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PART A

1988 PRE-BUDGET DAY PAPERS

DD's 25 years N Aziz 1/12/95.

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PART A

22-12-87

55:1

Ch
V bad. I have protested to PS/ Mr Rifkind. Shall I follow up with stiff letter?
AA

FROM: MISS M O'MARA
DATE: 23 MARCH 1987

MR TYRIE 15A/2

cc
Mr Culpin
Mr C W Kelly
Mr Hudson
Mr Pickering
GH/01

MR RIFKIND'S REACTION TO THE BUDGET

As I think you noticed during the Chancellor's meeting on First Order Questions this morning, the attached press release from Mr Rifkind, issued on 17 March, referred to "the expected fall in interest rates" and the "likely falls in interest rates and mortgage rates" as ways in which Scotland would benefit from the Budget!

2. As far as I am aware, this press release was cleared with no one in the Treasury. We certainly did not see it in EB. Should someone speak to the Scottish Office, pointing out the danger of such remarks and asking them to ensure that in future all such material is cleared with us in advance? I am not sure whether this would come better on the special adviser net or at Private Office level.

MOM

MISS M O'MARA

– Not very professional of the S. Office.
– I think this should be done through the private office net. It is an 'official' not 'political' matter.
– I also think the Chancellor should be made aware of this.

AGT. 23.iii.

cc. → PS/CX ✓
Miss O'Mara
Mr Culpin
Mr Hudson
Mr Pickering.

32/80

Scottish Information Office, New St. Andrew's House, Edinburgh

PA PQ file

Telephone: 031 244 1111

0379/87

ISSUED BY TELEX 17.3.87

SECRETARY OF STATE WELCOMES BUDGET MEASURES FOR SCOTLAND

The Rt Hon Malcolm Rifkind QC MP, Secretary of State for Scotland, has commented on the effect of the Budget for Scotland.

He said: "This excellent budget is particularly good for Scotland.

"For the North Sea oil industry it is especially good news. Together with the early repayment of advance petroleum revenue tax announced last autumn today's tax reliefs will stimulate new activity in the North Sea and will help safeguard existing jobs and create new ones. I am glad that the Chancellor has been able to respond positively to the representations made to him by Alick Buchanan-Smith and myself.

"The VAT concessions for small businesses will provide a welcome boost to the continued development of this important sector which is vital to Scotland's economic progress and future employment prospects.

"I am delighted that once again the Chancellor has recognised the importance to Scotland of the whisky industry by not increasing excise duty.

"Scots in rural areas will especially welcome the decision not to increase road tax or petrol duty.

"This budget demonstrates the success of the Government's strategy of sustained economic growth and low inflation.

"The expected fall in interest rates as a result of this budget will benefit industry in Scotland as elsewhere in the United Kingdom and will have a particularly beneficial effect on farmers. There is also likely to be a fall in mortgage rates which will be good news for Scotland's increasing numbers of home buyers.

"This year we have already had £4.5 billion extra spending announced on health, education, housing and other areas of public expenditure. Now we have substantial reductions for Scotland's taxpayers, help for the North Sea oil industry and for Scotch whisky as well as likely falls in interest rates and mortgage rates. All in all the best budget that Scotland and Great Britain has seen for years."

Alistair McNeill: 031 244 4955
March 18, 1987

IOD
Institute of Directors

MCU

B/F with advice

22 October 1987

BR

26 OCT 1987

Mrs Burnhams FP.
c.c. CHX, CST, FST, PMG, EST, Sir P MIDDLETON, SIR T BURNS, MR CASSELL, MR SCHOLAR, MR CULPIN, MISS SINCLAIR, IR, CE.

FST.

Rt Hon Norman Lamont MP
Financial Secretary
Treasury Chambers
Parliament Street
London
SW1P 3AG

Dear Financial Secretary

1988 BUDGET

I enclose a copy of the IOD's technical representations to Customs and the Revenue for the 1988 Budget and Finance Bill. As usual these cover a number of matters which involve both technical and wider policy considerations.

I would particularly mention, because the topic crosses Departmental boundaries, our comments on the tax treatment of expenditure on commercial buildings on page 31.

We fully support the Government's vigorous defence of VAT zero-rating before the European Court. If, nevertheless, the Court decides against the UK, at least with regard to industrial and commercial buildings, we urge that first call on the extra VAT revenue should be the extension of capital allowances to commercial buildings; indeed it would be an opportunity for a general rationalisation of the direct and indirect tax treatment of real property. A further consideration is the forthcoming revaluation of non-domestic property at 1st April 1988, since the prospective fiscal regime is an important determinant of relative property rental values. If the European Court announces its decision around the turn of the year, an early announcement of the Government's thinking (without waiting for the Budget) might reduce the chances of a false or disorderly property market around the valuation date.

Yours sincerely

Sandy Anson
Secretary, Taxation Committee

Enc

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TECHNICAL REPRESENTATIONS
FOR THE
1988 BUDGET AND FINANCE BILL

REPRESENTATIONS TO HM CUSTOMS AND EXCISE AND THE INLAND REVENUE

Policy Unit
Institute of Directors
116 Pall Mall
London SW1Y 5ED.

£2.95
October 1987

TECHNICAL REPRESENTATIONS FOR
THE 1988 BUDGET AND FINANCE BILL

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Keep pre-Budget secrecy on technical matters to the minimum.

11 Statutory Instruments

Avoid use of SI's instead of primary legislation on substantive matters. If SI's used, make them subject to affirmative resolution where possible, and establish a procedure for effective scrutiny of draft SI's by a Select, Standing or Independent Advisory Committee.

12 Notes on Clauses

With the Finance Bill, publish notes explaining the clauses and also, for amending legislation, the text of the previous legislation as amended.

13 Retrospective Legislation

Avoid retrospection, particularly where in Revenue's favour. If court decisions are nevertheless reversed retrospectively, allow all taxpayers who have stayed appeals pending the decision the benefit of that decision.

If retrospective legislation essential, legislate sooner to minimise the period of retrospection.

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Announce changes earlier or ideally publish Inspectors' manuals.

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37 Group Relief

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Abolish withdrawal of relief for events outside employee's control.

Extend relief to investment in employee-controlled companies at any time.

I GENERAL

As in previous years we start with some comments on matters of general significance to the UK tax system and its administration. Two recurrent themes in our representations to the Government on fiscal matters in recent years have been, first, the constitutional and practical implications of the line of court decisions on tax avoidance culminating in Furniss v Dawson and, second, the deterioration in the quality of UK fiscal legislation which has followed the acceleration in the 1980's of the growth in its volume and complexity. The two themes overlap in that bad legislation often creates both the incentive and the opportunity for avoidance and any solution to the problems involves reassessment of the way the Taxes Acts and related statutory instruments are legislated.

There have been large Finance Acts every year since 1980, except for 1983 when there would also have been a large Act but for the general election. In addition, there has been increasing use of instruments and even tertiary legislation. This volume of legislation has placed impossible demands on all concerned, draftsmen, Ministers, representative bodies and other interested parties, and above all on Parliament.

In 1983 the original Finance Bill was heavily truncated because of the election but the backlog of provisions dropped from the Bill has still not been completed eliminated. In 1987 instead of the Bill it was Parliamentary scrutiny that was truncated with the consequence that 211 pages of legislation reached the statute book without a proper Committee Stage. The volume and complexity of fiscal legislation is in part a function of the increasingly complex and rapidly changing world to which it applies. It seems unlikely that it will be feasible in future to take a rest from lengthy Finance Bills once every four or five years. Some better procedures must therefore be devised for the effective scrutiny of fiscal legislation in election years.

The problems in election years are, however, only an extreme instance of the problems which occur in normal years; more general changes are therefore required and we mention some of these below. We recognise that the remedy in some cases lies more in the hands of Parliament or Ministers but other points are directly within the ambit of the Revenue Departments. More radical changes also need to be considered. For example, one possibility is to amend the Provisional Collection of Taxes Act 1968 and Ways and Means resolutions procedure to allow Parliamentary consideration of the technical parts of Finance Bills to continue beyond 5th August. We and others have in recent years put forward a variety of such ideas without sparking the public debate which the subject deserves. The need for a thorough examination of the possibilities as they would affect the Revenue Departments, Ministers, Parliament and representative bodies is now urgently required. We would be happy to contribute to discussions both on how the debate might be initiated and on the actual issues.

Pre-Budget Secrecy and Consultations

Budget secrecy on technical measures should be kept to a minimum. Too often in recent years measures of a mainly technical significance and not politically or market-sensitive have been revealed as a fait accompli on Budget Day. The worst case of this was the 1986 proposals on charities, many of which had to be withdrawn when prior consultations would have revealed the defects at a stage when there was time to correct them and this could be done with the minimum of embarrassment. There was also no reason why the November 1986 consultative document "Improving the Pensions Choice" could not have been more frank about the anti-exploitation measures in pensions revealed on Budget Day this year. If forestalling is a potentially serious problem, the usual technique is to make the proposal effective from the date of announcement, whether this be a Budget Day or earlier; if earlier, there is a better change that the eventual legislation will be workable and accurately directed to its aims.

Prior consultation can be public or private. Public consultation, if possible on the basis of draft clauses, is generally preferable, but on some particularly sensitive issues it may be appropriate to keep the discussions confidential. The danger of private consultations is that the potential impact on others not consulted may be overlooked; this happened with the proposals for a new VAT regime for tour operators in FA 1987 which at a very late stage were found to have undesirable consequences for businesses outside the travel industry.

Statutory Instruments

Legislation by statutory instruments can have advantages in terms of flexibility, speed, time available for consultations and minimising the time Parliament needs to spend on matters of uncontroversial detail. The disadvantages are that Parliament often has to legislate the enabling power with no information as to what the subsequent regulations will contain, that SI's once laid before Parliament in draft can only be rejected by Parliament not amended and, if laid in the recess under the negative resolution procedure, can come into force long before Parliament has the opportunity to object. Even under the affirmative procedure the system is heavily weighted in favour of the legislation passing through Parliament "on the nod".

There has been increasing resort to legislation by statutory instrument in recent years; in particular, FA 1986 contained many provisions conferring regulation-making powers. It is understandably tempting for Ministers and officials by this means to avoid both the rigid timetable for the Finance Bill and effective scrutiny by Parliament, but the quality of legislation suffers when this happens in inappropriate cases. A case in point is the regulations under S.104 FA 1986 which provide relief in certain situations where double taxation under Inheritance Tax would otherwise arise. Such reliefs should in our views be in the primary legislation. In the event rather than more time for scrutiny of the provisions by interested parties there was less time than under Finance Bill procedures; one week was given to representative

bodies to comment on the draft regulations (the Revenue having taken nearly a year to produce the draft from when the enabling clause in the 1986 Finance Bill was published) and other instances of unjust double taxation which we and others pointed out were still ignored. Another case in point was the Value Added Tax (Construction of Buildings) Order 1987 which was laid without any prior warning of the change let alone consultation; some of the difficulties of applying this Order in practice might have been avoided if there had been prior consultation at the drafting stage.

We recommend that:

1. the use of statutory instruments should be kept to a minimum in the tax field;

2. If substantive tax provisions are to be legislated by statutory instrument which Parliament cannot amend:

   (a) they should normally be subject to the affirmative resolution procedure;

   (b) there should be some means whereby Parliament (and through Parliament the public) can be satisfied that there has been formal and effective scrutiny of the content, whether by a Select or Standing Committee with broader terms of reference than the present Committee on Statutory Instruments or by an independent body along the lines of the Social Security Advisory Committee.

Notes on Clauses

At the Committee Stage of Finance Bills Customs and the Revenue in recent years have provided MP's with notes on each clause (and on major Government amendments). These notes are intended to assist MP's by explaining to them in layman's terms the provisions of the clause and its purpose. We understand that in practice the notes are not uniformly informative, but they are certainly a great improvement on the former situation when no notes were provided.

With no consolidation of the Taxes Acts since 1970, the capital allowances legislation since 1967 or stamp duty legislation since 1894 and with increasing legislation by reference, it is now often very difficult, even for the tax expert, to work out from the Bill in one hand and Butterworths in the other what the effect of a particular clause is. There is enormous duplication of work by the advisers of interested parties and by those involved with representative bodies separately working out the effect of clauses; it duplicates work already done by the Revenue Departments; and it takes time which representative bodies and interested parties cannot afford, if within the increasingly abbreviated Parliamentary timetable they are to give the Bill the effective scrutiny it needs, make representations to the Revenue Departments and, if necessary, brief MP's.

We, therefore, urge that Customs and the Revenue publish together with the Finance Bill (for a price):

1. notes explaining the purpose and in reasonable detail the effect of each clause;

2. in cases of complex legislation by reference, the text of the original legislation as amended by the clause (this is done in the US).

Retrospective Legislation

The need for retrospective legislation is usually the consequence of bad drafting of earlier legislation. There is quite properly a strong presumption against retrospective legislation on grounds of natural justice but there are equally strong practical reasons:

1. both the original bad drafting and the admission of it in the amending legislation bring the law into disrepute generally;

2. regular resort to retrospective legislation, however justified in terms of restoring the "general understanding" of the law,

would substantially increase the uncertainty at the time an individual decides to act (or not to act) as to the law which would be applied. The extra risk from such uncertainty would prevent much economic activity which would take place in a stabler legal environment. Alternatively, it drives the economic activity into the black economy or offshore.

These objections carry less weight where the retrospective effects operate in the taxpayer's favour. FA (No.2) 1987, however, contained no less than three retrospective amendments in the Revenue's favour. In two of these cases, the amendments effectively overruled decisions of the Commissioners and courts (except for those involved in the specific cases) and therefore have the further disadvantage of creating inequity between taxpayers in similar circumstances some of whom get the benefit of the court decision and others who do not. Four points in particular arise from this year's retrospective legislation.

1. We welcome, so far as it goes, the assurance in the Financial Secretary's letter of 2 September that "any other taxpayer who was specifically informed by the Inland Revenue that his case would follow the decision in the relevant case will be similarly treated"; the benefit of the decision in Padmore v CIR would therefore be extended to Mr Padmore's partners for when he was a test case. We believe, however, that similar relief should be extended in future to any taxpayer who had agreed with the Revenue to stay his appeal pending the outcome of the case subsequently overruled by retrospective legislation, whether or not he had agreed to be bound by that decision. Otherwise, the consequence in practice will be that taxpayers will in future insist on their appeals being heard together with any similar cases, which will increase the expense, delay and inconvenience for all concerned.

2. Retrospection in more objectionable the longer the period of retrospection. In neither the Padmore nor the oil licence case has it been explained why it took so long to decide to legislate on a point which had been in dispute for several years. We

urge that the Government legislate more promptly where retrospection is involved or at the very least announce earlier that retrospective legislation is being considered.

3. The impression created by FA (No. 2) 1987 that there is greater enthusiasm among Ministers and officials for retrospective legislation in the Revenue's favour needs urgent correction (see "Transfer of Subsidiaries" in Part III below).

4. It would be completely unacceptable for taxpayers to suffer the automatic penalties proposed by the Keith Committee (and now partially legislated) as a result of their tax liabilities being retrospectively increased. Retrospective legislative and administrative changes should automatically qualify as a "reasonable excuse".

Revenue Changes in Practice/Interpretation

More generally with regard to the second recommendation on retrospective legislation above, we have long urged the Revenue to make an early announcement when it is considering making a change in its established practice or interpretation of the law or taking a point of law to appeal. Given the uncertainty of tax law since Furniss & Dawson, taxpayers should at least be allowed to know where the Revenue thinks there are specific uncertainties so that they can arrange their affairs in a way to minimise uncertainty. Indeed we would go further and suggest that Inspectors' manuals should be published so that taxpayers and their advisers may establish more easily whether this is an established Revenue practice.

Special Commissioners

The proposal to publish the decisions of the Special Commissioners was one of the items dropped from the 1983 Finance Bill and is still outstanding. We again urge strongly that these decisions should be published in anonymised form. Without this information taxpayers are at a significant disadvantage to the Revenue, who by definition have full knowledge to every case.

Cost of Tax Appeals

It is not unknown for the Revenue Departments to appeal to the High Court (and higher courts if necessary) against decisions of the Special or General Commissioners or VAT Tribunal in favour of the taxpayer where the amount of tax at stake is less than the irrecoverable costs which the taxpayer would be likely to incur if he contested and won the appeal (including an order for costs). More generally the taxpayer's resources are usually limited compared with the Revenue's and his interest is confined to the tax in his own case whereas the Revenue may be concerned about the tax in other similar cases as well. We consider it would be more equitable if, where the taxpayer has won an appeal before the Commissioners, VAT Tribunal or courts and the Revenue Department wishes to appeal against that decision, the Department were required to pay his costs at any further appeals. This would not be an incitement to frivolous appeals because the taxpayer would have demonstrated by winning the first decision in his favour that he had a good case.

Interest on Overpaid and Underpaid Tax

We welcome the proposal in "The Inland Revenue and the Taxpayer" to make repayment supplement the mirror image of interest on late payments of tax; and we agree with the general principle that interest should run on late payments and repayments of tax in a way which broadly achieves commercial restitution. We note, however, that it is intended to retain the present power to specify different interest rates for payments and repayments. We understand that this is because of concern about taxpayers, in particular large businesses, "round-tripping". We are opposed to any such deviation from the mirror image principle. A specially lower rate of interest on repayments would give the Revenue an incentive to be less diligent in making repayments speedily which would be no more acceptable than "round-tripping". We see no reason why this problem could not be controlled by updating the interest rate more frequently in line with the market. Indeed we suggest that the Treasury should investigate the possibility of tying the rate to one of the published market rates thus avoiding the need for changes in the rate to be announced by press release.

II VALUE ADDED TAX

Cash Accounting

The cash accounting scheme is supposed to make life easier for small businesses. Why then has the leaflet been produced with print so small that it is hard work even for someone with good eyesight and who understands VAT to read it?

We appreciate that the EC was reluctant to accede to the UK's request for a £250,000 turnover limit for the scheme and did so only on the basis that it was for a three year experimental period. A real increase in the limit would therefore be out of the question until the end of the three years and then the first priority would be to ensure the continuance of the scheme. Nevertheless, we remain of the view that the ultimate objective should be to extend the option of cash accounting to all registered traders and therefore the UK should be seeking to negotiate the removal of, or a significant increase in, the threshold at the three year review.

Bad Debt Relief

As the cash accounting leaflet makes clear, that scheme will not be beneficial for a substantial proportion of traders within the turnover limit. These traders and those with turnover over the limit will not enjoy the relief provided by the scheme for the VAT element of bad debts. It therefore remains a matter of urgency to provide an effective relief for traders accounting on the normal basis. We again urge that the same criterion for VAT relief should apply as applies for Schedule D income and corporation tax by virtue of the exception in S.130(i) ICTA 1970. Where such relief was given, it should of course be clawed back to the extent of any subsequent recoveries or release of the debt. It may well be that by providing proper relief for bad debts there would be a saving to the Exchequer from fewer traders becoming bankrupt themselves as

a result of bad debts they have incurred and fewer failed companies being put into liquidation solely to enable VAT relief to be claimed under S.22 VATA 1983.

VAT on Imports

We note that the European Commission's Global Communication of 5 August 1987 on the Completion of the Internal Market and the related documents on VAT approximation and the proposed VAT Clearing Mechanism make no mention of the draft 14th Directive (which proposed the adoption of the Postponed Accounting System for VAT on imports from other Member States). In the previous White Paper of June 1985 the 14th Directive was proposed as an interim measure pending the abolition of fiscal frontiers in 1992. The implication is that with 1992 approaching fast the 14th Directive is no longer thought worth pursuing. We would agree with that, if we had any confidence that the 1992 deadline would be met. We recognise that it would be unrealistic to expect the UK Government to achieve speedier progress on the 14th Directive if the Commission does not regard it as a priority. We, therefore, urge that the Government should support such efforts, if any, as are being made by the Commission to progress the 14th Directive but should not unilaterally revert to the PAS in the UK unless and until most other Member States are prepared to follow suit. As this looks unlikely in the near future, the Government should make every effort to make the present system of immediate payment on importation more tolerable for UK business. In particular, we repeat our recommendation that bank guarantees should only be required where Customs has reason to suspect that an importer is not creditworthy. The need for bank guarantees sufficient to cover the largest likely consignment in the year is a major burden on small businesses and those which import only occasionally; apart from the cost of obtaining the guarantee, it directly reduces the business's borrowing capacity by the full amount of the guarantee, which in turn is a significant constraint on the ability of the business to grow.

Payment of Refunds

The decision of the VAT Tribunal in R v Commissioners of Customs and Excise ex parte Strangewood Ltd [1987] STC 502 confirmed that a trader faced with an indefinite delay in a repayment which Customs is querying has no right to compel Customs either to make the claimed repayment before the investigations are complete or to make a decision or issue an assessment against which he could appeal. Whilst this safeguards Customs against fraudulent claims, it may well result in a trader whose claim is eventually found to be correct going out of business in the meantime. We consider that Customs should be compelled to make a decision within a statutory time limit or apply to the Tribunal for an extension. Customs could still ask for the case to be adjourned (and the repayment withheld) for a period while investigations were completed but at least the trader would know, and could show to his bank and other creditors, that the adjournment period (and any extension thereto) would be fixed by the Tribunal with the onus on the Customs to show adjournment was necessary.

The fact that repayment supplement becomes due after 30 days is an incentive for Customs to settle the matter before then, but once that date is past no further supplement is payable however long the investigation takes. We therefore suggest six weeks after the due date as the time limit for Customs to make an appealable decision.

Fuel for Private Use

As the standard scale for the VAT element of fuel provided for private mileage in company cars is based on the income tax scale charge, we discuss this under "Benefits in Kind - Motor Cars and Fuel" in Part VII below.

VAT on New Construction

In "Commercial Buildings" in Part V below we comment on some of the implications, if the European Court were to rule in the present infraction proceedings brought by the European Commission against the UK, that the UK could not retain the zero-rating of new construction of commercial and industrial buildings.

Artificial Splitting of Businesses

S.10 FA 1986 was enacted to prevent the obtaining of a VAT advantage by artifically splitting a business into two or more separate businesses each with turnover under the registration threshold. Subsection (3) of that section contains a departure from the normal rules relating to tax appeals in that a direction of the Commissioners under this section can only be overturned if the Tribunal "considers that the Commissioners could not reasonably have been satisfied" as to the matters specified in the section. This prevents the Tribunal coming to its own conclusions as to the facts of the situation and the application thereto of the anti-splitting provisions. We can see no justification for this departure from the normal rules which puts the taxpayer at an unreasonable disadvantage and we urge that section 40(3A) VATA 1983 as inserted by S.10(3) FA 1986 be repealed.

III CAPITAL GAINS

FA (No. 2) 1987

We warmly welcomed the provision in S.74 FA (No.2) 1987 extending imputation to the tax on companies' chargeable gains, a point we have particularly urged in recent years. The purpose of that measure was to eliminate (for basic rate taxpayers) and to reduce (for higher rate taxpayers) the double taxation of companies' gains. As such it had no bearing on the issue of whether there should or should not be a distinction for fiscal purposes between capital profits and income profits. The IOD has always argued that there are important differences between capital and income profits which should be reflected in their tax treatment:

(1) Capital gains usually accrue over a long period and in the case of income-producing assets any increase in income underlying the gain is fully subject to income or corporation tax. This raises the question of whether capital gains should be taxed at all - a matter to which we shall revert in our general Budget representations.

(2) Capital gains and losses by their nature tend to be "lumpy" (i.e. they occur infrequently and tend to be large in relation to income). This has the consequence that relief for losses is often only obtained, if at all, long afterwards so that the real value of the relief eventually obtained may only be a small proportion of its present discounted worth. Applying the same rate of tax to capital gains as to income therefore results in a higher effective tax burden on net capital gains in the economy than on net income. This discrepancy is compounded by provisions allowing the carry-back or group relief of income losses but not capital losses and by the absence of full relief for inflation in the computation of chargeable gains and losses. We therefore deplore the other provisions in S.74 as a result of which the same nominal rate of tax now applies to companies' capital profits as to their income profits,

particularly in the absence of relief for pre-1982 inflation. We likewise deplore the decision to leave the rate of capital gains tax at 30% when the basic rate of income tax was reduced to 27%.

Rates of Tax

There is no rational basis for gains now being taxed at 27, 30, 35 or 37%. For the reasons given above (which were accepted in 1965 when capital gains tax was introduced at a rate significantly lower than the rate of corporation tax and standard rate of income tax), we again urge that the rate of tax on both individuals' and companies gains should be reduced to substantially below the basic rate of income tax (and small companies' rate of corporation tax). The appropriate differential would depend on whether any relief for pre-1982 inflation or carry-back of losses were introduced as we recommend below.

Pre-1982 Inflation

It is indefensible and a cause of major injustice that in the computation of chargeable gains and losses no account is taken of the enormous inflation between 1965 and 1982 . It is worse still to increase the tax yield from inflationary gains which arose over that period, which was the effect of FA (No.2) 1987 (the Financial Statement and Budget Report predicted an increase of £80m much of which presumably relates to pre-1982 inflation). We recognise the Budgetary constraints affecting changes which would involve up to half the tax yield on chargeable gains (roughly equivalent to ½p on income tax rates in years following the year of change). We, therefore, again urge that at least a start be made towards remedying this injustice by means of a 10 or even 20 year cut-off, so that gains on assets held for longer than the cut-off period would be entirely exempt or would be taxable only to the extent of any gain since April 1982. This would remove the need for valuations of assets at April 1965 which involve particularly heavy costs both for the taxpayer and for the Revenue at a time when the Revenue's property valuation staff face an exceptional burden of work in connection with the revaluation of non-domestic property.

The onus would be on the taxpayer to show that an asset was acquired before the cut-off date. The fact that some taxpayers will not have retained the necessary records is no reason for not providing justice for those who have. We would accept that such cut-offs should cease ten (or twenty as the case may be) years after 1982.

Losses

As explained above, there is particular need for a carry-back provision for losses, if capital transactions are not to be taxed more heavily than income. We recommend that chargeable losses should be able to be carried back two years.

We similarly urge that the long deferred introduction of group relief for capital losses should now be effected. There would then no longer the need to incur the cost and trouble of transferring assets within the group prior to disposal or the uncertainty of tax treatment that still attaches to such transactions where made for tax mitigation reasons.

Annual Exemption

We again urge that, if full relief for pre-1982 inflation is not given companies should be given the same annual exemption as individuals.

We further urge that any unused annual exemption should be able to be carried forward without time limit, so that there would be no need for taxpayers to resort to special arrangements to take advantage of the exemption. If a general right to carry forward is not granted, there should at least be a right to carry forward for the limited purpose of relief on the disposal of business assets held throughout the years in question. This measure would be less necessary if there was full relief for pre-1982 inflation and the rates of tax on chargeable gains were lower.

Roll-over Relief

Roll-over relief under section 115 CGTA 1979 is restricted to the case where assets used for the purposes of the trade are disposed and the proceeds reinvested in assets also so used. We recommend that relief should be extended to shares in the following similar circumstances:

(1) where an individual disposes of shares in a company which would, apart from the condition as to his age, qualify as his family company for retirement relief purposes and the proceeds are reinvested in shares in another company which would similarly qualify;

(2) where a company disposes of the shares of a 75% subsidiary, which is a trading company or which holds assets used in the business of other companies in the group which are trading companies, and reinvests the proceeds in shares of another company which meets those conditions or in assets used for the purposes of a group company's trade.

Roll-over relief under section 115 CGTA 1979 is restricted where the asset has not been used for the purposes of the trade throughout the period of ownership. The restriction is on the basis of a time apportionment of the value of the asset between the periods of trade use and periods of other use. Inspectors, however, insist in the case of pre-1965 assets that it is only the proportion of trade use since April 1965 that is relevant. We are still not convinced this is the correct interpretation of the wording of section 115, but whether or not it is correct, we would suggest that a fairer treatment would be to restrict roll-over relief in the proportion that the period for which the asset is not used for the purposes of the trade after 5th April 1965 bears to the whole period of ownership. This would incorporate a modest degree of leniency in the taxpayer's favour similar to that considered appropriate in Schedule 5 CGTA 1979 where the taxpayer has the choice of

apportionment on a time or actual basis. Failing that, it would still be preferable to the present Revenue interpretation to have apportionment on the basis of the total period of trade use out of the total period of ownership.

S.278 ICTA 1970

When a company leaves a group, a charge under Section 278 ICTA 1970 will arise in connection with any capital assets transferred to that company from other group companies within the preceding six years. The operation of this section is particularly, and unnecessarily, harsh in two respects as follows:

(a) The charge is deemed to arise in the year in which the asset was acquired by the company leaving the group. Accordingly, by the time the company does leave the group and the charge crystallises, time limits, particularly for loss relief, may have expired. We urge that the time limits, especially the limit under s.177(2) ICTA 1970, should be extended in such circumstances. We appreciate that simplicity and certainty are considerations in fixing time limits but do not accept that there would be any particular difficulty in extending the limit under s.177(2) in this case. Indeed we note that the Revenue generally exercises its discretion to extend the time limit under paragraph 12(3) Schedule 5 CGTA 1979, if the chargeable gain arises by virtue of s.278. Extension in those circumstances should, however, be automatic.

(b) We understand that the Revenue do not accept that a gain arising in respect of a s.278 charge can be deferred by a roll-over claim under s.115 CGTA 1979 on the grounds that the reinvestment is in the same asset. There seems no reason why the deemed reacquisition should not qualify as a basis for a roll-over claim, but at the very least the s.278 charge should be able to be covered by a roll-over against reinvestment by the company in other qualifying assets.

Disincorporation

We are making separate representations on this subject in response to the consultative document of July 1987. We urge that room be found in the 1988 Finance Bill for the necessary legislation.

Transfer of Subsidiaries

Last year we explained how the High Court decision in Westcott v Woolcombers Ltd [1986] STC 182 produced a result which was both illogical and contrary to the previous well established understanding of the law. Briefly the effect of the decision is to double up the ultimate chargeable gain or loss within the group in respect of the shares of a subsidiary transferred in a way which falls within S.85 CGTA 1979. We called then for legislation to restore the previously understood position and when we discussed this with the Revenue they agreed that the decision was anomalous. The decision has since been upheld by the Court of Appeal [1986] STC 600. In the meantime the Finance (No.2) Act 1987 was passed reversing retrospectively two other cases (without waiting for the results of any appeals to higher courts) where the previous understanding was less well established. It may be that there was less enthusiasm on the Revenue's part to legislate on the Woolcombers anomaly because a chargeable gain is likely to be a more frequent outcome than the loss which Woolcombers suffered; doubling up may therefore be to the Revenue's overall advantage.

We again urge that this anomaly be corrected by restoring the previous understanding of the law in respect of future disposals of shares in subsidiaries previously transferred within the group.

IV INHERITANCE TAX

Business and Agricultural Property Relief

Under Capital Transfer Tax, if additional tax became payable because of death within three years of a gift of qualifying property, that tax was charged on the value of the gift after deducting any relief for which it qualified at the time of the gift. Under Inheritance Tax the relief is only given in respect of property which is the subject of a potentially exempt transfer which becomes chargeable on death, if it qualifies both at the time of the gift and at the date of death. It is the gift which is chargeable and the subject matter of it is valued at the date of the gift. Relief should be given if the property qualified for it at the date of the gift.

Gifts within five years of death

The burden of the tax in respect of gifts, where the donor dies between three and five years after making it, was increased by FA 1986 to 80% or 60% of the death rates of tax compared with 50% before 18 March 1986. The fact that this gives a tidy and symmetrical progression of rates over the last four years of the period of charge is not, in our view, a good reason for increasing the effective burden of a tax, which is levied by definition as a consequence of individual misfortune. Symmetry was not thought to be necessary in the previous previous taper relief for estate duty where the value of gifts was discounted by 15%, 30% and 60% in the last three years of the seven year period (after 1968). We urge that the tax chargeable should not exceed 50% of the death rate if the donor survives the gift by three years. If symmetry is considered to be essential, rates of 37½%, 25% and 12½% of the tax after four, five and six years or 25% after five years might be substituted for the scale in FA 1986 for those period of charge.

Double Charges Relief: S.104 FA 1986

We were unhappy at the original decision to deal with the matter of eliminating instances of double taxation under IHT by means of regulations under S.104 rather than in the Act itself. This was because what is or is not taxable or relievable should in our view be specified in primary legislation and, secondly, because the delay while the regulations were prepared would extend the period during which taxpayers and their advisers remained uncertain as to the current tax rules (the regulations were to be backdated to the inception of IHT). In the event this period of uncertainty extended to 1 July 1987 when the regulations were finally laid. This was despite prompt responses by ourselves and others, first in September 1986 to the Revenue's request for suggestions on the content and, again, in April when we were eventually given sight of the draft regulations and asked to comment effectively within a week.

Our concern now is that despite this excessive delay on the Revenue's part the Inheritance Tax (Double Charges Relief) Regulations 1987 still do not cover several instances of double charge which we drew to the Revenue's attention in both our submissions. Moreover, Mr Houghton's letter of 11 August indicated that there was "no intention to make further regulations in the near future".

We most strongly urge that another tranche of regulations is introduced as soon as possible covering the following further examples of double charge under IHT:

1. The former mutual transfers legislation removed both the original gift from the transferor's cumulative total of lifetime transfers and also the gift back from the transferee's cumulative total of lifetime transfers. Regulation 4 covers the former but not the latter. There should be a further Regulation to exempt from charge the original transferee's transfer back to the original transferor. In effect, property to which Regulation 4(3)(a)

and (b) applies should not be a PET or a chargeable transfer of the transferee. Otherwise, there will still be a double charge to tax on the same property or on property directly or indirectly representing the same property. We note that there is an exact parallel in the treatment of the reverter to settlor of settled property, which has always been exempted from charge.

2. Where there is a gift with reservation, such as the gift of shares in the PET in March 1993 in the second regulation 5 example in Part II of the Schedule, the subject matter of the gift is comprised in the estates of both the donor and the donee. Since the whole of the value of the subject matter is comprised in the donor's estate, no part of it should be included in the donee's estate so long as the reservation subsists. The position is analogous to that of the life tenant and remainderman of settled property - the former is treated by virtue of his interest in possession as owning the whole of the property and the latter as owning nothing.

3. Similar considerations apply to a loan back to the donor by the donee of a gift. While the amount of the loan back is not deductible from the estate of the original donor, it should not be included in the estate of the donee.

4. The former relief under Capital Transfer Tax for mutual transfers included relief for gifts back by the original donee to the original donor's spouse or to his/her widow/widower within two years after the original donor's death. This relief should be restored.

V BUSINESS EXPENDITURE DISALLOWED ("NOTHINGS")

General

The items in this part all concern business costs which for whatever reason are taken into account imperfectly, or not at all, in the calculation of the taxable income or chargeable gains to which they relate. In principle all genuine expenditure incurred for business purposes should be relieved in an appropriate form in the computation of the resultant profits of the business for tax purposes.

The Institute of Chartered Accountants in England and Wales made a submission last year including a lengthy list of both revenue and capital items for which relief is not at present but should be given. We accept that for both revenue and technical reasons it may not be possible to deal with every item on the list in one year but we urge that a commitment be made to the substantial reduction of that list over a period of say three years. We mention below those items which in our view are of greatest priority or on which we have particular comments.

Exchange Rate Losses

We are pleased to note that at last the Revenue seems to be giving serious consideration to legislation in this area, following the unanimous Report in July by the Working Group on which the IOD was represented. The subject has been talked about for many years. Action is overdue. We therefore urge that every effort be made by the Revenue to complete the further consultation and drafting stages in time for legislation in the 1988 Finance Bill. To this end we suggest that the next step should be the publication of draft clauses.

Commercial Buildings

The only reason we have ever been given for the absence of capital allowances for expenditure on commercial buildings is the eventual heavy cost to the Exchequer. The heavy cost is equally a measure of the size of the economic distortion caused by this anomaly. We note that there is a real possibility that the UK may be forced by the decision of the European Court due in the next few months to extend VAT to the supply of new industrial and commercial buildings; whilst the VAT charge would be recoverable by industrial and some commercial businesses, a significant proportion of commercial busness, notably in the financial sector, are partially or wholly exempt so that the charge would "stick" with them. If VAT were so extended, this would both increase the present distortion and remove any argument on revenue grounds against a commercial buildings allowance - indeed the revenue yield from the VAT charge would begin to flow immediately whereas the loss of corporation and income tax would build up slowly over many years. As there would also be a considerable overlap between the businesses affected by the two changes, there is a strong case for making both at the same time. We urge that relief for new expenditure on commercial buildings should be introduced at the rate pf 4% per annum, the same as for industrial buildings.

If relief for commercial buildings is not given in 1988, we urge that the 25% limit on the proportion which offices may comprise of an industrial building should be determined on the more logical basis of the floor area rather than the historic cost as at present.

Second-hand Industrial Buildings and Mineral Assets

Where an industrial building is sold and the purchaser uses it for the purposes of a trade, the purchaser is only entitled to claim an allowance based on the original cost of the building despite the fact that the full excess of the scale price over the tax written down value is charged to tax on the vendor in the form of a balancing charge and, to the extent that the scale price exceeds the original

cost, of a capital gain. This is asymmetrical in favour of the Revenue and does not accord with the general principle that a business should be able to deduct in an appropriate form any expense incurred for the purposes of the business. Similar considerations apply to capital allowances for expenditure on mineral extraction. We urge that the purchaser should be able to obtain relief for the full price paid for a second-hand building or mineral asset, provided that does not exceed its market value. With corporation tax rates now reduced to 29 and 35% and the capital gains tax rate still at 30% this would not be expensive in terms of lost revenue.

Pre-trading Expenditure

Since 1980 expenditure incurred within three years before the commencement of trading has been deductible. Three years is sufficient for most new trades but there will always be cases, particularly where major construction must be completed before trade can commence, where three years will not be nearly long enough. The effect of the three year limit is to penalise large projects: indeed the larger the project the longer the start-up time and thus the greater the disadvantage as against smaller projects which, almost by definition, are of correspondingly less importance to the infrastructure of the UK.

We can see no reason for the limit other than as a temporary limit on the cost to the Exchequer until full relief could be afforded. There is no question of tax avoidance, because the expenditure must meet all the usual criteria for deductibility and relief can then be obtained only if and after the company genuinely commences to trade. The three year limit is a serious economic distortion and we urge that it be abolished.

Similarly, in S.50(4) FA 1971, the words "about to carry it on" in relation to an intended trade would not necessarily cover a long start-up period. We suggest that in subsection (4) the words "who intends to" are substituted for "about to".

Post-trading Expenditure

No relief is available for post-trading expenditure except to the limited extent that deduction is permitted from post-trading receipts or allowances are available for the restoration costs of mineral extraction sites. There is no reason why relief should be available for expenditure incurred for the purposes of the trade before the date of commencement of the trade but not after the date of cessation. Indeed there is a stronger case for allowing expenditure in the immediate aftermath of cessation in that cessation may happen unexpectedly for reasons outside the business's control, for example a fire. We therefore urge that priority be given to allowing the deduction of expenditure incurred at least in the first twelve months after the trade ceases.

In the case of the restoration costs of mineral extraction sites we urge that the period for which relief is available be extended from three years after the cessation of trading to five years after completion of the restoration in line with the after-care obligations under the Town and Country Planning (Minerals) Act 1981.

Abortive Capital Projects

As the pace of commercial change quickens and the more obvious sites for minerals are explored, more false starts are likely to occur in the course of businesses searching for products or services which they might profitably supply in the market place. We again urge that relief should be given for expenditure on abortive capital projects.

Equity Finance

The anomaly that the incidental costs of equity finance are not deductible has been aggravated by the tightening of the VAT partial exemption and input tax rules in April this year which prevents the recovery of VAT on expenditure in connection with capital issues. This is a further reason for extending the relief in S.38 FA 1980 to cover the incidental costs of equity as well as loan finance.

Motor Cars Costing over £8,000

As a result of the failure to increase the £8,000 limit since 1979, the restrictions on capital allowances and on the deductibility of leasing payments for motor cars costing over £8,000 in paragraphs 8 to 12A Schedule 8 FA 1971 have long since ceased to apply only to especially large and luxurious cars as originally intended. The original intention was in any event misconceived in our view. In the case of capital allowances the restrictions only affect the timing of the deduction and may now actually create an advantage in that they have the effect of making cars over but not under the limit eligible for treatment as short life assets. In the case of leasing payments the excess over the permitted deduction is never deductible and so is a true "nothing". In either case the restriction involves businesses and the Revenue in considerable extra work in calculating tax liabilities. We again strongly urge that the restrictions on cars costing over £8,000 be abolished entirely.

Computer Software

Even very small businesses now have to spend money on computer software if they are to offer a competitive service to their customers and, for many, computer software is now a major item of cost. It should be a matter of priority to remove any doubts as to the deductibility of all such expenditure. We urge that lump sum payments for licences to use computer software should be made eligible for capital allowances in the hands of the licensee and that other payments for software not eligible as revenue or "plant and machinery" should be deductible in some form.

VI CORPORATION TAX

General

Most of the points in this part concern restrictions particularly in the rules for losses and group relief which we consider to be unnecessary and damaging impediments to the ability of UK businesses to compete in today's fast-changing markets. The rigidity of the present rules does not match the needs of business to adopt the most appropriate structure and to adapt fast and flexibly to market developments. The 1984 reform of corporation tax and the current economic boom have eliminated a large part of the "overhang" of losses brought forward which was previously of understandable concern to the Exchequer. We therefore urge that the opportunity be taken now to remove many of these restrictions.

Change of Ownership

We have written separately on the revised draft Statement of Practice on S.483 ICTA 1970 sent to us recently for our comments. As we said in our comments on the first draft, we still believe that S.483 ICTA 1970 and S.101 1971 are too widely drawn in terms of the changes within a three year period either side of a change in ownership which can trigger the disallowance of losses and surplus ACT brought forward, regardless of the motives for the respective changes. We consider that a motive test along the lines we have suggested as well as a Statement of Practice is required, if these sections are not to act as a barrier both to the development of successful businesses and the turn-around of unsuccessful ones.

Trading Losses

We believe that the restrictions on setting off brought forward losses only against the future profits of the same trade are anachronistic. We again urge that brought forward trading losses should be capable of offset against the profits of another trade within the same company or another group company, provided there has been no complete interruption in the company's or group's

trading, and in the case of a group both companies have been members of the group throughout the relevant span of periods.

Unrelieved Management Expenses

Likewise, unrelieved management expenses should be capable of offset against the profits of a trade within the same or another group company.

Group Relief - Excess Charges

Where a company has both "charges on income" (S.248 ICTA 1970) and foreign income which is wholly or mainly covered by Double Tax Relief and it then makes a Case 1 loss, the Case 1 loss is available for group relief under S.258/259, but the charges on income are not available for group relief due to the provisions of S.259(6). This is anomalous, since the "charges" have effectively been added back in arriving at the Case 1 loss, and may well be attributable to UK trading activity. The mandatory wording "shall be allowed on deductions" in S.248(1) means that the company is obliged to segregate its deductions for annual interest and then utilise them against income which may already be fully relieved by DTR. A further inequity is contained within S.259(7) which restricts the surrender of charges as group relief by reference to the utilisation of brought forward losses.

The sort of situation where problems with excess charges are likely to arise is where there is long term debt in the UK parent (or subsidiary), which has been used in financing the trade of the whole UK group but left as a central cost for ease of management. We welcomed the abolition in FA 1986 of the rule that ACT must first be utilised against income relieved by DTR; the company is now allowed to designate that ACT be used under S.100(6) FA 1972 rules and carry forward any balance as surplus. We urge that the same economic realism should be brought to the charges/group relief area by allowing the company to elect where to take its S.248 relief and to treat any surplus as a trading loss (or in the case of an

investment company, as an addition to its S.304 management expenses) available for group relief.

Group Relief

We are disappointed that the consultations in 1983 on group relief have still not been followed up by legislation except on the points relating to consortia. Besides the point on excess charges above, further changes to the group relief rules for losses are required in the following areas:

1. Consolidated basis: whether or not the rules are otherwise relaxed, fiscal equity between different group structures would be improved if some or all of the companies in a group were allowed to make a joint election for taxation on a consolidated basis.

2. Capital losses: the biggest single barrier to achieving equity between a business structured as a group and as a single company is the absence of group relief for capital gains. By their nature capital gains and losses tend to be infrequent and large in relation to profits and turnover and this often gives rise to a mismatch as to the group companies in which gains and losses arise. Although the mismatch can often be solved (so long as the present understanding on the scope of Furniss v Dawson holds) by transferring the asset within the group prior to the disposal to the third party, this solution involves an unnecessary cost burden for business in terms of the direct transaction costs and the possible delay in completing the disposal; and there remains the big trap for the unwary who do not appreciate the need for such action prior to disposing of an asset. We strongly urge that group companies be allowed to surrender unrelieved capital losses (including brought forward losses) for offset against capital gains arising in other group companies. Many years ago a Working Party

established by the Revenue recommended such a change but no Government proposal has yet materialised, although the subject was raised again in Mr Beighton's consultative paper on group taxation.

3. Capital loss buying: at the very least there should be no restriction on pre-acquisition losses brought forward within the purchased company being offset against gains on assets acquired prior to joining the group or acquired subsequently from outside the group. Similar considerations apply to losses unrealised at the date of acquisition. In any event we do not agree that capital or any other loss buying is a matter for concern. We still believe there is a good case for allowing a market in corporation tax losses as proposed in Dr Bracewell-Milnes' paper in 1983.

4. Case I and II trading losses: provided both companies are part of the group throughout the relevant span of accounting periods, a group should be able to carry back surrendered losses in the recipient company for offset against its total profits of the prior year (or prior three years trading profits for losses in respect of capital allowances) as it could if it was formed as a single company.

5. Time limits for elections for group relief should all be six years.

6. Case VI losses (which can only arise on items of a trading nature) should be capable of surrender and carry forward within the recipient company.

ACT - Group Relief

As we have recognised above, there are complexities in increasing the flexibility of the group relief rules for losses, but we do not accept any such reasons for not increasing the flexibility of ACT. ACT is not tied to a particular trade or source of income. There is therefore no reason why ACT should not be freely transferable

within a group with the same rules on carry back and carry forward in the recipient company as in the transferor company, provided only that both companies are members of the group throughout the relevant span of periods. We further urge that surrenders of ACT should be capable of revocation within the time limit for the original election.

ACT - Overseas Income

A further anomaly which has been the subject of representations by the Institute ever since the imputation system was introduced, is the interaction of the ACT rules with the double tax relief rules which discriminates against companies' income from overseas. The greater flexibility on transferring and offsetting ACT urged above would be of some assistance but would still not achieve the reasonable degree of neutrality between UK and overseas income which we believe to be desirable. In the absence of a more general review which might include more far-reaching options such as a return to the "net UK rate", we recommend that the best way forward would be to allow a company with insufficient profits to absorb all the DTR available to claim repayment of any surplus ACT not otherwise recoverable up to the amount of DTR not utilised under section 100(6)(b) FA 1972.

S.506 ICTA 1970

Where overseas subsidiaries have merged, underlying tax paid on the merged profits is inadmissible for credit through the strict wording of s.506 which makes it a condition for relief that the body corporate paying the dividends is the body which bore the tax. We consider that relief should be made available (whether by amendment of the section or by extra-statutory concession) in cases where, for bona fide commercial reasons, a merger in an overseas territory takes place and dividends are subsequently declared out of the merged profits.

S.482 ICTA 1970

We hold to the view that S.482 should be abolished forthwith as the original consultative papers which led to the legislation on CFC's implied and in line with the unanimous recommendation of the Royal Commission on Taxation of Profits and Income in 1955.

Dual Resident Companies

We understood that the purpose of the UK and US legislation on Dual Resident Companies was to prevent the "exploitation" of the UK and US Exchequers from DRC's being used to obtain double relief for losses, once from each Exchequer. Sections 63 and 64 FA (No. 2) 1987, however, go much further than preventing double deduction. They prevent any relief being obtained in many circumstances, including circumstances where double relief is not or cannot be claimed. One of the consequences of there having been no proper Committee stage for this year's Finance Bill is that the Government has still not explained why such overkill is necessary. In the absence of such an explanation we again urge that the restrictions on Dual Resident Investment Companies should be confined to disallowing relief within the UK group if the relief has been claimed within the US group. We would then be less concerned about the very wide definition of a DRIC which by no means excludes all genuine trading companies.

It is of great importance that the UK and US legislation are in fact "complementary" as the consultative document promised. Whether this has been achieved will not be known until the US regulations are published. We may well wish to make further detailed comments at that stage.

Small Companies Rate

We welcomed the reductions in the "small companies rate" in the last two Budgets in line with the basic rate of income tax. One consequence of this, however, in the absence of any increase in the limits for marginal relief has been to increase the differential between the marginal rate of corporation tax on profits between £100,000 and £500,000 and the normal rate which applies above this level. Any further reduction in the income tax basic rate and small companies rate in 1988 would further increase the differential. We

continue to urge that the higher intra-marginal rate should be eliminated by extending the "small companies rate" to the first £100,000 profits of all companies/groups. Failing that, it is time that the £100,000 and £500,000 limits for marginal relief were reviewed in the light of inflation since 1984 and the need to reduce the marginal rate between the limits.

Where the £100,000 and £500,000 limits have to be apportioned, s.95 FA 1972 requires non-resident associated companies to be included in the number of companies among which the limit is to be apportioned even though they are excluded by subsection (1) from gaining any relief in respect of the amount apportioned to them. This is a clear anomaly. Rather than extend the relief to non-resident associates, which might mainly benefit foreign-owned groups, we urge that the anomaly be removed by taking account only of UK resident associated companies in section 95(3)(b) FA 1972, which would mainly benefit UK-owned groups.

Repurchase of Own Shares

The flexibility facilitated by the FA 1982 rules enabling companies to repurchase their own shares in certain circumstances without this being treated as a distribution is not available where any of the shareholders concerned is non-resident. This restriction has caused problems in practice and is in our view unnecessary given the onus on the company to demonstrate to the Revenue's satisfaction that the repurchase will benefit not just the company but also its trade. We urge that the residence condition be abolished.

Close Companies Apportionment

Section 32 FA 1984 increased to £1,000 the limit for close companies' investment income apportioned to any one individual which is exempt from income tax. This still did not resolve the point of principle, which we had previously raised with the Revenue, that dividends or interest received by a parent close company out of the trading

income of its subsidiary should continue to be treated as income in the hands of the parent and therefore should be entirely exempt from apportionment. There may be good commercial reasons for the existence of the holding company and for retaining the profits in one group company rather than another.

Moreover, the Taxes Acts already recognise in other contexts that relief given to a trading company should also be available to the holding company of a trading group. We further note that in the US there are rules on the characterisation of income which would meet this point. We urge that <u>the close company apportionment rules should not apply to any income derived from trading within the group</u>.

VII INCOME TAX

Benefits in Kind - £8,500 Threshold

It is absurd that "higher paid" employment should be deemed to start at annual "emoluments" of £8,500 when average full-time earnings are now approaching £11,000 and even more absurd that, because of the inclusion of expenses and benefits in "emoluments" for the purpose of the £8,500 threshold, employees who are by any standards low paid can be caught.

In addition to the considerable inequity between different categories of lower paid taxpayers and the distortions from the astronomic marginal tax rates at the threshold, the present system imposes substantial compliance burdens on employers at a time when the Government is quite rightly trying to reduce such burdens. P11D's have to be completed for those above the threshold and the somewhat less onerous P9D's for those below. The employer has to ascertain whether an employee falls above or below the thresholds, keep the necessary records and prepare the individual and aggregate year end returns. Whilst dispensations under section 70 FA 1976 from submitting P11D's for employees with no taxable benefits are now readily granted by the Revenue even for small businesses, the many employees paid less than £8,500 whose expenses take them over the threshold are normally excluded by the Revenue from any such dispensation.

As well as the distortions around the £8,500 threshold (£163 per week) the new graduated structure of NIC has created similar anomalies and infinite marginal tax rates at pay rates (excluding benefits and expenses) of £65, £100 and £150 per week. The resultant bands of £5-10 above each threshold where it is pointless fixing pay rates means that a significant proportion of the wages spectrum comprises "no-go" areas which makes the development of appropriate pay structures more difficult for employers. We cannot envisage the graduated NIC structure being abandoned in the immediate future. The opportunity, however, of the introduction this year of the simpler one-page P11D form should be taken to abolish the £8,500 threshold, so that all employees are subject to income tax alike on their remuneration and the P11D and dispensation systems apply to all employees.

Benefits in Kind - Motor Cars and Fuel

We explained at length last year how raising the standard scale charge for the use of motor cars to anything close to average cost of the average private use of employer-provided cars would be so unjust for a large minority that there would be irresistible pressure from employees for a return to an actual basis for assessing the benefit and/or a massive switch to employees providing their own cars and charging their employers for business use. Either way there would be a substantial increase in administration costs for the Revenue. The scale charge is again to be raised in 1988 by more than inflation. Any further increases in the company car scale relative to the actual costs of running a car should be avoided, because in our view they would lead to a significant increase in the Revenue's costs.

The scale charge for fuel provided for private use was from the start deliberately set at a level which broadly reflected the average cost of fuel for the average private mileage done by company cars. This was because there is the option of avoiding the scale entirely by instituting a system to ensure that no fuel cost in respect of private mileage is borne by the employer. Since then, however, the scale charge system for private fuel has been extended to the VAT input tax rules and the standard input tax disallowance was fixed for convenience at 15% of the income tax scale charge. This has proved extremely unpopular and been perceived as unfair in practice because the scale charge for 1987-88, which was fixed before the fall in oil prices in 1985 and 1986, has represented at today's price of petrol a very high private mileage for present day cars with their increasingly efficient fuel consumption. The charge has been seen as particularly unfair by small, often one-man, businesses where substantial business relative to private mileage may be involved and where the cost of the businessman's time in establishing that no private mileage has been charged to the business would be disproportionate; they may have no practical options but to accept the income tax and VAT scale charges which overstate the private mileage of the car belonging to the business or to bear the cost of all petrol, whether for private or business

purposes personally. We now believe that there is a case for fixing the scale charges for fuel for income tax and VAT purposes lower than the "average" actual cost and that in the light of fuel price and consumption trends the scale charges for 1989-90 should even on the present basis be lower than those already announced.

Removal Expenses - Extra Statutory Concession A5

We wrote earlier this year to the Revenue concerning the apparent change in practice in the application of this concession. The Revenue's reply of 29 September invited our comments on the ESC and its application generally. These are as follows:

The majority of the problems with the ESC arise from the differing interpretations individual Tax Inspectors may apply to its provisions. We assume that the Revenue has no wish to erect barriers to the mobility of labour. Indeed during the early 1970's government assistance was available for individuals' removal costs from areas such as the North East to take up employment elsewhere.

Clearer guidance is required on the following points in the ESC:

1. "change his residence"

   This should be clearly defined and in our view should permit a person coming to the UK from overseas to retain their property overseas. It should also allow those moving within the UK from a high cost housing area to a lower cost area to retain their original property, without an unnecessary tax penalty on the company and/or the individual. This could be offset by restricting mortgage interest relief and/or the capital gains tax exemption on the property to which the person moves whilst he retains his original property. This should not adversely affect people moving within the UK as they would in most cases elect for the more expensive property to be the main residence.

2. "reasonable in amount"

Guidance on how the reasonableness of the expenses could be demonstrated would be useful. For example, in one major company at least two estimates of the costs are required before the company agrees to pay, and it is reasonable to assume that normally companies look for the most cost-effective choice.

3. "properly controlled"

Again there is no Revenue guideline here. Presumably, if the Inspector is prepared to grant a P11D dispensation, then he is satisfied concerning the level of control; conversely, if he is not prepared to grant a P11D dispensation, then he is not satisfied and the expenses would fail the conditions set by the ESC. Is this correct?

4. The concession states that items such as a temporary subsistence allowance while looking for accommodation will also be accepted as not assessable. It would be helpful to have a definitive list of the costs covered by the ESC, including:

furniture removal
legal fees
survey/valuation
estate agents' fees
connection of services
temporary accommodation
travel expenses while looking for accommodation
cost of replacing fixtures/curtains/carpets
costs of adapting furnishing to fit new property
restocking gardens etc.

Permanent Health Insurance

We have for many years called for permanent health insurance premiums to be made deductible for income tax with the corollary that the proceeds would be taxable. The present concession whereby any proceeds are tax-free for an initial period of between

12 and 24 months (on the basis that part of the proceeds represents a return of capital) is not likely to encourage people to take out such insurance, since only a minority of them will normally ever become claimants under their policies. The retirement annuity and now the personal pension rules allow annuities payable under the contract or scheme to commence early in cases of disability subject to the total premium remaining within the 17½% limit (or the higher limits for those over 50); in those cases the premiums are already deductible. There is, however, no particular likelihood that the best contract available in the market for an annuity commencing on retirement or earlier in case of disability will be cheaper than separate contracts (perhaps with different financial institutions) for an annuity commencing at normal retirement and for permanent health insurance; in a competitive market the prices for all three types of contract will be varying relative to each other all the time. We therefore still consider it desirable to make deductible for income tax purposes all permanent health insurance premiums, whether included in a retirement annuity premium or personal pension scheme contribution or paid under a free-standing PHI policy within the overall 17½% limit (or 15% limit for those in occupational schemes). We shall again revert to this subject in our general Budget representations, since the justification for a positive incentive to take out permanent health insurance involves social and public expenditure considerations, which are matters for Ministers.

Pensions - Lump Sum Commutation

We remain opposed to the provisions in FA (No.2) 1987 imposing the £150,000 restriction on the maximum lump sum which may be paid under a personal or occupational pension scheme. Such a change should not in our view be introduced without a full review and consultations regarding both what commutation rights it is desirable to permit in pension schemes and the tax treatment which should apply to commuted sums. The £150,000 restriction was, however, proposed in the Budget without prior consultation and confuses these two issues by applying the same limit for both purposes. We urge that the £150,000 restriction on lump sum commutation should be abolished, pending a more general review of the issues relating

to commutation, or that at least the £150,000 limit should be automatically indexed for inflation.

A similar logical distinction between the right to commute and the tax treatment of commuted sums applies in the case of AVCs. We deplore the removal of all commutation rights in respect of AVC arrangements commencing after 7 April 1987. The review recommended above should therefore extend to AVC arrangements.

AVC's

The pensions reforms in FA (No.2) 1987 have left AVC's as the Cinderella of pensions arrangements. They will be burdensome for employers and for the providers of free-standing arrangements and the beauty of the idea of self-provision to make up for inadequate occupational provision is lost beneath the heavy restrictions on the benefits that may be received. It is a poor reward for personal initiative if the benefit of good investment performance by the AVC fund cannot be passed on to the individual but the loss from bad performance is passed on.

We appreciate the difficulty in achieving fiscal neutrality for AVC arrangements, which have some of the characteristics of S.226 and personal pension schemes (which have restrictions on the contributions but not the benefits) and some of the characteristics of occupational schemes (which have restrictions on the benefits but not for the most part on contributions). But there are possible half-way houses which would be better than leaving AVC's with the worst of both worlds. For example, any surplus in the fund at the date of retirement above the amount needed to pay the approved benefits could be returned to the individual (whether as a lump sum or increased pension) less a special withholding tax (similar to that applying to repayments of occupational pension fund surpluses); this tax would claw back on a rough and ready basis an appropriate part of the benefit of the tax-free accumulation within the fund and deductibility of the original contributions. According to the rate at which it was set it could provide any degree of incentive or disincentive considered appropriate.

Occupational Pensions - Accelerated Accrual

As we said after the Budget at the time of the Finance Bill, we deplore the extension from ten to twenty years in the minimum period over which a maximum pension can be earned under the accelerated accrual provisions for arrangements entered after the Budget Day. This is a significant impediment to job mobility among senior executives, more significant in our view than the lump sum restrictions, and it therefore prevents the most effective deployment of the UK's management resources. We urge that the relevant provisions in FA (No. 2) 1987 be repealed.

VIII TAX TREATMENT OF SHARE INCENTIVES AND INVESTMENT

Major Reform - New Investment in Trading Companies

We wholly support the Government's aims of increasing share ownership and risk investment both by employees and generally. However, there is now a plethora of special schemes and reliefs for investment in company shares which have been introduced and extended in recent years of which the latest is Personal Equity Plans. These measures have tended to be narrowly targeted (and as a result too technically complex for any taxpayer to contemplate without specialist professional advice) and to have been devised as ad hoc responses to gaps or defects in the existing patchwork of legislation. The degree of fiscal support also varies from being a predominant factor in the case of the Business Expansion Scheme to nil in the case of enabling provisions such as the special rules for demergers and repurchase of own shares by companies. PEPs combine dilution of the aim by interposing an intermediary, administrative complexity for the intermediary (with consequent high costs for the investor) and minimal fiscal incentive. Meanwhile, there remain major disincentives and inflexibilities such as S.79 FA 1972 and S.460 ICTA 1970 which can catch the unwary and those whose arrangements cannot be made to fit the pattern expected by the legislation.

We believe that many pages of legislation could be removed, some coherence and logic could be restored to this area of the tax system and the Government's aims could be better achieved, if a straightforward income tax deduction for investment in new equity were introduced in place of the present schemes. The Loi Monory/ Loi Delors and other variants of such a deduction have proved cost-effective incentives in other European countries.

Under the variant we have put forward in our main representations for the last four years relief would be given against total personal income for any investment in new quoted or unquoted equity of UK trading companies or holding companies of trading groups. The

only further restrictions necessary would be claw-back of relief on disposals within five years and any ceiling set on the amount deductible by an individual in any one year either as a phasing-in measure or permanently: for example, the cost would not be large if the 15%/17½% limits on contributions to pension schemes were applied to the total of such contributions plus investments under this scheme.

Failing such a major reform, or in the meantime while it is being considered, there are a number of specific changes which should be made to the present system. We set these out below.

Approved Share Option Schemes

We have always contended that gains on employee share options should be taxed as capital gains not income. Otherwise as far as the shareholders are concerned, it would be cheaper to have the company pay a "phantom option", i.e. a cash bonus equal after tax to the gain on exercising a notional option at the exercise date, rather than grant a real option; the bonus is deductible for corporation tax but the gain on an actual option is not, although it results in no less real a diminution of the value of existing shareholders' holdings.

We therefore do not consider the tax treatment of options under approved schemes to be concessionary except to the extent that under capital gains treatment tax may be avoided altogether if the gain comes within the annual exemption, and now that the basic rate of income tax is lower than the rate of capital gains tax any benefit from treating gains on options as capital gains is further reduced.

We recognise that avoidance problems arise with share options as with other employee share incentives (eg manipulation of the share price by the addition or removal of restrictions on the shares) and that some anti-avoidance provisions and clearance procedures are always likely to be necessary. We do not, however, agree that all

the present restrictions on approved schemes are necessary or desirable. First, The ceiling on the maximum size of option that may be granted in paragraph 5 schedule 10 FA 1984 should be removed. Events in the last year have shown that existing shareholders or Investor Protection Committees on their behalf are likely in their own interests to police abuse in this area.

Second and more important, we consider unnecessary the rule in Section 38(4)(b) that to qualify for capital gains treatment the option must be exercised at least three years since the person last exercised an approved option. The risk of systematic abuse through the use of tax-free approved options in conjunction with the annual exemption as a tax-free substitute for a large and regular proportion of salaries is greatly overstated. That would require systematic fixing of the share price over a number of years, which is impossible, not to mention illegal, for employees of quoted companies, and should be immediately obvious to the Revenue in the case of unquoted companies. There is, moreover, considerable self-policing available in the form of quoted company rules on when directors and senior executives may deal (usually only in a short period following announcement of the interim and annual results), investor protection committees' concern that employee option schemes are genuinely performance-related and do not excessively dilute other shareholders' equity and the cost and time involved in obtaining frequent valuations of unquoted company shares. Whilst the annual exemption provides a measure of leniency for qualifying disposals of approved options, the income tax treatment of disposals which do not meet a restriction, such as the every 3 years' rule, is positively penal. We therefore strongly urge that this restriction be abolished.

Third, we believe that it is only fair to grant a measure of relief where there is a takeover or merger (events which may well not be within the option-holder's power to influence), which will result in a FA 1984 or FA 1980 option scheme ceasing to be approved, and the option-holder wishes to exercise options granted less than three years previously. We welcome the provisions in Schedule 4 FA 1987 allowing rights in the scheme to be exchanged for rights in a similar scheme operated by another company which takes control of the first company. We suggest that, in addition, a FA 1984 option exercised in the third year as a result of a takeover or merger

should attract two thirds of the relief it would have attracted if exercised after three years and one third if the option is so exercised in the second year.

Employee-controlled Companies

We regretted the Government's decision to confine the FA 1983 interest relief for borrowing used by employees to buy shares in an employee-controlled company to such borrowing only in the period of 12 months from the date of employee-control commencing. The short life of the relief is made shorter still by the rule that relief ceases for all employees once any of the conditions of employee-control have been breached. It is unjust that relief should be withdrawn from an employee as a result of events outside his control such as the death, retirement or departure of other employees or the sale of their shares by other employees. It is further unreasonable that financially unsophisticated employees should have to take such a risk on top of being employed in what is usually a high-risk venture. The IOD is opposed in principle to restrictions on the deductibility of interest paid but we consider that there is a particularly strong case for extending the deduction of interest on borrowings incurred to finance the purchase of shares in an employee-controlled company to borrowings made at any time not just in the initial 12 months.

CONFIDENTIAL

pmp.

FROM: P D P BARNES
DATE: 1 December 1987

MR KNOX - C&E

cc PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Culpin
Miss Sinclair
Mr Cropper
Mr Tyrie

Mr Jenkins - Parly Counsel

Mr Jefferson-Smith - C&E
Mr McGuigan - C&E
Mr Allen - C&E
PS/C&E

BUDGET 1988 : BETTING AND GAMING DUTIES (INCLUDING STARTER NO.5)

The Economic Secretary was grateful for your submission of 25 November.

2. The Economic Secretary agrees with you that none of the items in your submission should be considered as starters for the 1988 Finance Bill.

PB

P D P BARNES
Private Secretary

CONFIDENTIAL

14/12

Ch/ I have doubts about 'X'. We get budget submissions from the senior Ministers, and it might look a bit odd if you separately saw their juniors.
9/12

From: Nigel Forman.
9th December 1987.

PRAYERS.

To: Chancellor.

1988 Budget Soundings.

1. Now that you have met virtually all the new back-benchers on our side in the course of the drinks parties which you have given at Number 11 since July, I suggest that you may like to turn your attention to taking some informal soundings in a similar way among more senior back-benchers on our side. We could do this by holding similar weekly drinks parties for small groups each Wednesday at 6:00p.m. from January to the time of the Budget, if you thought that would be useful. It would certainly be good for your relations with the Parliamentary party and a few colleagues have already indicated to me that they would hope to be included in such informal sessions. X I imagine you would also wish to have meetings at appropriate times with junior Ministers and PPSs in other Departments. No doubt this could be arranged in a similar way perhaps by using the large Ministerial conference room at the House.

2. If you approve of these ideas, then I could draw up a schedule of names for you with about half a dozen colleagues invited to come to each meeting in broadly compatible groups. We could start the process on 13th or 20th January if that suited you.

[signature]

From: THE PRIVATE SECRETARY

HOME OFFICE
QUEEN ANNE'S GATE
LONDON SW1H 9AT

15 December 1987

Dear Jonathan,

You asked for bids for items for inclusion in the Budget. We would like to return to the question of alcohol taxation, and in particular the relationship of alcoholic strength to the level of duty. I understand that the Lord Privy Seal, the Home Secretary and the Secretary of State for Health and Social Security are to meet the Chancellor in the new year to discuss this, and we may wish to put more detailed proposals to you in the light of that meeting.

Yours sincerely

Nick

N C SANDERSON

CH/EXCHEQUER
REC. 15 DEC 1987 15/12
ACTION MRS T. BURNHAMS
COPIES TO CST FST PMG EST
SIR P. MIDDLETON
MR SCHOLAR MR CULPIN
MISS SINCLAIR
MR MICHIE
MR CROPPER
MR CALL
MR TYRIE
PS/C&E

J Taylor, Esq

RJ8.41 CONFIDENTIAL

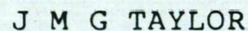
FROM: J M G TAYLOR
DATE: 15 December 1987

MR MITCHIE

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Scholar
Mr Culpin
Miss Sinclair
Miss Evans
Mr Revolta
Mr Cropper
Mr Tyrie
Mr Call
PS/IR
PS/C&E

1988 BUDGET: MOTORING TAXATION

The Chancellor has seen the Secretary of State for Transport's letter of 9 December. He has commented that the points Mr Channon makes seem reasonable.



J M G TAYLOR

Inland Revenue

Policy Division
Somerset House

From: I R SPENCE
Date: 17 December 1987

1. MR McGIVERN

2. FINANCIAL SECRETARY

PENSION BUSINESS REPAYMENTS: STARTER 217

1. We recommend that this starter be dropped. In summary the position is this:

a. ABI are looking for an acceleration of repayments of taxed income on their members' pension business, because they have to wait longer for their repayments than their present competitors (self-administered approved schemes) and will in future have to wait longer for repayments than other personal pension providers; (paragraph 2 below);

b. in principle, there is a case for their argument that they should have parity of treatment with their competitors. You told Sir William Clarke in the 1987 Finance Bill debates that the point would be sympathetically considered when ABI produced their detailed representations. And it is on Lord Young's list of tax issues in his recent letter to the Chancellor;

BUT

---

cc Chancellor
Chief Secretary
Economic Secretary
Sir Peter Middleton
Mr Scholar
Mrs Lomax
Mr Culpin
Miss Sinclair
Mr Cropper
Mr C J Riley
Mr Jenkins (OPC)
Mr Painter
Mr Pollard
Mr Beighton
Mr McGivern
Mr Spence
Mr Skinner
Mr Newstead
Mr Templeman
Mr Walker
Mr Arnold
PS/IR

c. the ABI claim for 1988 legislation to provide a level playing field in this respect is undermined by the fact that their members are now contending (with ABI encouragement) that under the current law they do not need to pay any tax at all on their profits from pension business (paragraphs 3 and 4); and

d. ABI's delay in making their representations (only just received) would in any event make it difficult to legislate on the point in the 1988 Finance Bill (paragraphs 5 and 6).

2. What ABI are asking for. They are looking for repayments of taxed investment income to be made in advance on a monthly basis to companies engaged in pension business. (This would involve netting off the tax paid against the estimated liability on the company's profits from writing pension business). ABI argue this is necessary to give them a level playing field with their competititors. At present insurance companies have to wait until they have produced their accounts after the end of the tax year for repayments on pension business, or at best get advanced repayments on a quarterly basis, whereas self-administered schemes get advance repayments on a monthly basis and other personal pension providers are also likely to get more or less immediate repayments.

3. The new development - the insurance companies contention that they are not liable to pay any tax at all on their profits from pension business. This contention is based on a Counsel's opinion of the effect of the current law which ABI have circulated to their members. Some companies are already operating on this basis and it is probable that others will do so. It will take a long time to sort out the position by litigation. The earliest remedy would be to legislate on the point - to ensure that insurance companies do pay tax on their profits from pension business - as part of the legislation on the life assurance review.

4. Until it can be established that there is a level playing field on the fundamental point - that insurance companies will actually pay tax on their profits like their competitors - it would be premature to make decisions on the second order point on the timing of repayments. So we consider that the question of legislation on the repayments point should be deferred until it can be dealt with in the context of the general life assurance legislation.

5. ABI's delay in making representations. We have been discussing the issue with ABI since they raised it with us last Spring. It was agreed that they would produce detailed representations setting out the extent of the competitive disadvantage which they suffered from the present treatment. We also asked ABI for figures on the scale of repayments that would be affected, since the impact cost of a change to - say - monthly repayments in advance could be considerable (perhaps £100 million). ABI's production of information has been fitful and they have in fact only just produced their full representations. This is despite the fact that we have told them on a number of occasions that their delay in producing their representations has been lessening the chances of Ministers being able to consider the point as a serious runner for the 1988 Finance Bill.

6. So it would be difficult for ABI to argue that they have treated this as a priority issue. A fair amount of discussion would be necessary with ABI to consider their representations properly, and work up detailed legislation. From where we are now, it would be difficult to fit this in with other Finance Bill issues. So Finance Bill priorities would probably rule this out as a 1988 starter, even if there were a case on merits for 1988 legislation.

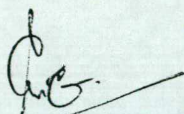
7. Handling with ABI. We are due to meet ABI next week (to discuss other, non-legislative, issues). If you wish, we could indicate to ABI that Ministers are not disposed to legislate on their repayments point.

8. We do not think ABI would be surprised to get this message, or that they will complain over much that it is unreasonable.

9. Alternatively, we could simply tell ABI that Ministers are considering their representations and that we could convey your decision after Budget Day.

I R SPENCE

I agree with Mr Spence's recommendation. This could be a useful concession to keep back for inclusion in a legislative package of reforms following the review of life assurance taxation.



E McGIVERN

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

Please Dial my Extension Direct:
Use Code (01)-382 followed by
Extension Number 5023

From: P R H ALLEN

Date: 18 December 1987

PS/CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Miss Sinclair
Mr Cropper
Mr Tyrie
Mr Call
PS/Inland Revenue

BUDGET 1988 EXCISE DUTIES : CORRIGENDUM TO PAPER DATED 16 DECEMBER 1987
ANNEX 4 - MINOR OILS

In line 1 of paragraph 2 "precludes an increase" should read "precludes a decrease".

Please accept our apologies for the error.

RA.

P R H ALLEN

Internal circulation: CPS, Mr Knox, Mr Jefferson Smith
Mr McGuigan, Mr Whitmore, Ms French,
Mrs Hamill

POLICY BACKGROUND TO THE 1988 BUDGET

PAGE

Policy framework 1

The MTFS since 1984 and recent performance 7

Developments over the past year 11

Monetary policy in the 1988 MTFS 12

Fiscal Policy 16

ANNEXES

A Medium-term economic developments

B Money GDP prospects and policy framework

C Review of the MTFS since 1984

POLICY BACKGROUND TO THE 1988 BUDGET

Policy framework

1. The aim of macro-economic policy is to bring about a progressive fall in the rate of inflation and to establish the conditions for a sustainable growth in output.

2. This is to be achieved by delivering an appropriate **medium-term path for money GDP.** That path has to take into account the initial rate of inflation and our estimate of the sustainable growth of output. For output growth to be sustainable it is important to maintain a suitable macro-balance within the economy; between public borrowing, taxation and public expenditure; between consumption and investment; and between the current account of the balance of payments and the natural flow of international capital. Otherwise there is a risk that pressures will build up which will force sharp changes in behaviour and, possibly, policy resulting in an interruption to steady output growth.

3. The observed path for money GDP is bound to fluctuate for a variety of reasons: world conditions; fluctuations in savings ratios; shifts in confidence; and unexpected developments in the pressure of monetary and fiscal policy. It is not possible to completely offset these fluctuations by policy adjustments nor should it always be desirable. The task of policy is to ensure that the medium-term path for money GDP is achieved, subject to any adjustments for changes in sustainable output growth. While not attempting to remove all short-term fluctuations policy should at least avoid being destabilising.

4. In principle both interest rates and fiscal policy affect money GDP. One approach to policy is to set interest rates and fiscal policy at levels which ensure that their joint impact delivers the money GDP we want; the particular mix of interest rates and fiscal policy is chosen from the point of view of its impact on the macro-balance of the economy.

5. Conceptually this approach is helpful, although in practice greater emphasis has been put on interest rates for achieving the

money GDP path. This is mainly because interest rates are effectively the only instrument that is available between Budgets although at Budget time it has been possible to alter the mix of interest rates and fiscal policy. In addition for a given money GDP, or exchange rate path changes to fiscal policy have a relatively small effect on activity and inflation in the short term (see Annex B, Table 2). The impact is also difficult to predict especially in later years, largely because it depends on how market confidence and the exchange rate in particular respond.

6. In what follows interest rates are discussed primarily in terms of their influence on money GDP and fiscal policy primarily in terms of its effects on macro-balance. The policy framework is discussed more fully in Annex B.

7. **Interest rate** changes exercise their greatest leverage on money GDP through the behaviour of the exchange rate which in turn has pronounced effects on inflation and net export demand. In addition they have a direct influence on consumer spending, fixed investment (especially house building) and stockbuilding.

TABLE 1: INDICATORS OF MONETARY CONDITIONS

	Money GDP growth (%)	MO growth (%)	M3 growth (%)	M4 growth (%)	Exchange rate (1975=100)	House price inflation[1] (%)
1980-81	13.9	7.1	16.4	15.9	98.2	18.8
1981-82	10.1	5.3	20.1	18.1	92.3	2.9
1982-83	9.2	3.2	17.2	16.3	88.0	2.7
1983-84	8.1	6.0	10.9	13.3	83.5	10.4
1984-85	7.3	5.5	9.6	13.2	76.2	8.3 (7.7)
1985-86	9.7	4.3	13.5	13.6	79.0	9.6 (8.7)
1986-87	6.6	4.3	19.0	15.2	71.5	17.4 (13.1)
Latest observation		4.9[2]	21.3[2]	15.2[2]	75.6[3]	15.9[4] (14.6[4])

[1] Percentage increase in DoE New House Price (Completions) Index. Halifax Index in brackets (all houses).

[2] Twelve months to November, not seasonally adjusted except MO.

[3] 17 December

[4] 1987Q3 on a year earlier.

8. Interest rate decisions are made by reference to an assessment of monetary conditions. Some relevant indicators are shown in Table 1. In recent years emphasis has centred on two indicators, MO and the exchange rate, although the growth of broad money and the behaviour of asset prices have also been taken into consideration.

9. MO has been a useful indicator of monetary conditions. It has had a relatively stable velocity trend of about 3 per cent a year and although it can be no more than a short leading indicator of money GDP it has had a reasonably good record of giving the correct signals about the movement of money GDP.

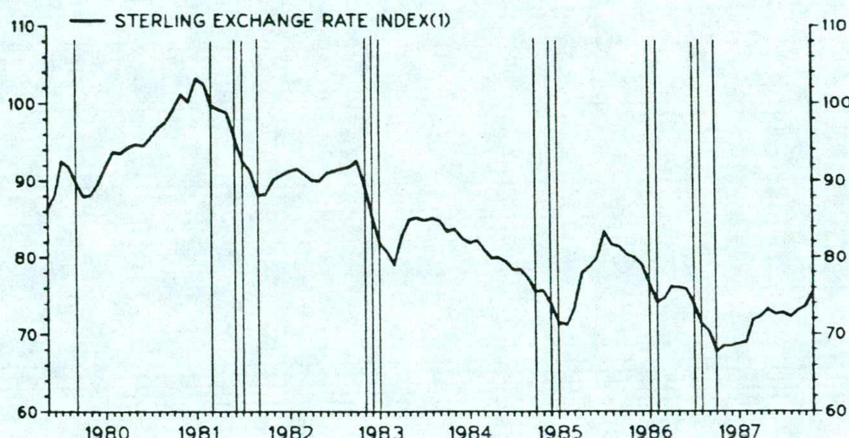
10. By contrast the behaviour of broad money has been difficult to interpret. Velocity has been declining since 1980 after increasing throughout the 1970s (see Annex A, Table 9). More recently the rapid acceleration of broad money growth seems to have been a factor in the strength of equity and house prices. Indirectly this may have been a factor leading to buoyant domestic demand growth.

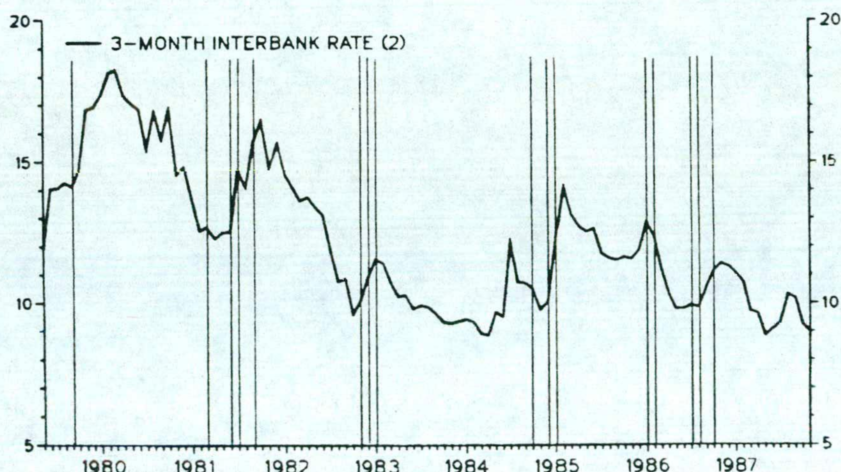
11. The exchange rate has been an important factor in monetary policy decisions for many years. Chart 1 shows the monthly paths for the Sterling Exchange Rate index and the 3-month interbank rate since mid-1979. Periods of sharp exchange rate reductions have usually coincided with sharp upward movements of interest rates. The important role of the exchange rate in interest rate decisions is not surprising; it has a direct effect on money GDP growth and can exercise a powerful effect on inflation expectations. In the past year we have seen a move towards giving the exchange rate a greater weight in interest rate decisions. This is in reaction to two developments. The first has been the difficulty of establishing market credibility for MO. As an anchor for inflation expectations it is probably not sufficient on its own. By contrast the exchange rate has a well recognised role in this respect. The second development has been the greater emphasis on exchange rate stability among the G7 countries since the Louvre agreement. This has been a convenient framework within which to give an enhanced role to the exchange rate. For operational purposes it is the DM/£ rate that has been taken as the crucial link, partly because of the EMS framework and its relevance for UK industry, and partly because the DM has a sound reputation as an anti-inflationary currency.

12. The task of ensuring a sustainable macro-balance within the economy - both internal and external - falls primarily to **fiscal policy.** There are two aspects of fiscal policy: the level of public expenditure and taxation in relation to the size of the economy; and the difference between them, ie the budget deficit.

CHART 1

THE EXCHANGE RATE AND 3-MONTH INTERBANK RATE





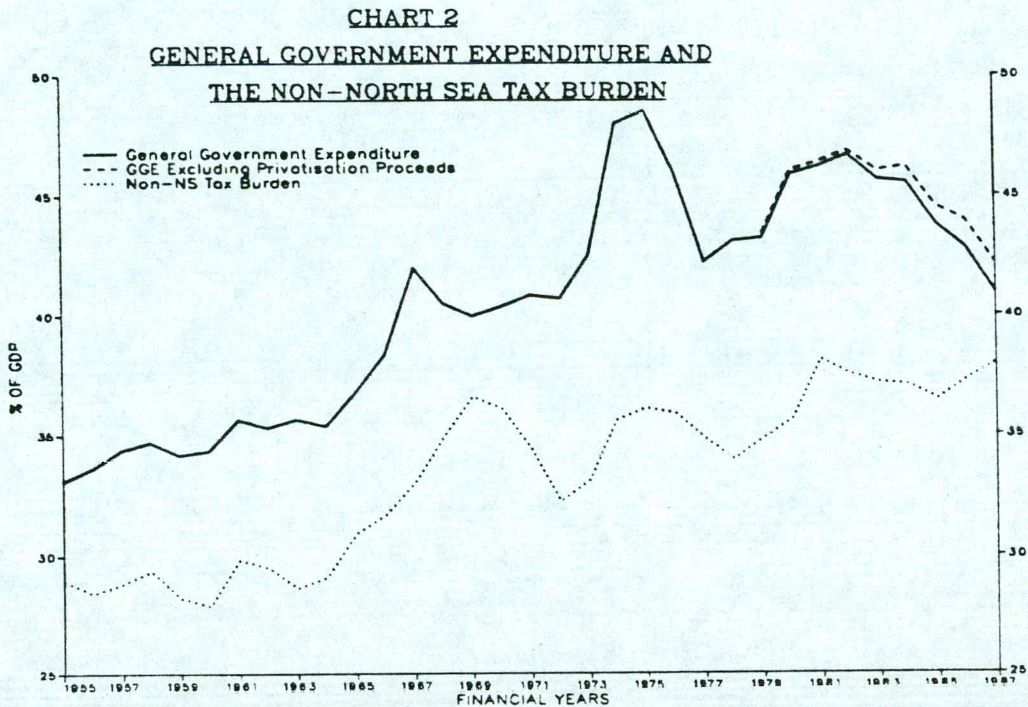
(1) MONTHLY AVERAGE
(2) END OF MONTH
(3) VERTICAL BARS INDICATE MONTHS IN WHICH THE EXCHANGE RATE DEPRECIATED BY MORE THAN 2 PER CENT

13. It has been an objective of policy to reduce the share of both public expenditure and taxation in the economy. As Chart 2 shows, during the 1960s and much of the 1970s the share of expenditure was rising, partly because of underlying demand for public services - health, education, etc; partly because of the growth of social security expenditure; and partly because of greater state

intervention and growth of subsidies. The result was higher tax rates with all the accompanying problems of distortions, tax shelters and disincentives. The aim has been to reverse this process: to reduce distortions, to improve incentives and limit the use of tax shelters through lower tax rates and a more neutral tax system; and to improve efficiency by subjecting as much economic activity as possible to the discipline of the private sector.

CHART 2

GENERAL GOVERNMENT EXPENDITURE AND THE NON-NORTH SEA TAX BURDEN



14. The second aspect of fiscal policy is the judgement of the appropriate balance between expenditure and taxation - the budget deficit. This is a difficult judgement which cannot be made with any precision.

15. As set out in the Chancellor's Lombard speech a number of objectives have been taken into account in setting the medium-term path for the PSBR each year in the Budget: public sector debt should not rise as a percentage of GDP; the budget deficit should be capable of being completely financed in a non-inflationary way; and there should be scope for absorbing possible fiscal shocks.

16. The constraint on the growth of the public sector debt ratio is intended to avoid any escalation of the burden of debt interest payments. This helps to maintain confidence in the sustainability of policy as a rising debt service burden clearly cannot continue indefinitely; and within an envelope of a declining ratio of public expenditure to GDP it clearly makes sense to keep the share of interest payments under control. This constraint has been met by reducing the PSBR as a percentage of GDP as the growth of money GDP has declined. At zero inflation and a growth rate of 2½ per cent it points to a PSBR of no more than 1 per cent of GDP.

17. The objective of maintaining a budget deficit that is capable of being comfortably financed in a non-inflationary way is obviously less precise and requires some difficult judgements. It is essentially concerned with the balance and hence sustainability of output growth. The balance of the PSBR, available domestic savings and the flow of overseas capital lies at the heart of it. If the PSBR is high in relation to available domestic savings, either domestic investment will be squeezed or there will be a current account deficit and a need for a capital inflow from overseas. If investment suffers, the ability of the economy to continue at current growth rates will be impaired. If instead there is a current account deficit there may be little difficulty initially if a sustained capital inflow is forthcoming, although the rising burden of interest payments abroad would in time pose a problem. If a sustainable inflow is not forthcoming there will be upward pressure on interest rates and/or downward pressure on the exchange rate. At some point both violate the objective of comfortable non-inflationary finance. It is therefore necessary to assess the PSBR in relation to the flow of savings; the prospects for investment and the current account; and the potential flow of overseas capital.

18. The present position of the United States is a classic example of the failure to heed these principles for the conduct of fiscal policy. The budget deficit has been high in relation to internal savings. The burden of interest payments has progressively risen putting further pressure on public expenditure. Domestic demand has grown rapidly and the combination of a large capital inflow and

current account deficit has emerged. The exchange rate has been highly unstable. Initially high interest rates and the strength of capital inflows pushed up the dollar to excessive levels. More recently private sector capital inflows have dried up and it is proving very difficult to finance the deficit without unacceptable increases of interest rates. As a result the dollar is currently very weak.

The MTFS since 1984 and recent performance

19. Before considering monetary and fiscal policies for the coming years it is instructive to look at what has been happening in recent years. The data for money GDP, real GDP and inflation are set out in Table 2. This section compares recent developments with what we expected in the MTFSs since 1984, and also, where appropriate, with developments in the 1950s and 1960s. Details are presented in Annexes A and C.

TABLE 2: MONEY GDP, OUTPUT AND INFLATION
(Percentages)

	Money GDP Growth	Output Growth[1]	INFLATION: GDP Deflator Growth	INFLATION: RPI Growth
ANNUAL AVERAGES[2]				
1955-64	6.2	2.9	3.3	2.9
1964-73	9.1	3.0	6.3	5.9
1973-79	17.8	1.4 (0.8)	16.1	15.7
1979-83	11.2	0.4 (-0.1)	11.0	10.8
FINANCIAL YEARS				
1982-83	9.2	1.8 (1.1)	7.1	7.1
1983-84	8.1	3.3 (3.0)	4.6	4.7
1984-85	7.3	2.5 (2.4)	4.4	5.1
1985-86	9.7	3.6 (3.7)	6.0	5.9
1986-87	6.6	3.3 (3.4)	3.0	3.2
1987-88[3]	9.0	4.1 (4.6)	4.6	3.9

[1]Non-North Sea output growth in brackets.

[2]Growth rates measured from first year to last.

[3]Figures are from the October forecast.

20. The broad picture is one of faster money GDP growth than expected, mainly because of faster output growth. Although

inflation has not come down very much, it is expected to be only 1 percentage point higher in 1987-88 than was assumed for this year in the 1984 MTFS. By contrast output growth is expected to be 2 percentage points higher this year. Since 1984 money GDP growth, output growth and inflation have all been at levels similar to those of the 1950s and 1960s.

21. Possible explanations for the faster than expected growth of output and money GDP are world developments, monetary and fiscal policies, demand pressures and supply performance. These are taken in turn.

22. World developments cannot explain this faster growth. World activity has grown more slowly than expected, and real oil and commodity prices have fallen. While the latter may have contributed to better supply performance, they have not raised money GDP growth directly. It is interesting that the UK economy has regained the growth rates of the 1950s and 1960s despite the fact that the world economy has not done so.

TABLE 3: INDICATORS OF POLICY STANCE
(percentages, except exchange rate which is 1975 = 100)

	Money GDP Growth	MO Growth	Short-term interest rates	Exchange rate	PSBR/GDP ratio (excluding privatisation proceeds)
ANNUAL AVERAGES[1]					
1955-64	6.2	3.7	4.7	144.2	2.5
1964-73	9.1	5.8	7.7	132.1	2.5
1973-79	17.8	12.7	11.1	90.7	6.5
1979-83	11.2	5.7	13.2	91.3	3.7
FINANCIAL YEARS					
1982-83	9.2	3.2	11.5	88.0	3.3
1983-84	8.1	6.0	9.7	83.5	3.5
1984-85	7.3	5.5	10.9	76.2	3.7
1985-86	9.7	4.3	12.1	79.0	2.3
1986-87	6.6	4.3	10.5	71.5	2.0
1987-88[2]	9.0	5.6	9.2	73.4	0.9

[1] Growth rates measured from first year to last; exchange rate is average of years excluding the first year; PSBR/GDP ratio is average of financial years excluding the first financial year.

[2] Figures are from the October forecast.

23. Turning to policies, the outturn for money GDP, M0, the exchange rate, interest rates and the PSBR are set out in Table 3. Fiscal policy has tended to be tighter than intended, mainly as a result of higher than anticipated revenues. The role of monetary policy is more ambiguous. Interest rates have been higher than envisaged in the 1984 MTFS; but the exchange rate has been lower. The lower exchange rate was fully reflected in later editions of the MTFS. Relative to the 1986 MTFS interest rates have been less than expected.

24. The implication is that the setting of policy instruments permitted a faster growth of money GDP than expected. To achieve the original objectives for money GDP tighter fiscal or monetary policy would have been necessary.

25. Looking at policy over a longer time horizon, both fiscal and monetary policies appear to be tighter now than they were in the 1950s and 1960s. They are also relatively tight by international standards.

26. Demand pressures from private sector saving and investment behaviour may be an explanation for higher money GDP growth than expected. In that case we should have seen either a greater fall in saving ratios or a greater rise in investment. Savings by the personal and probably also the total private sector have fallen faster than expected in recent years, although errors in the data obscure what has really been happening. As private investment has turned out more or less as expected, the conclusion is that demand pressures from the private sector have contributed to the higher than expected money GDP.

27. It is on the supply side that the most striking developments have occurred. As Table 4 shows productivity growth in manufacturing in recent years has been higher than in the 1950s and 1960s. Although productivity growth in the rest of the economy has been somewhat lower than before 1973, total non-North Sea productivity growth of 2¼% a year since 1983 is very similar to the rate of growth between 1955 and 1964 (although lower than that between 1964 and 1973). We did not fully anticipate the improvements in productivity that have occurred.

TABLE 4: PRODUCTIVITY GROWTH[1]
(Percentages)

	Manufacturing	Non-North Sea GDP
1955-64	2.7	2.2
1964-73	3.8	2.7
1973-79	0.7	0.6
1979-83	3.6	1.4
1983-87	4.7	2.3

[1] Growth rates measured from first year to last

28. There has been a related improvement in trade performance, in the sense of the excess of exports over imports for given levels of UK and world demand and competitiveness. Import penetration has probably increased less than we would have expected and the share of exports has been higher than expected. The rise in profitability which also exceeded expectations is another sign of the supply side improvement.

29. To the extent that faster output growth has been sustainable a higher path for money GDP growth has been justified. But to achieve the original objectives for inflation tighter fiscal or monetary policy would have been necessary. Part of the explanation for the higher inflation than expected in the 1984 MTFS could be the easing of monetary conditions that occurred in 1984. Another part is the growth of pay, which has continued to be higher than expected. This has been less of a problem than it could have been because productivity growth also turned out higher than expected, partly as a consequence of pay pressure. But the overall output-price split would have been more favourable and inflation closer to the MTFS path if pay had decelerated instead of being stuck at over 7% a year.

30. Although money GDP growth and the price-output split have been similar in recent years to what they were in the 1950s and 1960s, there are a number of differences in other respects. Profitability may still be lower; and the ratio of investment to GDP is lower than it was from the mid-1960s onwards although its quality may now be higher: a higher proportion is in the private sector where it is less favoured by taxes and subsidies than it used to be. Real

interest rates are higher. Net overseas assets are higher, but total national wealth (including both overseas assets and domestic tangible assets) is probably no higher relative to income than in 1973. The level of public expenditure and taxation are much higher relative to GDP than they were in the 1950s and 1960s although there has been some decline in the ratio of expenditure over the past four years. Total (public and private) consumption is also higher relative to GDP although not the private component on its own.

Developments over the past year

31. As background it is also interesting to compare performance over the past year with the outlook at last year's Chevening meeting and with this year's MTFS. Last year we discussed the puzzle of the strength of money GDP growth in the face of a relatively tight policy stance. In the event it has been even stronger despite a sharp fall in the budget deficit and some strengthening of the exchange rate.

32. An important feature of the growth of money GDP has been better than expected real output growth. Some of this may be cyclical. But the extent of rapid productivity growth, improved profitability and rising share of world trade point to continued better supply performance. On the demand side several factors are of note: the growth of money GDP for the previous year, 1986-87, has been revised upwards; pay has been growing more rapidly, partly because of higher overtime; export growth has been rapid despite disappointing growth elsewhere in the industrial countries; and the private sector savings ratio may have declined further, although the picture is obscured by the large residual error.

33. Faster growth of money GDP has been accompanied by faster MO growth; present estimates put this close to the upper limit of its range for this financial year. And broad money has continued to grow rapidly. On the other hand the exchange rate has been stronger than expected. The weakness of the dollar combined with the policy of holding the DM/£ exchange rate has meant an upward drift of the sterling index. Interest rates have been a little lower than expectations.

34. The PSBR looks like turning out well below expectations. Our best guess is for a small negative PSBR in 1987-88. Some of this has been cyclical reflecting rapid output growth. But there has also been a greater increase in tax revenues than would have been expected given the rise in output.

35. A year ago we argued that fiscal policy should be tightened and that the bulk of any fiscal adjustment should go to reduce the PSBR. This judgement reflected a number of factors: the need to tighten the overall policy stance; the existing high real interest rates; the worries about the balance of payments and the high ratio of consumption in GDP. One aim was to improve confidence in the exchange rate without suffering the effects of higher mortgage rates on inflation. That tightening of the fiscal stance has been achieved together with some reduction of taxes. The impact on the exchange rate-interest rate trade-off has been generally welcome although the strength of sterling has at times reached embarrassing proportions.

36. The reduction in the PSBR has not been reflected in a better recorded balance of payments. Instead it seems to have been accompanied by lower private sector savings, although the situation is confused by a large residual error in the data. It is likely that the private sector savings ratio has been less than expected, or investment higher. The alternative explanation for the data that we have is that the current account balance may be underestimated, in which case the lower PSBR would be linked to a better balance of payments.

Monetary policy in the 1988 MTFS

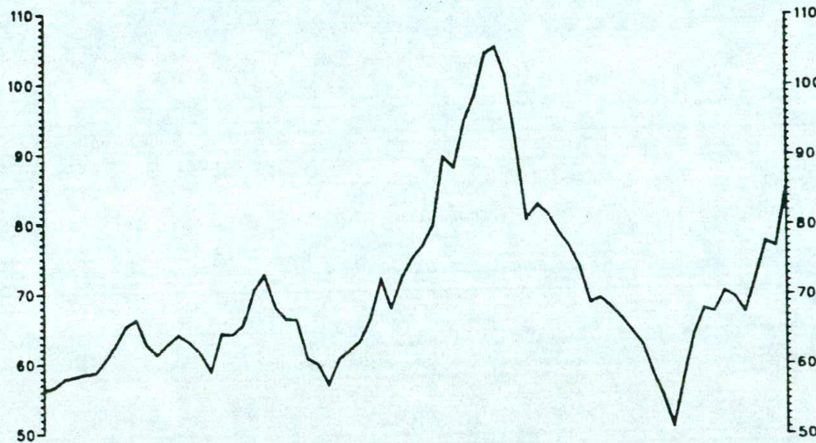
37. If present policy towards the exchange rate continues it will be necessary to make some changes to the presentation of monetary policy in the MTFS. The details of such changes can be decided later but at this stage we should consider the principles. In this section we consider in turn the path of inflation and money GDP if sterling is effectively linked to the DM, the implications for interest rates and the role of exchange rate realignments. These issues are discussed at greater length in Annex B.

38. Ceteris paribus we would expect that maintaining the DM/£ exchange rate at current levels would exercise gradual disinflationary pressure. The German inflation rate is very low and by persisting with a stable exchange rate against the DM we would expect to see UK inflation gradually converge towards the German rate. Exporters and producers of tradeable goods for the home market will be constrained in the prices they will be able to charge. In addition key import prices are likely to grow slowly. By operating as a drag on inflation they improve the climate for wage bargaining.

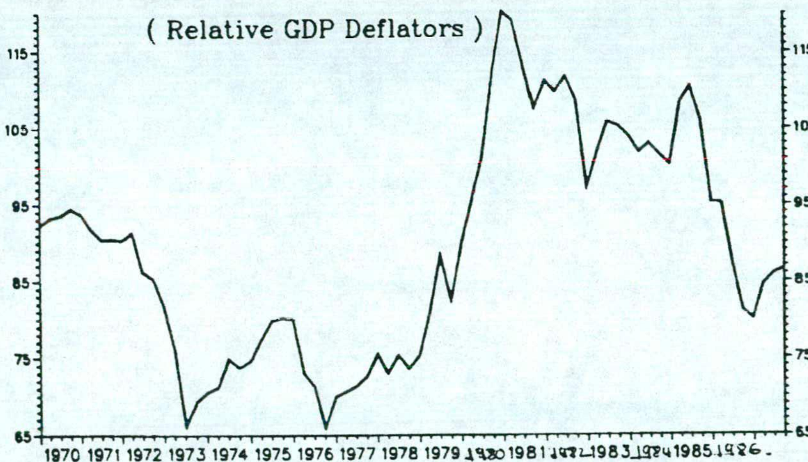
CHART 3

REAL DOLLAR – STERLING EXCHANGE RATE

(Relative GDP Deflators)



REAL DM – STERLING EXCHANGE RATE



1980=100

39. The initial degree of disinflationary pressure depends upon the level of the real exchange rate at the outset. If it is low there is some room for manoeuvre before the constraint starts to bite. If it begins at a bracing level the constraint could bite quite quickly. At the moment it is difficult to see a pronounced bias in either direction. As shown in Chart 3 the real sterling exchange rate is historically high by comparison with the dollar; but broadly in line with its historical average by reference to the DM. If the dollar continues to weaken the overall degree of pressure would increase even with an unchanged DM/£ rate.

40. Whilst sticking to the present DM/£ exchange rate should bring convergence of UK and German inflation rates they may not come completely into line. This is because of differences in productivity growth rates. Currently the UK is experiencing faster growth of productivity in manufacturing than Germany, and because the level is below the German level there is scope for this to continue. This means that manufacturing earnings in the UK could rise faster than in Germany without the fixed exchange rate putting any pressure on UK profit margins. If earnings growth in non-manufacturing is in line with manufacturing earnings in each country but there is less difference between productivity growth rates in non-manufacturing, the overall German inflation rate could be persistently lower than the UK inflation rate - by maybe 1-1½ per cent - reflecting the lower growth of non-manufacturing unit labour costs. This would be consistent with the experience during the fixed exchange rate era of the 1960s: countries with the fastest growth of manufacturing productivity tended to have the highest inflation rates, although the differences were not large. (See Annex B for the evidence.)

41. A fixed exchange rate may be more intelligible to wage bargainers than a fixed money GDP path. If so an increase in the credibility of the DM/£ link might lead to a fall in pay growth.

42. Taking account of these various factors our best guess is that holding to the present DM/£ rate will deliver a declining path for money GDP growth. In Table 5 are shown projections for money GDP growth and the exchange rate on different assumptions. With the

DM/£ rate between 2.90 and 3.00, as in the third case, money GDP growth is expected to decline at about the same rate as shown in the MTFS, which incidentally assumed a declining DM/£ rate.

43. If interest rates are directed at maintaining the DM/£ link there are limits to the extent to which they can also take account of domestic monetary factors. Conflicts could therefore arise. For example if the market confidently expected that the exchange rate link would be maintained UK interest rates might be pushed down and the interest rate differential diminished. This would tend to ease the overall pressure on monetary conditions in the UK and could be a de-stabilising factor. If the improvement in confidence was thought to be temporary it could be met by intervention or lower interest rates. But if lower interest rates were permanent and were a threat to inflation it would make more sense to revalue against the DM.

TABLE 5: PROJECTIONS OF MONEY GDP GROWTH AND EXCHANGE RATES

	1987-88	1988-89	1989-90	1990-91
1987 MTFS				
Money GDP Growth (%)	7.5	6½	6	5½
Effective Exchange Rate[2]	70	69	67	65
DM/£ Exchange Rate	2.85	2.70	2.50	2.40
October Forecast[1]				
Money GDP Growth (%)	9.0	7½	6½	6
Effective Exchange Rate[2]	73	74	73	73
DM/£ Exchange Rate	3.00	2.90	2.85	2.75
October Forecast[1] with Improved Confidence				
Money GDP Growth (%)	9.0	7½	6	5
Effective Exchange Rate[2]	73	75	76	78
DM/£ Exchange Rate	3.00	2.95	2.95	2.90

[1]Adjusted for stock market fall
[2]1975 = 100

44. Within this approach to monetary policy there is in principle some scope for exchange rate realignments, as in the case of the EMS (see Annex B for details). However, as part of the process of increasing credibility in this approach to anti-inflationary policy, it will be difficult to take advantage of this in the early years other than to revalue against the DM. If we become concerned that the DM link will not deliver the MTFS path for money GDP there would be a case for a step change. But we are not in a position to make that judgement at the moment. What is easier to conclude is that there is little scope for a depreciation against the DM if we wish to deliver a clear declining path for money GDP growth and maintain credibility.

Fiscal policy

45. The general approach to fiscal policy was set out earlier. In this section we attempt to put some numbers to these general concepts.

46. As a basis for the analysis we have used a set of projections from the October forecast, adjusted for the fall in share prices. By examining these projections we can ask how they perform relative to the objectives of fiscal policy set out earlier.

47. The projections show public expenditure falling as a share of GDP (Table 6). General Government expenditure (excluding privatisation proceeds) falls from 42.2 per cent in 1987-88 to 40.7 per cent by the end of the MTFS period. The PSBR is negative at close to 1 per cent of GDP through the period, meaning broad balance if privatisation proceeds are excluded. After making allowance for a cumulative fiscal adjustment of £6 billion over the next two years with more to follow there is a relatively flat profile for non-North Sea taxes as a share of GDP. They are projected at a level above the projected outcome for this year. In other words because of the projections of public expenditure and the buoyancy of North Sea taxes at unchanged rates, current projections show substantial scope for tax reductions coupled with a step down in the PSBR.

TABLE 6: PUBLIC FINANCES TO 1990-91
(Per cent of Money GDP)

			OCTOBER FORECAST[1]		
	1986 -87	**1987 -88**	**1988 -89**	**1989 -90**	**1990 -91**
General Government Expenditure Excluding Privatisation Proceeds	43.9	42.2	41.5	41.1	40.7
Privatisation Proceeds	1.1	1.3	1.3	1.2	1.2
General Government Receipts[2]	41.6	41.1	41.0	40.5	40.1
Of which:					
Non-North Sea Taxes[2]	36.7	37.1	37.5	37.3	37.3
North Sea Taxes	1.2	1.1	1.0	0.9	0.7
General Government Borrowing Requirement	1.3	-0.2	-0.9	-0.6	-0.6
PCMOB	-0.4	-0.2	-0.4	-0.5	-0.5
PSBR	0.9	-0.4	-1.3	-1.1	-1.1
Memorandum Items					
Net Debt Interest	3.0	2.9	2.7	2.5	2.3
Cumulative Fiscal Adjustment	0	0	0.9	1.3	1.7

[1]Adjusted for stock market fall.
[2]After fiscal adjustment.

48. The negative PSBR means a further sharp decline in the public - sector net debt/income ratio bringing it down to under 30 per cent by 1990-91 (the arithmetic is set out in Table 7). It would then be similar to the current levels in Canada, Germany and the US, but above those in France and Japan, and lower than in Italy. The ratio of net interest payments to GDP is declining over the period despite real interest rates higher than the growth rate (Table 6). So looking at the debt burden alone there is no reason to believe that the projections are not sustainable.

49. There are three further factors that need to be taken into account in judging the profile of the debt/income ratio: privatisation and other asset sales; the profile of North Sea revenues; and accumulating pension liabilities.

TABLE 7: THE PSBR AND CHANGES IN PUBLIC SECTOR DEBT (£ billion)

	1979 -80	1980 -81	1981 -82	1982 -83	1983 -84	1984 -85
PSBR	**10.0**	**12.7**	**8.6**	**8.8**	**9.7**	**10.[illegible]**
Adjustments[2]	-2.1	+1.6	+1.9	-1.2	+2.7	+3.[illegible]
Change in Net Public Sector Debt	7.9	14.3	10.5	7.7	12.4	13.5
Net Public Sector Debt (end year)	102.8	117.1	127.6	135.3	147.7	161.[illegible]
Money GDP[3]	223.6	248.0	272.1	295.6	317.9	246.5
Net Debt Ratio (%, end year)	**46.0**	**47.2**	**46.9**	**45.8**	**46.5**	**46.5**
Memo Item:						
Privatisation Proceeds (% of GDP)	0.2	0.2	0.2	0.2	0.4	0.[illegible]

OCTOBER FORECAST[1]

	1985 -86	1986 -87	1987 -88	1988 -89	1989 -90	1990 -91
PSBR	**5.8**	**3.4**	**-1.5**	**-6.0**	**-5.4**	**-5.5**
Adjustments[2]	+0.4	+1.0	+0.7	+0.6	+0.4	+0.5
Change in Net Public Sector Debt	6.2	4.4	-0.8	-5.4	-4.9	-5.[illegible]
Net Public Sector Debt (end year)	167.4	171.8	171.0	165.6	160.7	155.7
Money GDP[3]	373.3	403.7	436.8	467.1	497.7	528.[illegible]
Net Debt Ratio (%, end year)	**44.9**	**42.6**	**39.2**	**35.5**	**32.3**	**29.5**
Memo Item:						
Privatisation Proceeds (% of GDP)	0.7	1.1	1.3	1.3	1.2	1.[illegible]

[1] Adjusted for stock market fall

[2] Adjustments required to reconcile the PSBR with changes in net public sector debt. They comprise discounts and uplift on gilts, revaluations of net foreign currency debt, timing and coverage adjustments.

[3] GDP at current market prices for year centred on 31 March.

TABLE 8: CONTRIBUTIONS TO CHANGE IN NET DEBT RATIO 1987-88 TO 1990-91

(Per cent of GDP)

Net debt ratio at end 1987-88		39.2
Essentially capital transactions		-5.2
Of which:		
Privatisation proceeds	-3.7	
Council house sales	-0.9	
Transitory component of North Sea revenues		-2.1
Other		-2.4
Net debt ratio at end 1990-91		29.5

50. There is a good case for reducing the debt ratio to the extent of privatisation proceeds. These amount to a cumulative 3.7 per cent of GDP up to 1990-91 (Table 8). Similar capital transactions account for another 1½ per cent, most of which is council house sales. Despite the fall of oil prices, tax revenues from the North Sea are still above our calculations of the permanent income. The difference is not large - maybe ½ per cent of GDP a year; but during this period there is a good argument for taking advantage of these additional revenues to reduce the debt/income ratio. The cumulative amount implies a reduction in the ratio of 2 per cent of GDP to 1990-91. The financing of future pension obligations points in the same direction. The pay-as-you-go system combined with the continuing build up of obligations mean that current payments are less than would be required under a funded scheme. Again there is a good case for reducing the debt/income ratio during the period of build-up.

51. Taken together these three factors mean that the fall in the debt/income ratio probably overstates the strength of the public sector's balance sheet without changing the conclusions about sustainability.

52. The second objective of fiscal policy is to maintain a PSBR that can be comfortably financed. Clearly with a negative PSBR there is no net 'financing' requirement although there will be a

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

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

CHART 4

PRIVATE SAVINGS AND INVESTMENT

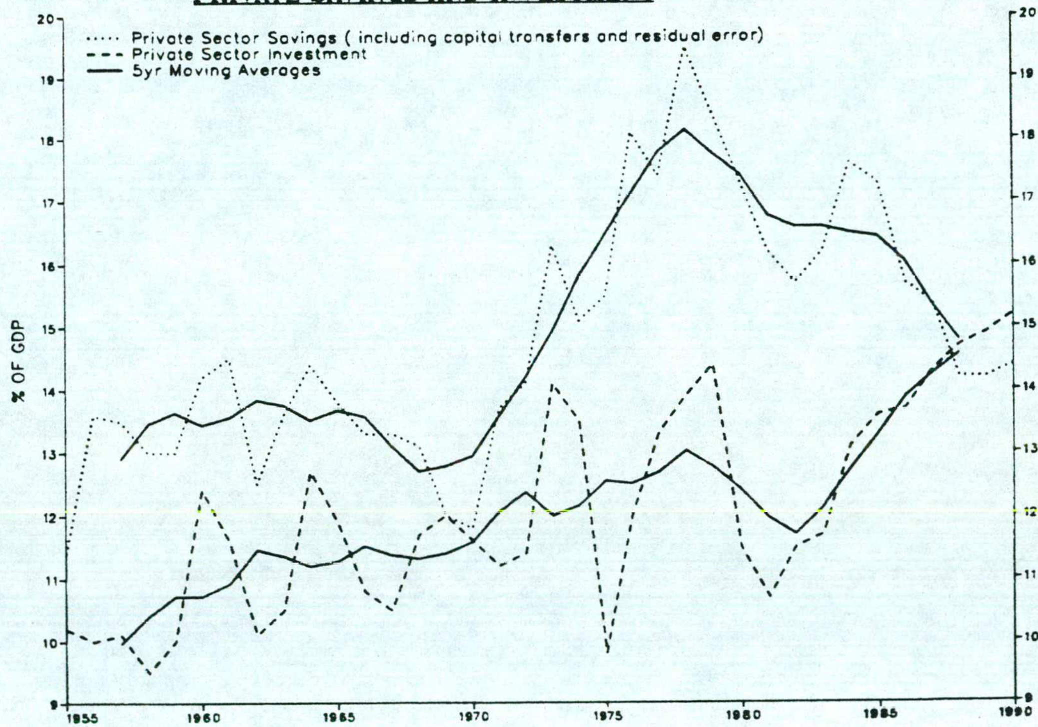
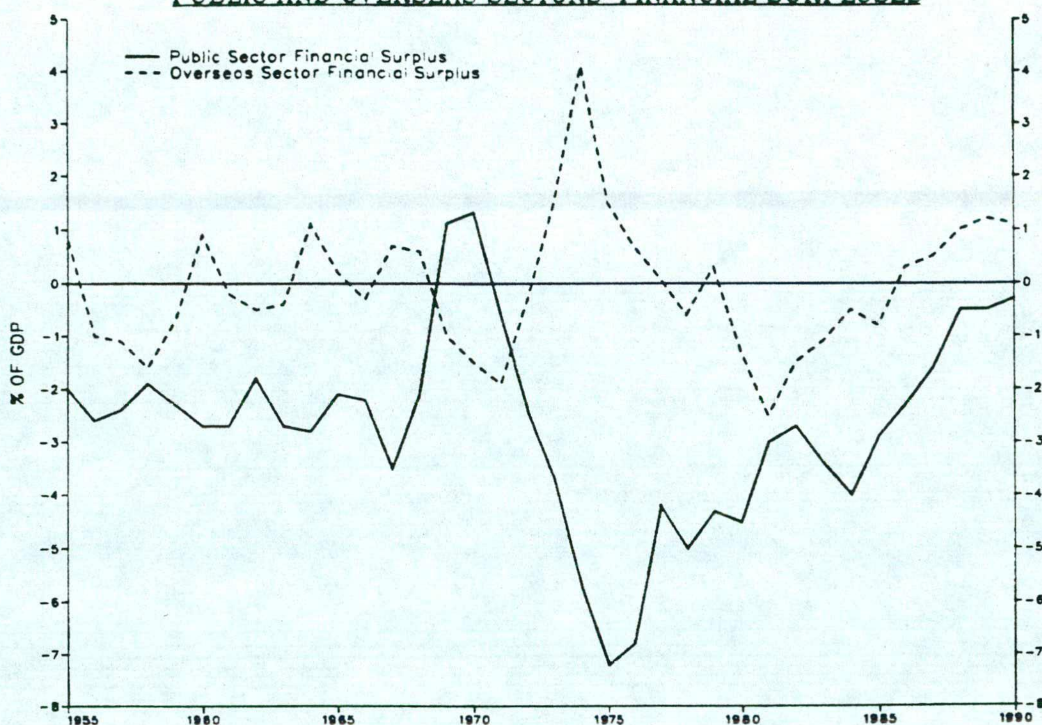


CHART 5

PUBLIC AND OVERSEAS SECTORS' FINANCIAL SURPLUSES



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

TABLE 9: SAVINGS, INVESTMENT AND FINANCIAL SURPLUSES
(Per cent of GDP)

	Private sector saving[1]	Private sector investment	Net acquisition of financial assets: Private sector[1]	Public sector	Overseas sector[2]
1980-83	16.4	11.4	5.0	-3.4	-1.6
1984-87	16.5	13.7	2.8	-2.7	-0.1
1985	17.3	13.6	3.7	-2.9	-0.8
1986	15.7	13.7	2.0	-2.3	0.3
1987[3]	15.4	14.3	1.1	-1.6	0.5
1988[3]	14.2	14.7	-0.5	-0.5	1.0
1989[3]	14.2	14.9	-0.7	-0.5	1.2
1990[3]	14.4	15.2	-0.8	-0.3	1.1

[1]Including national accounts residual error

[2]Equals current account of balance of payments with sign reversed

[3]Figures are from the October forecast, broadly adjusted for the effects of the stock market fall.

55. We are projecting a further strong rise in investment reflecting the recent profitability and the higher rates of capacity utilisation observed over the past year (Table 9). Unusually the projections suggest that by next year private sector investment could exceed private sector savings - normally the private sector is in surplus. As a result, although there is only a small public sector financial deficit, it is more than offset by a current account deficit.

56. This situation can be characterised in one of two ways. One is to say that the flow of domestic savings is completely absorbed in financing domestic investment; therefore the public sector financial deficit is being met by overseas capital flows. Alternatively we can say that after financing the PSFD the flow of domestic savings is insufficient to finance the level of private sector investment - hence the need for a capital inflow.

57. It must be stressed that these figures are very approximate. We have subtracted the residual error from the identified flow of

private savings as we suspect most of it is reflected there. One alternative is that private sector investment is being understated although that does not change the basic story as it leaves the balance of private savings and investment unchanged. A second alternative is that the current account position is better than recorded. The only other period in the last thirty years when the public sector deficit was anything like as small as that now forecast was in the late 1960s when there was a marked improvement in the current account. If part of the residual error is attributable to the current account not only would the current account picture be improved; there would be a small excess of private savings over investment which would go to finance the PSFD.

58. If the projections are correct and the residual error is attributable to private sector savings one approach is to aim for a yet smaller PSFD and an even bigger negative PSBR to leave more finance available for the private sector. The alternative approach is to view the low savings ratio as a temporary phenomenon and to be content to finance the investment by an inflow of capital, with a compensating current account deficit. In the circumstances, with a free flow of world financial capital and improved rates of return in the UK, this second approach has much to commend it. There should be no shortage of willing lenders to finance profitable private sector investment. In the long term, if this course is pursued, the build-up of interest, profits and dividends payable overseas will put an increasing strain on the economy.

59. Bringing these factors together (and recognising the uncertainties of the data) suggests that the projected flow of funds is sustainable and that the projected stance of fiscal policy should not put great strains upon the economy.

60. The third factor mentioned in the Lombard speech was the scope for absorbing possible fiscal shocks. This was obviously important for the coal strike and the sudden reduction of oil prices. Recently the pattern of tax receipts has introduced a further degree of uncertainty. Tax revenues have been very buoyant but we are unsure how far this will continue. If the higher tax revenues are permanent there is clearly scope for a further reduction of tax

rates. If they are temporary - for example because of cyclical factors, the pattern of profitability and the profile of the change in the corporation tax regime - it would be prudent to allow public sector borrowing to decline further in the meantime. Given the very rapid growth of output this year there must be some risk that the strength of tax receipts is cyclical; on the other hand the underlying buoyancy has been evident for some time now and may reflect the gearing of tax receipts in response to the faster underlying growth rate.

61. The general conclusion we reach is that the projections of public finances - with their substantial fiscal adjustments in place - are sustainable and meet with the objectives set out. Even so there is not much room to spare: the declining debt/income ratio has to be set against the pattern of privatisation receipts, North Sea taxes and public pension liabilities; the low savings ratio combined with the strength of private sector investment means that any public sector deficit may have to be financed by privatisation proceeds and overseas capital flows; and although the general buoyancy of tax revenues looks reasonably secure, they must be subject to risk given the speed and unexpectedness of recent increases.

POLICY BACKGROUND TO THE 1988 BUDGET

ANNEX A

MEDIUM TERM ECONOMIC DEVELOPMENTS

MP1 DIVISION

December 1987

MEDIUM TERM ECONOMIC DEVELOPMENTS

Introduction

1. This paper describes medium term economic developments since the 1950s, and includes future projections to 1990. The projections are based on the Treasury's October internal forecast which has been adjusted for the effects of the recent fall in equity prices. Since there is still a great deal of uncertainty about the likely effects of the fall in world stock markets, the projections are rather more uncertain than usual and should not be regarded as having the same status as regular Treasury forecasts.

2. Most tables show the average values of the economic variables over ranges of years. In general the ranges have been chosen in order that comparisons of period averages are not affected by the cycle in economic activity. Growth rates, for example, are calculated between cyclical peaks. However this is not true for the last three periods shown in each table and the numbers should be interpreted accordingly. In particular the period 1983 to 1987 is part of an upswing in economic activity and may not represent a sustainable level of economic performance.

3. Section A summarises the main points of interest. Section B discusses developments in the world economy. Section C considers the behaviour of productivity, productive potential and costs of production. Section D looks at output, inflation and the policy stance. Section E considers the balance of payments and section F examines the structural balance of the economy.

A. Summary

4. The similarity of recent economic performance in the UK to that of the 1950s and 1960s is the most striking feature of the data set out in this paper. However, the similarities are more marked for certain aspects of performance than for others.

5. In making comparisons with earlier performance, it is useful to focus on two major themes. These correspond to the two main objectives of government policy - low growth of money GDP combined with a satisfactory price/output split, and the evolution of the structure of the economy.

6. Starting with output and inflation, performance since 1983 has been slightly better than over the period 1955 to 1973 (table 8); output has recently been growing about ½ a percentage point faster than in the earlier period and inflation is nearly ½ a percentage point lower. But bearing in mind that the period since 1983 is part of a cyclical upswing, the current rate of sustainable economic growth is likely to be nearer to the average rate observed in the pre-1973 period. It is interesting to note that the improvement in UK performance has not been matched by other major developed countries; output growth in these countries has recently been about 2 percentage points lower than in the period 1955 to 1973 (Table 1).

7. Recent behaviour of output and inflation must be seen in the context of developments on the supply side and the stance of macroeconomic policy. Productivity growth in manufacturing has recently been higher than in the 1950s and 1960s, but in the rest of the economy it has been lower (Table 4). Total productivity growth in the non-North Sea economy is now about the same as it was in the period 1955 to 1964, although still a little lower than between 1964 and 1973. A slightly faster rate of growth of the labour supply in recent years means that the growth of productive potential is now similar to what it was before 1973 (Table 3).

8. The policy position is now, however, noticeably different from the 1950s and 1960s. On the monetary side, real and nominal interest rates and differentials with world rates are higher (Tables 10 to 12), indicating a tightening of policy since the earlier period. On the fiscal side, the PSBR as a proportion of GDP has declined significantly since the period 1955 to 1973 (after rising dramatically in the intervening years) but the difference can be accounted for by privatisation proceeds (Table 14). However, a noticeable tightening of the stance of fiscal policy, on all measures of the deficit, is projected for the future.

9. The UK experience since 1955 is consistent with the view that medium term output growth is determined more by supply side performance than by the general stance of policy.

10. Turning to the structural balance of the economy (section F of the paper), there is less evidence here of a full return to the patterns of the 1950s and 1960s. Profitability (Table 21) may still be lower, and the share of investment in GDP (Table 25) is lower than it was in the mid-1960s although private investment alone is higher. There are signs of recent improvements in both profitability and investment. The current account (Table 18) has declined in the last few years and

the projections suggest a substantial deficit in the next few years; this compares with an experience of small surpluses in the 1950s and 1960s.

B. The World Outlook

11. All measures of world activity and trade indicate a significant improvement in world performance over the last four years compared with the period since 1973. However output growth was still significantly lower than in the period 1955 to 1973 and the growth of world trade was even further below the pre-1973 average. The poor trade performance relative to output growth reflects the continuing debt problems of many developing countries and the absence of a significant effort to dismantle trade barriers in developed countries.

Table 1 World Activity — **Average Annual Percentage Changes**

	OECD Industrial Production	Major Seven Countries GNP		Developed Countries' exports of manufactures, weighted by UK markets
		Current Prices	Constant Prices	
1955-64	5.9*	8.5	5.2	7.1
1964-68	5.9	9.2	5.8	10.4
1968-73	6.0	10.9	4.7	8.7
1973-79	2.3	11.6	3.3	6.1
1979-83	-0.3	9.0	1.3	1.7
1983-87	3.5	7.0	3.3	4.0
1987-90	3.5	5.5	2.3	3.4

*1960-64

12. After the recent falls in stockmarkets, our views on future developments are subject to greater uncertainty than usual. Nonetheless , on balance it seems likely that developments in the world economy over the next three years will be more favourable for the UK than they were in the period 1979-87 as a whole, although not as favourable as in the last four years. The major uncertainty concerns the responses of financial markets and the US authorities to the US current account deficit.

13. The history and outlook for world inflation are set out in Table 2. Consumer price inflation in the major seven countries has fallen sharply in recent years and is now below the average of the period 1955 to 1973.

Table 2 Consumer and Commodity Prices. Average Annual percentage changes

	Major Seven Countries Consumer Prices	Industrial Materials Prices	World Oil Price
		Currency Basket Terms	
1955-64	2.5	na	-4.1
1964-68	3.3	-0.9	-0.5
1968-73	6.8	8.2	11.7
1973-79	8.4	7.0	35.8
1979-83	8.4	2.1	17.5
1983-87	3.3	-4.6	-16.3
1987-90	2.9	3.3	0

C. **Productivity and Productive Potential**

14. A useful starting point for a discussion of medium term trends in output growth is provided by a history of the economy's productive potential; it is likely that the growth of actual output over a number of years will be determined mainly by developments on the supply side. Table 3 sets out the various contributions to the growth of productive potential.

Table 3 Productive Potential Growth **Average Annual Percentage Changes**

	Labour Supply	Trend Productivity per head	Non-North Sea Productive Potential	North Sea Contribution	Productive Potential
1955-64	0.4	2.2*	2.6	-	2.6
1964-73	0.1	2.7*	2.8	-	2.8
1973-79	0.6	0.8	1.3	0.6	1.9
1979-83	0.0	1.7	1.6	0.5	2.1
1983-87	1.0	2.2	3.2	-0.1	3.1
1987-90	0.6	2.3	2.9	-0.5	2.4

* actual, not trend.

15. The growth of trend productivity has risen significantly in the last four years and is now close to the average rate observed in the period 1955 to 1973. The growth of productive potential has shown a rather larger rise in the recent period, but this reflects an upsurge in the growth of the labour supply following the sharp drop in participation rates which occurred during the 1980-81 recession. We do not expect the labour supply to continue to grow at the rate observed in recent years. In the next few years, productive potential is expected to grow at a slightly slower rate than it did in the period 1955-73. However, if one excludes the projected negative contribution from the North Sea sector as oil production falls, the growth of non-North Sea productive potential is expected to be slightly higher than in the pre-1973 period.

16. Table 4 shows the sectoral contributions to productivity growth in the onshore economy. The main features here are a marked improvement in the growth of productivity in manufacturing since the pre-1973 period and a small deterioration in non-manufacturing.

Table 4 Productivity Growth by Sector — **Average Annual Percentage change**

	Manufacturing	Non-Manufacturing	Public Non-Trading	Total (Non North Sea)
1955-64	2.7	2.7	-0.6	2.2
1964-73	3.8	2.9	-0.9	2.7
1973-79	0.7	0.6	0.2	0.6
1979-83	3.6	0.8	0.4	1.4
1983-87	4.7	1.9	0.3	2.3
1987-90	4.7	1.8	0.1	2.3

17. The projected rates of growth of the labour supply and productivity imply that non-North Sea productive potential would be growing at nearly 3 per cent over the next four years. Declining North Sea output is expected to reduce the growth of productive potential by ½ per cent per annum to nearly 2½ per cent. Actual output growth in the medium term is expected to be about ¼ per cent higher than that of productive potential. This implies a small fall in unemployment over the medium term.

Table 5 Employment and Unemployment

	Estimated Labour Supply	Total Employment	Unemployment (excluding school leavers) 000s	(%)
	millions			
1955	25.2	24.3	222	0.9
1964	26.0	25.0	366	1.4
1973	26.2	25.0	545	2.1
1979	27.1	25.4	1141	4.3
1983	27.1	23.7	2866	10.8
1987	28.1	24.9	2905	10.4
1990	28.6	25.6	2647	9.4

18. Estimates of productive potential are used to help determine the medium term output path which might plausibly be consistent with a given inflation path. In the absence of adjustment in the labour or goods markets, or any favourable developments in commodity prices, declining inflation is likely to require that output grows less rapidly than productive potential. But output growth at or slightly above that of productive potential is consistent with declining inflation if it is assumed that some adjustment takes place.

19. The history and outlook for labour costs, the major component of the rate of inflation, are set out in table 6. The contribution of earnings growth and productivity are shown separately. The difference between the growth of total labour costs per employee and earnings is accounted for by national insurance and other employers' contributions.

Table 6 Labour costs (whole economy) **Average Annual Percentage Change**

	Average Earnings	Total labour costs per employee	Real Earnings	Real labour costs	Productivity	Unit labour costs	Real unit labour costs
1955-64	5.9	5.9	2.6	2.6	2.2	3.5	0.2
1964-73	9.2	9.4	2.7	3.0	2.7	6.6	0.3
1973-79	16.6	17.9	0.4	1.5	0.4	17.5	1.1
1979-83	12.3	12.3	1.2	1.2	1.5	10.8	-0.3
1983-87	7.3	6.4	2.7	1.8	2.3	4.0	-0.5
1987-90	7.4	7.0	3.0	2.6	2.0	4.9	0.5

20. The growth of unit labour costs has fallen substantially since the 1970s and if recent trends are continued will grow at a similar rate to the average rate over the period 1955 to 1973. In real terms, unit labour costs have fallen slightly on average since 1979. Lower growth of average earnings and higher growth of onshore productivity have contributed to the fall in unit labour costs and are expected to continue at similar rates in the future. Unit labour costs are expected to grow rather faster than in recent years, however, both because of the abolition of the national insurance surcharge in 1984 which reduced growth in 1983-87, and because of the decline of North Sea oil output. Pension contribution 'holidays' have also made a significant contribution to the reduction in labour costs in recent years.

21. The behaviour of total unit costs has followed broadly the same pattern as unit labour cost. The recent fall in commodity prices has meant that the growth of total unit costs has fallen by rather more than that of unit labour costs.

D. Money GDP and the Policy Stance

22. Tables 7 and 8 describe the history and outlook for output, inflation and money GDP. Inflation has declined substantially since the early 1980s and further progress is expected in future. The average rate since 1983 has been below that of the late 1960s, although not as low as in the 1950s. In the past the GDP deflator has tended to grow slightly faster than the RPI; this reflects in part the tendency for the measured deflator for government consumption to grow faster than consumer prices. Turning to future projections, the producer price index shows a relatively large decline in the next few years for a number of reasons: much of the temporary rise in inflation in 1988 reflects the assumed

revalorisation of specific duties which does not affect producer prices; the rise in the exchange rate compared with the recent period contributes to lower inflation in future especially as measured by the producer price index but not as measured by the GDP deflator; and unlike the GDP deflator, the producer price index is not directly affected by higher growth of public sector pay expected in the next few years.

Table 7 Inflation Indicators — **Average Annual Percentage Changes**

	GDP (MP) Deflator*	Producer Price (Output) Index	Retail Price Index	Consumers' Expenditure Deflator
1955-64	3.3	2.1	2.9	2.8
1964-73	6.3	5.0	5.9	5.7
1973-79	16.1 (16.2)	16.4	15.7	15.6
1979-83	11.0 (10.8)	8.8	10.8	10.2
1983-87	4.5 (5.2)	5.2	4.6	4.1
1987-90	4.3 (4.2)	2.9	3.5	3.5

* Non-oil GDP deflator in brackets

Table 8 Output, Inflation and Money GDP Growth. — **Average Annual Percentage Change**

	Output (Compromise GDP)*	GDP (MP) Deflator	Money GDP
1955-64	2.9 (2.9)	3.3	6.2
1964-73	3.0 (3.0)	6.3	9.1
1973-79	1.4 (0.8)	16.1	17.8
1979-83	0.4 (-0.1)	11.0	11.2
1983-87	3.4 (3.5)	4.5	8.1
1987-90	2.6 (3.1)	4.3	7.1

* Growth of non-North Sea output in brackets

23. In terms of output growth, it is also the case that performance has recently returned to levels comparable with the 1950s and 1960s. A striking feature of table 8 is that relatively high output growth has been associated with relatively low inflation and vice versa. Thus economic history lends some support to the view that low inflation is conducive to high output growth.

24. The combination of monetary and fiscal conditions which underlies the above paths for output and inflation is set out in tables 9 to 15.

Table 9 Monetary Aggregates and their Velocity **Average annual percentage change**

			Velocity relative to GDP	
	MO	M3	MO	M3
1955-64	3.7	3.2	2.5	3.4
1964-73	5.8	10.4	3.1	-0.7
1973-79	12.7	9.8	4.5	7.7
1979-83	5.7	16.3	5.2	-4.3
1983-87	4.8	14.9	3.1	-5.8
1987-90	4.0	13.7	3.0	-5.8

25. The growth of MO has fallen steadily in recent years and is projected to be near the top of its illustrative MTFS range (1-5 in 1988-89 and 1989-90 and 0-4 in 1990-91) over the next three years. This reflect higher money GDP growth relative to the MO ranges; the velocity of MO is expected to rise at the same rate over the next few years as it has done in the last four years. This rate of increase is a little lower than that which occurred in the 1970s and early 1980s reflecting the fall in nominal interest rates over the later period compared with the rise in the earlier period.

26. M3 (formerly £M3) has recently grown considerably faster than money GDP and this trend is projected forward. The declining trend in velocity, which is expected to reach its lowest recorded level by 1990, has been apparent since 1979 and reflects a number of factors. High real interest rates have added to the attractiveness of financial assets in general, and the end of overfunding in 1985 has also contributed. But most importantly, increasing competition in financial markets has led to rapid growth in private sector liquidity and borrowing. As these trends seem set to continue, the increased difficulties in interpreting changes in

M3 as a result of widespread changes in financial practices resulted this year in the formal target being dropped.

27. In the last four years short term real and nominal interest rates have been high both by historical standards and in relation to rates in the other major developed countries. The differential is assumed to fall somewhat in future years reflecting increased international confidence in sterling.

Table 10 Real* Short-term Interest Rates

per cent

	1956-64	1965-73	1974-79	1980-83	1984-87	1988-90
United Kingdom	1.9	2.1	-4.5	3.0	6.7	5½
Major 6	na	1.6	-0.5	4.0	4.6	3½

*3 month rates less annual change in consumers' expenditure deflators.

Table 11 Short Rates in the UK and Other G7 Countries — Per cent

	1956-64	1965-73	1974-79	1980-83	1984-87	1988-90
United Kingdom	4.7	7.7	11.1	13.2	10.7	9.0
3 Month Eurodollar	3.7*	7.0	8.7	13.4	8.2	7.7
Trade-Weighted Overseas Short Rate	na	6.7	7.0	11.8	7.8	6.5

* 1957-64

Table 12 Long Rates in the UK and US — Per cent

	1956-64	1965-73	1974-79	1980-83	1984-87	1988-90
British government long-dated securities (20 years)	5.6	8.2	13.6	13.1	10.1	9.0
US long-dated government securities	4.0	6.5	8.7	13.0	10.6	10.5

28. The nominal and real exchange rates have fallen considerably since the early 1980s when sterling was unusually high both because it contained an oil premium and because of the high interest rates which were required to achieve a significant reduction in the rate of inflation. The real exchange rate is now near to the level more typical of the 1960s and 1970s.

Table 13 The Exchange Rate

	Effective Rate Index		Sterling/Dollar Rate
	Actual 1975=100	Real* 1980=100	
1956-1964	144.2	na	2.80
1965-1973	132.1	80.1	2.56
1974-1979	90.7	75.0	2.03
1980-1983	91.3	96.0	1.91
1984-1987	75.6	82.1	1.43
1988-1990	73.5	83.1	1.77

*Actual exchange rate multiplied by relative GDP deflators in the UK and Major 6

29. Table 14 shows that the average PSBR ratio since 1984/85 has been substantially below the average levels of the 1950s and 1960s. With privatisation proceeds worth about 1 per cent of GDP over this period, the PSFD and the PSBR excluding privatisation proceeds have been at similar levels in relation to GDP to what they were in the 1950s and 1960s.

Table 14 Indicators of Fiscal Stance — **Per cent of Money GDP**

	PSBR	Memo: North Sea Tax revenues	PSBR excluding Privatisation Proceeds	Public Sector Financial Deficit
1956/57-1964/65	2.5	-	2.5	2.4
1965/66-1973/74	2.5	-	2.5	1.8
1974/75-1979/80	6.4	0.3	6.5	5.5
1980/81-1983/84	3.7	2.5	4.0	3.4
1984/85-1987/88	1.3	2.3	2.3	2.4
1988/89-1990/91	-1.2	0.9	0.1	0.3

30. North Sea tax revenues are shown as a memo item in Table 19. One approach to setting the PSBR suggests that it might be appropriate to allow the PSBR to fall to the extent of the 'transitory' component in North Sea revenues; on this approach the current taxpayers should consume only the permanent income from the North Sea, allowing future generations to share equally in the benefits. Our most recent

estimates indicate that the permanent income component of the revenues in the period 1980-81 to 1983-84 was worth about 0.6 per cent of GDP on average. The figures above show that between the periods 1974-75 to 1979-80 and 1980-81 to 1983-84 when the major increase in oil revenues occurred, all three measures of fiscal stance fell by at least as much as the transitory part of the rise in oil revenues.

31. The decline in public sector borrowing as a proportion of GDP has been combined with a steady reduction in the ratio of general government expenditure to GDP since the early 1980s. The ratio is now similar to the levels achieved in the late 1960s but not as low as in the period 1955-56 to 1964-65. The non-North Sea tax burden rose steadily from the 1950s to the early 1980s since when it has not changed very much. Table 15 also shows net public sector debt (the stock analogue of the PSBR) as a proportion of GDP. This ratio has fallen dramatically since the 1950s as the growth of money GDP has exceeded additions to the stock of debt.

Table 15 Other Fiscal Indicators — **Per cent of Money GDP**

	GGE*	Non-North Sea Tax Burden (per cent non-North Sea GDP)	Net Public Sector Debt	PSFD	memo: GGFD*** Major 6	memo: GGFD*** UK
1956/57-1964/65	34.8 (4.0)	28.9	134.6	2.4	na	na
1965/66-1973/74	40.2 (3.8)	33.7	83.9	1.8	0.5	-0.1
1974/75-1979/80	45.1 (4.3)	35.2	54.6	5.5	2.5	1.0
1980/81-1983/84	46.1 (4.9)	37.1	46.6	3.4	3.4	2.9
1984/85-1987/88	43.3 (4.6)	37.6	43.3	2.4	3.1	2.8
1988/89-1990/91	39.9 (3.4)	38.0 (39.4)**	32.4	0.3	2.7	0.8

* Debt interest component in brackets
** Before fiscal adjustment in brackets
*** Calendar years

E. **The Balance of Payments**

32. Tables 16 and 17 show the recent history and prospects for exports and imports respectively, together with their major determinants. On the exports side, both price and cost competitiveness have improved recently, although the losses of the early 1980s have not been completely offset. World output and trade have also

shown improvements on the period 1973-1983. These developments have been reflected in a significant increase in the rate of growth of non-oil exports in recent years. A moderation of the recent growth rate is projected for the future as price competitiveness improves at a slower rate than in recent years and the growth of world trade declines slightly.

Table 16 Export Volumes and Major Determinants

	Average Annual Percentage Change		1980=100	
	Non-oil Exports	World Trade in Manufacturers	Relative Export Prices	Relative Unit Costs
1955-64	2.7*	7.1	na	na
1964-73	6.0*	9.7	84.0	76.3
1973-79	3.6	6.1	81.8	67.7
1979-83	-0.4	1.7	95.2	96.4
1983-87	6.1	4.0	89.0	79.9
1987-90	3.5	3.4	90.2	76.2

* Includes oil trade

33. On the imports side, an important influence is the growth of domestic demand. This has increased significantly over the last four years and although import price competitiveness has shown some improvement on the performance of the early 1980s, the import penetration ratio in manufacturing (the proportion of imports to total manufacturing output) has continued to rise and the growth of total non-oil imports has shown a substantial rise in the last four years. However, as with export volumes, the growth of import volumes is expected to fall somewhat from its current high rate.

Table 17 Import Volumes and Major Determinants

	Average annual percentage change		1980=100		
	Non-oil Imports	Total Domestic Demand	Domestic Prices relative to Import Prices	Relative unit Costs	Import Penetration in Manufacturing (ratio)
1955-64	4.3*	3.1	na	na	na
1964-73	6.4*	3.0	88.4	136.8	13.8
1973-79	4.9	1.0	82.2	148.4	22.3
1979-83	3.3	0.5	100.2	101.8	30.6
1983-87	6.9	3.4	97.2	118.2	36.1
1987-90	4.0	3.2	101.6	119.3	38.9

*Includes oil trade

34. There are two additional important influences on the current account. First the rise and fall in the value of net oil exports is obviously a major influence. But, secondly, the UK's net assets overseas which built up strongly during the years of peak oil production have recently generated strong growth in net receipts of interest, profits and dividends and will continue to do so for some time. Other important features to note are the projected continuation of the trend decline in net manufacturing exports and improvement in the balance on other goods and services.

Table 18 The Current Account — Percent of GDP

	Net Oil Exports	Net Manufactures Exports	Other Goods and Services (Net)	Interest Profits & Dividends	Transfers	Current Balance
1955-64	-1.3	7.1	-6.3	1.1	-0.3	0.3
1965-73	-1.4	4.3	-3.7	1.1	-0.5	0.2
1974-79	-2.3	3.0	-1.8	0.9	-0.8	-1.0
1980-83	1.2	1.1	-0.4	0.4	-0.7	1.6
1983-87	1.6	-1.3	-0.6	1.2	-0.7	0.1
1988-90	0.5	-2.3	-0.1	1.5	-0.7	-1.1

35. The implications for the stock of net overseas assets of the flows of assets which are the counterpart of the current account are shown in table 19 below. There were large rises between 1979 and 1983 (reflecting current account surpluses) and between 1983 and 1986 (mainly reflecting revaluations). The accumulated value of UK net assets overseas is expected to fall by over £20 billion between 1986 and 1990. The main contribution is expected to come from the cumulated current account deficits but there is also expected to be a reduction in the value of existing assets. Without the recent large fall in world stock markets, the extent of revaluations would have been expected to more than offset the effects of current account deficits on the value of the UK's net overseas assets.

Table 19 Net Overseas Assets

UK Net Overseas Assets, end year

		£ billion	% of GDP
1957		0.1	0.4
1964		1.6	5.0
1973		5.4	7.2
1979		12.2	6.2
1983		52.7	17.5
1986		114.4	30.2
Projected Change Between 1986 and 1990			
Due to:			
Current Account Deficit	-17.9		
Revaluations	-3.2		
Balancing item	1.2		
TOTAL	-19.9		
UK Net Overseas Assets at end 1990		94.5	18.7

F. The Structure of the Economy

36. In this section four aspects of the structural balance of the economy are examined:

(a) the path for factor income shares - the split of income between earnings, profits and rent;

(b) the path for sectoral acquisitions of financial claims on other sectors and the level and composition of national wealth;

(c) the expected pattern of expenditure - the share of GDP accounted for by consumption, investment and net trade;

(d) the implications for relative sectoral sizes: manufacturing, non-manufacturing and the public sector.

Factor Income Shares

37. Table 20 shows the factor income shares which have prevailed at particular times in the past and gives a projection for 1990.

Table 20 Factor Income Shares* — **Per cent of GDP(non-oil GDP)**

	Income from Employment	Income from Self Employment	Net Company Profits Oil	Net Company Profits Non-Oil	Public Corporation Surpluses**	Rent
1955	67.0(67.0)	9.6(9.6)	-	16.6(16.5)	2.4(2.4)	4.4(4.4)
1964	66.9(66.9)	9.3(9.3)	-	14.8(14.8)	3.3(3.3)	5.7(5.7)
1973	66.8(66.8)	10.8(10.8)	0.1	12.2(12.2)	3.0(3.0)	7.2(7.2)
1979	67.3(69.5)	8.8(9.1)	3.1	9.9(10.2)	3.0(2.9)	8.0(8.2)
1983	65.1(69.3)	9.1(9.7)	6.0	8.0(8.5)	3.7(3.9)	8.1(8.6)
1987	63.9(65.7)	10.6(10.9)	2.6	13.3(13.6)	2.1(2.1)	7.5(7.7)
1990	65.8(67.0)	10.9(11.1)	1.9	12.4(12.7)	2.2(2.2)	6.9(7.0)

* shares of non-oil GDP in brackets.

** includes trading surpluses of general government enterprises.

38. The share of employment income was on a rising trend between the 1950s and the mid 1970s reflecting rises in both real wages and employment. It then fell fairly steadily between 1975 and 1985 (except for some small rises in 1979 and 1980) to below the levels typical of the 1950s and 1960s. Excluding the North Sea sector, the employment share is a little below the 1955 level. The rise and subsequent fall of the employment share can be regarded as a result of the increase and decrease of the relative success of employees in capturing the gains from rising productivity.

39. As one would expect the share of non-oil profits tends to mirror that of employment incomes; a sharply falling share during the 1960s and 1970s was followed by a rising share in subsequent years. However, the scale of the changes is rather larger.

40. Another way to look at the trends in profits is to examine profitability - profits per unit of capital employed. However, there is a strong belief that as a result of the rapid increase in oil prices in 1979-80, capital (especially in manufacturing) was subject to much faster scrapping in the early 1980s than the official CSO data show. To the extent that this is the case, recorded profitability will understate true profitability from that period onwards.

Table 21 Profitability: Pre-tax Rates of Return — per cent

	All Industrial and Commercial Companies	Non-North Sea Industrial and Commercial Companies
1955	14.1*	14.1*
1960	13.1	13.1
1964	12.0	12.0
1973	8.9	9.0
1979	7.4	5.7
1983	9.1	4.8
1987	11.2	10.0
1990	9.7	9.1

* Estimated from rate of return on all companies including financial companies.

41. Table 21 tells a similar story to that revealed by table 20 so far as non-oil profits are concerned. Since 1979 there has been a marked (trend) increase in profitability from the low levels of the mid-1970s. According to the official data, profitability is still low by the standards of the 1950s and 1960s. However, internal estimates of the true value of the capital stock imply that actual profitability might be around 15 to 20 per cent higher than the above table suggests for the period since 1979. On this basis profitability is now at about the same level as in the 1960s.

Wealth and Sectoral Acquisitions of Assets

42. Another useful way of looking at the changing structure of the economy is to consider the sectoral financial surpluses and deficits. This is done in table 22.

Table 22 Financial Surpluses and Deficits by Sector **Percentages of GDP**

	Public Sector	Private Sector	Overseas Sector	Residual Error
1948-54	-0.6	1.5	-0.9	0
1955-64	-2.4	2.1	-0.3	0.6
1965-73	-1.6	2.1	-0.2	-0.3
1974-79	-5.5	3.4	1.0	1.1
1980-83	-3.4	5.6	-1.6	-0.6
1984-87	-2.7	4.7	-0.1	-1.9
1988-90	-0.4	2.3	1.1	-2.9

43. In principle, the sectoral surpluses/deficits should sum to zero since one sector's financial assets are another sector's liabilities. But in practice, errors and omissions in the national accounts mean that this is not so. Since 1982 there has tended to be a large excess of recorded income over expenditure and the even higher projection for the next three years reflects the errors observed in recent data. It is possible that at least some of the residual error should be allocated to private sector expenditure and income; the very latest data revisions (not incorporated in table 22) indicate some upward revision to personal sector expenditure for recent years and a downward revision to personal income.

44. Table 22A gives a breakdown of the private sector's financial surplus both in terms of savings and investment, and also in terms of the personal and company sectors.

Table 22A Private Sector Financial Surplus — **Percent of GDP**

	Private Sector Savings	Private Sector Investment	Private Sector Financial Surplus (= saving minus investment)	of which: Personal Sector	of which: Company Sector
1955-64	12.8	10.7	2.1	0.8	1.3
1965-73	13.7	11.7	2.1	1.9	0.2
1974-79	16.2	12.8	3.4	3.9	-0.5
1980-83	17.0	11.4	5.6	4.4	1.2
1984-87	18.4	13.7	4.7	2.0	2.7
1988-90	17.2	14.9	2.3	0.7	1.6

45. The economy's stock of tangible assets, shown as a ratio to GDP in Table 23 below, consists of the cumulated value of investment, adjusted for the effects of revaluations. The economy's total wealth, also shown, is the sum of net tangible assets and net overseas assets. Table 24 gives further details of savings and wealth in the personal sector.

Table 23 Wealth Income Ratio — Ratio to GDP

	Total Net Wealth*	Net Tangible Assets	Net Overseas Assets
1957	3.00	3.00	0
1964	3.35	3.31	0.04
1973	4.94	4.87	0.07
1979	4.79	4.73	0.06
1983	4.53	4.36	0.17
1986	4.78	4.48	0.30

* Sum of second and third columns

Table 24 Personal Sector Savings and Wealth/Income Ratios

	Savings Ratio	Wealth/Income Ratios* Net Financial Wealth	Total Wealth**
1957	5.1	2.26	3.99
1964	9.0	2.28	4.18
1973	10.8	1.65	4.70
1979	12.9	1.22	3.72
1983	10.7	1.59	4.08
1987	9.1	2.00	4.82
1990	9.4	1.84	5.04

* Ratio of wealth to annual personal disposable income

** Net Financial wealth plus housing wealth plus value of stock of consumer durables. (Note stock of consumer durables not included in table 23)

46. The main points of interest arising from tables 22 to 24 are as follows:

(a) Since 1960, the personal sector has been a net saver and a source of funds for the rest of the economy. The period from 1971 to 1980 saw a sharp rise in its financial surplus as the personal sector attempted to restore the real value of its wealth which had been eroded by accelerating inflation. This higher rate of savings has been sufficiently marked to raise the wealth income ratio of the personal sector above the levels experienced in the 1950s and 1960s. As inflation has come down and the wealth/income ratio has risen, the savings ratio has fallen. At the same time, the proportion of personal wealth held in financial rather than physical assets has risen significantly.

(b) The company sector has traditionally had small surpluses or deficits; much of their capital formation has been from internally generated funds. Since 1983 however, companies have moved into a period of sustained financial surpluses as increased profitability has not been matched completely by higher rates of capital formation. This partly reflects the downward trend in stockbuilding (see Table 25). Over the next few years companies' surpluses are projected to fall along with falling profitability. For the private sector as a whole, the financial surplus has recently shown a marked decline, and this trend is expected to continue.

(c) The decline in the public sector financial deficit between 1980-83 and 1984-87 was slightly smaller than the reduction in the private sector's surplus. While the deficit of the overseas sector has fallen significantly over the same period, the large change in the residual error makes the interpretation of these trends very difficult.

(d) After rising strongly in the period up to 1973, national wealth has since been fairly flat. Within the total, the share of net tangible assets has fallen and that of net overseas assets has risen. However, tangible assets still account for over 90 per cent of national wealth.

Expenditure shares

47. A third way to examine the structural behaviour of the economy is to consider the shares of GDP accounted for by the main expenditure categories.

Table 25 Percentage of Gross Domestic Expenditure accoumted for by the Main Expenditure Categories

	Consumers' Expenditure	General Government Current Expenditure		Gross Domestic Fixed Capital Formation		Stock-building	Net Trade
		Central Government	Local Authorities	private	public		
1955-64	66.5	11.4	5.3	9.6	6.8	1.1	-0.5
1965-73	62.6	10.6	6.7	10.8	8.0	0.9	0.3
1974-79	60.6	12.3	8.2	12.1	7.2	0.7	1.1
1980-83	60.3	13.3	8.2	12.0	4.6	-0.6	1.9
1984-87	61.7	13.1	8.2	13.6	3.6	0.1	0.3
1988-90	62.7	12.7	8.4	14.8	2.8	0.3	-1.9

48. The main points to note are as follows:

a. after remaining fairly flat as a proportion of total expenditure since the mid-1960s, total consumption has risen steadily since the late 1970s. Within total consumption there was a steady shift away from private to public consumption until the early 1980s when public consumption began to level off and private consumption grew more rapidly than GDP.

b. The share of total fixed investment was fairly flat at about 19 per cent of total expenditure from the mid-1960s until the the late 1970s after which it fell to around 17 per cent. The share is expected to rise a little over the next three years. Within the total there has been a marked shift between the public and private sectors. Private sector investment has risen by about four percentage points since 1955-64, with public sector investment falling by a similar amount.

c. The counterpart of the projected rises in the shares of consumption and investment compared with the early 1980s is a fall in the share of net trade.

Relative Sectoral Sizes

49. Another interesting aspect of the structure of the economy is the relative size of the public sector and of the manufacturing and non-manufacturing private sector. Table 26 below shows the relative shares of output which the various sectors have generated in the past and those projected for the future.

Table 26 Output Shares by Sector* **Per cent**

	Public Non-Trading	North Sea	Private and Public Trading	
			Manufacturing	Other
1968	14.2	-	31.6	53.0
1973	13.9	0.1	31.6	53.1
1979	14.3	4.2	28.1	52.8
1983	14.4	5.9	24.7	54.3
1987	12.6	5.6	24.6	56.6
1990	11.9	4.5	24.9	58.2

* At constant 1980 prices

50. The output share of the public non-trading sector remained nearly constant in the period up to 1983. But since then, there has been a discernible fall. By convention, the output of this sector is largely taken to be the sum of its input costs. As the present government has taken steps to hold back the rise in public expenditure, public non-traded output has inevitably grown less rapidly than the rest of the economy although these figures will overestimate the reduction to the extent that productivity has increased in the public sector. This trend is projected to continue into the future.

51. The output share of the North Sea reached a peak in 1984 and declined marginally in 1985 as production reached a plateau. As the North Sea share built up, it was manufacturing which suffered the counterpart loss of output share. This is not surprising; coupled with the increased competition from newly industrialised countries, the rise in the exchange rate associated with oil hit hardest at the traded goods sector - principally manufacturing. The share of the rest of the private and public trading sector has increased steadily since the 1960s.

52. Judged in terms of employment, rather than output, the projections have somewhat different implications for the relative sizes of sectors. As noted in section B earlier, productivity growth in manufacturing has been considerably greater than in non-manufacturing. Partly by virtue of the statistical convention for measuring its output, productivity growth in the public non-trading sector has been lower still. In broad terms, these relative speeds of productivity growth are expected to persist into the future. These trends ensure a faster downward trend in manufacturing's share of employment than of output, and a trend increase in the public sector's share of employment.

POLICY BACKGROUND TO THE 1988 BUDGET

ANNEX B

MONEY GDP PROSPECTS AND POLICY FRAMEWORK

MP1 DIVISION
December 1987

MONEY GDP PROSPECTS AND POLICY FRAMEWORK

While movements in sterling have influenced authorities' decisions about interest rates since the start of the MTFS, the role of the exchange rate has been given increased prominence during the last year. Since the Louvre agreement in February 1987 UK interest rates have in effect been assigned primarily to the stabilisation of the sterling/deutschemark exchange rate; and the prospect may now be that sterling will continue to be held at around current levels against the deutschemark. The continued assignment of interest rates primarily to maintaining a given level of sterling would entail some changes to the framework of fiscal and monetary policy as compared with that set out in the 1987 MTFS and in earlier versions of the MTFS.

2. The early sections of this paper discuss the implication of this framework for the evolution of inflation and money GDP growth over the medium term. The paper discusses the mechanisms by which exchange rate policy is likely to affect UK inflation; and considers the prospects for medium term inflation and output growth implied by the October forecast, and some of the sensitivities around those projections.

3. The later sections of the paper discuss the policy framework in more detail and the implication that giving greater weight to exchange rate stability will have for the Government's ability to control money GDP. The assignment of interest rates to delivering a particular exchange rate is likely to reduce the Government's ability to deliver a particular path of money GDP in the short term, as compared with a situation where interest rates were chosen in the light of an assessment of a range of indicators (including the targeted monetary aggregate and the exchange rate). The exchange rate constraint means that the Government has less freedom to take account of other indicators which may sometimes contain relevant information about money GDP.

4. The Government's freedom to achieve a particular medium term path of money GDP will depend on the scale and frequency of exchange rate realignments. In the extreme case of a permanently

fixed sterling/deutschemark rate the Government might have to accept a money GDP path largely determined by events outside its control (eg German policy). With regular annual exchange rate realignments the short term exchange rate constraint would not place much restriction on the medium term money GDP path that the Government could choose. (However, if the Government's short term control over money GDP is reduced by the existence of an exchange rate target this could in itself possibly lead to greater annual revisions in the medium term GDP path).

Factors underlying medium term prospects for inflation

5. If policy is directed now more explicitly towards stabilising the exchange rate, the question arises whether that is likely to be more effective in delivering lower inflation. It will be if it makes the stance of policy either:

- i. tighter, or
- ii. more readily understood and so taken account of by the private sector, or
- iii. more credible.

6. A fixed exchange rate regime can obviously imply either a <u>tighter</u> or <u>looser</u> policy stance than a regime of money GDP and M0 objectives/targets: it all depends on developments in other countries (eg Germany) and on how ambitious those objectives/targets are. A case can undoubtedly be made for arguing that holding sterling close to its present level against the deutschemark does represent a tighter policy stance than that implied by the targets in the 1987 MTFS. The 1987 MTFS money GDP projections were estimated at the time to imply a significant fall in sterling against the deutschemark, although the further evidence available over the last year of improved UK relative productivity performance may mean that a fixed exchange rate regime would be less tight than it seemed a year ago.

7. One potential advantage of a fixed exchange rate regime is that the private sector may be able to interpret the implications of such a policy better than it can assess what a particular MO or money GDP objective means. "Money GDP" is not a concept which is very familiar to non-economists, whereas firms (and their employees) that are involved in international trade are well aware of the implications of the level of the exchange rate for their pricing decisions and profits. Pay settlements may be slightly lower if the fixed exchange rate is perceived to be a firmer discipline than fixed money GDP or MO.

8. The credibility of policy set out in the MTFS is crucial: if the private sector acts on the basis that the Government will not do what it has announced, the cost of reducing inflation will be much greater. It is at least arguable that a fixed exchange rate policy will appear to leave the Government less opportunity for equivocation than policy which involves the assessment of monetary conditions in the light of a (several times changed) monetary target and a range of other indicators.

9. Fixing sterling to the deutschemark will clearly exercise a discipline over the prices that UK exporters and UK producers of tradeable goods for the home market will be able to charge. But how much of a constraint on UK domestic inflation will this represent?

10. The pressure of foreign prices on pricing of tradeable goods in the domestic market can be illustrated by the behaviour of UK producer output prices over the period of the appreciation of sterling in the late 1970s and 1980 and its subsequent fall. The rise and fall relative to other countries in UK producer prices over this period was much less than the relative change in unit labour costs; reflecting both competitive pressure on profit margins and the reduction of import costs that domestic producers experienced as sterling rose.

	Effective exchange rate 1975=100	Relative producer prices 1980=100	Relative unit labour costs 1980=100
1977	81.2	79	61.8
1978	81.5	81.7	65.9
1979	87.3	89.4	78.3
1980	96.1	100	100.0
1981	95.3	100.8	101.9
1982	90.7	97.7	95.5
1983	83.3	91	85.8

11. While these figures show the exchange rate exercising some discipline on prices, they also make clear that with the policies that were in operation in the late 1970s, the discipline was by no means absolute. Longer term experience does, however, suggest that maintenance of a fixed exchange rate leads to a high degree of inflation convergence. But this convergence is not necessarily complete, because the discipline provided by the exchange rate applies directly only to the tradeable sector of the economy.

12. One theory of the determination of inflation under fixed exchange rates (often referred to as the "Scandinavian" theory of inflation) suggests that countries with relatively high productivity in the tradeable goods sector will tend to experience relatively high inflation (for evidence on the 1960s, see Appendix 1). The argument is that relatively fast productivity growth in the tradeable goods sector permits relatively fast pay growth in that sector. This upward pressure on pay is transmitted to the rest of the economy (including the general government sector). Whole economy unit labour costs will rise faster in the country that is enjoying good productivity performance in the tradeable sector, unless the productivity performance of the non-tradeable sector relative to other countries is as good as that of the tradeable sector.

13. Currently the UK is experiencing faster growth of productivity in manufacturing than other major industrial countries; because the level of UK productivity is way below European (and particularly German) standards, there is scope for

relatively fast productivity growth in the UK for a considerable period. Since 1979 output per man has grown by about 2 per cent a year faster in UK manufacturing industry than in German manufacturing, and UK manufacturing productivity growth is expected to continue to exceed German productivity growth by around 2 per cent a year over the medium term.

14. This means that earnings in UK manufacturing could rise 2 per cent faster than German earnings without the fixed sterling/ deutschemark rate putting any pressure on UK manufacturing profit margins. If there were to be corresponding differences between UK and German non-manufacturing earnings, but no difference in non-manufacturing productivity, UK inflation might eventually converge to a rate of inflation some 1½ per cent higher than the German inflation rate. If German inflation settles at around the 1 per cent rate currently forecast for the medium term, this would still allow room for a significant fall in UK inflation from its current levels. The speed of convergence to the rate of inflation warranted by German inflation is uncertain, and would be affected by such factors as demand conditions in the UK and the degree of credibility given by price and wage setters to the Government's announced policy intentions. There would be virtually no room for any depreciation of sterling against the deutschemark.

Medium term projections

15. Another way of assessing the medium term prospects for inflation is to look at the October forecast. This has been broadly updated to take account of the fall in the world stock markets that occurred after the October forecast had been completed. The projections allow for tax cuts around £4 billion in 1988, and around £2-2½ billion a year over the following two years. This is forecast to leave the PSBR excluding privatisation proceeds close to zero over the medium term. The real GDP, money GDP, GDP deflator and exchange rate projections in this forecast are given below (1987 MTFS numbers in brackets).

	1987-88	1988-89	1989-90	1990-91
Real GDP, per cent change on year earlier	4.1 (3)	2.8 (2½)	2.4 (2½)	2.4 (2½)
GDP deflator, per cent change on year earlier	4.6 (4½)	4.8 (4)	4.1 (3½)	3.6 (3)
Money GDP, per cent change on year earlier	9.0 (7½)	7.7 (6½)	6.7 (6)	6.1 (5½)
Sterling index (1975=100)	73.4	73.8	73.2	73.0
Sterling/deutschemark rate	2.97	2.91	2.83	2.75

16. These projections show sterling falling below 2.80 deutschemarks by 1990-91, the third of the four years that will be covered in the 1988 MTFS. Given the judgements made in the forecast, a higher sterling exchange rate than this would imply medium term GDP growth falling clearly below the 2½ per cent rate set out in the last MTFS (even though the forecasters have revised their view of potential output growth up a little since the last MTFS). A variant on the above projections, in which UK interest rates are raised so that sterling depreciates more gradually against the deutschemark, remaining within the 2.80-3 range over the whole period up to 1991-92, shows real GDP growth falling to below 2 per cent a year in 1989-90 and 1990-91. Money GDP growth in this variant falls below that in the 1987 MTFS.

17. Prospects could also be affected by changes in the foreign exchange markets' confidence in sterling, with improved confidence leading to lower interest rates and hence tending to raise real GDP growth. Recent months have demonstrated the problems that improving confidence can bring, making it difficult to avoid interest rate cuts that have not seemed entirely appropriate in the light of domestic conditions. To illustrate the possible orders of magnitude involved, a simulation of a 2 point cut in UK interest rates for 2 years due to improved confidence shows an average increase in real growth over those two years of some ¾ per cent, with little change in inflation.

18. The prospects for output and inflation would, of course vary with different outturns for the dollar/deutschemark rate:

- further substantial dollar depreciation against the deutschemark would increase the tightness of stance implied by holding the sterling/deutschemark rate constant, giving a faster decline in money GDP growth; and, for a while at least, weaker growth of output

- a sharp recovery in the dollar against the deutschemark would raise the German inflation rate and would imply an easier policy stance in the UK and could possibly remove all downward pressure on UK inflation.

19. There are several other important judgements made by the forecasters that affect the output and inflation projections under particular settings of policy instruments. One important judgement is on the degree of labour market adjustment. In the past, MTFS projections have normally taken credit for a rather greater degree of labour market adjustment (ie lower growth in pay) than the forecasters have believed likely; unfortunately in recent years the forecasters' relative pessimism has tended to be justified by events. Other things being equal with a given sterling/deutschemark rate lower growth in pay will over the short to medium term reduce inflation and raise the rate of growth of real output.

20. Another important area of judgement - and one where the forecasters have tended to be over pessimistic in recent years - is UK trade performance. Better trade performance (a bigger share of world markets or lower import penetration for a given level of domestic demand) will tend to improve the current account and raise real growth; it might also tend to put upward pressure on UK inflation, particularly if there were any serious shortages of physical capacity or skilled labour in the economy.

21. A further important judgement in the forecast is on the private sector's likely rate of saving, given the forecast growth of incomes. The forecast implies a private sector financial

surplus that is very low by historical standards. While there are some special factors that help to explain this (in particular the scale of pension fund contribution "holidays"), these are subject to some uncertainty and the rate of saving by the private section could turn out higher than forecast, for given income growth. This would improve the current account, but reduce GDP growth (and might also reduce inflationary pressure).

The role of the exchange rate in previous versions of the MTFS

22. Successive versions of the MTFS have made it clear that the Government interprets monetary conditions with the help of a range of indicators, including the exchange rate; and in practice most of the major interest rate changes in recent years have occurred at times of pressure on the exchange rate. Since 1982 the text of the MTFS has said explicitly that the exchange rate is taken into account in decisions about setting interest rates. The references to the exchange rate in successive versions of the MTFS are given below.

> **1981 MTFS.** "Other indicators also suggest that financial conditions in 1980-81 were tight: the high exchange rate, high interest rates; the absence of any marked movement in the prices of houses or other assets."

> **1982 MTFS.** Referred to the recent behaviour of the exchange rate in a section on "recent financial conditions". In the section on monetary policy: "Interpretation of monetary conditions will continue to take account of all the available evidence, including the behaviour of the exchange rate."

> **1983 MTFS.** "Other financial indicators pointed to moderately restrictive monetary conditions. As in other industrial countries real short term interest rates remained high. For most of the year the exchange rate was strong." "The interpretation of monetary conditions will continue to take account of all the available evidence, including the exchange rate, structural changes in financial markets, saving behaviour, and the level and structure of interest rates."

1984 MTFS. "Broad and narrow money will have equal importance in the assessment of monetary conditions and interest rates. As in the past the authorities will take into account all the available evidence, including the exchange rate."

1985 MTFS. "Equal weight will be given to the performance of MO and £M3, which continue to be interpreted in the light of other indicators of monetary conditions. Significant changes in the exchange rate are also important. It will be necessary to judge the appropriate combination of monetary growth and the exchange rate needed to keep financial policy in track: there is no mechanistic formula."

1986 MTFS. "In implementing policy and in making decisions about short term interest rates, the Government has to make a careful assessment of the behaviour of the monetary aggregates in relation to their targets, together with other relevant evidence, especially the exchange rate. There is no mechanical formula for taking the exchange rate into account in assessing monetary conditions; a balance must be struck between the exchange rate and domestic monetary growth consistent with the Government's aim for money GDP and inflation."

23. The Louvre agreement was concluded just over three weeks before the 1987 Budget - by when the shape of the 1987 MTFS had been largely determined - so it affected the wording of the MTFS chapter rather than the substance of the 1987 MTFS. In addition to a paragraph which repeated quite closely what had been said about exchange rates in the 1986 MTFS, the 1987 MTFS included a paragraph which referred to the conclusion reached at the Louvre meeting that "a period of stability would be desirable". It then said that "the MTFS projections assume that there is no major change in either the sterling exchange rate index or the sterling/ dollar exchange rate from year to year".

24. The increased weight given to exchange rate stability has involved a change to the policy framework, as UK interest rates

now have to be assigned primarily to delivering a particular exchange rate. There can be a conflict between short-term exchange rate objectives and maintaining monetary conditions necessary to deliver the desired growth of money GDP, such as has in fact occurred in 1987. Strong upward pressure on the exchange rate has removed any scope for raising interest rates to prevent the overshooting of money GDP that has been forecast since the summer. The policy dilemma will become more obvious in public if MO starts overshooting its target range, as it is forecast to do at the beginning of 1988.

The role of monetary and fiscal policies

25. The aims of policy are to bring money GDP down and to contribute to a sensible balance in the economy. The instruments available to the authorities to do this are:

- interest rates have to be directed in the first instance to maintaining the exchange rate within its agreed range. This does not mean that that interest rates can never be directed to influencing the growth of money GDP: whether they are free for such use depends on where the exchange rate stands within its target range. Moreover in many (but not all) cases where inappropriately loose or tight monetary conditions call for policy response, this will be reflected in pressure on the exchange rate. Thus interest rate changes made to offset exchange rate may well be appropriate to deal with the general state of monetary conditions (which is why the exchange rate has been used as an important indicator of monetary conditions throughout the history of the MTFS)

- at Budget time, but not at other times (except in a major crisis), fiscal policy can be reviewed. Variations in fiscal policy will affect both money GDP and the balance of the economy, and budget decisions will normally represent a compromise between objectives on overall stance and on balance: eg if the prospects

were for very slow growth of money GDP and an acceptable current account position, a more expansionary fiscal stance might be adopted to achieve faster growth of money GDP, but at the expense of a less satisfactory current account.

- at intervals there would be an opportunity for exchange rate realignments. These would provide some opportunity to correct the balance of the economy. One way of helping the credibility of the Government's commitment to a fixed exchange rate would be to confine these realignments to the occasion of general realignments of central rates within the EMS.

26. These three instruments are discussed in turn.

Interest rates and monetary targets

27. Although interest rates are assigned to controlling the exchange rate in this framework, the assignment is not absolute. Intervention in the foreign exchange market allows some limited short term control over the exchange rate that is independent of interest rates. And as long as the exchange rate is allowed to vary within a band, then interest rates can be allowed to respond to some extent to indicators other than the exchange rate, provided that consequent movements in the exchange rate do not push it outside the permitted band.

28. In some situations, therefore, it may be possible to change interest rates in the light of what MO or other indicators are suggesting about monetary conditions, rather than directly in response to pressure on the exchange rate. Thus monitoring a range of indicators to assess monetary conditions remains an important activity.

29. Whether it is appropriate to continue an explicit target for MO is a further question:

- on the one hand, in assessing monetary conditions during the year it will be helpful to have a benchmark against which to assess the actual behaviour of MO (but a benchmark clearly does not have to be a formal target);

- retaining an MO target will reduce the impression of discontinuity in successive versions of the MTFS: if it is dropped it will be the fourth aggregate to be axed in the eight year life of the MTFS;

- on the other hand, it is rather odd to have a target which there will in some circumstances (eg those prevailing for much of the latter part of 1987) be no instrument to control;

- having in effect an exchange rate target and a monetary target at the same time may lead to accusations that the Government has made a howler that an A level economics student would be ashamed of (however, other countries currently in the exchange rate mechanism of the EMS continue to target monetary aggregates).

Fiscal policy

30. Major public statements about fiscal policy in recent years, such as the Lombard Speech of April 1986, have emphasised the following objectives:

- public sector debt should not rise as a percentage of GDP;

- the Budget deficit must be set at a level that can be comfortably financed in a non-inflationary way;

- there should be scope for absorbing possible fiscal shocks.

These objectives essentially reflect the need to set fiscal policy for the medium term in a way that we (and markets) believe to be sustainable and consistent with a satisfactory structure of demand and output within the economy.

31. Preventing public sector debt rising as a percentage of GDP should ensure that the burden of debt interest payments does not rise. A situation in which the burden of debt interest payments is rising may not be regarded by the markets as sustainable, and will cause particular problems for public expenditure control given the objective of reducing total public expenditure (including debt interest payments) as a proportion of GDP. As a matter of arithmetic, the debt income ratio remains constant when the level of borrowing is set equal to the rate of nominal GDP growth of the economy times the existing debt income ratio. Taking the sustainable rate of real economic growth as around 2½ per cent, and the current debt income ratio of around 40 per cent, annual borrowing at a rate of 1 per cent of GDP would be consistent with a stable debt/income ratio at zero inflation.

32. The need to finance the deficit in a non-inflationary way can be seen in terms of what different levels of the public sector deficit imply for the portfolio of assets owned by the private sector. The assets of the UK private sector consist of the liabilities of the public sector, net overseas assets and the UK capital stock. If there is a particular level of wealth that the private sector wants to hold at a given level of income, then an increased holding of one of these categories of assets will mean, other things being equal, that less of the other categories will be held: thus an increased rate of creation of public sector liabilities will tend to "crowd out" holdings of overseas assets and claims on the domestic capital stock.

33. This crowding out shows up in the current account of the balance of payments and changes in the level of domestic investment. In a closed economy, expansionary fiscal policy tends to raise domestic interest rates and "crowding out" occurs by the mechanism of higher interest rates depressing domestic investment. In an open economy with a high degree of capital mobility domestic

interest rates are largely determined by foreign interest rates and markets' views about likely exchange rate movements. Thus expansionary fiscal policy may not initially have much effect on domestic interest rates or domestic investment; instead the initial effect of expansionary fiscal policy may well be primarily to cause a deterioration in the current account, leading to a decline in holdings of overseas assets. However, a sustained deterioration in a country's current account position is likely to lead eventually to a loss of confidence in financial markets and to rising interest rates: increasingly it will be domestic investment that will be crowded out by a continued rise in share of public sector debt in private sector portfolios.

34. Thus, other things being equal, a high Budget deficit is likely to mean:

a. an increasingly negative contribution of net interest payments to the current account, requiring a growing proportion of the country's output to be devoted to the trade balance;

b. a falling capital/output ratio, leading to a slowing of growth.

35. A fiscal policy stance which involves these effects on a large scale will probably not be sustainable for very long. Either policy will be reversed, or some of the growth in debt will be monetised (of course markets' fears about the second option will intensify the difficulties of sustaining the growth in debt because markets will demand increasingly high interest rates as compensation for the risk of eventual monetisation).

36. At times it may be possible to identify developments in the economy that change the appropriate level of public borrowing. One example is the process of transfer of ownership of physical assets from public to private ownership in the course of the present Government's privatisation programme. Another example

would be a sustained reduction in the private sector's saving ratio. This would lead to a worse current account (and possibly also lower domestic investment) unless the Government reacted by reducing its borrowing.

37. The figures in Table 1 show the relationship between public sector borrowing (as measured by the public sector financial deficit) and the private sector surplus and the balance of payments current account over the last thirty years. One general feature is the rise in private saving and in the private sector financial surplus in the 1970s, associated with the rise in inflation: individuals saved more out of current income to try and make good the erosion of existing savings by inflation. This higher level of saving allowed the public sector to run a high rate of borrowing with only a relatively small deficit on the current account.

38. In the 1980s the private saving ratio has fallen, largely because inflation has fallen. There have been some other temporary factors at work, which may continue to depress saving over the medium term. One is the growing number of firms that have declared pension contribution "holidays"; another is the effect of financial liberalisation which has reduced credit rationing and allowed households to undertake a greater level of indebtedness.

39. Private sector investment has shown an upward trend over the last thirty years. Much of this is accounted for by the transfer of investment from the public sector (more owner occupied housing and fewer local authority dwellings, in recent years the privatisation programme). Investment was relatively low early in the 1980s (in particular stockbuilding, which included in these figures, was depressed) but has risen since then, and is forecast to rise quite strongly in the near future, reflecting the higher rates of capacity utilisation recorded over the last year. This means that the private sector financial balance (adjusted to take account of the statistical discrepancy between income and

Table 1 FINANCIAL SURPLUSES (per cent of GDP)

	Private sector saving*	Private sector investment	Net acquisition of financial assets		
			Private sector*	Public sector	Overseas sector**
1955-1958	12.9	10	2.9	-2.2	-0.7
1959-1962	13.6	11	2.6	-2.4	-0.2
1963-1966	13.8	11.5	2.3	-2.5	0.2
1967-1970	12.5	11.5	1.0	-0.8	-0.3
1971-1974	14.8	12.6	2.2	-3.1	0.9
1975-1979	17.5	12.2	5.3	-5.8	0.4
1979-1982	16.7	12.0	4.7	-3.6	-1.2
1983-1986	16.7	13.0	3.7	-3.2	-0.5
1987-1990	14.5	14.8	-0.3	-0.7	1.0

* Including national accounts residual error.

** Equals current account of balance of payments with sign reversed.

expenditure measures of GDP) is forecast to go into a small deficit over the next few years, while in the past it has almost always been in substantial surplus. Thus even with a very small public sector deficit a current account deficit is forecast.

40. The only other period in the last thirty years when the public sector deficit was anything like as small as that now forecast was in the late 1960s. At that period also, private sector saving was unusually low: the personal sector saving ratio fell, partly because a relatively tight fiscal policy restrained the growth of real disposable income. Nevertheless, the decline in the public sector deficit between the mid 1960s and the end of the decade did lead to some improvement in the current account.

41. When the exchange rate is free to move, its immediate reaction to changes in the stance of fiscal policy is rather unpredictable: on the one hand any upward pressure on domestic interest rates from more expansionary policy may tend to attract capital inflows and push the exchange rate up, on the other hand market worries about the sustainability of policy following a fiscal expansion will tend to weaken the exchange rate. Under a fixed exchange rate regime, and with high capital mobility, whether expansionary fiscal policy exerts much upward pressure on domestic interest rates will depend on the extent of market worries about sustainability.

42. Pressures on the sterling/deutschemark rate may, of course, reflect German fiscal policy as much as UK fiscal policy. Tightening of German fiscal policy, if it leads to worries about the sustainability of the existing exchange rate, will require higher interest rate or a fiscal tightening in the UK. A very tight German fiscal policy and persistent large German current account surplus could eventually put similar pressures on the rate to a very expansionary UK fiscal policy: in either case the markets might eventually react so as to force either a sharp UK fiscal tightening or a devaluation of sterling against the deutschemark.

43. To the extent that it may sometimes be acceptable to abstract from the effect of market worries about sustainability, it is possible to use model simulations to indicate the scale of effect on the economy of <u>temporary</u> changes in fiscal policy. Table 2 shows simulation results on the effect of a reduction in income taxes sufficient to reduce the PSBR by 1 per cent of GDP under the two regimes that represent roughly the pre-Louvre and post Louvre framework, ie

- (a) fixed money GDP, achieved by changing interest rates

- (b) fixed exchange rate, achieved by changing interest rates

In these simulations it is specifically assumed that the fiscal expansion is reversed after 5 years, and that markets know from the start that it will be reversed; so that effects due to worries about sustainability do not arise.

Table 2 EFFECTS OF INCREASE IN PSBR*

% change from base in:	Fixed money GDP	Fixed exchange rate	%change from base in:	Fixed money GDP	Fixed exchange rate
<u>REAL GDP</u>			<u>SHORT TERM INTEREST RATE</u>		
Year 1	.0	+.5	Year 1	+1.1	+.1
Year 2	+.5	+.7	Year 2	-.2	+.3
Year 3	+1.2	+1.0	Year 3	.0	+.5
Year 4	+1.4	+1.3	Year 4	+.7	+.8
<u>RPI INFLATION</u>			<u>REAL EARNINGS</u>		
Year 1	+.2	.0	Year 1	-.4	-.1
Year 2	-.7	-.3	Year 2	-.9	-1.0
Year 3	-.7	-.4	Year 3	-1.2	-1.5
Year 4	+.1	+.1	Year 4	-1.6	-1.8
<u>EMPLOYMENT</u>			<u>CURRENT ACCOUNT (£bn)</u>		
Year 1	+.1	+.3	Year 1	-.3	-1.2
Year 2	+.4	+.8	Year 2	-1.6	-2.0
Year 3	+1.2	+1.3	Year 3	-3.0	-2.5
Year 4	+1.9	+1.8	Year 4	-4.0	-3.3

NOMINAL EXCHANGE RATE

Year 1	+1.1	.0
Year 2	+.2	.0
Year 3	+.7	.0
Year 4	+1.2	.0

LONG TERM INTEREST RATE

Year 1	+1.6	+1.6
Year 2	+1.7	+1.8
Year 3	+1.9	+1.9
Year 4	+2.1	+2.0

REAL EXCHANGE RATE

Year 1	+1.1	.0
Year 2	-.3	-.3
Year 3	-.4	-.9
Year 4	-.2	-1.0

* PSBR is assumed to increase by 1 per cent of GDP for 5 years.

44. Under both frameworks temporary expansions in fiscal policy lead to temporary increases in output. An expansionary fiscal policy has a larger immediate impact on real GDP when interest rates are used to stabilise the exchange rate than when interest rates are used to stabilise money GDP (in the latter case the exchange rate rises). But apart from this there is not a large difference between the two regimes in the effect of temporary changes in fiscal policy on growth, inflation, or the current account.

45. In summary, the scope for sustained changes in fiscal stance on its own (ie without corresponding changes in monetary policy) is limited by the effect that such changes have on the balance of the economy, and the likely reactions of markets to such changes. This limitation on the scope for fiscal changes applies whether monetary policy is expressed in terms of a target for a monetary aggregate, money GDP, or the exchange rate. At the same time, short term changes in the profile of real output may in principle be achievable by temporary changes in fiscal stance, again under a variety of regimes for monetary policy.

Exchange rate realignments

46. The scale and frequency of exchange rate realignments will determine the extent to which the Government will be free to choose a particular medium term path of money GDP and to stick to it in the face of unexpected developments in the economy. Regular

(yearly) realignments might leave the Government with as much freedom as it would need for this purpose; but possibly at the cost of undermining the fixed exchange rate as a mechanism for reducing inflationary expectations.

47. It was suggested above that one option would be for exchange rate realignments to be confined to the occasion of general EMS realignments. Table 3 summarises the record of EMS realignments. There have been 11 realignments within the EMS, including 5 general realignments (for a detailed chronology of realignments see Appendix 2).

Table 3

EMS CENTRAL RATE CHANGES

	Belgian Franc	Danish Krone	Deutsche Mark	French Franc	Italian Lira	Irish Punt	Dutch Guilder
Total number of changes	5	6	7	5	5	3	6
Total percentage change in rate	-2½	-5½	+28	-11¾	-18¾	-9½	+23

To take the case of one major currency, the rate of the French franc against the deutschemark has been changed on six occasions as a result of realignments of the franc and or deutschemark . Thus in the past there has been considerable latitude for exchange rate movements within the fixed exchange rate regime of the EMS. While the greater convergence of inflation within Europe may reduce the number of realignments in future, it seems likely that there would, over the course of a few years covered by the MTFS, be one or two opportunities for limited realignments of sterling that would not undermine the credibility of the Government's commitment to a fixed exchange rate.

48. However, EMS realignments would not take place at the UK Government's convenience, to fit in with the timing of UK fiscal policy decisions. The scope for coordination of fiscal policy and exchange rate policy to achieve desired changes in the stance and balance of policy would be limited. Fiscal policy decisions would

be made in a situation of uncertainty about when any opportunity for exchange rate realignments might arise. Exchange rate realignments would be made in the knowledge that any consequential changes to fiscal policy that might be called for would have to await the next Budget.

THE FRAMEWORK OF MONETARY AND FISCAL POLICY: APPENDIX 1

CONVERGENCE OF INFLATION RATES IN THE 1960S

Some evidence on the likely behaviour of UK inflation under a fixed exchange rate can be obtained by looking at the degree of convergence of inflation in the industrial countries in the 1960s, before the breakdown of Bretton Woods. We consider here data for at consumer price inflation and manufacturing productivity in ten industrial countries. The information is summarised in the table attached.

2. For the period 1960-1970 as a whole, the cross-section correlation between average inflation and manufacturing productivity growth is 0.78. Japan, France, Italy, the Netherlands and Sweden emerge as relatively high productivity, high inflation countries; the US and Canada as the converse. Germany had rather less inflation than its productivity growth might have warranted while the UK had rather more. But as the second column of the table shows, Germany adjusted its exchange rate up during this period and the UK of course devalued. Belgium appears to be an outlier.

3. Adjusting rates of inflation for currency movements leads to a marginal improvement in the correlation across the whole sample even though three countries changed their parities during 1970 (when one would not expect to observe a full reflection in domestic inflation). Excluding these countries from the sample produces a correlation coefficient of 0.92.

4. The right hand panel of the table focuses on 1960-68 when only the UK is affected by a parity change in the final year. On the whole the evidence from this sub-sample appears to confirm the view that manufacturing productivity growth is a determinant of relative inflation under fixed exchange rates.

5. It is useful also to look at how much of these correlations is contributed by Japan with its double-digit productivity growth and markedly high inflation rate. The relevant statistics excluding Japan are as follows:

	1960-1970	1960-1968
Correlation between manufacturing productivity growth and:		
average inflation	0.528	0.691*
average inflation adjusted for exchange rate changes	0.584*	0.806*
(ditto, restricted sample)	(0.815)*	(0.760)*

*significant at 5% level

TABLE A1: INFLATION RATES AND MANUFACTURING PRODUCTIVITY

	1960-70			1960-68		
PER CENT PER ANNUM	AVERAGE INFLATION RATE	AVERAGE INFLATION RATE ADJUSTED FOR REAL-IGNMENTS	MANUFACT-URING PRODUCTI-VITY GROWTH	AVERAGE INFLATION RATE	AVERAGE INFLATION RATE ADJUSTED FOR REAL-IGNMENTS	MANUFACT-URING PRODUCTI-VITY GROWTH
United States	2.7	2.7	2.4	2.0	2.0	3.2
Japan	5.9	5.9	10.0	5.7	5.7	9.0
Germany	2.7	**3.99****	4.7	2.7	3.3	4.7
France	4.0	**2.75****	7.0	3.6	3.6	6.8
United Kingdom	4.1	2.43	3.0	3.6	**1.51****	3.4
Italy	4.0	3.98	6.8	4.0	3.98	7.2
Canada	2.7	**1.9****	3.6	2.4	0.96	3.9
Belgium	3.0	3.0	6.0	2.8	2.8	4.9
Netherlands	4.0	4.47	6.2	3.6	4.19	5.6
Sweden	4.0	4.0	6.1	3.8	3.8	5.2
Correlation with productivity	0.777*	0.788*		0.852*	0.887*	
(restricted sample)		(0.919)*			(0.867)*	

* significant at the 5% level.

** adjustment affected by change in exchange rate in last year of period.

Source: OECD.

THE FRAMEWORK OF MONETARY AND FISCAL POLICY: APPENDIX 2

CHRONOLOGY OF EMS CENTRAL RATE CHANGES

The table below sets out the details of EMS central rate changes.

		FB/FL	DKR	DM	FF	LIT	IRL	HFL
1979	23 September		-2.9	+2.0				
	30 November		-4.8					
1980				NONE				
1981	22 March (2)					-6.0		
	4 October			**+5.5**	**-3.0**	**-3.0**		**+5.5**
1982	21 February	-8.5	-3.0					
	12 June			**+4.25**	**-5.75**	**-2.75**		**+4.25**
1983	**21 March**	**+1.5**	**+2.5**	**+5.5**	**-2.5**	**-2.5**	**-3.5**	**+3.5**
1984				NONE				
1985	20 July (2)	+2.0	+2.0	+2.0	+2.0	-6.0	+2.0	+2.0
1986	**6 April**	**+1.0**	**+1.0**	**+3.0**	**-3.0**			**+3.0**
	2 August (2)						-8.0	
1987	**12 January**	**+2.0**		**+3.0**				**+3.0**

(1) Bold characters indicate general realignments.

(2) Realignments carried out without a formal ministerial meeting.

POLICY BACKGROUND TO THE 1988 BUDGET

ANNEX C

REVIEW OF THE MTFS SINCE 1984

MP1 DIVISION

December 1987

REVIEW OF THE MTFS SINCE 1984

I. INTRODUCTION AND SUMMARY

1. This paper looks at economic developments over recent years, and attempts to assess how and why they have differed from those envisaged in successive versions of the MTFS since 1984.

2. Rapid progress was made in reducing inflation from its peak in 1980 although growth performance was poor in the early 1980s: since 1983-84 the economy has been on a low inflation-steady growth plateau. Over the period 1983-87 both inflation (GDP deflator) and real output growth were relatively steady averaging about 4½ per cent and 3¼ per cent a year respectively. The latest forecast suggests that this plateau is likely to continue at least through to 1988-89. The relevant data are given in the following table:

Money GDP and the Inflation/Output Split

(per cent per annum)

	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88[2]	1988-89[2]
Money GDP[1] Growth	9.2	8.1 (8.3)	7.3 (8.6)	9.7 (8.3)	6.6 (6.5)	9.0	7.7
Output growth[1]	1.8	3.3 (3.5)	2.5 (3.8)	3.6 (2.2)	3.3 (3.2)	4.1	2.8
Inflation (GDP Deflator)	7.1	4.6	4.4	6.0	3.0	4.6	4.8

1. Figures in brackets are adjusted for the coal strike
2. Figures from October Internal Forecast adjusted for stock market fall.

3. If the forecast to 1988-89 is included there is little sign of any medium term downward trend in money GDP growth or inflation over the period since 1983-84. This is despite the declining path for money GDP growth set in successive MTFSs with the intention of further reducing inflation. To help understand developments this paper reviews policy and performance in terms of a range of indicators. It focuses on revisions to the medium term paths between successive

versions of the MTFS since 1984 and compares them against the outturn, or our latest view[1] for 1987-88 (and 1988-89). The remarks in the text are based on our interpretation of the detailed figures that appear in the set of tables at the end.

4. Money GDP has grown significantly faster than expected relative to successive versions of the MTFS since 1984. Higher output growth and higher inflation have both contributed; but output growth has dominated the inflation component in the ratio of at least 2:1. This obviously implies that the inflation/output growth split has proved considerably more favourable than expected - particularly since the end of 1985-86. Thus we have prima facie evidence of better than expected supply-side performance (supported by other more direct indicators). However, if more favourable supply-side performance were the only factor we would have tended to expect more output growth and less inflation, instead of more of both. Consequently the explanation must range wider.

5. It was always implicit that faster underlying growth of output would permit a higher growth path for money GDP. To a significant extent this has happened. But it is interesting to explore whether policy was looser than the original policy settings intended it to be. The paper argues that, if anything, fiscal policy has been tighter than expected. In part this has been a direct consequence of faster output growth resulting in revenue buoyancy. Although it is difficult to argue that fiscal policy has contributed directly to faster money GDP growth, it may have contributed indirectly by enhancing market confidence which has permitted lower interest rates for a given exchange rate. For example, compared to the 1986 (and 1987) MTFSs interest rates have been lower than expected because of growing exchange rate confidence. The net effect on monetary conditions (relative to the more recent MTFSs) may have been fairly neutral, although it would seem that the overall loosening of monetary conditions following the unexpected loss of confidence during 1984-85 has not been reversed by policy. Thus policy may have contributed a little to faster growth of money GDP relative to the 1984 MTFS. Nonetheless, it does not seem to provide any clear explanation for faster money GDP growth than expected in the subsequent MTFSs.

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[1] Internal October Forecast adjusted for the stock market fall

6. Private savings have probably been falling more than expected, which would have added to demand pressures and the growth of money GDP, although errors in the data mean we cannot be certain. On the other hand, world developments have probably been a negative influence even though unexpected falls in real oil and commodity prices have no doubt helped to ease inflation and improve supply behaviour. Finally, improved supply-side performance - for which the evidence is quite persuasive - combined with sustained earnings growth have been key factors accounting for the faster than expected growth of money GDP. On its own improved supply-side flexibility would simply have enhanced output growth and reduced inflation. Excessive earnings growth alone would have done the reverse. Together, however, and taking account of the fall in private savings, they seem to have resulted in a case of supply creating its own demand. The supply-side performance combined with rapid earnings growth has encouraged a shift in demand. This is consistent with the unexpected strength of money GDP growth consisting of both additional output growth and inflation; but with output growth being the more dominant factor.

7. Overall we can conclude that the inflationary effects of the easier monetary conditions that followed the exchange rate fall during 1984-85, of the fall in private savings and of sustained rapid earnings growth, have been mitigated by progressively better than expected supply-side performance (in part due to favourable oil and commodity price movements); with the result that unexpected output growth has come to dominate the explanation of faster money GDP growth.

8. The layout of the paper is as follows. The next section establishes the facts about money GDP growth and the split between inflation and output growth. Subsequent sections then look respectively at unexpected policy and non-policy developments. Section III covers fiscal policy, monetary policy and monetary conditions. In section IV we examine external developments in world trade and oil and commodity prices; indicators of supply-side performance; and demand side developments associated with earnings growth and shifts in private savings and investment behaviour.

II. MONEY GDP GROWTH AND THE INFLATION/OUTPUT GROWTH SPLIT

9. Table 1 shows a clear pattern of successive upward revisions to the path of money GDP growth since the 1984 MTFS. This contrasts with the downward revision to the path that occurred between the 1983 and 1984 versions of the MTFS. It is also apparent from tables 2 and 3 that in general both inflation and output growth paths have been subject to upward revisions. The exceptions are associated with the oil price shock in 1986 and the coal strike in 1984 (assumed in the 1984 MTFS to be short-lived).

10. A clearer picture of the cumulative effect of the successive revisions is given in tables 4, 5 and 6. These show:

- without exception cumulative money GDP growth over 1983-84 has been revised upwards in each successive MTFS irrespective of which forecast year we look at. Also each MTFS understated the cumulative final outturn now estimated for 1987-88 and 1988-89;

- the same can be said for output growth; and the pattern is similar for inflation but to a lesser extent, helped by the oil price fall.

11. An alternative presentation is given in table 7 which further highlights the extent of cumulative money GDP growth revisions and the relative contributions of revisions to inflation and output growth. This shows that upward revisions to output growth have been the dominant factor in upward revisions to money GDP growth for the years after 1985-86. For example, it can be seen that money GDP growth to 1987-88 (cumulative over 1983-84) is now expected to be about 7½ per cent higher than shown in the 1984 MTFS: about two thirds (5 per cent) of this is accounted for by higher output growth. Typically the output growth contribution to cumulative money GDP growth revisions has dominated the inflation contribution by a ratio of at least 2:1 (1985-86 being the obvious exception).

12. Thus faster than expected output growth has been the major contributory factor to faster than expected money GDP growth (although inflation has also on average been higher than expected). In other

words the inflation/output growth split of money GDP has proved considerably more favourable than previously expected - particularly since the end of 1985-86.

III. MACROECONOMIC POLICY AND MONETARY CONDITIONS

13. **Fiscal Policy:** Substantial progress towards lowering the PSBR (including and excluding privatisation proceeds) as a percentage of GDP commenced in 1985-86 (see table 8). Without doubt the fiscal deficit has been reduced significantly faster and further than previously planned. In part this is due to faster than expected growth of output; for example we could reasonably explain most of the reduction in 1987-88 relative to the 1984 MTFS in these terms. But it is clear that in successive editions of the MTFS there has been a notable failure to catch up with the pace of reduction of the PSBR.

14. General Government Expenditure (excluding privatisation proceeds) has fallen as a percentage of GDP and is expected to continue falling more or less in accordance with previous plans (see table 9). In cash terms previous GGE plans have, of course, been overshot, but the ratio to GDP has been rescued by faster than expected money GDP growth. A second way in which higher output growth has worked to arrest slippage against previous plans is through its direct impact on GGE, for example through lower unemployment benefits and higher public corporation surpluses.

15. The counterpart to the PSBR and GGE picture is a tax burden path that turned out unexpectedly high in 1986-87 and is currently expected to do so again in 1987-88 (see table 10). In part this is due to the 1987 Budget decision to take part of the benefit of unexpected revenue buoyancy in a lower PSBR. The result has been that the tax burden has not fallen as intended in earlier MTFSs. This is even more obvious for the non-oil tax burden (see table 11), which increased to compensate for the loss of oil revenues in 1986-87, and is currently expected to turn out higher again in 1987-88.

16. **Monetary Policy and Conditions:** The indicators in this area are less easy to interpret. The path for MO is not now expected to show much hint of the downward trend that characterised the 1984 MTFS (see table 12). The only discernible pattern seems to be that the 1985 MTFS was fairly close to what we now know or expect, but the later

MTFSs were too optimistic. In part this reflects the pattern of short term interest rates (see table 14), as we would expect to see an inverse relationship between them and MO. With regard to broad money (M3) growth table 13 shows the extreme optimism of the earlier MTFSs and the familiar fact that actual growth has consistently overshot previous expectations to a progressive extent with each year.

17.. Nominal short term interest rates have been much higher than expected in the 1984 MTFS (with a less marked sign of downward trend); pretty much the same as in the 1985 MTFS; and lower than expected in the 1986 and 1987 MTFSs (see table 14). A similar pattern is evident for real short term interest rates (table 15). But the increase in UK short rates in 1985-86 went against the trend of world interest rates (table 17), and the fall in 1986-87 did not reflect the full extent of the fall in world interest rates. The result was a significant unexpected widening in the differential of UK over world rates in 1985-86 that carried through to 1986-87 (table 18).

18. Bringing the exchange rate into the frame fills out the picture (see table 16). The 1984 MTFS appears to have been over optimistic on market confidence in sterling. In response to the fall of sterling during 1984-85 monetary policy was tightened ie interest rates were raised absolutely and relative to world rates. Nevertheless, on balance monetary conditions probably remained easier than envisaged in the 1984 MTFS (and have continued to do so). The 1985 MTFS made a fairly good judgement about market confidence - the differences in the exchange rate path relative to the outturn being explained by a higher UK/world interest rate differential, and the oil price effect. The 1986 MTFS seems to have been too pessimistic about exchange market confidence: the exchange rate has turned out much as expected, despite a narrower interest rate differential than expected. The apparent recovery of market confidence since 1985-86 can be partly associated with policy - especially the tightening of both fiscal and monetary policies in early 1985 and the prudent Budgets of 1986 and 1987. All other things being equal, this could have led to tighter monetary conditions than envisaged in the 1985 to 1987 MTFSs. However, the opportunity has been taken to allow interest rates to fall (easier monetary policy) which has tended to stabilise the exchange rate. The overall result is that monetary conditions have probably remained much as expected (except relative to the tighter position envisaged in the 1984 MTFS), although perhaps a little easier in 1986-87.

19. The conclusion from this discussion of policy is that it is difficult to find a clear explanation for faster than expected money GDP growth in terms of looser policy settings. Arguably the interest rate response to a favourable swing of confidence in recent years has broadly neutralised the effect on monetary conditions. More obviously the overall loosening of monetary conditions following the loss of confidence during 1984-85 (and relative to the 1984 MTFS) has not been reversed by policy.

20. Although policy has not been significantly looser than intended when judged in terms of policy settings, it was not sufficiently tight to deliver the original objectives for inflation. Various factors, discussed in the next section, put upward pressure on money GDP growth, and policy was not sufficiently tight to prevent them pushing up inflation. The definition of policy stance in terms of whether inflation deviated from the MTFS path leaves no escape from the conclusion that policy was looser than intended even though it was not loose relative to the original settings. On the other hand it was always implicit that a faster growth of output would permit a higher growth path for money GDP. To a significant extent this is what has happened.

IV. NON-POLICY DEVELOPMENTS

21. **External Factors:** World trade growth has generally been appreciably weaker than expected (see table 19), and so would not seem to have contributed to faster than expected money GDP growth. It also seems unlikely that oil price changes (see table 20) have contributed. Following the big shock in early 1986 the exchange rate was allowed to depreciate offsetting at least some of the beneficial effect on inflation. But inflation was clearly lower than expected in 1986-87 and it is difficult to believe this had nothing to do with oil prices. Non-oil output probably received some boost with oil output little changed, at least in the short term. On balance the net effect on money GDP growth seems likely to have been small - if anything slightly restraining it. Unexpected commodity price changes (see table 21) are another influence that has probably taken pressure off inflation - perhaps quite substantially. A supply-side benefit to output also seems probable, but again this does not contribute clearly towards an explanation of unexpected upward pressure on money GDP growth reflecting both output growth and inflation.

22. **The Supply-Side:** Indirect evidence on better than expected supply-side performance is testified by the inflation/output growth split having been much more favourable than previously expected (as discussed in section II). The degree of improvement points clearly towards an unexpected outward shift or a favourable tilt of the supply curve. Further evidence comes from labour productivity comparisons (see table 22) which show that the 1984 and 1985 MTFSs sharply underestimated the trend rate of growth. Profit margin comparisons (see table 23) also corroborate the picture of improved supply-side performance. With regard to trade performance unexpected improvement is more obvious with respect to exports than imports. Import penetration in manufactures (see table 24) has risen marginally less than expected. This is more clearly indicative of better performance once we allow for faster than expected output growth (which would normally be expected to add further to import penetration). However, comparisons in terms of total imports as a percentage of total final expenditure are more ambiguous. On the other hand the UK share in main country exports of manufactures (see table 25) has fairly consistently exceeded expectations.

23. The only obvious aspect of supply-side performance that has turned out worse than expected is earnings growth (see table 26). This has failed to show any downward adjustment or conformity with the trend decline projected in successive MTFSs. Maybe the persistently high earnings growth has itself to some extent spurred productivity growth, which along with other favourable supply-side influences has in turn enabled further earnings growth to be accommodated. But productivity growth has more than compensated in the sense that unit labour costs have on average been somewhat lower than expected, helped by only small rises in non-wage labour costs. Moreover, monetary policy has allowed exchange rate movements that have permitted this to be translated into better than expected competitiveness (relative unit labour costs - see table 27).

24. Overall, supply-side responses would seem to have improved sufficiently to accommodate rapid earnings growth, while at the same time leading to higher than expected output growth. The end result is perhaps consistent with faster than expected money GDP growth showing up rather more in output growth than inflation.

25. <u>**Demand Pressures:**</u> The high degree of unexpected earnings growth coupled with favourable supply-side performance (which has given rise to unexpectedly high employment) have made an important contribution to creating additional nominal demand. There also appears to be something in the argument that unexpected year to year falls in the personal sector savings ratio (see table 28) between 1984 and 1986 may have added to domestic demand pressure. An examination of the recorded figures from total private sector savings (see table 29) suggests no obvious pattern, but there has been an increasingly negative residual in the national accounts which suggests that "true" private savings have probably been falling as much as or more than expected. This could therefore have contributed to the unexpected domestic demand growth. On the other hand, there is little evidence that the growth in the share of private sector domestic investment was underestimated in the MTFSs (see table 30).

TABLES

NB All figures in the MTFS rows of the tables are forecasts/ projections, except those in brackets in certain tables which are estimated outturns as at the time.

Figures in the Adjusted October Forecast lines are latest estimates of outturns up to and including 1986-87 and forecasts thereafter.

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Table 1: Money GDP Growth (%)

	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89
1983 MTFS	7.9	8.5	7.6	6.6		
1984 MTFS		7.9	6.8	6.1	5.6	5.2
1985 MTFS			8.4	6.6	5.7	5.0
1986 MTFS				6.8	6.4	6.0
1987 MTFS					7.5	6.4
ADJ OCT FORECAST	8.1(8.3*)	7.3(8.6*)	9.7(8.3*)	6.6(6.5*)	9.0	7.7

*Coal strike adjusted figures

Table 2: Inflation: Growth of GDP (Market Price) Deflator (%)

	1984-85	1985-86	1986-87	1987-88	1988-89
1984 MTFS	4.6	4.2	3.9	3.5	3.1
1985 MTFS		5.0	4.4	3.5	2.9
1986 MTFS			3.7	3.8	3.3
1987 MTFS				4.4	4.0
ADJ OCT FORECAST	4.4	6.0	3.0	4.6	4.8

Table 3: Real GDP (at Factor Cost) Growth (%)

	1984-85	1985-86	1986-87	1987-88	1988-89
1984 MTFS	3.2	2.4	2.0	2.0	2.0
1985 MTFS		3.5	1.9	2.0	1.9
1986 MTFS			2.9	2.4	2.5
1987 MTFS				2.8	2.4
ADJ OCT FORECAST	2.5(3.8*)	3.6(2.2*)	3.3(3.2*)	4.1	2.8

*Coal strike adjusted figures

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Table 4: Money GDP Cumulative Growth Over 1983-84(%)

	1984-85	1985-86	1986-87	1987-88	1988-89
1984 MTFS	7.9	15.2	22.3	29.1	35.8
1985 MTFS	(6.8)	15.8	23.4	30.4	37.0
1986 MTFS	(6.9)	(17.2)	25.1	33.1	41.1
1987 MTFS	(7.4)	(17.8)	(25.0)	34.4	42.9
ADJ OCT FORECAST	7.3(8.6*)	17.6(17.5*)	25.4	36.6	47.2

*Coal strike adjusted figures

Table 5: Inflation: Cumulative Growth of GDP Deflator Over 1983-84 (%)

	1984-85	1985-86	1986-87	1987-88	1988-89
1984 MTFS	4.6	9.0	13.2	17.2	20.8
1985 MTFS	(4.4)	9.6	14.4	18.4	21.9
1986 MTFS	(4.1)	(10.5)	14.5	18.9	22.9
1987 MTFS	(4.3)	(10.8)	(14.3)	19.3	24.1
ADJ OCT FORECAST	4.4	10.7	14.0	19.2	25.0

Table 6: Real GDP Cumulative Growth Over 1983-84 (%)

	1984-85	1985-86	1986-87	1987-88	1988-89
1984 MTFS	3.2	5.7	7.8	9.9	12.1
1985 MTFS	(2.2)	5.8	7.8	9.9	12.0
1986 MTFS	(2.6)	(6.1)	9.2	11.8	14.6
1987 MTFS	(2.9)	(6.2)	(9.2)	12.2	14.9
ADJ OCT FORECAST	2.5(3.8*)	6.2(6.1*)	9.7	14.2	17.4

*Coal strike adjusted figures

Table 7: Cumulative Outturn/Adjusted October Forecast LESS Cumulative Growth in MTFSs (both relative to 1983-84 base)*

	(percentage points)				
	1984-85	**1985-86**	**1986-87**	**1987-88**	**1988-89**
Money GDP Growth:					
Revision relative to					
1984 MTFS	0.7	2.3	3.1	7.5	11.4
1985 MTFS		1.7	2.0	6.2	10.2
1986 MTFS			0.3	3.5	6.1
1987 MTFS				2.2	4.3
Inflation Contribution:					
Revision relative to					
1984 MTFS	-0.2	1.8	0.9	2.2	4.7
1985 MTFS		1.2	-0.4	0.9	3.5
1986 MTFS			-0.5	0.3	2.4
1987 MTFS				-0.1	1.0
Output Growth Contribution:					
Revision relative to					
1984 MTFS	0.6	0.4	2.2	5.1	6.6
1985 MTFS		0.3	2.2	5.1	6.7
1986 MTFS			0.6	2.9	3.5
1987 MTFS				2.4	3.1

*Shortfall of cumulative MTFS path growth rate against latest outturn/forecast (where the outturn is coal strike adjusted). The money GDP growth figures can be derived directly from Table 4, and the decomposition into inflation and output growth contributions follows from the figures in Tables 5 and 6 after allowing for multiplicative interaction.

Table 8: PSBR Excluding Privatisation Proceeds as Percentage of GDP

	1984-85	1985-86	1986-87	1987-88	1988-89
1984 MTFS	2.8	2.9	2.4	2.3	2.2
1985 MTFS		2.7	2.6	2.3	2.3
1986 MTFS			3.1	2.9	2.7
1987 MTFS				2.2	2.1
ADJ OCT FORECAST	3.7(2.8*)	2.3(2.1*)	2.0	0.8	-0.2

*Coal strike adjusted figures

Table 9: GGE Excluding Privatisation Proceeds as a Percentage of GDP

	1984-85	1985-86	1986-87	1987-88	1988-89
1984 MTFS	45.2	44.0	43.0	41.8	40.7
1985 MTFS		45.8	44.0	42.9	41.8
1986 MTFS			44.0	42.9	41.6
1987 MTFS				43.4	42.4
ADJ OCT FORECAST	46.2	44.6	44.0	42.1	41.3

Table 10: Tax Burden (Total Taxes plus NICs after Fiscal Adjustment as a Percentage of GDP)

	1984-85	1985-86	1986-87	1987-88	1988-89
1984 MTFS	38.9	38.4	37.4	36.7	35.8
1985 MTFS		39.0	36.3	37.1	36.3
1986 MTFS			37.6	36.8	36.0
1987 MTFS				38.0	37.3
ADJ OCT FORECAST	39.1	38.5	38.0	38.2	38.4

Table 11: Non North Sea Tax Burden (Non-North Sea Taxes plus NICS after Fiscal Adjustment as a Percentage of Non-North Sea Money GDP(A))

	1984-85	1985-86	1986-87	1987-88	1988-89
1984 MTFS	38.0	37.6	36.7	36.0	35.0
1985 MTFS		37.8	36.9	36.4	35.8
1986 MTFS			36.9	36.6	35.7
1987 MTFS				37.8	37.1
ADJ OCT FORECAST	37.9	37.0	37.5	38.0	38.2

Table 12: MO Growth (Percentage Change of Average Level Outstanding During Year)

	1984-85	1985-86	1986-87	1987-88	1988-89
1984 MTFS	7.0	5.7	5.6	4.6	3.3
1985 MTFS		4.6	4.4	5.5	4.5
1986 MTFS			2.6	3.9	4.9
1987 MTFS				4.0	3.4
ADJ OCT FORECAST	5.5	4.3	4.3	5.3	4.9

Table 13: M3 Growth (End Year to End Year Percentage Change)

	1984-85	1985-86	1986-87	1987-88	1988-89
1984 MTFS	8.8	8.2	8.0	7.0	6.0
1985 MTFS		8.0	7.2	6.2	5.2
1986 MTFS			11.3	11.4	9.7
1987 MTFS				14.4	13.1
ADJ OCT FORECAST	11.9	16.9	19.0	20.1	11.8

Table 14: Short Term Interest Rates (3 month Interbank Rate, %)

	1984-85	1985-86	1986-87	1987-88	1988-89
1984 MTFS	9.7	8.7	7.8	6.8	6.1
1985 MTFS		11.9	10.1	9.3	8.5
1986 MTFS			12.1	11.3	9.7
1987 MTFS				10.5	10.3
ADJ OCT FORECAST	10.9	12.1	10.5	9.2	9.0

Table 15: Real Short Term Interest Rates (3 month Interbank Rate less Backward Consumer Price Inflation, (%))

	1984-85	1985-86	1986-87	1987-88	1988-89
1984 MTFS	5.1	4.0	3.5	3.1	3.0
1985 MTFS		7.5	6.2	6.0	5.8
1986 MTFS			8.1	7.9	5.8
1987 MTFS				6.7	7.0
ADJ OCT FORECAST	5.9	7.1	7.4	6.1	5.0

Table 16: Effective Sterling Exchange Rate (1975 = 100)

	1984-85	1985-86	1986-87	1987-88	1988-89
1984 MTFS	83.5	83.4	82.5	81.3	80.2
1985 MTFS		73.5	73.9	72.4	72.0
1986 MTFS			73.3	70.6	69.2
1987 MTFS				70.4	68.7
ADJ OCT FORECAST	76.2	79.0	71.5	73.4	73.8

Table 17: World Short Term Interest Rates: G7 (excluding UK) Weighted Average (%)

	1984-85	1985-86	1986-87	1987-88	1988-89
1984 MTFS	8.6	8.1	8.0	8.0	8.0
1985 MTFS		8.9	7.6	7.2	7.3
1986 MTFS			6.7	5.9	5.5
1987 MTFS				6.0	6.4
ADJ OCT FORECAST	9.5	8.0	6.3	6.5	6.6

Table 18: UK/World Short Term Interest Rate Differentials (Table 14 less Table 17), Percentage Points

	1984-85	1985-86	1986-87	1987-88	1988-89
1984 MTFS	1.1	0.6	-0.2	-1.2	-1.9
1985 MTFS		3.0	2.5	2.1	1.2
1986 MTFS			5.4	5.4	4.2
1987 MTFS				4.5	3.9
ADJ OCT FORECAST	1.4	4.1	4.2	2.7	2.4

Table 19: World Trade Growth (Weighted World Imports of Goods - UK Weights)(%)

	1984	1985	1986	1987	1988
1984 MTFS	4.9	5.8	5.6	4.6	3.6
1985 MTFS		4.6	4.7	4.5	5.0
1986 MTFS			4.9	4.7	4.3
1987 MTFS				3.0	4.3
ADJ OCT FORECAST	7.1	4.0	4.0	3.1	3.3

Table 20: Real Sterling Oil Price (1984-85 Outturn = 100)
(Sterling Oil Price/Sterling Manufactured Export Prices)

	1984-85	1985-86	1986-87	1987-88	1988-89
1984 MTFS	90.1	82.6	81.5	81.4	81.4
1985 MTFS		93.8	81.1	74.6	73.8
1986 MTFS			43.8	41.9	41.0
1987 MTFS				37.7	36.8
ADJ OCT FORECAST	100	83.5	35.8	43.0	40.7

Table 21: Real Commodity Prices, Percentage Change
(UK UVI for Imports of Basic Materials/UK UVI for Manufactured Exports)

	1984	1985	1986	1987	1988
1984 MTFS	6.9	2.2	0.9	1.4	0.7
1985 MTFS		1.6	-6.0	0.7	2.6
1986 MTFS			-10.8	3.3	-3.7
1987 MTFS				-1.6	6.6
ADJ OCT FORECAST	6.5	8.8	-15.5	-1.8	-0.5

Table 22: Whole Economy Labour Productivity Growth (%)

	1983	1984	1985	1986	1987	1988	6 year average
1984 MTFS	(2.8)	2.4	1.8	1.3	1.4	1.4	1.8
1985 MTFS		(1.2)	2.2	0.9	0.9	0.9	1.6
1986 MTFS			(2.6)	2.2	1.5	1.5	2.2
1987 MTFS				(2.1)	2.0	1.4	2.2
ADJ OCT FORECAST	4.0	1.6	2.2	2.4	2.7	1.1	2.3

Table 23: Domestic Profit Margins in Manufacturing, Percentage Change

	1984	1985	1986	1987	1988
1984 MTFS	1.0	0.3	-0.3	0.2	-0.2
1985 MTFS		-0.9	0.3	-0.9	0.1
1986 MTFS			4.1	-0.1	1.4
1987 MTFS				2.3	0.9
ADJ OCT FORECAST	0.7	2.0	4.9	3.3	1.6

Table 24: Import Penetration in Manufactures (Percentage of Total Demand for Manufactures met by Imports)

	1984	1985	1986	1987	1988
1984 MTFS	34.9	35.9	36.6	37.7	38.9
1985 MTFS		35.7	36.8	38.1	39.7
1986 MTFS			36.5	37.3	37.7
1987 MTFS				37.0	37.8
ADJ OCT FORECAST	35.1	35.6	36.5	37.3	38.7

Table 25: Share of UK in Main Countries Manufactured Exports (Measured at Constant Prices): Index, 1984 = 100

	1984	1985	1986	1987	1988
1984 MTFS	100	100.0	100.3	100.8	101.6
1985 MTFS		100.9	100.5	99.5	99.2
1986 MTFS			103.7	104.2	104.5
1987 MTFS				106.9	107.7
ADJ OCT FORECAST	100	104.2	104.0	108.8	108.8

Table 26: Private Sector Earnings Growth (%)

	1984	1985	1986	1987	1988
1984 MTFS	7.9	6.6	5.9	4.9	3.9
1985 MTFS		7.7	6.9	4.9	3.7
1986 MTFS			8.2	6.3	4.8
1987 MTFS				7.0	6.4
ADJ OCT FORECAST	5.9	7.9	8.1	8.1	7.8

Table 27: Competitiveness of Manufactures (Relative Unit Labour Costs, 1980 = 100)

	1983	1984	1985	1986	1987	1988
1984 MTFS	(97.1)	98.5	97.0	94.3	90.0	85.0
1985 MTFS		(94.1)	90.4	92.5	90.8	85.6
1986 MTFS			(97.4)	91.2	88.7	85.4
1987 MTFS				(83.0)	80.5	79.8
ADJ OCT FORECAST	92.6	90.3	92.1	83.4	83.3	84.8

Table 28: Personal Sector Saving Ratio (Personal Sector Saving as a Percentage of Personal Sector Disposable Income)

	1983	1984	1985	1986	1987	1988
1984 MTFS	(9.5)	8.7	9.1	8.8	7.8	6.9
1985 MTFS		(10.7)	11.1	11.2	10.8	10.2
1986 MTFS			(11.3)	12.1	11.8	11.5
1987 MTFS				(10.8)	10.8	10.0
ADJ OCT FORECAST	10.7	11.2	10.4	9.1	9.1	9.2

Table 29: Domestic Private Sector Savings as a Percentage of Gross National Disposable Income*

	1983	1984	1985	1986	1987	1988
1984 MTFS	(14.7)	15.6	15.2	14.3	14.1	13.9
1985 MTFS		(17.4)	18.8	17.7	17.8	17.6
1986 MTFS			(19.0)	19.2	18.9	19.0
1987 MTFS				(17.1)	17.9	17.1
ADJ OCT FORECAST	16.3	17.9	18.1	17.5	18.0	17.0

*Small errors arise owing to minor technical problems with the MTFS figuring, but they should not affect comparison between MTFS paths or outturn. The figures are not adjusted to make allowance for the national accounts residual error problem.

Table 30: Domestic Private Sector Investment (including Stockbuilding) as a Percentage of Gross National Disposable Income)

	1983	1984	1985	1986	1987	1988
1984 MTFS	(10.8)	11.8	12.4	12.3	12.8	13.0
1985 MTFS		(12.6)	13.2	13.7	14.0	14.8
1986 MTFS			(13.3)	13.8	14.3	14.1
1987 MTFS				(13.7)	14.5	14.4
ADJ OCT FORECAST	11.5	12.8	13.4	13.5	14.0	14.3

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FROM: SIR T BURNS
DATE: 18 DECEMBER 1987

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Mr Anson
Sir G Littler
Mr Cassell
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr S Davies
Mr Allan
Mr C M Kelly
Ms Turk
Mr Franklin
Mr Cropper
Mr Tyrie
Mr Call

Mr Battishill (I/Rev)
Mr Unwin (C & E)

POLICY BACKGROUND TO THE 1988 BUDGET

I attach my Chevening paper.

2. It is in the form of a main paper with three substantial annexes. The annexes contain some of the supporting evidence but are self-standing and are optional reading.

3. The main conclusions of the paper are as follows:

(i) Over the past few years the UK economy has been performing well. UK growth and inflation have been much the same as they were during the 1950s and 1960s in contrast to the main industrial countries as a whole where output growth remains disappointing. There are signs of a return to the pattern of the 1950s and 1960s with a number of other indicators: profitability,

productivity and the PSBR. Even so money GDP has been growing faster than set out in successive editions of the MTFS. Most of the excess has been due to faster growth of real output; but part is due to higher inflation.

(ii) There is some evidence that the underlying supply performance of the economy has improved: faster growth of manufacturing productivity, improved rates of return and a better trade performance.

(iii) There is no evidence that fiscal policy has been easier than intended. Even allowing for faster growth of output and privatisation proceeds the PSBR has turned out below expectations.

(iv) The evidence on monetary policy is more ambiguous. Compared to the 1984 MTFS the exchange rate has been lower, suggesting an easing of monetary conditions. Compared to later editions there is no clear pattern.

(v) The implication is that the setting of policy permitted a faster growth of money GDP than expected. To the extent that faster output growth has been sustainable a higher path for money GDP growth has been justified. But to achieve the original objectives for inflation tighter fiscal or monetary policy would have been necessary. One of the mechanisms leading to faster money GDP growth has been the sustained growth of earnings. Faster productivity growth has been reflected in earnings increase rather than lower inflation.

(vi) If monetary policy is conducted to maintain the DM/£ exchange rate at around the present levels we expect to see downward pressure on money GDP as well as inflation.

(vii) But if interest rates are directed towards the exchange rate they have a more limited role with regard to

domestic monetary conditions. This could cause conflicts for interest rate policy.

(viii) If improved confidence, perhaps because of the Deutschemark link, leads to pressure for lower interest rates and so threatens domestic monetary conditions, there would be scope for stabilising sterling at a higher DM/£ rate.

(ix) The October forecast, updated for the fall in share prices, shows public expenditure falling as a share of GDP; a negative PSBR of about 1 per cent of GDP after allowing for a fiscal adjustment of £6 billion over the next two years; and a relatively flat profile for non-North Sea taxes as a share of GDP, after fiscal adjustment.

(x) The negative PSBR points to a further sharp decline in the public sector debt/income ratio. The ratio of net interest payments to GDP is projected to decline. A decline in the debt ratio can be justified in terms of privatisation proceeds, North Sea tax revenues and public pension liabilities.

(xi) There is no net financing of the PSBR required even if privatisation proceeds are ignored. On the other hand the flow of private savings is projected to be below the level of private sector investment. This is an unusual combination. Private sector savings have been falling largely because of inflation, but there are other temporary factors at work, including pension contribution 'holidays' and the effect of financial liberalisation. Private sector investment is rising because of the transfer of investment from the public sector (particularly housing and the privatisation programme), higher profitability and the higher levels of capacity utilisation.

(xii) The implication is that the private sector will have to finance part of its investment from overseas, unless the PSBR is cut back further. Given the small size of the current account deficit in relation to the stock of net overseas assets, the availability of world financial capital, the improved rate of return and the possibly temporary nature of the fall in private sector savings there is no strong case for a further reduction of the PSBR compared to the projections.

(xiii) Clearly there is substantial uncertainty about the figures for public sector finances. The scale of the tax receipts has been surprising. We cannot be sure that they are permanent. Given the very rapid growth of output this year there must be some risk that part is cyclical. On the other hand it may reflect the gearing of tax receipts in response to the faster underlying growth rate.

(xiv) On balance we conclude that the projections of public finances are sustainable with the assumed fiscal adjustments in place. Even so there is not as much room to spare as might be suggested by the crude PSBR figure. The declining debt/income ratio has to be set against the pattern of privatisation proceeds, North Sea taxes and public pension liabilities; the low savings ratio combined with the strength of private sector investment means that any further increase in public sector borrowing may have to be financed by larger overseas capital flows; and although the general buoyancy of tax revenues looks permanent there is a substantial margin of error.

T BURNS

21 DEC 1987

REED INTERNATIONAL PLC

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CHIEF EXECUTIVE

ECONOMIC SECRETARY	
REC'D	22 DEC 1987
ACTION	Mr P.R.H. Allen - C&E
COPIES TO	PS/Chancellor PS/PMG Mr Culpin, Miss Sinclair, Mr Cropper, Mr Tyrie PS/C&E

18th December 1987

Mr Peter Lilley MP
Economic Secretary to the Treasury
H.M. Treasury
Treasury Chambers
Parliament Street
LONDON SW1P 3AG

Dear Mr Lilley

I wrote to your colleague, Peter Brooke last week with reference to VAT and the 1988 budget. I understand that you are dealing with VAT matters and therefore I enclose a brief submission by Reed International relating to the Budget.

Reed International are very anxious that the Government should maintain its current policy of applying a zero-rating for VAT purposes on books, magazines, newspapers and journals. Reed International would be affected throughout its constitutent parts by any change in the tax treatment of these items; but we believe additionally that such a change would not be in the interests of Britain either.

In this context we understand that there is considerable pressure in Europe to harmonize the application of VAT across the Community. It seems that this would involve the removal of a zero-rating option, and its replacement by a lower rate band of 4-9%.

Given the UK Government's commitment to zero-rating, we would strongly advocate the extension of this lower rate band to encompass a zero-rate.

Yours sincerely

Peter Davis

P J Davis
Chief Executive

Enc.

P.S. I have now had your letter and understand your position

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REED INTERNATIONAL: BUDGET SUBMISSION.

PROFILE OF THE COMPANY

Reed International is a major international company operating principally in the United Kingdom and North America. Its annual turnover is approximately £2 billion and it employs some 32,000 people. In the last five years profits have trebled thanks to restructuring and focusing on core businesses.

Reed International's interests are publishing and packaging/paper - the major business being publishing which produces 60% of profits.

Reed International is the largest publisher in the UK. It has a significant position in:

i) Adult book publishing through the Octopus Publishing Group (Octopus Books, Hamlyn, Heinemann and Mitchell Beazley) and Butterworth (legal, scientific, medical and technical);

ii) Children's books through Octopus, Hamlyn, Heinemann and Brimax, and educational publishing through Heinemann and Ginn;

iii) Business Magazines through Reed Business Publishing;

iv) Women's interest magazines through IPC and Carlton;

v) Consumer magazines through IPC;

vi) Paid-for and free newspapers with 115 titles through Reed Regional Newspapers;

vii) Data-base publishing, through ABC Travel Guides, ICC and Online.

THE ECONOMIC IMPACT OF VAT ON PUBLISHING

The unique position of Reed International as a publisher of books, journals, magazines and newspapers makes the company particularly vulnerable to decisions relating to the abandonment of zero-rated VAT in the UK. Any decision which could impose an additional taxation of 15% on our products overnight would have considerable impact on all our businesses.

Reed International companies are members of the following trade associations: The Periodical Publishers' Association, The Publishers Association, The Newspaper Society and the Association of Free Newspapers each of whom will now have made representations to HM Treasury on behalf of the industry as a whole. Reed International fully supports the case made out by these associations, but believes that there are additional points (especially of a commercial nature) which should be raised. Naturally, assessments of the impact of an imposition of VAT must rest on certain assumptions. The first is that the UK standard rate of 15% would apply; the second relates to the subsequent trading consequences. Our assumptions of the latter are based upon sound business judgment and considerable, successful experience of the operations of our market places.

Magazines & Newspapers - Reduction in sales, revenue and employment

No branch of Reed International would choose to absorb any imposed VAT. This would directly affect the pre-tax profitability of companies with a consequent serious effect upon growth and future trading. As an example, IPC Magazines estimate that absorption of VAT would lead to a loss of direct revenue of some £12.7 million - which on a total estimated turnover for 1988-9 of £164 million is a significant amount.

In the magazine publishing field, we have estimated that imposition of 15% VAT would lead to a reduction in copy sales of some 10%, and a reduction in advertising revenue of 5%. The direct consequence would be that those titles with very narrow margins would no longer be viable and would probably close. Those which were in a better position would need to trim costs to remain competitive (especially in the face of developing competition from German imports).

The net consequence would be loss of employment and substantial redundancy costs which would have to be borne. For the 10 titles of Prospect Magazines alone, the latter could be as high as £600,000 on a turnover of £19.6 million. For Reed Regional Newspapers, redundancy costs could be £3.5 million out of a turnover of £87 million.

The impact on the market

These closures and redundancies are liable to have a sharp effect upon the market itself. Recent years have seen a large increase in numbers of titles published, covering a wide spectrum of consumer interests. The imposition of VAT would not only cut back on current titles, but would hamper the development of new magazines and newspapers. While Reed International may, by virtue of its size, weather such a storm successfully, others would not. Competition would decrease; consumer choice would

be reduced. In the long-term this would probably not benefit Reed since it is competition which maintains discipline for a company, and stimulates its development.

Regional Newspapers - Paid-for and free

In the field of newspapers, Reed International has substantial regional interests, both in paid-for newspapers and free newspapers. It is not clear to Reed how VAT could be levied on a free newspaper, since it has no cover charge, and its revenue comes solely from advertising, on which VAT is already levied.

To levy VAT on, say, a notional cover charge would lead to estimated increases in advertisement rates of up to 20%. Advertisers in Reed International free newspapers tend to be smaller companies who have few such outlets because of the relative expense of national newspapers, television and radio advertising. Any increase in rates will be particularly damaging to a sector of the economy which the Government has rightly sought to nurture - and therefore damaging to the communities to which smaller companies are so crucially linked.

On the other hand, if no additional VAT is levied on free newspapers, their paid-for competitors would be placed at a substantial disadvantage. From Reed International's point of view, such a distortion would disrupt business planning and place paid-for titles in jeopardy with the inevitable consequence of job losses.

Books - Reduction in sales to limited budget purchasers

As far as book publishing is concerned, a different type of market operates. It is true that for parts of Reed, such as Butterworths, a proportion of sales are to customers who are VAT registered. Nevertheless, Reed sell a substantial number of books to organisations, such as libraries and educational establishments, which have fixed budgets and are not VAT registered, and to individuals on fixed incomes, such as students. Any 15% VAT imposition is likely to lead to 15% fewer sales with a serious impact upon Reed's trading position. Similar factors apply in sales to the general public.

Reed is particularly concerned about the area of general education. Reading is an essential part of the educational process; any reduction in the availability of books, to children in particular, or any unwarranted increase in the price, will place a constraint on the supply of books which would not only be damaging to the book industry in the short term, but more importantly, will restrict the development of childrens' educational skills. This applies equally to the consequences of price increases to public centres of reference such as libraries.

Exports - Economic significance

A fall in business activity is certain to put pressure on prices, and this would damage the competitive position of Reed exports, which are a vital part of the Company's trade.

A significant proportion of material exported by Reed relates to British scientific, technological, legal and business expertise. Without resorting to any unquantifiable suggestions relating to British culture, it is not unreasonable to say that Reed International plays an active role in promoting British ideas abroad in key areas. Anything that damages the levels of these exports would have an impact well beyond the trading figures of Reed International.

Social effects

There are a substantial number of additional social arguments which could be raised in support of the maintenance of the current VAT position. Not least among these are the effect of potential closures of regional newspaper titles on isolated communities, and the damaging educational consequences of a 15% increase in the price of children's books. These issues have been raised elsewhere and so will not be treated in detail here.

SUMMARY

The purpose of this submission is to underline the overall effect that such a taxation change would have on a publishing company with a broad spectrum of trading interest. The accompanying papers act as a sample to illustrate the concern of Reed International.

VAT ON PERIODICALS

£m	Reed Regional Newspapers	IPC Magazines	Reed Business Publishing	Butterworth Scientific	Butterworth Legal
Reduction in Turnover	4.5	23.2	5.4	0.3	0.2
Savings	-	15.5	5.0	-	-
Reduction in Profits	-	7.7	0.4	-	-
Job Losses (No.)	425	238	50	-	-
Redundancy/ Closure Costs	4.5	2.9	0.6	-	-
Titles	20	20	3	-	-

VAT ON PERIODICALS

	REED REGIONAL NEWSPAPERS		IPC MAGAZINES		
		£m		£m	
TURNOVER	Estimate 87/8	87.0	Plan 88/89	163.8	
	Reduction		Closures		
	Cover Price	0.5	Circulation 8.2	(11.8))	)
	Advertisement	4.0	Ad. Rev 3.6		)
			10% Circulation)		) 23.2
			5% Ad. Rev)	(11.4)	)
			Revised T/o	140.6	
SAVINGS			Paper 4.25)		)
			Printing 3.5)	15.5	)
			Distrib. .9)		) 9.65 = Outside
			Pub. 1.0)		) Purchases
			Emp. Cost 1.25)		
			" " 2.6)		
			Ed. 2.0)		
PRE-TAX PROFIT LOSS			PROFITS 88/89		)
			REDUCED BY	7.7	) BEFORE RED.
			(23.2-15.5)		) COSTS
JOB LOSSES	Editorial		Closures	88	
	250-300 say	275	Staff cutting	150	
	Daily News	150		238	
		425			
REDUNDANCY	Editorial	3.5m		2.85	
	Daily News				
	(Closure not all Red.)	1.0m			
TITLE CLOSURES	At risk	20 titles	Regular titles	11	
			Specials	6	
			Annuals	3	

Assuming 15% VAT on paid for titles

REED BUSINESS PUBLISHING

£m

88/89

Advertising	9.8	
Circulation	9.8	
	19.6	
Ad less 5%	0.5)	1.5
Circ. less 10%	1.0)	
	18.1	
Closures	3.9	3.9
	14.2	5.4

Savings	
Outside	.8
Closures	4.1
	4.9

PROFITS 88/89	)	
REDUCED BY	0.4)	BEFORE RED.
5370-4950	420)	COSTS

Closures	40
Central Services	10
	50

Closures	480
Central Services	120

Regular titles	3

BUTTERWORTH SCIENTIFIC

£m

88/89 T/o	11
88/89	
Reduction in T/o	
Journals	(0.1)
Books	(0.2)
	0.3

Reduction in T/o £0.34m

BUTTERWORTH LEGAL

£m

86/87 T/o	33
Student Sales Account	(0.2)
New Law Journal	(0.025)

PJ/C/9

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Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
H M Treasury
Parliament Street
London SW1P 3AG

22 December 1987

Dear Nigel,

BUDGET 1988

I am putting forward in this letter some proposals that I hope you will be able to consider in preparing your Budget statement. They are principally aimed at improving the environment for small firms and encouraging enterprise.

The measures taken by the present Government have already made a great contribution to the flourishing of the small firms sector and the revival of enterprise. Nevertheless, I think there are still areas where a legitimate case can be made out for further changes. There is considerable evidence that the greatest administrative burden on small businesses is V.A.T. This is partly because of the complexities introduced into the simple concept we started with, and cannot be easily dealt with. I understand that studies have been proceeding on this problem and I would emphasise the importance we attach to it. A perennial concern among small businesses is the difficulty of raising finance for new projects or expansion. Argument will continue over the existence and nature of a "finance gap", but the consensus of those with first-hand experience of the subject is that genuine difficulties remain. In part these are due to the managerial and other weaknesses of small firms themselves - which we try to remedy through advice and training - but for some time to come there will still be a case for some measures to help small firms overcome their

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inherent disadvantages in raising finance. Such a case is recognised in the Business Expansion Scheme, which offers investors a very substantial tax incentive to offset the higher risk involved in investing in unquoted shares.

As I suggested in my letter of 11 September there is some doubt whether the BES is fully meeting its original aims. One of these aims was to encourage direct investment by individuals in small companies in which they would take a close personal interest. We know from the BES statistics and from anecdotal evidence that such investment takes place, but it is a small percentage of the total and I believe there is potential for more. The stumbling block is the rule withholding eligibility for BES relief from investors who take paid employment with the company concerned. In practice an investor cannot put both money and management expertise into a company and still get BES relief. I hope that you will give serious consideration to a partial relaxation of the present rule. Item 1 in the Annex to this letter explores this point more fully, and considers other possible changes to BES. I am still of the view that there should be some limit on total BES investment in any one company and you have said you will consider this again.

Much attention has recently been focussed on the concept of "corporate venturing". Investment by large firms in smaller ones potentially offers an enormous source of finance (and inputs of expertise). Studies like the NEDO guide published last year show that corporate venturing can have commercial advantages for both sides. As yet, however, there is little evidence that corporate venturing activity is taking off in practice. A limited tax incentive, on a temporary and experimental basis, would encourage larger firms to take the plunge and gain some practical experience in this area. Item 2 in the Annex considers this further.

You will recall that last year David Young proposed a new initiative to provide for "Local Enterprise Companies". A tax incentive for corporate investment would be an element in this proposal. I understand that David Young has revised his proposals and I hope you will seriously consider this imaginative approach.

For businesses requiring investment of under £100,000 the clearing banks will remain the dominant source of external finance. In those cases where promising businesses cannot be financed on purely commercial terms for lack of security, the Loan Guarantee Scheme provides some assistance. The maximum lending permissible under the Scheme to any one business has been fixed at £75,000 since the Scheme's inception in May 1981. A recent analysis (see Item 3 in the Annex) shows an increasing usage of the Scheme at the upper limit, which suggests that the time has come to reconsider the position. I believe that an increase to £100,000 would be justified.

I should also like to modify slightly the conditions of the Scheme relating to personal assets. Between 1981 and 1984, the LGS was widely used by borrowers who possessed substantial personal assets but were unwilling to make them available as security for convential lending. This was clearly unacceptable, and following the review of the Scheme in 1984 a rule was introduced that where the borrower could offer personal assets which would be acceptable to the lender as a basis for lending outside the Scheme a guaranteed loan would not be available. This rule has been strictly applied, so that, for instance, where directors of a company seeking an LGS loan (other than those who are primarily consultants or professional advisers) have any equity in their family home, this should be fully committed to non-LGS lending before an LGS loan can be considered. The rule for example, stops a married woman getting an LGS loan for her business unless her husband will pledge their jointly owned home. Moreover, lenders themselves are often reluctant to demand the full commitment of the family home. I would like to give lenders greater flexibility to consider how far personal assets should be taken into account in assessing the personal commitment of borrowers. My proposal is explained more fully in Item 3 in the Annex.

However much loan capital is available, for many small firms gearing problems and the difficulty (and cost) of raising external finance makes it important that they should make the best use of funds generated within the business. The substantial reductions in Corporation Tax (including the "small companies" rate) and Income Tax (affecting the

unincorporated trader) since we took office have increased the ability of businesses to retain and use more of their own earnings but the withdrawal of initial capital allowances has reduced it. The majority of small firms' representative bodies are concerned, as they were last year, that the withdrawal of the allowances bites hardest on expanding small businesses for whom external financing presents the greatest problems. A variety of solutions are offered, most of which involve some tax relief on an initial "tranche" of retained earnings. It is difficult to evaluate these arguments and proposals, and I am aware that with some approaches the loss of revenue could be very heavy. In view of the persistent concern expressed by small firms representatives I believe there is a need for further examination of the problem but I have not put up a specific suggestion this year.

Representative organisations have put forward a number of other suggestions for simplification of taxes or the removal of anomalies. You have received or will receive submissions directly from the organisations concerned, and I am sure you will consider the suggestions on their merits. Some proposals which I think should be viewed sympathetically are discussed at Items 4 onwards in the Annex to this letter.

Moving away from strictly small firms issues, Item 11 in the Annex outlines some proposals on employee share schemes and related matters.

Finally I would like to make the general point that an assessment should be made of the effects on employment and incentives to work of any measures you are proposing to include in the next Budget. For example, despite some restructuring, national insurance contributions still cause particular incentives problems because of the "cliff edge" start to payments and the uneven marginal tax steps resulting from lack of integration between tax and national insurance. While full resolution of these problems would repudiate the contribution principle to which I know you are committed, I believe our aim should be as far as possible to reduce the national insurance burden on the low paid and to bring the tax and national insurance system more into line. If you are prepared to contemplate such changes, I will ask my officials to discuss this approach with yours.

Since we took office in 1979 the needs of small businesses and enterprise have rightly been given a high priority in Budget decisions. Much has been done to improve the climate. A transformation of the small business sector and the prospects for enterpise is well under way. To sustain the momentum I hope you will give sympathetic consideration to the proposals I have outlined.

NORMAN FOWLER

ANNEX

ITEM 1: BUSINESS EXPANSION SCHEME

A. ENCOURAGING MANAGEMENT INVOLVEMENT

When the predecessor to the BES, the Business Start-up Scheme, was introduced, the Chancellor commented: "One of the biggest problems faced by people thinking of starting their own business is the difficulty of attracting sufficient risk capital to finance it during its critical early years. The amounts of additional money needed can be modest - at least compared with the sums in which the big financial institutions commonly deal...
The individual private investor has for many years had little encouragement to help fill that gap in the capital market. I propose to change that. The private investor can often contribute not only risk capital, but direct personal business experience. The opportunities are certainly there. What is needed is to make it more attractive and more rewarding for private investors to take advantage of them" (Hansard, 10 March 1981).

2. The BSS and the BES have been only partially successful in meeting the need identified in these comments. The "gap in the capital market" is usually identified as the need for investment in amounts of less than £100,000 or, increasingly, up to £250,000. BES has been of some benefit in this area. Inland Revenue statistics for 1984 - 5 show that 511 companies received BES investment of less than £100,000 - 65% of the total number of companies. Up to £250,000 the number was 666 - 85% of the total. But this is a very small proportion of the total small company sector. The amounts invested were also a small proportion of total BES investment : 10% up to £100,000, 27% up to £250,000.

3. Although no statistics are available on this point, it is doubtful if the scheme has helped investors who wish to contribute "direct personal business experience" as well as money. Discussion with enterprise agencies and others confirms that there are many experienced businessmen - including retired, semi-retired or redundant executives - who are interested in helping small companies. They normally wish, however, to take a close personal interest in the company and to work for it on a full or part-time basis. They reasonably expect to receive remuneration for this employment with the company. However, under section 54 of the Finance Act 1981 a person who takes paid management employment with the company within 5 years of making an investment is not eligible for BES relief. The effectiveness of the BES in these circumstance is therefore limited.

4. To provide a greater incentive for people wishing to contribute both money and expertise <u>it is suggested that the section 54 exclusion of paid employees should apply only to people who have been paid employees before making their investment. People coming in from outside, having no prior connection with the company (of the kinds defined in section 54) would then be eligible for BES relief.</u>

5. There are several possible objections to this proposal:

a) people closely connected with a company through paid employment would be willing to invest in it anyway, so the additionality of investment would be low. But this surely applies only to people <u>previously</u> connected with the company, not people coming in from outside. BES relief would be a significant incentive to people to take the major step of joining a small business for the first time;

b) remuneration of BES investors for employment in the company could be used as a device to extract their investment within the 5 year period. This is undeniably a risk, but it should be noted that the remuneration would itself be taxable. Investors would gain from this ploy only if the remuneration were taxable at a lower rate than the BES relief. In some circumstances this would be a danger, but abuse could be controlled by the ability of the Revenue to check that remuneration was reasonable and necessary. Section 54 already allows an investor to receive 'reasonable and necessary' remuneration for professional services (such as accountancy advice). The 'reasonable and necessary' test could be extended to remuneration for other employment.

c) The company could use these provisions to avoid Corporation Tax, by paying out true profits in remuneration to employees and receiving them back into the company through tax-free BES investment. This is a real danger where existing employees are concerned, but seems far less likely to arise where the employee is previously an outsider.

It is not suggested that the scope for abuse can be eliminated, but the risk of abuse should be balanced against the benefits of encouraging outsiders to invest in small companies and contribute their business expertise.

6. The cost of the proposed change is difficult to estimate, but there is no reason to expect the 'floodgates to open'. A reasonable assumption is that up to 1,000 people a year would take advantage of the new provision, investing an average of, say, £20,000. Assuming an average BES relief of 55% (cf the Peat Marwick report on BES) the maximum loss of revenue would be £11m - a

small proportion of BES as whole. This figure would also be partly offset by taxation of remuneration from the employment of the individuals concerned which might not otherwise have taken place (eg if past retirement age).

B. BES - CO-OPERATIVES

1. The Scottish Co-operative Development Committee have argued strongly that the BES rules militate against workers' co-operatives attracting finance under the BES. The SCDC suggests that changes should be made to the rules to allow tax-relief on non-voting preference shares specifically where the authorised ordinary share capital does not exceed £500.

2. The types of co-operative which could take advantage of such a change are those which are:

a) limited by guarantee under the Companies Act; and

b) have a co-operative share model constitution.

3. The SCDC have emphasised that preference shares in co-operatives may bear a high risk, comparable to that of ordinary shares in other companies, because the ordinary share capital of co-operatives is usually very limited. Such co-operatives will typically have between 30-50 members with a total issued ordinary share capital at £1 per person not exceeding £50. The preference shareholders would, therefore, only have a preference prior to £30-£50 of ordinary shares issued. In the event of liquidation any deficiency in the assets would quickly eat into the funds available to repay preference shareholders. In addition under the preference share scheme BES investors would be taking more risk and would be clearly disadvantaged compared to ordinary BES investors since they would possess no voting rights.

The SCDC have a fair point in saying that preference shares in co-operatives may carry a relatively high risk, although the proposals do not guarantee it. The authorised or issued share capital of a company often bears little relation to the "shareholders' funds" available in a liquidation. If a substantial reserve had been built up, or if the ordinary shares had been issued at a premium, the preference shareholders might be in a relatively safe position.

5. Nevertheless we feel that if this loophole could be dealt with there seem to be good grounds for seeking a change to the BES rules to make it easier for co-operatives to attract BES finance.

ITEM 2: CORPORATE VENTURING

1. A 1986 NEDC report, "Corporate Venturing: A Strategy for Innovation and Growth" described corporate venturing and presented the results of a survey. It found that about a third of large UK firms claimed to have some experience of corporate venturing. It also identified many potential commercial advantages to both sides. Despite this, corporate venturing seems to be developing slowly if at all. For large companies with spare money to invest, straightforward acquisition may seem a better, and certainly simpler, way of using their money. For small companies seeking investment there is the fear that they will lose control or that the large firm will steal their ideas.

2. A recent Bow Paper by Nicholas Panes puts forward a case for a tax incentive, for a limited period, to encourage large firms to experiment with corporate venturing. It proposes an incentive by way of Corporation Tax deferral on profits invested in qualifying companies (rules for eligibile investments being based on BES). Assuming a take-up rate of 10% Panes estimates the revenue cost at £150 million in the first year.

. The Bow Paper proposal is an interesting approach but in some respects probably too generous. The paper suggests that up to 50% of Corporation Tax might be deferred. We think a lower figure, perhaps 10%, with a maximum of, say, £10 million would be more appropriate to prevent abuse. A maximum could also be set to investment in any one company in any one year; we suggest £250,000 in line with our proposals on BES. With these restrictions it might be acceptable to offer the incentive in the form of a relief rather than a deferral (which would simplify administration). As the Bow Paper stresses, large companies would still take a cautious approach to corporate venturing. It is unlikely that total qualifying investment would exceed £100 million in the first year (a figure of the same order as BES) at a maximum revenue cost of £35 million.

ITEM 3: LOAN GUARANTEE SCHEME

a) The £75,000 ceiling

1. Since the inception of the Loan Guarantee Scheme in 1981 each borrower has been limited to a maximum of £75,000 under the Scheme. This applies to the cumulative total of borrowing: a borrower may obtain, for instance, a loan of £50,000 but if he seeks a further loan will be limited to £25,000. At present the cumulative limit applies even where existing loans have been paid off. We have recently agreed with the Treasury that this rule can be modified to enable businesses which have paid off a loan in full to have access to a further loan.

2. During the first 5 years of the Scheme the average size of loan varied little and the proportion of total loans represented by loans at the maximum £75,000 level has varied only between 10 and 12%. There has been little pressure from either banks or borrowers for a higher ceiling. Since the

Scheme was relaunched in May 1986, however, the proportion of loans at the maximum level has increased significantly to about 17%. It is not known how many borrowers have reached the maximum by obtaining second or third rounds of lending.

3. The increase in usage at the upper limit could be explained in several ways. It may be that alternative sources of finance are becoming less accessible, or that bank managers are more willing to consider using the Scheme for relatively large projects (or less willing to use it for small ones). Whatever the reason, after a lapse of over 6 years there is a case for reviewing the ceiling. During this period the RPI has increased by 37.2%. An increase of 1/3 from £75,000 to £100,000 would be justified to keep approximately in line with inflation.

4. Against an increase it could be argued that we should be encouraging the supply of equity capital for projects of this size. Certainly this would be preferable, but at present the supply of small amounts of equity is still limited and may be getting worse, as most venture capital organisations are raising their 'floors'.

5. The effect of raising the ceiling to £100,000 would not be dramatic but there would be some increase both in the number of loans and in the average size of loan. Some loans presently confined to £75,000 would probably be granted for larger amounts. Combining these factors an increase in the total volume of LGS lending of around £13 million a year would be plausible. (This assumes that there would be around 100 additional loans at an average of £85K and that around 350 loans which otherwise would be granted at £75K would be granted on average £10K more). Assuming prudently a failure rate of 10% in each of the 3 years from 1989-90 to 1991-92, and an average guarantee payment of £50K, the additional gross cost would be around £2.25m in 1989-90, £4.5m in 1990-91, and £6.75m in 1991-92.

Personal assets

6. The present rule is that borrowers must be willing to make any personal assets available as security for non-LGS lending before being considered for an LGS loan. In theory this means that the family home of the entrepreneur may be placed at risk, even if its value is relatively modest. In practice, the rule is not as harsh as it may seem. The banks have to consider what is 'available' and whether it is 'adequate' as security for non-LGS lending. Their valuation of property tends to be cautious, and if there is any existing charge on the property the remaining value is often too small to be of much use. On the other hand, where there is very substantial equity in the house it seems reasonable that the entrepreneur should put part of it behind the business.

7. We do not propose any dramatic change in the present rules, but it would help remove some of the objections often made to the present position if the banks were explicitly given more discretion to decide how much personal security the borrower should be expected to put behind the business. The key to this is the requirement of personal commitment. Borrowers are already expected to demonstrate personal commitment, but this is loosely defined. Our proposal is that personal commitment and the use of personal assets should be more closely linked. Instead of laying down a specific rule on personal assets where the family home is concerned, the banks should be required to satisfy themselves of the borrower's personal commitment, and in doing so to consider whether the borrower should be required to offer part or all of the equity in the house as security for non-LGS lending. The intention is that in practice this would mean only a marginal difference in treatment in most

cases, and the effect on additionality of lending should be slight. As the banks carry 30% of the risk on LGS lending, we would not expect them to be over-generous to borrowers in applying their discretion. If this approach is acceptable, we should need to discuss with the banks how it would be applied before implementing the change.

ITEM 4: INHERITANCE TAX

Inheritance tax distorts decisions by unquoted companies. It is payable if the donor dies within seven years of making the gift. This is a barrier to sensible commercial decision-making on the choice of successor in an unquoted company, because it encourages premature transfer of the business. Unquoted companies have to bear heavy insurance charges, from which quoted companies are effectively exempt, against death within seven years, or take irresponsible risks if they fail to insure. The tax is also a disincentive to employee share ownership schemes since it discourages any increase in the net worth of the business.

This obstacle should be removed by 100% Business Property Relief. The cost has been estimated as a direct loss of revenue of about £20 million with additional costs arising out of behavioural changes.

ITEM 5: SUB-CONTRACTOR'S TAX CERTIFICATE ("714")

The current eligibility conditions for a sub-contractor's tax certificate have a disincentive effect on self-employment and are of an anti-competitive nature in that those without a certificate suffer cash-flow disadvantages and restrictions on the availability of work opportunities. This could be

remedied by relaxing the eligibility conditions, only requiring a satisfactory explanation of what an applicant for a certificate has been doing in the three years prior to applying rather than three years' continuous employment or self-employment in the last six years. Possible satisfactory explanations would include long-term unemployment (which many Enterprise Allowance Scheme applicants have suffered) or attendance at full-time education or training (such as YTS graduates). [The cost of this change would be neutral in the longer term. There would be a first year cost because those with a certificate pay tax at the end of the financial year rather than week by week.]

ITEM 6: BUSINESS EXPENSES AND INCIDENTAL COSTS OF RAISING CAPITAL

The Government are keen to encourage equity investment but, in certain areas, the current tax regime does not support such encouragement. Section 38, FA 1980, allows tax relief on the incidental costs of obtaining finance by means of loans or the issue of loan stock but we consider that extension should be granted to cover the incidental costs of raising all types of finance, particularly equity and short term note issue programmes in the UK or elsewhere. The relief restriction to longer-term loan capital is too narrow and does not take into account the necessity of the smaller businesses seeking to raise equity capital to prevent continuing undercapitalisation with its inherent failure risks. This deterrent to raising more capital can be removed by lifting the current tax bias in legislation.

Other legitimate and bona fide business expenditure can often not be relieved either as a trading expense, as a cost for capital gains purposes, nor be available for capital allowances. It is anomalous that what is clearly business expenditure should not be relieved as a revenue or as a capital

outgoing. We therefore advocate that the cost of abortive capital projects or feasibility studies should be deductible in computing business profits so promoting continuing enterprise and business development.

ITEM 7: CLASS 2 AND CLASS 4 NATIONAL INSURANCE

The self employed clearly welcomed the 50% allowance for Class 4 National Insurance payments. The Government are consistently encouraging enterprise through self employment and we consider that a similar allowance should be given to Class 2 National Insurance payments. The cost would be about £50 million in 1988-9.

ITEM 8: PIID

I have received very consistent representation on the administrative burden that the current PIID system places on employers. I understand that the Inland Revenue are currently monitoring the take up of 'dispensations' and that the results should be available early next year. It would be very helpful if any changes to be introduced as a result of this exercise could be announced in the Budget speech.

ITEM 9: VAT REGISTRATION

The extension of the VAT registration period from 10 days to 30 days has been welcomed but it still falls short of the time many new small businesses need to comply with the regulations. It would be helpful if the registration period could be extended to 60 days.

ITEM 10: CASH ACCOUNTING

The introduction of cash accounting has generally been well received. However, the stipulation that businesses opting to join the scheme must be up to date in their VAT payments can disadvantage those small firms facing cash flow problems through late payment by customers. It would therefore be helpful if the rules were relaxed to allow such firms onto the scheme for at least a trial period, perhaps a year, in which they could get their payments up to date.

ITEM 11: APPROVED EMPLOYEE SHARE SCHEMES AND PROFIT-RELATED PAY

(i) Proposal to tie executive scheme relief to the introduction of all employee schemes

1. There has been a phenomenal growth in the number of approved 1984 discretionary schemes. By the end of 1987 it seems likely that the number of these schemes will be almost double the total of the other two types of approved share schemes.

2. The main rationale for making discretionary scheme relief conditional upon the company having an all-employee scheme (either a share scheme or PRP) is that it will oblige managements who wish to benefit from the generous 1984 tax concessions to enable all their employees to participate financially. This would give a significant boost to PRP and employee share ownership. The element of coercion in such a measure would be tempered by the fact that managements who, for whatever reason, did not wish to introduce an all-employee scheme would be free to grant non-approved share options to selected employees (without the tax concessions).

3. It was never the intention that discretionary and all-employee schemes should be in competition. However there are signs that this is indeed becoming the case and that discretionary schemes are winning. There is therefore now a stronger case for making executive scheme relief conditional upon the presence of an all-employee scheme, with the aim of encouraging wider employee share ownership. It would also be desirable to raise the maximum limits currently operating on the all-employee schemes.

(ii) Proposals for tax relief for share purchase

4. We still consider that there appears to be merit in a suggestion put forward by the Industrial Participation Association (IPA) that tax relief should be provided on amounts invested by employees to buy ordinary shares in their company through a savings contract. This proposal differs from the existing SAYE scheme in that the employee would immediately become a shareholder and would gradually build up his shareholding before having to decide whether to keep or sell his shares. There would of course be an element of risk for the individual in that the value of his shares could fall as well as rise. However this is not in any way inconsistent with the principle of giving the individual a degree of financial commitment to the success of the company in which he works - a principle which is given expression with Profit Related Pay.

(iii) Proposals relating to employee share trusts

5. The American concept of Employee Stock Ownership Plans (ESOPs) is in many respects similar to the 1978 Approved Profit Sharing Scheme. It would

clearly be undesirable and unnecessary to adopt the American concept without considerable modification taking into account the current scheme in existence in the UK and ensuring avoidance of the abuses which have been noted in the operation of some ESOPs in the US.

6. Nevertheless we do recognise that employee share trusts based on the American concept can be attractive in certain circumstances, in particular we think that employee share trusts could be particularly valuable in assisting private companies to give their employees a substantial stake in the business.

7. Two proposals for encouraging the setting up of employee share trusts and thereby increasing employee share ownership could be examined. The first is to establish incentives for taking out loans to buy substantial shareholdings for such trusts. This could involve an extension of corporation tax relief on a firm's payment to a trust so that not only would relief be available on payments to build up the trust's holding (as at present under the 1978 scheme), but also on payments to pay off the interest and capital on a loan taken out by the trust to buy shares in the company. The second is to give incentives for the owners of family firms or the major shareholders in private companies to donate or bequeath equity to an employee share trust. Gifts of shares to trusts which hold less than 50% of a firm's equity are at present subject to Capital Transfer Tax. This restriction could be removed. In addition some relief from Inheritance Tax could be given for bequests of equity to employee share trusts.

(iv) Proposals relating to Profit Related Pay (PRP) and the public trading sector

8. We fully appreciate that it was considered important to focus the

benefit of PRP on the private sector and also the practical difficulties of applying the scheme to the public sector. Nonetheless the public trading sector in principle stands to gain from the benefits of PRP in terms of closer identification of employees, and in some cases at least, pay flexibility, just as much as the private sector. Also, if PRP becomes widespread in the private sector, its absence in the nationalised industries might lead to higher wage claims there.

9. The main difficulty arises from the extent to which nationalised industries are "price-makers" who can use their market power to achieve Government-set profit targets. If there were a scheme in operation such that the workforce shared in any additional profits made over and above financial target threshold, the industry would be able to set its price so as virtually to fix the size of the PRP payment in advance. A possible solution might be to build in a formula to nationalised industries' PRP schemes so that increases in prices above an agreed threshold would automatically raise the profit threshold which triggers profit related payments to the workforce.

10 Even if this does not prove to be possible, there seems to be a strong case for allowing separate smaller-scale profit-dependent organisations within the public sector to apply for PRP tax relief, subject of course to Inland Revenue approval of each individual application upon its merits.