PO-CH/NL/0495 PTA

PO CH/NL/0495
PART. A

PO CH/NL/0495
PART. A

1989 BUDGET STATEMENT
AND UNLEADED PETROL.

28.2.89

CLOSED

THIS FOLDER HAS BEEN
REGISTERED ON THE
REGISTRY SYSTEM

BUDGET
STATEMENT 495 &
UNLEADED PETROL
21

fp.ac.gilhooly/171

BUDGET CONFIDENTIAL

BF 3/2

FROM: J F GILHOOLY

DATE: 1 February 1989

PS/ECONOMIC SECRETARY

cc APS/Chancellor
PS/Financial Secretary
Mr Culpin
Mr Michie

UNLEADED PETROL AND MINISTERS CARS

We spoke about Mr Chope's letter of 31 January to colleagues.

2. This raises a number of questions, as we discussed:

- will Treasury Ministers' cars be unleaded by Budget Day? Will the Prime Minister's?

- if and when Mr Chope might announce his initiative. Before Budget Day might be taken as a pre-Budget hint.
After Budget Day would look like confusion. DoEnv's Budget Day Press Notice giving their Ministers' reactions to the Budget looks best;

- what Mr Chope plans to say (we should see in draft);

- whether Customs should not be asked for advice: you agreed to arrange;

- what response we can make to questions about cars used by Civil Servants. Some Departments (eg MOD) and the NHS have significant numbers of cars used by officials. We particularly need to know about Customs and Inland Revenue cars. Again, Customs may be able to help;

- when DoEnv Ministers might be told what will be in the Budget.

J F GILHOOLY

31 JAN 1989

DEPARTMENT OF THE ENVIRONMENT
2 MARSHAM STREET LONDON SW1P 3EB
01-276 3000

PARLIAMENTARY UNDER SECRETARY OF STATE

FINANCIAL SECRETARY	
REC.	31 JAN 1989
ACTION	Mr Partridge 21/2
COPIES TO	PPS, CST, PMG, EST
	Sir P. Middleton
	Mr. Anson Mr. Monck
	Mr Gilhooly Mr. S. Wood

Stan Spackman
3913 5107

My ref
Your ref

31 January 1989

Dear Colleague

I am writing to inform you of two changes affecting the Government Car Service (GCS).

First, I am offering all colleagues who do not already have such a vehicle, the option of a replacement car capable of running on lead free petrol. Montegos, Sierras and Cavaliers are available and I would be grateful if colleagues who are eligible and wish to take up this offer would arrange for their offices to contact the GCS Superintendent, Mr T McCarthy, direct to let him know their preference. GCS will aim to provide replacement vehicles no later than 1 July 1989, and the additional costs of early replacement will be absorbed through efficiency savings. Cabinet Ministers' cars will be converted to unleaded running, where necessary, to the same timescale.

Secondly, you will wish to be aware of a proposed change in GCS organisation arising from the planned privatisation of The Crown Suppliers (TCS), of which GCS is currently part. GCS is not part of the package for sale, so a new home needs to be found for it. I therefore propose, unless I receive any strong views to the contrary, that the operational responsibility for the Edinburgh, London and Bristol GCS service should transfer by 1 April 1989 from TCS to the PSA's Directorate of Home Regional Services, PSA Scotland and PSA South West Region respectively. It has been agreed at official level that the Cardiff operation should transfer to the Welsh Office, and that the Belfast service should be taken over by NIO.

A copy of this letter goes to Sir Robin Butler.

Mr. A. J. Edwards
cc: Mr. Willacy
Mr. Call

Yours faithfully

David Mottershead

pp CHRISTOPHER CHOPE

Approved by the Minister and signed in his absence

100% RECYCLED PAPER

3/130

est.ld/james/22 Feb/Wilmott

B U D G E T   C O N F I D E N T I A L

ECONOMIC SECRETARY TO THE TREASURY

FROM: S M A JAMES
DATE: 22 February 1989

MR WILMOTT - C&E

cc: PS/Chancellor
Mr Culpin
Mr Gilhooly
Mr Michie

PS/C&E
Mr Jefferson-Smith - C&E
Mr Gaw - C&E

UNLEADED PETROL

Further to my minute yesterday containing comments on your draft overview paper, the Economic Secretary has asked for a further point to be covered. We need to know the typical price differential at present between 2 star and 4 star on the same forecourt (as opposed to the difference between average 2 star and average 4 star). Similarly we should know the typical differential for leaded and unleaded.

2. Paragraph (iii) of my minute of yesterday mentioned Sir Archibald Foster's remarks to the Chancellor and Economic Secretary about price differentials in Germany. I understand Sir Archibald referred to a recent increase in the German tax differential in favour of unleaded. The Economic Secretary would be grateful for advice.

S M A JAMES
Private Secretary

H.M. CUSTOMS AND EXCISE
NEW KING'S BEAM HOUSE, 22 UPPER GROUND
LONDON SE1 9PJ
01-620 1313

ECONOMIC SECRETARY

FROM: P G WILMOTT
DATE: 2 February 1989

UNLEADED PETROL

Introduction

1. This paper discusses options for giving unleaded petrol a further tax boost, by increasing the tax differential between it and leaded petrol, by imposing a surcharge on two star leaded petrol, or both. It also looks at three 'second order' issues: tax differentials in other EC Member States, the pros and cons of a wider Government information campaign coordinated with the Budget announcement, and the presentational question of litres versus gallons. These last three points are covered in the annex to this paper.

Circulation:

Chancellor
Chief Secretary
Financial Secretary
Paymaster General
Sir P Middleton
Sir T Burns
Mr Anson
Dame A Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr P N Sedgwick
Mr Riley
Mr Macpherson
Miss J Simpson
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Gilhooly
Mr Matthews
Sir A Battishill IR
Mr Beighton IR
Mr Isaac IR
Mr Painter IR

CPS
Mr Jefferson Smith
Mr Allen
Mr Vernon
Mr Gaw
Mr Spackman

2 a prime?

The main question

2. The aim of any tax change is to favour the uptake of unleaded petrol. A component could be a measure to discourage the use of two star leaded fuel (since nearly all cars capable of using this fuel could use unleaded without modification, and the elimination of two star would free storage capacity at garages for stocking unleaded fuel). The issue is therefore what options are available, what - broadly - are their relative merits and what constraints affect the decisions to be taken (mainly timing).

Unleaded - the market picture

3. This is a time of rapid change. From a low start - well below 1 per cent before the 1988 Budget - unleaded fuel has grown to take around 4 per cent of the market now (based on Customs clearance figures available on 31 January, and relating to removals from bond in the month to 14 January). We look set for continuing growth through 1989, even in the absence of further duty incentives, with possible market shares of 8 per cent by March 1990 and 12 per cent by March 1991.

The options

4. There are four runners at present:

Option	Unleaded	two star leaded
A	increase present tax differential by 0.7p/litre	duty up by 1.1p/litre
B	As A	No change
C	increase present tax differential by 1.1p/litre	No change
D	as C	duty up by 1.1p/litre

All assume a general standstill in (four star) leaded duty rates. Their effects on the differentials can be summarised as:

Option	effect
A	Pump price gap between unleaded and four star raised to a full 2 pence a litre (around 9 pence a gallon) from its present level of 1.3 pence a litre (6 pence a gallon) but with two star priced above four star (and effectively made uncompetitive). ?
B	As A but with relative position of two star unchanged.
C	pump price gap between unleaded and four star leaded raised to 2.4 pence a litre (just short of 11 pence a gallon); position of two star unchanged.
D	as C, but with two star priced above four star (and effectively made uncompetitive).

Analysis

5. Any increase in the differential between leaded and unleaded fuel will speed the rate of uptake of the latter. By how much is difficult to estimate, but options B and C could add some 4 and 7 percentage points respectively to the March 1990 market share of unleaded and around 8 and 13 to the share a year later.

6. Surcharging two star leaded petrol, to make it uncompetitive, will speed up a process that is taking place anyway. With present duty rates, pump prices and differentials, two star could disappear in 1990 (its market share was nearly 12 per cent in 1985 and under 7 per cent by the end of 1988). The dwindling return on investment as two star fell could bring forward its demise and increasing the price advantage of unleaded over leaded petrol would in any case hurry things up. It follows that positive discrimination against two star, coupled with a widening of the gap between four star and unleaded, would accelerate the process further. Option D could possibly eliminate two star petrol within 9 months from now. Forecasting the effects in terms of the market share of unleaded petrol is difficult, with a rapidly changing scene and a number of different factors all working at once. Our best guess is that a surcharge on two star could very rapidly add at least two percentage points to the unleaded market share.

7. Putting a surcharge on two star could be administratively complicated. Customs' control problems would grow, and refineries' compliance costs would go up. We could cope with the former, while the latter could be presented as part and parcel of the initiative. We see no overriding objections to a surcharge here. Perhaps more difficult would be the task of explaining the reasons behind a surcharge. Given two star's small and dwindling share of the market, it could hardly be presented as central to the Government's unleaded policy. Not all two star users would switch to unleaded; some <u>could</u> not (a few cars cannot

be converted - their owners will need to use four star leaded - and until unleaded became more widely available, as it would when two star disappeared, some would be beyond the reach of unleaded pumps); some users would not (business users, for example, appear to be insensitive to price levels and some motorists would remain persuaded that leaded petrol conferred advantages - performance, for instance - that leaded did not). Overall, the real issue would remain that of persuading four star users (90% of the market at present) to convert. But against this it could be said that there is a slice of the motoring population that could be switched to unleaded relatively painlessly, and that the short-term complication of a surcharge was worth the gain.

8. We conclude that the judgement on two star is basically a tactical one, to be taken in the light of Ministers' views of the presentational aspects of the petrol package as a whole. But a point to watch is the (outside) chance that the two star market could collapse very much more rapidly than we expect. Signs that this were about to happen could possibly be discernible and would argue against option A and D. This a good reason for keeping options open until a late stage (see paragraph 11).

9. The judgement on the leaded/unleaded differential is similarly one to be based on the emphasis that Ministers wish to give to the role of taxation in the process of converting users to unleaded petrol. Either option B or option C would speed the process - the choice is essentially between two rates of increase, which can be further modified by the addition, as with options A and D, of a two star surcharge.

Revenue

10. The latest estimates of costs are shown in the scorecard, for each of options A to D.

Handling decision-making

11. There is no need to take firm decisions now. Insofar as market share information is likely to influence the final shape of the package, we expect to have clearance figures for the period to 14 February (distinguishing between leaded and unleaded, but not between two and four star leaded) by the end of February. The final choice could be left until then, provided it was narrowed down to, say, two options (this is because we might have to print material for both, and discard the one not used). If holding options open in this way is attractive, we can give more precise guidance on the possible combination of options and decision deadlines.

Minor issues

12. The annex discusses the three lesser questions mentioned in the introduction. It concludes, broadly, that

(i) differentials in other EC states need not influence our decisions

(ii) a Government information campaign, coordinated with DoE, would be better than Treasury/Customs guidance alone; this could involve some very limited pre-Budget disclosure to DoE

(iii) presentationally, differentials expressed in gallons sound more impressive than figures quoted in litres.

Conclusion

13. Options A to D are all technically feasible. The difference between them turns on Ministers' judgement of the degree of assistance that they wish the tax system to give to the unleaded campaign, and of the relative merits of squeezing two star petrol out of the market place earlier than would otherwise be the case. We can advise further on precise deadlines, but there is scope for holding the decision on precise duty rates open until two weeks or so before the Budget.

for · P G WILMOTT

ANNEX

TAX DIFFERENTIALS AND TREATMENT IN OTHER MEMBER STATES OF THE EUROPEAN COMMUNITY

1. The attached table shows the current tax differentials in other Member States. Countries not listed make no tax distinction between leaded and unleaded petrol. We have no information immediately to hand on how these differentials translate into pump prices.

2. The United Kingdom is already towards the top of the tax differential league and a further increase in the differential of 1.1 pence a litre (ie options C or D) would place us second only to Denmark (to take first place we would need to increase the rise in our differential to around 1.5 pence a litre). Topping the Community league table has some attraction in presentational terms. But critics could point out that other EC countries were nonetheless ahead of us in other measures to stimulate uptake of unleaded petrol (eg greater filling station coverage, notably in the Netherlands, and tax reductions for new cars fitted with catalytic converters in Denmark, Germany and the Netherlands).

3. Increasing the rise in the differential from 1.1p to 1.5p a litre is unlikely in our view to affect the uptake of unleaded petrol sufficiently to make "largest differential in the EC" a more attractive presentation than "5p a gallon (or whatever) more in favour of unleaded petrol".

GOVERNMENT INFORMATION CAMPAIGN

4. There is an obvious difficulty in preparing a campaign to maximise the impact of any increase in the tax differential in favour of unleaded petrol while preserving Budget secrecy. Although Customs and

e Treasury will produce factual and other briefing material on this and other Budget matters in the usual way, we do not have the expertise or the resources to devise and run a full blown campaign targeted at the various groups in need of information and persuasion (motorists, garages and filling stations, car makers etc). Since promoting unleaded petrol is the primary responsibility of the Department of the Environment (they sponsor the Campaign for Lead Free Air, CLEAR, and chair the Unleaded Petrol Group which encourages and co-ordinates publicity) we suggest that that Department is best placed to take the lead. (The next meeting of the Group is on 16 February). But this would involve widening the circle of those privy to Budget decisions.

5. However, we believe that DoE have contingency plans anyway to mount a fresh drive to coincide with the Budget, whatever action the Chancellor may or may not take. And Mr Chope's initiative on the Government Car Service could possibly be fitted into such a campaign. As a way out of the confidentiality problem, the Chancellor could tell the Secretary of State that he was minded to give some additional encouragement to unleaded petrol without disclosing prematurely either the size of the new differential or, more important, his overall judgement on the oil duties. If a two star surcharge remained a front runner it would be necessary to tell DoE, but without disclosing the actual rate change. On this basis a properly targeted campaign could be designed by DoE to achieve maximum impact after the Budget.

LITRES VERSUS GALLONS : PRESENTATIONAL POINTS

6. The Department of Trade and Industry's price marking order came into force on 23 January 1989. This authorises filling stations dispensing petrol in litres to display the price at the roadside in litres only rather than, as now, in litres and gallons.

7. Over time this will eliminate price displays of leaded four star in pence per gallon and enable the space thus released to be used to display the unleaded price. The ready comparison and consequent

heightened awareness of the differential should encourage further take up of unleaded.

8. Given that the rest of the Community, except the Republic of Ireland, use litres, and given the increasing familiarity with the price in litres which the above Order will encourage, there is a *prima facie* case for expressing any Budget change in the unleaded petrol differential in litres too. But on Budget Day the effects of the Order will have hardly started and the British people have frequently demonstrated their deep conservative attachment to Imperial measurement. And since changes expressed in gallons simply *sound* more impressive than those expressed in litres, we advise against using solely litres in Budget publicity.

TAX DIFFERENTIALS IN EC MEMBER STATES

MEMBER STATE	TAX DIFFERENTIAL (including VAT) GALLONS/pence	LITRES/pence
DENMARK	17.54	3.86
GERMANY	12.67	2.79
UK	13.64 **10.56**	**2.32** 3.00
NETHERLANDS	9.93	2.18
BELGIUM	8.30	1.83
LUXEMBOURG	7.44	1.64
GREECE	4.24	0.93
IRELAND	3.72	0.82

Exchange rates as at 16 January 1989

BUDGET CONFIDENTIAL

FROM: S W MATTHEWS
DATE: 2 February 1989

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Anson
Dame Anne Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr Riley
Mr Sedgwick
Mr A C S Allan
Mr S J Davies
Mr Gilhooly
Dr Courtney
Mr Macpherson
Mr Michie
Miss Simpson
Mr Lawton
Mr Flanagan
Mrs Chaplin
Mr Tyrie
Mr Call

Sir Anthony Battishill)
Mr Beighton)
Mr Isaac) IR
Mr Painter)

Mr Unwin)
Mr Jefferson-Smith)
Mr Wilmot)
Mr P R H Allen) C&E
Mr Vernon)
Ms French)
Mr Spackman)

LEADED AND UNLEADED PETROL

To assist discussion of what further fiscal incentives are needed to encourage the use of unleaded petrol, this note considers how far the present duty differential in favour of unleaded petrol will lead motorists to switch from leaded and presents estimates of the effects of increasing the differential further.

Introduction

2. In the 1988 Budget you increased the tax (duty plus VAT) differential in favour of unleaded petrol from 5 pence to 10.6 pence a gallon. This has helped increase the market share of unleaded petrol from a very low base of about 0.2 per cent at the time of the budget to about 3 per cent now. The oil companies and petrol retailers clearly expect significant further market growth and are undertaking substantial investments to meet it. At the end of 1988 unleaded petrol was available at 3000 outlets (about 15% of the total) with a current petrol station conversion rate of about 60 per week.

3. The future growth in the market share of unleaded petrol will depend on a range of factors:

(a) the price differential with leaded petrol;

(b) the number of cars that can currently run on unleaded petrol without re-tuning;

(c) the implementation of regulations requiring (new) cars to be able to run on unleaded petrol;

(d) the cost of re-tuning cars which currently run with leaded petrol, but which could in principle run on unleaded if converted. (Owners may also be averse to having their cars tinkered with);

(e) publicity from government, pressure groups, petrol companies encouraging motorists to switch to unleaded petrol;

(f) the availability of unleaded petrol.

4. The price differential is thus one factor among a number which will influence the use of unleaded petrol. The differential will in turn reflect a number of components:

(i) relative costs of production : unleaded petrol costs about 3-4 pence per gallon more than four star leaded petrol to produce;

(ii) relative fuel efficiency of leaded and unleaded petrol : it is widely thought that there is a deterioration in performance if unleaded petrol is used, although a recent "Which?" report found that there was no significant loss;

(iii) relative rates of duty : the differential (duty + VAT) is currently 10.6p a gallon;

(iv) relative profitability to oil companies and petrol stations : some incentive in the form of higher profitability may be needed to encourage investment to increase the supply of unleaded petrol;

(v) competition between petrol stations may lead to heavy discounting of 4 star petrol in some areas, which may erode the tax differential in favour of unleaded petrol.

5. Allowing for differences in production costs means that the current duty differential of 10.6 pence a gallon is equivalent to a potential price differential of about 7 pence a gallon. This difference is "potential" in that suppliers may not pass it all on to consumers. This is not necessarily undesirable as some incentive may, as already noted in (iv), be needed to generate an increase in the supply of unleaded petrol.

6. At present the price differential between lead and unleaded petrol is about 5½ pence a gallon on average (according to a report in the January edition of "Which?"), implying that about 1½ pence a gallon of the duty differential is retained by suppliers. The 5½ pence a gallon pump price differential is, however, an average. "Which?" reported that by shopping around motorists could usually still find leaded petrol cheaper than unleaded.

Potential use of unleaded petrol

7. At present both the supply of and demand for unleaded petrol are constrained : many stations do not stock it and many cars can not use it. The latter appears to be a greater constraint at the moment, so we consider first how far it is likely to be relaxed over the next few years.

8. There is some uncertainty over the number of cars (used here as a proxy for car mileage) that can already use unleaded petrol without re-tuning. It is probably around 3 million at present. This includes almost all cars which can run on two star petrol. From October 1989, all new models must be capable of using either leaded or unleaded petrol, and from October 1990 all new cars. Thus the number of cars which can run on either is likely to grow as follows:

1989-90	4m
1990-91	5m
1991-92	7m

9. The number of cars that cannot use unleaded petrol at all is currently about 5 million but projected to decline gradually, as they grow old and are scrapped, while new cars will all be able to run on unleaded petrol.

10. About 10 million cars currently on the road could be converted to run on unleaded petrol, about 70% relatively easily at a cost of about £15-20 on average.

11. Potential demand for unleaded petrol is shown in table 1 below. The figures assume that, where conversion is both easy and worthwhile, owners will have the necessary re-tuning done.

Table 1

	Potential number of cars able to use unleaded petrol	Potential share of unleaded petrol, %
1989-90	11m	58%
1990-91	13m	67%
1991-92	15m	75%

Forecasts of demand for unleaded petrol

12. There is thus huge potential demand for unleaded petrol. But the current unleaded share is, at 3%, well below the maximum possible. This is partly a problem of information:

(a) owners are uncertain about whether their cars can use unleaded petrol and garages are giving incorrect advice about conversion;

(b) owners are uncertain about the effects of using unleaded petrol on performance;

(c) owners are uncertain about the availability of unleaded petrol. It is available at only 15% of garages, so there is therefore a time cost in searching for it, reducing the perceived price differential below the actual pump price differential. (Owners do not realise that it does not matter if leaded and unleaded are mixed in the tank, so that there is in fact no need to search specifically for unleaded petrol).

This information gap and the wide disparity between actual and potential demand for unleaded petrol make it difficult to predict how fast its market share will grow, or how sensitive that growth will be to tax differentials.

13. The current duty differential of 10.6 pence a gallon is yielding an average price differential of 5½ pence at the petrol pump for 4 star and 2½ pence for 2 star. In practice, discounted

leaded petrol may often be as cheap, reducing the incentive to have cars re-tuned. (The £15-20 cost of re-tuning means that a motorist would need to drive about 10,000 miles using unleaded petrol if it were 5½ pence a gallon cheaper in order to justify this cost).

14. We can perhaps assume that, on current price differentials, only a small fraction of owners who have to pay to have their cars converted from using four star leaded to using unleaded petrol will do so. In addition the incentive to switch from two star to unleaded is fairly weak, and a sizeable proportion of the cars currently on the road that can use either leaded or unleaded run on two star. The growth in demand for unleaded petrol will thus be determined largely by the growth in the number of cars on the road that can use either leaded or unleaded without conversion, and by a gradual realisation by their owners that it is cheaper to use unleaded. There will be about 5m such cars in 1990-91 (about 25% of the car stock). A working assumption might be that about half will be using unleaded by the end of 1990-91, giving unleaded an average share over the year of 10%.

15. If the tax differential were increased by a further 5 pence a gallon, on the basis of experience to date the change in pump prices might be 4 pence. This would make unleaded petrol cheaper than the most heavily discounted four star leaded petrol. The switch to unleaded petrol by cars which can run on both is likely to occur more rapidly, and it will also be worthwhile for many more motorists to get their cars converted.

16. As two star and unleaded are close substitutes (since most cars that run on two star leaded petrol can also run on unleaded) the price of two star petrol would tend to fall initially, limiting the additional market share captured by unleaded. But the implied reduction in the profitability of two star would hasten its withdrawal from the market - its market share is already under 8 per cent and falling.

17. Even so, it will take time to overcome the inertia arising from the information problems described in paragraph 12, as well as to expand the availability of unleaded petrol, although there should be ample incentive to the petrol companies to do this. Our working assumption is that of the 13m cars that can technically potentially

use unleaded in 1990-91, about one third will be doing so by the end of the year. Unleaded thus has an average share in 1990-91 of 18%.

18. The metric option of increasing the tax differential by 0.7 pence a litre is equivalent to only 3.2 pence per gallon. As a result, the unleaded share grows less rapidly than under the imperial option, reaching 15% in 1990-91.

19. If, at the same time, the duty on 2 star were increased to bring the price of 2 star into line with the price of 4 star, then the demise of 2 star would be hastened. As a result, the unleaded share would grow more rapidly in both the imperial and metric cases.

20. Table 2 sets out our forecasts, agreed with Customs and Excise, of the actual share of unleaded petrol under these different options.

	Current	Proposed imperial		Proposed metric	
	10.6p /gal	15.6p /gal	+ 2 star surcharge	0.7p /ltr	+ 2 star surcharge
	%	%	%	%	%
1988-89	2½	2½	2½	2½	2½
1989-90	6	9	11	8	9½
1990-91	10	18	20	15	17

Implications for Tax Revenue

21. Since the tax on unleaded petrol is lower than that on leaded, any rise in the unleaded share implies a fall in the average tax rate on petrol as a whole. The fall in the average tax rate expected with the current tax differential reduces revenue by some £15m in 1989-90 and £45m in 1990-91.

22. The additional costs of the various options for changing the differential are shown in table 3. The presentation is as in the Budget scorecard, with revenues from yearly indexation not taken into account (having been scored elsewhere).

Table 3

	Proposed imperial		Proposed metric	
	15.6p /gal	+ 2 star surcharge	0.7p /ltr	+ 2 star surcharge
	£m	£m	£m	£m
1989-90	45	60	30	30
1990-91	110	125	60	75

Except in the first year of the metric case, a surcharge on 2 star is more costly. This is because the loss from a further switch to unleaded more than outweighs the additional revenue from the dwindling amounts of 2 star sold.

D. M. Lawton

for **S W MATTHEWS**

rc 1989/3.2.02

BUDGET CONFIDENTIAL

FROM: ROBERT CULPIN
DATE: 3 February 1989

CHANCELLOR

Budget Spn

cc: Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Anson
Mr Scholar
Mr Gilhooly
Mr Wilson
Mrs Chaplin
Mr Tyrie
Mr Call

Ch/
As Robert says... (para 1).
JT
3/2

UNLEADED PETROL

Here is a batty scheme to cheer you up.

Problem

2. Not enough people are having their cars converted to unleaded. We are told anyone can have the job done for £15-20; but scientific surveys by your office cast some doubt on this. It takes months for people to get their money back, from the saving on unleaded petrol; and this makes no allowance for the cost in inconvenience of taking the car to the garage, being without it, and running the risk that mechanics will make a mess of it. We may not solve this by fiddling with pennies a gallon. The market signals are too weak.

Solution

3. Announce in, or immediately after, the Budget that anyone who has a car converted by 30 June can have the operation at the Government's expense. They take their cars to participating garages. They have them converted, and pay nothing. Garages are free to choose whether to play or not. If they do, they send the Government the registration numbers of cars they have converted. Someone checks, as for multiple share applications, that we are not paying on the same numbers twice. The Government then pays the garages (say) £17 per conversion. We keep the administration simple.

4. Alternatively, we could pay only half the cost.

Maximum cost

5. Broadly £170 million, all in 1989-90, as a charge on the Reserve. In future years, we get our money back by levying more duty on unleaded petrol than would otherwise be the case.

Snags

6. We should no doubt pay for some conversions which have already been made, and for some cars which are piled up in junk yards. There would be no direct quality control. People might blame the Government, as well as the garages, for anything that went wrong.

Clinching advantages

7. A public expenditure measure - the Chief Secretary should love it. A Budget for cowboys.

8. I don't think this will run. But if I don't air it, someone else will. And we still need <u>something</u> to liven things up.

9. Your turn.

RC

ROBERT CULPIN

cst.pas/mc/2.3.2

BUDGET CONFIDENTIAL

FROM: MARK CALL
DATE: 3 FEBRUARY 1989

CHANCELLOR

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Mrs Chaplin
Mr Tyrie

LEADED AND UNLEADED PETROL

Having seen Mr Matthew's minute of 2 February, I am more convinced than ever that a significant encouragement of unleaded petrol would be of major presentational value. I'm not entirely convinced however that we need to impose a surcharge on 2-star for the use of unleaded petrol to take off.

2. Firstly, I was surprised to see that the potential share of unleaded petrol in 1989-90 is already 58%, compared with 3% actual use. The market share of 2-star is currently 8% and falling. In other words we are not talking about encouraging a shift of usage from 2-star to unleaded, so much as from 4-star to unleaded.

3. There are currently two main barriers to the take-off of unleaded petrol. Firstly, availability at the pumps. Oil companies will soon switch 2-star pumps to unleaded when consumers start demanding it. The second, in my view more serious barrier, is ignorance among consumers. Most people do not know if their car can use unleaded. They do not know (I certainly didn't) that you can mix leaded and unleaded petrol, so that there is no risk of being stranded if you can't find an unleaded pump. They do not know (again I didn't) that the cost of conversion is typically as low as £15-20. Consequently they do not realise the speed of payback, which is about a year with the current differential and would be significantly shorter with an increased differential. (Assuming 30 miles per gallon, 5½p to the gallon differential, and an average 12,000 miles per year.) Most people believe that performance will be impaired - perhaps they see it as a threat to their virility; the image of unleaded petrol is pretty wimpish! Finally, there is very low awareness of the damage caused by lead pollution.

CALL 3/2

4. What this suggests to me is needed is a good information campaign to back up any increase in the duty differential. The oil companies are always trying to show they are good citizens - we should be able to get them to contribute to such a campaign. I believe unleaded petrol is poised to take off rapidly, and that there is a major opportunity to reap the presentational benefit. But I think there is a risk that by being seen to tax 2-star out of existence we would destroy some of the goodwill.

MC

MARK CALL

chex.rm/mw/2

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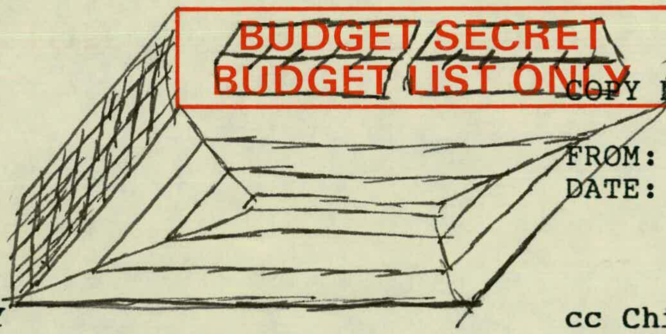

FROM: MISS M P WALLACE
DATE: 13 February 1989

BUDGET SECRET

MR RILEY

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr Sedgwick
Mr A C S Allen
Mr Gilhooly
Mr S W Matthews
Mr Pickford
Mr Macpherson
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill - IR
Mr Isaac -IR
Mr Painter - IR

Mr Unwin - C&E
Mr Jefferson-Smith - C&E

D
if allowed

B.L.O.

BUDGET STATEMENT: OUTLINE

... I attach the outline of the Budget statement which I put to the Chancellor on Friday evening.

2. The ordering of the various sections will no doubt change, when we have the Chancellor's comments, and as we write it up. In particular, some of the tax measures could just as well go in one section as another (eg perks, or PRP): we can think further about this depending on the overall balance of the speech, as it develops.

SECRET

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BUDGET SECRET

3. I shall be putting a first full draft of the speech to the Chancellor this Friday, 17 February. In the meantime, I should be grateful for any comments you or others may have on the overall structure.

MPW.

MOIRA WALLACE

SECRET

B.L.O.

SECRET

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OUTLINE

A. INTRODUCTION

Vigorous growth, employment/unemployment, unprecedented strength of public finances. Reaffirm policies that brought success, crucially determination on inflation.

B. ECONOMIC BACKGROUND

2. 88 activity much stronger than expected worldwide. Figures.

3. UK maintains place at top of growth league cf main European competitors, with another year of vigorous growth.

4. Judge that in 88 output growth [4½ per cent] in line with income and output measures but higher than unreliable expenditure measure.

Discrepancies between different measures of GDP an increasing problem in 88. Part of wider problem

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with economic stats, of concern to Govt, TCSC, outside commentators - launched Review, conclusions announced/expected shortly.

5. In meantime have to take most sensible view can of what is happening on basis of raw data we have.

6. Present our best estimates in FSBR. Which also sets out unadjusted figures. Full press notice on methodology. Not gone whole way (why). In some cases adjustment makes little difference. In some cases figures less favourable. But believe that adjusted figures nearer accurate picture of what is happening to demand and output, and it is these shall be using in setting out background.

7. 4½ per cent means xth year of [steady growth/ growth above y]. Within this manufacturing esp strong in 88 at [6 3/4 per cent] (past previous peak)

8. Productivity.

9. Employment : new figs and falls in unemployment

10. Manufacturing investment (past previous peak). Investment generally. Investment and consumption.

11. Faster than expected growth in domestic demand a sign of confidence in Govt's handling of economy. But led to [capacity constraints] faster growth in imports, and deterioration in current account. Estimate deficit at [£10 billion]. Large but no problem financing. Govt commitment to fiscal prudence and monetary discipline recognised.

12. But with stronger growth of domestic demand also some resurgence of inflationary pressures. Have had no hesitation in acting, and interest rates taking effect. But in short term perversely caused rise in recorded inflation.

13. For 89, already signs of desirable deceleration of demand. (Evidence) Expect to continue. Forecast investment to remain high (reasons). More marked effect on consumer spending. (Reasons). GDP growth forecast to be correspondingly slower than in recent years at x.

14. With mortgage rate increases coming into RPI early in year, (and reductions from early 88 dropping out of the annual figures) recorded inflation will peak at around x% [next month] before falling back to y% by end of year.

15. Current account may take longer to improve. Same in 89 as 88. Improve later. Import growth to slow with domestic demand. Trade performance should improve as capacity constraints wear off. No sign of any financing problems [as long as seen to maintain prudent policies].

16. [Manifestly no loss of confidence in £. Ended yr slightly firmer, but generally period of welcome stability. Risks / prospects internationally]

17. Risk at home ... pay. If employers fail to control, Govt will not bail them out, jobs will be lost.

THE MEDIUM TERM

18. Have shown that will take necessary action - however unpalatable - to bring the economy back on

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to track set out in MTFS. Now entering 10th year: MTFS remains central framework of policy.

19. Determined to maintain steady downward pressure on inflation, downward path for money GDP.

20. Critics of early versions argued that aims could only be achieved at expense of lost output; but record proves otherwise.

21. This year, however, some resurgence of inflationary pressure. Action taken to restrain demand, bring money GDP growth and inflation back down; path set out in MTFS.

22. [Something on savings]

23. [More on current account]

<u>**Monetary Policy**</u>

24. Within MTFS central role in bringing inflation down belongs to monetary policy, buttressed by prudent fiscal stance.

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25. Inflation a monetary phenomenon: monetary policy key to fight against inflation. Means interest rates. Alternatives don't work. [Credit controls]

26. Shall therefore continue to ensure that interest rates are at the level necessary to ensure downward pressure on inflation. MO and other evidence suggests domestic inflationary pressures now easing as predicted in response to tightening of monetary stance. [It may however be necessary to maintain the current level of short-term interest rates for some time yet.]

27. Decisions on the appropriate monetary stance will continue to take full account of role of exchange rate. Have made clear increases in domestic costs will not be accommodated either by monetary expansion or by exchange rate depreciation. Appropriate that exchange rate strengthened slightly in light of emerging inflationary pressures. [[Objective-stability subject to overriding need to bear down on inflation.]]

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28. [Ultimate objective stable prices] No government could be proof against short-term fluctuations along the way. But can guarantee the will to ensure that they <u>are</u> only short-term.

29. Accordingly confirm 1989-90 <u>target for MO</u> growth of 1-5 per cent, set last year. Measured on twelve month basis will start the next financial year above top of this range reflecting high growth figures in spring and summer of 88. But growth of MO over latest 6 months very low - equivalent to X at an annual rate - so twelve month growth will fall below 5 per cent within a few months.

[Here, or somewhere else, a <u>section on COBO</u>, benefits of liberalisation generally?]

Public Sector Finances

30. Prudent fiscal policy always part of MTFS: need to limit burden of debt and public sector's claim on savings and inflows of capital. Needs to be set in medium term context. Not short-term "demand management" tool, but key element of

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successful supply side policies [expand]: pattern of taxes and expenditure, and impact on supply side.

31. Last year provided for PSDR of X in <u>1988-89.</u> Public finances have turned out to be even stronger (give figures). Reflects buoyant economy, so revenues up sharply, public expenditure down as a share of GDP. 1988-89 Public Expenditure outturn and reasons. Also higher privatisation proceeds.

32. Strong position enables Government to repay debt, and reduce the public expenditure burden of debt servicing on present and future generations. [Illustrate with some figures.]

33. This makes room for further debt repayment, tax reductions, or increased expenditure elsewhere on priority services. Already seen latter (cf Autumn Statement).

34. Implications for <u>funding.</u> Restructuring. New techniques etc. [Finance Bill powers to enable government to buy gilts from Issue Department and cancel them.]

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35. Factors bearing on PSDR in 1989-90:

- as always prudent and cautious approach essential;

- must not undo all the progress of recent years, and the strong position that we have built up.

- present strong position partially reflects cyclical influences which will tend to unwind as economy reverts to more sustainable path;

[- gradualist approach essential, to avoid sharp changes in fiscal stance and disruption of the economy;]

36. Conclude that should provide for PSDR in 1989-90 of X.

37. Beyond 1989-90, expect to see PSDR revert [gradually/eventually] to zero - a balanced budget. Illustrative path [for medium term] set out in

MTFS. Though precise path may vary, should permit continuation of steady process of tax reform. To which we now turn.

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TAXATION SECTION

1. BUSINESS

Main CT rate. International comparisons? Businesses doing fine, so no major change. But small companies profits limit

Pre-trading expenditure relief (plus any other minor business changes)

Oil incrementals

ITV levy

Perks: cars
~~subsidised mortgages~~
~~relocation~~

PRP

Simplification/deregulation:

close companies
VAT package
Schedule E receipts basis

2. SAVINGS

Rationale. Discrimination in tax treatment of different kinds of savings. Redress in favour of ownership.

[N.B. Independent taxation and savings]

Stamp Duty

Unit trusts

Life Assurance

Pensions

Wider share ownership

PEPs
ESOPs / ESS

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3. TAXES ON SPENDING

mention VAT ECJ stuff in passing
already announced VAT deregulation
VAT on charities

charities generally:

PRG
[National Trust starter]

VED:
equity (get coaches and rigids up to track costs)
simplification (reduce number of rates)

number plates

excise duties: rationale for unleaded petrol

4. CGT:

~~limit~~
gift deferral
~~block avoidance - cobo tax changes, etc~~

5. INCOME TAX

allowances (age allowance)'

rates

Board Room
H M Customs and Excise
New King's Beam House
22 Upper Ground
London SE1 9PJ
Telephone: 01-620 1313

Copy No 2 of 11

From: P G Wilmott
Date: 17 February 1989

ECONOMIC SECRETARY

UNLEADED PETROL

Parliamentary Counsel is busy drafting the clause to give effect to the decision taken at the Overview meeting on 6 February (that we should increase the duty and tax differential for unleaded petrol to 2 pence a litre and introduce a surcharge on 2-star fuel of 1.1 pence a litre). We shall have to put this to bed in a little over a fortnight. But it could first be useful to run over the ground again to check that the package is right, against the background of a rapidly changing petrol market.

The Treasury have booked space at the Overview meeting on 27 February. If you agree, we would circulate a paper by 23 February for discussion on the 27th. I attach a draft, on which we would welcome your comments. I envisage that it could be accompanied by a very short note, drawing attention to the main points, something on the lines of what follows below.

Our 'green' petrol package has two components: a <u>reduction</u> in the duty on unleaded fuel and an <u>increase</u> in that on two-star. The first question is, then, "are the numbers right ?". The widening of the gap between unleaded petrol and 4-star fuel by around 0.7

circulation:	PS/Chancellor	CPS
	Mr Culpin	Mr Jefferson Smith
	Mr Gilhooly	Mr Allen
	Mr Call	Mr Gaw
		Mr Spackman

pence (duty plus VAT) should take the pump price differential to about 2 pence a litre (9 pence a gallon) and increase the uptake of unleaded to a projected 15 per cent of the market by the end of 1989-90 and 20 by 1990-91. There is nothing in the latest market information, or public campaigns for action, to suggest that any more is needed. The surcharge on two-star is more difficult. What matters is the differential <u>on the forecourt</u>; average price differences (around 1 pence per gallon nationwide) are misleading, since it is the perceived price advantage of two-star at his usual pump that is most likely to encourage the motorist to buy it. To be on the safe side (ie to ensure that two-star is <u>at least</u> as expensive as four-star), we think that it would be wise to stick with the figure proposed.

A further question is **"do we still need the two-star surcharge ?".** The market is declining fast. Although we think there is little risk that it may collapse before the Budget itself, it could be only a matter of months before the lower grade becomes virtually unavailable. This exposes the Budget measure to the criticism that it is unnecessary and (perhaps) gimmicky. Against this, public opinion is widely conditioned to expect a widening of the unleaded differential. The figure in the package could be lower than many hope to see; the addition of an unexpected component could help prevent the measures turning out to be something of a damp squib. Our advice, on balance, is to keep the package as it is.

A subsidiary point, finally, is publicity. As the paper explains, DoE now see little need for a further campaign centred on the Budget (although CLEAR and the RAC are pushing for one). They argue that recent events have done more than enough to raise the profile of the unleaded initiative - and it is true that the use and availability of the fuel are growing at an accelerating rate. Unless Ministers feel strongly about concerting publicity, we now think the Budget publicity machine will be sufficient by itself.

P G WILMOTT

CHOSEN OPTION

1. The Overview Meeting of 6 February adopted Option A (increase the present tax differential by 0.7p/litre and surcharge two star leaded petrol by 1.1p/litre).

2. In setting out the Options, no account was taken of the availability of 3 star, which has an octane rating between 2 and 4 star. If only 2 star were surcharged it is probable that the trade would find it attractive to market 3 star. We have therefore interpreted the decision to require a surcharge on all petrol other than 4 star and have instructed Parliamentary Counsel accordingly.

3. In our view the option will ensure that unleaded is always sold at below the price of any remaining 2 or 3 star. The 2 star price should be at or above that of 4 star sold on the same forecourt. Unleaded will be cheaper than 4 star on the same forecourt, but we cannot exclude the possibility of heavily discounted 4 star sometimes being cheaper than unleaded in the same area.

UNLEADED - THE MARKET PICTURE

4. There has been a recent dramatic upsurge in availability. At the end of January 4,300 sites stocked unleaded, some with more than one pump. The rate of conversion has more than quadrupled to 250 a week. About 22 per cent of filling stations were therefore selling unleaded at the end of January and because they tend to represent the higher throughput outlets 40-45 per cent of fills were obtained at sites where there is a choice of unleaded. The trade are building a market base in the expectation of a further pricing incentive in the Budget.

5. Unleaded market share based on tanker deliveries to filling stations was 1.1 per cent for the whole of 1988, 3.14 per cent for December and 4.1 per cent for January 1989. These trade figures correspond closely with Customs figures for clearances from bonded warehouse which showed

just over 4 per cent for the month ended 14 January. Figures for the month ended 14 February, available on 28 February, are expected to show a figure in excess of 4.5 per cent.

6. We would expect Option A to increase the unleaded market share to around 15 per cent by 31 March 1990 and to some 20 per cent by 31 March 1991.

PUBLICITY

7. The position on publicity has changed since the beginning of the month with a surge of activity boosted by the Queen's attendance at the Motability "I Love Lead-Free" launch on 13 February. CLEAR are running their final "Lead Free Petrol Weeks" in Hampshire on 17-24 February and in Tyne and Wear on 10-17 March. Much publicity effort is being organised in anticipation of the Budget and although the RAC and CLEAR are pressing for a Government-led campaign to co-incide with the Budget, Department of the Environment officials are reluctant to sanction large expenditure. We believe that Budget action will crown existing publicity plans and our advice is that there is now no particular need to press Environment to mount a special "Budget" campaign.

8. Two pieces of negative publicity have emerged - both spurious. The Daily Mail published a report purporting to come from the Warren Springs laboratory showing an increase in lead in the air. The 1988 figures were fabricated. In the second incident the Chief Fire Officer for Wiltshire apparently alleged that unleaded petrol fires were more difficult to extinguish than leaded petrol fires. This is untrue but received wide credence. A Home Office working party is considering a rebuttal.

TWO STAR

9. The market share of two star continues to fall sharply and is conservatively estimated to have declined in January to 6.3 per cent. Virtually all cars using two star can use unleaded but there are a number of vehicle types (but not many vehicles) which must use leaded: a list is annexed. Most petrol-engined equipment other than cars, including motor cycles, lawnmowers and all two stroke engines can use unleaded. All engines using two star can run without adjustment on four star leaded.

10. Ministers may wish to consider where the balance of advantage now lies in squeezing out remaining two and three star. The imposition of the surcharge can be expected to accelerate the already steep decline and has the attraction of being a novel and innovative measure. On the other hand opinion in the industry is that the decline in two star will continue in any case and CLEAR appear to have dropped their demand for a ban. Presentationally it could be awkward defending action which obliges owners of generally older and cheaper cars, albeit few in number, to use a fuel of higher octane than they need and which is thus intrinsically more expensive.

NETHERLANDS AND GERMANY

11. In December 1988 the Netherlands unleaded market share was 26 per cent (4 per cent two star and 22 per cent four star). The overall percentage was the same as in June 1988 but within the total there has been an unlooked-for and marked shift from two star (Regular) to four star (Premium).

12. In Germany the unleaded share is now 50 per cent of the market but the increase since September 1988 has only been 4 per cent.

VEHICLE TYPES RECOMMENDED TWO STAR WHICH CANNOT USE UNLEADED

MODEL	TYPE	YEAR	ENGINE CODE
AUSTIN ROVER			
Mini	850	1977-84	85H
Mini	1000	1976-78	99H
Mini Van	850	1976-81	85H
Mini Van	1000	1976-83	99H
Metro	1,3LC	1980-86	12H
Metro Van	1,0	1980-84	99H
Metro Van	1,0	1985-89	99H
Metro Van	1,3	1986-89	12H
Maestro Van	1,6LC	1984-89	16HS
Marina	1700LC	1978-80	17V
Marina Van/Pick-up	1,1	1976-78	10V
Marina Van/Pick-up	1,3	1976-78	12V
Ital Van Pick-up	1,1	1980-85	10V
Ital Van Pick-up	1,3	1980-85	12V
Sherpa	1600	1974-78	16V
Sherpa	1800LC	1974-78	18V
Sherpa	V8	1985-89	-

MODEL	TYPE	YEAR	ENGINE CODE
BEDFORD			
HA/Chevanne	HA	1978-88	92170
HA/Chevanne	HA	1978-88	92370
CF	1,8	1975-82	18
	1,8	1983-84	18
	2,3	1975-82	23
	2,3	1983-84	23
CITROEN			
2CV6	602	1978-84	A06/635
Dyane 6	602	1978-83	AM2
Visa	652	1979-82	VO6/630
DAIHATSU			
Fourtrack	F20/F25	1978-83	12R/J
FIAT			
126	652	1977-87	126A/1,000
MITSUBISHI			
Colt (RWD)	1,4 Turbo	1982-83	4G12T
Mirage (RWD)	1,4 Turbo	1983-84	4G12T
Celeste	1600 GSR	1976-81	4G32GS
Sigma	2000 GLX	1977-81	4G52
New Sigma	1600	1983-84	4G32GS

MODEL	TYPE	YEAR	ENGINE CODE
NISSAN			
Pick-up	1,6	1979-80	J16
Urvan	2,0	1980-82	H20
Cabstar	2,0	1978-82	H20
OPEL			
Ascona-B	1,3	1975-81	13
Ascona-B	1,6	1976-81	16
Ascona-B	1,9N	1975-81	19N
Ascona-B	2,0N	1975-81	20N
Manta-B	1,6	1979-82	16
Manta-B	1,9	1979-82	19N
Manta-B	2,0	1979-82	20N
Rekord-E	2,0N	1978-81	20N
Kadett-D	1,0	1979-84	10
Kadett-D	1,0S	1979-84	10S
Kadett-D	1,2	1979-84	12N
PORSCHE			
924	924S	1985	M44/07/08
SUBARU			
GTi		1984-86	EA82(m)
GTi		1987-89	EA82(m)
Turbo		1985-86	EA82(T)
'L' Series Coupe	Turbo	1986	EA82(T)
'XT' Hardtop	Turbo	1985-86	EA82(T)

MODEL	TYPE	YEAR	ENGINE CODE
TALBOT			
Dodge 1100	1100	1979-84	350
Express	1,8	1986-89	169B
TOYOTA			
Celicia/Supra	2,0ST	1978-82	18R
Celicia/Supra	2,OXT	1978-82	18R
Cressida	1,8	1977-81	18R
Hi-Lux	1,6	1979-84	12R
Hi-Lux	1,8 4x4	1979-84	18R
Hi-Ace Van	1,6	1977-86	12R
Hi-Ace Van	2,0	1977-83	18R
Hi-Ace Pick-up	1,6	1977-86	12R
HI-Ace Pick-up	2,0	1977-83	18R
Landcruiser	4,2	1981-84	2F
VAUXHALL			
Cavalier	1900	1975-81	19N

Budget
Statement

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FROM: MISS M P WALLACE
DATE: 20 February 1989

MR RILEY pl keep as appropriate.

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Dame A Mueller
Mr Wicks
Mr Hardcastle
Mr Byett
Mr Scholar
Mr Culpin
Mr Sedgwick
Mr A C S Allen
Mr Gilhooly ← Mr Grieve.
Mr S W Matthews
Mr Pickford
Mr Macpherson
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill - IR
Mr Beighton - IR
Mr Isaac - IR
Mr Painter - IR
Mr G Bush - IR
Mr C McNicol - IR

Mr Unwin - C&E
Mr Jefferson Smith - C&E
Mr P R H Allen - C&E
Ms A French - C&E

BUDGET STATEMENT: FIRST DRAFT

... I attach the first draft of the Budget statement, which I put to the Chancellor on Friday evening.

2. As you will see, a number of gaps remain. I expect the introduction and the conclusion will be the last sections we write. I plan to write the penultimate section on income tax etc this week. Otherwise, the order of the tax section is still highly provisional. We have our first discussion of presentation

at today's overview, and can firm up the order in the light of that, and the Chancellor's comments on this draft. In the meantime, the second half of the speech is essentially "loose leaf" and the linking passages remain to be written. I am also conscious that there is a hand full of subjects that still need a mention: residence, independent taxation, (tax treatment of exchange gains and loses?). I would welcome suggestions on what we might say on these, and where. I would also particularly welcome ideas on how the speech can be shortened.

3. I should be grateful for any comments as soon as possible. It would be helpful if the absolute deadline could be Thursday lunchtime, as I am to put a further revised draft to the Chancellor for the weekend.

MOIRA WALLACE

[INTRODUCTION - to follow]

THE ECONOMIC BACKGROUND

I start with the economic background.

2. 1988 has been another year of buoyant growth world wide, exceeding expectations in each of the major industrial countries, in most cases substantially so. World trade in manufactures probably grew by [10] per cent, and output in the G7 by an average of 4 per cent.

3. In the UK, growth has again been above the G7 average, and ahead of all our major European competitors. I now judge that the figure for 88 as a whole will turn out to be around 4½ per cent.

4. Overall output growth of 4½ per cent means that in this upswing we have now recorded x years of sustained growth. Within this overall very vigorous growth performance, the performance of manufacturing has again been particularly strong, with growth of getting on for 7 per cent in 1988, and manufacturing output now 10 per cent above its previous all time peak.

5. The key to this sustained improvement in manufacturing performance has been the major improvement

in productivity that has been secured under this Government. In the '80s, our manufacturing productivity has grown faster than that of any other industrial country - following years at the bottom of the league in the '60s and '70s.

6. [We now know that] employment has risen continuously since 1983, by a total of [over 2½] million, to an all-time record high. Unemployment has now been falling for 30 consecutive months, the longest period of continuous decline since the War, taking it below 2 million.

7. Another very satisfactory feature of the recent past, and a very good omen for the future, is the strength of investment, which looks to have grown by some 14 per cent in 1988. Indeed, over the last 7 years, investment has grown twice as fast as consumption. In the previous 14 years consumption grew faster on all but three occasions.

8. The recorded figures for investment growth show a smaller increase in 1988. But it is perfectly clear from the well-known discrepancies within the National Income accounts that the estimates of expenditure, and of investment spending in particular, are inconsistent with all the other evidence. The Treasury has, in consultation with the CSO, undertaken an exercise to

produce a set of accounts that gives a more consistent picture of how the economy developed between 1986 and 1988, and it is those figures which form the basis for the forecast I shall be giving today. Full details are published in the Financial Statement and Budget Report.

9. The strong growth of investment - and indeed the strong growth of consumers expenditure too - is no doubt in great part a reflection of confidence in the British economy. But with domestic investment exceeding domestic saving, some of the investment has had to be financed from overseas. As a result the current account now looks to have been in deficit by some £10 billion in 1988. This is a sizeable deficit, clearly, but it has been financed without difficulty, thanks to the Government's firm commitment to monetary discipline and fiscal prudence.

10. At home, it became clear during 1988 that the growth of domestic demand was stronger than thought, and had come to be too much of a good thing. There was evidence of some resurgence of inflationary pressures. I had no hesitation in acting to nip this in the bud, by tightening monetary policy. The first effects of higher interest rates began to show through at the end of the year, for example, in the figures for M0 growth, retail sales, and house prices.

11. However, in the short-term, the fact that the UK, unlike almost all other EC nations, includes mortgage interest payments in its consumer price index, means that the very action taken to combat inflation appears to cause it to rise. Thus, annual inflation, as measured by the retail price index, ended the year rather higher, while the underlying rate of inflation remained fairly steady in the second half of the year, at around 5 per cent.

12. Looking ahead to 1989, we are already seeing more and more evidence that inflationary pressures are coming back under control. M0 has slowed markedly since last summer, retail sales have been broadly flat for the last six months, and the housing market shows clear signs of cooling off. This is backed up by surveys of consumers' and retailers' confidence.

13. But some of the effect of higher interest rates is only just beginning to have an impact. For example, those whose mortgages are adjusted only once a year, will only now be feeling the effects of last year's increases in interest rates. So further slowing in consumer spending is to be expected. This will bring overall output growth down to a more modest rate of [2½] per cent in 1989.

14. This may seem disappointing by the standards we have come to expect in the last few years. But it is a respectable figure, by any standards, historical or international. And with investment likely to remain high - a view confirmed by all the latest surveys of investment intentions - the growth prospects beyond [1989] are good.

15. The underlying path of inflation will, of course, continue to be obscured by the influence of mortgage interest rates. First we will see a peak in annual RPI inflation [at around x per cent] [next month] before it falls back to [y per cent] by the end of the year.

16. As I have always made clear, the current account will take longer to adjust. Import growth should slow, as consumer spending eases a little. And trade performance should improve as new capacity comes on stream. Although I expect the monthly deficits to be on an improving trend through the year, I expect that the deficit for the year as a whole will be much the same for that of 1988 [with a more marked improvement thereafter].

17. Turning to the world economy .....[strong/steady growth; US budget deficit; imbalances.]

18. In parallel, it is clearly desirable that the major nations should continue the process of international cooperation, to guard against the risks of renewed turbulence in the international markets. I can assure the House that the UK will continue to play its full part in this co-operation.

The Medium Term

19. In an increasingly open world economy, no nation can be insulated from external shocks. What individual Governments can guarantee is that they will put the right economic policies in place, and stick to them. Provided they do this, they can survive the difficult years, and excel in the good ones.

20. This describes exactly what has been achieved in the UK. This Government has now been in power for nearly a decade, during all of which time economic policy has been steady/essentially unchanged. This has brought outstanding success.

21. At the very heart of the Government's strategy has been the determination to bear down on inflation. For ten years now, the medium term financial strategy has provided a clear and disciplined framework for reductions in the growth of money GDP, and hence inflation. Between 1974 and 1979 inflation averaged

15 per cent [and was rising]; between 1984 and 1989 it averaged 5 per cent [and is now set to fall].

22. This is the answer to those who doubted that the MTFS would be successful. Or those who maintained that the Government's inflation objectives could only be achieved at the expense of lost output, or falling living standards, or harsh public expenditure cuts.

23. Far from suffering, output in the UK has grown faster than in all other major EC countries during the '80s - a marked contrast with the two previous decades when the UK was at the bottom of the league.

24. The knowledge that the overall financial framework is prudent and sustainable has given business and industry the confidence to expand. Tax reforms have increased the incentives to enterprise, and supply side reforms have removed the disincentives and barriers. Indeed, the supply response of the economy has improved out of all recognition in the '80s.

25. The cornerstone of this dramatic improvement in the performance of British industry has been a large and sustained improvement in productivity. Whole economy productivity has grown by $2^{3}/_{4}$ per cent a year since 1980 - [putting the UK, with Japan, ahead of all other

major industrialised countries in terms of productivity growth.]

26. At the same time, more people are in work than ever before in this country, and their real take home pay has risen by almost a third since the Government took office. And they enjoy better public services too. For while the Government has been able to achieve its aim of bringing the growth of public expenditure within that of the economy as a whole, so that its share of national income has fallen, within that overall constraint more has been spent on priority areas, such as health, law and order, and capital spending.

27. The last ten years, then, have been a time of unprecedented improvement to the economic fundamentals in the UK. When we came to power, Britain was a textbook example of relative economic decline. Now it is out-performing the competition, and the policies that have brought success - tax reform, firm fiscal and monetary policy and the determination to improve the supply side - are being emulated the world over.

28. Unfortunately, it is taking rather longer for conventional economic wisdom to catch up with Britain's economic renaissance. Ten years on, some people still think it cannot last, and are permanently on the lookout for bad times. And so they pick on the things that - in

another, unhealthier, age - would have set the alarm bells ringing.

29. This perhaps explains the great agitation in some quarters about the fall in the personal savings ratio. Once, a fall in personal savings might indeed have been cause for concern - in the '70s, for example, when there was precious little chance of a shortfall of saving from households being offset by the corporate sector or - still more unlikely - the Government itself.

30. But that is exactly what <u>has</u> happened under this Government: with a dramatic recovery in company profitability, company saving has risen to offset the decline in personal savings. In addition, of course, the Government itself has moved from deficit to surplus. So, in fact, total national saving has been rising in recent years, and now stands at [roughly the same percentage of GDP as we inherited].

31. I expect the personal savings ratio to recover during 1989. High interest rates will discourage consumer borrowing and increase the incentives to save. They are indeed the appropriate market route to dealing with [any pressures caused by] low personal savings.

32. The other notable respect in which commentators have failed to catch up with the transformation of the

British economy is in the significance they attribute to a deficit on the current account of the balance of payments.

33. There are clearly some circumstances in which a current account deficit would be cause for concern: if it were a consequence of a Budget deficit, if monetary conditions were too loose, or if the Government did not have the confidence of markets.

34. The position today could not be more different. The current account deficit has arisen at a time when the public sector, far from being in deficit, is running an unprecedented surplus. The external deficit is, in fact, the result of private sector behaviour. And in time private sector behaviour will correct it.

35. But it will take time, as I have repeatedly made clear. There are no quick fixes, and there is no need for them. In the meantime, the Government will stick to its well-tried and proven policies.

<u>**Monetary policy**</u>

36. From this point of view, as from every other, it is essential that we remain prepared to take whatever action is necessary - however unpalatable it may be - to bear down on inflation. [Within MTFS] the central role

in bringing inflation down rightly belongs to monetary policy, buttressed by a prudent fiscal stance. As I have always made clear, short-term interest rates are the essential instrument of monetary policy: this Government will set interest rates at whatever level is necessary to bear down on inflation, and will keep them at that level for as long as is necessary.

37. The Government is under no illusions about the short-term effects of last year's rises in interest rates on homeowners and other borrowers. They will have had to restrain other expenditure, in some cases quite sharply, to meet increased interest charges.

38. But here again, we have to have an eye to the medium-term. It is already difficult to remember the days of runaway inflation. But those who can cast their minds back know that the pain of higher interest rates for a time now is far preferable to the damage that was done to working families, pensioners, industry, and the whole of the nation's economic and social fabric, by years of rapidly rising prices. The Government is determined that there shall be no return to that.

39. Interest rates are indeed a remarkably well-directed instrument to deal with the particular inflationary pressures we have seen reappearing in the last year. First, they are well targeted on the housing

market, which has been the major force behind the strong consumer credit growth [of the last year]. In this respect, they are also very well targeted from a regional point of view, as they will tend to focus the adjustment on the South of England, where inflationary pressures have arguably been strongest, as more people in the South have mortgages in excess of £30,000, and so do not have the full effect of increased repayments cushioned by tax relief.

40. Most importantly - and this point is not, perhaps, well understood - they are also well targeted as between households and companies. While the household sector has moved from being a net lender to being a substantial net borrower, the company sector's finances are in far better shape than a few years ago, so that it is far less vulnerable to increases in short-term interest rates. The company sector is also well placed to benefit from the fact that long-term interest rates have remained very stable, and well below short rates - an indication of the markets' confidence that inflation will be brought down.

credit controls, and link with

[Possible slot for piece on COBO/financial deregulation]

41. Now all the evidence is that the tightening of the monetary stance is taking effect in exactly the way we predicted. [M0, retail sales, etc.] This is, of

course, welcome. [But the process is bound to take time. I can assure the House that I shall not keep short-term interest rates at their present level for any longer than is necessary: on the other hand, there will be no question of relaxing the monetary stance before it is appropriate to do so.]

42. Decisions on the appropriate monetary stance will continue to take full account of the role of the exchange rate. The Government has made it clear that increases in domestic costs will not be accommodated either by monetary expansion, or by exchange rate depreciation. In fact, sterling ended 1988 slightly stronger against both the deutschemark and the dollar than at the beginning of the year, and I judged this appreciation appropriate in the light of the inflationary pressures that had emerged. [Overall objective - stability/overriding need to bear down on inflation.]

43. This determination to bear down on inflation is the absolute key to the Government's economic strategy. The ultimate objective remains stable prices. No Government could be proof against short-term fluctuations along the way. But Governments can guarantee the will to ensure that they <u>are</u> only short-term. This Government has demonstrated that determination, by taking action to

bring the economy back onto the track set out in the MTFS.

44. Accordingly, I propose in that the target range for M0 growth in 1989-90 should be 1-5 per cent exactly as envisaged in last year's MTFS. Measured on a twelve month basis, M0 will start the next financial year above the top of this range, reflecting the high growth figures in the spring and summer of 1988. However, the growth of M0 over the last six months has been appreciably slower - equivalent to [X] at an annual rate - and I am confident that the twelve month figures will come within the target range [within a few months].

PUBLIC SECTOR FINANCES

45. A prudent fiscal stance has always been an essential buttress to a sound monetary policy, within the MTFS. [Needs to be set in medium-term context. Not a short-term demand management tool, but key element of successful supply side policies - pattern of taxes and expenditure, impact on supply side etc.]

46. In our early years of office we made steady progress in reducing the burden of Government borrowing. Now the public finances have been completely transformed with the budget in surplus since 1987-88.

47. Last year I budgeted for this surplus to continue in 1988-89, the year now ending. In fact, we have done rather better, for a variety of reasons. First, the success of the economy, particularly the now very marked reductions in unemployment, and the continued success of the right to buy programme, reduced the expected claims on public expenditure, so that the outturn for the year is likely to be some £[X] billion below the planning total we provided for.

48. Second, privatisation proceeds are appreciably higher than expected, at some £[X] billion for the year as a whole - a welcome boost to the public finances, and one that not many would have predicted a year ago, in the aftermath of the stock market fall.

49. Finally, a more buoyant economy has led to tax revenues significantly higher than expected. Taking all these factors into account, I now expect that the final outturn for the current year will be a Budget surplus of £[X] billion.

50. In the last two years, then, we have seen the largest period of repayment of public debt for [how long?]. This has permanently reduced the burden of debt servicing, both now and for future generations. For the coming year, for example, the debt repayments of the

last two years mean that debt interest costs are lower by £[X] billion a year.

51. We have already seen one beneficial effect of lower debt interest payments - namely that spending on priority services can be increased, without jeopardising the Government's overall objective for public expenditure. In the Autumn Statement I was able to announce that within an unchanged planning total we were able to allocate significant extra resources to our priority programmes. Those who saw a conflict between tax cuts and spending on the health service have been confounded, with a record increase in resources for the NHS in the UK of some £[X] billion. And there were significant increases for other priorities, notably capital spending on the prisons programme, and in the transport field for road maintenance and improvement, and for improved safety programmes.

52. But these selective increases in spending are just one of the possibilities opened up by debt repayment. Alternatively, and just as importantly, we can take advantage of lower debt interest payments to reduce taxes, or, indeed, to repay even more debt, continuing the virtuous circle.

53. [The dramatic improvement in the UK's public finances has also provided a welcome opportunity to

devote more attention to the structure of the debt that remains. Now that the Government has become a net purchaser of debt, it has been possible to tailor buying-in policies so as to reduce future interest costs, and to improve the quality of funding by relying less on the more liquid borrowing instruments.

54. For example, it has been possible to increase the proportion of indexed gilts in the remaining stock: since the Government is determined to eliminate inflation, index-linked borrowing is particularly cost-effective. The authorities have also been able to achieve a desirable adjustment in the average life of Government debt: buying-in has concentrated on longer maturity issues, so that in future years even the debt that remains will have a relatively lower interest cost.]

55. The long-term benefits that can be achieved from a period of public sector surplus are clear. This is one factor I have taken into account in deciding the fiscal stance for the coming year. Furthermore, this Government's approach to public finances has always been prudent and cautious, and this too is obviously the right course. There are two particular reasons for caution this year.

56. First, our present stronger than expected position clearly reflects some influences which are essentially cyclical. These will tend to unwind as the economy reverts to a more sustainable level of growth.

57. Secondly, we cannot ignore the role played by privatisation proceeds in our present fiscal strength. [Although major privatisations still lie ahead, in the longer-term the contribution of privatisation proceeds must logically tail away eventually to zero.]

58. It has been a hallmark of this Government that it has not committed resources to extra public expenditure or reductions in the tax burden unless it was certain that these could be sustained. I have continued to be guided by these principles in setting the public sector debt repayment for 1989-90. I have therefore concluded that it is right to budget for a further healthy surplus, of £[X] billion.

59. In last year's Budget I made it clear that the norm for the medium-term would henceforth be a balanced budget. For the coming year, as I have explained, we can and should do better than that. But beyond 1989-90, I expect to see the public sector debt repayment revert [gradually/eventually] to zero. The illustrative path for the medium-term is set out in the MTFS. [Implications for tax burden/tax reform.]

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SHARE OWNERSHIP

Introduction

I place first in my Budget measures to encourage Wider share ownership. Over the last 10 years the number of shareholders has risen from X to Y; and with this increase has come a greater sense of identification with British industry. [Survey results]

2. Exactly three years ago I introduced the Personal Equity Plan - a radical new scheme to encourage investment in British equities. In the first two years that the scheme has been in operation more than 350,000 plans have been taken out. This despite the stock market crash. I now have a number of improvements to propose.

3. First, I propose to raise the limit on the amounts that can be invested in unit and investment trusts. It will rise from £750 to £2,400. Unit and investment trusts are a good introduction to the equity market for smaller investors, and I want to encourage them. This increase will apply only to unit and investment trusts which invest mainly in UK equities.

4. Second, I propose to raise the overall PEP limit from £3000 to £4,800.

5. I also intend to make it possible for PEP holders who apply for new share issues, to put their resulting allocation straight into their PEP, provided this does not breach the overall limit.

6. Third, I propose to abolish a number of restrictions on PEPs, and to simplify them as much as possible.

7. I propose to do away with the rule that PEPs must be held for a full year; if investors choose to cash in their PEPs within a year of purchase, they will, in future be able to do so without tax penalty. I also propose to abolish the rules governing the amount of an investment that may be held in cash. Instead, interest on cash held in PEPs will, in future, be subject to composite rate tax.

8. Finally, I intend to move the PEP year from a calendar to a fiscal year basis. It has become clear that this would be more convenient for all concerned. I therefore intend that the next PEP year will start on 6 April. Anyone who has taken out a plan already in 1989 will also be able to take one out in the new PEP year.

9. Taken together, these changes will make PEPs simpler to administer and more attractive to first time

investors. I am confident that the package will lead to a considerable increase in PEP take up, and a substantial widening and deepening in share ownership.

10. Our measures to encourage employee share schemes have also had a major impact in widening share ownership. The number of approved all - employee share schemes has risen from 30 in 1979 to almost 1600 today, covering around 1¾ million employees, and involving shares worth over £4 billion.

11. This year I have a number of further improvements to the employee share legislation to propose.

12. I propose to raise the limits on the 1978 profit sharing scheme and on the 1980 SAYE option scheme since 1984. The limit on the annual value of shares which can be given tax-free to employees under the 1978 scheme, will rise from £1,250 or 10% of salary, subject to an overall limit of £5,000, to £2,000 or 10% salary, subject to a limit of £6,000. [This will be of particular benefit to lower paid employees.]

13. I also intend to raise the maximum monthly savings limit for the all-employee SAYE scheme from £100 to £150. [And I propose to increase the maximum discount from market value at which options can be granted from 10 per cent to 20 per cent.]

14. These changes should give a substantial further boost to existing share schemes.

15. Employee share ownership plans - known as ESOPs - are a new form of employee share ownership, which have had much recent publicity. [Explain what's new about them].

16. A number have already been put in place in the UK. To encourage their development, I propose to introduce a new tax relief for contributions to employer share trusts provided they meet certain requirements, designed to ensure that their shares are placed in the hands of employees within a reasonable time. I hope that, as a result, more firms will be encouraged to consider establishing ESOPs.

[17. I have one further change to propose which will benefit conventional employee share schemes, ESOPs, and profit-related pay schemes alike. I propose to modify the so-called material interest tests where companies have established trusts to acquire their shares for the benefit of their employees. These tests are designed to exclude from tax relief employers who already have a significant interest in the company. Sometimes, however, the present rules can exclude

employees too. The changes I propose will ensure that only those employees who have a significant material interest in the company will be excluded in future.]

Unit trusts

18. As I mentioned a moment ago, unit trusts have a valuable role to play in providing, for many people, the first introduction to direct investment and share ownership. I therefore consider it desirable to remove an anomaly which means that the tax system bears unduly harshly on unit trust investors, compared with other forms of direct investment.

19. Normally a unit trust investor pays the same tax on dividends and capital gains as someone who had invested in the same shares or securities independently. But if the trust invests in gilts or other securities, and is not an all-gilt trust, it has to pay corporation tax on the income, so the saver ends up bearing tax at 35 per cent, rather than 25 per cent.

20. I have therefore decided that as from 1 January 1990, the Corporation Tax rate on unit trusts should be cut from 35 per cent to 25 per cent. [Unit holders' CGT position will be unaffected, as will the additional income tax paid by higher rate taxpayers.

And rules will be introduced to prevent corporate investors using this change as a tax shelter.]

21. This reduction in the tax rate on unit trusts will incidentally have the beneficial effect of removing the competitive disadvantage which UK mixed unit trusts would otherwise have faced in the near future, when firms from other EC countries acquire the right to sell collective investment vehicles in the UK.

Stamp duty

22. I have one further measure to propose in this context.

23. In my 1984 Budget, I was able to reduce the 2 per cent stamp duty on share transactions to 1 per cent. I halved it again to ½ per cent in 1986. I have now decided to abolish it altogether, with effect from 1 April 1990 [to coincide with the introduction of paperless transactions on the Stock Exchange.] These measures will remove a barrier to ownership, and eliminate an aspect of the tax system which puts the British financial services sector at a disadvantage compared with some of its competitors.

Tax reform

24. The measures I have just announced will further strengthen the growing trend of wider and deeper share ownership. They will remove a major disincentive to the more direct forms of saving. And they build on the targeted incentives that already exist to promote ownership.

[25. As such, their longer-term effect may be to redress an imbalance that arguably exists in the pattern of savings in the UK, which, in the last 30 years has become increasingly dominated by institutional forms of saving, such as life assurance and pensions. Throughout our time in government, our approach to the provision and taxation of savings has had two common threads. First, as far as possible, we have been concerned to ensure maximum choice for individuals. Secondly, we have tried to ensure that choices are distorted as little as possible by the tax system.

26. This is not an area where one can make great changes overnight. Nonetheless we have made considerable progress in improving choice, and reforming the tax system in step. Today, I have more progress to announce.

27. I turn first to pensions.

28. The Government record is one of widening pensions' choice and encouraging private provision. We have reformed SERPS, improved the rights of pension scheme members and, most important of all, introduced personal pensions. These have been a great success with a million taken out in the first 6 months of operation.

29. But there is still scope for further widening of choice, deregulation of the tax system. I have a number of changes to propose.

30. First, I propose to make it easier for people in personal pension schemes to manage their own investments. Pension savings are highly institutionalised with scheme members having little involvement in investment policy. This measure will encourage greater individual involvement in pension plans [as IRAs have in US].

31. I also propose a number of changes to simplify and improve rules for occupational pension schemes, in particular to improve the conditions on which people can take early retirement.

32. And I intend to simplify the rules for additional voluntary contributions. [At present, if AVCs perform well, occupational pensions may be reduced. In future any surplus contributions will be returned to employees subject to special tax charge.

33. And finally I propose to rectify the anomaly whereby limits for tax relief have come to determine limits on pensions paid. With a tax relief as generous as that for pensions, it is clearly essential that there should be some upper limit. But that is no reason for tax law effectively to constrain the size of the pension an employer may choose to provide. Accordingly, I propose that employers should now be able to set up "top-up" schemes for their employers, with no limits on benefits but without any special tax privileges.

<u>**Rationale for limits**</u>

34. With employers able to pay whatever pensions they like, it is clearly appropriate to put a cap on amount of relief. All other reliefs - BES, PEPS, mortgage interest - are subject to a ceiling.

35. I therefore propose to build on my 1987 changes by making final salary schemes subject to a cash limit on pensions paid from tax approved schemes, based on earnings of £60,000 a year. This is consistent with a privileged pension of £40,000 a year or a tax free lump sum of £90,000 a year. I intend that this earnings limit should be indexed to prices and that these changes should apply to members joining new or existing schemes on or after Budget day.

[36. It is clear that unfettered relief for pensions savings distorts savings choice. People pay less tax if they save through pension funds than if they invest directly in equities or put money in building society They are allowed tax relief on contributions. The returns are untaxed in the hands of pension funds, though tax is paid on the pensions when received. And savings financing pension lump sums escape tax altogether. They are not taxed on the way in or out. This is anomalous by any standard.

37. With the 1988 reductions in top rate of tax, there is less need for tax breaks for higher paid. They can afford to save out of taxed income, by investing directly in equities etc.]

38. I also propose changes to the rules for personal pensions, to enable them to equal the benefits of final salary schemes. The self-employed are often unable to contribute to personal pension schemes until late in life, at which point they may fall foul of contributions limits. I therefore propose to increase the contribution limits for personal pension scheme members over 50.

39. This will improve position of PPs relative to final salary schemes. Indeed it will pay some employees to leave FS schemes and take out personal pensions. However I also propose to subject to an overall cash limit on contributions. Like the final salary scheme limit, the personal pension cash limit will be tied to prices.

<u>Conclusion</u>

40. These proposals represent an important long-term reform of pensions system. However, the effects will take time to come through. Because of the level at which the limits will be set only a few thousand high paid employees

will be affected at first, rising to 50,000 by the end of the century. But that is how it should be. There is no question of undermining pension saving by a huge upheaval.

41. The long term effect, though, is likely to be considerable. It will result in a major turnround in the balance of savings in the course of 21st century.

42. The last few years have seen a large number of pension reforms. It is time they were allowed to settle down. Accordingly, I do not plan any further changes in this Parliament.

LIFE ASSURANCE

43. I now turn to the taxation of life assurance. In July last year, the Revenue issued a consultative document on the taxation of Life Assurance. It pointed to some important defects in the present tax regime and outlined possible changes.

44. There has now been a very full process of consultation and I have considered the representations made very carefully. My conclusions are as follows.

45. The Life Assurance industry is unique, not just in the product it provides but also in the tax regime which

applies to it. The policyholder's returns and the shareholder's profits are not, as in a normal business, taxed individually but jointly by taxing the funds held by the Life Offices on their policyholders' and shareholders' behalf.

46. It is a peculiarity of this system that relief is given "up front" for expenses incurred on the policyholder's behalf. This has two distortive effects: first it means that policyholders receive a tax break - "up front" relief on initial costs which would not be available if they invested directly in shares. And it distorts the incidence of tax as between one Life Fund and another. The system unduly favours the rapidly expanding Life Office where tax can be deferred for many years.

[47. I have considered very carefully whether this problem is best resolved by improving the existing system; or by adopting a completely new basis of taxation for the Life Office. I have concluded that the defects can be dealt with within the present regime.]

48. I shall be bringing forward in the Finance Bill measures which will mean that in future, relief for the initial expenses associated with new policies will be spread forward so that one-seventh only is available for relief against tax in each of the first and subsequent

six years. Taken on its own this would increase the tax liability of life offices, indeed quite markedly in the early years. But this effect will be eased by phasing provisions to give the industry time to adjust to the new regime, and by other measures which I have to propose.

49. But first I have one other proposal which will also restrict the amount of relief available. At present nothing requires life offices to keep their pensions and life assurance businesses separate. So some Life Offices can set the unrelieved expenses on the pensions side of their business against the income and realised gains of Life Funds. This means that their pensions profits enjoy unduly favourable tax treatment. The Finance Bill will include provisions to end this anomaly.

50. [The Finance Bill will also include a number of lesser measures, giving a better specification of charge, and bringing into charge miscellaneous items of income which currently fall outside the tax net].

51. These measures would cover the main part of the proposals discussed in last year's consultative document. The Finance Bill will provide for them to be introduced from 1 January 1990. But there are other, more technical items which require further consultation.

Any legislative changes following that consultation will be included in the 1990 Finance Bill.

52. These measures give a fairer basis for the taxation of the Life Companies. In isolation they would increase the long-run tax burden by £[ ]m. However, here as throughout the tax system, widening the tax base allows tax rates to be reduced. This I propose to do.

53. At present, Life Funds pay tax at 35 per cent on unfranked investment income and 30 per cent on realised capital gains of their policyholders. As from 1 April 1990, these rates will be reduced to 25 per cent. Life Assurance Premium Duty will be abolished from the same date. Together these will be worth £[ ]m to Life Assurance in a full year. On top of this, the industry, like all those who deal in shares, will benefit from the abolition of stamp duty to the tune of X a year.

54. [Net effect of these changes on the industry as a whole.]

[A <u>conclusion</u> still needed for this tax reform section]

55. I now have a number of other, less daunting, reforms to propose. Most of them represent simplifications and deregulation.

56. The first is a piece of tidying up which follows from the major reforms of income and capital gains tax in my last Budget.

57. My reforms of capital gains tax have produced a fairer and more neutral system. However they have exacerbated one existing anomaly, which I now propose to remove. The holdover relief for gifts postpones tax on past gains made by the giver until the recipient disposes of the asset. When we still had capital transfer tax on lifetime transfers, this relief was necessary to avoid a double capital tax charge. But this need no longer remains. Moreover, now that a single rate of capital gains tax has been replaced by 2 rates aligned with income tax, the gifts relief is open to exploitation by higher rate taxpayers wishing to avoid paying CGT at their marginal rate. I therefore propose to abolish the general gifts relief. There are some circumstances where tax deferral continues to be justified for wider economic reasons, notably in the case of gifts of business assets and gifts to charities. For these cases, the relief will be retained.

[58. Still on capital gains tax, I propose to change the tax treatment of certain bonds so as to simplify the tax rules and to prevent a loss of yield by the conversion of income into capital gains.

59. First I propose to exempt from capital gains tax, all sterling non-convertible corporate bonds. This will prevent exploitation of indexation relief to manufacture capital losses.

60. Second, I propose to put the tax rules for deep discount bonds onto a simpler and more effective basis. Where the return on a bond can be mathematically split into capital gains and income then those two elements will be taxed separately. Where the return on a bond cannot be so split then it will be taxed as income.

61. These changes will apply to gilts although existing issues of deep discount gilts will continue to be taxed under the existing rules.]

62. Last year, by rebasing capital gains tax to 1982, I completed the process of taking purely paper gains out of tax. At the same time I reduced the exempt threshold as it no longer needed to compensate for the lack of indexation relief for pre-1982 gains. Its only remaining function is to exclude small gains from the tax. I judge that it still performs that

function perfectly adequately and I therefore propose to maintain it at its current level of £5000. Following independent taxation in 1990, husbands and wives will, of course, benefit from a double exemption.

63. The taxation of close companies is another area ripe for simplification. Again this has been made possible by last year's reform of personal tax.

64. Under the current rules undistributed income and gains of close companies are apportioned among its shareholders in order to determine tax payable. The rules governing this are an exceptionally complicated area of the tax system, running to some 20 pages of legislation. I therefore propose to abolish apportionment rules for close companies. In future income and gains of a close company will be subject to normal corporation tax rules, subject only to simple rules to prevent abuse. This reform will represent a major simplification of the tax affairs of a great many small businesses.

65. The next set of deregulation measures I have to propose will also benefit the small business sector. These measures relate to the operation of VAT.

66. At present,traders are normally liable to VAT on their sales whether or not their customers pay them.

Bad debt relief can be claimed only where the debtor has become insolvent. This takes far too long. I therefore propose that from 1 August, all debts which are over eighteen months old will qualify for bad debt relief. This will be of great help, from both an administrative and financial point of view, to a great many businesses.

67. I also propose simpler rules to govern registration for VAT. At present there are quarterly and annual turnover thresholds, and businesses are required to look ahead to the next twelve months to see if the limits <u>might</u> be exceeded. This complication is unnecessary. As from Budget Day I propose a single rule for determining registration based on turnover in the <u>past</u> twelve months.

68. Finally, I propose to simplify the VAT default surcharge. At present this rises by stages each time a business defaults to a maximum of 30 per cent. Experience suggests that by the time a business reaches a surcharge rate of over 20 per cent, it has moved from the "won't pay" to "can't pay" category. I propose to recognise this by capping the default surcharge rate at 20 per cent.

Schedule E

69. I propose one simplification in the income tax field . At present, under Schedule E, tax assessments are done on the basis not of earnings received <u>in</u> a year, but instead on earnings <u>for</u> the year - accruals rather than receipts. I propose to change this, so that in future it is assessed on a receipts basis.

70. For the vast majority of ordinary taxpayers this will make no difference at all. But it will greatly simplify the tax affairs of about half a million people. It will also make the tax system simpler and cheaper to administer. There will be no lasting loss of revenue, but there is a transitional cost of £[X] in the first two years, offset thereafter.

Corporation Tax

71. I now turn to the taxation of businesses generally.

72. It is now five years since I announced the major reform of business taxation which has given us one of the lowest corporation tax rates [in the world?]. Our neutral system of business taxation, combined with low rates, has set the scene for a dramatic improvement in the performance of British firms. The reform of capital

allowances has encouraged more efficient investment, based on real returns rather than tax advantages. And the removal of the bias against job creation has played a key role in the UK's impressive employment growth. In this healthier climate, company profitability has recovered dramatically.

73. The system we have is clearly right, and is working well. Accordingly, I have no change to propose to the main Corporation Tax rate for 1988-89.

74. However, at the moment, only a small minority of companies pay this main rate of 35 per cent. The remainder have no liability at all, or pay at reduced rates, determined by the small companies' profits limits. These limits have remained unchanged since 1983. I propose now to increase them, so that the lower limit, below which companies pay at 25 per cent, will increase from £100,000 to £150,000. Above that level, companies pay at a gradually increasing rate, until they reach the main rate threshold of £500,000. I propose to increase this, too, by 50 per cent, to £750,000.

75. [I have one other minor change to CT. I propose to extend relief available for expenditure incurred by individuals or companies prior to their commencing trading from the present 3 years before trading

commences to 5 years. This will benefit new companies undertaking projects requiring long lead times.]

Cars

76. I have to set the 1989-90 car and fuel benefit scales for those with company cars. For years, the car scale charges have fallen significantly short of the true value of the benefit, and in successive Budgets I have made significant progress to redress this. I intend to continue this, and increase the car scales by a further 20 per cent for 1989-90. I propose no change to the fuel scales.

Profit Related Pay

77. Two years ago, I introduced in my Budget a tax relief for Profit Related Pay Schemes, designed both to give workers a more direct sense of identification with the firms that employ them, and to promote a greater degree of pay flexibility. The current success of British firms is built on improvements in both these respects.

78. The Profit Related Pay Scheme has played its role in this process, but it is also clear that more firms are interested in launching schemes, but are not able to comply with all the present

rules. I therefore propose to make three modifications to the scheme in this year's Finance Bill. First as I have already announced, I intend to abolish the requirement that PRP must equal at least 5 per cent of pay.

79. Second, I propose to raise the limit on the amount of PRP which can attract relief from £3,000 to £4,000. Finally, I propose to relax the rules banning headquarters and other central units from using the profits of the whole company or group for their own profit calculations, as I am persuaded that this too is unnecessarily restrictive. I am confident that these modifications will ensure continued growth in the number of firms offering some element of profit related pay.

TAXES ON SPENDING

80. I now turn to taxes on spending.

81. First, VAT. I have already announced a package of significant deregulatory measures. The FB will also implement the changes necessary to comply with the ECJ's judgement on certain of the UK's zero rates, notably that on non-domestic construction. The only other change I propose to make to the coverage of VAT is to introduce a small number of extra reliefs for charities,

of which the most important is the exemption of their fund-raising events, subject to an upper limit.

82. The main thrust of Government encouragement to charities, however, continues to be focused on the act of giving. Accordingly, I propose to increase the weekly limit for the PRG scheme from X to Y.

VED

83. Next, I have a number of measures to propose which will greatly simplify the structure of vehicle excise duty and make it more equitable.

84. There are at present X rates of VED. I propose to reduce the number of tax classes by over 70 - a major simplification.

85. At the same time I propose to rectify anomalies in the present structure of rates. At the moment a bus or a coach has to have sixty six seats before it pays as much VED as a family car. I propose to increase the relevant rates to bring this group up to track cost.

86. There will also be increases in the rate of VED for the heaviest of the rigid HGVs so as to put them on a more equal basis with articulated HGVs.

87. I turn now to the duty on petrol. Last year I increased the tax differential in favour of unleaded petrol to nearly 11p a gallon. This has undoubtedly helped to increase the take up of unleaded petrol.

88. But the Government is committed to phasing out leaded petrol, and progress is still too slow. Unleaded petrol still accounts for only 4 per cent of total sales, when X per cent of cars can use it without any adjustment, and most of the remainder could be adjusted to use it at very little cost.

89. One of the problems is clearly ignorance of the facts about unleaded petrol. Many people do not realise that they can already use it. And others who could cheaply have their cars converted hold back because they fear - wrongly - that after conversion their cars could no longer use leaded. Fortunately, the myths about unleaded petrol are beginning to be dispelled.

90. But I propose to do my part too, and to make sure that the market signal is clear enough. I therefore propose to reduce the tax on unleaded petrol further by something over 3p a gallon. If this reduction is passed on to consumers - and I look to the oil companies to make sure that this happens - the price of unleaded petrol will generally be about 9p a gallon below that of

4 star. This in itself should provide a strong encouragement for 4 star users to have their cars converted.

91. However, I propose to go further by introducing a surcharge of 5p a gallon on 2 and 3 star petrol. This will bring the price of these grades broadly into line with that of 4 star. Virtually all cars which use 2 and 3 star can run on unleaded petrol without any conversion. These motorists will now have a strong incentive to change their habits. This in turn, will provide the necessary signal for more garages to stock unleaded - if necessary by freeing up a pump that formerly sold 2 star.

92. Taken together, these two duty changes will give us the largest differential between leaded and unleaded petrol of any EC country, with the exception of Denmark. I hope that we shall soon match this performance in terms of take-up of unleaded. Both these duty changes will take effect from 6.00pm tonight.

93. I have no other changes in excise duties to propose.

INCOME TAX [to follow]

allowances

rates

[NICs]

Earnings rule

CONCLUSION AND PERORATION [to follow]

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FROM: MISS M P WALLACE
DATE: 20 February 1989

PWP

MR RILLY

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Dame A Mueller
Mr Wicks
Mr Hardcastle
Mr Byett
Mr Scholar
Mr Culpin
Mr Sedgwick
Mr A C S Allen
Mr Gilhooly ← Mr Grieve.
Mr S W Matthews
Mr Pickford
Mr Macpherson
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill - IR
Mr Beighton - IR
Mr Isaac - IR
Mr Painter - IR
Mr G Bush - IR
Mr C McNicol - IR

Mr Unwin - C&E
Mr Jefferson Smith - C&E
Mr P R H Allen - C&E
Ms A French - C&E

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BUDGET STATEMENT: FIRST DRAFT

... I attach the first draft of the Budget statement, which I put to the Chancellor on Friday evening.

2. As you will see, a number of gaps remain. I expect the introduction and the conclusion will be the last sections we write. I plan to write the penultimate section on income tax etc this week. Otherwise, the order of the tax section is still highly provisional. We have our first discussion of presentation

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at today's overview, and can firm up the order in the light of that, and the Chancellor's comments on this draft. In the meantime, the second half of the speech is essentially "loose leaf" and the linking passages remain to be written. I am also conscious that there is a hand full of subjects that still need a mention: residence, independent taxation, (tax treatment of exchange gains and loses?). I would welcome suggestions on what we might say on these, and where. I would also particularly welcome ideas on how the speech can be shortened.

3. I should be grateful for any comments as soon as possible. It would be helpful if the absolute deadline could be Thursday lunchtime, as I am to put a further revised draft to the Chancellor for the weekend.

MOIRA WALLACE

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[INTRODUCTION - to follow]

THE ECONOMIC BACKGROUND

I start with the economic background.

2. 1988 has been another year of buoyant growth world wide, exceeding expectations in each of the major industrial countries, in most cases substantially so. World trade in manufactures probably grew by [10] per cent, and output in the G7 by an average of 4 per cent.

3. In the UK, growth has again been above the G7 average, and ahead of all our major European competitors. I now judge that the figure for 88 as a whole will turn out to be around 4½ per cent.

4. Overall output growth of 4½ per cent means that in this upswing we have now recorded x years of sustained growth. Within this overall very vigorous growth performance, the performance of manufacturing has again been particularly strong, with growth of getting on for 7 per cent in 1988, and manufacturing output now 10 per cent above its previous all time peak.

5. The key to this sustained improvement in manufacturing performance has been the major improvement

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in productivity that has been secured under this Government. In the '80s, our manufacturing productivity has grown faster than that of any other industrial country - following years at the bottom of the league in the '60s and '70s.

6. [We now know that] employment has risen continuously since 1983, by a total of [over 2½] million, to an all-time record high. Unemployment has now been falling for 30 consecutive months, the longest period of continuous decline since the War, taking it below 2 million.

7. Another very satisfactory feature of the recent past, and a very good omen for the future, is the strength of investment, which looks to have grown by some 14 per cent in 1988. Indeed, over the last 7 years, investment has grown twice as fast as consumption. In the previous 14 years consumption grew faster on all but three occasions.

8. The recorded figures for investment growth show a smaller increase in 1988. But it is perfectly clear from the well-known discrepancies within the National Income accounts that the estimates of expenditure, and of investment spending in particular, are inconsistent with all the other evidence. The Treasury has, in consultation with the CSO, undertaken an exercise to

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produce a set of accounts that gives a more consistent picture of how the economy developed between 1986 and 1988, and it is those figures which form the basis for the forecast I shall be giving today. Full details are published in the Financial Statement and Budget Report.

9. The strong growth of investment - and indeed the strong growth of consumers expenditure too - is no doubt in great part a reflection of confidence in the British economy. But with domestic investment exceeding domestic saving, some of the investment has had to be financed from overseas. As a result the current account now looks to have been in deficit by some £10 billion in 1988. This is a sizeable deficit, clearly, but it has been financed without difficulty, thanks to the Government's firm commitment to monetary discipline and fiscal prudence.

10. At home, it became clear during 1988 that the growth of domestic demand was stronger than thought, and had come to be too much of a good thing. There was evidence of some resurgence of inflationary pressures. I had no hesitation in acting to nip this in the bud, by tightening monetary policy. The first effects of higher interest rates began to show through at the end of the year, for example, in the figures for M0 growth, retail sales, and house prices.

11. However, in the short-term, the fact that the UK, unlike almost all other EC nations, includes mortgage interest payments in its consumer price index, means that the very action taken to combat inflation appears to cause it to rise. Thus, annual inflation, as measured by the retail price index, ended the year rather higher, while the underlying rate of inflation remained fairly steady in the second half of the year, at around 5 per cent.

12. Looking ahead to 1989, we are already seeing more and more evidence that inflationary pressures are coming back under control. M0 has slowed markedly since last summer, retail sales have been broadly flat for the last six months, and the housing market shows clear signs of cooling off. This is backed up by surveys of consumers' and retailers' confidence.

13. But some of the effect of higher interest rates is only just beginning to have an impact. For example, those whose mortgages are adjusted only once a year, will only now be feeling the effects of last year's increases in interest rates. So further slowing in consumer spending is to be expected. This will bring overall output growth down to a more modest rate of [2½] per cent in 1989.

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14. This may seem disappointing by the standards we have come to expect in the last few years. But it is a respectable figure, by any standards, historical or international. And with investment likely to remain high - a view confirmed by all the latest surveys of investment intentions - the growth prospects beyond [1989] are good.

15. The underlying path of inflation will, of course, continue to be obscured by the influence of mortgage interest rates. First we will see a peak in annual RPI inflation [at around x per cent] [next month] before it falls back to [y per cent] by the end of the year.

16. As I have always made clear, the current account will take longer to adjust. Import growth should slow, as consumer spending eases a little. And trade performance should improve as new capacity comes on stream. Although I expect the monthly deficits to be on an improving trend through the year, I expect that the deficit for the year as a whole will be much the same for that of 1988 [with a more marked improvement thereafter].

17. Turning to the world economy .....[strong/steady growth; US budget deficit; imbalances.]

18. In parallel, it is clearly desirable that the major nations should continue the process of international cooperation, to guard against the risks of renewed turbulence in the international markets. I can assure the House that the UK will continue to play its full part in this co-operation.

The Medium Term

19. In an increasingly open world economy, no nation can be insulated from external shocks. What individual Governments can guarantee is that they will put the right economic policies in place, and stick to them. Provided they do this, they can survive the difficult years, and excel in the good ones.

20. This describes exactly what has been achieved in the UK. This Government has now been in power for nearly a decade, during all of which time economic policy has been steady/essentially unchanged. This has brought outstanding success.

21. At the very heart of the Government's strategy has been the determination to bear down on inflation. For ten years now, the medium term financial strategy has provided a clear and disciplined framework for reductions in the growth of money GDP, and hence inflation. Between 1974 and 1979 inflation averaged

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15 per cent [and was rising]; between 1984 and 1989 it averaged 5 per cent [and is now set to fall].

22. This is the answer to those who doubted that the MTFS would be successful. Or those who maintained that the Government's inflation objectives could only be achieved at the expense of lost output, or falling living standards, or harsh public expenditure cuts.

23. Far from suffering, output in the UK has grown faster than in all other major EC countries during the '80s - a marked contrast with the two previous decades when the UK was at the bottom of the league.

24. The knowledge that the overall financial framework is prudent and sustainable has given business and industry the confidence to expand. Tax reforms have increased the incentives to enterprise, and supply side reforms have removed the disincentives and barriers. Indeed, the supply response of the economy has improved out of all recognition in the '80s.

25. The cornerstone of this dramatic improvement in the performance of British industry has been a large and sustained improvement in productivity. Whole economy productivity has grown by $2^3/_4$ per cent a year since 1980 - [putting the UK, with Japan, ahead of all other

major industrialised countries in terms of productivity growth.]

26. At the same time, more people are in work than ever before in this country, and their real take home pay has risen by almost a third since the Government took office. And they enjoy better public services too. For while the Government has been able to achieve its aim of bringing the growth of public expenditure within that of the economy as a whole, so that its share of national income has fallen, within that overall constraint more has been spent on priority areas, such as health, law and order, and capital spending.

27. The last ten years, then, have been a time of unprecedented improvement to the economic fundamentals in the UK. When we came to power, Britain was a textbook example of relative economic decline. Now it is out-performing the competition, and the policies that have brought success - tax reform, firm fiscal and monetary policy and the determination to improve the supply side - are being emulated the world over.

28. Unfortunately, it is taking rather longer for conventional economic wisdom to catch up with Britain's economic renaissance. Ten years on, some people still think it cannot last, and are permanently on the lookout for bad times. And so they pick on the things that - in

another, unhealthier, age - would have set the alarm bells ringing.

29. This perhaps explains the great agitation in some quarters about the fall in the personal savings ratio. Once, a fall in personal savings might indeed have been cause for concern - in the '70s, for example, when there was precious little chance of a shortfall of saving from households being offset by the corporate sector or - still more unlikely - the Government itself.

30. But that is exactly what has happened under this Government: with a dramatic recovery in company profitability, company saving has risen to offset the decline in personal savings. In addition, of course, the Government itself has moved from deficit to surplus. So, in fact, total national saving has been rising in recent years, and now stands at [roughly the same percentage of GDP as we inherited].

31. I expect the personal savings ratio to recover during 1989. High interest rates will discourage consumer borrowing and increase the incentives to save. They are indeed the appropriate market route to dealing with [any pressures caused by] low personal savings.

32. The other notable respect in which commentators have failed to catch up with the transformation of the

British economy is in the significance they attribute to a deficit on the current account of the balance of payments.

33. There are clearly some circumstances in which a current account deficit would be cause for concern: if it were a consequence of a Budget deficit, if monetary conditions were too loose, or if the Government did not have the confidence of markets.

34. The position today could not be more different. The current account deficit has arisen at a time when the public sector, far from being in deficit, is running an unprecedented surplus. The external deficit is, in fact, the result of private sector behaviour. And in time private sector behaviour will correct it.

35. But it will take time, as I have repeatedly made clear. There are no quick fixes, and there is no need for them. In the meantime, the Government will stick to its well-tried and proven policies.

Monetary policy

36. From this point of view, as from every other, it is essential that we remain prepared to take whatever action is necessary - however unpalatable it may be - to bear down on inflation. [Within MTFS] the central role

in bringing inflation down rightly belongs to monetary policy, buttressed by a prudent fiscal stance. As I have always made clear, short-term interest rates are the essential instrument of monetary policy: this Government will set interest rates at whatever level is necessary to bear down on inflation, and will keep them at that level for as long as is necessary.

37. The Government is under no illusions about the short-term effects of last year's rises in interest rates on homeowners and other borrowers. They will have had to restrain other expenditure, in some cases quite sharply, to meet increased interest charges.

38. But here again, we have to have an eye to the medium-term. It is already difficult to remember the days of runaway inflation. But those who can cast their minds back know that the pain of higher interest rates for a time now is far preferable to the damage that was done to working families, pensioners, industry, and the whole of the nation's economic and social fabric, by years of rapidly rising prices. The Government is determined that there shall be no return to that.

39. Interest rates are indeed a remarkably well-directed instrument to deal with the particular inflationary pressures we have seen reappearing in the last year. First, they are well targeted on the housing

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market, which has been the major force behind the strong consumer credit growth [of the last year]. In this respect, they are also very well targeted from a regional point of view, as they will tend to focus the adjustment on the South of England, where inflationary pressures have arguably been strongest, as more people in the South have mortgages in excess of £30,000, and so do not have the full effect of increased repayments cushioned by tax relief.

40. Most importantly - and this point is not, perhaps, well understood - they are also well targeted as between households and companies. While the household sector has moved from being a net lender to being a substantial net borrower, the company sector's finances are in far better shape than a few years ago, so that it is far less vulnerable to increases in short-term interest rates. The company sector is also well placed to benefit from the fact that long-term interest rates have remained very stable, and well below short rates - an indication of the markets' confidence that inflation will be brought down.

[Possible slot for piece on credit controls, and link with COBO/financial deregulation]

41. Now all the evidence is that the tightening of the monetary stance is taking effect in exactly the way we predicted. [M0, retail sales, etc.] This is, of

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course, welcome. [But the process is bound to take time. I can assure the House that I shall not keep short-term interest rates at their present level for any longer than is necessary: on the other hand, there will be no question of relaxing the monetary stance before it is appropriate to do so.]

42. Decisions on the appropriate monetary stance will continue to take full account of the role of the exchange rate. The Government has made it clear that increases in domestic costs will not be accommodated either by monetary expansion, or by exchange rate depreciation. In fact, sterling ended 1988 slightly stronger against both the deutschemark and the dollar than at the beginning of the year, and I judged this appreciation appropriate in the light of the inflationary pressures that had emerged. [Overall objective - stability/overriding need to bear down on inflation.]

43. This determination to bear down on inflation is the absolute key to the Government's economic strategy. The ultimate objective remains stable prices. No Government could be proof against short-term fluctuations along the way. But Governments can guarantee the will to ensure that they are only short-term. This Government has demonstrated that determination, by taking action to

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bring the economy back onto the track set out in the MTFS.

44. Accordingly, I propose in that the target range for M0 growth in 1989-90 should be 1-5 per cent exactly as envisaged in last year's MTFS. Measured on a twelve month basis, M0 will start the next financial year above the top of this range, reflecting the high growth figures in the spring and summer of 1988. However, the growth of M0 over the last six months has been appreciably slower - equivalent to [X] at an annual rate - and I am confident that the twelve month figures will come within the target range [within a few months].

PUBLIC SECTOR FINANCES

45. A prudent fiscal stance has always been an essential buttress to a sound monetary policy, within the MTFS. [Needs to be set in medium-term context. Not a short-term demand management tool, but key element of successful supply side policies - pattern of taxes and expenditure, impact on supply side etc.]

46. In our early years of office we made steady progress in reducing the burden of Government borrowing. Now the public finances have been completely transformed with the budget in surplus since 1987-88.

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47. Last year I budgeted for this surplus to continue in 1988-89, the year now ending. In fact, we have done rather better, for a variety of reasons. First, the success of the economy, particularly the now very marked reductions in unemployment, and the continued success of the right to buy programme, reduced the expected claims on public expenditure, so that the outturn for the year is likely to be some £[X] billion below the planning total we provided for.

48. Second, privatisation proceeds are appreciably higher than expected, at some £[X] billion for the year as a whole - a welcome boost to the public finances, and one that not many would have predicted a year ago, in the aftermath of the stock market fall.

49. Finally, a more buoyant economy has led to tax revenues significantly higher than expected. Taking all these factors into account, I now expect that the final outturn for the current year will be a Budget surplus of £[X] billion.

50. In the last two years, then, we have seen the largest period of repayment of public debt for [how long?]. This has permanently reduced the burden of debt servicing, both now and for future generations. For the coming year, for example, the debt repayments of the

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last two years mean that debt interest costs are lower by £[X] billion a year.

51. We have already seen one beneficial effect of lower debt interest payments - namely that spending on priority services can be increased, without jeopardising the Government's overall objective for public expenditure. In the Autumn Statement I was able to announce that within an unchanged planning total we were able to allocate significant extra resources to our priority programmes. Those who saw a conflict between tax cuts and spending on the health service have been confounded, with a record increase in resources for the NHS in the UK of some £[X] billion. And there were significant increases for other priorities, notably capital spending on the prisons programme, and in the transport field for road maintenance and improvement, and for improved safety programmes.

52. But these selective increases in spending are just one of the possibilities opened up by debt repayment. Alternatively, and just as importantly, we can take advantage of lower debt interest payments to reduce taxes, or, indeed, to repay even more debt, continuing the virtuous circle.

53. [The dramatic improvement in the UK's public finances has also provided a welcome opportunity to

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devote more attention to the structure of the debt that remains. Now that the Government has become a net purchaser of debt, it has been possible to tailor buying-in policies so as to reduce future interest costs, and to improve the quality of funding by relying less on the more liquid borrowing instruments.

54. For example, it has been possible to increase the proportion of indexed gilts in the remaining stock: since the Government is determined to eliminate inflation, index-linked borrowing is particularly cost-effective. The authorities have also been able to achieve a desirable adjustment in the average life of Government debt: buying-in has concentrated on longer maturity issues, so that in future years even the debt that remains will have a relatively lower interest cost.]

55. The long-term benefits that can be achieved from a period of public sector surplus are clear. This is one factor I have taken into account in deciding the fiscal stance for the coming year. Furthermore, this Government's approach to public finances has always been prudent and cautious, and this too is obviously the right course. There are two particular reasons for caution this year.

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56. First, our present stronger than expected position clearly reflects some influences which are essentially cyclical. These will tend to unwind as the economy reverts to a more sustainable level of growth.

57. Secondly, we cannot ignore the role played by privatisation proceeds in our present fiscal strength. [Although major privatisations still lie ahead, in the longer-term the contribution of privatisation proceeds must logically tail away eventually to zero.]

58. It has been a hallmark of this Government that it has not committed resources to extra public expenditure or reductions in the tax burden unless it was certain that these could be sustained. I have continued to be guided by these principles in setting the public sector debt repayment for 1989-90. I have therefore concluded that it is right to budget for a further healthy surplus, of £[X] billion.

59. In last year's Budget I made it clear that the norm for the medium-term would henceforth be a balanced budget. For the coming year, as I have explained, we can and should do better than that. But beyond 1989-90, I expect to see the public sector debt repayment revert [gradually/eventually] to zero. The illustrative path for the medium-term is set out in the MTFS. [Implications for tax burden/tax reform.]

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SHARE OWNERSHIP

Introduction

I place first in my Budget measures to encourage Wider share ownership. Over the last 10 years the number of shareholders has risen from X to Y; and with this increase has come a greater sense of identification with British industry. [Survey results]

2. Exactly three years ago I introduced the Personal Equity Plan - a radical new scheme to encourage investment in British equities. In the first two years that the scheme has been in operation more than 350,000 plans have been taken out. This despite the stock market crash. I now have a number of improvements to propose.

3. First, I propose to raise the limit on the amounts that can be invested in unit and investment trusts. It will rise from £750 to £2,400. Unit and investment trusts are a good introduction to the equity market for smaller investors, and I want to encourage them. This increase will apply only to unit and investment trusts which invest mainly in UK equities.

4. Second, I propose to raise the overall PEP limit from £3000 to £4,800.

5. I also intend to make it possible for PEP holders who apply for new share issues, to put their resulting allocation straight into their PEP, provided this does not breach the overall limit.

6. Third, I propose to abolish a number of restrictions on PEPs, and to simplify them as much as possible.

7. I propose to do away with the rule that PEPs must be held for a full year; if investors choose to cash in their PEPs within a year of purchase, they will, in future be able to do so without tax penalty. I also propose to abolish the rules governing the amount of an investment that may be held in cash. Instead, interest on cash held in PEPs will, in future, be subject to composite rate tax.

8. Finally, I intend to move the PEP year from a calendar to a fiscal year basis. It has become clear that this would be more convenient for all concerned. I therefore intend that the next PEP year will start on 6 April. Anyone who has taken out a plan already in 1989 will also be able to take one out in the new PEP year.

9. Taken together, these changes will make PEPs simpler to administer and more attractive to first time

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investors. I am confident that the package will lead to a considerable increase in PEP take up, and a substantial widening and deepening in share ownership.

10. Our measures to encourage employee share schemes have also had a major impact in widening share ownership. The number of approved all - employee share schemes has risen from 30 in 1979 to almost 1600 today, covering around 1¾ million employees, and involving shares worth over £4 billion.

11. This year I have a number of further improvements to the employee share legislation to propose.

12. I propose to raise the limits on the 1978 profit sharing scheme and on the 1980 SAYE option scheme since 1984. The limit on the annual value of shares which can be given tax-free to employees under the 1978 scheme, will rise from £1,250 or 10% of salary, subject to an overall limit of £5,000, to £2,000 or 10% salary, subject to a limit of £6,000. [This will be of particular benefit to lower paid employees.]

13. I also intend to raise the maximum monthly savings limit for the all-employee SAYE scheme from £100 to £150. [And I propose to increase the maximum discount from market value at which options can be granted from 10 per cent to 20 per cent.]

14. These changes should give a substantial further boost to existing share schemes.

15. Employee share ownership plans - known as ESOPs - are a new form of employee share ownership, which have had much recent publicity. [Explain what's new about them].

16. A number have already been put in place in the UK. To encourage their development, I propose to introduce a new tax relief for contributions to employer share trusts provided they meet certain requirements, designed to ensure that their shares are placed in the hands of employees within a reasonable time. I hope that, as a result, more firms will be encouraged to consider establishing ESOPs.

[17. I have one further change to propose which will benefit conventional employee share schemes, ESOPs, and profit-related pay schemes alike. I propose to modify the so-called material interest tests where companies have established trusts to acquire their shares for the benefit of their employees. These tests are designed to exclude from tax relief employers who already have a significant interest in the company. Sometimes, however, the present rules can exclude

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employees too. The changes I propose will ensure that only those employees who have a significant material interest in the company will be excluded in future.]

Unit trusts

18. As I mentioned a moment ago, unit trusts have a valuable role to play in providing, for many people, the first introduction to direct investment and share ownership. I therefore consider it desirable to remove an anomaly which means that the tax system bears unduly harshly on unit trust investors, compared with other forms of direct investment.

19. Normally a unit trust investor pays the same tax on dividends and capital gains as someone who had invested in the same shares or securities independently. But if the trust invests in gilts or other securities, and is not an all-gilt trust, it has to pay corporation tax on the income, so the saver ends up bearing tax at 35 per cent, rather than 25 per cent.

20. I have therefore decided that as from 1 January 1990, the Corporation Tax rate on unit trusts should be cut from 35 per cent to 25 per cent. [Unit holders' CGT position will be unaffected, as will the additional income tax paid by higher rate taxpayers.

And rules will be introduced to prevent corporate investors using this change as a tax shelter.]

21. This reduction in the tax rate on unit trusts will incidentally have the beneficial effect of removing the competitive disadvantage which UK mixed unit trusts would otherwise have faced in the near future, when firms from other EC countries acquire the right to sell collective investment vehicles in the UK.

Stamp duty

22. I have one further measure to propose in this context.

A

My next announcement also affects the City,

~~and indeed~~

23. In ~~my~~ the 1984 Budget, ~~I was able to reduce~~ the 2 per cent stamp duty on share transactions was cut to 1 per cent. ~~I halved it~~ It was cut again again to ½ per cent in 1986. I have now decided to abolish it altogether, with effect from ~~1 April 1990~~ [when?] [to coincide with the introduction of paperless transactions on the Stock Exchange.] ~~These measures~~ This will remove a barrier to ownership, and eliminate an aspect of the tax system which puts the British financial services sector at a disadvantage compared with some of its competitors.

though with the expansion of share ownership we have seen in recent years, it will affect a great many individual

though, with the expansion of popular share ownership we have seen in recent years, its effects go far wider than that.

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Tax reform

24. The measures I have just announced will further strengthen the growing trend of wider and deeper share ownership. They will remove a major disincentive to the more direct forms of saving. And they build on the targeted incentives that already exist to promote ownership.

[25. As such, their longer-term effect may be to redress an imbalance that arguably exists in the pattern of savings in the UK, which, in the last 30 years has become increasingly dominated by institutional forms of saving, such as life assurance and pensions. Throughout our time in government, our approach to the provision and taxation of savings has had two common threads. First, as far as possible, we have been concerned to ensure maximum choice for individuals. Secondly, we have tried to ensure that choices are distorted as little as possible by the tax system.

26. This is not an area where one can make great changes overnight. Nonetheless we have made considerable progress in improving choice, and reforming the tax system in step. Today, I have more progress to announce.

27. I turn first to pensions.

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28. The Government record is one of widening pensions' choice and encouraging private provision. We have reformed SERPS, improved the rights of pension scheme members and, most important of all, introduced personal pensions. These have been a great success with a million taken out in the first 6 months of operation.

29. But there is still scope for further widening of choice, deregulation of the tax system. I have a number of changes to propose.

30. First, I propose to make it easier for people in personal pension schemes to manage their own investments. Pension savings are highly institutionalised with scheme members having little involvement in investment policy. This measure will encourage greater individual involvement in pension plans [as IRAs have in US].

31. I also propose a number of changes to simplify and improve rules for occupational pension schemes, in particular to improve the conditions on which people can take early retirement.

32. And I intend to simplify the rules for additional voluntary contributions. [At present, if AVCs perform well, occupational pensions may be reduced. In future any surplus contributions will be returned to employees subject to special tax charge.

33. And finally I propose to rectify the anomaly whereby limits for tax relief have come to determine limits on pensions paid. With a tax relief as generous as that for pensions, it is clearly essential that there should be some upper limit. But that is no reason for tax law effectively to constrain the size of the pension an employer may choose to provide. Accordingly, I propose that employers should now be able to set up "top-up" schemes for their employers, with no limits on benefits but without any special tax privileges.

<u>**Rationale for limits**</u>

34. With employers able to pay whatever pensions they like, it is clearly appropriate to put a cap on amount of relief. All other reliefs - BES, PEPS, mortgage interest - are subject to a ceiling.

35. I therefore propose to build on my 1987 changes by making final salary schemes subject to a cash limit on pensions paid from tax approved schemes, based on earnings of £60,000 a year. This is consistent with a privileged pension of £40,000 a year or a tax free lump sum of £90,000 a year. I intend that this earnings limit should be indexed to prices and that these changes should apply to members joining new or existing schemes on or after Budget day.

[36. It is clear that unfettered relief for pensions savings distorts savings choice. People pay less tax if they save through pension funds than if they invest directly in equities or put money in building society They are allowed tax relief on contributions. The returns are untaxed in the hands of pension funds, though tax is paid on the pensions when received. And savings financing pension lump sums escape tax altogether. They are not taxed on the way in or out. This is anomalous by any standard.

37. With the 1988 reductions in top rate of tax, there is less need for tax breaks for higher paid. They can afford to save out of taxed income, by investing directly in equities etc.]

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38. I also propose changes to the rules for personal pensions, to enable them to equal the benefits of final salary schemes. The self-employed are often unable to contribute to personal pension schemes until late in life, at which point they may fall foul of contributions limits. I therefore propose to increase the contribution limits for personal pension scheme members over 50.

39. This will improve position of PPs relative to final salary schemes. Indeed it will pay some employees to leave FS schemes and take out personal pensions. However I also propose to subject to an overall cash limit on contributions. Like the final salary scheme limit, the personal pension cash limit will be tied to prices.

<u>**Conclusion**</u>

40. These proposals represent an important long-term reform of pensions system. However, the effects will take time to come through. Because of the level at which the limits will be set only a few thousand high paid employees

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will be affected at first, rising to 50,000 by the end of the century. But that is how it should be. There is no question of undermining pension saving by a huge upheaval.

41. The long term effect, though, is likely to be considerable. It will result in a major turnround in the balance of savings in the course of 21st century.

42. The last few years have seen a large number of pension reforms. It is time they were allowed to settle down. Accordingly, I do not plan any further changes in this Parliament.

LIFE ASSURANCE

43. I now turn to the taxation of life assurance. In July last year, the Revenue issued a consultative document on the taxation of Life Assurance. It pointed to some important defects in the present tax regime and outlined possible changes.

44. There has now been a very full process of consultation and I have considered the representations made very carefully. My conclusions are as follows.

45. The Life Assurance industry is unique, not just in the product it provides but also in the tax regime which

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applies to it. The policyholder's returns and the shareholder's profits are not, as in a normal business, taxed individually but jointly by taxing the funds held by the Life Offices on their policyholders' and shareholders' behalf.

46. It is a peculiarity of this system that relief is given "up front" for expenses incurred on the policyholder's behalf. This has two distortive effects: first it means that policyholders receive a tax break - "up front" relief on initial costs which would not be available if they invested directly in shares. And it distorts the incidence of tax as between one Life Fund and another. The system unduly favours the rapidly expanding Life Office where tax can be deferred for many years.

[47. I have considered very carefully whether this problem is best resolved by improving the existing system; or by adopting a completely new basis of taxation for the Life Office. I have concluded that the defects can be dealt with within the present regime.]

48. I shall be bringing forward in the Finance Bill measures which will mean that in future, relief for the initial expenses associated with new policies will be spread forward so that one-seventh only is available for relief against tax in each of the first and subsequent

six years. Taken on its own this would increase the tax liability of life offices, indeed quite markedly in the early years. But this effect will be eased by phasing provisions to give the industry time to adjust to the new regime, and by other measures which I have to propose.

49. But first I have one other proposal which will also restrict the amount of relief available. At present nothing requires life offices to keep their pensions and life assurance businesses separate. So some Life Offices can set the unrelieved expenses on the pensions side of their business against the income and realised gains of Life Funds. This means that their pensions profits enjoy unduly favourable tax treatment. The Finance Bill will include provisions to end this anomaly.

50. [The Finance Bill will also include a number of lesser measures, giving a better specification of charge, and bringing into charge miscellaneous items of income which currently fall outside the tax net].

51. These measures would cover the main part of the proposals discussed in last year's consultative document. The Finance Bill will provide for them to be introduced from 1 January 1990. But there are other, more technical items which require further consultation.

Any legislative changes following that consultation will be included in the 1990 Finance Bill.

52. These measures give a fairer basis for the taxation of the Life Companies. In isolation they would increase the long-run tax burden by £[ ]m. However, here as throughout the tax system, widening the tax base allows tax rates to be reduced. This I propose to do.

53. At present, Life Funds pay tax at 35 per cent on unfranked investment income and 30 per cent on realised capital gains of their policyholders. As from 1 April 1990, these rates will be reduced to 25 per cent. Life Assurance Premium Duty will be abolished from the same date. Together these will be worth £[ ]m to Life Assurance in a full year. On top of this, the industry, like all those who deal in shares, will benefit from the abolition of stamp duty to the tune of X a year.

54. [Net effect of these changes on the industry as a whole.]

[A conclusion still needed for this tax reform section]

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55. I now have a number of other, less daunting, reforms to propose. Most of them represent simplifications and deregulation.

56. The first is a piece of tidying up which follows from the major reforms of income and capital gains tax in my last Budget.

57. My reforms of capital gains tax have produced a fairer and more neutral system. However they have exacerbated one existing anomaly, which I now propose to remove. The holdover relief for gifts postpones tax on past gains made by the giver until the recipient disposes of the asset. When we still had capital transfer tax on lifetime transfers, this relief was necessary to avoid a double capital tax charge. But this need no longer remains. Moreover, now that a single rate of capital gains tax has been replaced by 2 rates aligned with income tax, the gifts relief is open to exploitation by higher rate taxpayers wishing to avoid paying CGT at their marginal rate. I therefore propose to abolish the general gifts relief. There are some circumstances where tax deferral continues to be justified for wider economic reasons, notably in the case of gifts of business assets and gifts to charities. For these cases, the relief will be retained.

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[58. Still on capital gains tax, I propose to change the tax treatment of certain bonds so as to simplify the tax rules and to prevent a loss of yield by the conversion of income into capital gains.

59. First I propose to exempt from capital gains tax, all sterling non-convertible corporate bonds. This will prevent exploitation of indexation relief to manufacture capital losses.

60. Second, I propose to put the tax rules for deep discount bonds onto a simpler and more effective basis. Where the return on a bond can be mathematically split into capital gains and income then those two elements will be taxed separately. Where the return on a bond cannot be so split then it will be taxed as income.

61. These changes will apply to gilts although existing issues of deep discount gilts will continue to be taxed under the existing rules.]

62. Last year, by rebasing capital gains tax to 1982, I completed the process of taking purely paper gains out of tax. At the same time I reduced the exempt threshold as it no longer needed to compensate for the lack of indexation relief for pre-1982 gains. Its only remaining function is to exclude small gains from the tax. I judge that it still performs that

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function perfectly adequately and I therefore propose to maintain it at its current level of £5000. Following independent taxation in 1990, husbands and wives will, of course, benefit from a double exemption.

63. The taxation of close companies is another area ripe for simplification. Again this has been made possible by last year's reform of personal tax.

64. Under the current rules undistributed income and gains of close companies are apportioned among its shareholders in order to determine tax payable. The rules governing this are an exceptionally complicated area of the tax system, running to some 20 pages of legislation. I therefore propose to abolish apportionment rules for close companies. In future income and gains of a close company will be subject to normal corporation tax rules, subject only to simple rules to prevent abuse. This reform will represent a major simplification of the tax affairs of a great many small businesses.

65. The next set of deregulation measures I have to propose will also benefit the small business sector. These measures relate to the operation of VAT.

66. At present, traders are normally liable to VAT on their sales whether or not their customers pay them.

Bad debt relief can be claimed only where the debtor has become insolvent. This takes far too long. I therefore propose that from 1 August, all debts which are over eighteen months old will qualify for bad debt relief. This will be of great help, from both an administrative and financial point of view, to a great many businesses.

67. I also propose simpler rules to govern registration for VAT. At present there are quarterly and annual turnover thresholds, and businesses are required to look ahead to the next twelve months to see if the limits <u>might</u> be exceeded. This complication is unnecessary. As from Budget Day I propose a single rule for determining registration based on turnover in the <u>past</u> twelve months.

68. Finally, I propose to simplify the VAT default surcharge. At present this rises by stages each time a business defaults to a maximum of 30 per cent. Experience suggests that by the time a business reaches a surcharge rate of over 20 per cent, it has moved from the "won't pay" to "can't pay" category. I propose to recognise this by capping the default surcharge rate at 20 per cent.

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Schedule E

69. I propose one simplification in the income tax field . At present, under Schedule E, tax assessments are done on the basis not of earnings received in a year, but instead on earnings for the year - accruals rather than receipts. I propose to change this, so that in future it is assessed on a receipts basis.

70. For the vast majority of ordinary taxpayers this will make no difference at all. But it will greatly simplify the tax affairs of about half a million people. It will also make the tax system simpler and cheaper to administer. There will be no lasting loss of revenue, but there is a transitional cost of £[X] in the first two years, offset thereafter.

Corporation Tax

71. I now turn to the taxation of businesses generally.

72. It is now five years since I announced the major reform of business taxation which has given us one of the lowest corporation tax rates [in the world?]. Our neutral system of business taxation, combined with low rates, has set the scene for a dramatic improvement in the performance of British firms. The reform of capital

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allowances has encouraged more efficient investment, based on real returns rather than tax advantages. And the removal of the bias against job creation has played a key role in the UK's impressive employment growth. In this healthier climate, company profitability has recovered dramatically.

73. The system we have is clearly right, and is working well. Accordingly, I have no change to propose to the main Corporation Tax rate for 1988-89.

74. However, at the moment, only a small minority of companies pay this main rate of 35 per cent. The remainder have no liability at all, or pay at reduced rates, determined by the small companies' profits limits. These limits have remained unchanged since 1983. I propose now to increase them, so that the lower limit, below which companies pay at 25 per cent, will increase from £100,000 to £150,000. Above that level, companies pay at a gradually increasing rate, until they reach the main rate threshold of £500,000. I propose to increase this, too, by 50 per cent, to £750,000.

75. [I have one other minor change to CT. I propose to extend relief available for expenditure incurred by individuals or companies prior to their commencing trading from the present 3 years before trading

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commences to 5 years. This will benefit new companies undertaking projects requiring long lead times.]

Cars

76. I have to set the 1989-90 car and fuel benefit scales for those with company cars. For years, the car scale charges have fallen significantly short of the true value of the benefit, and in successive Budgets I have made significant progress to redress this. I intend to continue this, and increase the car scales by a further 20 per cent for 1989-90. I propose no change to the fuel scales.

Profit Related Pay

77. Two years ago, I introduced in my Budget a tax relief for Profit Related Pay Schemes, designed both to give workers a more direct sense of identification with the firms that employ them, and to promote a greater degree of pay flexibility. The current success of British firms is built on improvements in both these respects.

78. The Profit Related Pay Scheme has played its role in this process, but it is also clear that more firms are interested in launching schemes, but are not able to comply with all the present

rules. I therefore propose to make three modifications to the scheme in this year's Finance Bill. First as I have already announced, I intend to abolish the requirement that PRP must equal at least 5 per cent of pay.

79. Second, I propose to raise the limit on the amount of PRP which can attract relief from £3,000 to £4,000. Finally, I propose to relax the rules banning headquarters and other central units from using the profits of the whole company or group for their own profit calculations, as I am persuaded that this too is unnecessarily restrictive. I am confident that these modifications will ensure continued growth in the number of firms offering some element of profit related pay.

TAXES ON SPENDING

80. I now turn to taxes on spending.

81. First, VAT. I have already announced a package of significant deregulatory measures. The FB will also implement the changes necessary to comply with the ECJ's judgement on certain of the UK's zero rates, notably that on non-domestic construction. The only other change I propose to make to the coverage of VAT is to introduce a small number of extra reliefs for charities,

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of which the most important is the exemption of their fund-raising events, subject to an upper limit.

82. The main thrust of Government encouragement to charities, however, continues to be focused on the act of giving. Accordingly, I propose to increase the weekly limit for the PRG scheme from X to Y.

VED

83. Next, I have a number of measures to propose which will greatly simplify the structure of vehicle excise duty and make it more equitable.

84. There are at present X rates of VED. I propose to reduce the number of tax classes by over 70 - a major simplification.

85. At the same time I propose to rectify anomalies in the present structure of rates. At the moment a bus or a coach has to have sixty six seats before it pays as much VED as a family car. I propose to increase the relevant rates to bring this group up to track cost.

86. There will also be increases in the rate of VED for the heaviest of the rigid HGVs so as to put them on a more equal basis with articulated HGVs.

87. I turn now to the duty on petrol. Last year I increased the tax differential in favour of unleaded petrol to nearly 11p a gallon. This has undoubtedly helped to increase the take up of unleaded petrol.

88. But the Government is committed to phasing out leaded petrol, and progress is still too slow. Unleaded petrol still accounts for only 4 per cent of total sales, when X per cent of cars can use it without any adjustment, and most of the remainder could be adjusted to use it at very little cost.

89. One of the problems is clearly ignorance of the facts about unleaded petrol. Many people do not realise that they can already use it. And others who could cheaply have their cars converted hold back because they fear - wrongly - that after conversion their cars could no longer use leaded. Fortunately, the myths about unleaded petrol are beginning to be dispelled.

90. But I propose to do my part too, and to make sure that the market signal is clear enough. I therefore propose to reduce the tax on unleaded petrol further by something over 3p a gallon. If this reduction is passed on to consumers - and I look to the oil companies to make sure that this happens - the price of unleaded petrol will generally be about 9p a gallon below that of

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4 star. This in itself should provide a strong encouragement for 4 star users to have their cars converted.

91. However, I propose to go further by introducing a surcharge of 5p a gallon on 2 and 3 star petrol. This will bring the price of these grades broadly into line with that of 4 star. Virtually all cars which use 2 and 3 star can run on unleaded petrol without any conversion. These motorists will now have a strong incentive to change their habits. This in turn, will provide the necessary signal for more garages to stock unleaded - if necessary by freeing up a pump that formerly sold 2 star.

92. Taken together, these two duty changes will give us the largest differential between leaded and unleaded petrol of any EC country, with the exception of Denmark. I hope that we shall soon match this performance in terms of <u>take-up</u> of unleaded. Both these duty changes will take effect from 6.00pm tonight.

93. I have no other changes in excise duties to propose.

INCOME TAX [to follow]

allowances

rates

[NICs]

Earnings rule

CONCLUSION AND PERORATION [to follow]

rc 1989/21.2.03

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COPY 2 OF 5 COPIES

FROM: ROBERT CULPIN
DATE: 21 February 1989

ECONOMIC SECRETARY

cc: Principal Private Secretary
Mr Gilhooly
Mr Michie

UNLEADED PETROL

We agreed yesterday to return to unleaded petrol at the next Overview. Mr Wilmott has sent you a draft paper, with his note of 17 February.

2. I have a pedestrian concern. So far as I can see, we do not know for certain what duty changes we need to make in order to make unleaded 2p a litre cheaper than 4-star, or to make 2-star as expensive as 4-star. That is because we are not certain what the price differentials are at present.

3. I have had one go at Customs in a letter of 7 February, which I attach. Do you think you could have another, when you comment on the Wilmott draft?

RC

ROBERT CULPIN

rc 1989/7.2.01

BUDGET CONFIDENTIAL

H M Treasury

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Robert Culpin

Head of the Fiscal Policy Group

P G Wilmott Esq
Customs and Excise
New King's Beam house
22 Upper Ground
LONDON
SE1 9PJ

7 February 1989

Dear Peter,

UNLEADED PETROL

Now that the Chancellor has decided what advantage he wants in principle to give unleaded petrol, I should like to be sure that the Scorecard specifies correctly the duty changes he needs to make.

The first objective is that unleaded should be 2p a litre cheaper than 4-star, so far as the Government can bring this about. When I was doing the Scorecard last week, I found that Which? says that unleaded is probably about 1.2p a litre cheaper at the moment, on average. An AA survey last autumn found that it was then roughly 1.1 or 1.2p a litre cheaper. The current Customs estimate is 1.3p. The difference between these figures is trivial, and I have no reason whatever to doubt the Customs estimate. But are we reasonably sure that the required duty change is only 0.7p a litre, if the duty change is fully passed on to consumers? If so, will we be able to stand this up, or is there a danger that others will argue plausibly that it is not quite enough to deliver Ministers' stated objective?

The second objective is that 2-star should be at least as expensive as 4-star. The Scorecard assumes that this requires a surcharge of 1.1p a litre. As the Chancellor pointed out yesterday, it looks as if this would make 2-star <u>more</u> expensive than 4-star on average; but the objective is presumably to make it as expensive as 4-star at <u>most</u> pumps, not just on average. Again, are we reasonably sure that 1.1p is the right amount to achieve this - and can we stand up that judgement? (The AA survey last autumn suggested, I think, that 2-star was only about 0.75p a litre cheaper than 4-star.)

I stress that I am <u>not</u> asking these questions because I have misgivings about <u>the</u> numbers we have used so far; but now that we know what Ministers want in principle to achieve, it seems sensible to check how robust and defensible the precise numbers seem to be.

I am sending a copy of this note to Keith Vernon.

Yours, Robert.

ROBERT CULPIN

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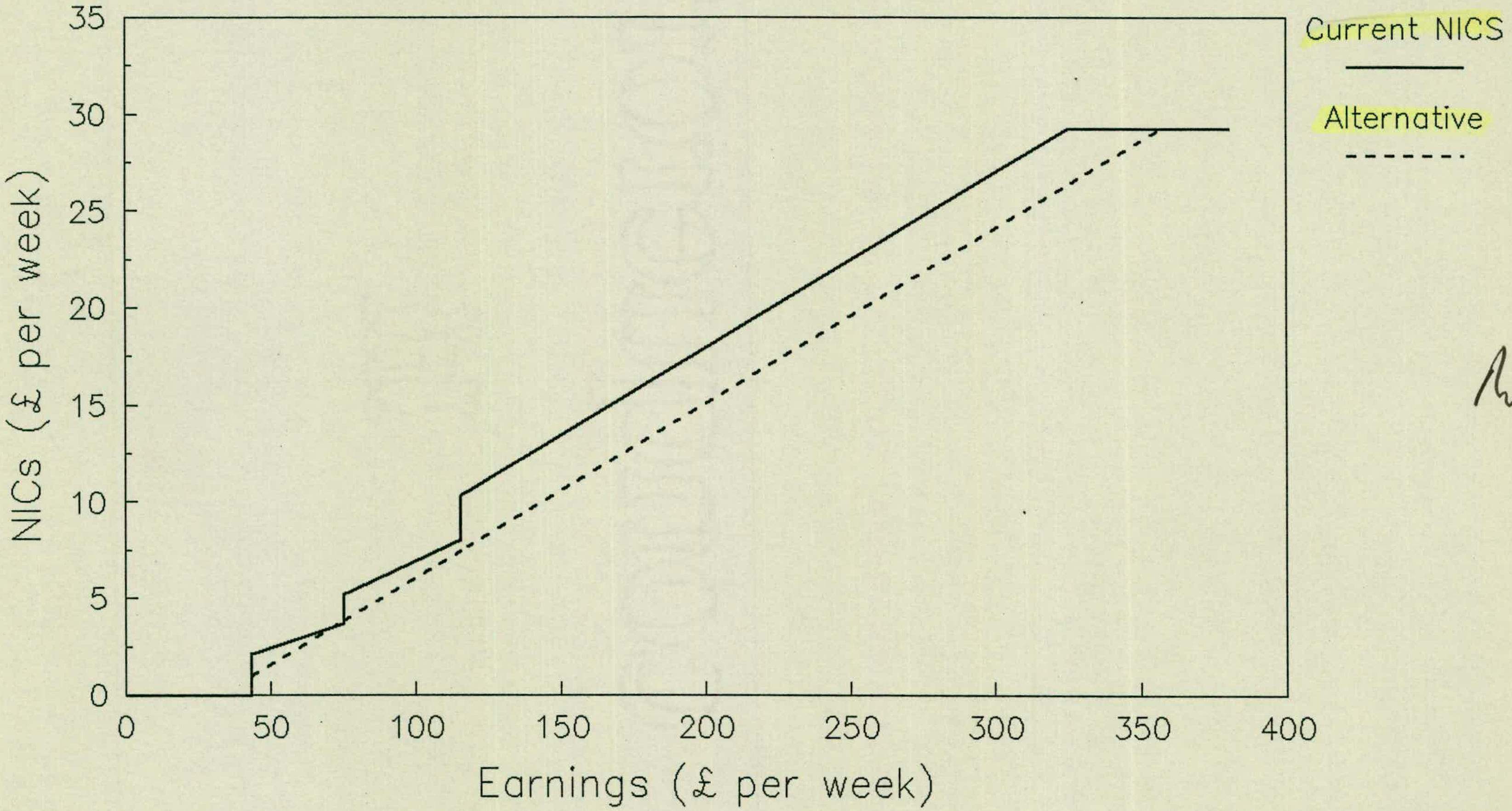
C This is the NIC option.

Broadly same cost as option 4 – poss. bit cheaper. MacIntyre & I seeing Treasury in morning.

Advantages: abolishes > 100% marginal rate @ LEL; reduces step from £2.15 to £1; simpler. But loses 5% band.



£1 "entry fee"
9% on earnings between £43 and £357

Minute tomorrow.

RC 20/2

est.ld/james/21 Feb/Wilmott

BUDGET CONFIDENTIAL

PS. Re 2 star, do we know the use of the 'surcharge' rate of duty? It's a higher r.

FROM: S M A JAMES
DATE: 21 February 1989

MR WILMOTT - C&E

cc:
PS/Chancellor
Mr Culpin
Mr Gilhooly
Mr Matthews
Mr Michie
Mr Call
Mr Tyrie

PS/C&E
Mr Jefferson-Smith - C&E
Mr Gaw - C&E
Mr Spackman - C&E

Ch/ À propos our conversation earlier today, EST has asked ('X' below) for C+E to cover W. German differentials in their paper for next week's O'view.
21/2

OK. But we need to know what the current differential (pump price) is now, & what it was to be.

UNLEADED PETROL

The Economic Secretary was grateful for your minute of 17 February covering your draft overview paper. He had the following comments on the draft:

(i) He does not agree that there is little need for further publicity in the sense of educating the public about unleaded petrol. There will be a particular need for information about the position of 2 star users. In addition we will need a campaign to get across:

- that conversion costs only £15-£20 and thus pays for itself in less than a year;

- once converted, a car can use leaded if no unleaded is available;

- there is no loss of performance when cars use unleaded;

(ii) Paragraph 10. The Economic Secretary does not think a surcharge would prove too awkward presentationally since people feel guilty about using leaded anyway.

(iii) The Economic Secretary would be grateful if the paper could also explain

- why do the Netherlands and Germany have unleaded 2 star?

- the German experience of pricing leaded and unleaded petrol. When Sir Archibald Forster called recently on the Chancellor, he mentioned that the German experience had been that a differential equivalent to 10p a gallon was required in order to encourage demand for unleaded petrol.

- what is the efficiency differential in miles per gallon between unleaded and 2 star, and unleaded and 4 star?

S M A JAMES
Private Secretary

FROM: MISS M P WALLACE
DATE: 21 February 1989

MR NEILSON

BUDGET STATEMENT

Thank you again for your speech contribution on PEPs and ESOPs etc. I attach the version I eventually put to the Chancellor (section 2 paragraphs 1 to 23) for any comments you may have. I also attach the passage on COBO-related tax changes (section 2 paragraphs 58 to 61), which you said you would find helpful for the press release you were drafting. Again, any thoughts you have on this section, or on what might go in the COBO/controls piece in the first section of the speech, would be "gratefully received."

MPW.

MOIRA WALLACE

SHARE OWNERSHIP

Introduction

I place first in my Budget measures to encourage Wider share ownership. Over the last 10 years the number of shareholders has risen from X to Y; and with this increase has come a greater sense of identification with British industry. [Survey results]

2. Exactly three years ago I introduced the Personal Equity Plan - a radical new scheme to encourage investment in British equities. In the first two years that the scheme has been in operation more than 350,000 plans have been taken out. This despite the stock market crash. I now have a number of improvements to propose.

3. First, I propose to raise the limit on the amounts that can be invested in unit and investment trusts. It will rise from £750 to £2,400. Unit and investment trusts are a good introduction to the equity market for smaller investors, and I want to encourage them. This increase will apply only to unit and investment trusts which invest mainly in UK equities.

4. Second, I propose to raise the overall PEP limit from £3000 to £4,800.

5. I also intend to make it possible for PEP holders who apply for new share issues, to put their resulting allocation straight into their PEP, provided this does not breach the overall limit.

6. Third, I propose to abolish a number of restrictions on PEPs, and to simplify them as much as possible.

7. I propose to do away with the rule that PEPs must be held for a full year; if investors choose to cash in their PEPs within a year of purchase, they will, in future be able to do so without tax penalty. I also propose to abolish the rules governing the amount of an investment that may be held in cash. Instead, interest on cash held in PEPs will, in future, be subject to composite rate tax.

8. Finally, I intend to move the PEP year from a calendar to a fiscal year basis. It has become clear that this would be more convenient for all concerned. I therefore intend that the next PEP year will start on 6 April. Anyone who has taken out a plan already in 1989 will also be able to take one out in the new PEP year.

9. Taken together, these changes will make PEPs simpler to administer and more attractive to first time

investors. I am confident that the package will lead to a considerable increase in PEP take up, and a substantial widening and deepening in share ownership.

10. Our measures to encourage employee share schemes have also had a major impact in widening share ownership. The number of approved all - employee share schemes has risen from 30 in 1979 to almost 1600 today, covering around 1¾ million employees, and involving shares worth over £4 billion.

11. This year I have a number of further improvements to the employee share legislation to propose.

12. I propose to raise the limits on the 1978 profit sharing scheme and on the 1980 SAYE option scheme since 1984. The limit on the annual value of shares which can be given tax-free to employees under the 1978 scheme, will rise from £1,250 or 10% of salary, subject to an overall limit of £5,000, to £2,000 or 10% salary, subject to a limit of £6,000. [This will be of particular benefit to lower paid employees.]

13. I also intend to raise the maximum monthly savings limit for the all-employee SAYE scheme from £100 to £150. [And I propose to increase the maximum discount from market value at which options can be granted from 10 per cent to 20 per cent.]

14. These changes should give a substantial further boost to existing share schemes.

15. Employee share ownership plans - known as ESOPs - are a new form of employee share ownership, which have had much recent publicity. [Explain what's new about them].

16. A number have already been put in place in the UK. To encourage their development, I propose to introduce a new tax relief for contributions to employer share trusts provided they meet certain requirements, designed to ensure that their shares are placed in the hands of employees within a reasonable time. I hope that, as a result, more firms will be encouraged to consider establishing ESOPs.

[17. I have one further change to propose which will benefit conventional employee share schemes, ESOPs, and profit-related pay schemes alike. I propose to modify the so-called material interest tests where companies have established trusts to acquire their shares for the benefit of their employees. These tests are designed to exclude from tax relief employers who already have a significant interest in the company. Sometimes, however, the present rules can exclude

employees too. The changes I propose will ensure that only those employees who have a significant material interest in the company will be excluded in future.]

Unit trusts

18. As I mentioned a moment ago, unit trusts have a valuable role to play in providing, for many people, the first introduction to direct investment and share ownership. I therefore consider it desirable to remove an anomaly which means that the tax system bears unduly harshly on unit trust investors, compared with other forms of direct investment.

19. Normally a unit trust investor pays the same tax on dividends and capital gains as someone who had invested in the same shares or securities independently. But if the trust invests in gilts or other securities, and is not an all-gilt trust, it has to pay corporation tax on the income, so the saver ends up bearing tax at 35 per cent, rather than 25 per cent.

20. I have therefore decided that as from 1 January 1990, the Corporation Tax rate on unit trusts should be cut from 35 per cent to 25 per cent. [Unit holders' CGT position will be unaffected, as will the additional income tax paid by higher rate taxpayers.

And rules will be introduced to prevent corporate investors using this change as a tax shelter.]

21. This reduction in the tax rate on unit trusts will incidentally have the beneficial effect of removing the competitive disadvantage which UK mixed unit trusts would otherwise have faced in the near future, when firms from other EC countries acquire the right to sell collective investment vehicles in the UK.

Stamp duty

22. I have one further measure to propose in this context.

23. In my 1984 Budget, I was able to reduce the 2 per cent stamp duty on share transactions to 1 per cent. I halved it again to ½ per cent in 1986. I have now decided to abolish it altogether, with effect from 1 April 1990 [to coincide with the introduction of paperless transactions on the Stock Exchange.] These measures will remove a barrier to ownership, and eliminate an aspect of the tax system which puts the British financial services sector at a disadvantage compared with some of its competitors.

[58. Still on capital gains tax, I propose to change the tax treatment of certain bonds so as to simplify the tax rules and to prevent a loss of yield by the conversion of income into capital gains.

59. First I propose to exempt from capital gains tax, all sterling non-convertible corporate bonds. This will prevent exploitation of indexation relief to manufacture capital losses.

60. Second, I propose to put the tax rules for deep discount bonds onto a simpler and more effective basis. Where the return on a bond can be mathematically split into capital gains and income then those two elements will be taxed separately. Where the return on a bond cannot be so split then it will be taxed as income.

61. These changes will apply to gilts although existing issues of deep discount gilts will continue to be taxed under the existing rules.]

62. Last year, by rebasing capital gains tax to 1982, I completed the process of taking purely paper gains out of tax. At the same time I reduced the exempt threshold as it no longer needed to compensate for the lack of indexation relief for pre-1982 gains. Its only remaining function is to exclude small gains from the tax. I judge that it still performs that

FROM: J M G TAYLOR
DATE: 22 February 1989

pp

PS/ECONOMIC SECRETARY

cc Mr Culpin
Mr Gilhooly
Mr Matthews
Mr Michie
Mr Call
Mr Tyrie

PS/C&E
Mr Jefferson Smith - C&E
Mr Gaw - C&E
Mr Spackman - C&E
Mr Wilmott - C&E

UNLEADED PETROL

The Chancellor has seen your note of 21 February.

2. On the position in Germany, he has commented that we need to know what the current differential (pump price) is, and what it used to be.

3. On 2 star, he has commented that he does not like the use of the term "surcharge": it is a higher rate of duty.

J M G TAYLOR

Pg

FROM: J GIEVE
DATE: 23 FEBRUARY 1989

MISS WALLACE

cc Principal Private Secretary
Sir P Middleton
Sir T Burns
Mr Riley
Mr Sedgwick
Mr Pickford
Mrs Chaplin
Mr Tyrie

BUDGET STATEMENT - FIRST DRAFT

I think there is a case for changing the order of opening sections. Since this is the Chancellor's fifth Budget and the tenth anniversary of 1979, I would have thought they might start with the medium term record and restating the principle themes of the MTFS (ie broadly paragraphs 9-27). They would be followed by the section on the economy in 1988; again I would start with the world economy before coming to the British economy.

2. Within the section on the British economy (ie paras 2-16 of your draft), the passage on the accounts adjustment comes just before the announcement of the figures for the current account deficit which is not the change we wish to highlight. I would put it right at the beginning with the passage on growth, perhaps on the following lines:

> "There is no doubt that 1988 has once again been a year of rapid growth in the UK as well. My best estimate is that output grow last year by about 4½ per cent. Leaving aside North Sea oil which was badly effected by a number of accidents, growth was around 5½ per cent. That brings overall growth of national output in a period since 1983 to some 20 per cent; 5 years of sustained growth averaging 3¾ per cent.

The figures for 1988 are unusually uncertain because of the growing inconsistencies in the National Income Accounts. During the course of the last year it has become clear in particular that the estimates of expenditure, and most notably investment spending, have been substantially under-recorded. It has been necessary, therefore, to look behind the published figures in order to make a coherent assessment of the current state of the economy and produce a sensible forecast for the coming year. This assessment is inevitably uncertain but it represents our best estimate of what has happened in the economy. ~~It~~ it is set out together with the forecast in the Financial Statement and Budget Report and the Treasury is also publishing a more detailed paper explaining the background and methodology.

3. My other suggestions are:

Paras 9 and 10 I would combine these and I would be inclined to omit the figure for the current account in 1988.

Para 14 The forecast does not show particularly good prospects for growth in 1990-91 so it may be better to refer to "the prospects for the 1990s".

Para 16 I would insert "and industry switches production to export markets" at the end of the third sentence.

Para 19 I think the first sentence needs to go wider than external shocks. It is more a matter of the inherent limitations of economic management. No Government can pretend to drive the economy like a tram. What it can do is to put in place the right broad framework and then to react sensibly to events.

Paras 25 I would use manufacturing productivity figures.

Paras 29-31 I would be inclined to drop this, or at least make it less scornful.

Paras 33-35 I would combine this with para 16.

Another candidate for omission would be the material in paras 53 and 54.

J St. Gieve

JOHN GIEVE

BUDGET CONFIDENTIAL

H.M. CUSTOMS AND EXCISE
NEW KING'S BEAM HOUSE, 22 UPPER GROUND
LONDON SE1 9PJ
01-620 1313

PS/ECONOMIC SECRETARY

FROM: D A GAW
24 February 1989

UNLEADED PETROL

I have seen Mr Taylor's note of 22 February.

2. The pump price differential in Germany has been researched (as far as possible in the time available) and included in our Overview paper.

3. I confirm that instructions to Parliamentary Counsel were based on a higher rate of duty for "petrol other than four star". We have noted the Chancellor's dislike of the use of the term "surcharge".

D A GAW

Circulation:

PS/Chancellor
Mr Michie

CPS
Mr Jefferson Smith
Mr Wilmott
Mr Allen
Ms French
Mr Spackman

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BUDGET

FROM: MISS M P WALLACE

DATE: 27 February 1989

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Dame A Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr Sedgwick
Mr Riley
Mr A C S Allan
Mr Gieve
Mr Gilhooly
Mr Matthews
Mr Pickford
Mr Macpherson
Mr Michie
Miss Hay
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill - IR
Mr Beighton - IR
Mr Isaac - IR
Mr Painter - IR
Mr G Bush - IR
Mr C McNicol IR [+1]

Mr Unwin - C&E
Mr Jefferson Smith - C&E
Mr P R H Allen - C&E
Ms A French - C&E [+1]

SECRET

B.L.O.

BUDGET STATEMENT: TAX SECTION

The Chancellor was most grateful to all those who commented on earlier drafts of the tax section. He worked on this over the weekend, and I attach his redraft. He will want to look at this again at the end of the week, and has therefore asked for comments to reach me by close of play on Wednesday, 1 March.

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2. The present draft is near complete, except for the "home straight" (income tax, earnings rule, NICs, peroration) which I shall be circulating as soon as he has finished work on it.

3. You will see that the Chancellor has also issued various remits to other Ministers:

(i) he would like the <u>Financial Secretary</u> to draft a short paragraph on unit trusts CT rate. He would also like the <u>Financial Secretary</u> to draft a short paragraph on Keith: he has not yet decided whether to include this in the Speech or not, but would like to consider this again;

(ii) he would be grateful for the <u>Economic Secretary's</u> advice on what and how much should be said about the ECJ judgement. He would also like his views on whether we should list all the new VAT reliefs for charities;

(iii) he would be grateful if the <u>Paymaster General</u> could vet the section on Payroll Giving, and redraft as necessary.

4. I should also mention that the following items have been deliberately omitted from the draft:

- Pre-trading expenses (doesn't need to be mentioned in the Budget Speech).

- ITV levy (already announced, and doesn't fit in very well).

- Schedule E receipts basis, and CGT set-off for unincorporated companies (both to be discussed at this afternoon's Overview).

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5. Finally, on mechanics, I am sending one spare copy of the Speech each to the Revenue and Customs, on which Mr McNichol and Ms French might like to mark collected comments. Perhaps the easiest thing for others is to mark any drafting comments in manuscript on their copy, send it back to me so that I can record them on the master, and I will then return copies to their owners.

MPW.

MOIRA WALLACE

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TAXPAYER CONFIDENTIALITY

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

2. As the House knows, the new official secrets legislation currently passing through Parliament [where will it have got to by 14 March?] is very much narrower in scope than the present Official Secrets Act. In particular, it does not cover information in the possession of either of the Revenue Departments concerning the private affairs of individual taxpayers.

3. I am sure that the whole House will agree that it is essential that taxpayer confidentiality is properly protected. I therefore propose to introduce provisions in this year's Finance Bill to ensure that it will continue to be a criminal offence for officials or former officials of either the Inland Revenue or Customs and Excise to reveal information about the private affairs of an individual taxpayer.

4. I would only add that the need for this protection is in no sense a reflection on the probity and integrity of the members of those two Departments. Indeed, after nearly six years as Chancellor and more than eight years

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as a Treasury Minister, I would like to take this opportunity to pay public tribute to the outstanding service I have consistently received from the officials of the two great Revenue Departments.

BUSINESS TAXATION

5. I now turn to taxation. As I have done on a number of previous occasions, I propose to divide this into three broad sections: the taxation of business, the taxation of savings, and the taxation of personal income and spending.

6. First, taxes on business.

7. The rate of corporation tax for small companies, defined for this purpose as those with annual profits of less than £100,000, has, ever since the corporation tax reform I introduced in 1984, been set at the basic rate of income tax, currently 25 per cent. Large companies, defined as those with profits of £$^1/_2$ million or more, pay the main rate of corporation tax of 35 per cent, one of the lowest rates of tax on company profits in the world. Between those two monetary limits, intermediate rates are payable.

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8. I propose to leave both the small companies rate and the main corporation tax rate unchanged for 1989-90. But I propose to increase the monetary limits substantially, by 50 per cent.

9. Thus the 25 per cent rate of tax will apply to companies with profits of under £150,000, and the 35 per cent rate will only be reached at profits of £$^3/_4$ million. These changes will reduce the corporation tax burden for more than half of all those companies that do not already enjoy the full benefit of the small companies rate.

10. The reduction in the top rate of income tax to 40 per cent in last year's Budget enables me to make a major simplification of the tax treatment of close companies - companies that are controlled by [insert <u>simple</u> definition].

11. The rules for the so-called apportionment of close companies' profits are notoriously complex, taking up some twenty pages of impenetrable legislation. These rules are no longer needed and I propose to abolish them. I believe that many hundreds of thousands of small businesses, and particularly family businesses, will welcome the removal of this burden.

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12. I do, however, have to guard against the avoidance of tax on investment income by channelling it through a closely controlled investment company. Any such company which does not distribute its profits will therefore be taxed at 40 per cent, equivalent to the higher rate of income tax.

13. When I doubled the scales for the taxation of the private use of company cars in last year's Budget, I made it clear that this still left the company car, which remains far and away the most widespread benefit in kind, significantly undertaxed.

14. Accordingly, I propose to increase the car scales by a further [25] per cent for 1989-90. The yield from this will be £110 million in 1989-90 and £135 million in 1990-91. There will be no change in the fuel scales.

15. There is one further tightening in this general area which I believe it right to make. I propose to put the extra-statutory concession which relieves from tax payments made by employers to employees to cover their incidental costs when they are required to move house because of their job on a proper statutory footing. But at the same time I propose to withdraw the extra-

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statutory concession which at present exempts housing subsidies from tax when the move is to a higher cost area, since this artificially blunts the market forces which should be leading employers to consider locating in lower cost areas.

16. Over the years I have received a steady stream of representations from business complaining about the long-standing tax treatment of foreign exchange gains and losses. I recognise that as business becomes more global this subject becomes increasingly important. However, I have to say that I find it one of the most intractable I have encountered. Certainly, there can be no question of any change in the present system until a number of crucial and complex issues have been satisfactorily resolved. I have therefore authorised the Inland Revenue to publish today a consultative document which explores those issues and examines the scope for reform.

17. Lastly, on the business front, I have a number of proposals to make the VAT system less burdensome, which should be of particular help to newer and smaller businesses. In this context, it is particularly encouraging that over the past year the number of

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businesses in Britain has been growing, at the record rate of 1,000 a week.

18. First, at the present time there are both quarterly and annual turnover thresholds for VAT, and businesses are required to say if they expect to exceed either of those thresholds over the coming twelve months. I propose to sweep away both the quarterly threshold and the requirement to predict, and introduce as from today a single annual test based on turnover in the preceding twelve months.

19. I also propose to increase the VAT threshold to £23,000, the maximum permitted under European Community law.

20. Second, at present the VAT default surcharge, whose introduction has led to a marked improvement in compliance, is set at 5 per cent for the first default, rising by 5 per cent stages for subsequent defaults, up to a maximum of 30 per cent. In the light of experience with the surcharge I am satisfied that its purpose can be adequately served with a reduced maximum of 20 per cent.

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21. Third, there is the perennial problem of VAT on bad debts. In general, traders are liable to pay VAT on their sales at the time they render their invoice, irrespective of whether the customer actually pays the bill. Bad debt relief can then be claimed only where the debtor has been formally declared insolvent, a requirement which, for the smaller business, is frequently prohibitive. It was partly in order to meet this problem that I introduced, in my 1987 Budget, the option for traders with a turnover of under £$^1/_4$ million to account for VAT on a cash basis, so that no VAT is due unless and until the bill is paid.

22. But there remains the problem of those traders with a turnover greater than £$^1/_4$ million, the highest figure for which I was able to secure a derogation from the European Community's sixth VAT directive. I therefore propose that, as from 1 October, all debts which are more than 18 months old and which have been written off in the trader's accounts should automatically qualify for bad debt relief.

23. The total cost of all these VAT reliefs, over and above the cost of revalorising the VAT threshold, will be £105 million in 1989-90 and £270 million in 1990-91.

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TAXES ON SAVING

24. I now turn to the taxation of saving.

25. The sharp decline in the ratio of personal saving to personal income over the past two years in particular has led to even more discussion than usual of the merits of providing greater tax incentives for personal saving.

26. Certainly it is desirable that, over the medium-term, we generate as a nation a level of saving high enough to finance a high level of investment without having to rely too much on inflows of capital from overseas.

27. But what matters here is not personal savings alone, but corporate savings too, which are running at historically high levels, and even public sector savings, which are higher than they have been for some considerable time.

28. Moreover, the fall in the personal savings ratio, which is of course measured in net terms, that is to say gross saving net of borrowing, has occurred as a result of the sharp increase in personal borrowing. And the

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appropriate remedy for that is to raise the cost of borrowing, as we have done.

29. But above all, it is essential that tax reform is seen in a medium-term, even a long-term context. It is wholly inappropriate as an answer to what are essentially cyclical or even conjunctural difficulties. In that context, the Government's policy is clear. It is to strengthen and deepen popular capitalism in Britain, by encouraging in particular wider share ownership.

30. If, in doing so, the overall level of personal saving rises, well and good; but that is not the object of the exercise and is something which in any event would only become apparent over the longer term. Over the past ten years we have done a great deal, on a number of fronts, to encourage wider share ownership in general and employee share ownership in particular.

31. The latest Treasury/Stock Exchange survey, conducted earlier this year, reveals that there are now [X] million individual shareholders in this country, equivalent to one adult in every (five), and some three times as many as there were ten years ago.

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Indeed, there are now more individual shareholders than there are trade unionists. (Check).

32. The privatisation of the water and electricity industries is likely to provide a further impetus to popular capitalism over the next two years.

33. Meanwhile, I have a number of measures to announce today to the same end.

34. Personal equity plans were first announced in my 1986 Budget, and started up in January 1987. As the House knows, those who invest in these plans pay no tax at all, either on the dividends they receive or on any capital gains they may eventually make - indeed, there will normally be no need for them to get involved with the Inland Revenue at all.

35. Personal equity plans got off to a good start, with over a quarter of a million investors, many who had never owned shares before, subscribing almost £$^{1}/_{2}$ billion between them.

36. Since then, however, the rate of growth has slowed down considerably, not least as a result of the changed

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climate in the equity market since the October 1987 Stock Exchange crash.

37. So the time has come to give them a new lease of life.

38. First, I propose to raise the annual limit on the overall amount that can be invested in a PEP from £3,000 to £4,800.

39. Second, within that, I propose to raise substantially the amount that can be invested in unit trusts or investment trusts from £750 to £2,400 a year. Moreover, the requirement that the amount invested in unit or investment trusts should not exceed one-quarter of the total amount invested in a PEP will be dropped, and replaced simply by the requirement that, to qualify for PEP treatment, a unit or investment trust must be preponderately invested in UK equities.

40. Third, at present, only cash may be directly invested in a PEP. I propose that investors should also be permitted to place renounceable letters of allotment, obtained by subscribing to new share issues, including privatisation issues, directly into a PEP.

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41. Fourth, I propose to simplify the PEP rules in a number of important respects, so as to make the scheme more flexible, better directed to the needs of small and new investors, and cheaper to administer. The substantial improvements I have announced respond to a number of detailed representations I have received from plan managers. Needless to say, I have not been persuaded to accept every suggestion that has been made. In particular, I have not been persuaded to replace the complete tax relief on exit, which is the essence of the PEP scheme, by tax relief on payments into a plan instead - not least because, while the degree of relief is in principle the sake in both cases, those countries which have opted for front-end relief have been forced to festoon it with a complex web of restrictions to prevent abuse. I am confident that the changes that I have announced today will enable personal equity plans to play an important part in stimulating individual ownership of British equity in the years ahead.

42. I also have a number of improvements to announce specifically designed to encourage employee share ownership.

43. It is a striking fact that the number of approved employee share schemes has risen from a mere 30 in 1979

to almost 1,600 today, involving [number] companies and benefiting some $1^3/_4$ million employees. I propose, first, to increase the annual limit on the value of shares which can be given income tax-free to employees under all-employee profit-sharing schemes from £1,250 to £2,000; and for the alternative limit of 10 per cent of salary, to raise the ceiling from £5,000 to £6,000.

44. Second, I propose to increase the monthly limit for contributions to all-employee save-as-you-earn schemes from £100 to £150, and at the same time to double the maximum discount from market value at which options may be granted from 10 per cent to 20 per cent.

45. Third, a number of my Hon. Friends have been concerned that current tax law may be inhibiting the development of employee share ownership plans, otherwise known as ESOPs. (Insert brief definition/description of what an ESOP is.] I propose to make it clear that companies that place their shares in ESOPs qualify for corporation tax relief, provided they meet certain requirements designed to ensure that the shares become directly owned by their employees within a reasonable time. I hope that this will encourage more British companies, particularly in the unquoted sector, to consider setting up ESOPs.

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46. Those firms with employee share ownership schemes have no doubt that it helps to improve company performance, by giving the workforce a direct personal interest in its profitability and success.

47. This was one of the reasons why I introduced the profit-related pay scheme in my 1987 Budget. I have some improvements to make to that, too.

48. First, as I have previously announced, I propose to abolish the restriction that profit-related pay must equal at least 5 per cent of total pay. Second, I propose to raise the limit on the annual amount of profit-related pay which can attract relief from £3,000 to £4,000.

49. And, third, I propose to relax the rules preventing headquarters units from using the profits of the whole company or group for their profit calculations.

50. Taken together, the package of measures I have announced to encourage wider share ownership in general, and employee share ownership and profit participation in particular, will help to ensure that the idea of a

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share-owning democracy becomes ever more entrenched as a part of the British way of life.

51. I now turn to life assurance.

52. The tax regime for life assurance is sui generis. Moreover it has developed over the years in a piecemeal way, leading to a state of affairs in which the incidence of tax is extremely uneven, with some successful life offices paying no tax at all.

53. There is clearly a powerful case for reform, with a view to securing a tax regime which is more equitable both within the industry and as between life assurance and most other forms of savings. Accordingly, last July the Inland Revenue issued with my authority a major consultative document on the taxation of life assurance. Since then, I have considered very carefully the representations the industry has made, and taken full account both of the forthcoming changes to the regulatory regime for life assurance proposed by the Securities and Investment Board under the Financial Services Act and the prospects for increased competition within the European Community after 1992. In the light of these factors, I have decided not to proceed with the more radical reforms canvassed in the consultative

document. But I do have a number of less radical changes to propose, based for the most part on the general tax reform principle of seeking lower rates on a broader base.

54. First, many life offices run a pensions business as well as a life assurance business, and they are not required to keep the two businesses separate. This enables them to set the unrelieved expenses of the pensions business against the income and gains of their life funds, thus giving their pensions profits unduly favourable tax treatment. I propose to end this anomaly.

55. This change, which will come into force on 1 January 1990, will yield £ million in 1990-91. The remainder of the changes I have to propose constitute a balanced package which, overall, will sightly reduce the taxation of life assurance. (true?)

56. I propose that the expenses incurred by life offices in attracting new business should continue to be fully deductible for tax purposes from the income and gains of life funds, but spread over a period of seven years rather than immediately, as now. To give the industry time to adjust, this change will be phased in

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gradually over the next four years, starting on 1 January.

57. There are certain other, even more technical matters raised in the consultative document which will require further discussion with the industry, and any legislative changes will have to wait for next year's Finance Bill.

58. But I propose here and now, as from 1 January 1990, to abolish Life Assurance Premium Duty. And I also propose, from the same date, to reduce the rate of tax payable on the income and gains of life offices, which at present stands at 35 per cent on unfranked investment income and 30 per cent on realised capital gains, to the basic rate of income tax, 25 per cent.

59. The net revenue effect of this reform of the taxation of life assurance will be a cost of £20 million in 1989-90 and a yield of £45 million in 1990-91, rising in subsequent years.

60. But above all it will provide a more efficient and equitable tax regime for this most important industry.

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[Brief para on reduction in unit trust CT rate: FST to draft, please]

61. I now turn to pensions.

62. Of all forms of savings, the most favourable tax treatment is that accorded to pension schemes. This is necessarily circumscribed by Inland Revenue rules.

63. I do not propose to do away with such rules as a means of limiting the tax relief available - indeed, there is a case for tightening them in some respects. But it is quite wrong that tax law has, effectively, come to set a limit on the overall pension someone can receive. Accordingly, I propose to remove the obstacles in the way of employers setting up pension schemes to provide benefits above the tax limits. Such "top-up" schemes will carry no limit on benefits whatsoever, but, equally, will have no special tax privileges. Employers will now be free, therefore, to provide whatever pensions package they believe necessary to recruit and reward their employees.

64. Another anomaly with the existing tax reliefs for pensions is that there is no limit to them, in cash terms: the higher someone's salary, the greater the

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pension they can have, and the more tax relief goes with it. Of course, someone who receives a very high salary will expect a pension of a comparable level, so as to maintain his or her standard of living on retirement. But given that one man's tax relief is another man's tax increase, and in the light of the income tax reforms I introduced last year, it is hard to justify a state of affairs in which the tax advantages of pension provision are available with no upper limit whatever.

65. So long as the limits on tax relief effectively constrained total pension provision, it was not practicable to avoid this result. But dealing with the first anomaly makes it possible to act on the second.

66. I therefore propose to set a limit on the pensions which may be paid from tax-approved occupational schemes, based on earnings of £60,000 a year. I have deliberately set the ceiling at a level which will leave the vast majority of employees unaffected, and it will be subject to annual uprating in line with inflation. It will still be possible for a tax-approved occupational scheme to pay a pension of as much as £40,000 a year, of which up to £90,000 may be commuted for a tax-free lump sum.

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67. The new ceiling will apply only to pension schemes set up, or to new members joining existing schemes, on or after today. And, as I have already said, there will now be complete freedom to provide benefits above the limits without the tax advantages.

68. The introduction of this ceiling on tax relief also enables me to simplify and improve the rules for the majority of pension scheme numbers, in particular to improve the conditions on which people can take early retirement. Full details will be included in a press release issued by the Inland Revenue.

69. I also propose to simplify very substantially the rules concerning additional voluntary contributions. In particular, the present requirements place a heavy administrative burden on employers at the point where an employee wants to start paying AVCs. In future, the necessary checks will be greatly reduced in many cases employers will not need to be involved at all.

At present, if AVC investments perform very well, occupational pensions may have to be reduced to keep total benefits within the permitted limits. I propose that in future any surplus AVC funds should be returned

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to employees, subject to a special tax charge. This will remove the penalty on good investment performance.

70. These changes should give a further impetus to saving through AVCs.

71. The most important development in the pensions field in recent years has undoubtedly been the introduction and success of personal pensions. Since July last year, a million people have already taken advantage of the new flexibility and opportunities these offer. I have two proposals today to make personal pensions still more attractive.

72. First, I propose to make it easier for people in personal pension schemes to manage their own investments. In general, pension savings have been highly institutionalised. There has been little opportunity for scheme members to be involved in the investment decisions taken on their behalf. I now intend to remove the obstacles to greater individual involvement in personal pension plans.

73. Second, I propose to increase substantially the annual limits, as a percentage of earnings, on contributions to personal pensions for those aged 35 and

over. This will be of particular value to those running their own business, who are often unable to make contributions until later on in their working life. It will also improve the position of personal pensions relative to occupational schemes. The new limits will be subject to an overall cash ceiling based on earnings of £60,000, corresponding to the new ceiling for occupational pensions, and similarly indexed

74. These reforms build on, and complete, the pension measures I introduced in my 1987 Budget. They represent a significant deregulation which will allow more flexibility in a number of circumstances, while setting for the first time a reasonable limit on the tax relief available to any individual. They should give a boost, in particular, to saving through personal pensions and free-standing AVCs.

75. The proposals I have announced for personal equity plans, for life assurance and for pensions amount to a significant further measure of tax reform, this time in the field of the taxation of saving.

76. But it should not be overlooked that a more far-reaching reform which I announced in last year's Budget, to come into effect in April 1990, may well have

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an even more marked effect in encouraging the growth of personal saving.

77. I refer, of course, to independent taxation. For there can be no doubt that the greatest disincentive to saving in the whole of the present tax system is the treatment of the savings of married women, which have to be disclosed to their husbands and taxed at the husband's marginal rate. In particular, those married women who have little or no earnings will be able to set their personal allowances against their savings income, in many cases removing such income from tax altogether. (Insert brief announcement of new publicity leaflet: IR to draft.)

78. A further consequence of the introduction of independent taxation next year is that married women will acquire their own capital gains tax threshold, so that a married couple will enjoy two such thresholds. In the light of this, I propose to maintain the capital gains tax threshold at £5,000 for 1989-90.

79. I have three other proposals to make concerning capital gains tax. First, I propose to abolish the general holdover relief for gifts.

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80. This was rightly introduced by my predecessor in ?1981, when there was still capital transfer tax on lifetime gifts, in order to avoid a form of double taxation. But the tax on lifetime giving has since been abolished, and the relief is increasingly used as a popular form of tax avoidance.

81. But while the general holdover relief will go, I propose to retain it for gifts of business, farm and heritage assets, and also for all gifts to charities. And of course gifts between husband and wife will continue to be exempt.

82. As for gifts of chattels, these will not enjoy holdover relief, but any chattel worth less than £3000 is already exempt from capital gains tax on disposal. I propose to [double] the chattels exemption limit for capital gains tax to [£6000].

83. My last capital gains tax proposal is to change the tax treatment of certain bonds so as to simplify the tax rules and prevent a loss of yield by the conversion of income into capital gains.

84. My final proposal for the taxation of savings concerns stamp duty on share transactions. I halved

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this from 2 per cent to 1 per cent in my 1984 Budget, and again from 1 per cent to $^{1}/_{2}$ per cent in my 1986 Budget.

85. I now have to decide how to adapt it in the light of the Stock Exchange's welcome plans to get rid of paper transactions and move to a cheaper and more efficient electronic system - a process happily known as dematerialisation.

86. Stamp duty on share transactions have been a useful revenue raiser over the years. But it sits uncomfortably with the Government's commitment to encourage wider share ownership, and puts London at a competitive disadvantage to those overseas financial centres where there is no tax on share transactions. Moreover I have to tell the House that I have found some difficulty in solving the problem of how to apply stamp duty when there is nothing to stamp.

87. I therefore propose that, as from 1 April next year, the earliest date on which the Stock Exchange is likely to be able to introduced paperless transactions, stamp duty on share transactions be abolished. The legislation will be in this year's Finance Bill, and the cost in 1990-91 will be £900 million.

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88. This brings the number of major taxes I have abolished since becoming Chancellor to six: an average of one a Budget.

TAXES ON SPENDING

89. I now turn to taxes on personal income and spending.

90. First, VAT. [EST to redraft ECJ para(s), please]

91. Although I have done my best to mitigate the effect of the European Court judgement on charities, as the charities themselves have generously acknowledged, I have been unable to protect them altogether. I have therefore, in these special circumstances, considered whether there is anything further I can sensibly do, however modest, to assist charities with their VAT bills. Accordingly, I propose to relieve charities from VAT on [complete list].

92. I also propose to relieve cars leased to the disabled by Motability from car tax.

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93. But I general, I continue to believe that the best way of helping charitable causes through the tax system is by directly encouraging the act of charitable giving. The Payroll Giving Scheme, which I introduced in my 1986 Budget, has been growing steadily. Some 3,400 schemes have now been set up, and over 100,000 employees are already participating, quite a few of them giving the full £240 annual limit. I now propose to double that limit to £480, or £40 a month.

94. But for the Payroll Giving Scheme to achieve its full potential, it is clearly necessary for the charities themselves, and others involved, to mount a major information campaign about it. I am particularly glad that my noble Friend, the Viscount Whitelaw, has agreed to become Chairman of the new Payroll Giving Committee, which will co-ordinate efforts in this field. [PMG to check this para, please, and redraft as necessary.]

95. I now turn to the excise duties.

96. The damage to the environment in general, and to child health in particular, from lead in the atmosphere, and the contribution of ordinary leaded petrol to this problem, is increasingly widely known. The government

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is committed to phasing out leaded petrol altogether, and in successive Budgets I have sought to assist this. I first introduced a tax differential in favour of unleaded petrol in 1987, and increased it last year. But although sales are undoubtedly rising, unleaded petrol still accounts for less than 5 per cent of total petrol savings, even though two-thirds of the cars now on the road could use it, either without any adjustment or else with a conversion costing only some £15-£20. (check).

97. One of the problems is ignorance of the facts. Many motorists do not realise that their cars can already use unleaded petrol. Many others are unaware how modest the conversion cost is. Many are under the false impression that, if they do convert to unleaded petrol, their cars will no longer be able to use leaded petrol. Others wrongly imagine that their car's performance would suffer were they to use unleaded fuel.

98. It is clearly essential that these myths are rapidly dispelled. Meanwhile, I propose to take the opportunity of this Budget to increase still further the tax differential in favour of unleaded petrol, by reducing the tax on it by something over 3 pence a gallon. If this reduction is fully passed on to the

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customer - and I look to the oil companies to see that it is - it means that the price of unleaded petrol at the pump will generally be some 9 pence a gallon, or two pence a litre, cheaper than four star leaded petrol. This will be one of the most substantial differentials between the price of leaded and unleaded petrol within the European Community.

99. But I do not intend to stop there. I also propose to raise the tax on two and three star petrol by roughly 4 pence a gallon, so that the pump price of these grades will be at least as high as that of four star. This should expedite the phasing out of two star petrol, which is already down to 6 per cent of the total market, thus enabling garages to switch storage capacity and in some cases a pump, too, to unleaded petrol - quite apart from the incentive to the remaining two-star users to switch to unleaded fuel.

100. I am confident that the duty changes I have announced, which will take effect from six o'clock this evening, will help to lead to a marked increased in the use of unleaded petrol over the next twelve months.

101. They will of course also lead to a loss of revenue. I propose to recoup this from Vehicle Excise

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Duty. A the present time a bus or a coach has to have 66 seats before it pays as much in Vehicle Excise Duty as a family car. I propose to rectify this anomaly by increasing the tax rates of this group of vehicles so that they cover their track costs. I also propose to increase the rate of duty for the heaviest non-articulated lorries, to put them on a more equal footing with articulated lorries. Finally on Vehicle Excise Duty, I propose to simplify the system by reducing the number of separate rates of tax from x to y.

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

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ACSA.

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BUDGET

FROM: MISS M P WALLACE
DATE: 27 February 1989

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Dame A Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Scholar
Mr Culpin
Mr Sedgwick
Mr Riley
Mr A C S Allan
Mr Gieve
Mr Gilhooly
Mr Matthews
Mr Pickford
Mr Macpherson
Mr Michie
Miss Hay
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill - IR
Mr Beighton - IR
Mr Isaac - IR
Mr Painter - IR
Mr G Bush - IR
Mr C McNicol IR [+1]

Mr Unwin - C&E
Mr Jefferson Smith - C&E
Mr P R H Allen - C&E
Ms A French - C&E [+1]

Alex

Thank you. Taken on
I have retained
the "attachment."

M

Moira
Comment noted.

Alex

SECRET

B.L.O.

BUDGET STATEMENT: TAX SECTION

The Chancellor was most grateful to all those who commented on earlier drafts of the tax section. He worked on this over the weekend, and I attach his redraft. He will want to look at this again at the end of the week, and has therefore asked for comments to reach me by close of play on Wednesday, 1 March.

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2. The present draft is near complete, except for the "home straight" (income tax, earnings rule, NICs, peroration) which I shall be circulating as soon as he has finished work on it.

3. You will see that the Chancellor has also issued various remits to other Ministers:

(i) he would like the Financial Secretary to draft a short paragraph on unit trusts CT rate. He would also like the Financial Secretary to draft a short paragraph on Keith: he has not yet decided whether to include this in the Speech or not, but would like to consider this again;

(ii) he would be grateful for the Economic Secretary's advice on what and how much should be said about the ECJ judgement. He would also like his views on whether we should list all the new VAT reliefs for charities;

(iii) he would be grateful if the Paymaster General could vet the section on Payroll Giving, and redraft as necessary.

4. I should also mention that the following items have been deliberately omitted from the draft:

- Pre-trading expenses (doesn't need to be mentioned in the Budget Speech).

- ITV levy (already announced, and doesn't fit in very well).

- Schedule E receipts basis, and CGT set-off for unincorporated companies (both to be discussed at this afternoon's Overview).

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5. Finally, on mechanics, I am sending one spare copy of the Speech each to the Revenue and Customs, on which Mr McNichol and Ms French might like to mark collected comments. Perhaps the easiest thing for others is to mark any drafting comments in manuscript on their copy, send it back to me so that I can record them on the master, and I will then return copies to their owners.

MOIRA WALLACE

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TAXPAYER CONFIDENTIALITY

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

2. As the House knows, the new official secrets legislation currently passing through Parliament [where will it have got to by 14 March?] is very much narrower in scope than the present Official Secrets Act. In particular, it does not cover information in the possession of either [of] the Inland Revenue [Departments] or Customs & Excise concerning the private affairs of individual taxpayers.

Just drafting, to make first reference to 2 Depts separately

3. I am sure that the whole House will agree that it is essential that taxpayer confidentiality is properly protected. I therefore propose to introduce provisions in this year's Finance Bill to ensure that it will continue to be a criminal offence for officials or former officials of either of the [Inland] Revenue Departments or Customs and Excise] to reveal information about the private affairs of an individual taxpayer.

4. I would only add that the need for this protection is in no sense a reflection on the probity and integrity of the members of those two Departments. Indeed, after nearly six years as Chancellor and more than eight years

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as a Treasury Minister, I would like to take this opportunity to pay public tribute to the outstanding service I have consistently received from the officials of the two great Revenue Departments.

BUSINESS TAXATION

5. I now turn to taxation. As I have done on a number of previous occasions, I propose to divide this into three broad sections: the taxation of business, the taxation of savings, and the taxation of personal income and spending.

6. First, taxes on business.

7. The rate of corporation tax for small companies, defined for this purpose as those with annual profits of less than £100,000, has, ever since the corporation tax reform I introduced in 1984, been set at the basic rate of income tax, currently 25 per cent. Large companies, defined as those with profits of £$^1/_2$ million or more, pay the main rate of corporation tax of 35 per cent, one of the lowest rates of tax on company profits in the world. [Between those two monetary limits, intermediate rates are payable.]

Those with profits between the next £100,000 and £1/2 million pay an intermediate rate.

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8. I propose to leave both the small companies rate and the main corporation tax rate unchanged for 1989-90. But I propose to increase the monetary limits substantially, by 50 per cent.

thresholds for the small and main companies' rates

9. Thus the 25 per cent rate of tax will apply to companies with profits of under £150,000, and the 35 per cent rate will only be reached at profits of £$^{3}/_{4}$ million. These changes will reduce the corporation tax burden for more than half of all those companies that do not already enjoy the full benefit of the small companies rate.

Next, I have some further changes to propose following on from the reforms I introduced in last year's Budget.

10. The reduction in the top rate of income tax to 40 per cent in last year's Budget enables me to make a major simplification of the tax treatment of close companies - companies that are controlled by [insert simple definition].

11. The rules for the so-called apportionment of close companies' profits are notoriously complex, taking up some twenty pages of impenetrable legislation. These rules are no longer needed and I propose to abolish them. I believe that many hundreds of thousands of small businesses, and particularly family businesses, will welcome the removal of this burden.

is this really true?

12. I do, however, have to guard against the avoidance of tax on investment income by channelling it through a closely controlled investment company. Any such company which does not distribute its profits will therefore be taxed at 40 per cent, equivalent to the higher rate of income tax.

13. When I doubled the scales for the taxation of the private use of company cars in last year's Budget, I made it clear that this still left the company car, which remains far and away the most widespread benefit in kind, significantly undertaxed.

14. Accordingly, I propose to increase the car scales by a further third [25] per cent for 1989-90. The yield from this will be £110 million in 1989-90 and [£135] million in 1990-91. There will be no change in the fuel scales.

15. There is one further tightening in the [this] general area of employee benefit which I believe it right to make. I propose to put the extra-statutory concession which relieves from tax payments made by employers to employees to cover their incidental costs when they are required to move house because of their job on a proper statutory footing. But at the same time I propose to withdraw the extra-

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statutory concession which at present exempts housing subsidies from tax when the move is to a higher cost area, since this artificially blunts the market forces which should be leading employers to consider locating in lower cost areas.

16. Over the years I have received a steady stream of representations from business complaining about the long-standing tax treatment of foreign exchange gains and losses. I recognise that as business becomes more global this subject becomes increasingly important. However, I have to say that I find it one of the most intractable I have encountered. Certainly, there can be no question of any change in the present system until a number of crucial and complex issues have been satisfactorily resolved. I have therefore authorised the Inland Revenue to publish today a consultative document which explores those issues and examines the scope for reform.

in my eight years as a Treasury Minister

17. Lastly, on the business front, I have a number of proposals to make the VAT system less burdensome, which should be of particular help to newer and smaller businesses. In this context, it is particularly encouraging that over the past year the number of

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businesses in Britain has been growing, at the record rate of 1,000 a week – net of those who ceased trading.

18. First, at the present time there are both quarterly and annual turnover thresholds for VAT, and businesses are required to say if they expect to exceed either of those thresholds over the coming twelve months. I propose to sweep away both the quarterly threshold and the requirement to predict, and introduce as from today a single annual test based on turnover in the preceding twelve months.

19. I both on the business front, [also] propose to increase the VAT threshold to £23,000, the maximum permitted under European Community law.

20. Second, at present the VAT default surcharge, whose introduction has led to a marked improvement in compliance, is set at 5 per cent for the first default, rising by 5 per cent stages for subsequent defaults, up to a maximum of 30 per cent. In the light of experience with the surcharge I am satisfied that its purpose can be adequately served with a reduced maximum of 20 per cent.

? [I didn't like this anyway!]

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21. Third, there is the perennial problem of VAT on bad debts. In general, traders are liable to pay VAT on their sales at the time they render their invoice, irrespective of whether the customer actually pays the bill. Bad debt relief can then be claimed only where the debtor has been formally declared insolvent, a requirement which, for the smaller business, is frequently prohibitive. It was partly in order to meet this problem that I introduced, in my 1987 Budget, the option for traders with a turnover of under £$^1/_4$ million to account for VAT on a cash basis, so that no VAT is due unless and until the bill is paid.

22. But there remains the problem of those traders with a turnover greater than £$^1/_4$ million, the highest figure for which I was able to secure a derogation from the European Community's sixth VAT directive. I therefore propose that, as from 1 October, all debts which are more than 18 months old and which have been written off in the trader's accounts should automatically qualify for bad debt relief.

23. The total cost of all these VAT reliefs, over and above the cost of revalorising the VAT threshold, will be £105 million in 1989-90 and £270 million in 1990-91.

TAXES ON SAVING

24. I now turn to the taxation of saving.

25. The sharp decline in the ratio of personal saving to personal income over the past two years in particular has led to even more discussion than usual of the merits of providing greater tax incentives for personal saving.

26. Certainly it is desirable that, over the medium-term, we generate as a nation a level of saving high enough to finance a high level of investment without having to rely too much on inflows of capital from overseas.

27. But what matters here is not personal savings alone, but corporate savings too, which are running at historically high levels, and [even] public sector savings, which [are higher than they have been for some considerable time]. have of course been boosted by the record Budget surpluses.

28. Moreover, the fall in the personal savings ratio, which is of course measured in net terms, that is to say gross saving net of borrowing, has occurred as a result of the sharp increase in personal borrowing. And the

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appropriate remedy for that is to raise the cost of borrowing, as we have done.

Too defensive

29. [But] Above all, it is essential that tax reform is seen in a medium-term, even a long-term context, [It is wholly inappropriate as an answer to what are essentially cyclical or even conjunctural difficulties.] [In that context,] and here the Government's policy is clear. It is to strengthen and deepen popular capitalism in Britain, by encouraging in particular wider share ownership.

30. If, in doing so, the overall level of personal saving rises, well and good; but that is not the object of the exercise and is something which in any event would only become apparent over the longer term. Over the past ten years we have done a great deal, on a number of fronts, to encourage wider share ownership in general and employee share ownership in particular.

31. The latest Treasury/Stock Exchange survey, conducted earlier this year, reveals that there are now [X] million individual shareholders in this country, equivalent to one adult in every (five), and some three times as many as there were ten years ago.

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Indeed, there are now more individual shareholders than there are trade unionists. (Check).

32. The privatisation of the water and electricity industries is likely to provide a further impetus to popular capitalism over the next two years.

33. Meanwhile, I have a number of measures to announce today to the same end.

34. Personal equity plans were first announced in my 1986 Budget, and started up in January 1987. As the House knows, those who invest in these plans pay no tax at all, either on the dividends they receive or on any capital gains they may eventually make - indeed, there will normally be no need for them to get involved with the Inland Revenue at all.

35. Personal equity plans got off to a good start, with over a quarter of a million investors, many who had never owned shares before, subscribing almost £$^1/_2$ billion between them.

36. Since then, however, the rate of growth has slowed down considerably, not least as a result of the changed

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climate in the equity market since the October 1987 Stock Exchange crash.

37. So the time has come to give them a new lease of life.

38. First, I propose to raise the annual limit on the overall amount that can be invested in a PEP from £3,000 to £4,800.

39. Second, within that, I propose to raise substantially the amount that can be invested in unit trusts or investment trusts from £750 to £2,400 a year. Moreover, the requirement that the amount invested in unit or investment trusts should not exceed one-quarter of the total amount invested in a PEP will be dropped, and replaced simply by the requirement that, to qualify for PEP treatment, a unit or investment trust must be preponderately invested in UK equities.

This change will be of particular importance to the small investor, as a simple means of investing in British companies:

40. Third, at present, only cash may be directly invested in a PEP. I propose that investors should also be permitted to place renounceable letters of allotment, obtained by subscribing to new share issues, including privatisation issues, directly into a PEP.

41. Fourth, I propose to simplify the PEP rules in a number of important respects, so as to make the scheme more flexible, better directed to the needs of small and new investors, and cheaper to administer. The substantial improvements I have announced respond to a number of detailed representations I have received from plan managers. Needless to say, I have not been persuaded to accept every suggestion that has been made. In particular, I have not been persuaded to replace the complete tax relief on exit, which is the essence of the PEP scheme, by tax relief on payments into a plan instead - not least because, while the degree of relief is in principle the sake in both cases, those countries which have opted for front-end relief have been forced to festoon it with a complex web of restrictions to prevent abuse. I am confident that the changes that I have announced today will enable personal equity plans to play an important part in stimulating individual ownership of British equity in the years ahead.

42. I also have a number of improvements to announce specifically designed to encourage employee share ownership.

43. It is a striking fact that the number of approved employee share schemes has risen from a mere 30 in 1979

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to almost 1,600 today, involving [number] companies and benefiting some $1^3/_4$ million employees. [I propose, first, to increase] At present, the annual limits on the value of shares which can be given income tax-free to employees under all-employee profit-sharing schemes from £1,250 to £2,000; and for the alternative limit of 10 per cent of salary, to raise the ceiling from £5,000 to £6,000.]

are £1,250 or 10 per cent of salary up to a ceiling of £5,000. I propose to raise these limits to £2000 and £6000 respectively.

44. Second, I propose to increase the monthly limit for contributions to all-employee save-as-you-earn schemes from £100 to £150, and at the same time to double the maximum discount from market value at which options may be granted from 10 per cent to 20 per cent.

45. Third, a number of my Hon. Friends have been concerned that current tax law may be inhibiting the development of employee share ownership plans, otherwise known as ESOPs. (Insert brief definition/description of what an ESOP is.] I propose to make it clear that companies that place their shares in ESOPs qualify for corporation tax relief, provided they meet certain requirements designed to ensure that the shares become directly owned by their employees within a reasonable time. I hope that this will encourage more British companies, particularly in the unquoted sector, to consider setting up ESOPs.

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46. Those firms with employee share ownership schemes have no doubt that it helps to improve company performance, by giving the workforce a direct personal interest in its profitability and success.

47. This was one of the reasons why I introduced the profit-related pay scheme in my 1987 Budget. I have some improvements to make to that, too.

48. First, as I have previously announced, I propose to abolish the restriction , to qualify for the tax relief, that profit-related pay must equal at least 5 per cent of total pay. Second, I propose to raise the limit on the annual amount of profit-related pay which can attract relief from £3,000 to £4,000.

49. And, third, I propose to relax the rules preventing headquarters units from using the profits of the whole company or group for their profit calculations.

50. Taken together, the package of measures I have announced to encourage wider share ownership in general, and employee share ownership and profit participation in particular, will help to ensure that the idea of a

share-owning democracy becomes ever more entrenched as a part of the British way of life.

51. I now turn to life assurance.

52. The tax regime for life assurance is sui generis. Moreover it has developed over the years in a piecemeal way, leading to a state of affairs in which the incidence of tax is extremely uneven, with some successful life offices paying no tax at all.

The present system dates back to the First World War and

53. There is clearly a powerful case for reform, with a view to securing a tax regime which is more equitable both within the industry and as between life assurance and most other forms of savings. Accordingly, last July the Inland Revenue issued with my authority a major consultative document on the taxation of life assurance. Since then, I have considered very carefully the many representations the industry has made, and taken full account both of the forthcoming changes to the regulatory regime for life assurance proposed by the Securities and Investment Board under the Financial Services Act and the prospects for increased competition within the European Community after 1992. In the light of these factors, I have decided not to proceed with the more radical reforms canvassed in the consultative

that it would not be right

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substantial

document. But I do have a number of less radical changes to propose, based for the most part on the general tax reform principle of seeking lower rates on a broader base.

54. First, many life offices run a pensions business as well as a life assurance business, and they are not required to keep the two businesses separate. This enables them to set the unrelieved expenses of the pensions business against the income and gains of their life funds, thus giving their pensions profits unduly favourable tax treatment. I propose to end this anomaly.

55. This change, which will come into force on 1 January 1990, will yield £ million in 1990-91. The remainder of the changes I have to propose constitute a balanced package which, overall, will sightly reduce the taxation of life assurance. (true?)

56. I propose that the expenses incurred by life offices in attracting new business should continue to be fully deductible for tax purposes from the income and gains of life funds, but spread over a period of seven years rather than immediately, as now. To give the industry time to adjust, this change will be phased in

being deductible

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gradually over the next four years, starting on 1 January. 1990

57. There are certain other, even more technical matters raised in the consultative document which will require further discussion with the industry, and any legislative changes on those issues will have to wait for next year's Finance Bill.

58. But I propose here and now, as from 1 January 1990, to abolish Life Assurance Premium Duty. And I also propose, from the same date, to reduce the rate of tax payable on the income and gains of life offices, which at present stands at 35 per cent on unfranked investment income and 30 per cent on realised capital gains, to the basic rate of income tax, 25 per cent.

59. The net revenue effect of this reform of the taxation of life assurance will be a cost of £20 million in 1989-90 and a yield of £45 million in 1990-91, rising in subsequent years.

This reform of the taxation of life assurance is thus fully in line with our general tax strategy of lowering tax rates and broadening the tax base, wherever that is possible.

60. But Above all it will provide a more efficient and equitable tax regime for this most important industry.

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[Brief para on reduction in unit trust CT rate: FST to draft, please]

61. I now turn to pensions.

62. Of all forms of savings, the most favourable tax treatment is that accorded to pension schemes. This is necessarily circumscribed by Inland Revenue rules.

63. [I do not propose to do away with such rules as a means of limiting the tax relief available - indeed, there is a case for tightening them in some respects.] But it is quite wrong that tax law has, effectively, come to set a limit on the overall pension someone can receive. Accordingly, I propose to remove the obstacles in the way of employers setting up pension schemes to provide benefits above the tax limits. Such "top-up" schemes will carry no limit on benefits whatsoever, but, equally, will have no special tax privileges. Employers will now be free, therefore, to provide whatever pensions package they believe necessary to recruit and reward their employees.

(don't understand)

64. Another anomaly with the existing tax reliefs for pensions is that there is no limit to them, at all in cash terms: the higher someone's salary, the greater the

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pension they can have, and the more tax relief goes with it. Of course, someone who receives a very high salary will expect a pension of a comparable level, so as to maintain his or her standard of living on retirement. But given that one man's tax relief is another man's tax increase, and in the light of the income tax reforms I introduced last year, it is hard to justify a state of affairs in which the tax advantages of pension provision are available with no upper limit whatever.

65. So long as the limits on tax relief effectively constrained total pension provision, it was not practicable to avoid this result. But dealing with the first anomaly makes it possible to act on the second.

66. I therefore propose to set a limit on the pensions which may be paid from tax-approved occupational schemes, based on earnings of £60,000 a year. I have deliberately set the ceiling at a level which will leave the vast majority of employees unaffected, and it will be subject to annual uprating in line with inflation. It will still be possible for a tax-approved occupational scheme to pay a pension of as much as £40,000 a year, of which up to £90,000 may be commuted for a tax-free lump sum.

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67. The new ceiling will apply only to pension schemes set up, or to new members joining existing schemes, on or after today. And, as I have already said, there will now be complete freedom to provide benefits above the limits without the tax advantages.

68. The introduction of this ceiling on tax relief also enables me to simplify and improve the rules for the majority of pension scheme numbers, in particular to improve the conditions on which people can take early retirement. Full details will be included in a press release issued by the Inland Revenue.

69. I also propose to simplify very substantially the rules concerning additional voluntary contributions. In particular, the present requirements place a heavy administrative burden on employers at the point where an employee wants to start paying AVCs. In future, the necessary checks will be greatly reduced in many cases employers will not need to be involved at all.

At present, if AVC investments perform very well, occupational pensions may have to be reduced to keep total benefits within the permitted limits. I propose that in future any surplus AVC funds should be returned

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to employees, subject to a special tax charge. This will remove the penalty on good investment performance.

70. These changes should give a further impetus to saving through AVCs.

71. The most important development in the pensions field in recent years has undoubtedly been the introduction and success of personal pensions. Since July last year, a million people have already taken advantage of the new flexibility and opportunities these offer. I have two proposals today to make personal pensions still more attractive.

72. First, I propose to make it easier for people in personal pension schemes to manage their own investments. In general, pension savings have been highly institutionalised. There has been little opportunity for scheme members to be involved in the investment decisions taken on their behalf. I now intend to remove the obstacles to greater individual involvement in personal pension plans.

73. Second, I propose to increase substantially the annual limits, as a percentage of earnings, on contributions to personal pensions for those aged 35 and

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73 Infrings Green Paper.

"cash limit on any individual"??
Two careers

over. This will be of particular value to those running their own business, who are often unable to make contributions until later on in their working life. It will also improve the position of personal pensions relative to occupational schemes. The new limits will be subject to an overall cash ceiling based on earnings of £60,000, corresponding to the new ceiling for occupational pensions, and similarly indexed

74. These reforms build on, and complete, the pension measures I introduced in my 1987 Budget. They represent a significant deregulation which will allow more flexibility in a number of circumstances, while setting for the first time a reasonable limit on the tax relief available to any individual. They should give a boost, in particular, to saving through personal pensions and free-standing AVCs.

75. The proposals I have announced for personal equity plans, for life assurance and for pensions amount to a significant further measure of tax reform, this time in the field of the taxation of saving.

76. But it should not be overlooked that a more far-reaching reform which I announced in last year's Budget, to come into effect in April 1990, may well have

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an even more marked effect on in encouraging the growth of personal saving.

77. I refer, of course, to independent taxation. For there can be no doubt that the greatest disincentive to saving in the whole of the present tax system is the treatment of the savings of married women, which have to be disclosed to their husbands and taxed at the husband's marginal rate. In particular, those married women who have little or no earnings will be able to set their personal allowances against their savings income, in many cases removing such income from tax altogether. (Insert brief announcement of new publicity leaflet: IR to draft.)

78. A further consequence of the introduction of independent taxation next year is that married women will acquire their own capital gains tax threshold, so that a married couple will enjoy two such thresholds. In the light of this, I propose to maintain the capital gains tax threshold at £5,000 for 1989-90.

79. I have three other proposals to make concerning capital gains tax. First, I propose to abolish the general holdover relief for gifts.

(is this necessary?)

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80. This was rightly introduced by my predecessor in ?1981, when there was still capital transfer tax on lifetime gifts, in order to avoid a form of double taxation. But the tax on lifetime giving has since been abolished, and the relief is increasingly used as a popular form of tax avoidance.

81. But while the general CGT holdover relief will go, I propose to retain it for gifts of business, farm and heritage assets, and also for all gifts to charities. And of course gifts between husband and wife will continue to be exempt.

82. As for gifts of chattels, these will not enjoy holdover relief, but any chattel worth less than £3000 is are already exempt from capital gains tax on disposal. I propose to [double] the chattels exemption limit for capital gains tax to [£6000].

Gifts of personal belongings can benefit from the so-called chattels ~~exempt~~ relief, under which items

83. My last capital gains tax proposal is to change the tax treatment of certain bonds so as to simplify the tax rules and prevent a loss of yield by the conversion of income into capital gains.

84. My final proposal for the taxation of savings concerns stamp duty on share transactions. I halved

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this from 2 per cent to 1 per cent in my 1984 Budget, and again from 1 per cent to $^1/_2$ per cent in my 1986 Budget.

85. I now have to decide how to adapt it in the light of the Stock Exchange's welcome plans to get rid of paper transactions and move to a cheaper and more efficient electronic system - a process unhappily known as dematerialisation.

(surely!)

86. Stamp duty on share transactions have been a useful revenue raiser over the years. But it sits uncomfortably with the Government's commitment to encourage wider share ownership, and puts London at a competitive disadvantage to those overseas financial centres where there is no tax on share transactions. Moreover I have to tell the House that I have found some difficulty in solving the problem of how to apply stamp duty when there is nothing to stamp.

87. I therefore propose that, as from 1 April next year, the earliest date on which the Stock Exchange is likely to be able to introduced paperless transactions, stamp duty on share transactions be abolished. The legislation will be in this year's Finance Bill, and the cost in 1990-91 will be £900 million.

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88. This brings the number of major taxes I have abolished since becoming Chancellor to six: an average of one a Budget.

TAXES ON SPENDING

89. I now turn to taxes on personal income and spending.

90. First, VAT. [EST to redraft ECJ para(s), please]

91. Although I have done my best to mitigate the effect of the European Court judgement on charities, as the charities themselves have generously acknowledged, I have been unable to protect them altogether. I have therefore, in these special circumstances, considered whether there is anything further I can sensibly do, however modest, to assist charities with their VAT bills. Accordingly, I propose to relieve charities from VAT on [complete list].

92. I also propose to relieve cars leased to the disabled by Motability from car tax.

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93. But I general, I continue to believe that the best way of helping charitable causes through the tax system is by directly encouraging the act of charitable giving. The Payroll Giving Scheme, which I introduced in my 1986 Budget, has been growing steadily. Some 3,400 schemes have now been set up, and over 100,000 employees are already participating, quite a few of them giving the full £240 annual limit. I now propose to double that limit to £480, or £40 a month.

94. But for the Payroll Giving Scheme to achieve its full potential, it is clearly necessary for the charities themselves, and others involved, to mount a major information campaign about it. I am particularly glad that my noble Friend, the Viscount Whitelaw, has agreed to become Chairman of the new Payroll Giving Committee, which will co-ordinate efforts in this field. [PMG to check this para, please, and redraft as necessary.]

95. I now turn to the excise duties.

96. The damage to the environment in general, and to child health in particular, from lead in the atmosphere, and the contribution of ordinary leaded petrol to this problem, is increasingly widely known. The government

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is committed to phasing out leaded petrol altogether, and in successive Budgets I have sought to assist this. I first introduced a tax differential in favour of unleaded petrol in 1987, and increased it last year. But although sales are undoubtedly rising, unleaded petrol still accounts for less than 5 per cent of total petrol sales savings, even though two-thirds of the cars now on the road could use it, either without any adjustment or else with a conversion costing only some £15-£20. (check).

??

97. One of the problems is ignorance of the facts. Many motorists do not realise that their cars can already use unleaded petrol. Many others are unaware how modest the conversion cost is. Many are under the false impression that, if they do convert to unleaded petrol, their cars will no longer be able to use leaded petrol. Others wrongly imagine that their car's performance would suffer were they to use unleaded fuel.

98. It is clearly essential that these myths are rapidly dispelled. Meanwhile, I propose to take the opportunity of this Budget to increase still further the tax differential in favour of unleaded petrol, by reducing the tax on it by something over 3 pence a gallon. If this reduction is fully passed on to the

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customer - and I look to the oil companies to see that it is - it means that the price of unleaded petrol at the pump will generally be some 9 pence a gallon, or two pence a litre, cheaper than four star leaded petrol. This will be one of the most substantial differentials between the price of leaded and unleaded petrol within the European Community.

99. But I do not intend to stop there. I also propose to raise the tax on two and three star petrol by roughly 4 pence a gallon, so that the pump price of these grades will be at least as high as that of four star. This should expedite the phasing out of two star petrol, which is already down to 6 per cent of the total market, thus enabling garages to switch storage capacity and in some cases a pump, too, to unleaded petrol - quite apart from the incentive to the remaining two-star users to switch to unleaded fuel.

100. I am confident that the duty changes I have announced, which will take effect from six o'clock this evening, will help to lead to a marked increased in the use of unleaded petrol over the next twelve months.

101. They will of course also lead to a loss of revenue. I propose to recoup this from Vehicle Excise

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Duty. A the present time a bus or a coach has to have 66 seats before it pays as much in Vehicle Excise Duty as a family car. I propose to rectify this anomaly by increasing the tax rates of this group of vehicles so that they cover their track costs. I also propose to increase the rate of duty for the heaviest non-articulated lorries, to put them on a more equal footing with articulated lorries. Finally on Vehicle Excise Duty, I propose to simplify the system by reducing the number of separate rates of tax from x to y.

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

Inland Revenue

Personal Tax Division
Somerset House

FROM: P LEWIS
EXT: 6371
DATE: 27 FEBRUARY 1989

CHANCELLOR

CAR SCALES

1. I understand that, following Mr Culpin's note of 23 February, you would like to consider the distributional impact of somewhat larger car scale increases combined with the new NIC package. I am sorry this note was not ready sooner, but it was not possible quickly to analyse these complex packages, or to assess the operational implications of linking income tax increases with NIC reductions occurring part way through the tax year.

Car scale increases with UEL remaining at £325

2. The figures in this note are based on the same assumptions as in Mr Mace's note of 23 February ie a 2% of earnings charge at the LEL (£43 per week in 1989/90) and with 9% of earnings (7% for the contracted out) payable above the LEL up to an unchanged UEL of £325. It is assumed also that the change takes effect from October, so that only half the annual gain is available to set against increased car scales ie about £1.50 a week averaged over

cc Chief Secretary
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Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Anson
Mr Scholar
Mr Culpin
Mr Riley
Mr Gilhooly
Mr Matthews
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Mrs Chaplin
Mr Tyrie
Mr Call
Sir Anthony Battishill
Mr Painter
Mr Bush
Mr Lewis
Mr Mace
Mr Massingale
Mr Hodgson
Mr I Stewart
Mr Evershed
PS/IR

the whole year. (This is the basis used in paragraph 4 of Mr Mace's note of 23 February, but not the car benefits annex attached which looked at the position as if the new regime applied for a full year).

3. Eight tables are attached. They are similar to tables D and D2 in my note of 26 January, in providing an analysis of losers both by annual amount of losses and by income range.

4. The options looked at in the tables are increases of 20% up to 50% in 5% steps.

5. The main features of the options are summarised in the following table which, for comparison, also shows how the 20% option stood before the NICs package.

CAR SCALE OPTIONS

Option	No of losers* (thousands)	Average loss in year	Revenue yield+ from car scale increase 1989/90 £m	1990/91 £m
20% increase (before NICs package)	370	£49	90	110
20% increase (with NICs package)	60	£25	90	110
25% increase	110	£32	120	140
30% increase	180	£41	140	170
35% increase	270	£47	160	200
40% increase	370	£58	180	220
45% increase	530	£62	200	250
50% increase	590	£79	230	280

* In addition there would be people brought over the £8,500 P11D threshold for the first time, ranging from about 10,000 (20% increase) to 30,000 (50% increase).

+ These figures exclude behavioural changes. If scales rise by 20%, the behavioural response would probably be negligible; but we ought to do further quick work on this if you wish to go significantly higher.

6. In comparing these options with where we stood before the NICs package (Table 1) the main feature (apart from total number of losers and average loss) is that their distribution by income has changed significantly. When you get up to broadly the same number of losers as before, with the 40% option, there are a few more losers below £15,000, substantially fewer losers in the middle income bands (£15,000 to £30,000 - broadly the "middle managers" for whom Lord Young was concerned) and many more over £30,000. As before, at the bottom we have to add in also those brought over the P11D threshold for the first time, perhaps 25,000 in all with a 40% increase. (For them, a car scale increase brings forward the time at which they come into the P11D field.)

Presentation/Operational

7. In looking at the car scales again you will want to keep in mind the presentational aspects of setting off a full year income tax increase against a half-year NIC reduction. The car scale changes would normally be implemented with the Budget recoding, effective from the first pay day after 17 May. At that point car drivers would see their weekly/monthly net pay reduced, to the extent that car scale increases exceeded the benefit of indexation ie by up to about £1.50 a week (on average) if you decided that company car drivers should get no net benefit in 1989/90 from the NIC changes. From October they would gain £3.00 a week in NIC, leaving a net gain of £1.50 each week to set against the previous income tax losses of the same amount.

8. The picture shown by the tables is for 1989/90 taken as a whole, ie the position reached by 5 April after there have been 6 months of net NIC gains to set against the income tax losses of the first half of the tax year. It follows from the pattern of events described in the previous paragraph that purely in cash flow terms during the course of the year there would be more

losers than shown in the tables; and that those who end up losers at 5 April would "lose" more in cash-flow terms during the first half of the year.

9. If you see no particular difficulty with this in-year cash-flow pattern, incorporating any increased car scales in the normal Budget recoding would be much the easiest approach to implementation (for employers as well as the Revenue).

10. Any other approach - which would necessarily involve an additional, later recoding exercise - would certainly be more complicated, and we would need to do a good deal of further work over the next day or two to be certain that it would work and to assess the implications for the workstate and competing priorities. Time is now very short for sorting out any alternative approach.

Car scale increases if UEL increased to £358

11. Even if you were to decide to increase the UEL as part of the NICs package, there would probably still be some scope for further increases in the car scales before you got back to the same number of losers you were contemplating before the NICs package. The reason for this is that the 150,000 basic rate taxpayers below the UEL who were previously losers would still gain from the NICs package, as well as basic rate taxpayers above the UEL who were losers and who fall in the income band £325 to £358.

12. We would, of course, be happy to do further work on these options, or any others you would like to consider.

Other car questions

13. I hope to let you have a note shortly on the other two car points raised at the end of last week (private use of high business mileage drivers and the proportion of cars on the road which are company cars).

Questions for Decision

14. Final decisions on car scales are needed quickly (ie by close on Friday if possible, or next Monday morning at the latest if we are to maintain the 17 May implementation date). Subject to any further work you would like us to do over the next day or two

a. Are you inclined to stick with the 20% increase, taking the benefit of the NICs package in the substantially reduced number of losers, or to go for a higher figure?

b. If the latter, what should it be?

c. If you wish to go for a higher figure, do you agree that Budget implementation should follow its normal course?

Peter Lewis

P LEWIS

Table 1

20% increase in car scales BEFORE NICs package

Tax and NIC: analysis of losers by annual amount of losses

	Main Scale	"Perk Car"	Over 18,000 business miles	Total
	(number of losers - thousands)			
Annual loss				
over £200	-	1	-	1
£100-£199	19	5	-	24
£50-£99	104	9	25	138
£1-£49	146	26	35	207
Totals	269	41	60	370
Average annual loss	£49	£56	£45	£49

Tax and NIC: analysis of losers by income range

A = Average loss
B = Number of losers (thousands)

Income range 18,000 (total income of tax unit)	Number of losers (thousands)	Average loss
under £15,000	59	£27
£15-£20,000	122	£42
£20-£25,000	118	£62
£25-£30,000	39	£50
over £30,000	32	£66
All income ranges	370	£49

Table 2

20% increase in car scales WITH NICs package

Tax and NIC: analysis of losers by annual amount of losses

	Main Scale	"Perk Car"	Over 18,000 business miles	Total
	(number of losers - thousands)			
Annual loss				
over £200	-	-	-	-
£100-£199	-	1	-	1
£50-£99	2	2	-	4
£1-£49	51	5	1	57
Totals	53	8	1	62
Average annual loss	£22	£45	£ 1	£25

Tax and NIC: analysis of losers by income range

Income range (total income of tax unit)	Number of losers (thousands)	Average loss
under £15,000	-	-
£15-£20,000	24	£22
£20-£25,000	26	£20
£25-£30,000	7	£23
over £30,000	5	£65
All income ranges	62	£25

Table 3

25% increase in car scales WITH NICs package

Tax and NIC: analysis of losers by annual amount of losses

	Main Scale	"Perk Car"	Over 18,000 business miles	Total
	(number of losers - thousands)			
Annual loss				
over £200	-	1	-	1
£100-£199	1	2	-	3
£50-£99	15	3	-	18
£1-£49	80	9	3	92
Totals	96	15	3	114
Average annual loss	£27	£65	£ 8	£32

Tax and NIC: analysis of losers by income range

Income range (total income of tax unit)	Number of losers (thousands)	Average loss
under £15,000	1	£40
£15-£20,000	37	£26
£20-£25,000	53	£24
£25-£30,000	10	£33
over £30,000	13	£78
All income ranges	114	£32

Table 4

30% increase in car scales WITH NICs package

Tax and NIC: analysis of losers by annual amount of losses

	Main Scale	"Perk Car"	Over 18,000 business miles	Total
	(number of losers - thousands)			
Annual loss				
over £200	1	2	-	3
£100-£199	2	4	-	6
£50-£99	34	8	-	42
£1-£49	107	18	5	130
Totals	144	32	5	181
Average annual loss	£36	£66	£14	£41

Tax and NIC: analysis of losers by income range

Income range (total income of tax unit)	Number of losers (thousands)	Average loss
under £15,000	38	£ 14
£15-£20,000	42	£ 41
£20-£25,000	65	£ 35
£25-£30,000	14	£ 42
over £30,000	22	£100
All income ranges	181	£ 41

Table 5

35% increase in car scales WITH NICs package

Tax and NIC: analysis of losers by annual amount of losses

	Main Scale	"Perk Car"	Over 18,000 business miles	Total
	(number of losers - thousands)			
Annual loss				
over £200	2	5	-	7
£100-£199	5	9	-	14
£50-£99	63	4	-	67
£1-£49	139	23	23	185
Totals	209	41	23	273
Average annual loss	£42	£95	£11	£47

Tax and NIC: analysis of losers by income range

Income range (total income of tax unit)	Number of losers (thousands)	Average loss
under £15,000	52	£27
£15-£20,000	62	£42
£20-£25,000	86	£42
£25-£30,000	19	£54
over £30,000	54	£80
All income ranges	273	£47

Table 6

40% increase in car scales WITH NICs package

Tax and NIC: analysis of losers by annual amount of losses

	Main Scale	"Perk Car"	Over 18,000 business miles	Total
	(number of losers - thousands)			
Annual loss				
over £200	2	10	-	12
£100-£199	22	7	-	29
£50-£99	93	20	1	114
£1-£49	166	22	24	212
Totals	283	59	25	367
Average annual loss	£52	£102	£19	£58

Tax and NIC: analysis of losers by income range

Income range (total income of tax unit)	Number of losers (thousands)	Average loss
Under £15,000	67	£39
£15-£20,000	86	£47
£20-£25,000	87	£53
£25-£30,000	30	£59
over £30,000	97	£84
All income ranges	367	£58

Table 7

45% increase in car scales WITH NICs package

Tax and NIC: analysis of losers by annual amount of losses

	Main Scale	"Perk Car"	Over 18,000 business miles	Total
	(number of losers - thousands)			
Annual loss				
over £200	5	13	-	18
£100-£199	63	10	-	73
£50-£99	125	26	2	153
£1-£49	226	13	46	285
Totals	419	62	48	529
Average annual loss	£56	£137	£17	£62

Tax and NIC: analysis of losers by income range

Income range (total income of tax unit)	Number of losers (thousands)	Average loss
Under £15,000	97	35
£15-£20,000	159	45
£20-£25,000	118	51
£25-£30,000	39	68
over £30,000	116	115
All income ranges	529	£62

Table 8

50% increase in car scales WITH NICs package

Tax and NIC: analysis of losers by annual amount of losses

	Main Scale	"Perk Car"	Over 18,000 business miles	Total
	(number of losers - thousands)			
Annual loss				
over £200	12	15	-	27
£100-£199	141	27	-	168
£50-£99	133	12	4	149
£1-£49	187	15	46	248
Totals	473	69	50	592
Average annual loss	£72	£162	£25	£79

Tax and NIC: analysis of losers by income range

Income range (total income of tax unit)	Number of losers (thousands)	Average loss
Under £15,000	106	50
£15-£20,000	172	58
£20-£25,000	120	64
£25-£30,000	52	73
over £30,000	142	136
All income ranges	592	£79

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FROM: MISS M P WALLACE
DATE: 28 February 1989

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
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Sir T Burns
Mr Anson
Dame A Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Monck
Mr Scholar
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Mr Riley
Mr A C S Allan
Mr Gieve
Mr Gilhooly
Mr Matthews
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Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill IR
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Mr Isaac IR
Mr Painter IR
Mr G Bush IR
Mr C McNicol IR (+1)

Mr Unwin C&E
Mr Jefferson Smith C&E
Mr P R H Allen C&E
Ms A French C&E

BUDGET STATEMENT: TAX SECTION

... As promised in my minute of yesterday, I now attach the Chancellor's revise of the sections on income tax, and the earnings rule. The rest will follow in due course.

2. Again, I should be grateful for comments by close tomorrow, Wednesday 1 March.

MOIRA WALLACE

TAXATION OF INCOME

103. Nor do I propose any change this year to either the basic or higher rate of income tax.

104. I propose to raise all the main thresholds and allowances by the statutory indexation factor of 6.8 per cent, rounded up. Thus for example the single person's allowance will rise by £180 to £2,785, and the married man's allowance will rise by £280 to £4,375. [The basic rate limit will rise by £1,400 to £20,700. The single age allowance will rise by £220 to £3,400, and the married age allowance by £350 to £5,385. The higher rate of age allowance will rise by £230 to £3,540 for a single person, and for a married couple by £360 to £5,565.]

do we really need all this?

105. I have a number of measures to help the elderly. I propose that the higher age allowances, which are currently for those over 80, should be extended to cover all those aged 75 and over. This will take an additional [15,000] elderly pensioners out of tax altogether.

106. The income limit for the age allowance will rise by £800 to £11,400, again in line with indexation. However, I propose to reduce the rate at which the age

allowance is withdrawn above this income limit. But I propose that in future it should be withdrawn at the rate of £1 for each £2 of income, instead of the present withdrawal rate of £2 in every £3. This will mean that the marginal tax rate for those in this income band will be reduced to well below 40 per cent.

107. The Finance Bill will also include the provisions to establish the new tax relief for the pensioners' health insurance premiums, which I announced to the House in January, and which will take effect from April next year.

108. Under the notorious earnings rule, any pensioner who decides to continue to work after reaching the statutory retirement age has his or her pension docked at a rate of 50 per cent on every £1 earned between £75 and £79 a week, rising to 100 per cent for every £1 earned over £79 a week.

109. The Manifesto on which we were first elected in 1979 acknowledged that it was wrong to penalise pensioners who wished to work beyond retirement age in this way, and pledged that we would abolish the earnings rule.

[I presume he's cleared this?]

110. Of all the pledges in our 1979 Manifesto, that is the only one to remain unfulfilled. It will do so no longer. My Rt.Hon Friend the Secretary of State for Social Services and I have agreed that the pensioners' earnings rule should be abolished as from 1 October. The necessary legislation will be included in the Social Security Bill currently before the House.

111. The cost to public expenditure will be £[X] million in 1989-90, which will be entirely met from the Reserve. But the true cost of this measure will be considerably less than this, given the additional income tax and employers' National Insurance Contributions that will flow from the increase in the numbers of elderly at work, once this harsh disincentive has been removed.

112. Those who wish to defer taking their pension will, of course, remain entirely free to do so, and will continue to earn a higher pension in return.

113. I am sure the whole House will welcome this long overdue reform.

114. If one were to adopt the so-called "duck test" now in vogue across the Atlantic, the pensioners' earnings rule would qualify as a tax, and I would now be able to

BUDGET - SECRET

sixth

claim to have abolished a seventh tax. But my innate modesty and natural reticence inhibits me from doing so.

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COPY NO 2 of 15

ECONOMIC SECRETARY

FROM: D A GAW
DATE: 28 February 1989

PS/ let me know: on the basis of latest evidence, what will be the average pump-price differential between 4* & unleaded post Budget. ✓ JM

UNLEADED PETROL

Points arising at the Overview meeting on 27 February have been actioned as follows:

DUTY CHANGES

2. We have instructed Parliamentary Counsel to:

(a) increase the rebate of duty on unleaded petrol to £0.0272 a litre; and

(b) insert a new charging provision for a higher rate of duty on two and three star petrol of £0.2122 a litre.

Distribution:

Chancellor	CPS
Sir P Middleton	Mr Jefferson Smith
Mr Culpin	Mr Wilmott
Mr Gilhooly	Mr Allen
Mr Michie	Mr Vernon
Miss Simpson	Mr Spackman
Mr Call	

3. The increase in rebate under 2(a) above is equivalent to 0.7 pence per litre duty (3.18 pence per gallon) plus 0.1 pence per litre VAT (0.46 pence per gallon). Total VAT inclusive increase in differential = 0.8 pence per litre (3.64 pence per gallon).

4. The higher rate of duty for two and three star under 2(b) above is equivalent to 0.78 pence per litre duty (3.55 pence per gallon) plus 0.12 pence per litre VAT (0.54 pence per gallon). Total VAT inclusive increase on two and three star = 0.9 pence per litre (4.09 pence per gallon).

5. The total VAT inclusive differential between

four star petrol and unleaded is 3.128 pence per litre (14.22 pence per gallon); and

two and three star petrol and unleaded is 4.028 pence per litre (18.31 pence per gallon).

UK PUMP PRICES

6. The scene is one of rapid change with the price of two star noticeably closing on four star petrol. On 16 February the average national difference was given as 0.9 pence per litre. Information received today indicates a further eroding of the pump price differential: the Department of Employment quotes 0.5p per litre and the Automobile Association 0.6p per litre. A separate source shows that in five areas (16 per cent) four star was cheaper than two star.

EFFICIENCY DIFFERENTIAL

7. Department of Energy confirm that as far as the ordinary motorist is concerned there is no detectable difference (after vehicle adjustment) in efficiency between leaded petrol, of any grade, and unleaded. This is supported by "Which" magazine tests. Several motoring magazines have made the same point (eg Motoring and Leisure) and have gone as far as suggesting that two and three star users changing to unleaded might well notice some improvement.

MARKET SHARE

8. Over recent few weeks the market share of two and three star has declined more sharply than predicted as the trade prepares for an anticipated further widening of the duty differential between leaded and unleaded. Deliveries of two star for the month of January was only 6.1 per cent and still in decline.

9. The market share of unleaded based on deliveries from bonded warehouse increased dramatically in the period ended 14 February 1989 to about 5.5 per cent. We now estimate the share of unleaded to reach 17 per cent by 31 March 1990 (average 11 per cent) and 23 per cent by 31 March (average 20 per cent).

TWO AND THREE STAR

10. Our best estimate is that fewer than 350,000 cars (less than two per cent) recommended to use two or three star petrol cannot be adjusted to use unleaded.

PUBLICITY

11. Customs and Department of Environment officials are meeting on 1 March to arrange Budget-linked publicity concentrating on:

(a) action on two star;

(b) costs of engine adjustment; and

(c) the ability of cars adjusted to use unleaded and leaded four star when necessary.

Gaw

D A GAW