1	-	-	-	-
3. Public corporations' market and overseas borrowing	- 0.1	- 1	- ½	-	+ 1
4. Other adjustments(1)	+ 0.6	- ½	-	-	-
5. General government expenditure(1)	+ 0.3	- 2½	- ½	-	+ 1½
Receipts					
6. North Sea tax(2)	-	- 2	- 5	- 5	- 3½
7. Other taxes(1)(2)	+ 0.5	+ 2	+ 3½	+ 5½	+ 6
8. National Insurance and other contributions	+ 0.2	- ½	-	+ ½	+ 1
9. Interest and dividends	-	-	-	-	- ½
10. Other receipts(1)	+ 0.1	- 1	- 1½	- 1½	- 1½
11. Accruals adjustment	-	- ½	-	-	-
12. General government receipts(1)	+ 0.8	- 1½	- 3	- 2	-
13. General government expenditure less receipts	- 0.5	- 1	+ 2½	+ 2	+ 2
14. Implied cumulative fiscal adjustments(3)	-	-	- 3½	- 2½	- ½
15. GGBR	- 0.5	- 1	- 1	-	+ 1
16. Public corporations' market and overseas borrowing	+ 0.1	+ 1	+ ½	-	- 1
17. PSBR	- 0.4	-	- ½	-	-

(1) After allowing for classification changes, which add the following amounts:

	1984-85	1985-86	1986-87	1987-88	1988-89
Interest payments	- 0.3	- 0.2	-	+ 0.1	+ 0.1
Other adjustments	+ 0.5	+ 0.5	+ 0.2	+ 0.1	+ 0.1
General government expenditure	+ 0.2	+ 0.3	+ 0.2	+ 0.2	+ 0.2
Other taxes	- 0.2	- 0.2	- 0.3	- 0.3	- 0.3
Other receipts	+ 0.4	+ 0.5	+ 0.5	+ 0.5	+ 0.5
General government receipts	+ 0.2	+ 0.3	+ 0.2	+ 0.2	+ 0.2

(2) The allocation of tax receipts between North Sea and other is affected by the treatment of advance corporation tax set-off. See footnote (2) to Table [ ].

(3) Line (14) = (17) - (16) - (13).

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Changes in classification

2A.4 Some classification changes have been made since the 1985 FSBR which affect the comparison of the 1985 and 1986 projections (eg ECGD interest support costs are now treated as a subsidy rather than as debt interest; and fees and fines as current transfers rather than as a tax on expenditure). The net effects on total expenditure and total receipts are the same, and so, to make the comparison more helpful, the 1985 projections were reclassified before calculating the changes in Table 2.5 (see footnote (1)).

Changes in expenditure

2A.5 The planning totals for 1986-87 onwards are as in Cmnd 9702; the expected underspend in 1985-86 (line 1 of Table 2.5) is discussed in Chapter 5. Public corporations have repaid less market and overseas debt in 1985-86 than assumed a year ago (line 3)*, but they have also borrowed less from central government; that change is assumed to persist in 1986-87 (see Chapter 6); but in 1988-89 continued repayment of market and overseas debt is assumed, unlike last year's projection.

Changes in receipts

2A.6 On the receipts side, the reductions in North Sea revenues in line 6 are a result of lower sterling oil prices. Other taxes (line 7) are higher throughout the period, partly reflecting the carrying-through to later years of higher estimates of expenditure taxes in 1985-86 and partly the assumed higher level of money incomes. The latter also explains why national insurance contributions (line 8) are higher towards the end of the period.

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* 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 3 and added back in line 16.

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Annex to Chapter 4

The Budget Proposals in Detail

Income tax

It is proposed -

to increase the single person's allowance and the wife's maximum earned income relief from £2,205 to £2,335 and the married allowance from £3,455 to £3,655

to increase the additional personal allowance and widow's bereavement allowance from £1,250 to £1,320

to increase the age allowance for the single person from £2,690 to £2,850, for the married from £4,255 to £4,505 and the age allowance income limit from £8,800 to £9,400

to increase the basic rate limit to £17,200

to increase the width of the 40 per cent band to £3,200, of the 45 per cent band to £5,500 and of the 50 per cent and 55 per cent bands to £8,400.

As a consequence of these changes, the structure of personal tax rates in operation in 1986-87 will be:

Bands of Taxable Income

£	Per cent
0-17,200	30
17,201-20,400	40
20,401-25,900	45
25,901-34,300	50
34,301-42,700	55
over 42,700	60

It is also proposed -

to abolish the £10,000 limit on higher rate relief for covenanted donations to charities

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to introduce from April 1987 relief for charitable donations up to £100 a year made through payroll deduction schemes

to change on a revenue neutral basis, with effect from 1987-88, the present engine size breakpoints in the scales for taxing car and car fuel benefits in respect of company cars provided to directors and to employees whose remuneration is at a rate of £8,500 a year or more, and to increase the new scale for car benefits by 10 per cent

to extend the relief for overseas travel expenses incurred by UK employees working abroad and by expatriates working in the UK, and to extend to UK self-employed persons with businesses wholly abroad all of the reliefs for overseas travel and subsistence that are available to UK employees working wholly abroad. Changes to apply from 1984-85

to amend the tax charging provisions relating to directors' and employees' acquisitions of shares and interests in shares in their companies

to permit the use in approved employee share schemes of shares subject to restrictions on their retention by ex-directors and ex-employees

to permit the use in approved employee share schemes of shares of a class the majority of which is held by directors and employees and which gives them control of the company

to enable approved savings-related share option schemes to permit exercise of options within three years in certain circumstances

[to enable [registered bona fide co-peratives/worker co-operatives] to use redeemable shares in approved profit sharing schemes]

[to change the basis of assessment of the enterprise allowance from Case I to Case VI of Schedule D.]

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to exempt certain pensions paid to victims of Nazi persecution

to exempt from the requirement to deduct tax certain dividends in respect of securities held in recognised clearing systems

to allow the Department of Employment to pass on to local authorities certain specified information supplied to that Department from the Inland Revenue Employers' Index.

Income tax and capital gains tax

It is proposed -

to extend indefinitely the duration of the Business Expansion Scheme, to introduce an exemption from capital gains tax on the first sale of qualifying shares and to make certain changes to the coverage of the scheme.

Income tax and corporation tax

It is proposed -

to amend the mines and oil wells capital allowances; in particular to change to percentage based writing down allowances on a reducing balance and incurred basis, instead of the existing output-related allowances

to amend the provision governing the agricultural buildings allowance

to amend the legislation relating to capital allowances on machinery or plant which is leased

to amend the capital allowance provisions in respect of fixtures to provide for loaned equipment

to disallow deductions for VAT penalties, interest and surcharges and to disregard VAT repayment supplement

[to provide immediate relief for expenditure incurred on research and development by a company which is not yet trading]

Income tax, corporation tax and capital gains tax	It is proposed -	
		to introduce a new tax relief for individuals investing in equities
		to introduce provisions to counter abuse of the tax reliefs for charities
		to remove certain securities within the Accrued Income Scheme from the scope of the anti-bondwashing provisions
		to make minor amendments to the Accrued Income Scheme
Income tax, corporation tax, capital gains tax and capital transfer tax	It is proposed -	
		to make changes in relation to securities replacing special rates for Stock Exchange jobbers by rules for market makers
Income tax, corporation tax and recovery charge	It is proposed -	
		to introduce a tax recovery charge on payments from over-funded occupational pension schemes to sponsoring employers
Corporation tax	It is proposed -	
		to introduce a relief from tax for single donations to charity by companies which are not close
		to correct an anomaly in the taxation of loans to participators in close companies
		to restrict the transfer of tax losses on a company reconstruction
		to make a technical amendment to the definition of associated company for ring fence ACT set-off purposes

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Corporation tax and capital gains tax

It is proposed -

to exempt, with effect from 2 July 1986, gains on the disposal of any option or contract to acquire or dispose of gilt-edged securities or qualifying corporate bonds

[to amend the provisions dealing with small part disposals of land]

[to give exemption for onshore venture capital companies]

Oil taxation

It is proposed -

to clarify allocation of tariff charge in cases of fields in common ownership which received development consent on same day

[to exempt certain disposals in wholly exempt gas fields]

to ensure that the onshore/offshore boundary for oil tax purposes coincides with the UK coastline

to provide an alternative basis for determining the market value of methane and certain other light gas

Capital gains tax

It is proposed -

to increase the annual exempt amount in line with the increase in the retail prices index so that for 1986-87 an individual will be exempt on the first £6,300, and most trusts on the first £3,150, of capital gains

to amend the hold-over relief for gifts to dual resident trusts

Capital transfer tax and inheritance tax

It is proposed -

to abolish the charge on transfers between individuals made on or after 18 March 1986 and more than 7 years before the transferor's death, and to charge inheritance tax on other transfers on or after that date

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to charge transfers made on or after 18 March 1986 but within 7 years of the transferor's death as tapered amounts of tax due on the death rate scale

It is proposed, for events on or after 18 March 1986 -

to reduce from 10 to 7 years the period for cumulation of a transferor's or settlor's previous chargeable transfers for the purpose of the rate of tax on transfers into trust and on property held in trust.

It is proposed -

to tax gifts with reservation of benefit made on or after 18 March 1986 in connection with the donor's death as if the whole of the gifted asset had remained in his estate until the reservation was finally given up

to increase the bands of chargeable value for transfers on deaths occurring on or after 18 March 1986, in line with the increase in the retail prices index as follows:

Band of chargeable value £000	Rate on death per cent
0- 71	0
71- 95	30
95-129	35
129-164	40
164-206	45
206-257	50
257-317	55
Over 317	60

to charge at half the death rates transfers (other than between individuals) not within 7 years of the transferor's death

to amend the rules concerning the interaction of partially exempt transfers and business and agricultural reliefs

[to extend the exemption for transfers of shares in a company to an employee trust]

Stamp duties It is proposed with effect from 19 March 1986 -

to charge duty at a rate of 0.5 per cent on takeovers and certain other company reorganisations

to introduce a new exemption for company reconstructions

to withdraw exemptions from sale duty for certain categories of loan stock and purchases by a company of its own shares

to withdraw the exemption from bearer instrument duty for bearer letters of allotment

to charge duty at 3 per cent on the conversion of shares into depository receipts

It is proposed with effect from a date in the autumn:

to reduce the rate of duty on transfers of shares to 0.5 per cent

to impose a tax on certain share transactions which do not at present pay stamp duty

to withdraw the exemption from sale duty for letters of allotment

to change the rate of duty on bearer instruments

Value Added Tax It is proposed -

to increase the registration limit to £20,500 per annum and £2,000 per quarter

to make VAT relief available for charities on installation of distress alarms and lifts for the handicapped, most press advertising by charities, medicinal products, video and refrigeration equipment supplied to certain charities, recording equipment used by charities for the blind, and welfare vehicles used by charities to transport the deaf, blind or mentally handicapped

to define the VAT treatment of accommodation in a hotel more closely, and in particular to restrict provision relating to long stays to stays by individuals (to take effect from 1 November 1986)

to change the law to counter tax avoidance by artificial disaggregation of businesses

Excise duties

It is proposed -

to increase the duties on cigarettes and hand rolling tobacco by [11.2p] per packet of 20 cigarettes

to increase the duties on road fuels by [7.5p] a gallon and on derv by [6.5p] a gallon

to abolish the duties on aviation kerosene and lubricating oils

to increase the duty on gas oil by [1.5p] per gallon

Vehicle Excise Duties

It is proposed -

to increase from 19 March 1986 the rate of duty for hackney carriages of up to 20 seats to £52.50, and the additional payment for each additional seat to £1.05. The concessionary rates of duty for farmers' heavy goods vehicles over 7.5 tonnes, will be increased by varying amounts as a second stage in the process of bringing them into line with the proportion of average mileage covered by these vehicles on public roads

to increase from 1 January 1987 the rate of duty for trade licences to £70 for cars and £14 for motorcycles. The increase in trade licence rates will be part of a package of measures reforming trade licence arrangements, including widened availability and changes in the duration for which they are available to 6 months and 12 months. A new type of probationary trade licence is also to be introduced for new businesses and for businesses where there is a doubt whether there is sufficient business to justify a full licence.

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ANNEX 6.A: Relationship between Tables in Chapter 6

6A.1 Table 6.7 is based on the definitions used to compile the national accounts. In order to show the financial deficit (which is often used in international comparisons), 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 and the borrowing requirement.

6A.2 Table 6.6 is a summary version of Table 6.7, showing the public sector only, but separating current and capital expenditure in order to show the current surplus. Also, in order to give a clearer picture, capital spending in Table 6.6 includes defence capital and excludes asset sales, as in Table 1.14 of the Public Expenditure White Paper. (However, unlike the White Paper table, capital spending in both Tables 6.6 and 6.7 also includes expenditure by nationalised industries prior to privatisation, changes in the level of stocks, and certain national accounts adjustments.) Taxes on capital are included in current receipts in Table 6.6.

6A.3 Tables 6.3-6.5 are summary versions of the sectoral columns of Table 6.7. The information in Table 6.7 is rearranged so that, for example, central government grants to local authorities (which appear as negative expenditure in the local authorities column of Table 6.7, lines 17 and 22) appear as receipts in Table 6.4. Also, interest paid by local authorities to central government (which appears as negative receipts in the local authorities column of Table 6.7, line 8) appears as expenditure in Table 6.4. Finally, lending and other financial transactions (lines 25-29 of Table 6.7) are included in the receipts and expenditure of Tables 6.3-6.5.

6A.4 Table 6.1 uses the same information as Table 6.7, 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 in the third column of Table 6.7 (including some of the "financial transactions" in lines 25-29), but also borrowing or capital

expenditure by public corporations in the fourth column. General government expenditure as shown in Table 6.1 is then obtained by adding general government debt interest from the third column of Table 6.7 and the national accounts adjustments already included in Table 6.7, and deducting public corporations' borrowing from the market and overseas.

6A.5 Alternatively, general government expenditure in Table 6.1 (and table [2.4]) can be obtained as the sum of lines 23, 25 and 26 (third column) in Table 6.7 and on-lending to public corporations in Table 6.5.

6A.6 To derive general government receipts, Table 6.1 takes the receipts shown in the third column of Table 6.7 (lines 12, 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 6.7) plus oil royalties. The sub-total "total taxes and royalties" is the same as the first line of Table [2.3] in Chapter 2.

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ANNEX 6.B : CENTRAL GOVERNMENT TRANSACTIONS

Table 6.B.1 Summary of Central Government Transactions

£ billion

	1985-86 Latest estimate	1986-87 Forecast
Consolidated Fund		
Revenue (Table 6.B.3)	106.1	109.8
Expenditure (Table 6.B.2)	-110.2	-114.5
Deficit met from National Loans Fund	4.2	4.7
National Loans Fund		
Receipts (Table 6.B.4)	14.3	15.4
Payments (Table 6.B.4)	-19.2	-19.1
Consolidated Fund deficit (as above)	-4.2	-4.7
Total net borrowing by the National Loans fund	**-9.1**	**-8.4**
Other funds and accounts (net)	**-1.0**	**-0.7**
Central Government Borrowing Requirement (including borrowing for on-lending to local authorities and public corporations)	**-10.2**	**-9.1**

Table 6.B.2 Consolidated Fund Expenditure

£ million

	1985-86 Latest estimate	1986-87 Forecast
Supply Issues(1)	**98200**(2)	**101100**
Standing Services		
Payment to the National Loans Fund in respect of Service of the National Debt	7600	8500
Northern Ireland-share of taxes etc.	1800	1900
Payments to the European communities	2600(2)	2800
Other	60	50
Total Standing Services	12100	13300
Total Consolidated Fund expenditure	**110200**	**114500**

(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.) equates closely to total Supply Issues in most years, although there may sometimes be slight timing differences between the two.
(2) £970 million was paid to the European Communities from Supply Issues instead of Standing Services.

Table 6.B.3 Consolidated Fund Revenue

£ million

	1985-86		1986-87
	Budget forecast	Latest estimate	Forecast
Inland Revenue-			
Income tax	35200	35100	39300
Corporation tax[1][2]	10100	10800	11900
Petroleum revenue tax[3]	8200	6630	2460
Capital gains tax	790	900	1000
Development land tax	55	60	35
Capital transfer tax[4]	760	880	920
Stamp duties	1100	1230	1400
Recovery charge	-	-	25
Total Inland Revenue	*56200*	*55600*	*57040*
Customs and Excise-			
Value added tax	18300	19300	20700
Petrol, derv etc. duties	6500	6500	7300
Cigarettes and tobacco	4300	4300	4800
Spirits, beer, wine, cider and perry	4200	4200	4400
Betting and gaming	700	740	800
Car tax	760	880	980
Other excise duties	20	20	20
EC own resources[5]			
Customs duties, etc.	1400	1200	1300
Agricultural levies	100	160	160
Total Customs and Excise	*36300*	*37300*	*40500*
Vehicle excise duties[6]	2500	2400	2500
National Insurance surcharge	30	30	-
Oil royalties	2500	2000	950
Gas Levy	520	520	500
Broadcasting receiving licences	790	980	1000
Interest and dividends	870	990	840
Other[7]	6700	6400	6500
Total Consolidated Fund revenue	**106500**	**106100**	**109800**

(1) Includes advance corporation tax (net of repayments)	3600	3900	4400
(2) North Sea corporation tax	2800	3030	2600
of which satisfied by setting off ACT	1200	1180	1100

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.

(3) Includes advance payments of petroleum revenue tax.

(4) Includes estate duty	4	6	5

(5) 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.

(6) Includes driving licence receipts.

(7) Includes the 10 per cent of 'own resources' refunded by the European Communities to meet the costs of collection, other receipts from the European Communities and central privatisation proceeds.

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Table 6.B.4 National Loans Fund Receipts and Payments

£ million

	1985-86 Latest estimate	1986-87 Forecast
Receipts		
Interest on loans, profits of the Issue Department of the Bank of England, etc.	6700	6900
Service of the National Debt-balance met from the Consolidated Fund	7600	8500
Total	**14300**	**15400**
Payments		
Service of the National Debt		
Interest	14100	15300
Management and expenses	170	170
Total Service of the National Debt	14300	15400
Loans to:		
Nationalised industries	180	-680
Other public corporations	260	210
Local authorities	4400	4000
Private sector and within central government	100	140
Total National Loans Fund lending[1]	5000	3700
Total	**19200**	**19100**

[1] On-lending to local authorities and public corporations in Tables 6.4 and 6.5 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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Appendix B

Chapter 6 of FSBR

1. Chapter 6 has been rewritten, compared with earlier years, to try to make it more interesting and easier to read, along the lines of the revisions to earlier chapters.

2. However, the present structure of Chapter 6 depends in part on the provisional assumption that the Reserve is fully allocated in table 6.7 (formerly 6.5). If non-allocation were decided instead, the sectoral split of the PSBR and its components (paragraphs 6.23-31, tables 6.2-6.5 and part of chart 6.9) would have to be dropped, since 1986-87 forecasts could not be given. Hence the threefold structure would become twofold, being restricted to the "functional" and "economic category" analyses.

3. Chapter 6 is, as usual, restricted to the current year and the year ahead (except for a brief new passage -paragraphs 6.21-22 and part of chart 8 - making some useful and, we think, interesting comparisons with 1978-79). The figures in the text and tables are merely illustrative at present, and will of course change.

4. The chapter includes more explanation than in previous years of the year-on-year and forecast-on-forecast changes in revenue and expenditure. It also includes some new tables and charts:-

(i) table 6.1, which is last year's 5.4 (a popular table with the TCSC and others) with a slightly modified grouping of taxes;

(ii) table 6.6, the proposed new summary table of capital and current (see below);

Also, some detailed tables on a funds and account basis (which overlap with the earlier tables in - in earlier years - an unexpected way) have been put into the annexes.

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5. Table 6.6 is the summary table (the "Rodney Lord" table) of capital and current expenditure and financing, on the lines agreed at your meeting on 15 January. As agreed then, there is virtually no associated text. It should be noted that:-

(a) The definition of capital in the new table has been brought as close as possible to that in table 1.14 of the PEWP. However, there remain significant differences, principally because the PEWP table excludes

- capital spending by nationalised industries which have been, or are about to be, privatised,
- changes in stocks,
- certain national accounts adjustments, and
- in 1986-87, any allocation from the Reserve.

The FSBR figures of total capital expenditure are consequently about £1¾ billion and £1¼ billion higher than the PEWP figures in 1985-86 and 1986-87 respectively.

(b) The table depends on the allocation of the Reserve. If that were notionally allocated to current expenditure, the current surplus and capital expenditure would both be distorted downwards in 1986-87. The table already shows a significant drop in the current surplus between 1985-86 and 1986-87 (which is not likely to improve when the figures are brought into line with Budget decisions). If the Reserve were not allocated at all, the table would become meaningless.

(c) The table shows central privatisation proceeds and council house sales clearly as financing items, which is inconsistent with the way we treat them in public expenditure and could be regarded as an own goal. (They are also treated as financing items in table 6.7, but that table does not get the attention which the new, simpler table will.)

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Financial Statement and Budget Report

Chapter 1: The Budget Proposals

Definition of the Budget

1. The main proposals in the Budget are summarised in Table 1.1 below and described in detail in Chapters 4 and 5. The Budget is defined to include tax, National Insurance and expenditure changes announced in the Budget Statement, together with certain other changes set out in this Financial Statement and Budget Report.

Table 1.1

Budget Measures: Summary of Direct Effects

£ million at current prices

	1986-87		1987-88	
	Changes from an indexed base	Changes from an non-indexed base	Changes from an indexed base	Changes from a non-indexed base (yield(+)/cost(-))
Tax Proposals:				
Income tax allowances & thresholds	Nil	-1135	Nil	-2405
Excise duties - petrol/derv	+135	+465	+145	+725
- VED	-135	+5	-140	+90
- tobacco	+175	+315	+180	+435
- alcohol	-175	Nil	-190	+110
- gas oil	+25	+30	+25	+35
- other minor oil duties	-25	-20	-25	-15
Stamp duty - cut in rate	-70	-70	-110	-110
- extension of base	+70	+70	+120	+120
Capital Transfer Tax	-35	-55	-55	-120
Charities - package of reliefs	Neg	Neg	-50	-50
- anti-abuse measures	Neg	Neg	+20	+20
Pension Fund Surpluses	+20	+20	+120	+120
Other tax changes	-20	-20	+20	+20
National Insurance contributions	-150	-150	-400	-400
Total tax and national insurance contributions	-185	-545	-340	-1425
Expenditure Measures:				(cost(+)/saving(-))
Enterprise Allowance	+20	+20	+90	+90
Loan Guarantee Scheme	Nil	Nil	+10	+10
New Workers Scheme	+25	+25	+50	+50
Counselling Initiative	+85	+85	+45	+45
Jobstart	+25	+25	+50	+50
Community Programme	+45	+45	+90	+90
Fraud abuse	Neg	Neg	+5	+5
Northern Ireland	+5	+5	+10	+10
Total expenditure increases	+205	+205	+350	+350
Offsetting reductions in social security benefits	-95	-95	-145	-145
Net call on the Reserve	+110	+110	+205	+205

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Taxation

2. The net effect of the tax proposals in the Budget is shown on the basis conventionally used in the preparation of economic forecasts which allows for the full indexation of 1985-86 excise duty rates and main income tax allowances and thresholds in line with inflation in the year to December 1985. On this basis the tax proposals in the Budget are expected to cost [£25m] in 1986-87 and to yield [£60] in 1987-88. Measuring the effects of the Budget proposals from existing levels of rates and allowances gives an expected cost of [£395] in 1986-87 and [£1025] in 1987-88. The measures are described in detail in Chapter 4.

National Insurance Contributions

3. The cost of the reductions in national insurance contributions is expected to be [£150 million] in 1986-87 and [£[illegible]m] in 1987-88. Details are given in Chapter 4.

Expenditure Measures

4. Table 1.1 shows the costs of the public expenditure measures in the Budget. These will not add to the public expenditure Planning Total as the costs will be met from the Reserve. Details of the measures are given in Chapter 5.

PSBR

5. The PSBR for 1986-87 has been set at [   ], or 1¾% of GDP. The Budget measures are expected to contribute about [   ] to this figure over and above the cost of simply indexing tax rates and allowances. This allows for indirect as well as direct effects on public sector transactions.

covering SECRET

FROM: C J RILEY

DATE: 4 March 1986

PPS/CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Sir T Burns
Sir G Littler
Mr F E R Butler
Mr Cassell
Mr Odling-Smee
Mr Peretz
Mr Scholar
Mr Cropper
Mr Lord
Mr H Davies
PS/Governor)
PS/Deputy Governor) Bank of
Mr Flemming) England
Mr George)

Ch/
In practice this is for tomorrow's meeting with the Bank. But you may as well have it with the rest of the papers.
RL.
4/3

Not significantly different from previous version

CHANCELLOR'S MEETINGS ON THE MTFS

The draft to be discussed is that circulated by Central Unit on Friday 28 February. Version B is also now attached.

CJR

C J RILEY

covering SECRET

FROM: C J RILEY

DATE: 4 March 1986

PPS/CHANCELLOR

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Sir T Burns
Sir G Littler
Mr F E R Butler
Mr Cassell
Mr Odling-Smee
Mr Peretz
Mr Scholar
Mr Cropper
Mr Lord
Mr H Davies
PS/Governor)
PS/Deputy Governor) Bank of
Mr Flemming) England
Mr George)

CHANCELLOR'S MEETINGS ON THE MTFS

The draft to be discussed is that circulated by Central Unit on Friday 28 February. Version B is also now attached.

C J R

C J RILEY

9/2080

pwf.

SECRET

FROM: MISS M E PEIRSON
DATE: 4 March 1986

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr Cassell
Mr H Evans
Mr Scholar
Mr Powell
Dr Webb

PSBR IN 1986-87

1. Since Mr Evans' note of 25 February, reporting our then view of the PSBR in 1985-86 and 1986-87, the forecast has continued to move about in response to some new information. Mr Devereux's note of earlier today reported on the PSBR for 1985-86 (£6½-7 bn); this note gives another update for 1986-87, as requested by Mrs Lomax this morning.

2. On the continued assumptions that

(i) the Budget package (B) is incorporated
(ii) the oil price is $15 during 1986 (but see below),
(iii) privatisation proceeds are as before (£4¾ bn),

the forecast PSBR in 1986-87 is at present around **£6½ bn.** Further changes are liable to take place over the next few days.

3. The reasons for the increase since 25 February are mainly:-

(a) Slightly higher supply expenditure, as in 1985-86.

(b) Slightly lower expected electricity price increases (for industrial customers) in April.

(c) Slightly higher debt interest.

4. However, please note that:

- the forecast now includes a £0.4 bn overspend on the planning total, for such reasons as (b) and (c) above (plus earlier increases), although we shall not want to publish that;

- if the oil price were \$12½ during 1986, the PSBR would be around £0.7 bn higher, ie around £7-7½ bn. (The futures prices of West Texas Intermediate crude for April-January 1987 averaged \$13½ yesterday.)

MEP

MISS M E PEIRSON

002/1283

See also CST's note
comments on ch 6 below

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FROM: CHIEF SECRETARY
DATE: **5 March 1986**

CHANCELLOR

In the light of the CST's views, I am content with no allocation this year; depending as advised by Miss Peirson (complex ex a ten submission) premised with the argument (@ Y). If in the light of experience, we come to think again we can argue this the next year. N.

cc: Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Anson
Mr Cassell
Mr Kemp
Mr Evans
Mr Jameson
Mr Odling-Smee
Mr Scholar
Mr Turnbull
Mrs R Butler
Mr Culpin
Miss Peirson
Mr Lord

1986 FSBR: CHAPTER 6 - ALLOCATING THE RESERVE

We discussed this after the overview meeting on Monday. You asked me to pull together the arguments; and make a recommendation.

2 I think we could adopt either no allocation; or notional allocation in the FSBR. I recommend no allocation. I see the arguments as follows.

3 The case for full allocation rests on the fact that it would provide an objectively better published forecast of the public sector accounts that underlie your Budget judgement. Without implicit full allocation of the reserve, the numbers put in for the public sector accounts for 1986-87 will be less useful, particularly to outside commentators, since comparisons will be made between outturns for 1985-86 and plans (without any allocation or with only a notional allocation of reserve) for 1986-87. Full allocation would

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also make monitoring outturn against forecast more meaningful, again particularly for outside commentators. It would avoid the confusion which could arise if monitoring and briefing were based on different forecasts, one published the other not.

4 But I think there are real risks associated with this course of action.

5 First, there will be those who seek to make deductions about the allocation of the Reserve. I recognise that they probably will not be able to make these deductions correctly. But rightly or wrongly they may come quite close. For example, Table 6.4 shows a 9.1% increase in local authority current spending (and a much lower increase for capital spending which is also unhelpful). If the figure is adjusted for teachers' backpay the increase falls to only 6.9%; but the PEWP showed an almost constant figure between the two years. Those who wish to will attribute the difference to the Reserve. Similarly Table 6.5 shows current grants to the personal sector (which some will interpret as social security benefits plus employment measures) of £50.3 billion. The same figure appears in the PEWP which could be taken to imply no allocation from the Reserve to these areas.

6 Arguably it may not matter too much if commentators do make fairly accurate estimates of our allocations. In the end, it is a matter of timing when the information will become available. My point is not whether calculations of this sort are legitimate; nor whether they could be answered. It is simply that there is scope for confusion and mischief which I think we should steer clear of unless there are very good reasons for doing otherwise.

7 Second, I think we would be opening up a running battle with the TCSC. We have just told the Committee that specific components of the Reserve cannot be identified. To publish figures incorporating an implicit allocation of the Reserve so soon afterwards, and then to refuse to reveal how we had allocated it would, in my opinion, be inviting trouble. I do not think an attempt to distinguish between "control documents" and "forecasts" would be sustainable.

8 It was these arguments in part which led us last year to adopt a notional allocation. This course too has its disadvantages:

(i) the forecasts of local authority spending and borrowing are likely to be criticised as unrealistically low given what is already known about local authority budgets. The figures for 1986-87 would show a borrowing requirement of some £7 bn for central government, £¼ bn for local authorities and a repayment of approaching £1 bn for public corporations (depending of course on the final decision on the PSBR). The local authority figure is particularly awkward in relation to the £2 bn or so they have borrowed in the past two years. For me this is the critical factor which has persuaded me on balance against this course of action this year.

(ii) this discrepancy is also potentially awkward because outside commentators may be inclined to revise up the forecast local authority borrowing requirement without revising down the more plausible looking central government and public corporations borrowing requirement. The answer to this is to point to the notional nature of the Reserve allocation that underlies the forecast. But there is scope for misunderstanding about the basis of your Budget judgement about the PSBR which would be most undesirable;

(iii) the notional nature of the allocation may be more generally misunderstood. Last year this (then novel) approach led to some comment - notably in the Guardian, as I recall it. But it was limited. Whatever we do there will be those who draw the wrong conclusion. Providing the notional nature of the allocation is made absolutely clear in the FSBR I do not believe the presentational problems of this approach would be significantly greater than with any other approach but there might be some flutters; I do not put much weight on this point.

9 There are some positive advantages in a notional allocation. It follows the practice of last year - I think we should avoid chopping and changing if we can. There would be no risk of outside commentators "deducing" where we really expect to use the Reserve. And the TCSC would accept it. They did not comment on this approach last year.

10 There is, however, one difference from last year - and I am persuaded it is a significant difference - in that the numbers for local authorities especially must call into question whether it is worth publishing tables on a notional basis at all. Last year, by good fortune, the notional allocation was close to the genuine forecast for local authorities (though not very close for central government or public corporations). This year however, as paragraph 8(i) above explains, the very low figure for local authority borrowing could provoke questions about the plausibility of the overall PSBR forecast. The straight answer to these questions of course is that the individual numbers are not intended to be realistic. But in the end, this may not be a satisfactory answer.

11 For the reasons I have given, I am sure we should not publish a full implied allocation of the Reserve. I believe on the basis of the analysis above that we could live with a notional allocation; but I accept that the numbers will look so palpably odd that on balance it is better not to allocate the Reserve at all.

12 This approach will mean dropping some of the information currently in Chapter 6. We would explain this on the basis that the misunderstandings that arose last year led us not to repeat the experiment (and anyone with a calculator and a few minutes to spare could do his own pro rata allocation anyway). The outside commentators will make their own forecasts of central and local government borrowing which I expect will be fairly close to ours. In short, I think the risk of misunderstandings will be minimised if we make no allocation and that is the course I think we should adopt.

JM

JOHN MacGREGOR

FROM : P M LEAHY
DATE : 5 MARCH 1986

1. ~~MR~~ ROBSON NOT SEEN

2. CHANCELLOR

c.c. Chief Secretary
Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Cassell
Mr Monck
Mr H Evans
Mr Scholar
Mr Turnbull
Mr Mowl
Mr Fellgett
Mr Hacche
Mr Coombes
Mr H Davies

Mr Pitts/IR

I agree

This was discussed at PCC, and no one thinks different oil price assumptions would be a problem. Accordingly we can close the books on this one, for good, on Monday. (The Estimates assume $15 like the forecasts & FSBR) RL. 6/3

ROYALTY OIL RECEIPTS 1986-87 - ESTIMATES AND FSBR FORECASTS

My minute of 25 February (copy attached for ease of reference) alerted you to the possibility that different figures might be given in Estimates and the FSBR for 1986-87 Royalty receipts although they are both published on the same day.

2. The very last opportunity to change the Estimates is at Reader Press on the morning of Wednesday 12 March. DEn would need to be given time to re-do their calculations. This means that a different oil price assumption could probably be reflected in Estimates provided a decision was taken by close Monday 10 March.

3. If a different oil price figure was agreed after this leading to different figures in the Estimates and the FSBR it is likely that no-one will notice. If they did and the FSBR forecast was higher than the Estimates (implying a higher oil price assumption) we could point to the different printing deadlines and to the 1984-85 precedent. It might however lead to adverse comment and speculation about fudging the Budget figures. There should be no

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PR problem if the figure in the FSBR is lower than in Estimates as this could be explained as prudence.

4. The only way to avoid the possibility of different figures appearing is to go firm by close Monday 10 March on the oil price figures for the FSBR.

J Wilson

pp. P M LEAHY

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FILE.

FROM: MS P M LEAHY
Date: 25 February 1986

1. MR ~~ROBSON~~ SHR 25.2
2. CHANCELLOR

cc Chief Secretary
Financial Secretary
Sir P Middleton
Mr Butler
Mr Cassell
Mr Monck
Mr Moore
Mr H Evans
Mr Scholar
Mr Turnbull
Mr Mowl
Mr Fellgett
Mr Hacche
Mr Coombes
Mr H Davies
Mr Pitts - IR

ROYALTY OIL RECEIPTS 1986-87: ESTIMATES AND FSBR FORECASTS

This note alerts you to the possibility that different figures might be given in Estimates and the FSBR for 1986-87 Royalty receipts - both of which are due to be published on Budget day.

2. This may occur because the printing deadline for Estimates is earlier than for the FSBR. Estimates have to be finalised by Tuesday, 4 March. DEn are currently using the central WEP oil price forecast of $15 bbl (£10.50), giving royalty receipts of about £1 billion. We understand that a decision on the price to be used for the FSBR may not be made until after this. A $2.50 increase in the forecast price would increase royalty receipts to about £1.2 billion.

3. Different figures in Estimates and the FSBR would not be unusual. In 1984-85 the forecast in the FSBR was £2 billion and in the Estimates £1.75 billion. As far as we are aware, no-one noticed. But oil revenues are a more sensitive issue this year and it could cause adverse comment if it was noticed.

4. The only way to avoid this possibility however would be to go firm on the oil price figure for the FSBR by the end of this week. But we assume you will want to leave your options open instead.

PM Leahy

P M LEAHY

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1 of 26

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FROM R J BROADBENT

DATE 5 March 1986

PS/CHANCELLOR Cl

See CST's comments on ch 6, especially on the PSBR margin of error, & the longer time scale.

As you know, I have already decided that Ch VI should follow the 1985 model, & ~~[illegible]~~ that Scholar revolution is therefore rejected — tho it continues to exist in a unique paper for the TSC, subject to CST's pts. Meanwhile (a) I like a revise of Ch VI from the 1985 FSBR and (b) I agree with CST on the PSBR margin of error.* It would be far better, if poss, if we could use a new relative average errors over a period for all forecast variables. ~~[illegible]~~ PSB Can Sir TB urgently consider this pl.

* a pt I think I made myself the other day

KL 5/3

cc: Financial Secretary
Economic Secretary
Minister of State
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Cassell
Mr Evans
Mr Odling-Smee
Mr Monger
Mr Scholar
Mr Turnbull
Mr Culpin
Miss O'Mara
Miss Peirson
Mr Pratt
Mr Cropper
Mr H J Davies
Mr Lord

Mr Calder - IR
Mr John - IR
PS/IR
PS/C & E

1986 FSBR

I have passed directly to GE Division the Chief Secretary's comments on Chapter 5 of the FSBR. The Chief Secretary also has some comments on Chapters 3 and 6 as follows.

Chapter 3

2 The Chief Secretary thinks that the last sentence of 3.59 carries with it the unfortunate implication that the growth in manufacturing productivity has been due primarily to job losses rather than to changes in working practices. He does not think this is a good time to poke up this particular argument.

Chapter 6

3 Paragraph 6.12: The Chief Secretary thinks that the difference between the £2 bn referred to here (on a GGE basis) and the prospective underspend of perhaps £½ bn (on a planning total basis) needs to be explained more clearly. The £2 bn figure appears very abruptly; is potentially damaging; and paragraph 6.14 which ultimately explains it is itself difficult to follow.

4 Paragraph 6.20: The Chief Secretary is concerned about emphasising a margin of error as high as £5 bn in relation to the PSBR. While he recognises that the average error is high, he thinks if possible it is worth, taking the average over a period which keeps it within more limited bounds relative to the total PSBR. And he does not think anyway that it need be over emphasised in this paragraph. He is concerned that the argument will be turned against the Chancellor and himself in July discussions and later if too much weight is given to the argument that swings of nearly £1 bn are just "small errors".

5 Paragraph 6.21: The Chief Secretary thinks the tone of this paragraph needs to be brought in line with the approach adopted in chapter 5 - I have spoken separately to Mr Turnbull who has this in hand.

6 The Chief Secretary is doubtful about the analysis of trends over the past ten years, particularly in relation to expenditure, contained in paragraph 6.22 and subsequently. He recognises why this exercise has been undertaken, but he feels that much of the information has already been provided in its proper context in the public expenditure White Paper; and that to rehearse it here may lead to differences in emphasis which he would prefer to avoid.

7 For similar reasons, the Chief Secretary is not attracted by Charts 6.8 and 6.9 which he would prefer to see deleted.

R J BROADBENT
Private Secretary

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276/006 Justified (How easy?) TCSC-ish A lot of sensitive figs

Appendix B

Chapter 6 of FSBR

1. Chapter 6 has been rewritten, compared with earlier years, to try to make it more interesting and easier to read, along the lines of the revisions to earlier chapters.

NB 2. However, the present structure of Chapter 6 depends in part on the provisional assumption that the Reserve is fully allocated in table 6.7 (formerly 6.5). If non-allocation were decided instead, the sectoral split of the PSBR and its components (paragraphs 6.23-31, tables 6.2-6.5 and part of chart 6.9) would have to be dropped, since 1986-87 forecasts could not be given. Hence the threefold structure would become twofold, being restricted to the "functional" and "economic category" analyses.

3. Chapter 6 is, as usual, restricted to the current year and the year ahead (except for a brief new passage -paragraphs 6.21-22 and part of chart 8 - making some useful and, we think, interesting comparisons with 1978-79). The figures in the text and tables are merely illustrative at present, and will of course change.

4. The chapter includes more explanation than in previous years of the year-on-year and forecast-on-forecast changes in revenue and expenditure. It also includes some new tables and charts:-

(i) table 6.1, which is last year's 5.4 (a popular table with the TCSC and others) with a slightly modified grouping of taxes;

(ii) table 6.6, the proposed new summary table of capital and current (see below);

Also, some detailed tables on a funds and account basis (which overlap with the earlier tables in - in earlier years - an unexpected way) have been put into the annexes. ?

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5. Table 6.6 is the summary table (the "Rodney Lord" table) of capital and current expenditure and financing, on the lines agreed at your meeting on 15 January. As agreed then, there is virtually no associated text. It should be noted that:-

(a) The definition of capital in the new table has been brought as close as possible to that in table 1.14 of the PEWP. However, there remain significant differences, principally because the PEWP table excludes

- capital spending by nationalised industries which have been, or are about to be, privatised,
- changes in stocks,
- certain national accounts adjustments, and
- in 1986-87, any allocation from the Reserve.

NB ~~[illegible]~~

The FSBR figures of total capital expenditure are consequently about £1¾ billion and £1¼ billion higher than the PEWP figures in 1985-86 and 1986-87 respectively.

(b) The table depends on the allocation of the Reserve. If that were notionally allocated to current expenditure, the current surplus and capital expenditure would both be distorted downwards in 1986-87. The table already shows a significant drop in the current surplus between 1985-86 and 1986-87 (which is not likely to improve when the figures are brought into line with Budget decisions). If the Reserve were not allocated at all, the table would become meaningless.

(c) The table shows central privatisation proceeds and council house sales clearly as financing items, which is inconsistent with the way we treat them in public expenditure and could be regarded as an own goal. (They are also treated as financing items in table 6.7, but that table does not get the attention which the new, simpler table will.)

Discuss

.Chapter 6

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 1986-87, together with new estimates of outturn in 1985-86. It also provides a commentary on the main features of the public sector's finances in those two years, including the most important changes which have taken place since last year's projections.

Public sector's finances: three-fold analysis

6.02 The public sector's finances may be analysed in a number of different ways:

- on a functional basis, showing on the one hand the receipts (North Sea revenues, other company taxes, income taxes, expenditure taxes, and so on); and on the other the spending (on social security, health, defence, education and so on), financed by those receipts and by borrowing;

- by sector, ie by the authority which undertakes the financing or spending: central government, local authorities or public corporations;

- by economic category: capital and current, grants and spending on goods and services, and so on.

6.03 This threefold analysis of the public sector's finances is analogous to the threefold presentation of public spending which has become an established feature of Part I of the Public Expenditure White Paper: see paragraphs 14 and 15 of Cmnd 9702-I. The rest of this Chapter sets out these three analyses in detail.

Analysis by function

6.04 Table 6.1 and Chart 6.8 at the end of this chapter -gives a functional analysis of the public sector's finances. Table 6.1 itemises the main receipts of "general government" (ie central plus local government), grouping them according to the type of activity which gives rise to them. It also sets out the various kinds of general government spending, by department, as in Chapter 5 and in the

Pubic Expenditure White Paper. Finally, it shows how its bottom line, the public sector borrowing requirement, is derived from those two totals.

6.05 Thus, for 1986-87, general government receipts are forecast to be £[157] billion; general government expenditure is put at £[163½] billion; and, after taking account of public corporations' expected repayments of £[½] billion of borrowing from the market and overseas, the forecast public sector borrowing requirement comes out at £[6¾] billion.

[Insert table 6.1 attached]

Receipts

6.06 Expected general government receipts have changed little overall in 1985-86 since the 1985 Budget forecast, being still some £[150] billion. However, within the total there have been substantial changes, lower oil revenues [being broadly offset by] an increase in other revenues. There are similarly large changes in 1986-87.

6.07 Oil revenues in 1985-86 are expected to be some £1½ billion lower than in the 1985 Budget forecast, at £11¾ billion. The reduction, which is much as forecast in the Autumn Statement, is mainly because the $/£ exchange rate has turned out higher than assumed in the 1985 Budget. (The sharp drop in the $ oil price since December has had little effect on revenues in 1985-86, because of the lags in payments.)

? £/$

6.08 In 1986-87 oil revenues are now forecast at around £[6] billion, compared with £11½ billion projected in the 1985 FSBR, because of the lower $ oil price (and higher $/£ exchange rate) than earlier assumed. The forecast depends heavily on the future course of oil prices: the price of North Sea crude is assumed to be $[15] per barrel for the rest of 1986. (If prices were $1 per barrel lower on average in 1986, but other things - including the exchange rate - were unchanged, North Sea revenues would be around £½ billion lower in 1986-87.) The forecast also depends on the exchange rate: the $/£ exchange rate is assumed not to change very much.

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Table 6.1 The public sector's finances analysed by function

£ billion

	1985-86		1986-87
	1985 Budget	Latest estimate	Forecast
Receipts			
Corporation tax excl. North Sea[1]	8.2	8.4	9.6
Other taxes on income	35.2	35.1	39.3
Taxes on capital	1.9	2.4	2.7
Expenditure taxes:			
Value added tax	18.3	19.3	20.7
Local authorities rates	13.6	13.7	15.8
Petrol, derv etc. duties	6.5	6.5	7.3
Cigarettes and tobacco	4.3	4.3	4.8
Spirits, beer, wine, etc.	4.2	4.2	4.4
Other	8.6	8.6	8.9
Total expenditure taxes	55.5	56.5	62.0
North Sea revenues:			
North Sea corporation tax	2.8	3.0	2.6
Petroleum revenue tax	8.2	6.6	2.5
Oil royalties	2.5	2.1	1.0
Total North Sea	13.5	11.8	6.1
Other[2]	-0.8	-0.8	-0.7
Total taxes and royalties	**113.5**	**113.4**	**119.0**
National Insurance and other contributions	24.6	24.3	25.9
Interest and dividend receipts	6.4	6.6	6.4
Other			
Gross trading surpluses and rent	3.1	2.8	2.7
Miscellaneous	2.1	3.1	2.9
Accruals adjustments	0.2	-0.4	-0.1
General government receipts	**150.1**	**149.8**	**156.9**

	1985-86		1986-87
	1985 Budget	Latest estimate	Forecast
Expenditure			
DHSS - Social security	40.1	41.2	42.9
Defence	18.1	18.2	18.5
DHSS - Health and personal social services	16.5	16.7	17.7
Scotland, Wales and Northern Ireland	13.9	14.4	15.0
Education and science	13.6	14.5	14.3
Other	29.4	31.1	31.5
Central privatisation proceeds	-2.5	-2.6	-4.8
Reserve	5.0	-	4.5
Adjustments	0.1	-0.2	-0.4
Public expenditure planning total	**134.2**	**133.4**	**139.3**
General government debt interest less public corporations' net market and overseas borrowing	18.0 -2.3	17.7 -1.3	18.2 -0.6
Other national accounts adjustments	5.0	5.1	5.6
General government expenditure	**159.5**	**157.5**	**163.8**
Difference between expenditure and revenue financed by borrowing:-			
General government expenditure	159.5	157.5	163.8
General government receipts	150.1	149.8	156.9
General government borrowing requirement	9.4	7.7	6.9
Public corporations market and overseas borrowing	-2.3	-1.3	-0.6
Public sector borrowing requirement	**7.1**	**6.3**	**6.3**

(1) Excluding corporation tax on capital gains

(2) Adjustments for advanced corporation tax set off against North Sea corporation tax plus accruals adjustments

Centre

6.09 The forecast drop in oil revenues between 1985-86 and 1986-87 results mainly from the drop in the $ oil price, but partly from the higher $/£ exchange rate.

6.10 Other revenues however are proving more buoyant than earlier expected. In particular, VAT receipts are expected to be some £[1] billion higher in 1985-86 than forecast in the 1985 Budget, mainly reflecting some increase in the proportion of consumers' spending on goods subject to VAT. Receipts of capital taxes are likely to be some £[½] billion higher, because of a greater number of estates subject to capital transfer tax, and higher capital gains tax receipts.

6.11 Between 1985-86 and 1986-87, non-oil revenues are forecast to rise by [10]%. This is faster than the [9½]% rise in non-oil incomes, because of three main factors:

- onshore company tax receipts are expected to rise by [14]% between the two years, reflecting the estimated rise of around 18% in onshore company incomes between 1984 and 1985;

- income tax receipts are forecast to rise by [12]%, reflecting mainly the expected real growth in earnings;

- expenditure tax receipts are forecast to rise by [9½]%, partly because of continuing growth in consumers' expenditure and the sharp rises in rates expected from many local authorities.

Expenditure

6.12 Total general government expenditure is now expected to be around £[157½] billion in 1985-86, some £[2] billion lower than forecast in the 1985 Budget, for two main reasons.

6.13 First, as explained in Chapter 5, the planning total outturn is now expected to be £[½] billion below the figure set in the 1985 FSBR. The delay in ratification of the teachers' pay settlement for 1985 reduces local authorities' cash spending in the current year by around £400 million.

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6.14 Secondly, within the planning total the nationalised industries have been borrowing less from central government and hence repaying less (net) to the market than forecast in the 1985 Budget. Therefore general government expenditure, which excludes their borrowing from the market and overseas, is less than forecast a year ago.

6.15 General government gross debt interest payments in 1985-86 are expected to total about £[17¾] billion, [close to the] forecast in the 1985 Budget. The rise in interest rates two months ago will have had little effect in 1985-86.

6.16 In 1986-87, general government expenditure is forecast at £[163½] billion, [a little lower than] indicated in the 1985 FSBR. The planning total remains the same, as £139 billion; but within it (as in 1985-86) the forecast of nationalised industries' net repayments to the market [is a little lower]. Debt interest payments are forecast at about £[18] billion, [as] in the 1985 FSBR. The rise in interest payments between 1985-86 and 1986-87 is due to the net increase in debt, partially offset by an assumed decline in interest rates from present levels and by lower inflation affecting index-linked instruments.

Borrowing

6.17 The difference between general government receipts and expenditure gives the general government borrowing requirement, as shown in Table 6.1. Together with public corporations' market and overseas borrowing, that gives the public sector borrowing requirement (PSBR).

6.18 The PSBR, shown at the bottom of Table 6.1, is forecast to be around £[6¾] billion in 1985-86, or [1¾]% of GDP, compared with £7.1 billion (2% of GDP) in the 1985 Budget forecast. [Net revenues are broadly unchanged,] as discussed above, and the reduction in the PSBR results mainly from the expectation that the planning total outturn will be below plans.

6.19 However, borrowing in March is always high and unpredictable, with high expenditure and in some cases low income (eg the local authorities, which have low rate incomes in that month). On past

experience there is still a likely margin of error of at least £1 billion either way in the present estimate of the PSBR in 1985-86.

6.20 In 1986-87 the PSBR is forecast at £[6¾] billion, or [1½]% of GDP. However, the flows of receipts and expenditure are very large: indeed, including the revenues and expenditure of the public corporations, the PSBR represents the difference between flows of around £200 billion on each side. A small error in forecasting either flow will result in a large error in the PSBR forecast. Hence the average margin of error in the forecast of the PSBR in 1986-87 is very large, at around £[5] billion either way.

Fig 20? (also of PSBR & margin of error!)

Earlier years

6.21 The changes between 1985-86 and 1986-87 imply that general government receipts and expenditure are both expected to fall relative to money GDP: from [ ]% to [ ]% in the case of expenditure. Next year will be the second successive year in which receipts have fallen sharply in relation to GDP, and the fourth successive year in which expenditure has done so (allowing for the coal strike). The upward trend in the tax burden and public expenditure until the early 1980s has now been clearly reversed (Chart [2.5]).

?

6.22 There have also been changes in the structure of receipts and expenditure. Comparing 19878-89 with the forecast for 1986-87, Chart [6.8] shows the following main developments:

See the Budget Round again!

? Use a table

- borrowing has become a much less important means of financing expenditure, its share falling from 12% in 1978-79 to 5% in 1986-87

- North Sea revenues have grown, but in 1986-87 they are expected to finance only [4%] of expenditure compared with 8% at their peak in 1984-85

- there has been a switch away from direct to indirect taxation; expenditure taxes, including rates, financed 31% of expenditure in 1978-79 but are expected to finance 38% in 1986-87

- the contribution of income tax has fallen from 26% to 24%

- some expenditure programmes, notably defence, health and personal social services, and social security, have increased their shares of total expenditure, while the shares taken by housing, trade and industry, and contributions to the European Community have fallen.

Analysis by sector

6.23 The bottom line of Table 6.1 - the public sector borrowing requirement - may also be analysed by the authority or sector which will be undertaking (or, as the case may be, repaying) the borrowing: central government, local authorities and public corporations.

6.24 This analysis is shown in summary form in Table 6.2 (and in chart 6.9 at the end of the Chapter). It is also shown in the tables for each of the three sectors (Tables 6.3, 6.4 and 6.5): these tables include some of the analysis by economic category discussed further below.

Table 6.2 Public Sector Borrowing Requirement, analysed by sector

£ billion

	1985-86 Latest estimate	1986-87 Forecast
Central government on own account[*]	4.6	5.3
Local authorities	1.9	1.8
Public corporations	-0.2	-0.8
Public sector borrowing requirement	**6.3**	**6.3**

[*]Central government borrowing less on-lending to local authorities and public corporations.

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Central government finances

6.25 The receipts and expenditure which lead to the central government borrowing requirements shown above are:-

Table 6.3 Central Government borrowing requirement

	1985-86	1986-87
£ billion	Latest estimate	Forecast
Receipts		
Taxes and royalties	99.7	103.2
National Insurance and other contributions	24.3	25.9
Other	9.9	10.1
Total	**133.9**	**139.2**
Expenditure		
Current expenditure on goods and services	46.4	49.6
Current grants and subsidies	71.5	75.7
Interest	16.1	17.0
Net lending and capital expenditure, excluding on-lending to local authorities and public corporations	4.5	2.3
Total	**138.5**	**144.6**
Central Government Borrowing Requirement on own account	**4.6**	**5.3**
On-lending to local authorities and public corporations	5.6	3.8
Central government borrowing requirement	**10.2**	**9.1**

6.26 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 also shows central government onlending to local authorities and public corporations, giving the whole CGBR, but the forecasts of onlending are particularly uncertain (since the local authorities and public corporations may instead choose to borrow more from, or repay less to, the market and overseas).

Local authority finances

6.27 The receipts and expenditure which lead to the local authority borrowing requirements shown in Table 6.2 overleaf:-

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Table 6.4 Local authority borrowing requirement

£ billion

	1985-86 Latest estimate	1986-87 Forecast
Receipts		
Rates (net of rate rebates)[*]	13.7	15.8
Rate support grant	11.2	11.8
Other grants from central government	9.7	10.5
Other	5.0	5.0
Total	**39.6**	**43.1**
Expenditure		
Current expenditure on goods and services	28.0	30.7
Current grants and subsidies	5.2	5.7
Interest	4.3	4.5
Net lending and capital expenditure	3.9	4.1
Total	**41.5**	**44.9**
Local Authority Borrowing Requirement	**1.9**	**1.8**
of which:		
Borrowing from central government	4.4	4.0
Other borrowing	-2.5	-2.2

[*] Memo: Rate rebates 1.7 1.7

6.28 Local authority receipts consist primarily of rate income plus grant from central government. The increase forecast in net rate income between 1985-86 and 1986-87 is based on recent information about rate decisions by individual local authorities. The main change in local authority expenditure since the Public Expenditure White Paper is the delay in ratification of the teachers' pay settlement, referred to above.

6.29 The latest estimate of local authority borrowing in 1985-86 takes account of the Borrowing Intentions Survey of a sample of authorities. However, borrowing in the last month of the financial year is always very high and the margin of error is correspondingly great. The forecast of borrowing in 1986-87 is still more uncertain, as is the source of their borrowing: in 1985-86 they are expected to have borrowed [much more] from central government than forecast in the 1985 Budget, and to have repaid correspondingly more to the market, but in 1984-85 it was the other way round.

Public corporations' finances

6.30 The receipts and expenditure which lead to the public corporations' borrowing requirements shown in Table 6.2 are:-

Table 6.5 Public Corporations' borrowing requirement

£ billion

	1985-86 Latest estimate	1986-87 Forecast
Receipts		
Gross trading surplus (including subsidies)	7.4	7.7
Other	3.2	2.7
Total	**10.6**	**10.4**
Expenditure		
Interest, dividends and taxes on income	4.1	3.6
Net lending and capital expenditure	6.4	6.0
Total	**10.5**	**9.6**
Public Corporations' Borrowing Requirement	**-0.2**	**-0.8**
of which:		
Borrowing from central government	1.2	-0.2
Other borrowing	-1.3	-0.6

6.31 The main public corporations are the nationalised industries. Their receipts include subsidies from central government. Their net external finance, ie their borrowing plus those subsidies, is included in the planning total. The effects of the coal strike have continued in 1985-86, adding about £1 billion to the industries' financing needs, eg for coal stock rebuilding by the Electricity Supply Industry.

Analysis by economic category

6.32 The bottom line of Table 6.1 - the public sector borrowing requirement - may also be analysed by economic category (some details of which are given in Tables 6.3-6.5 above). This analysis is shown below, first in summary form (Table 6.6 - see also chart 6.9), giving prominence to the distinction between current and capital expenditure and receipts, and to the current surplus. Table 6.6 also shows how gross capital spending is financed in terms of the current surplus, asset sales and borrowing.

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6.33 The analysis by economic category is shown more fully in Table 6.7, with a breakdown by borrowing authority or sector, and giving the derivation of the financial deficit. Table 6.7 is in the format which has become familiar in successive versions of the FSBR.

[Insert Table 6.6 attached.]

[Insert Table 6.7 attached.]

Outturn data

6.34 Outturns for the PSBR 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 issues of Financial Statistics. Outturns for the details of the PSBR on national accounts definitions, as in Table 6.7, are compiled quarterly and published in sections 2 to 5 of Financial Statistics three months after the end of the quarter.

6.35 The first outturn for the PSBR in 1985-86 will accordingly be published on April 16. The first national accounts outturns for 1985-86 will appear in the June issue of Financial Statistics, including Supplementary Table 13 which is based on Table 6.7.

Table 6.6 **Public Sector current and capital transactions**

£ billion

	1985-86 Latest estimate	1986-87 Forecast
Current expenditure		
Current expenditure on goods and services	68.8	74.6
Current grants and subsidies	56.5	59.9
Debt interest	18.2	18.6
Total current expenditure	143.5	153.2
Capital expenditure		
Gross domestic fixed capital formation	20.1	19.9
Increase in stocks	0.7	0.4
Capital grants (net)	2.8	2.7
Total capital expenditure	23.6	23.1

	1985-86 Latest estimate	1986-87 Forecast
Current receipts		
Taxes and royalties	113.2	118.9
National Insurance contributions	24.3	25.9
Trading surpluses, rent, interest etc.	18.1	18.4
Total current receipts	155.5	163.2
Current surplus	**12.0**	**10.1**
Capital expenditure financed by:		
Current surplus	12.0	10.1
Central privatisation proceeds	2.6	4.8
Council house and other net sales	2.0	1.8
Other financial transactions (net)	0.6	0.1
Borrowing requirement	**6.3**	**6.3**
Total capital expenditure	23.6	23.1

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Table 6.7 The Public Sector's Finances Analysed by Sector and Economic Category

£ billion[1]

1985-86 Latest estimate

	Line[2]	General government: Central government	General government: Local authorities	General government: Total	Public corporations	Public sector
Current and capital receipts						
Taxes on income	*1*	52.3	-	52.3	-0.3	52.1
Taxes on expenditure	*2*	43.0	13.7	56.7	-	56.7
Taxes on capital	*3*	2.4	-	2.4	-	2.4
North Sea oil royalties	*4*	2.0	-	2.0	-	2.0
National Insurance and other contributions	*5*	24.3	-	24.3	-	24.3
Gross trading surplus	*6*	-0.3	0.3	-0.1	7.4	7.4
Rent and miscellaneous current transfers	*7*	0.3	2.8	3.1	0.5	3.6
Interest and dividends from private sector and abroad	*8*	3.0	0.6	3.6	1.1	4.8
Interest and dividends within public sector	*9*	5.5	-2.6	2.9	-2.9	-
Imputed charge for non-trading capital consumption	*10*	0.9	1.4	2.3	-	2.3
Capital transfers from private sector	*11*	-	-	-	0.2	0.2
Total	***12***	**133.4**	**16.2**	**149.6**	**6.1**	**155.8**
Current and capital expenditure						
Current expenditure on goods and services	*13*	-46.4	-28.0	-74.4	-	-74.4
Subsidies	*14*	-5.6	-1.2	-6.8	-	-6.8
Current grants to personal sector	*15*	-43.1	-4.1	-47.1	-	-47.1
Current grants paid abroad	*16*	-2.6	-	-2.6	-	-2.6
Current grants within public sector	*17*	-20.2	20.2	-	-	-
Debt interest	*18*	-16.1	-1.5	-17.7	-0.6	-18.2
Gross domestic fixed capital formation	*19*	-3.1	-3.4	-6.5	-6.0	-12.5
Increase in stocks	*20*	-0.6	-	-0.6	-0.1	-0.7
Capital grants to private sector	*21*	-2.2	-0.7	-2.9	-0.1	-3.0
Capital grants within public sector	*22*	-1.2	0.7	-0.6	0.6	-
Total	***23***	**-141.1**	**-18.0**	**-159.1**	**-6.2**	**-165.3**
Financial surplus/deficit	***24***	**-7.6**	**-1.8**	**-9.5**	**-0.1**	**-9.6**
Financial transactions						
Net lending to private sector and abroad	*25*	-0.1	0.2	0.1	-0.1	-
Cash expenditure on company securities (net) (including central privatisation proceeds)	*26*	2.7	-	2.7	-	2.7
Transactions concerning certain public sector pension schemes	*27*	0.5	-	0.5	-	0.5
Accruals adjustments	*28*	-0.4	0.1	-0.4	0.4	0.1
Miscellaneous financial transactions	*29*	0.4	-0.4	0.1	-	0.1
Borrowing requirement	***30***	**4.6**	**1.9**	**6.5**	**-0.2**	**6.3**

(1) Sign convention : receipts positive, payments negative.
(2) Relationship between lines : (24) = (12) + (23) = - {(25) to (30)}

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Table 6.7 continued

£ billion[1]

1986-87 Forecast

	Line[2]	General government: Central government	Local authorities	Total	Public corporations	Public sector
Current and capital receipts						
Taxes on income	*1*	53.1	-	53.1	-0.2	52.9
Taxes on expenditure	*2*	46.3	15.8	62.2	-	62.2
Taxes on capital	*3*	2.7	-	2.7	-	2.7
North Sea oil royalties	*4*	1.0	-	1.0	-	1.0
National Insurance and other contributions	*5*	25.9	-	25.9	-	25.9
Gross trading surplus	*6*	-0.6	0.3	-0.3	7.7	7.4
Rent and miscellaneous current transfers	*7*	0.3	2.9	3.3	0.5	3.8
Interest and dividends from private sector and abroad	*8*	3.2	0.6	3.8	1.0	4.8
Interest and dividends within public sector	*9*	5.7	-3.1	2.6	-2.6	-
Imputed charge for non-trading capital consumption	*10*	1.0	1.4	2.4	-	2.4
Capital transfers from private sector	*11*	-	-	-	0.2	0.2
Total	***12***	**138.7**	**18.0**	**156.8**	**6.7**	**163.5**
Current and capital expenditure						
Current expenditure on goods and services	*13*	-49.6	-30.7	-80.3	-	-80.3
Subsidies	*14*	-5.9	-1.2	-7.0	-	-7.0
Current grants to personal sector	*15*	-45.8	-4.5	-50.3	-	-50.3
Current grants paid abroad	*16*	-2.5	-	-2.5	-	-2.5
Current grants within public sector	*17*	-21.5	21.5	-	-	-
Debt interest	*18*	-17.0	-1.2	-18.2	-0.5	-18.6
Gross domestic fixed capital formation	*19*	-3.3	-3.6	-6.9	-5.6	-12.5
Increase in stocks	*20*	-0.2	-	-0.2	-0.2	-0.4
Capital grants to private sector	*21*	-2.1	-0.7	-2.8	-0.1	-2.9
Capital grants within public sector	*22*	-1.4	0.8	-0.6	0.6	-
Total	***23***	**-149.2**	**-19.7**	**-168.8**	**-5.8**	**-174.7**
Financial surplus/deficit	***24***	**-10.5**	**-1.6**	**-12.1**	**0.9**	**-11.2**
Financial transactions						
Net lending to private sector and abroad	*25*	-0.2	0.3	-	-0.1	-0.1
Cash expenditure on company securities (net) (including central privatisation proceeds)	*26*	4.8	-	4.8	-	4.8
Transactions concerning certain public sector pension schemes	*27*	0.6	-	0.6	-	0.6
Accruals adjustments	*28*	-0.2	-	-0.1	-	-0.1
Miscellaneous financial transactions	*29*	0.1	-0.5	-0.4	-	-0.4
Borrowing requirement	***30***	**5.3**	**1.8**	**7.1**	**-0.8**	**6.3**

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Chart 6.8

THE BUDGET POUND

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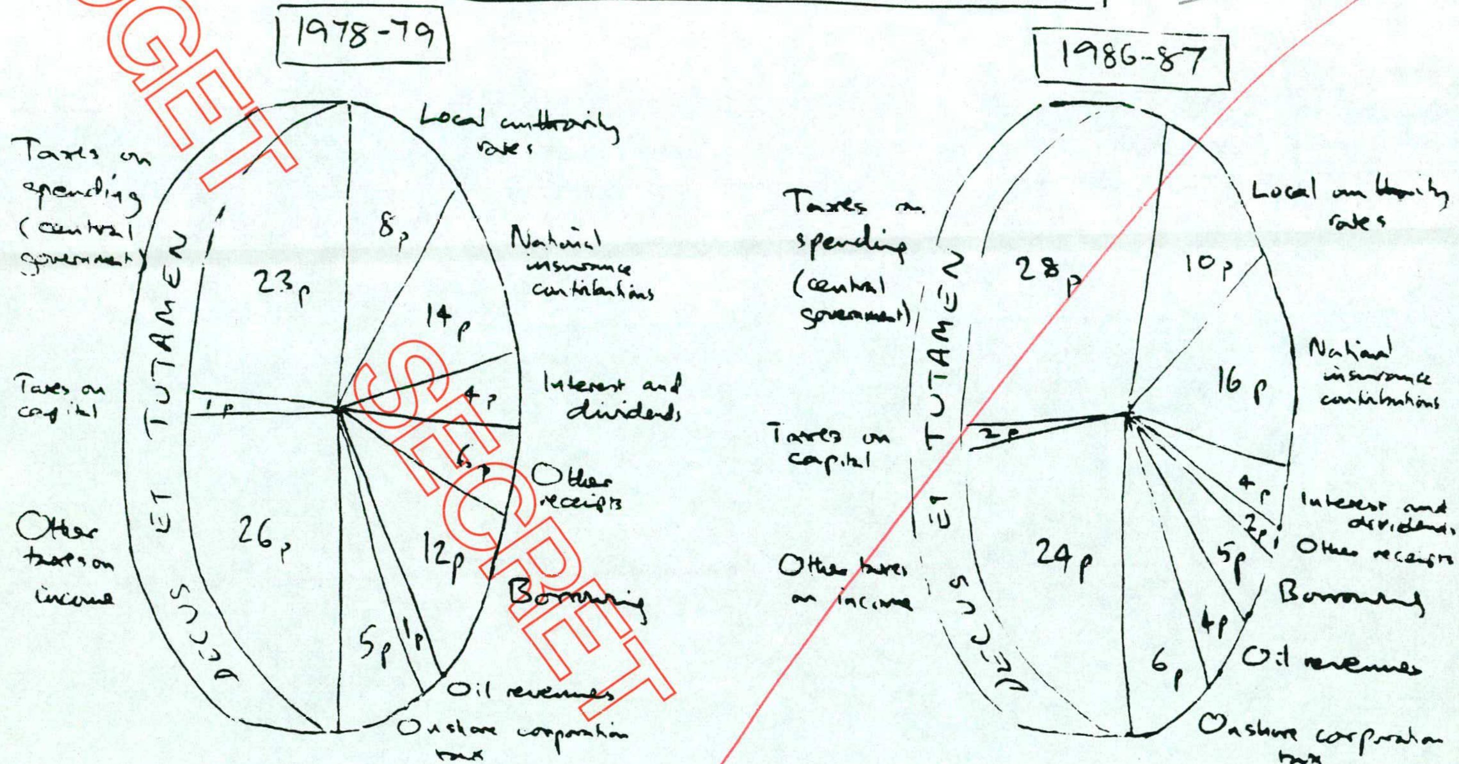
WHERE IT COMES FROM



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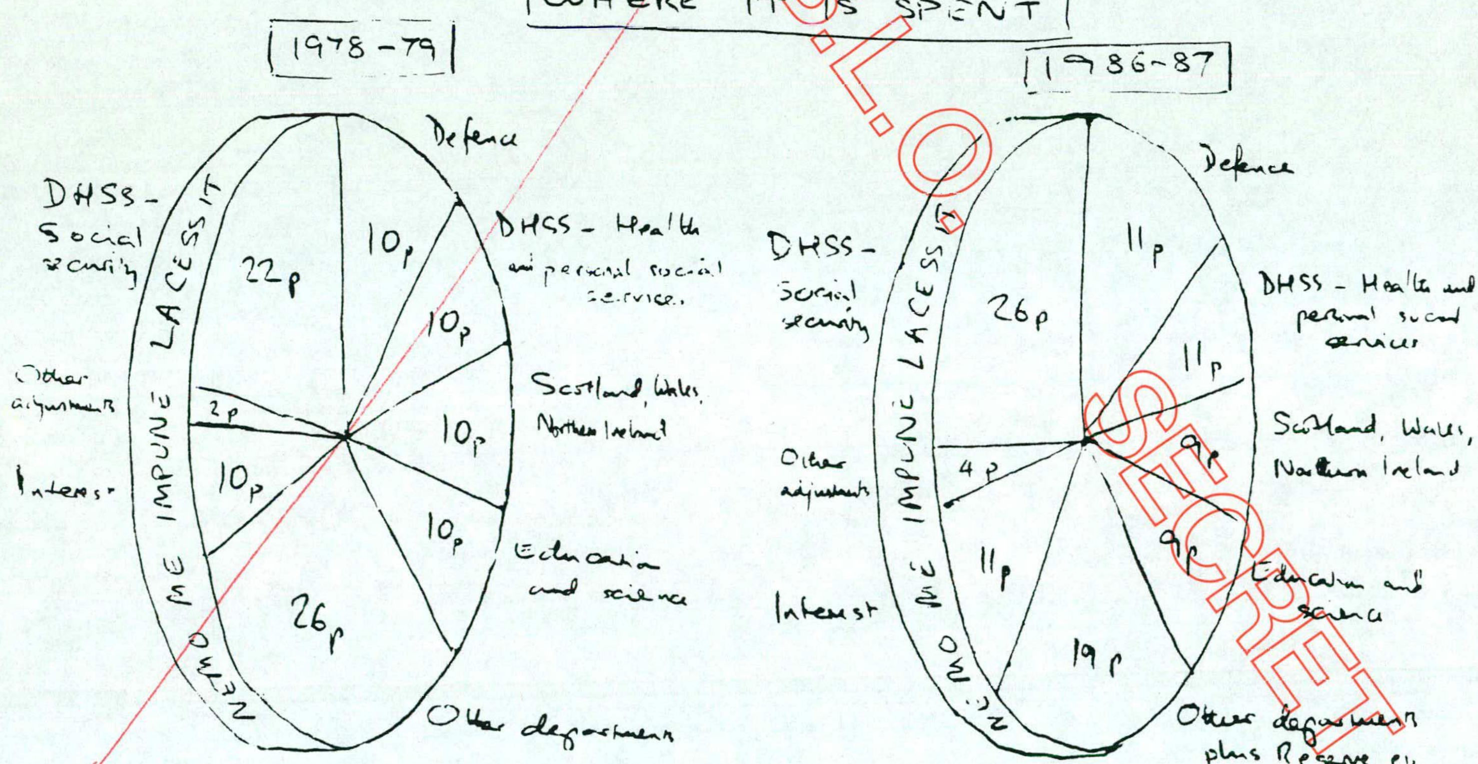

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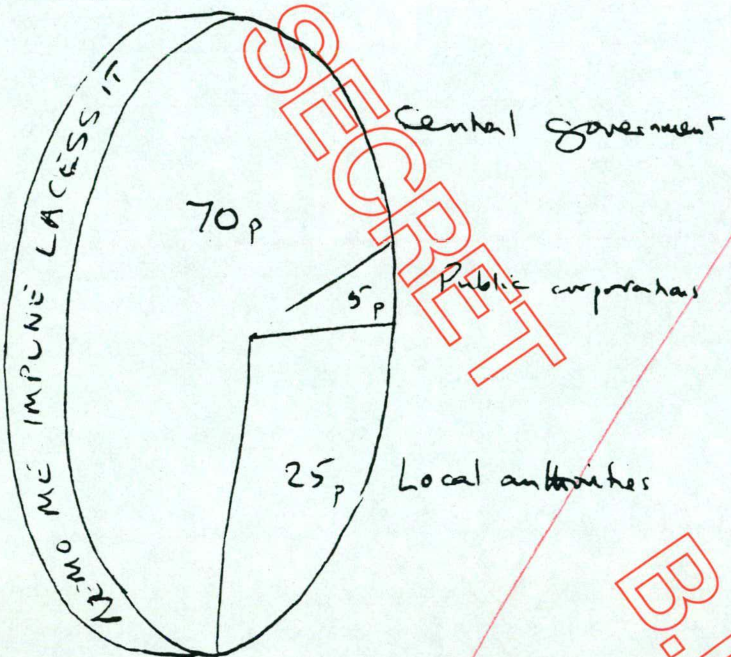
Chart 6.9

THE BUDGET POUND
(continued)

1986-87

WHO SPENDS IT



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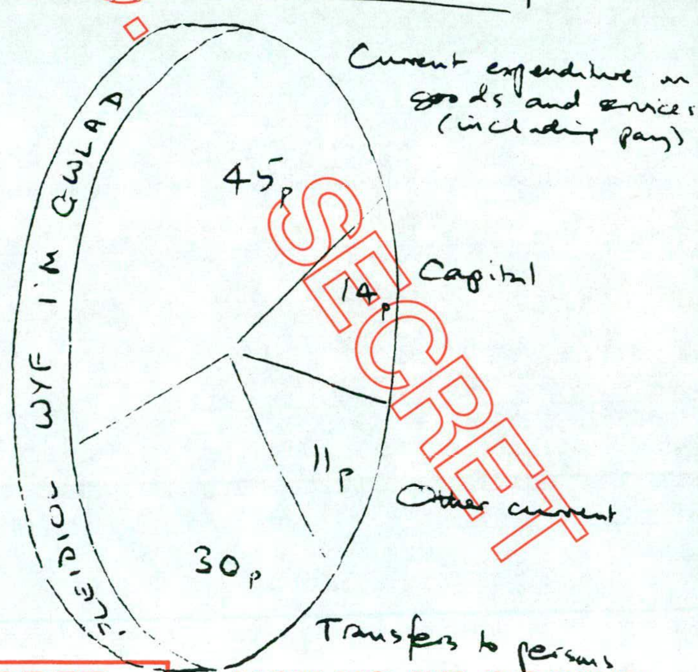

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CONFIDENTIAL

FROM: MRS R LOMAX

DATE: 6 March 1986

PS/CHIEF SECRETARY

Nigel
MJ 7/3
Pl. alert Thomas Mo
to X dash
for early reply.

cc PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Cassell
Mr Evans
Mr Odling-Smee
Mr Scholar
Mr Turnbull
Mr Culpin
Miss O'Mara
Miss Peirson
Mr Pratt
Mr Cropper
Mr H J Davies
Mr Lord

1986 FSBR

The Chancellor has seen your minute of 5 March recording the Chief Secretary's comments on Chapters 3 and 6 of the FSBR. He notes that it has already been agreed that Chapter 6 should follow the 1985 model - though the original draft contains the seeds of a useful paper to the TCSC, subject to the Chief Secretary's points. He looks forward to seeing a revise of Chapter 6 along last year's lines.

2. The Chancellor agrees with the Chief Secretary on the PSBR range of forecasting error. He thinks it would be far better if from now on we could use average errors over a more recent period for all forecast variables. He would be grateful for Sir Terence Burns' views on this.

RL

RACHEL LOMAX

BR/38

CONFIDENTIAL

pwp

FROM: MRS R LOMAX

DATE: 7 MARCH 1986

MISS LEAHY

cc Chief Secretary
Financial Secretary
Economic Secretary
Ministry of State
Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Cassell
Mr Monck
Mr H Evans
Mr Scholar
Mr Turnbull
Mr Mowl
Mr Robson
Mr Fellgett
Mr Hacche
Mr Coombes
Mr H Davies
Mr Pitts IR
PS/IR

ROYALTY OIL RECEIPTS 1986-87 - ESTIMATES AND FSBR FORECASTS

The Chancellor has seen your minute of 5 March. He does not think that a difference in the oil price assumptions used in the FSBR and the estimates would be a serious problem. But in practice he thinks we will be in a position to take a final decision on the oil price on Monday - and the chances are that we will want to stay with the $15 a barrel now assumed in both the estimates and the FSBR forecast.

RL

RACHEL LOMAX

BR/39 CONFIDENTIAL

FROM: MRS R LOMAX

DATE: 7 MARCH 1986

PS/CHIEF SECRETARY

cc Sir P Middleton
Sir T Burns
Mr F E R Butler
Mr Anson
Mr Cassell
Mr Kemp
Mr Evans
Mr Jameson
Mr Odling-Smee
Mr Scholar
Mr Turnbull
Mrs R Butler
Mr Culpin
Miss Peirson
Mr Lord

1986 FSBR: CHAPTER 6 - ALLOCATING THE RESERVE

The Chancellor has seen the Chief Secretary's minute of 5 March. In the light of the Chief Secretary's views, he is content not to allocate the reserve this year. This can be defended by reference to the trouble caused last year by the notional attribution to the local authorities, (and of course to the note sent recently to the Treasury Select Committee which argued that specific components to the reserve cannot be identified). He has commented that if, in the light of experience, we come to regret this decision, we can think again next year.

RACHEL LOMAX

AGENDA

1. **THE POLICY BACKGROUND TO THE 1986 MTFS**
[references are to Sir T Burns' paper]

(a) Introduction (paragraphs 1-10)
Assessment of economy's progress since 1979 - comparison with 1975-79; success in reducing money GDP - improved output/inflation split (but still worse than for OECD 6) - excessive real earnings growth, higher productivity - large rise in unemployment. Is the analysis in paras 1-10 accepted?

(b) The Medium Term Prospect (paragraphs 11-25)
Scope for output growth consistent with declining inflation is now revised upwards and put at about 2½% (para 25) a year. Does this seem a reasonable medium term projection, taking proper account of the prospects for productivity, labour supply and the North Sea (para 18 and Table 8); the beneficial movements in commodity prices (paragraph 14 and 22); as well as the continuing failure of the labour market to adjust (paras 8-9 and Table 8 of the Annex)?

(c) Inflation objectives (paragraphs 28-34)
Should we stick to the profile of 3% inflation by 1988-89 (and 2½% by 1989-90)? How important is it to ensure that this is achieved? Is the projected path of money GDP sufficient to secure it?

(d) Role of money GDP and monetary policy (paragraphs 35-45)
It is not proposed to discuss the presentation of monetary policy and money GDP in detail at this stage; there are a lot of technical questions to be sorted out first. The usual procedure is to return to this at a later stage in the context of the MTFS chapter of the FSBR.

(e) The overall stance of policy (paragraphs 46-56)

Is the assessment, that the overall policy stance was eased in 1983-84, tightened in the first few months of 1985 and needs no further tightening for the year ahead (still?) accepted?

(f) Balance of fiscal and monetary policy (paragraphs 57-77)

(i) If the need to avoid sterling weakness and to apply downward pressure on earnings, the rapid growth of £M3 and high world interest rates point to a cautious approach towards monetary policy, do the short term arguments, together with the unexpectedly sharp North Sea revenue decline, suggest (as paragraph 67 indicates) that an easier fiscal stance might be desirabl/possible?

(ii) Or is monetary policy now uncomfortably tight, with a real exchange rate and real interest rates high in relation to our competitors'? Would a tighter fiscal stance offer the prospect of lower interest rates?

(iii) We have acknowledged that asset sales are taken into account in setting the PSBR, and our presentation (eg in the Autumn Statement) has begun to show them separately. Do the higher receipts in prospect point (paragraph 73) to a much lower PSBR than planned in the 1985 MTFS? What weight should be given to the other arguments for fiscal caution - the undesirability of a boost to consumption, and worries about debt interest, confidence, and loss of room for manoeuvre (paragraphs 74-77)?

(g) PSBR arithmetic for 1986-87: balance of arguments (paragraphs 78-94)

(i) Should the PSBR for 1986-87 be in the range £6-7½ billion?

(ii) If so, where in the range?

(iii) What working assumption should we adopt at this stage for the scale of the fiscal adjustment?

(iv) Is it agreed that macro-economic considerations do not give any decisive pointers to the use of the fiscal adjustment next year (paragraphs 92-94)?

(v) If oil prices fall sharply higher interest rates would be needed to keep monetary conditions on track and limit the fall in the exchange rate. In these circumstances should non-North Sea taxes (fuel duties?) be raised to limit the likely rise in [interest rates and] the PSBR?

2. **EMPLOYMENT AND ENTERPRISE ISSUES**

[references are to Mr Monck's paper]

Paragraph 56 poses the main questions for discussion:

(a) In the light of the unemployment position and prospect (paragraphs 1-9), the scale of the existing special employment measures (especially those in the 1985 Budget whose effects have not yet come through fully), and the need to hold to the public expenditure plans and reduce taxation, is there any need for a further public expenditure package of employment and enterprise measures? (Note that our Budget arithmetic will have to show any such extra public expenditure being financed not from the fiscal adjustment, but from within published spending plans.)

(b) What is the scope for definitional change (paragraphs 17-18 and 26) or administrative measures, eg removing earners and drawers or those languishing on the count (paragraphs 21-27)? Should we make all possible progress with these measures - which will require work with the Department of Employment - in any event?

(c) If there is a need for a package

(i) should its scale be such that it can realistically be charged to the Reserve for 1986-87 and fitted within the planning total for later years (note the projection in Mr Evans' submission that the Reserve will not be able to accommodate this and other likely demands in 1987-88 and 1988-89)?

(ii) should the measures be taken from Lord Young's November list - ie those in the top half of Table 3 (paragraph 31), with their 'enterprise' bias - ie

- Enterprise Allowance (Annex B paras 2-3)
- Loan Guarantee Scheme (ibid paras 4-5)
- New Workers' Scheme (paras 6-11)
- Derelict Land Grant (paras 27-29) — Surely not on LY's list
- more fraud staff?

Should those in the bottom half of the Table be rejected - ie the remainder of Lord Young's November proposals:

- extending the pilot measures for the long-term unemployed (Annex B paras 8-11);
- more Community Programme places (paras 13-16);
- extension of the Technical and Vocational Education Initiative (paras 18-19);
- and almost all of the CBI's proposals (eg introducing a Building Improvement Programme, extending the Urban Development Programme, expansion of Job Release and Job Splitting Schemes).

(d) Given the importance of pay, the poor labour market adjustment performance of recent years and the increased profile of the pay and jobs connection, would it be worthwhile, if only to buttress our exhortatory efforts, to consider a scheme of the Sam Brittan variety (paras 36-39)?

(e) Is there an employment case for a general reduction in the CT rate or in employers' NICs?

(f) Should profit-sharing (Weitzman) be pursued, for substantive or presentational reasons (paras 41-42; other relevant papers are Mr Monck's submission of 16 August, Mr Isaac's of 12 December, PS/FST's minute of 20 December and Mr H J Davies' of 2 January)?

Howard

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(g) Which of the minor measures in paragraphs 44-45 look worth pursuing? Viz:

(i) Small Business Investment Companies

(ii) Cooperatives - increase in maximum shareholding
- reduction in registration charge
- access to profit-sharing schemes
(Mr Farmer's submission of 20 December)

(iii) Training Loan Pilot Scheme

(iv) Exempting Enterprise (and Jobstart) Allowances from tax (Mr Elliott's submission of 25 November)

(v) Increase VAT limit beyond indexation.

3. **TAX ISSUES**

[references are to Mr Monger's paper, except where stated)

(1) General Approach

(a) The tax issues need to be approached against the background of the earlier discussion under 1(g) above together with the preliminary prospects for expenditure and revenue indicated in Mr Evans' note on the Winter Forecast.

(b) The main tax questions are identified in paras 3-5 of Mr Monger's paper:-

(i) the overall scope for income tax cuts, from rate reductions or threshold increases or both;

(ii) whether additional revenue might be raised through higher indirect taxes, either by over-indexation of excise duties, or by an increase in the VAT standard rate;

(iii) what other major changes - on, for example, CTT, stamp duty, BES, pension funds surpluses, charitable giving - are to be included.

(2) Excise Duties and VAT (paragraphs 15-18)

(a) Should we set an overall limit on the impact effect of the Budget measures on the RPI?

(b) Should we take an interim decision - interim until the major decisions have been taken - to aim for some overall over-indexation on the excise duties (1½ times revalorisation on all duties increases the RPI by 0.6 per cent compared with 0.4 per cent for straight revalorisation; and raises £370-£385 million)?

(c) Is there a case for higher, or lower increases for specific duties -

(i) bigger increases in derv and petrol and tobacco duties (Sir A Fraser, paragraphs 7 and 8)?

(ii) smaller changes in VED (Mr Ridley wants no change for cars and a reduction for lorries, perhaps made up for by extra increases in fuel duties) (Sir A Fraser, paragraph 8)?

(iii) more lenient treatment (Sir A Fraser, paragraph 6) for drinks, and all the main drinks to get the same treatment?

(d) Should the VAT rate be increased and, if so, by how much?

(e) Should there be any VAT exemption for charities (Sir A Fraser, paragraph 4)?

(3) <u>Personal Income Tax</u>

(a) The balance between increased allowances and cuts in the basic rate (paragraphs 7-10)

? cost of making age allowance universal (& limit)

(i) To what extent does the case for giving preference to a basic rate cut this year (over a further increase in allowances) depend on the prospect (and cost) of a substantial increase in allowances accompanying the move to transferable allowances in 1990?

Whatever because of marginal rate (but if no ... not)

(ii) Have the Fowler reforms permanently altered the balance of advantage between action on allowances and on the basic rate (paragraph 8)?

+ from when (ie relevant to this year?)

(iii) What is the minimum acceptable increase in allowances - 5½ per cent (prices indexation) or 7 per cent (earnings - the minimum necessary to avoid an increase in the number of taxpayers and Inland Revenue manpower)? What might be adopted as a target increase?

(iv) What is the minimum acceptable cut in the basic rate - is anything less than a 2p cut worth doing? What might be adopted as a target cut?

(b) What changes to the higher rate structure are worth considering (paragraph 11, and Annex 7 to Mr Blythe's paper)?

No: look @ IR's options

(i) simplification, by stretching out the rate bands (including the relatively short first slice of £3000 at 40 per cent), on a revenue-neutral basis? Would the resultant pattern of gainers/losers be acceptable?

(ii) should such restructuring be combined with restriction of mortgage interest relief to the basic rate (paragraph 12)?

(c) What other personal tax changes are runners:

(i) Is it confirmed that a reduced rate band is ruled out (paragraph 13)?

(ii) An increase in the mortgage interest relief ceiling (paragraph 14)?

(iii) An increase in car benefit scale changes (paragraph 14)?

(iv) Is it confirmed that relief for domestic employees is ruled out (paragraph 14)?

(4) Business Taxes (paragraph 19 and Annex 4)

(a) Is it confirmed that there will be no changes in the basic CT structure announced in 1984? Can the Ernst and Whinney Study be ignored (Mr Bush's paper of 30 December)?

(b) Is there a case for help to the small firms/ unincorporated sector (Annex 4, paras 12-13) -

either (i) a cut in the small firms' CT rate (if the basic rate of income tax is cut)?

or (ii) an increase in the small companies profit limit?

(c) Mining and oil allowances -

(i) is it agreed that there should be no change in the North Sea fiscal regime (paragraph 21)?

(ii) would it be worthwhile to include a statement on the tax treatment of incremental projects (paragraph 21)?

(ws follow concept) (5) Capital Taxes

(a) Should the Capital Transfer Tax lifetime charge be abolished (paragraph 22)?

(b) Is it confirmed that there should be no major changes in Capital Gains Tax in 1986?

(c) On Stamp Duty (paragraph 24) -

(i) is it agreed that reduction/abolition of duty on share transactions by individuals/ institutions is desirable?

(ii) should this be revenue-neutral, and if so, what offsetting changes can be made to gilts and to other city financial transactions?

(iii) what other changes should be made - eg duty on houses, on capital duty and unit trust duty?

(iv) what scope is there for an alternative tax on financial services (paragraph 25)?

(6) <u>Pensions and Saving</u> (paragraphs 26 and 27)

(a) What action should be taken this year on surpluses? Is it confirmed that action on personal pensions is for 1987?

(b) Is there a case for a further tranche of tax-privileged savings possibly linked to retirement or targeted on equities?

(7) <u>Enterprise and Employment: tax measures</u>

(a) Mostly considered in the discussion of Mr Monck's paper; but provisional decisions on <u>Business Expansion Scheme</u> have been taken (paragraph 28).

(b) Are the changes to <u>employee share schemes</u> in paragraph 30 accepted?

(8) Charitable Giving (paragraphs 31 and 32)

(a) Should the £10,000 limit on higher rate relief for covenants by individuals be abolished, and should 'private indirect' charities be excluded?

(b) Should any of Sir Adam Ridley's suggestions be taken further -

(i) CT relief for single gifts by companies?

(ii) encouragement for payroll giving?

(iii) partial tax relief for single gifts by individuals?

= You wanted to raise LOLLIPOPS

| minimum tax

4. Next Steps

(1) What are the priorities for further work?

(2) Does the following outline timetable look acceptable?

NB Green Paper

31 January	Report of the Winter forecast
13 February	Cabinet discussion of economic prospects
21 February	First draft of Budget Statement and FSBR
28 Feb	VAT rate
3-~~4~~ 4 March	Deadlines for decision on main tax changes
14 March	Final draft of FSBR and Budget decisions
18 March	Budget Day

(3) Which Ministers should be seen (last year: S/S Environment, Transport, Employment, Home Secretary, Minister of Agriculture)?

Lord Young

Mr Ridley

Mr Fowler

Mr Brittan (who has asked for a meeting)

Mr Baker

? Hurd &/or Luce on charities?

(4) Anything to be added on the presentation of the Budget?

(5) Any other points?

CONFIDENTIAL

FROM: ROBERT CULPIN
DATE: 10 JANUARY 1986

CHANCELLOR

cc CST
FST
EST
MST
Sir P Middleton
Sir G Littler
Mr F E R Butler
Sir T Burns
Mr Cassell
Mr Monck
Mr Scholar
Mrs Lomax
Mr Cropper
Mr Lord
Mr H Davies

THE PRESS BEFORE THE BUDGET

THE PRESS BEFORE THE BUDGET

Sir Peter Middleton asked me to do a note for Chevening.

Background

2. We go into the Budget much stronger than last year. At the beginning of 1985, inflation and unemployment were unequivocally rising, the pound was on a toboggan, and interest rates were heading to 14%. Miners were striking. We were about to launch a Public Expenditure White Paper with its head in the sand.

3. This followed a bad autumn. You had an unfortunate Party Conference and poor receptions in the House. Thanks to the student grant row, it took a police escort to get us back from a TCSC hearing. We were forced before Christmas into a reassurance about pension lump sums, and then faced non-stop lobbying from special interests on VAT.

4. Our credibility was low. The rhetoric was of battening down the hatches.

5. We have turned much of this around. And although this week has seen interest rates and unemployment up, Wednesday's action

has clearly strengthened our credibility.

6. We may now be in for one of those happy periods when inflation and unemployment both fall. I think it would be the first time this has happened for 8 years. We should have a favourable background against which to present the Government's policies. A small cloud is that RPI inflation will be rising after the summer.

7. I see no real problem about **monetary policy**. People say it is unclear, but know quite well what puts interest rates up, and what lets them come down. We must have another go at explaining it in and around the Budget, as we discussed this morning. But until then, we rest on the Mansion House speech, and the evidence that you mean what you say.

8. On **fiscal policy**, we have succeeded in dumping the fiscal adjustment, and we are no longer arguing (much) about infrastructure versus tax. Some still think there is a choice between letting people keep more of their own money and doing something about unemployment - and the CBI's Budget representations won't help. But in the main, most people assume the priority to be tax. There are two simple questions: how much and what measures?

Amounts

9. The consensus expectation is tax reductions of about £2 billion. That is what our survey of outside forecasts shows. It is also what we read in the papers. Give or take about £½ billion, it is the figure most journalists mutter to me.

10. On average, the outside forecasters assume that £2 billion of tax cuts will leave the PSBR at about £8½ billion. So if they were to constrain it to something like the Red Book figure, the implied fiscal adjustment would only be about £1 billion.

11. This precision is spurious, if only because the average forecast does not take full account either of the fall in oil prices or of the acceleration in the privatisation programme. Nor is

it a sum I have seen in print. But journalists have the impression that the consensus estimate is edging down: they now put it at £2 billion or less, rather than £2-3 billion.

12. So if the Budget were to reduce taxes by a net £2 billion, my customers would not be surprised. Significantly more or less and they would be.

13. This is not to say they would describe fiscal policy as unchanged. Most would see it as a mild easing, taking privatisation proceeds into account: sub-sub-Reaganomics.

14. If we took £2 billion off taxes and set the PSBR at £6½-7 billion, consistently with our last forecast, the surprise would not be the figure for taxes but that for the PSBR. To most of my customers, it would look implausibly low. A major reason, of course, is that most outsiders doubt our public expenditure figures. The first **essential** in the run-up to the Budget will be to persuade people next week that the **Public Expenditure** White Paper is **realistic.**

15. It is helpful that the consensus expectation for tax reductions is coming down. The only specific contribution we have made to this is to state the obvious - that lower oil prices mean lower revenues. You have said that in the House, and we should clearly go on saying it.

16. If you wanted me to go further, I could draw attention to the arithmetic in paragraph 10, and remind people how relatively small previous fiscal adjustments have been. But this is a delicate game. While it would suit us politically to lower expectations further - and I rather like the figure of £1 billion - anything which comes as a nice surprise to taxpayers risks being a nasty surprise to markets.

17. I think the **line** should be this:-

- we are giving no estimate whatever of the fiscal adjustment for any assumed PSBR

- you have acknowledged that lower oil prices mean lower revenue

- on the fiscal stance, you have told the FT to wait for the Budget, but said prudence will continue to be your watchword

18. If journalists speculate about the PSBR, adjustments for privatisation proceeds and so on, we should simply acknowledge what is already on the record:-

- the Red Book is a starting point

- the path for borrowing has always taken "account of important influences such as the pattern of North Sea oil revenues, and the level of asset sales arising from the privatisation programme" (1984 Budget Speech)

- "there is nothing sacrosanct about the precise mix of monetary and fiscal policies" (1985 Budget Speech).

The object should be to confuse them.

Measures

19. On measures, we face some problems of success. We have ended speculation on many, so it has narrowed to few. You have done companies and national insurance, ruled out VAT extension, and remitted personal taxes to a Green Paper. No one believes you could make much headway on mortgage relief or pensions (surpluses apart).

20. The popular question is **rates versus thresholds**. People have had thresholds dinned into them over the last few years, but you are now seen as a rate cutter. The links with Fowler and with transferable allowances have both been made (especially by Hogg and Raphael). There is some expectation of what John Cole called the old "tanner off".

21. The **line** on this is clear:

- rates and thresholds are both important
- the Government has reduced one and raised the other
- the first thing to establish is whether we can afford either

22. An increasing risk is that, looking further ahead, colleagues will start describing to journalists umpteen "better" ways of using £5 billion than to introduce transferable allowances. Most of these will be ways of spending more. If this happens, we shall just have to repeat that the only question is what form any tax reductions should take, if any can be afforded.

23. These issues apart, interest focusses on what more you can do to improve the **labour market** and the prospects for employment. People expect more of the same on special employment measures. Some are touting marginal employment subsidies or inflation taxes or incentives to profit sharing.

24. The most difficult conversation I have is with people who support or understand the Government's policy. "OK, you set the nominal framework and leave the split to the market. OK, unemployment has much more to do with real wages being too high than with macro policy. But the labour market manifestly isn't working properly. After six years of non-accommodation, union reforms and micro measures, pay is rising well above market clearing rates, and those with jobs are expropriating those without. What are you going to do to make the market work better?"

25. One answer is to build up case by case examples of increasing flexibility and realism. We are trying to do that.

2.

26. But people will be looking for some measure or measures in the Budget. If, for instance, you could build on previous Budgets by giving further incentives to profit sharing schemes, it would be a great help.

27. People are not, so far, speculating about higher VAT to finance

lower income tax.

Conclusion

28. My present forecast of what journalists will forecast is this:-

- monetary targets for MO (probably unchanged) and £M3 (certainly raised)

- EMS nearer

- some traditional employment measures, plus something or other to fill the role of NIC restructuring last time

- indexed thresholds: if anything, indexed plus rather than indexed minus

- the usual bundle of taxes going up (?fuel) and down (? stamp duty)

- whatever reduction in the basic income tax rate you can afford for about a net £2 billion of tax reliefs

- a PSBR in the region of this year's likely outturn - around £8 billion - which would be perceived (a) as a modest easing, given privatisation proceeds, and (b) as a number we would probably overshoot slightly.

as high as this in the MTFS?

The **line** on all such packages is blindingly obvious: wait for the Budget.

Rc

ROBERT CULPIN

MRS LOMAX

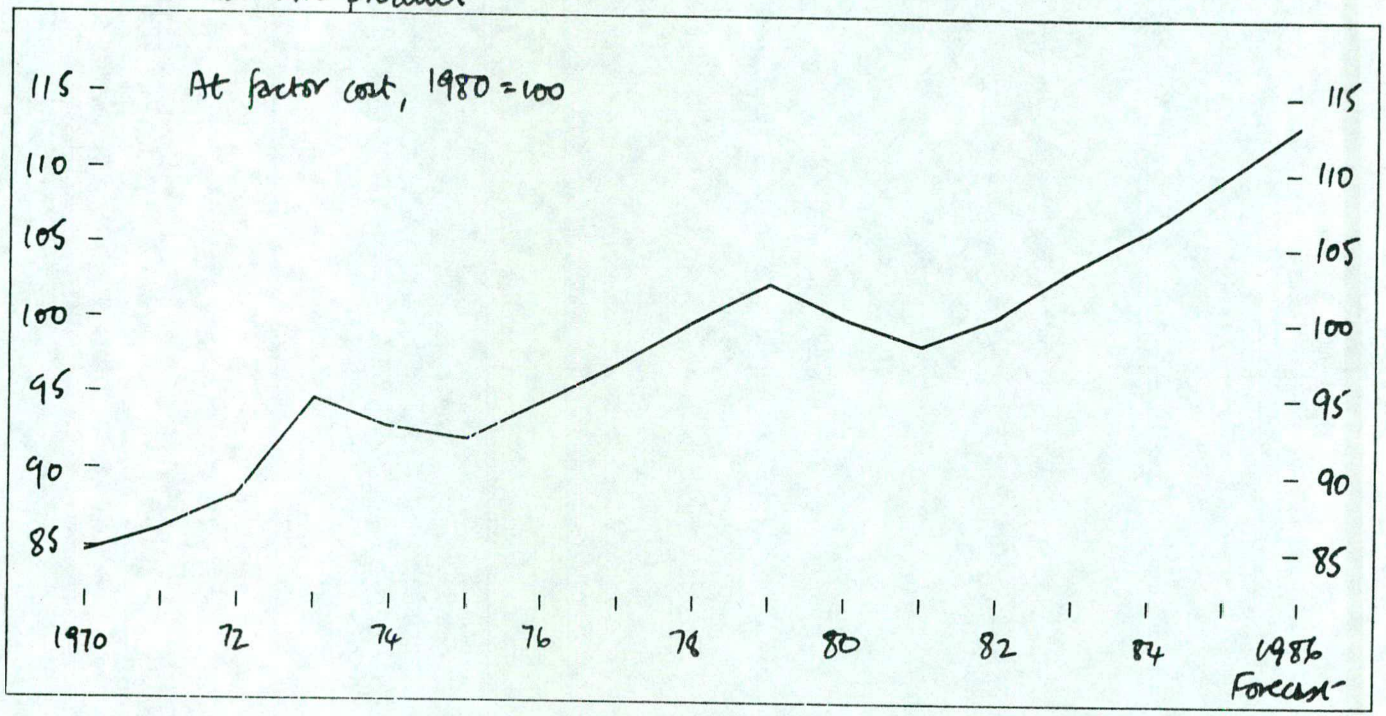
CHART OF GDP

Mr Scholar tells me that the Chancellor was anxious to see the latest version of the attached chart.

S J Davies

2

Gross domestic product



(45)

BUDGET - SECRET

PRIME MINISTER

1986 BUDGET: MTFS

My two previous minutes set out my Budget tax proposals with the exception of those for income tax, which we agreed at our meeting on ~~[Date]~~. 5 March.

2. I have since agreed a package of employment measures with David Young, ~~about~~ on which I ~~[will be]~~ have minut~~ing~~ed you separately.

3. This leaves the question of the PSBR and monetary targets for 1986-87.

Public Sector Borrowing

4. The latest indications are that this year's PSBR will come out slightly below the £7 billion forecast in the last Budget (and still more below the figure forecast last autumn). A substantial shortfall on oil revenues has been more than made up by the buoyancy of other tax revenues and an expected small underspending of the Reserve. We have thus achieved this year a significant step down in the PSBR, the first since 1981-82, reducing the PSBR as a proportion of GDP from over 3 per cent to just 2 per cent.

5. Last year's MTFS envisaged a PSBR of £7½ billion for 1986-87 (after allowing for a "fiscal adjustment" of £3½ billion). Since then we have added £2½ billion to expected receipts from privatisation, offsetting a similar addition to gross expenditure plans. We have had to revise down our forecast of oil revenues by over £5 billion (on an assumed oil price averaging $15 a barrel (for calendar 1986, implying $14 a barrel for March-December inclusive). But other tax receipts are forecast to be significantly higher than was expected a year ago. So the reduction in total government tax revenues is ~~about~~ rather less than £3 billion. At unchanged tax rates, therefore, we would foresee a PSBR of around £6 billion. The Budget package that ~~I propose~~ we have agreed would come to just under £1 billion, raising the PSBR to £7 billion or 1¾ per cent of GDP.

~~must be £2½ bn [illegible]~~

6. In view of all the uncertainties I think it is wise to err on the side of caution and aim for a borrowing figure

below the £7½ billion envisaged a year ago. It is important that the Budget should be seen by the markets as sound and responsible. I think that a PSBR of £7 billion would be so regarded, and indeed should leave us with some room for manoeuvre if, for example, there were a further weakening in oil prices later in the year.

7. For the remainder of the MTFS period ~~years further ahead~~ I plan to show a path in which the PSBR falls slightly further ~~remains at £7 billion, falling as a proportion of GDP~~ to 1½ per cent of GDP ~~by the end of the MTFS period.~~ 1988/89. (Each 1/4 per cent of GDP is approximately £1 billion.)

8. For the monetary targets I ~~am~~ intend~~ing~~ to stick to MO and £M3, but in view of the uncertainties about the velocity trend of broad money, the ranges for £M3 growth will ~~not~~ be shown for ~~the years beyond~~ 1986-87 only. Ranges for MO will be shown for the whole MTFS period, as will a figure for money GDP.

9. Deciding the appropriate target range for £M3 for the coming year has ~~required considerable judgement~~ not been easy. A year ago we set a range of 5-9 per cent growth in 1985-86; in the 12 months to February the actual growth of £M3 has been nearly 15 per cent. We must set a range for 1986-87 that is credible and I have decided that this should be 11-15 per cent, which would ~~allow for~~ assume a continuation of the recent velocity trend.

10. For MO the choice of target range is much easier. Its growth over the past 12 months has been 3½ per cent, towards the bottom of the range 3-7 we set a year ago and I am reaffirming for 1986-87 the 2-6 per cent range indicated in last year's MTFS. The~~se~~ target ranges for both aggregates have been agreed with the Bank.

~~DRAFT (PARAS 8-10)~~

Monetary Targets

For the monetary targets in 1986-87 I ~~am~~ intend~~ing~~ to stick to MO and £M3. In view of its past behaviour, a case can be made for dropping £M3 altogether. As you know, £M3 has for some years shown a tendency to grow more rapidly than money GDP, partly in response to ~~of~~ financial liberalisation, and partly~~, I suspect,~~ because high real interest rates have increased the demand for broad money as a medium for saving. £M3 growth has regularly exceeded our expectations ~~overshot its target range~~, without adverse consequences for inflation. This year has been no exception. A year ago we set a range of 5 to 9 per cent growth ~~in~~ for 1985-86; in the 12 months to February the actual growth of £M3 has been nearly 15 per cent. And yet all the indications are that inflation is set to fall further over the coming ~~next~~ year.

After careful consideration, however, I have concluded that dropping £M3 would risk giving the wrong signal about our attitude to liquidity ~~broad money~~. But I cannot risk a repetition of this year's experience. We must set a range for 1986-87 that is both credible and achievable. I have decided that this should be 11-15 per cent, to allow for a continuation of the recent velocity trend. In view of all the uncertainties about broad money, however, I do not propose to show ranges of £M3 growth for the years beyond 1986-87.

The choice of target range for MO has been much easier. Its growth over the past 12 months has been 3½ per cent, towards the bottom of the (3-7 per cent) range set a year ago, and I am reaffirming for 1986-87 the 2-6 per cent range indicated in last year's MTFS. As in the last two years, I shall be publishing illustrative ranges for MO for the whole MTFS period.

The presentation of monetary policy has undoubtedly suffered from the continuing problems with £M3, and the market's reluctance ~~refusal~~ to fully accept MO as a credible substitute. I have sought to re-establish the credibility of the MTFS by giving a slighly more prominent role to money GDP in explaining the Government's strategy. This has no real operational significance, but it is a useful way of making the point that, whatever the problems with particular monetary aggregates, the Government remains committed to reducing the growth in money incomes, as a means of achieving a further reduction in inflation.

This approach has been fully discussed with the Bank ~~[?and Brian Griffiths]~~ who support these recommendations.

N.L.

BR/33

BUDGET CONFIDENTIAL

FROM: MRS R LOMAX
DATE: 5 MARCH 1986

MR RILEY

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Sir T Burns
Mr Butler
Mr Cassell
Mr Odling-Smee
Mr Peretz
Mr Scholar
Miss Peirson
Mr Lord
Mr H Davies

MEDIUM TERM FINANCIAL STRATEGY: FISCAL SECTION

This minute records the main points made at the Chancellor's meeting on the MTFS last night.

2. There was an initial discussion of the latest revised forecast for the PSBR in 1985/6 and 1986/7. The Chancellor was particularly sceptical about the large borrowing requirement now being forecast for March 1986, relative to the comparable period last year and the year before. It was agreed that the books should finally be closed on the PSBR early next week, when the figures for February are available.

3. It would probably be necessary to finalise the assumption about oil prices at the same time, if not earlier. Decisions about what should be published for oil prices and the PSBR were to some extent related. At this stage, the choice for 1986/87 probably lay between a PSBR of £7½ billion, on an oil price assumption of \$14 a barrel, and a PSBR of £7 billion, assuming \$15 a barrel. The MTFS should continue to be drafted on the latter set of assumptions.

4. The following decisions were taken about the charts in the fiscal policy section of the MTFS: -

- The chart in paragraph 2.20 should be redrawn on a different scale, dropping money GDP. The Chancellor would be prepared to add one further year - 1986/87 (but no more).

- The chart in paragraph 2.29 should be dropped.

5. The following points were made on the draft text:-

- Paragraph 2.20 should be written up, to highlight the two step changes in the PSBR since 1980 - in 1981/82 and then again in 1985/86. The second half of the final sentence should be re-drafted as follows: "This would still have been the case even if there had been no proceeds from privatisation". (The Chancellor strongly disliked the phrase "central privatisation proceeds" and wanted it removed from both text and tables.)

- Paragraph 2.22 and 2.23 should be redrafted (and aligned with the final version of the Budget speech). It would be important to offer some explanation for a PSBR different from the one shown in last year's MTFS. The final sentence of paragraph 2.22 should be deleted.

- The second sentence of paragraph 2.24 should say that the assumption for 1989/90 is that the planning total will remain broadly flat in real terms.

- Paragraph 2.25 should be shortened and the table now shown as footnote to table 2.4 should be included here. Either here, or at an earlier stage in the text, there should be some comment on why the money GDP figures are higher than in the 1985 MTFS; this could include an explanation of why the forecast for real output has increased, though it might not be possible to say anything very convincing about inflation (especially in view of lower oil prices). The Chancellor found the third sentence of the present draft of paragraph 2.25 particularly unconvincing.

- The first part of the third sentence in paragraph 2.27 should be redrafted as follows: "This will enable a continued low level of borrowing to be combined..."

- In paragraph 2.28 the sentence on North Sea Oil revenues should be redrafted to put more emphasis on the behaviour of oil prices (rather than production).

- Paragraph 2.32 - especially the first sentence - should be redrafted along the lines of last year's MTFS, to make a wider point about uncertainties. In the final sentence, the reference should be to the Government's economic policy (rather than specifically its micro economic policies).

6. Your minute of 3 March on Fiscal Projections in the MTFS was also discussed. The economic assumptions summarised in the first paragraph were approved. The Chancellor was content with the path of the fiscal adjustment shown in case B (central revenue projections, public expenditure forecast case). It was provisionally agreed to set the PSBR at £7 billion in all years from 1985/6 to 1989/90. (All the cash figures in table 2.2, 2.3 and 2.4 should be rounded to the nearest £1 billion; as now, the PSBR percentage should be rounded to the nearest ¼ per cent).

Rh.

RACHEL LOMAX

JT

276/004

COPY NO 1 OF 39

FROM: M C SCHOLAR
DATE: 7 March 1986

CHANCELLOR OF THE EXCHEQUER

cc: Principal Private Secretary
Chief Secretary (2)
Financial Secretary (2)
Economic Secretary (2)
Minister of State (2)
Sir P Middleton (2)
Sir Terence Burns
Mr F E R Butler
Sir Geoffrey Littler
Mr Cassell
Mr Monck
Mr A Wilson
Mr H P Evans
Mr Monger
Mr Odling-Smee
Mr Culpin
Miss O'Mara
Miss Peirson
Mr Riley
Miss Sinclair
Mr Pratt
Mr Cropper
Mr H J Davies
Mr Lord

Sir Lawrence Airey-IR
Mr Battishill-IR
Mr Isaac-IR
Mr Calder-IR
Mr Johns-IR

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

1986 FSBR: SECOND DRAFT

I attach Chapters 3, 4 and 5 of the FSBR, revised in accordance with the comments which you and others made on the version submitted last weekend. We need your comments on this version as soon as possible on Monday, in order to make amendments to and return the proofs to the printer before early afternoon. Drafts of Chapters 1, 2 and 6 will be submitted to you on Monday. We need to return these drafts to the printer, amended as necessary in the light of your comments, at latest by early Tuesday afternoon, in order not to fall behind with our timetable.

BLO enclosure pages

JT

2. Table 4.2 (and therefore Table 1.1) has been drawn up on the lines agreed at your meeting on Monday - ie showing the effect of the tax changes in three columns: the first two for 1986-87 against both a non-indexed and an indexed base; the second for 1987-88 against a non-indexed base. There is no problem about this. But the Revenue point out that this latter presentation follows a different approach from that elsewhere in the FSBR, where it is assumed that the 1986-87 cash allowances, rates of duty etc, are indexed between 1986-87 and 1987-88. The Revenue note that an alternative presentation would have the 1987-88 column showing the costings against an indexed base (as in the scorecard). I attach a short note by them on this point (Appendix A).

3. For myself, I see no reason to alter the decision reached on Monday. It is clear from the heading of the table (comparison with an unindexed base) that no indexation has been allowed for. That is, I think, good enough.

4. I was asked at Monday's meeting to consider whether the FSBR presentation of the Stamp Duty package deals adequately with the increased yield from CGT which arises from higher turnover. This point is covered in footnote t to Table 4.2, which notes that the £75m estimate of lower receipts in 1987-88 arising from the ½% rate reduction takes account of a yield of £35m capital gains tax arising on additional transactions expected to follow from the rate reduction. I think this is satisfactory.

5. I also attach (top copy only) a revised frontispiece for the FSBR. Proofs from the printer for the whole FSBR should now be available on Wednesday.

MCS

M C SCHOLAR

Appendix A

1. Tables 4.2 and 1.1 have been drawn up on the lines agreed at Monday's discussion of the FSBR. No technical problems emerged; but we ought to record that this leads to a difference in approach from other parts of the FSBR.

2. The definition of the post-Budget tax regime used in table 4.2 to derive the effects of changes against the non-indexed base in 1987-88 is not the same as the post-Budget regime used in the MTFS (Chapter 2), forecasts and scorecard. This is because the post-Budget regime in tables 1.1 and 4.2 assumes the same cash levels of allowances, rates of duty etc in 1987-88 as in 1986-87; while the MTFS post-Budget regime assumes that those cash levels are then indexed between 1986-87 and 1987-88. Further, in the absence of the 1987-88 figures against an indexed base, the tables do not now provide 1987-88 figures which use the same baseline as the MTFS.

3. Provided the reader can be aware of the differences of definition (as he can by reference to the annex to Chapter 4) these do not seem to be overriding objections. If, however, you wished to avoid them, a possible alternative would be a three column approach in both tables, but converting the 1987-88 column to show costs against the indexed base (as in the scorecard). This compares an indexed post-Budget regime (as in the MTFS) with an indexed pre-Budget regime. The unindexed base figures for 1986-87 in table 4.2 would continue to give a measure of the immediate cash effect in the first year, as you wished.

3 The Economy: Recent Developments and Prospects to Mid-1987

Summary

Demand and activity

3.01 1985 saw further sizeable increases in both exports and business investment. For the forecast period substantial growth is likely not only in mo areas of domestic spending but also in exports. Total domestic production and manufacturing output are both expected to record further growth in th range 2–3 per cent.

Labour market

3.02 Employment has continued to rise, with over 200 000 extra jobs in the year to September 1985. In spite of this there has been some further rise in unemployment over the last year. However, with labour force growth now likely to fall, prospects for unemployment are somewhat better than for some years.

Inflation

3.03 After rising in the early months of 1985, inflation has been on a downward path since June and in January 1986 the RPI increase was 5½ per cent. The inflation rate is expected to be at or below 4 per cent for most of the forecast period.

Assumption

3.04 The UK forecast is based on the assumption that fiscal and monetary policies are set within the framework of the MTFS. North Sea oil prices are assumed to average $15 in 1986–87. Neither the sterling index nor the sterling dollar exchange rate is assumed to change much.

World economy

3.05 Output in the world economy has now been rising since early 1983, and inflation has been coming down since 1980. The recent large fall in oil prices will be of particular help to oil importing countries both in the developed and developing world. Assisted by further moves to lower interest rates, a period of low inflation and good growth in output and trade is in prospect. Many of the problems arising from payments imbalanc and debt repayments will remain. But the benefits to trade, output and inflation from the fall in oil prices should prove substantial.

Trade and the current account

3.06 Exports have grown strongly over the last two years. The current account of the balance of payments is expected to remain in sizeable surplus despite the big fall in oil prices. Offsets include higher export earnings on other goods—with most overseas markets benefiting from the fall in oil prices—lower profits earned by foreign oil companies in the North Sea, and higher earnings from the UK's stock of overseas assets.

World economy

Recent developments

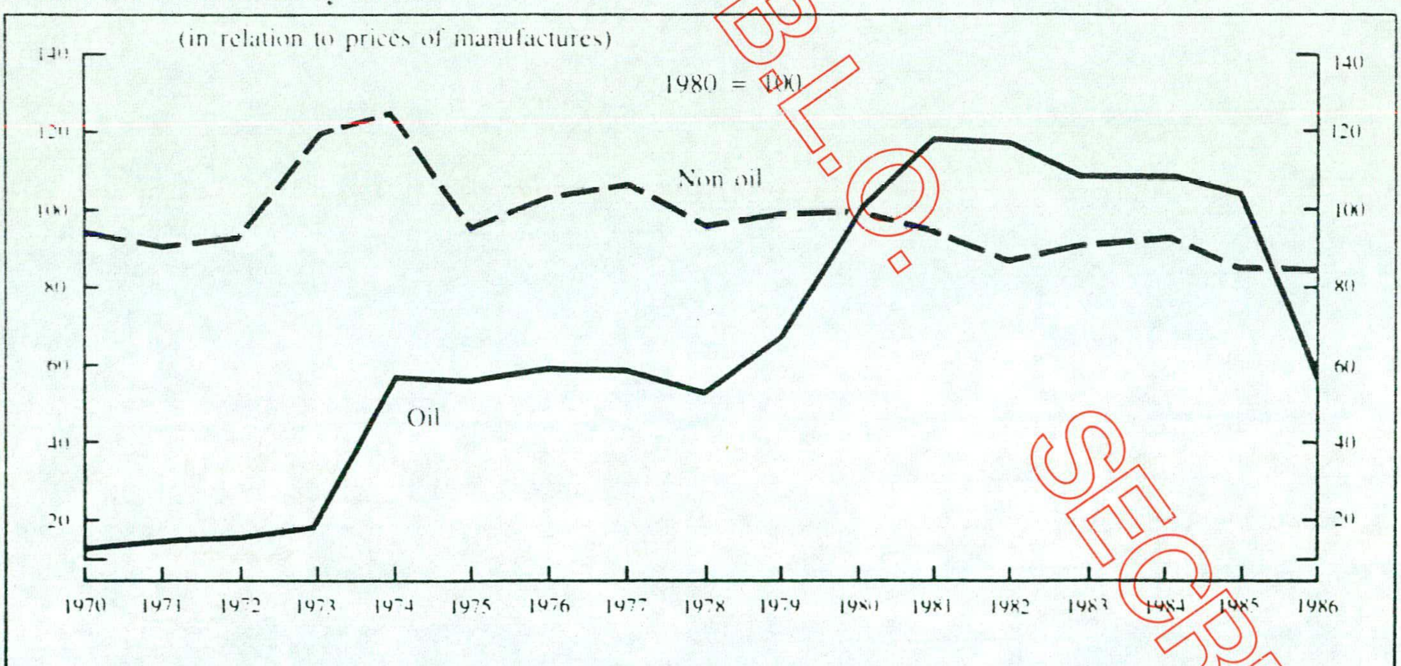
3.07 After a spurt in 1983 and the first half of 1984, US economic growth has slowed down sharply. By the final quarter of 1985 real GNP was 2½ per cent higher than a year earlier. The performance of the US economy has strongly influenced the pattern of economic growth in other major industrialised countries. In Japan and Germany, in particular, output grew significantly faster than domestic demand in both 1984 and 1985, thanks to the substantial external contribution to demand, stemming in

large part from the US. More recently the recovery in Europe has strengthened and growth has become less dependent on exports to the US. In Japan growth has shown some signs of slackening, although remaining high by European standards.

3.08 Domestic demand is now growing at similar rates in the US and other major industrialised countries. But the effect of much faster growth between 1982 and 1984 in the US, together with the effects of the rise—still only partially reversed—in the dollar, are seen in the pattern of current account balances: a large deficit in the US and large surpluses in Germany and Japan. There have, though, been a number of helpful steps towards reducing these imbalances over the past year. Slower growth in the US has not only reduced the increase in US imports, but also contributed to lower interest rates and a fall in the dollar. The latter was helped by the Plaza Agreement of 22 September between the Finance Ministers of the Group of Five. Nevertheless, a period in which US domestic demand growth is significantly slower than that in Europe and Japan is likely to prove necessary if current account surpluses and deficits are to be reduced.

3.09 The rate of inflation fell further in 1985: consumer prices in the major industrialised countries increased on average by about 4 per cent, compared with over 4½ per cent in 1984. This partly reflects the weakness of primary product prices (see Chart 3.1).

Chart 3.1 Commodity Prices



3.10 Since December 1985, oil prices have fallen sharply. The background to these oil price developments is set out in Chart 3.2. Before the first oil price shock the non-communist world demand for oil was around 48 million barrels per day, and about 30 mbd of this was produced by OPEC members. Despite the 1973–74 increase in oil prices OPEC managed to

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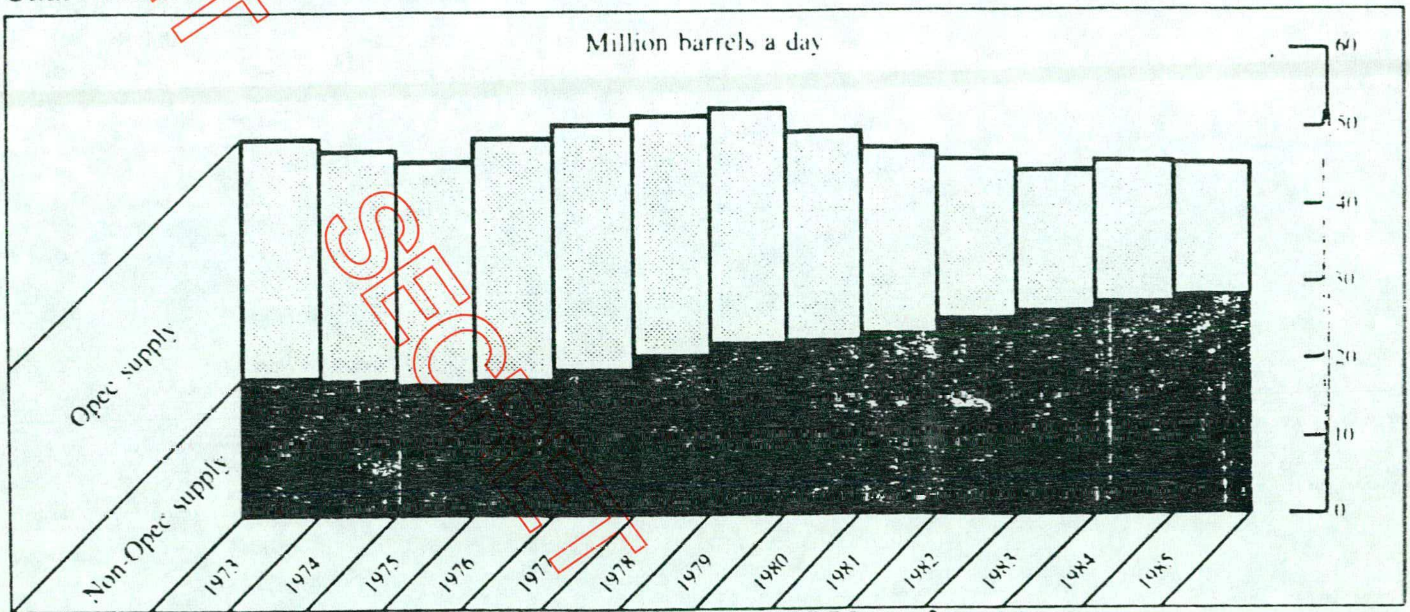
maintain roughly this level of production throughout the 1970s.
After falling in 1974 and 1975 total demand for oil rose again during the rest of the decade, while non-OPEC supply grew by roughly the same amour in absolute terms.

Chart 3.2 Oil Production



(1) Total oil production is the sum of OPEC and non-OPEC(2) production and is equal to non-communist world consumption plus stockbuilding.

(2) Non-OPEC production includes net exports of oil from centrally planned economies.

3.11 Experience since the second sharp increase in oil prices in 1979 has been very different. Demand for oil has fallen and non-OPEC supplies have continued to rise sharply. OPEC's pricing policy made it effectively the residual source of supply and demand for OPEC oil nearly halved: from about 30 mbd in 1979 to less than 17½ mbd on average in 1985. A large share of the production cuts fell on Saudi Arabia.

3.12 Towards the end of 1985 Saudi Arabia indicated that it was no longer prepared to maintain its own production at very low levels in order to maintain the existing level of prices. The resulting increase in supply, combined with no sign that other producers were prepared to make offsetting cuts in their production, has produced a sharp fall in prices.

Prospects

3.13 Total demand and supply for oil may well respond only slowly even to the large fall in price, and so excess capacity is likely to be present for some time. This forecast assumes that prices will settle at around $15 per barrel—rather below, in real terms, the level between 1974 and 1979.

3.14 The prices of most other primary products are also unlikely to strengthen significantly over the next year or so, since with some exceptions (for example a temporary shortfall in the coffee crop), supplies are abundant and stocks relatively high. The industrial countries can therefore expect further improvements in their terms of trade, raising real incomes and enabling inflation to fall further (see Table 3.1).

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Table 3.1: World economy

	percentage change on a year earlier			
	1984	1985	1986	1987 first half
Major Seven countries*:				
Real GNP	4½	2½	3½	4
Consumer prices	4½	4	2½	1½
World trade, at constant prices				
Total imports	10	3	6	5½
Trade in manufactures (UK weighted)	8½	4	5	5

* USA, Japan, Germany, France, UK, Canada and Italy.

3.15 The growth of real GNP in the US should pick up in 1986, benefiting from lower oil prices and from the effect of the lower dollar on trade. Consumers' expenditure, while growing more slowly than in recent years, should be helped by the lagged effects of lower interest rates and rises in asset prices.

3.16 Growth in Japan may be weaker than usual in 1986 as the expansion of domestic demand may not be sufficient to compensate for a slowdown in the growth of exports. In most European countries the economic recovery should strengthen in 1986, with the rate of growth increasing, particularly in Germany.

3.17 Overall the major industrialised countries may grow by about 3½–4 per cent over the next year. Together with lower inflation and interest rates in the major countries and the reduced cost of their oil imports, this should provide a better prospect for the non-oil developing countries, despite weak commodity prices. Oil producing countries, on the other hand, particularly those already heavily indebted, face severe difficulties and will have to cut their imports further.

Chart 3.3

GROWTH AND INFLATION

MAJOR 7 ECONOMIES

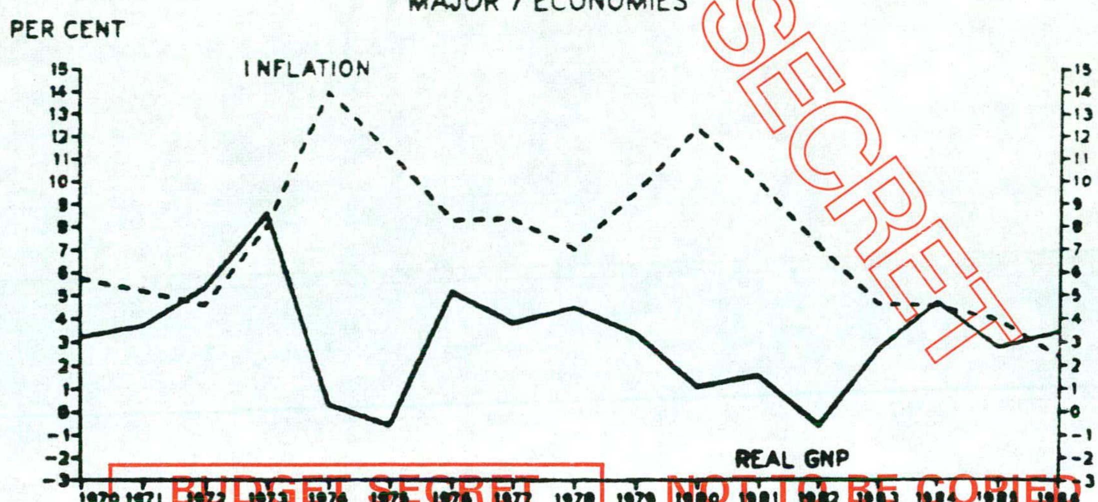

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Table 3.2: World import volumes, annual growth rates

	USA	Japan	Europe*	OPEC	Developing countries	Other	Total
Weights in 1984	19	8	31	7	14	21	100
1984	24	11	6	- 10	8	10	10
1985	3	1	5	- 8	1	6	3
1986	9	8	7	- 16	7	5	6

* Germany, France, UK, Italy, Netherlands and Belgium

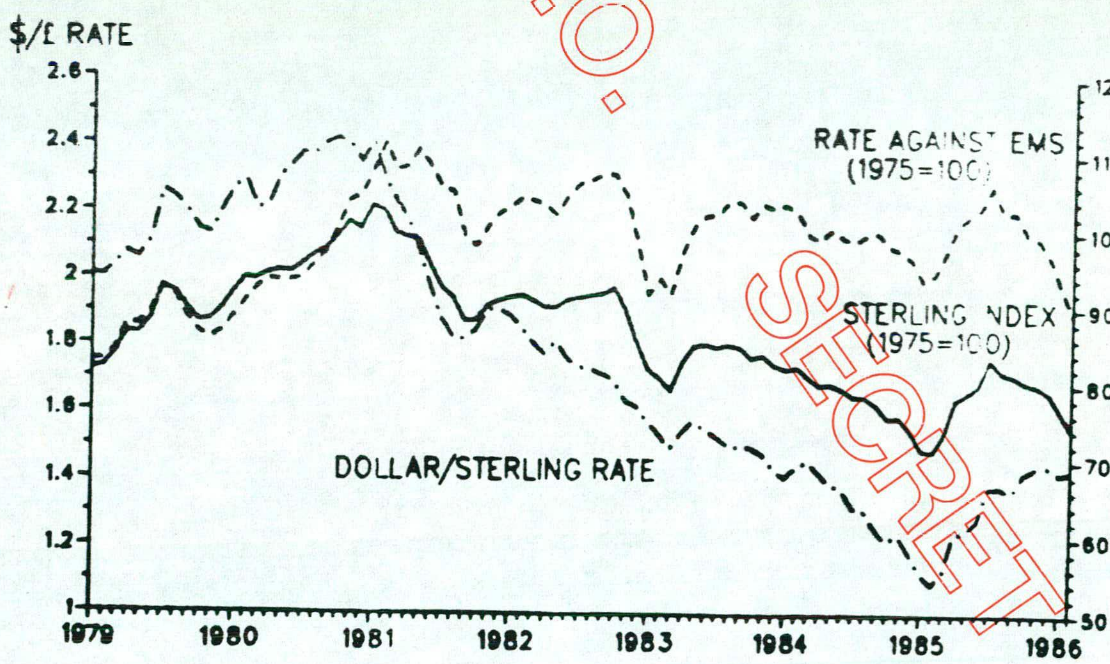
3.18 This picture of world activity is reflected in the pattern of world trade growth. Import growth is likely to be strongest in oil-importing countries and in those whose exchange rates have appreciated most over the past year. This points to rapid growth of imports into Europe, Japan and many developing countries, but to large falls in oil producers' imports. Overall import growth in 1986 should be well above that of 1985

Financial conditions

Exchange rates

3.19 The **dollar** has declined substantially (by over 20 per cent against a basket of other currencies) since its peak in early 1985. In 1985 as a whole the **sterling** index was little different from 1984. There were however some sizeable swings during the course of the year. The index ros from a lowpoint of 70½ in January to a high of 84½ in July, when UK interest rates fell, before declining to 78 in December. The index has fallen a little further this year as a result of the fall in oil prices. Over the pa year sterling has risen by about 30 per cent against the dollar, but fallen against most other currencies.

Chart 3.4 STERLING EXCHANGE RATES

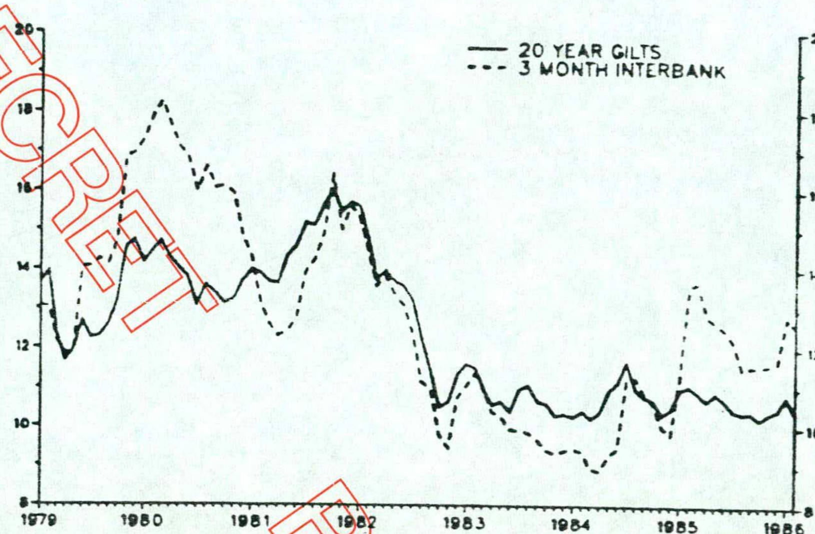


3.20 The forecast assumes that sterling will not change much from its present level, either in dollar or effective terms.

Interest rates **3.21** Short-term interest rates fell during much of 1985 from the peak levels reached in February and March. They rose again in January this year as sterling weakened but in 1986 so far they have been a little below levels a year earlier. However on average in 1985–86 short rates, at 12 per cent, have been a point or so above the levels of 1984–85 and several points above levels in the US, and most other industrialised countries. Long rates have been much more stable. Yields on 20 year gilts have been within the 10–11 per cent range for almost all of the last three years. Real yields on index-linked gilts have also been relatively stable.

Chart 3.5

INTEREST RATES IN THE UK



Narrow money **3.22** M0 was near the centre of its target range in the early months of 1985–86, but growth slowed during the course of the year, in response to the increase in interest rates last winter. In recent months M0 growth has generally been just above the bottom of its target range. The annual increase in M0 velocity has been stable for many years now, and is expected to remain so.

3.23 Growth in the non-interest bearing component of M1, 3 per cent over the last year, has also slowed. This has been in response to higher interest rates and the increased availability of high interest cheque accounts which are in M1, contributing to an acceleration in M1 in total.

Broad money **3.24** The rate of growth of £M3 has risen during the course of 1985–86 and has been well above both the target range set in the 1985 MTFS and the growth of money GDP. With the funding objective now set at the level needed to cover the PSBR, £M3 growth (at 14–15 per cent on a year earlier in recent months) has reflected a continued strong expansion of bank credit. Other broad aggregates have grown at much the same rate.

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3.25 The rapid expansion of broad money and credit reflects to a large extent the pace of financial innovation and liberalisation. In addition, since over two-thirds of £M3 bears interest and is now an attractive means of holding financial wealth, the high level of real interest rates may have contributed to higher bank deposits. The higher levels of broad money and debt in relation to incomes probably reflect a permanent and continuing shift in the private sector's portfolio which is not likely to be reversed through higher spending. They do not therefore pose a threat to the slower growth of nominal incomes and the fall in inflation in this forecast.

Trade and the balance of payments

Relative costs and prices 3.26 The last two to three years as a whole have exhibited relatively little change in most measures of cost and price competitiveness, although there have been large short-term swings associated with movements in the nominal exchange rate. As Table 3.3 shows, the effects of a lower nominal exchange rate have been broadly offset by unit labour cost increases at home above those in the UK's main overseas competitors, despite a good UK productivity performance. Assuming an unchanged exchange rate, the UK's cost and price competitiveness may be little different from the average of the last three years.

Table 3.3: The nominal exchange rate and relative costs and prices in manufacturing.*

	Sterling Index (1975=100)	Relative actual unit labour costs	Relative export prices (1980=100)	Import Price Competitiveness
1983	83½	85	89	94½
1984	78½	83½	87½	92
1985 (Estimate)	78	86	89½	91½

* Ratio of UK to overseas costs/prices

Trade prices 3.27 Prices of most categories of imports fell during the course of 1985. The exchange rate appreciated during the course of the year, inflation in the developed world was low and commodity prices were weak. By the final quarter of 1985 import prices of all goods and services were 5 per cent lower than a year earlier.

Terms of trade 3.28 For 1985 as a whole, the terms of trade were 1 per cent above those of 1984 because of the weakness of commodity prices. But the terms of trade are likely to be worse in 1986 because the price of oil has fallen relative to other goods and services. As oil has a greater share in UK exports than in imports, a fall in its prices reduces export prices relative to import prices. On its own, the fall in oil prices worsens the terms of trade in goods by 3 per cent, producing a fall in real national disposable income of 1 per cent.

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Table 3.4: Trade in goods - balance of payments basis

per cent changes on a year earlier

All goods

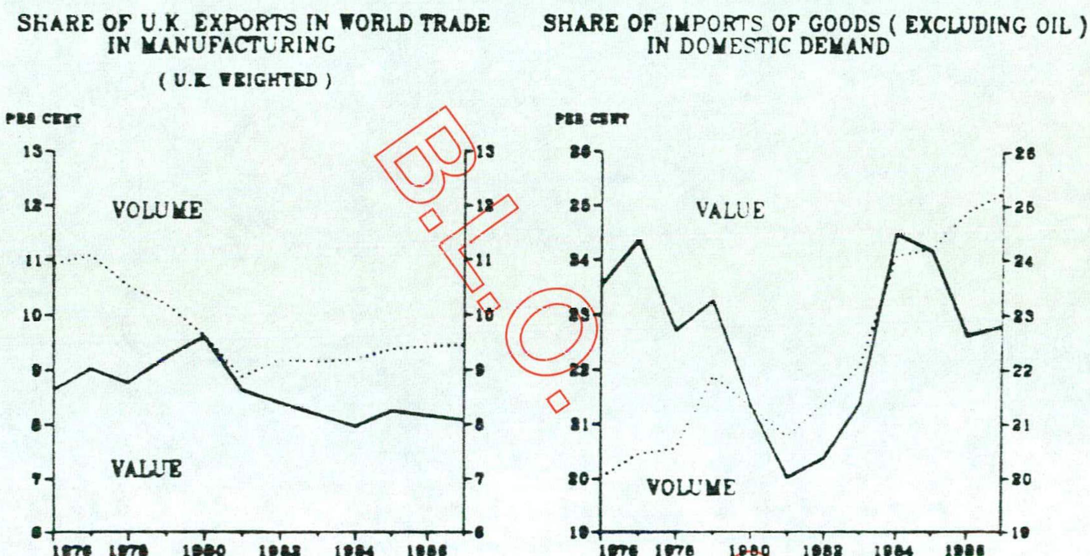
	Export Volume	Import Volume	Terms of Trade*
1983	2	8	- ½(-1)
1984	8½	11	- 1½(-1)
1985	5½	3	2½(3½)
1986(Forecast)	5½	6½	- 4 (1)

Trade volumes (goods other than oil)

3.29 As shown in Chart 3.6 UK exporters of manufactures improved their share of world trade in volume terms in 1984 and may also have done so in 1985. The value share was broadly unchanged in 1984 when UK export prices fell relative to those of our competitors, but probably rose in 1985. The forecast of exports of manufactures (excluding erratics) in volume terms is for further growth of 5 per cent in 1986. This is the same as the rise in world trade, but less than in 1985.

Chart 3.6

EXPORT SHARES AND IMPORT PENETRATION



3.30 Between 1982 and 1985 the growth in demand for manufactures (5½ per cent at an annual rate) has been shared by importers and domestic producers, with importers continuing to increase their share. Domestic demand for manufactures is expected to grow in 1986, because of further growth in investment and expenditure on consumer durables in particular. Growth in imports of manufactures in 1986 is forecast to be around 7 per cent, twice as fast as domestic demand growth, a relationship similar to that between 1982 and 1985.

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Trade in oil **3.31** The prospect is for a substantial fall in the surplus on trade in oil in 1986 as a result of lower oil prices, partly offset in the current account as a whole by reduced earnings of foreign owned companies operating in the North Sea. Little change in oil production is expected and domestic demand for oil will be below the 1985 level which was boosted by the coal strike.

Invisibles **3.32** The surplus on trade in **services** has more than doubled since 1982. 1985 was an exceptionally good year, with large gains in earnings from financial services, tourism and travel. With imports of services, particularly tourism, likely to grow faster, the balance on services may show only a modest gain in 1986.

3.33 The profile of the **transfers** balance is affected by the timing of official transactions with the European Community. As the bulk of the UK's rebate on its 1984 contribution was delayed into 1986 the transfers balance was unusually low in 1985, by about £½ billion. A correspondingly high figure is projected for 1986.

3.34 On provisional estimates, the surplus on **interest, profits and dividends** (IPD) fell in 1985. Earnings on UK investment overseas were depressed by a once-for-all write off of losses on BP's Sohio subsidiary and UK banks' net earnings on their foreign currency business fell. In 1986 the surplus on IPD is expected to increase. Lower oil prices will reduce the profits of foreign oil companies operating in the North Sea more than they reduce the profits of UK oil companies' overseas operations. There should be a net rise in the other components of the IPD balance as a result of a projected further increase in the UK's net overseas assets.

Table 3.5: Current account of the balance of payments, £billion

	Oil	Other Goods**	Invisibles	Total: Actual and forecast	Total: After allowing for special factors*
1983	7	- 8 (-2½)	4	3	3
1984	7	- 11 (-4)	5	1	4
1985	8	- 10 (-3)	5	3	4½
1986 (Forecast)	5½	- 10 (-3½)	8½	4	3½

* The timing of EC rebates and the effect of the coal strike.

** The balance on manufactures is in brackets.

3.35 Table 3.5 summarises the current account and its main components. Allowing for the effects of the coal strike the current account was in sizeable surplus in each of the last three years and a substantial surplus is again forecast for 1986. On an underlying basis, the surplus in 1986 is expected to be lower than in 1985, as a result of the big fall in oil prices. The contribution of North Sea oil to the current account—ie the balance of trade in oil less foreign companies' North Sea profits—is forecast to fall from a strike-adjusted £6½ billion in 1985 to £3½ billion in 1986. Chart 3.7 shows the components of the account over a longer period, relative to GDP.

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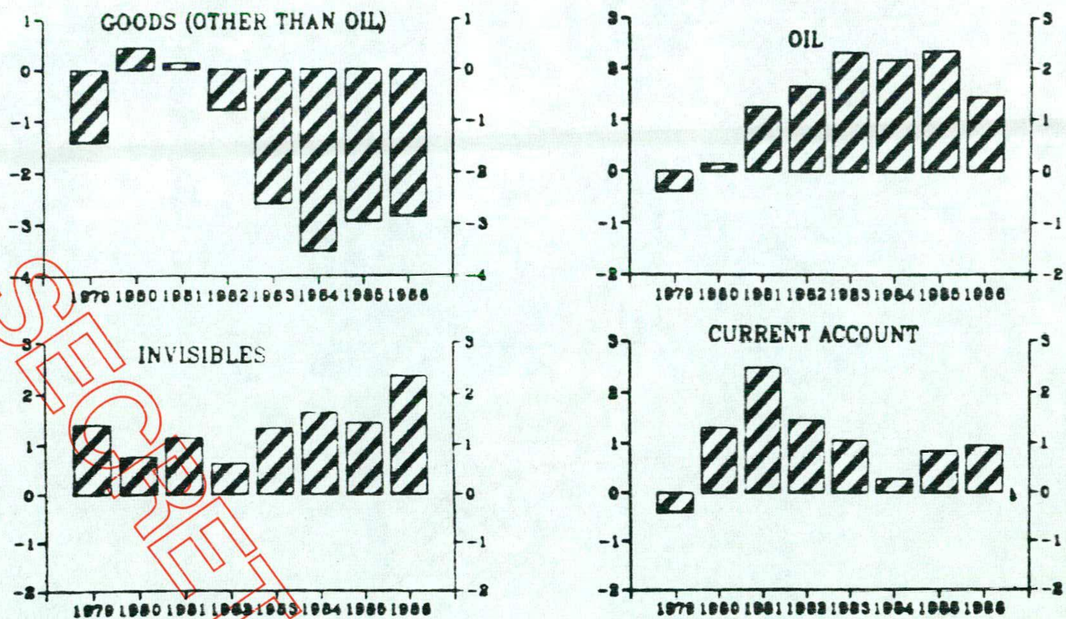
Chart 3.7 THE CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS

(SURPLUSES AND DEFECITS AS A PER CENT OF GDP)



Overseas assets 3.36 The UK's stock of net overseas assets is estimated to have been 24 per cent of GDP (£85 billion) at the end of 1985, compared with 6 per cent of GDP in 1979.

Inflation

Inflation and costs in 1985 3.37 In the year to 1985Q4 the RPI increased by 5½ per cent, a little more than forecast in last year's FSBR. In the middle of the year retail price inflation touched 7 per cent reflecting in particular increases in mortgage interest rates in February and April 1985 and the weakness of sterling in late 1984 and early 1985. Between May and January retail prices rose by only 1·1 per cent in total, helped by a fall in mortgage rates, by lower petrol prices, and a general easing of cost pressures.

3.38 Import prices declined during 1985 and in the final quarter were about 5 per cent lower than in 1984Q4; the prices of imported fuels fell 14 per cent over the same period. Prices of the manufacturing sector's imported inputs fell rapidly from their peak in February and by the end of the year were 6 per cent below their December 1984 level. The rate of increase in manufacturing output prices started to slow down in the second half of 1985.

3.39 The underlying growth of average earnings (that is, abstracting from the effects of strikes, delayed settlements and other temporary factors) continued at about 7½ per cent in 1985 — little changed from 1984. With output per head growing at about 2 per cent (after allowing for the effects of the coal strike) the growth in unit wage costs was about 5½ per cent in 1985. Unit labour costs rose by about 1 per cent less mainly because of the abolition of NIS in October 1984. In the manufacturing sector, average earnings increased by 8½–9 per cent and unit labour costs by 4 per cent. This was much faster than in most other major industrial

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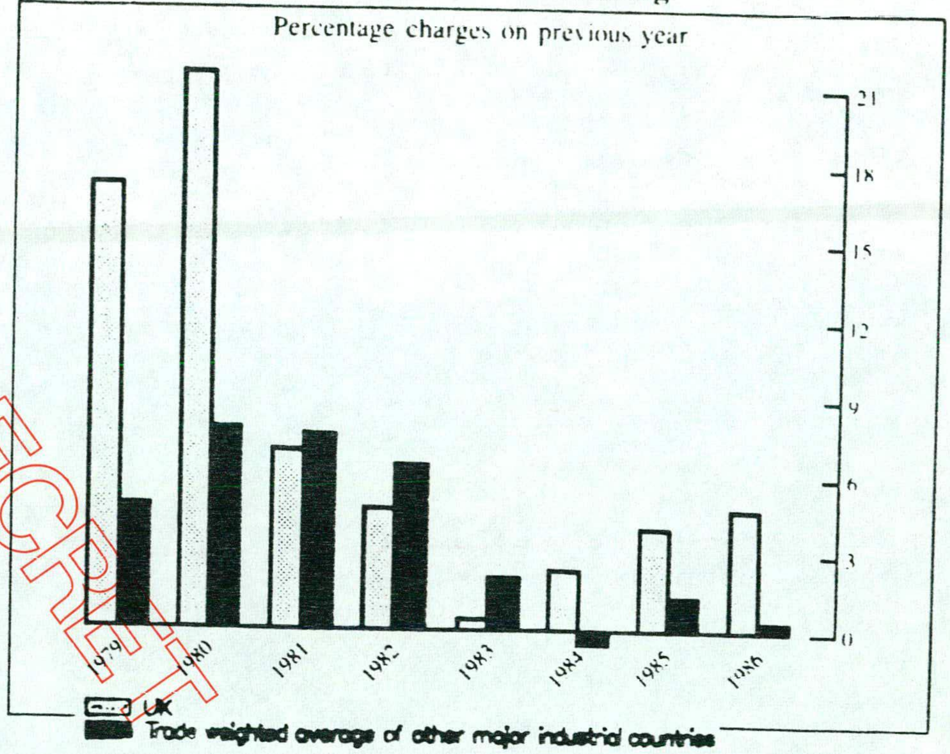
countries (see Chart 3.8). Pre-tax real earnings of employees increased by an average of almost 2½ per cent a year between 1982 and 1985.

Chart 3.8 Unit labour costs in manufacturing



Prospects 3.40 So far the current pay round is showing little sign of any significant change in the level of pay settlements or in the underlying rate of growth of average earnings in the private sector. Unit labour costs for the economy as a whole may rise by 5 per cent in 1986, and unit labour costs in manufacturing may rise slightly less than this. World commodity prices are likely to remain weak in 1986. With oil prices in sterling terms falling by almost a half between 1985 and 1986, the overall cost of manufacturers' material and fuel inputs should fall quite sharply between the two years. The prospects are for very modest growth in manufacturers' total costs and a widening of profit margins.

Table 3.6: Costs in manufacturing (percentage changes on a year earlier)

	Unit Labour Costs in Manufacturing	Materials and fuels purchased by manufacturing industry(1)	Estimated Total Costs	Output Prices(1)
1983	½	8	2½	5½
1984	2½	8½	4½	5½
1985	4	4	4	6½
1986 (forecast)	4½	-11	½	4½

(1) Excluding food, drink and tobacco

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3.41 The fall in import prices since the spring of 1985 has contributed to the recent low monthly growth in retail prices, and will continue to contribute to low increases in prices over the coming months. The annual rate of inflation will fall quite sharply in the months after January 1986. In the last quarter of the year RPI inflation may be about 4 per cent, with little change likely in the first half of 1987. The fall in oil prices is expected to work its way fully through to petrol prices in the course of 1986. The forecast increase in the housing component of the RPI (which cov mortgage payments, rents, rates, and other housing costs) mainly reflects the prospects for local authority rates in 1986–87.

Table 3.7: **Retail prices index**

Per cent changes on a year earlier

	Weights in 1985	1984 Q4	1985 Q4	Forecast 1986 Q4	Forecast 1987 Q2
Food	19	3½	3	3	3½
Nationalised Industries (including water)	9	4	5½	4½	3
Housing	15	10½	9½	9½	3½
Other*	57	4	5½	3	4
Total	100	5	5½	4	3¾

3.42 Other price indices sometimes move differently from the RPI because of differences in coverage. In particular they vary in the degree to which they are affected by movements in import prices, and the housing component of the RPI includes a direct effect from interest rate changes which is absent from other price indices.

3.43 The GDP deflator measures the price of domestic value added— principally unit labour costs and profits per unit of output—and excludes imports altogether. The GDP deflator covers all sectors of the economy, including oil output in the North Sea, and so is highly sensitive t the fall in world oil prices. This contributes to a marked slowdown in the growth of GDP deflator over the coming year. The deflator for GDP at market prices is estimated to have increased by 5½ per cent in 1985–86, about one per cent faster than in 1984–85. In 1986–87, inflation on th measure is expected to fall back to about [3¾] per cent. With no further benefit from lower oil prices assumed after 1986, the GDP deflator is not expected to show any further decline in 1987–88.

Demand and activity

3.44 Latest estimates suggest that GDP rose by about 3½ per cent in 1985, or 2½ per cent after making allowance for the effect of the recovery from the coal strike. Over the year to the first quarter of 1985, GDP is estimated to have risen by almost 4 per cent in strike adjusted terms; since then the path of GDP has been flatter. The rise in GDP between the first and third quarters of the year was more than accounted for by recovery from the coal strike, but growth seems to have picked up again in the fourth quarter: the preliminary estimate of the output measure of GDP showed growth at annual rate of 2½ per cent between the third and fourth quarters

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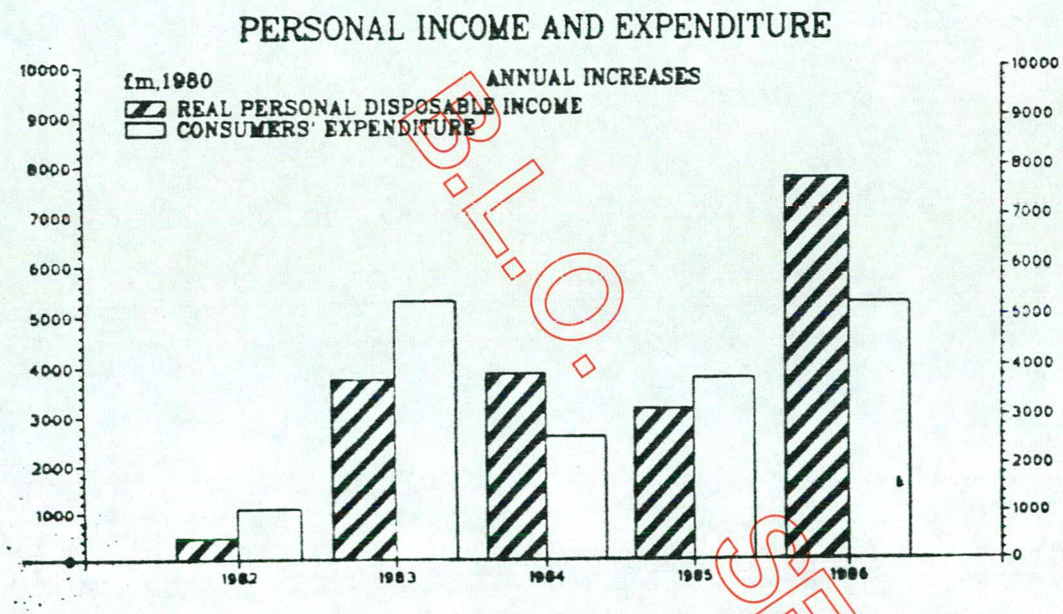
of the year. The flattening out of strike adjusted GDP during the middle of 1985 reflected in part the high level of business investment and North Sea output in the first quarter of the year. Output in most sectors of the economy, including manufacturing, continued on an upward trend throughout 1985.

Personal sector expenditure

3.45 Between 1980 and 1983 the inflation rate fell by about three-quarters and the personal saving ratio fell by almost a quarter. In 1984, with the uncertainties caused by the long coal strike, consumers were more cautious and saving rose. During 1985 spending has picked up again, particularly spending on durables which was some 7 to 8 per cent higher in the second half of 1985 than in the second half of 1984.

3.46 The combination of lower price inflation and little change in earnings growth, together with higher dividend income reflecting the buoyant profitability of the company sector, is expected to lead to substantial growth of real personal disposable income of about 4 per cent in 1986. There may be some increase in the saving ratio, as consumers adjust to higher levels of income; but most of the rise in incomes should be reflected in higher spending, with continuing strength in purchases of durables. Chart 3.9 shows recent and forecast changes in personal income and consumer spending.

Chart 3.9



3.47 Investment in dwellings by the personal sector fell between 1984 and 1985, but a resumption in growth is expected for 1986. Investment in housing improvements, which fell in the second half of 1984, started to recover during 1985, and is expected to show further growth in 1986 as personal incomes rise. In spite of the increases in mortgage interest rates early in 1985, house prices remained firm; private housing starts which had fallen during 1984 were rising

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throughout 1985, and the total for the year was well above the number of completions. This trend in starts should show up in investment in new houses during 1986.

3.48 The demand for housing (as reflected in house prices) and spending on consumer durables have both been resilient in the last year or so, in spite of the high level of real interest rates. The personal sector has been responding to the financial liberalisation of recent years and the greater availability of credit as well as to the changes in interest rates. Borrowing from banks and building societies by the personal sector increased by about 18 per cent in 1985, and by 20 per cent a year on average between 1980 and 1985. This borrowing has not only helped to finance current consumption and spending on tangible assets, but has also been accompanied by substantial acquisition of financial assets: in fact the growth in the personal sector's financial assets has recently more than matched the growth in their liabilities, partly because of capital gains on holdings of equities and gilts.

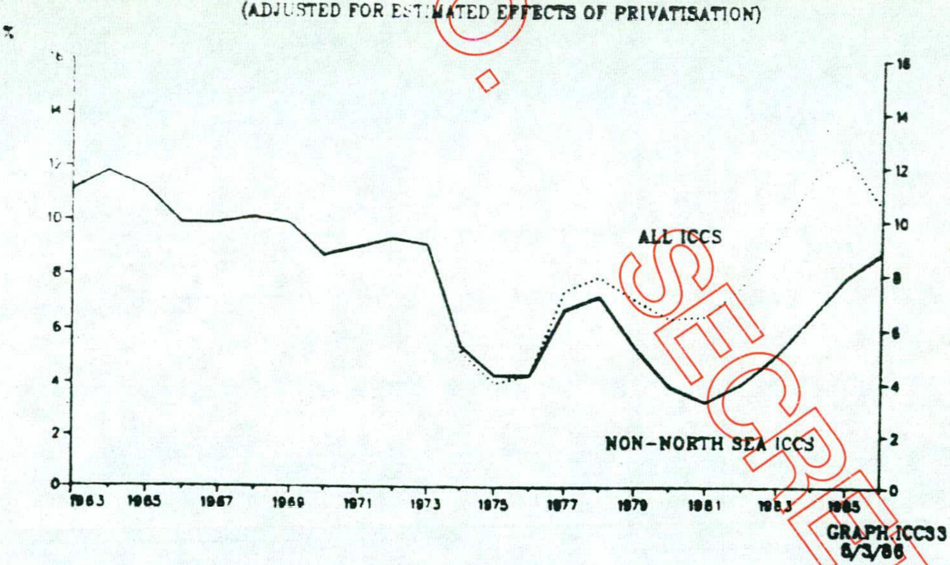
Company income and expenditure

3.49 Company profitability has continued the recovery that began in 1981. The net real rate of return for all industrial and commercial companies (ICCs) for 1985 is estimated to have been the highest since 1960. For non-North Sea ICCs, profitability in 1985 was higher than any time since 1973.

3.50 The recent sharp fall in oil prices will mean a substantial reduction in North Sea profits in 1986, and the overall return earned by ICCs may fall. However, non-North Sea ICCs will be prime beneficiaries of the fall in oil prices, as they have been of the weakness of other commodity prices during 1985; their profitability is expected to increase further in 1986 (see Chart 3.10).

Chart 3.10

REAL RATE OF RETURN
INDUSTRIAL AND COMMERCIAL COMPANIES
(ADJUSTED FOR ESTIMATED EFFECTS OF PRIVATISATION)



Fixed investment

3.51 Total business investment, including North Sea investment and investment by public corporations, grew by about 4 per cent in 1985. Within this total manufacturing investment increased by 5 per cent, after taking into account the increase in assets leased by manufacturing companies. This was a somewhat smaller increase than Intentions surveys had earlier suggested was likely. The path of investment during 1985 was greatly influenced by the reduction in capital allowances which became effective at the end of the first quarter of the year. Leasing business was particularly buoyant in the first quarter and fell back heavily thereafter.

3.52 1986 is likely to see a similar quarterly pattern. The level of business investment in 1986 as a whole will be affected by the transition to the reformed system of company taxation announced in the 1984 Budget: this gave firms an incentive to bring investment forward that would otherwise have taken place during 1986. The fundamental prospects for business investment remain very favourable. Profitability has been rising strongly: one indication of the past and prospective recovery in profits is the buoyancy of the stock market. In addition, there is evidence from CBI surveys that an expansion of capacity will be needed in a number of industries. The DTI survey published last December indicated an increase in manufacturing and service industries investment of about 1 per cent, within which total manufacturing investment is expected to fall by about 2 per cent. By contrast the CBI interpret their most recent survey as implying a 5 per cent rise in manufacturing investment in the first three quarters of 1986 compared with the corresponding period of 1985.

3.53 With the additional boost to profits of most companies from lower oil prices, a rise in business investment in 1986 of 5per cent, rather more than suggested by the DTI survey.

3.54 Table 3.8 provides details of the forecast for total investment and its major components. Overall in 1986, fixed investment is expected to show a further year of good growth. North Sea investment is expected to recover this year to a similar level to that in 1984, mainly reflecting increases in expenditures on oil fields already under development and on gas fields due for development.

Table 3.8: **Gross Fixed Domestic Capital Formation**

(at constant prices)

	1984 £ billion at 1980 prices	Per cent change on previous year		
			Forecasts	
		1984	1985	1986
Business(1)	29.0	11	4	5
Private dwellings(4)	9.5	4	- 1	4
General government	6.9	4	- 5	0
Total fixed investment	45.4	8	1	4½

(1) Including investment by public corporations

(2) Figures for manufacturing include assets leased from finance lessors, figures for other industries exclude these assets.

(3) Figures are for industry class 13 (1980 SIC)

(4) Includes purchases less sales of land and existing buildings by persons, companies and public corporations, other than purchases of council houses.

Stockbuilding 3.55 Survey evidence suggests that despite the low expenditure on stock building in 1985, most companies still regard their current stock levels as more than adequate in relation to output and sales. The fall in stock ratios in recent years may reflect in part cautious behaviour by companies after the last recession. Another factor has been the high cost of holding stocks as

3.55 Survey evidence suggests that despite the low expenditure on stock building in 1985, most companies still regard their current stock levels as more than adequate in relation to output and sales. The fall in stock ratios in recent years may reflect in part cautious behaviour by companies after the last recession. Another factor has been the high cost of holding stocks as

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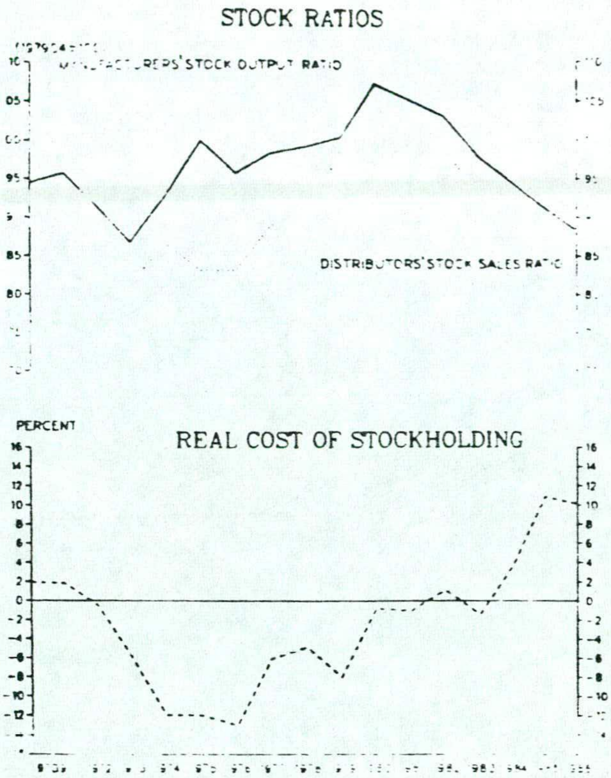
a result of the high level of real interest rates and the abolition of stock relief in the 1984 Budget. Stock ratios and the estimated real cost of holding stocks are illustrated in Chart 3.11.

Chart 3.11



Prospects for demand and activity

3.56 Strong growth in exports has made an important contribution to GDP growth over the last two years. In 1985 the increase in manufactured exports was twice the estimated increase in world trade in manufactures, while UK imports of manufactures grew less in relation to the growth in demand than has normally been the case in recent years.

3.57 The fall in oil prices has improved the prospects for world trade, and the adjustment of the exchange rate to lower oil prices has made British manufactures more competitive. As in most other industrial countries, higher domestic demand (stimulated by lower inflation) is expected to, make an important contribution to growth in 1986, but exports should also show substantial growth. The slowdown forecast for export growth in the first half of 1987 reflects the path of North Sea oil output and hence oil exports.

Table 3.9: **Domestic Demand and Trade at constant prices**

per cent changes on a year earlier

	1985	1986	1987 First half
Domestic demand	2	3½	2½
Exports of goods and services	6½	5	3
Imports of goods and services	3½	6	4½

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3.58 Total domestic production is expected to increase by 3 per cent in 1986, following 3½ per cent growth in 1985. After allowance for the coal strike, growth is close to 2½ per cent in both years as shown in Table 3.10. The average level of oil production in 1986 is likely to be close to its level in 1985 and 1984, but the fall forecast for oil output between the first half of 1986 and the first half of 1987 may cut total GDP growth by over ½ per cent. Output growth in the non-oil economy in 1986 and the first half of 1987 is expected to be comparable to that seen in 1985. Manufacturing output has grown slightly faster than GDP since 1983. The composition of demand growth in the forecast suggests that growth in manufacturing output may continue at around the underlying rate of growth of GDP.

Table 3.10: GDP and Manufacturing Output

	Per cent changes on year earlier		
	1985	1986	1987 First half
GDP (average measure)	3½	3	2
GDP, adjusted for coal strike (*)	2½	2½	2
GDP, adjusted for coal strike and excluding oil output	2½	2½	2½
Manufacturing output	3	2½	2

Productivity and the labour market

3.59 Total employment in Great Britain is estimated to have grown by about 220 000 over the year ending September 1985, giving a total increase since March 1983 of over 700 000.

3.60 The published figures show an increase of 12 000 in the number of employees in employment during the first nine months of 1985: a further rise in the number of employees in the service industries was largely offset by falls in the production and construction industries. Self employment is assumed to have risen by about 31 000 a quarter since the middle of 1984, the same as the estimated quarterly increase over the previous three years. This compares with an increase of about 68 000 a quarter recorded between the middle of 1983 and the middle of 1984. The estimates of growth in employment over the recent past shown in Table 3.11 are subject to revision when the Census of Employment for 1984 and the Labour Force Survey for 1985 become available.

Table 3.11: Employment (GB, seasonally adjusted)

	Employees in Employment			Self employed	HM Forces	Employed labour force
	Male	Female full-time	Female part-time			
September 1983 to September 1984	- 84	+ 19	+ 174	+ 237	+ 3	+ 349
September 1984 to September 1985	- 105	+ 20	+ 181	+ 125	- 2	+ 219

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3.61 Following upward revisions to the estimates of manufacturing output, output per head in manufacturing now appears to have risen by about 3¾ per cent in 1985, in line with the annual average of 3½ per cent for the period 1979–85. This marks a major improvement on the productivity performance recorded between 1973 and 1979: the trend growth in productivity in manufacturing now appears to be close to the rate achieved during the sixties (see Table 3.12). Non-manufacturing productivity has also been rising faster of late than in the 1973 to 1979 period. Growth in output per man hour has been rising at about 2 per cent per annum since 1979. However, the rise in part-time employment, is currently bringing down growth in output per head in non-manufacturing, to about 1 per cent a year.

Chart 3.12 OUTPUT EMPLOYMENT AND OUTPUT PER HEAD

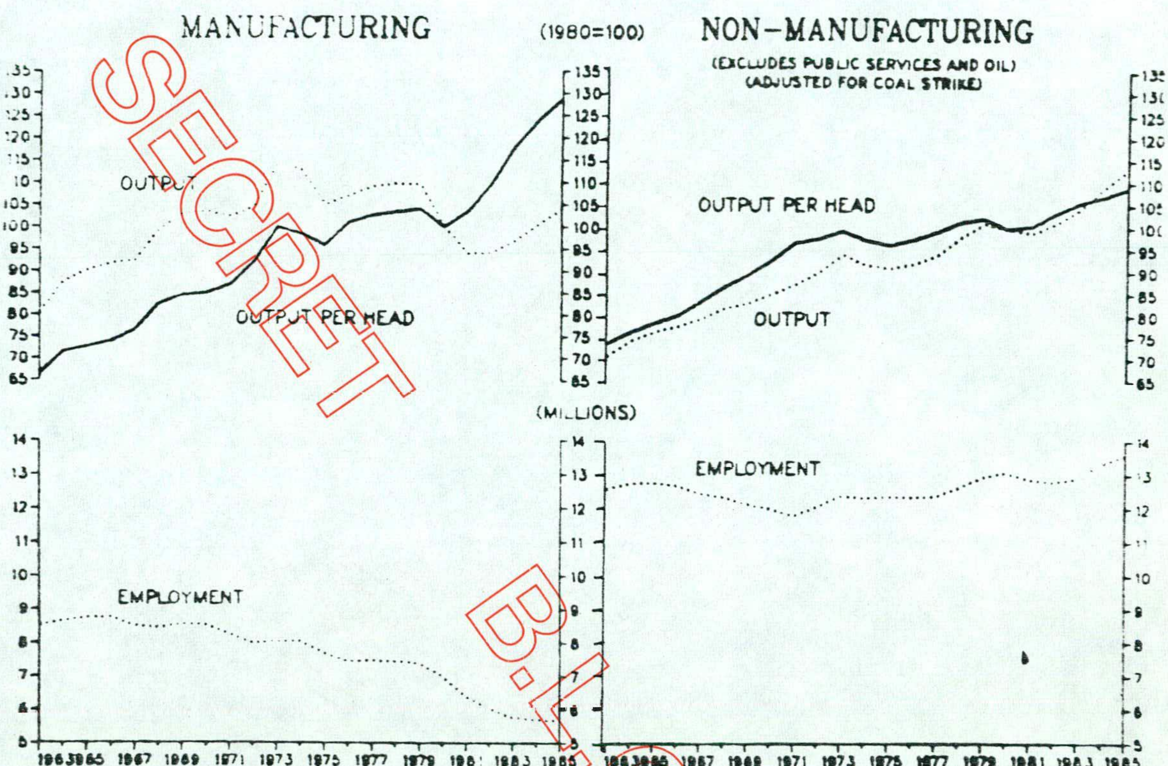

Table 3.12: Output per head of the employed labour force

	Employed Labour Force in 1984 (millions)	Percentage change in output per head (annual averages) 1964-73	1973-79	1979-85
Manufacturing	5½	3¾	¾	3½
Non-manufacturing*	13½	3	½	1

* Excludes public services and oil, and includes nationalised industries except steel.

Unemployment **3.62** The rise in unemployment has slowed down over the last year: the average increase in adult unemployment was 5½ thousand a month over the twelve months to February. With output and employment continuing to grow quite strongly, and growth in the labour force starting to slow down, the prospects for unemployment are better than they have been for some years.

Forecast and outturn

3.63 The table below compares the main elements of the forecast published in the 1985 FSBR with outturn or latest estimate:

Table 3.13: Forecast and Outturn

	Forecast	Outturn	Average error from past forecasts
RPI: per cent increase between the fourth quarters of 1984 and 1985	5	5½.	2

	Forecast	Latest estimate/ forecast	Average errors from past forecasts
Total output: per cent change between 1984 and 1985	3½	3½	1
Current account of the balance of payments in 1985, £ billion	3	3	2½
PSBR, financial year 1985-1986 £ billion	7	6¼	4½
Money GDP, per cent change between 1984-85 and 1985-86.	8½	9	2

3.64 Inflation in the fourth quarter of 1985 turned out a little higher than forecast a year ago. The forecasts made at the time of the last Budget for output growth and the current balance in 1985, and for the PSBR in 1985–86, are all very close to the latest estimates for these variables. In each case such error as there appears to have been is considerably smaller than the average error from past forecasts.

Table 3.14: The Prospects: Summary

	Forecast	Average errors from past forecasts*
A. Output and expenditure at constant 1980 prices; per cent changes between 1985 and 1986.		
Domestic demand	3½	[ ]
of which:		
Consumers' expenditure	3½	[1]
General Government consumption	1	[1½]
Fixed investment	4½	[2]
Change in stockbuilding (as per cent of level of GDP)	0	[¾]
Exports of goods and services	5	[2½]
Imports of goods and services	6	[2½]
Gross domestic product: total	3	[1]
Gross domestic product: manufacturing	2½	[3¼]
B. Inflation		
Retail prices index, per cent change on a year earlier		
1985Q4 to 1986Q4	4	[2]
1986Q2 to 1987Q2	3¾	[3½]
Deflator for GDP at market prices, per cent change on previous year		
Financial year 1985-86	5½	[ ]
Financial year 1986-87	3½	[ ]
C. Balance of payments on current account £billion:		
1986	4	[2½]
1987 first half (at an annual rate)	2	[4]

D. Money GDP at market prices, per cent change

Financial year 1985-86	9	[ ]
Financial year 1986-87	6½	[ ]

E. PSBR

£billion (in brackets, per cent of GDP at market prices):

Financial year 1985-86	6½ (1¾)	[1 (¼)]
Financial year 1986-87	7 (1¾)	[4½(1½)]

---

* 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 for the constant price variables [and the GDP deflator] are derived from forecasts made during the period between June 1965 and October 1983. For the current balance and the retail prices index, forecasts made between June 1970 and October 1983 are used. For the PSBR, Budget forecasts since 1967 are used. The errors are after adjustment for the effects of major changes in fiscal policy where excluded from the forecasts.

Risks and uncertainties

3.65 No forecast is complete without an indication of error margins. Table 3.14 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 approach £200 billion; and for the current account of the balance of payments exceed £150 billion.

3.66 While the size of errors will change over time as the economy fluctuates, and as forecasting techniques change, in many cases the averages have not shifted very much since 1976. For the RPI, however, average errors are derived from a period of high and fluctuating inflation, averaging 12 per cent, and overstate likely errors at current rates of inflation. The average error in the last three Budget forecasts looking ahead to the end of the year was ½ per cent.

Table3.15

Table 3.15 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 1980=100
1981	136.5	48.9	37.7	62.0	-2.5	282.7	55.9	30.2	-0.3	196.3	98.5
1982	137.6	49.4	40.1	62.8	-1.1	288.7	58.7	30.6	0.7	200.1	100.4
1983	142.9	50.2	41.9	64.4	0.7	300.1	62.1	31.6	0.2	206.7	103.7
1984	145.5	50.9	45.4	69.0	-0.1	310.6	67.9	32.9	1.9	211.7	106.2
1985	149.3	51.0	46.0	73.4	0.5	320.2	70.3	33.0	1.9	218.8	109.8
1986	154.7	51.4	48.0	77.0	0.8	331.8	74.5	34.3	2.0	225.0	112.9
1984 H1	72.5	25.2	22.5	33.8	-0.4	153.7	33.0	16.3	0.5	105.0	105.3
H2	72.9	25.7	22.8	35.2	0.2	156.8	34.9	16.5	1.3	106.7	107.1
1985 H1	73.9	25.6	23.2	37.0	0.1	159.8	35.4	16.2	0.8	109.0	109.4
H2	75.4	25.4	22.8	36.4	0.4	160.4	34.9	16.8	1.2	109.9	110.3
1986 H1	76.6	25.6	24.2	38.2	0.2	164.8	36.9	17.0	0.9	111.9	112.3
H2	78.0	25.7	23.8	38.8	0.6	166.9	37.7	17.2	1.1	113.1	113.5
1987 H1	79.4	25.7	24.5	39.4	0.5	169.5	38.6	17.5	1.0	114.4	114.8
% change											
1983 to 1984	2	1½	8	7	-	3½	9½	4	-	-	2½
1984 to 1985	2½	½	1½	6½	-	3	3½	½	-	-	3½
1985 to 1986	3½	½	4½	5	-	3½	6	3½	-	-	3
1986H1-1987H1	3½	0	1	3	-	3	4½	3	-	-	2

* 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. Totals in £ billion may not add due to rounding. Figures for 1986H1 and beyond are forecasts. Figures for periods up to the end of 1985 are based mainly on the national accounts published earlier this year (covering periods up to 1985 Q3) and incorporate some revised and later data and forecasts. A full set of national accounts, to end 1985, will be published by CSO on 21 March.

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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 the Annex to this Chapter.

Income Tax

4.02 The basic rate of income tax will be reduced to 29 per cent.

4.03 Income tax personal allowances will be increased by statutory indexation (based on the 5.7 per cent increase in the RPI in the year to December 1985). This will mean that

the single persons and wife's earned income allowances will rise from £2205 to £2335

the married allowance will rise from £3455 to £3655

the additional personal allowance and widow's bereavement allowance will rise from £1250 to £1320

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

Tax Rate	£
29%	0-17,200
40%	17,201-20,200
45%	20,201-25,400
50%	25,401-33,300
55%	33,301-41,200
60%	over 41,200

Social Security uprating

4.05 The uprating date for Social Security benefits is being changed from November to April. As part of the transitional arrangements there will be an uprating in July 1986 which will apply for a part year only. The amounts of tax payable on the increased benefits, mainly by retired pensioners, would be small and in these special circumstances, the Government has decided to exempt from income tax the amount of the increase payable in 1986-87.

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Excise duties

4.06 The duties on cigarettes and hand rolling tobacco will rise by about 13½ per cent, equivalent to just over 11p on a packet of 20 cigarettes. Those on pipe tobacco and cigars will remain unchanged.

4.07 Duties on alcoholic drinks will remain unchanged.

4.08 Duties on road fuels will go up by a little more than 8 per cent or approximately 7.5p on a gallon of petrol and 6.5p on a gallon of derv.

Vehicle Excise Duty

4.09 The duty on most cars, light vans, lorries and motor cycles will remain unchanged. The duty rates on buses, coaches, taxies will rise by 5%.

Encouragement of Enterprise

Business Expansion Scheme

4.10 The Business Expansion Scheme has made a valuable contribution to the growth of risk investment and employment. It is therefore proposed to continue it after 1 April 1987 and to exempt new BES shares from CGT on first sale. Proposals to modify the scheme are being made to ensure that it provides effective encouragement to high risk investment. Some asset based activities are to be excluded.

Capital Transfer Tax

4.11 In order to remove obstacles to outright giving, the lifetime CTT charge is to be abolished for gifts between individuals made on or after Budget Day. A charge will however be maintained on transfers involving trusts. Provision will be made to charge gifts in relation to which the donor may continue to enjoy a benefit. To reflect its new structure, the tax will be known as the Inheritance Tax.

4.12 Under the new arrangements, the yield from Inheritance Tax on deaths is to be protected by charging gifts within 7 years of death at tapered rates. The exempt amount and rate bands of the tax will be increased by 5.7% under the statutory indexation provisions.

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Encouragement of Wider Share Ownership

4.13 The Government propose to introduce a new initiative, as from 1 January 1987, specifically designed for individuals who invest directly in equities. Shares held in specially designated accounts will be free of any tax on both capital gains and reinvested dividend income. Investment of up to £2,400 will be permitted each year and the shares will have to be held for a minimum period.

Stamp Duty

4.14 It is proposed that the rate of Stamp Duty should be reduced from 1 per cent to ½ per cent on share transactions. The scope of the duty will be widened to cover the following transactions (currently exempt):

Intra-account dealing
Takeovers including mergers
Loan Stock
Renounceable letters
Company purchase of own shares

A 5 per cent duty is being imposed where shares are converted into Depository Receipts.

Employee Share Schemes

4.15 To build on the progress already made in recent years, the following measures are proposed to encourage the spread of approved employee share schemes:

- the extension of the present tax relief to shares subject to a restriction requiring disposal when employment ends;
- easier access for employee controlled companies (and worker co-operatives);
- easier conditions on exercise of savings-related share options.

Pension Fund Surpluses

4.16 It is proposed to clarify and revise the present rules relating to pension fund surpluses as follows:

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- pension funds' assets and liabilities will be valued, for the purposes of the new regime only, on standard assumptions provided by the Government Actuary:

- where such valuation shows an actuarial surplus of assets over liabilities of over 5%, the trustees shall reduce it to not more than 5% by (i) an increase in pension benefits (within existing limits), (ii) a contribution reduction or holiday by either employer or employee or (iii) a refund to the employer; (provided the surplus does not fall below 5%) or by any combination of these measures;

- where a refund is made, it will be subject to tax in the employer's hands at a rate of 40%.

Charitable giving

4.17 Four new types of tax relief are proposed:

- Companies - other than close companies - will for the first time be able to claim tax relief for single gifts to charity. The relief will be on single gifts up to a maximum equal to 3 per cent of the ordinary dividends paid by the company in an accounting period.

- The Government will remove the present annual limit of £10,000 on the amount of charitable giving through deeds of covenant for which an individual taxpayer may claim higher rate relief.

- There will be a new scheme from April 1987 to encourage individuals to make donations to charity through deductions from their wages and salaries. Employees whose employers participate in the scheme will be able to get tax relief on donations of up to £100 a year.

- VAT relief will be available on distress alarms and lifts for the handicapped and their charities, non-classified advertising and medicinal products supplied to charities, video

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and refrigeration equipment used in medical applications by certain eligible bodies including charities, welfare vehicles used by such bodies to transport the deaf, blind and mentally handicapped, and recording equipment used by charities for the blind.

4.18 Measures are also to be taken to prevent abuse of the tax relief for charities.

Business taxation

4.19 The final stage in the business tax reforms introduced in 1984 will take effect on 1 April 1986 with the reduction in the main corporation tax rate to 35% and (with a few mainly transitional exceptions) the disappearance of first year and initial capital allowances. It is proposed to complete these reforms by updating the mines and oil wells capital allowances code, and adapting the system of allowances for agricultural buildings. In order to provide a full measure of tax depreciation for agricultural buildings and works with a short life, balancing adjustments will be available on their disposal or destruction if the taxpayer chooses.

Oil taxation

4.20 No other changes are being proposed to oil taxation apart from technical changes to remove some anomalies.

Capital gains tax

4.21 To maintain its value, the CGT annual exempt amount is to be increased in accordance with the statutory indexation provisions by 5.7% from £5,900 to £6,300 in the case of individuals, and from £2,950 to £3,150 in the case of most trusts.

Car and car fuel benefits

4.22 The scales which determine the taxable cash equivalents of car and car fuel benefits in respect of company cars provided for directors and employees earning £8,500 a year or more are to be changed from 6 April 1987. The present 1300cc and 1800cc engine-size break points are to be aligned, on a revenue- neutral basis, with those - 1400cc and 2000cc - for the European Community Directive on car exhaust emissions. The resulting scale charges for car benefits will be increased by 10 per cent for 1987-88. From April 1987 the car fuel benefit scale is to be used both for income tax purposes and to assess the VAT chargeable on fuel used for private journeys in business cars.

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Value Added Tax

4.23 From 19 March 1986 the registration limits will become £20,500 per annum and £7,000 per quarter.

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Table 4.2 Direct effects of changes in taxation

£million

	Effect in 1986-87		Effect in 1987-88
	Changes from an indexed base(a)	Changes from a non-indexed base(a)	Changes from a non-indexed base(a)
INLAND REVENUE			
Income tax			
Increase in single allowance of £130 and married allowance of £200	Nil	-895	-1130
Increase in additional personal allowance and widow's bereavement allowance of £70	Nil	-10	-10
Increase in age allowance of £160 (single) and £250 (married) and income limit of £600	Nil	-115	-145
Increase in basic rate limit of £1000 to £17,200	Nil	-70	-115
Reduction of 1p in basic rate	-830	-830	-1245 (b)
Changes to further higher rate thresholds	+15	-35	-70
Abolition of higher rate relief limit for charitable covenants	Negligible	Negligible	-5
Relief for charitable donations through payroll deduction schemes	Nil	Nil	-20 (c)
Measures to counter avoidance and evasion by non-resident entertainers and sportsmen	Nil	Nil	+75 (d)
Fringe benefits - car and car fuel scales	Nil	Nil	+15
Changes to relief for overseas travel expenses	-10	-10	-5 (e)
Exemption for 1986-87 of July increase in social security benefits	-20	-20	Negligible
Changes in taxation of employee share acquisitions	Negligible	Negligible	Negligible (f)
Use of restricted shares in approved employee share schemes	Negligible	Negligible	Negligible (g)
Use of shares providing employee control in approved employee share schemes	Negligible	Negligible	Negligible
Exercise of options granted under approved savings-related share option schemes	Negligible	Negligible	Negligible
Worker co-operatives' use of redeemable shares in approved profit-sharing schemes	Negligible	Negligible	Negligible
Change in basis of assessment of enterprise allowance	Negligible	Negligible	-5
Exemption of pensions paid to victims of Nazi persecution	Negligible	Negligible	Negligible
Income tax and capital gains tax			
Tax relief for equity savings scheme	Negligible	Negligible	-25 (h)
Business Expansion Scheme- continuation beyond April 1987 and changes in coverage	Negligible	Negligible	+10 (i)
Income tax and corporation tax			
Refunds by occupational pension schemes	[+25]	[+25]	+125 (j)
Mines and oil wells capital allowances	Negligible	Negligible	-45 (k)
Changes in agricultural buildings allowance rules	Negligible	Negligible	Negligible (l)
Changes in capital allowance rules for leased assets	Negligible	Negligible	Negligible
VAT penalties, interest, surcharges and repayment supplement	Negligible	Negligible	Negligible (m)
Income tax, corporation tax and capital gains tax			
Charities: anti-avoidance measures	Negligible	Negligible	+20
Limiting scope of anti-bondwashing provisions	Negligible	Negligible	Negligible
Amendments to Accrued Income Scheme	Negligible	Negligible	Negligible

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	Effect in 1986-87: Changes from an indexed base(a)	Effect in 1986-87: Changes from a non-indexed base(a)	Effect in 1987-88: Changes from a non-indexed base(a)
Income tax, corporation tax, capital gains tax and capital transfer tax			
Changes in relation to securities	Negligible	Negligible	Negligible
Corporation tax			
Reduction in rate of ACT to 29/71 times the amount of the dividend	-120	-120	-60 (n)
Reduction in small companies rate to 29 per cent	Negligible	Negligible	-20 (o)
Relief for single donations to charity by companies	Negligible	Negligible	-35 (p)
Loans by close companies	(q)	(q)	(q)
Transfer of losses on company reconstruction	Negligible	Negligible	+5 (r)
Corporation tax and capital gains tax			
Small part disposals of land	Nil	Nil	-5
Oil taxation			
Technical changes to remove anomalies	Negligible	Negligible	Negligible
Capital gains tax			
Indexation of annual exempt amount	Nil	Nil	-5
Restriction of holdover relief for dual resident trusts	Nil	Nil	+5
Capital transfer tax and inheritance tax			
Abolition of lifetime charge on transfers between individuals	-35	-35	-55 (s)
Indexation of chargeable rate bands	Nil	-20	-45
Stamp duties			
Reduction in rate on shares to 1/2 per cent from Autumn 1986	-70	-70	-75 (t)
Changes from 18 March 1986	+50	+50	+50
Other changes from Autumn 1986	+20	+20	+35
TOTAL INLAND REVENUE	-975	-2135	-2780

	Effect in 1986-87: Changes from an indexed base(a)	Effect in 1986-87: Changes from a non-indexed base(a)	Effect in 1987-88: Changes from a non-indexed base(a)
CUSTOMS AND EXCISE			
Value added tax			
Increase in registration limits	Nil	Nil	Nil
Revised treatment of motoring expenses	Nil	Nil	+40
New rules on disaggregation of registrations	Negligible	Negligible	+20
Long term lettings of accommodation	Nil	Nil	+10
Reliefs for charities and the handicapped	-10	-10	-10
Excise duties			
No change in rate of spirits duty	-45	Nil	Nil
No change in rate of beer duty	-95	Nil	Nil
No change in rate of duty on cider and perry	-5	Nil	Nil
No changes in rates of wine and made wine duties	-30	Nil	Nil
Increases in rates of duty on light oil etc	+110	+380	+400
Increase in rate of duty on heavy oil for use in road vehicles	+30	+95	+105
No change in rate of fuel oil duty	-5	Nil	Nil
Abolition of duty on lubricating oils	-10	-10	-10
Abolition of duty on AVTUR	-10	-10	-10
Increase in rate of duty on gas oil	+25	+30	+30
Increases in rates of tobacco products duties	+175	+315	+335
TOTAL CUSTOMS AND EXCISE	+130	+790	+910
Vehicle excise duty			
No change in VED on car, light van and main lorry rates	-135	Nil	Nil
Increase in other VED rates	Nil	+5	+5
Changes in trade licensing arrangements	Negligible	Negligible	Negligible
Increased penalties for VED evasion	Negligible	Negligible	+10
Other			
Bus fuel grants	-5	-10	-10
TOTAL CHANGES IN TAXATION	-985	-1350	-1865

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a. Estimates are rounded to the nearest £5million. 'Negligible' means less than £3million. Components may not sum to totals because of rounding. A detailed list of the proposals is contained in Annex [ ] with a description of the method of estimating the direct effects on revenue.

b. In addition there will be a £5million reduction in public expenditure on mortgage interest relief to those below the tax threshold.

c. This estimate is highly uncertain and depends on take-up.

d. The yield in subsequent years will be in excess of £100million.

e. The higher first year cost arises from the proposal to apply these improvements with effect from 6 April 1984.

f. Full year yield at 1986-87 income levels, £5million. This estimate is highly uncertain.

g. Full year cost at 1986-87 income levels, £10million. This estimate is highly uncertain.

h. This estimate is highly uncertain. The cost will build up over a period and will depend on take-up.

i. The scheme has a full year cost at current levels of investment of about £100million. The 1987-88 figure includes a small first year cost for continuing the scheme after April 1987.

j. The figure for 1987-88 includes a yield of £[70]million in corporation tax and income tax reflecting changed levels of contributions to or benefits paid from pension funds. [The overall yield including the charge on refunds may be about £[250]million in each of the following three years. These estimates are highly uncertain.

k. The cost will decline gradually in later years.

l. The cost will not exceed £5million in early 1990's. The long term cost will not exceed £20million.

m. The yield will build up over time to about £40million by 1991-92.

n. Increases subsequent liability to mainstream tax. The full year cost will be £10million.

o. Full year cost £35million.

p. Rising to about £70million, depending on take-up.

q. Without this measure the anomaly in the treatment of loans to participators in close companies could have led to widespread avoidance, costing tens of £million.

r. Rising to an eventual yield of about £50million a year.

s. The estimated eventual effect attributable to transfers in 1986-87 is £70million. If increased lifetime giving reduces the amounts in the death estates of donors, the CTT yield from those death estates will be reduced. But the effects are long-term and uncertain.

t. Duty on additional transactions expected to follow from the reduction in the rate is taken into account. The estimate is subject to a wide margin of error. The figure for 1987-88 takes account of a yield of £40million capital gains tax arising on the additional transactions.

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Annex to Chapter 4

The Budget Proposals in Detail

Income tax

It is proposed -

to increase the single person's allowance and the wife's maximum earned income relief from £2,205 to £2,335 and the married allowance from £3,455 to £3,655

to increase the additional personal allowance and widow's bereavement allowance from £1,250 to £1,320

to increase the age allowance for the single person from £2,690 to £2,850, for the married from £4,255 to £4,505 and the age allowance income limit from £8,800 to £9,400

to increase the basic rate limit by £1,000 to £17,200

to reduce the basic rate from 30 per cent to 29 per cent

to retain the width of the 40 per cent band at £3,000, of the 45 per cent band at £5,200 and of the 50 per cent and 55 per cent bands at £7,900.

As a consequence of these changes, the structure of personal tax rates in operation in 1986-87 will be:

Bands of Taxable Income

£	Per cent
0-17,200	29
17,201-20,200	40
20,201-25,400	45
25,401-33,300	50
33,301-41,200	55
over 41,200	60

[To reduce to 29 per cent with effect from 6 November 1986 the rate of deduction on account of tax etc from payments to certain sub-contractors in the construction industry.]

It is also proposed -

to abolish the £10,000 limit on higher rate relief for covenanted donations to charities

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to introduce from April 1987 relief for charitable donations of up to £100 a year made through payroll deduction schemes

to introduce measures to counter tax avoidance and evasion by non-resident entertainers and sportsmen who derive income from the UK

to change on a revenue neutral basis, with effect from 1987-88, the present engine size breakpoints in the scales for taxing car and car fuel benefits in respect of company cars provided for directors and employees whose remuneration is at a rate of £8,500 a year or more, and to increase the new scale for car benefits by 10 per cent

to extend from 1984-85 the relief for overseas travel expenses incurred by UK employees working abroad and by expatriates working in the UK, and to extend to UK self-employed persons with businesses wholly abroad all of the reliefs for overseas travel and subsistence that are available to UK employees working wholly abroad.

to exempt for 1986-87 the increase in social security benefits payable from July 1986

to amend the tax charging provisions relating to directors' and employees' acquisitions of shares and interests in shares in their companies

to permit the use in approved employee share schemes of shares subject to restrictions on their retention by ex-directors and ex-employees

to permit the use in approved employee share schemes of shares of a class the majority of which is held by directors and employees and which gives them control of the company

to enable approved savings-related share option schemes to permit exercise of options within three years in certain circumstances

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to enable registered worker co-operatives to use redeemable shares in approved profit sharing schemes

to change the basis of assessment of the enterprise allowance from Case I to Case VI of Schedule D.

to exempt certain pensions paid to victims of Nazi persecution

Income tax and capital gains tax

It is proposed -

to introduce a new tax relief for individuals investing in equities

to extend indefinitely the duration of the Business Expansion Scheme, to introduce an exemption from capital gains tax on the first sale of qualifying shares and to make certain changes to the coverage of the scheme.

Income tax and corporation tax

It is proposed -

to amend the mines and oil wells capital allowances; in particular to change to percentage based writing down allowances on a reducing balance and incurred basis, instead of the existing output-related allowances

to amend the provision governing the agricultural buildings allowance

to amend the legislation relating to capital allowances on machinery or plant which is leased

to disallow deductions for VAT penalties, interest and surcharges and to disregard VAT repayment supplement

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to introduce a tax recovery charge on payments from over-funded occupational pension schemes to sponsoring employers

Income tax, corporation tax and capital gains tax

It is proposed -

to introduce provisions to counter abuse of the tax reliefs for charities

to remove certain securities within the Accrued Income Scheme from the scope of the anti-bondwashing provisions

to make minor amendments to the Accrued Income Scheme

Income tax, corporation tax, capital gains tax and capital transfer tax

It is proposed -

to make changes in relation to securities replacing special rules for Stock Exchange jobbers by rules for market makers

Corporation tax

It is proposed -

to introduce a relief from tax for single donations to charity by companies which are not close

to correct an anomaly in the taxation of loans to participators in close companies

to restrict the transfer of tax losses on a company reconstruction

Corporation tax and capital gains tax

It is proposed -

to exempt, with effect from 2 July 1986, gains on the disposal of any option or contract to acquire or dispose of gilt-edged securities or qualifying corporate bonds

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to amend the provisions dealing with small part disposals of land

Oil taxation

It is proposed -

to clarify allocation of tariff charge in cases of fields in common ownership which received development consent on same day

to ensure that the onshore/offshore boundary for oil tax purposes coincides with the UK coastline

to provide an alternative basis for determining the market value of methane and certain other light gas

Capital gains tax

It is proposed -

to increase the annual exempt amount in line with the increase in the retail prices index so that for 1986-87 an individual will be exempt on the first £6,300, and most trusts on the first £3,150, of capital gains

to amend the hold-over relief for gifts to dual resident trusts

Capital transfer tax and inheritance tax

It is proposed -

to abolish the charge on transfers between individuals made on or after 18 March 1986 and more than seven years before the transferor's death, and to charge inheritance tax on other transfers on or after that date

to charge transfers made on or after 18 March 1986 but within seven years of the transferor's death according to the scale for transfers on death; the charge will be reduced in the case of transfers more than 3 years before death.

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It is proposed, for events on or after 18 March 1986 -

to reduce from ten to seven years the period for cumulation of a transferor's or settlor's previous chargeable transfers for the purpose of the rate of tax on transfers into trust and on property held in trust.

It is proposed -

to tax gifts with reservation of benefit made on or after 18 March 1986 in connection with the donor's death as if the whole of the gifted asset had remained in his estate until the reservation was finally given up

to increase the bands of chargeable value for transfers on deaths occurring on or after 18 March 1986, in line with the increase in the retail prices index as follows:

Band of chargeable value £000	Rate on death per cent
0- 71	0
71- 95	30
95-129	35
129-164	40
164-206	45
206-257	50
257-317	55
Over 317	60

to charge at half the death rates transfers (other than between individuals) not within 7 years of the transferor's death

[to extend the exemption for transfers of shares in a company to an employee trust]

Stamp duties

It is proposed with effect from 19 March 1986 -

to charge duty at a rate of ½ per cent on takeovers and certain other company reorganisations

to introduce a new exemption for company reconstructions

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to withdraw exemptions from sale duty for certain categories of loan stock

to withdraw the exemption from bearer instrument duty for bearer letters of allotment

to charge duty at 5 per cent on the conversion of shares into depositary receipts

It is proposed with effect from a date in the autumn:

to reduce the rate of duty on transfers of shares to ½ per cent

to impose a tax on certain share transactions which do not at present pay stamp duty

to withdraw the exemption from sale duty for letters of allotment and for purchases by a company of its own shares

to change the rate of duty on bearer instruments

Value Added Tax

It is proposed -

to increase the registration limit to £20,500 per annum and £7,000 per quarter

to make VAT relief available for distress alarms and lifts for the handicapped and their charities; non-classified advertising and medicinal products supplied to charities: video and refrigeration equipment used in medical applications by certain eligible bodies, including charities; welfare vehicles used by such bodies to transport the deaf, blind or mentally handicapped; and recording equipment used by charities for the blind.

to restrict the VAT provision relating to long stays in hotels by individuals (to take effect from 1 November 1986)

to change the law to counter tax avoidance by artificial disaggregation of businesses

to use the Inland Revenue fuel benefit scale to assess VAT chargeable on fuel used for private journeys in business cars.

Excise duties

It is proposed -

to increase the duties on cigarettes and hand rolling tobacco by 11.1p per packet of 20 cigarettes

to increase the duties on road fuels by 7.5p a gallon and on derv by 6.5p a gallon

to abolish the duties on aviation kerosene and lubricating oils

to increase the duty on gas oil by 1.5p per gallon

Vehicle Excise Duties

It is proposed -

to increase from 19 March 1986 the rate of duty for hackney carriages of up to 20 seats to £52.50, and the additional payment for each additional seat to £1.05. The concessionary rates of duty for farmers' heavy goods vehicles over 7.5 tonnes, will be increased by varying amounts as a second stage in the process of bringing them into line with the proportion of average mileage covered by these vehicles on public roads

to increase from 1 January 1987 the rate of duty for trade licences to £70 for cars and £14 for motorcycles. The increase in trade licence rates will be part of a package of measures reforming trade licence arrangements, including widened availability and changes in the duration for which they are available to 6 months and 12 months. A new type of probationary trade licence is also to be introduced for new businesses and for businesses where there is a doubt whether there is sufficient business to justify a full licence.

to introduce a provision requiring a person convicted of using an unlicensed vehicle to pay twice the level of back duty owing, in addition to any fine.

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The Direct Effects of Changes in Taxation

Table 4.1 gives the direct effects of changes in taxation. 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 rates allows for the expected increase in dutiable 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 footnotes to the table 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 1986-87 or 1987-88; or where the impact of the proposal is expected to build up over a period of years.

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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 1986-87 continue to apply for 1987-88 and compare the effect on receipts in that year with allowances and rates of duty unchanged from their money levels in 1985-86 (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 in the PSBR. The base for the post-Budget forecast of each tax (given in table [6.8]) takes account of the effects, direct and secondary, of all the measures announced in the Budget.

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5 Public Expenditure

Public spending trends

5.01 The public expenditure planning total is the measure on which the Government's spending controls are based. Table 5.1 and Chart 5.1 show the path of the planning total in cash and in real terms ie after adjusting for the rate of inflation as measured by the GDP deflator. (The updated GDP deflator assumptions and money GDP figures are given in Part 2.)

Table 5.1 The public expenditure planning total and general government expenditure

	£ billion 1984-85	1985-86	1986-87	1987-88	1988-87
Department					
DHSS - Social security	38.1	41.3	42.9	44.4	45.9
Defence	17.2	18.1	18.5	18.8	19.0
DHSS - Health and personal social services	15.8	16.7	17.7	18.5	19.1
Scotland, Wales and Northern Ireland	13.7	14.5	15.0	15.0	15.2
Education and science	14.0	14.1	14.3	14.4	14.5
Other	33.0	31.6	31.2	31.3	31.7
Privatisation proceeds	-2.1	-2.6	-4.8	-4.8	-4.8
Reserve			4.5	6.3	8.0
Adjustments			-0.4[1]		
Public expenditure planning total	129.6	133.6[2]	139.1	143.9	148.7
General government gross debt interest	16.1	17.7	18.2	18 ½	19
Other adjustments	4.3	6.2	6.2	6.4	6.6
General government expenditure	150.0	157.5	163.5	168.9	174.3
Planning total in real terms (base year 1984-85)	129.6	127.8	126.7	126.7	127.1
General government expenditure as percentage of GDP	46	44	43	42	40 ½

[1] Includes external finance of -£400m for nationalised industries to be privatised in 1986-87

[2] The Treasury's latest estimate of outturn

5.02 The latest estimates suggest that the planning total outturn in 1985–86 is likely to be £0.6 billion below the figure set at the time of the 1985 Budget. Of this £0.4 billion is accounted for by teachers' back pay which, as a result of the delay in ratifying the pay settlement, will slip from 1985–86 into 1986–87. Even after allowing for this and the effects of the miners' strike spending in real terms in 1985–86 should

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be below the level of 1984–85, the first time since 1977–78 there has been no increase in real terms. For the three following years the expenditure plans in cash terms are as set out in Cmnd. 9702. In real terms the planning total is expected to fall slightly in 1986–87, and then to remain broadly constant over the period to 1988–89.

5.03 Table 5.1 and Chart 5.1 also show that general government expenditure as a percentage of GDP is projected to continue the downward trend established since 1982–83, with a substantial further fall over the next three years. By 1988–89 the percentage is expected to be the lowest since 1972–73. [These trends remain valid however one treats privatisation proceeds.] This will free an increasing share of the nation's resources to the private sector, and provide the basis for further reductions in the tax burden.

Chart 5.1 Trends in Public expenditure 1978–79 to 1988–89

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 and forecasts and the MTFS. The main difference between general government expenditure and the planning total is general government gross debt interest, amounting to some £18·5 billion in 1986–87. There are also a number of other definitional differences and adjustments which are described in Part 7 of Cmnd. 9702 (paragraph 42). In 1986–87, these adjustments account for a further £[6] billion.

Enterprise and employment measures

5.05 Included in the announcements in the Budget speech was provision for further enterprise and employment measures. The gross cost of these measures will be £195 million in 1986–87 and £290 million in 1987–88. The net public expenditure cost after allowing for reduced

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expenditure on unemployment and supplementary benefit will be £100 million in 1986–87 and £165 million in 1987–88 as shown in Table 1.1. The net cost to public expenditure of these measures will be charged against the Reserves provided in Cmnd. 9702, and thereby met within unchanged planning totals. Summer Supplementary Estimates will be presented to Parliament in due course for the extra resources required by the Department of Employment and the Manpower Services Commission in 1986–87.

5.06 Two pilot schemes to help the long term unemployed were introduced in January 1986. The aim of the counselling scheme has been to help the long term unemployed through an in-depth interview. Interviewees may for instance be submitted for jobs, offered places on employment or training schemes or in a Jobclub, offered a specially designed Restart training course, as appropriate. The Job Start scheme provides an allowance of £20 per week to long term unemployed people who take a full-time job earning less than £80 per week. The schemes will be extended nationwide as soon as possible. [An intensive programme of counselling, offering interviews to a significant proportion of the long term unemployed, will be carried out in 1986–87.] The costs of this extension will be £95 million in 1986–87 [and £70 million in 1987–88].

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Extra provision for this and for an increase in the average wage limit to £67

5.07 The number of places on the Community Programme, which is targeted at long term unemployed adults, is being increased to 250 000 from the existing level of nearly 200 000 places. The cost of this will be £60 million in 1986–87 and £120 million in 1987–88. The programme offers jobs to the long term unemployed for up to a year on projects of benefit to the community. When the expansion is complete, the scheme will be helping over 330 000 of the long term unemployed every year.

B.L.O.

5.08 The Enterprise Allowance Scheme is to be expanded to allow for 100 000 entrants a year [by April 1987], as against 65 000 previously provided for. This scheme is intended to encourage enterprise and self-employment amongst those previously unemployed. Another scheme to help small business and enterprise is the loan guarantee scheme, under which the Government guarantees 70 per cent of qualifying loans to small businesses . The rules of the scheme will be revised, with the premium reduced from 5 per cent to 3 per cent, and a ceiling on the portfolio of loans covered of £90 million in 1986–87 and £130 million in the two subsequent years. These two measures together will cost about £10 million in 1986–87 and £45 million in 1987–88.

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5.09 A new scheme has been announced to help 18–20 year olds to find jobs. This scheme, the New Workers Scheme, will provide for an allowance of £15 per week for employers taking on 18 to 19 year olds on earnings of £55 per week or less and 20 year olds on earnings of £65 per week or less. The cost of this scheme, minor changes to Department of Employment programmes [including any offsetting savings]] is expected to be £25 million in 1986–87 and £50 million in 1987–88.

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Supply Estimates **5.10** For 1986–87, plans have now been translated into detailed control totals. The Supply Estimates set out the sums that the Government asks Parliament to vote for most expenditure by Government departments and certain other bodies. The main Estimates for 1986–87, are published on 18 March 1986 with a Summary and Guide (Cmnd. 9742) which summarises the Estimates and explains how they relate to the public expenditure planning total. Of the £99 billion included in the Supply Estimates, £74·6 billion is direct public expenditure in line with the plans published in Cmnd. 9702 for public expenditure to be voted in Estimates. Nearly [60] 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 5.2 Supply expenditure

£ billion

	1984-85 Expected outturn in 1985 Budget	1984-85 Final outturn	1985-86 Expected outturn	1986-87 Provision
Main Supply Estimates	90.4 [1]	90.4 [1]	96.0	99.1
Supplementaries and net under-spending	3.4	3.2	2.0	-
Total Supply Expenditure	93.8	93.6	98.1	
(public expenditure element)	(70.6)	(70.6)	(74.9)	

[1] Adjusted for abolition of NIS

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From: K F MURPHY

Date: 10 March 1986

MR SCHOLAR

cc PPS
Sir T Burns
Sir G Littler
Mr F E R Butler
Mr Cassell
Mr Monck
Mr Monger
Mr Turnbull
Mr Odling-Smee
Mr Evans
Mr Cropper
Mr Lord
Mr H Davies

FSBR CHAPTER 1

Sir Peter Middleton has tried his hand at a redraft of Chapter ... 1 of the FSBR which I attach. This will of course need to be looked at in the light of the speech as it emerges from the Chancellor's office during the course of the day.

KFMurphy

K F MURPHY
Private Secretary

DRAFT

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

2. The FSBR supplements the Chancellor's Budget Statement. It describes the Medium Term Financial Strategy; outlines developments in the economy over the past year; provides forecasts to mid-1987; details the Government's tax proposals; summarises the public expenditure background; and brings together the financial position of the public sector.

3. Chapter 2 describes the Medium Term Financial Strategy (MTFS) which provides the framework for all economic policy decisions. Monetary and fiscal policy is set to bring about lower inflation while providing for a continued growth in output. Micro-economic policies enhance the prospect for output and employment by improving incentives, removing unnecessary controls, ensuring that markets work properly - and generally improving the adaptability of the economy.

4. The measures in the Budget are designed to strengthen these policies. They are in line with the Government's objective to reduce the burden of taxation and reduce the role of the State in the economy. Both tax and expenditure are on a declining path as a proportion of GDP.

5. Chapter 3 describes the main developments in the economy and the prospect for the next eighteen months. The sharp fall in oil prices creates problems, but it will sustain growth and reduce inflation in the world economy, and it will help industry in this country. Inflation in the United Kingdom is set to fall further - to 4% in 1986, output is expected to continue to grow by around 3%. Investment and exports are to grow rapidly. The balance of payments may be in surplus by £4 billion in 1986 even though oil prices are low.

6. Chapter 4 sets out the tax proposals in the Budget ..... (redraft in line with speech). Table 1.1 summarises the effect of all these measures.

7. Chapter 5 describes the public expenditure consequences of the measures in table 1.1. The .....

8. Chapter 6 brings together the complete financial picture for the public sector. The public expenditure measures will be financed from the reserve and thus do not add to public expenditure. Taxes have been reduced by about £1 billion. This leaves a public sector borrowing requirement of £7 billion - 1¾ of GDP. This is rather below the level indicated in the MTFS published in last year's FSBR.

From: K F MURPHY

Date: 10 March 1986

MR SCHOLAR

cc PPS
Sir T Burns
Mr F E R Butler
Sir G Littler
Mr Cassell
Mr Evans

FSBR: PART 3

Sir Peter Middleton has a number of comments on Part 3 of the FSBR (the version circulated under cover of your minute of 7 March.

2. Sir Peter Middleton thinks that the summary should have a page to itself so that the section on the world economy beginning paragraph 3.07 should start on a new page.

3. Chart 3.2, footnote 2. Sir Peter Middleton wonders whether the words "centrally" and "planned" mean the same thing?

4. Paragraph 3.17. Sir Peter Middleton thinks that the reference to oil producing countries should be to oil exporting countries.*

5. Chart 3.7. Sir Peter Middleton wonders whether we really want to include this chart?

* As drafted, he thinks it could just as easily be a reference to the US as anywhere else.

K F Murphy

K F MURPHY
Private Secretary