FILE NUMBER

PO-CH/NL/0741 PART A

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FILE BEGINS 01/03/1989

ENDS 07/03/1989

FILE TITLE

BUDGET STATEMENT:
TAX SECTION

1/2

GIEVE

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

[NB All para numbers now overtaken. But main points remain]

BUDGET STATEMENT - FIRST DRAFT

Sixth!

DONE 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. ~~If~~ 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:

The question

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".

deceased

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.

Attractive - related to Berlin / IEA. I've tried to incorporate at beginning but could go much further

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.

gone.

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

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

gone ↑

[indexed gilts, buying-in etc]

J St. Gieve

JOHN GIEVE

CHIEF SECRETARY

cst.ps/14ce28.

BUDGET SECRET

0305

CHIEF SECRETARY TO THE TREASURY

COPY NO. 1 OF 3 COPIES

FROM: MISS C EVANS
DATE: 28 February 1989

MISS M P WALLACE

BUDGET STATEMENT: TAX SECTION

The Chief Secretary has seen the 27 February draft of the tax section of the Chancellor's Budget Statement and thinks it is coming on well. He had the following comments.

Paragraph 6

Add at end: "where I have a series of changes to propose.", to indicate that what follows is a good business package.

Paragraph 17

Delete "lastly on the business front" (sounds an anticlimax, after such a short section". The VAT measures are good, solid and popular changes we should introduce this paragraph more positively by saying "I turn now to VAT, where I have a number of proposals etc".

Paragraph 23

Add at end (to conclude by summarising the overall impact of the VAT package)

> " I believe these changes will be widely welcomed, both for the tax relief they offer and the simplicity they impart to the VAT regime".

Paragraphs 24 - 29

The Chief Secretary thinks that paragraphs 24 to 29 sound too defensive and are open to misinterpretation. We do not need to defend the personal saving ratio and to do so simply draws attention to the fact that this is not a Budget for savings. He would redraft these paragraphs as attached.

Paragraph 37

Expand to read "So the time has come to improve and simplify PEPS to give them a new lease of life".

Paragraph 53

The two penultimate sentences sound defensive, as if we are running away from radical reform. Redraft as follows:

> "In the light of these factors I have decided to reform the taxation of life assurance within the framework of the present regime. With this in mind I have a number of changes to propose, based for the most part on the general tax reform principle of seeking lower rates on a broader base."

Paragraph 64

Last sentence delete "And in the light of the income tax reforms I introduced last year". Add at the end of the sentence. "This is especially true following the income tax reforms I introduced last year."

Paragraph 69

Final sentence insert "anomalous" before penalty.

BUDGET SECRET

Paragraph 88

As a tease you might insert after "average" "so far."

Paragraph 92

Add at end: "which should reduce the cost to the [ ] disabled drivers' by [ ]".

CE

MISS C EVANS
Private Secretary

TAXES ON SAVINGS

24 I now turn to reform of 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.

27 But what matters in this context of course, 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 Delete

29 In the saving field, as in all others, tax reform must be seen in a medium-term, even a long-term context. It is in that sense that I have introduced measures in previous Budgets and that I do so today. The Government's policy is clear. It is to strengthen and deepen popular capitalism in Britain, by encouraging in particular wider share ownership.

MPW PLUS OTHER COMMENTS

chex.ul/mw/1.28.2

REF MPW/BS/

BUDGET SECRET

COPY NO 15 OF 26.

MASTER VERSION

FROM: MISS M P WALLACE
DATE: 28 FEBRUARY 1989

SIR T BURNS

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Mr Anson
Mr Wicks
Mr Scholar
Mr Culpin
Mr H P Evans
Mr Peretz
Mr Sedgwick
Mr Riley
Mr A C S Allan
Mr Gieve
Mr Hibberd
Mr O'Donnell
Mr Pickford
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Moira,

On re-reading this, there is a lot of repetition, and I have suggested some radical surgery.

good

I continue to dislike the over-triumphalist tone of the first few pages.

Alex

BUDGET STATEMENT: ECONOMIC SECTION

I attach my latest draft of the economic section of the speech, in which, as you will see, I have drawn heavily on your suggested revised structure, and comments from others, for which I was most grateful. I showed the Chancellor a preliminary version of this at the weekend, and he agrees that the new structure is a great improvement, so we should work on this basis.

2. I would welcome any comments you or others may have on the draft as it stands. In particular, the difficult points seem to me to be:

(i) where do we put the passage on statistics? I found it difficult to attach to the passage on growth in 1988, and for the moment have left it with investment. But there may be good reasons why this doesn't work.

(ii) How do we handle the numbers for the current account? The possibilities range from giving no number at all, to quoting both "their" number and ours. At the moment, the draft merely mentions the adjusted figure, but I would be interested in views.

(iii) Should we be trying to explain the economic background more in terms of the "nominal framework"? This is still notable by its absence at times.

(iv) Do we need to say anything more about personal saving than in the present draft? My inclination is that we don't, as much of that material has now been incorporated in the second section of the speech. But again, I would welcome views.

(v) COBO has still not found its home. Mr Scholar is now drafting something, and we can slot this in later, at an appropriate point in, or at the end of, the monetary policy section.

(vi) Can we shorten the section on the world in 89 – para 27?

3. I would appreciate comments as soon as possible, and at the latest by lunchtime on Thursday, 2 March.

Moira

MOIRA WALLACE

chex.ps/mw/3

The economic background

Too valedictory? JC

1. It is now almost ten years since this Government took office. And today I am publishing the tenth edition of the Medium Term Financial Strategy. [It is an occasion for looking back and assessing achievements, as well as charting the course for the future.]

2. Our first ten years in office have been a decade in which ~~of complete transformation for~~ the British economy has been transformed. The achievements of these years have been recognised both worldwide and - more importantly, [for this is the real test] - in two overwhelming General Election victories.

JC

[JG - "altered debate" also "parties opposite ~~each~~ accept, tho' not enough" ~~have been achieved~~

JC

3. The economic [strength] growth and prosperity [that Britain has enjoyed in these ten years have occurred] have been achieved despite ~~[some very unwelcome]~~ [shocks from the wider world economy - first a world recession, then the collapse of oil prices, and more recently the stock market fall.

and at home! RPC Scargill

4. In an increasingly open world economy, no nation can be insulated from the impact of events like these. But what 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~~ ~~navigate~~ the economy can ~~withstand~~ weather the difficult

JC - survive too negative

move ahead strongly

times, and ~~excel~~ in the good ones. This is exactly what has happened in the UK.

5. ~~First, we got the policy right.~~ From the very beginning of our time in office, we have put the determination to bear down on inflation at the very heart of economic strategy. This we have pursued consistently within the clear and disciplined nominal framework of the medium-term financial strategy.

X

JC

Too sophisticated

AGT

6. Between 1974 and 1979 inflation averaged over 15 per cent, yet since 1982, it has averaged under 5 per cent. That is the clearest possible answer to those who doubt that inflation can be controlled by monetary policy.

JG - take in PSDR here: sound money + finances theme.

7. The benefits of lower inflation and a clear and disciplined framework for the medium-term are felt throughout the economy. The knowledge that the overall financial framework is prudent and sustainable has given business and industry the confidence to expand. At the same time, tax reforms and lower tax rates have increased the incentives to enterprise, and ~~structural reforms have removed the disincentives and barriers.~~ disincentives and barriers which stood in the way of enterprise have been removed.

RPC: underplays link to next para. Sound money + free mkts. unions WSO setting people free

RPC - hasn't been easy. Acknowledge pain at first

8. We have seen the fruits of this in a dramatic improvement in the performance of British industry. In the '60s and '70s the low growth of our productivity, JC/SJP investment and output saw us near or trailing ~~at~~ the bottom of the league compared with our European competitors. In the '80s, we have been at the top of the EC league. [Since 1980] manufacturing productivity has grown faster than in all other major industrialised countries, [as has investment.] And we have had ~~an unprecedented~~ eh? SJP eight years of steady, sustainable growth, averaging over 3 per cent a year, something ~~unprecedented~~ we have not previously seen this century.

9. This improvement in Britain's economic performance JC has been matched by [very much] improved living standards JC [for ordinary people.] We now have more people in work than ever before in this country. They enjoy better public services, as the success of the economy has allowed us to spend more on priority areas of health, law and order, and transport.

JG 10. And they are better-off. For a married man on average earnings real take home pay is now almost a third higher than when we took office. And they have shared in ~~an unprecedented~~ ~~increase in~~ greatly increased personal wealth, with the expansion of owner occupation and share ownership.

8. We have seen the fruits of this in a dramatic improvement in the performance of British industry. In the '60s and '70s the low growth of our productivity, investment and output saw us at the bottom of the league compared with our European competitors. In the '80s, we have been at the top of the EC league. [Since 1980] manufacturing productivity has grown faster than in all other major industrialised countries, [as has investment.] And we have had an unprecedented eight years of steady, sustainable growth, averaging over 3 per cent a year.

9. This improvement in Britain's economic performance has been matched by very much improved living standards for ordinary people. We now have more pecple in work than ever before in this country. They enjoy better public services, as the success of the economy has allowed us to spend more on priority areas of health, law and order, and transport.

10. And they are better-off. For a married man on average earnings take home pay is now almost a third higher than when we took office. ~~And~~ they have shared in an unprecedented increase in personal wealth, with the expansion of owner occupation and share ownership.

A

Turning to ~~An assessment~~ of the UK our assessment is complicated by the large & growing inconsistencies that have appeared in the national accounts. While it is clear that the UK has experienced another year of rapid growth ~~of some 4½ per cent~~ — more rapid indeed than for most of our G7 partners — the composition of that growth is made clouded by the clear underrecording of expenditure & investment expenditure in particular.

~~It is clearly import~~

~~We have set up a study to examine how to improve the collection~~

* We are taking steps to improve the collection of statistics & the national accounts but that is bound to be a long process. In the meantime we have had to form the best view ~~of~~ we can of what ~~lies behind~~ is really happening in the economy. [Take in para 17.]

(Then) On that basis I estimate that [back to 14]

~~OK. But "income-producing assets" also a problematic link.~~

personal wealth & net overseas assets are very different animals

And, externally, the ~~UK has~~ United Kingdom has been building up its net overseas assets, so that they are now [second only to those of Japan].

~~11. Nor is it only at home that we have been accumulating wealth. In terms of net overseas assets, the UK is now in the top [three] internationally.~~

SJP thinks difficult to use figs if dropping from FSBR

People forget too easily the situation at the end of the 70s - JC

12. The last ten years, then, have been a time of extraordinary improvement to the economic fundamentals in the UK. When we came to ~~power~~ office, Britain was a textbook case of relative economic decline. Now it is out-performing ~~the competition~~ most of its major competitors, 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.

RPC: tax reform is supply side. macro/micro better.

SJP

13. It is against this background that we ~~can~~ should consider developments over the past 12 months. Growth throughout the world was more buoyant ~~last year~~ in 1988 than forecast a year ago, exceeding expectations in each of the major industrial countries. Overall, output in the G7 ~~looks~~ is likely to have risen by an average of 4 per cent, and world trade in manufactures probably grew by 10 per cent.

JC

see JG suggestion opposite.

14. [The UK experienced, if anything, stronger growth than most of its G7 partners.] The sustained upswing of the last 8 years continued with a second successive year of GDP growth at about 4½ per cent, [the first time this has happened since the mid-sixties.] Manufacturing

δ/ [JC]

"Where's Money GDP?" RPC.

output grew particularly rapidly, by [5½ per cent in 1987 and] over 7 per cent in 1988. It is now [ ] per cent above its previous peak in 1974.

15. Unemployment fell by more than half a million. [LFS Bull points.] Productivity growth continued to outpace our own past performance and that of other countries. Profitability rose to its highest level since the 1960s, and companies invested heavily to meet future demand.

SJP suggests: However some economic indicators showing increasingly inconsistent picture of developments For example

JG prefers to do this on output

16. Investment growth clearly <u>has</u> been very strong indeed in 1988, probably well into double figures. But the recorded figures for investment growth show a smaller increase. This is part of a wider problem with economic statistics generally. It is perfectly clear from the well known discrepancies within the national income accounts that the estimates for expenditure, and

JC of investment spending in particular, are [completely]

JC inconsistent with [all the] other evidence. [Mention Stats Review or not?] [In the meantime we have to take the most sensible view we can of what is really happening on the basis of the raw data we have.]

JG For 87 + 88 assisted by

17. [~~In~~ a recent article the CSO have attempted to produce a more coherent set of accounts for 1985, 1986

and 1987. But so far they have been unable to extend this exercise to cover 1988. In order to provide a basis from which to understand developments this year, to compare them with the past, and to forecast next year, the Treasury has had to adjust the recorded figures to produce a more coherent picture of 1988. These adjustments draw on the results of the CSO reconciliation exercise and are described fully in the Red Book. More detail is set out in a working paper being published by the Treasury today.

!!

JG

18. [On the basis of this exercise,] I judge that investment grew by some [X] per cent in 1988, a figure that is consistent with all the evidence from independent surveys of investment intentions. So, for the [Xth] year running, [or X out of the last Y years] investment has grown faster than consumption - in stark contrast to [......best comparison].

and imports [SJP]

19. Nonetheless, consumers expenditure continued to expand strongly. ~~However, although consumption did grow less strongly than investment in 1988, there was still a marked pick-up in the growth of consumers expenditure.~~ This was not surprising. People have been prepared to finance their spending by borrowing more because they have confidence in the future ~~government's handling of the economy~~, and because with buoyant house prices ~~they feel~~ their wealth has increased.

[I wouldn't = tax cuts?]

mention higher real incomes (JC)

JC

~~wealthier~~. The house price bubble we saw emerging last year also led to a rapid turnover in housing, and an increase in spending on all the consumer durables associated with house moves.

20. So the aggregate result of buoyant investment and consumer spending was that domestic demand grew at an unsustainable rate and inflationary pressures began to re-emerge. And with domestic investment outstripping domestic saving the difference was financed from overseas and the current account deficit widened in 1988.

AGT says: "it didn't"

JC

JC

RPC dislikes

[a PEM formulation]

JG also dislikes

21. An essential feature of disciplined framework of the the MTFS is that it points to the appropriate policy action when circumstances change things get off track in one way or another. Accordingly, this increase in inflationary pressure has been countered by the only effective means: a tightening of monetary policy. Over the past [X] months there have been increasing signs that this firm action has begun to check the growth of spending by households, although ~~happily, there seems to have been [relatively little] falling off in~~ investment spending remains strong, reflecting the healthy position ~~of the~~ of the company sector. The housing market has cooled down, particularly in the South East, with lending for house purchase rising much less rapidly than in the middle of last year, and house prices stabilising in

[oops ~~not~~ true? of intentions not figs!]

most areas and falling in some. [The growth of retail sales in general has moderated, and sales of some consumer durables have fallen.] The growth of the narrow measure of the money supply, M0, has slowed appreciably.

22. All the signs now are that consumer spending will grow more slowly in the year ahead as higher interest rates continue to have their effect. Indeed, part of the effect of higher interest rates has yet to have its impact.

The impact of

JC

Those mortgages that are adjusted ~~only~~ once a

is working through

year will only now [be feeling the effects of last year's increases in interest rates.]

23. Equally, with the obvious increased attractiveness of saving at present interest rates the personal sector saving ratio is likely to recover somewhat.

RPC: tighten mon. policy → reduce growth Money GDP + inflation

But these changes take time

JC

24. [All this will show through in the RPI in time.] But the underlying path of inflation in 1989 will continue to be obscured by the perverse inclusion of mortgage interest payments in the RPI. The latest rise in the mortgage rate will almost certainly lead to RPI inflation approaching 8 per cent for a while

Whereas the RPI

~~(although~~ excluding mortgage interest payments the rate should remain below 6 per cent). ~~But in time [both~~

sounds bad -

RPC - can we say "well below"?

most areas and falling in some. [The growth of retail sales in general has moderated, and sales of some consumer durables have fallen.] The growth of the narrow measure of the money supply, M0, has slowed appreciably.

22. All the signs now are that consumer spending will grow more slowly in the year ahead as higher interest rates continue to have their effect. Indeed, part of the effect of higher interest rates has yet to have its impact. ~~Those~~ because many mortgages ~~that~~ are adjusted ~~only~~ only once a year ~~will only now be feeling the effects of last year's increases in interest rates.~~ generally in the first four months of the year. So the full effect of last year's increases will not be felt until next month.

April for June

23. Equally, with the obvious increased attractiveness of saving at present interest rates the personal sector saving ratio is likely to recover somewhat.

24. All this will show through in ~~the RPI~~ inflation in time. But the underlying path of inflation in 1989 will continue to be obscured by the perverse inclusion of mortgage interest payments in the RPI. The latest rise in the mortgage rate will almost certainly lead to RPI inflation approaching 8 per cent for a while (although excluding mortgage interest payments the rate should remain below 6 per cent). But in time [both

* This is the crucial paragraph. My inclination would be to toughen it up a bit to say

— how much of a slowdown is involved will depend on the reaction of industry

— we will bring down inflation, have ~~make~~ no doubt about that

— if industry fail to keep costs down then this will happen at cost to employment.

L By the 4th Q

is likely to fall

JC measures ~~will fall]~~ with RPI inflation [~~itself~~ coming back to 5½ per cent [~~by the fourth quarter of this year~~] and 4½ per cent by the second quarter of 1990.

Will

slowing

25. [The slowdown in] consumer spending growth [is likely to mean] GDP growth will be [somewhat] below trend over the coming year. But even with relatively slow growth through the year I [still] expect GDP in 1989 to be 2½ per cent higher than 1988. This may seem disappointing by the standards we have come to expect in the last few years. But it is a respectable figure, and with investment likely to remain high the medium-term growth prospects are good.

JC

AGT

"all real again" RPC

* See JG opposite

26. The action I have taken to tighten monetary policy will in time improve the current account [too]. As the level of domestic saving responds to higher interest rates, our strong domestic investment will depend less [and less] on finance from overseas. But as I have always made clear, this will take time, and the outturn for 1989 as a whole [may well] be much the same as that for last year which I now judge to have been some £[10] billion. But experience over the current year shows that there is no difficulty in financing a [~~temporary~~] current account deficit of this size,

JC

is likely to

JC

won't work points of order etc, SJP [I agree, even tho' I drafted - mpr]

JC

~~in most~~ elsewhere and as a result we were the first to raise interest rates in response. Other countries are now experiencing similar problems and interest rates are rising, thus inevitably reducing the difference between UK rates and those overseas. That is not in itself a cause of difficulty: each country must decide what action it needs to take to keep inflation at bay. But, as we have seen over the past [four] years, international cooperation on monetary and fiscal policies can help to ~~promote combine anti-inflationary policies with~~ form a consensus on what the appropriate global stance should be, and
? what action is necessary to help the process of reducing imbalances. The UK will continue to play its full part in these discussions

provided the Government is determined - as we are - to maintain an appropriate monetary policy.

27. [In part the outcome will depend on developments in the rest of the world. The latest indicators suggest that activity in the major economies will remain strong, ~~though increases in short-term interest rates to counter~~ rising inflation may lead to some slowing through 1989. So far, actual inflation in most countries has increased only a little. It is clearly desirable that monetary policy should be used effectively to counter it. We must also look to see continued co-operation on monetary and fiscal policy, to help the process of reducing imbalances and to maintain the much greater exchange rate stability of the past two years. I can assure the House that the UK will continue to play its full part in this co-operation.]

Own goal - RPC

?

JG: Shorten. Cooperation ∴ stability ∴ [helps] investment boom

The recent indications on inflation have been less comfortable: there are clear signs of inflation edging up in many of the major countries, and it is essential firm action is taken to nip this in the bud. The indications of inflationary pressure emerged earlier in the UK than

facing page

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MONETARY POLICY

Events since the summer show clearly that the Government will take whatever action is necessary to bear down on inflation, and to ensure that the next 10 years of the MTFS are as successful as its first decade.

RPC and JC: inflation a monetary phenomenon etc.

Repetitive

2. The central role in bringing down inflation belongs to monetary policy, buttressed by a prudent fiscal stance. As I have already made clear, short-term interest rates are the essential instruments of monetary policy. [Interest rates will be kept at their present level until inflation is clearly subsiding. Thereafter they will be kept at whatever level is necessary to bear down on inflation.]

PEM formulation JG dislikes

JC 3. ~~The~~ Our ultimate objective ~~is~~ remains stable prices. But no Government can be proof against short term fluctuations

JG along the way, but this ~~Governments~~ [can guarantee] is determined the will to ensure that they are only short term.

JC 4. [The determination to] keep the interest rates at the [appropriate] level [- however unpalatable that may be sometimes - is the key] ~~be~~ needed to bringing inflation down is never popular. ~~And~~

JC ~~it does require determination,~~ for higher interest rates are always unwelcome to home owners and other borrowers.

But we have always made it clear that we will not accommodate inflationary pressures. To do so would mean a return to rapidly rising prices and, as in the past, untold damage done to working families, savers, and the whole of the nation's economic and social fabric. The important thing is to avoid that.

But

pensioners

would be more damaging.

~~5. Interest rates are clearly the best directed and most effective instrument to deal with inflation in general, and particularly with the pressures we have seen reappearing in the last year.~~

JC

targeted

weapon

defeat

JC

(discourage increased mortgages and borrowing for house purchase

JC

~~6. First, they have an important influence on the housing market [where the rise in house prices has been a major force behind the strong growth in borrowing and consumers' expenditure over the last year]. They are also well directed from a regional point of view, having greatest effect in the south of England where inflationary pressures have arguably been strongest.~~

~~7. In addition - and this point is not, perhaps, well understood - they also target those sectors of the economy where restraint is needed. While the household sector has moved from being a net lender to being a substantial net borrower, companies' finances are in far better shape than a few years ago, so that they are~~

consumer spending

JC

Many are funding expansion from profits -AGT

JC add §25 on investment (expanded)

~~far less vulnerable to increases in short term interest rates. Companies are 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.~~

8. Now all the evidence is that the tightening of the monetary stance is taking effect in the way we predicted. 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 the 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. [Repetitive - better here or earlier?]

JG JC
[I agree]

9. Decisions on interest rates will continue to be based on a comprehensive assessment of monetary conditions, in which particular weight is given to the behaviour of MO, which has a reliable and predictable relationship with money GDP. The target range for MO growth in 1989-90 will be 1-5 per cent, as envisaged in last year's MTFS. Measured on a 12 month basis, MO growth will start the year above the top of this range, reflecting rapid growth last spring and summer.

However, its growth has slowed appreciably over the last six months - equivalent to x per cent at an annual rate - and I am confident that the 12 month figures will before long come within the target range.

10. Interest rate decisions will also continue to take full account of the role of the exchange rate. The Government's clear commitment not to accommodate increases in domestic costs by exchange rate depreciation remains a key safeguard against rising prices. In particular we cannot afford to let a temporary increase in inflation lead to a lasting increase in the pay bill.

Fiscal policy

11. A prudent fiscal policy is also a central feature of the MTFS, buttressing a sound monetary policy. The

must be to set

JG primary focus ~~is the medium term, and the impact of~~ taxation, expenditure and borrowing on ~~the supply side. But its role is very different from monetary policy: it~~

AA ~~cannot be used effectively in the short term as a means of managing demand and keeping the growth of money GDP on track. That was the mistake of the 70s. It is much too inflexible for that: fiscal changes take time to implement and are difficult to reverse. Furthermore,~~

JG a sustainable course in m. term, + within that to make structural reforms to improve supply side.

JC - frequent changes damage long term supply side benefits.

JG - delete

& AA

~~the effects on the economy in the short term are very uncertain and unreliable, depending crucially on the reactions in financial markets and the response of private sector spending. Fiscal policy objectives are best set for the medium to long term and set to embrace tax and expenditure measures which improve the performance of the economy.~~

12. From our early years of office, we made steady progress in reducing the burden of Government borrowing. But now the public finances have been completely transformed, with the budget in surplus for the last two years. Last year I budgeted for a small surplus [~~this year~~]. In fact ~~we have done much better than this~~ the Government finances have been even stronger than that, and I now expect a debt repayment of [£14 billion] in 1988-89.

13. This is a remarkable achievement, ~~and a reward for~~ the result of many years of hard work in reducing the deficit. No other major country ~~enjoys~~ has a comparable Budget surplus.

AA & JG wd delete

~~The improvement owes something to higher tax revenues, from a more buoyant economy, and in particular higher profits. Also, the outturn for public expenditure is likely to be some £X billion below the total we provided for, and privatisation proceeds are also appreciably higher than expected.~~

It is the result of higher tax revenues, ~~as a result~~ as a result of the stronger economic growth of recent years, and from control of total public spending.

unclear JG

The Government's objective remains a balanced Budget over the medium-term. That

it is clear that it would not be sensible to

return to Budget balance too rapidly and that

14. But ~~even allowing for these factors~~ we should still be contemplating further debt repayment over the next few years. ~~and can be confident of being able to achieve the medium term objective of a balanced Budget.~~ ~~This~~ is a position in which the state makes no claim on the nation's saving, or on flows of finance from overseas.

15. The massive repayment of public debt over the past 2 years 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 2 years mean that debt interest costs are lower by £X billion a year. Indeed, debt reduction on this scale means that in this year's Finance Bill I shall have to take a new power, not needed before, to enable gilts to be acquired by the NLF, for cancellation.

JC

X

next page

16. The dramatic improvement in the UK's public finances [has also] provided a welcome opportunity to devote more attention to the structure of the [sterling] 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.

JC

Similarly it has proved possible to restructure part of the Government's foreign currency debt, launching an innovative and cost-effective programme of Treasury bills denominated in ecu. The first experimental six monthly tenders for these bills have proved extremely successful, and I can announce today that the programme will be continuing, at a level of around ecu 2½ billion.

X

17. It ~~would not be wise to revert to a balanced Budget immediately~~. There are several reasons for caution. Our present strong position reflects some influences which are essentially cyclical. They are difficult to quantify, but they will tend to unwind as the economy reverts to a more sustainable rate of growth.

18. Moreover, we must allow for the role played by privatisation proceeds in strengthening the public finances. These do not create room for sustainable increases in expenditure or reductions in taxation, and are much better used to repay debt.

AGT - "a new principle"

19. Most importantly however in present circumstances, until domestic demand slows appreciably a prudent fiscal stance is essential. ~~with continuing strength of domestic demand, it is vital not to take any taking risks with the credibility of our policies. A prudent fiscal stance~~ This will help maintain confidence and provide a general support for monetary policy.

JC

JC

/ implies we have doubts - prefer "firm buttress" - AGT

I agree.

20. I have concluded that we must aim for a further substantial budget surplus in the coming year. I have therefore budgeted for a PSDR of [£12 billion]. Beyond 1989-90, I expect to see a gradual return to ~~Budget~~ a Budget balance. ~~the public sector debt repayment revert gradually towards zero.~~ [An illustrative path for the medium term is set out in the MTFS.][[Implications for tax burden/tax reform.]]

rc 1989/2.3.01

Covering BUDGET CONFIDENTIAL

CULPIN

FROM: ROBERT CULPIN
DATE: 1 March 1989

MISS WALLACE

cc: Mr A C S Allan

SPEECH: ECONOMIC SECTION

incorporated in general annotated

This reads very well. I scribbled a few things on the chunk I read last night: take in spirit meant. I am happy to explain or expand whenever you like.

2. The one general thing which struck me is that I think there is a bit too much statistics and reporting and not quite enough philosophy or reflection on the last ten years; and in the statistical/reporting stuff, there is a bit too much about macro-economic policy and real economic variables, and not quite enough about micro-policy and nominal variables. It may be that you are going to tack on a thematic introduction, or conclusion, or something - I don't know. In any case, if what follows looks like egg-sucking, just forget it.

3. Very briefly, I think the semi-buried thought is something like this. For the last ten years, the Government has worked consistently to establish two big things. First, sound money. That means being prepared to use interest rates as often and as much as it takes to keep on top of inflation; completely transforming the public sector's financial position; and being prepared, when necessary, to defer other important objectives, such as a reduction in the tax burden. It means accepting that inflation is a monetary phenomenon

which can only be tackled through macro-economic policy, and not through price codes, pay codes, other sorts of non-price administrative rationing, or other micro-economic distortions. And, most importantly, it means accepting the corollary that macro-economic policy has to be addressed to the defeat of inflation and not the promotion of employment; and that it can only reliably influence nominal variables, and not real ones.

4. Second, free markets. This means giving management back to the managers, unions back to their members, and the benefits of ownership to ordinary people. It means accepting that economic efficiency can only be promoted by getting the Government off people's backs, and giving them their head. And, again, it means accepting the corollary that the only real way to get more jobs is through micro-economic policy, and not the short-term manipulation of demand, or any kind of fiscal levitation.

5. This is all so familiar that we take it completely for granted; and most of the points appear somewhere in the speech. But putting it together, this has in many ways been the biggest change in economic policy over the last ten years or so. I think the Budget speech is a place to give what the press would call a ringing defence, or reaffirmation, of this view of the world, especially as the Chancellor personally is so closely identified with it.

6. It leads, if you like, into another point which is there in the draft, but could be worth bringing out still more explicitly. Simplifying drastically, if - and it is a very big if - the Government delivers these two big things, sound money and free markets, it is not the business of the Chancellor of the Exchequer to tell people how much they should save, whether they should buy goods at home or abroad, how they should finance their spending, and so on.

7. Needless to say, none of this is in speech form, and I have not spent any time polishing or refining it at all. But I thought it might be slightly more help to dictate it than just to scribble the code shorthand "Mais/IEA".

Rc

ROBERT CULPIN

chex.pj/jc/1.3.2

BUDGET CONFIDENTIAL

FROM: MRS JUDITH CHAPLIN
1st March 1989

MISS WALLACE

cc Chancellor
Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Mr Tyrie
Mr Call

BUDGET STATEMENT

As requested I have given you my copy of the speech marked with my drafting comments. Below are some additional points.

1. Paragraphs 6-23. As the business taxation section has a good message, it seems a pity not to emphasise this either at the beginning or at the end, with a sentence such as:

> "These measures taken together represent a considerable reduction and simplification of the burden of business taxation, particularly for small businesses."

2. Paragraphs 24-30. At the beginning of the taxes on saving section there are three ideas: that savings include corporate savings and public sector savings as well as personal savings; that gross savings have been relatively stable; and that tax reform should not be used in response to short-term changes. This makes the beginning of this section seem complicated and I think it would be better without paragraph 28.

3. Paragraph 63. I think the first sentence of this paragraph is unclear. It is also rather negative and I think it is best omitted as the following sentence follows well from the end of paragraph 62.

4. Paragraphs 109-110. I agree that it is a bull point to say that the final pledge of the 1979 Manifesto is to be fulfilled. My concern is that it will encourage the rereading of that Manifesto by the Opposition and commentators. Although so much of it has been achieved, it does have some unfortunate sentences in it, for example "The prospect of very high mortgage interest rates deters some people from buying their homes and the reality can cause acute difficulties to those who have done so. Mortgage rates have risen steeply because the Government's financial mismanagement. Our plans for cutting Government spending and borrowing will lower them." The rate in that year was 11.75 or lower.

5. Paragraph 114. Is the "duck test" well enough known to be used in this context?

JC

JUDITH CHAPLIN

rc 1989/1.3.02

BUDGET SECRET

FROM: ROBERT CULPIN
DATE: 1 March 1989

CHANCELLOR

cc: Miss Wallace

Ch/ My vote goes for version one, for the speech. If you feel like opting for one at this stage, we might circulate to rest of the cast, for completeness.

MPW.

SPEECH

I attach two versions of NICs. I am happy to try other approaches if you would like me to.

2. We shall need to work in a reference to the Secretary of State for Social Services.

3. Strictly speaking, we need to remember that there are a million married women optants for whom the step at the LEL will continue to be 3.85 per cent of earnings, or £1.65 in 1989-90. If they would be better off with 2 per cent and 9 per cent, they are free to transfer.

RC

ROBERT CULPIN

BUDGET SECRET

SHORT VERSION

NATIONAL INSURANCE CONTRIBUTIONS

I have one further measure to propose.

It has long been a feature of the National Insurance system that, once people earn more than the lower earnings limit, which in 1989-90 will be £43, they have to pay National Insurance contributions at the same rate on the whole of their earnings. There are now three different rates - 5 per cent, 7 per cent and 9 per cent.

This produces a rather jagged pattern of contribution rates; and it has the unfortunate effect that, at a few points on the income scale, people can be worse off if they earn more. Their extra earnings take them from a lower rate band to a higher one, and they therefore lose more in National Insurance contributions than they gain in extra pay. These few points have come to be known, somewhat inelegantly, as the National Insurance steps.

I now propose a simple reform. For everyone who pays employee National Insurance contributions, I propose to reduce to only 2 per cent the rate of contributions on earnings up to and including the lower earnings limit. On earnings above that limit, there will be a single rate of 9 per cent, up to the Existing upper earnings limit, which has already been set for 1989-90 of at £325.

This will abolish altogether the steps which at present exist at earnings of £75 and £115. I believe it right to keep the small step which has always existed at the lower earnings limit, where people first come into the National Insurance system, because that is the entry ticket to the full array of contributory benefits. As such, it is an essential feature of the contributory principle. But my proposals will reduce this step very considerably, to only 86 pence in 1989-90.

This reform will reduce the burden of National Insurance contributions across the board. For the lowest paid, that burden is now heavier than the burden of income tax. This is the most effective measure I can take to lighten it. For everyone on half average earnings or more, the reform will leave them £3 a week more of their own money; and most of the benefit will go to those below average earnings.

I propose to make a consequential reduction, in accordance with the existing formula, in the Class 2 National Insurance contributions for the self-employed, from £4.25 a week to £2.95.

[There will be no change in the contributions paid by employers.]

[mention.. earliest possible date]

These measures will take effect from [1 October]. The cost will be around £1 billion in 1989-90 and £2,900 million in 1990-91.

LONGER VERSION

NATIONAL INSURANCE CONTRIBUTIONS

I have one further measure to propose.

It has long been a feature of the National Insurance system that, once people earn more than the lower earnings limit, which in 1989-90 will be £43, they have to pay National Insurance contributions at the same rate on the whole of their earnings. This creates what has come to be known as a step at the lower earnings limit.

When I became Chancellor, that step was 9 per cent of earnings - the starting rate of National Insurance contributions. If I had left it unchanged, anyone earning £43 a week in 1989-90 would have to pay very nearly £4 a week in National Insurance contributions.

I started the process of reform in my 1985 Budget, by reducing the starting rate of contributions from 9 per cent to 5 per cent. This means that the step in 1989-90 will be just over £2, instead of nearly £4. I also introduced an intermediate band of 7 per cent [, so that the full contribution rate of omit – too complex

9 per cent will only be reached in 1989-90 at earnings of £115 a week].

or "take things one step at a time"

I had, however, to contain the cost; and the only way I could sensibly do this was to retain the long-standing rule that people pay the same rate of contributions on the whole of their earnings. This has the unfortunate side-effect that, at a few points on the income scale, people can be worse off if they earn more. Their extra earnings take them from a lower rate band to a higher one, and they therefore lose more in National Insurance contributions than they gain in extra pay.

I now propose to carry my reforms further. For everyone who pays employee National Insurance contributions, I propose to reduce to only 2 per cent the rate of contributions on earnings up to and including the lower earnings limit. On earnings above that limit, there will be a single rate of 9 per cent, up to the upper earnings limit, which has already been set for 1989-90 at £325.

This will abolish altogether the steps which at present exist at earnings of £75 and £115. I believe it right to keep some small step at the lower earnings limit, where people first come into the National Insurance system, because that remains the entry ticket to the full array of contributory or "reduce to a reasonable level" [after all, not planning any more further reductions]

benefits. It is essential to the contributory principle. But my proposals will make a [further] substantial reduction in this step, [so that it will be only] to 86 pence [when the reform takes effect.]

The reform will reduce the burden of National Insurance contributions on employees across the board. For the lowest paid, that burden is now heavier than the burden of income tax. This is the most effective measure I can take to lighten it. For everyone on half average earnings or more, the reform will leave them £3 a week more of their own money; and most of the benefit will go to those below average earnings.

I propose to make a consequential reduction, in accordance with the existing formula, in the Class 2 National Insurance contributions for the self-employed, from £4.25 a week to £2.95.

[The contributions paid by employees will be unaffected.]

These measures will take effect from [1 October]. The cost will be around £1 billion in 1989-90 and £2,900 million in 1990-91.

rc 1989/1.3.02

BUDGET SECRET

Thanks.

PS: circulate 1st version of this, as NICs

2 as amended, as section of Budget speech.

FROM: ROBERT CULPIN
DATE: 1 March 1989

CHANCELLOR

cc: Miss Wallace

SPEECH

I attach two versions of NICs. I am happy to try other approaches if you would like me to.

2. We shall need to work in a reference to the Secretary of State for Social Services.

3. Strictly speaking, we need to remember that there are a million married women optants for whom the step at the LEL will continue to be 3.85 per cent of earnings, or £1.65 in 1989-90. If they would be better off with 2 per cent and 9 per cent, they are free to transfer.

RC

ROBERT CULPIN

Ch

The longer version follows a comment I made to Robert that it looked odd not to mention your 1985 reforms at all

AA

Moira has commented separately on copy below.

BUDGET SECRET

SHORT VERSION

NATIONAL INSURANCE CONTRIBUTIONS

I have one further measure to propose.

Currently

It has long been a feature of the National Insurance system that, once people earn more than the lower earnings limit, which in 1989-90 will be £43, they have to pay National Insurance contributions at the same rate ~~on~~ (up to the upper earnings limit) on the whole of their earnings. There are ~~now~~ three (for those on low pay) different rates - 5 per cent, and 7 per cent and 9 per cent. The two reduced rates, which I introduced (for both employers and employees in my 1985 Budget, cut the cost of employing the young and unskilled, among whom unemployment was then highest, and cut the ~~and in general~~ ~~[illegible]~~ burden of ~~[illegible]~~ national insurance contributions on the very low paid. ~~But at the same time they~~) the "standard" rate of

But at the same time ~~This~~ this produces a rather jagged pattern of contribution rates; and ~~it~~ has the unfortunate effect that, at a few points on the income scale, people can be worse off if they earn more. Their extra earnings take them from a lower rate band to a higher one, and they therefore lose more in National Insurance contributions than they gain in extra pay. These few points have come to be known, somewhat inelegantly, as the National Insurance steps.

In agreement ~~[illegible]~~ with my right hon Friend the Sec. of State for Social ~~Security~~ Security, I now ~~I~~ propose a simple reform. For everyone who pays employee National Insurance contributions, I propose to reduce to only 2 per cent the rate of contributions on earnings up to and including the lower earnings limit. On earnings above that limit, there will be a single rate of 9 per cent, up to the upper earnings limit, which has already been set for 1989-90 at £325, a week.

This will abolish altogether the steps which at present exist at earnings, for 1989-90, of £75 and £115, a week. I believe it right to keep the ~~small~~ step which has always existed at the lower earnings limit, where people first come into the National Insurance system, because that is the entry ticket to the full array of contributory benefits. As such, it is an essential feature of the contributory principle. But my proposals will reduce this step very considerably, to only 86 pence in 1989-90.

Insert ⊗ here

This reform will significantly reduce the burden of employees' National Insurance contributions across the board. For the lowest paid, that burden is now heavier than the burden of income tax. This is the most effective measure I can take to lighten it. For everyone on half average earnings or more, the reform will leave them £3 a week more of their own money; and most of the benefit will go to those below average earnings.

[~~I propose to make a consequential reduction, in accordance with the existing formula, in the Class 2 National Insurance contributions for the self-employed, from £4.25 a week to £2.95.~~]

[There will be no change in the contributions ~~paid~~ payable by employers.]

(the earliest practicable date.

These measures will take effect from ~~[1 October]~~. The cost will be around £1 billion in 1989-90 and £2,900 million in 1990-91. The necessary legislation will be included in the Social Security Bill ~~at~~ currently before the House.

BUDGET SECRET

LONGER VERSION

NATIONAL INSURANCE CONTRIBUTIONS

I have one further measure to propose.

It has long been a feature of the National Insurance system that, once people earn more than the lower earnings limit, which in 1989-90 will be £43, they have to pay National Insurance contributions at the same rate on the whole of their earnings. This creates what has come to be known as a step at the lower earnings limit.

When I became Chancellor, that step was 9 per cent of earnings - the starting rate of National Insurance contributions. If I had left it unchanged, anyone earning £43 a week in 1989-90 would have to pay very nearly £4 a week in National Insurance contributions.

I started the process of reform in my 1985 Budget, by reducing the starting rate of contributions from 9 per cent to 5 per cent. This means that the step in 1989-90 will be just over £2, instead of nearly £4. I also introduced an intermediate band of 7 per cent [, so that the full contribution rate of

9 per cent will only be reached in 1989-90 at earnings of £115 a week].

I had, however, to contain the cost; and the only way I could sensibly do this was to retain the long-standing rule that people pay the same rate of contributions on the whole of their earnings. This has the unfortunate side-effect that, at a few points on the income scale, people can be worse off if they earn more. Their extra earnings take them from a lower rate band to a higher one, and they therefore lose more in National Insurance contributions than they gain in extra pay.

I now propose to carry my reforms further. For everyone who pays employee National Insurance contributions, I propose to reduce to only 2 per cent the rate of contributions on earnings up to and including the lower earnings limit. On earnings above that limit, there will be a single rate of 9 per cent, up to the upper earnings limit, which has already been set for 1989-90 at £325.

This will abolish altogether the steps which at present exist at earnings of £75 and £115. I believe it right to keep some small step at the lower earnings limit, where people first come into the National Insurance system, because that remains the entry ticket to the full array of contributory benefits. It is essential to the contributory principle. But my proposals will make a further substantial reduction in this step, so that it will be only 86 pence when the reform takes effect.

The reform will reduce the burden of National Insurance contributions across the board. For the lowest paid, that burden is now heavier than the burden of income tax. This is the most effective measure I can take to lighten it. For everyone on half average earnings or more, the reform will leave them £3 a week more of their own money; and most of the benefit will go to those below average earnings.

I propose to make a consequential reduction, in accordance with the existing formula, in the Class 2 National Insurance contributions for the self-employed, from £4.25 a week to £2.95.

[The contributions paid by employee will be unaffected.]

These measures will take effect from [1 October]. The cost will be around £1 billion in 1989-90 and £2,900 million in 1990-91.

MR ANSON

ANSON

I agree. See also my note below on para 114.
A 1/3

FROM: J P MCINTYRE
DATE: 1 March 1989

1. MR ANSON
2. PS/CHANCELLOR (Miss Wallace) cc PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
PS/Financial Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Dame A Mueller
Mr Wicks
Mr Hardcastle
Mr Byatt
Mr Monck
Mr Scholar
Mr Sedgwick
Mr Riley
Mr A C S Allan
Mr Gieve
Mr Gilhooly
Mr Matthews
Mr Pickford
Mr Macpherson
Miss Hay
Miss Simpson
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A Battishill IR
PS/IR

Mr Unwin C&E
PS/C&E

MP

BUDGET STATEMENT: TAX SECTION

You asked for comments on the draft attached to your minute to PS/FST of 28 February. I attach a marked-up version of the draft. Two of the suggested changes are explained below.

<u>Para 108</u>

2. To acknowledge the pensioners' earnings rule as "notorious" would risk provoking people to press for abolition of other earnings rules or relaxation of the rules for means-tested benefits. These benefits (Income Support etc) are withdrawn as income rises in much the same way as the pension is reduced under the earnings rule.

BUDGET SECRET

Para 111

3. Mr Bolton's minutes of 24 and 28 February explained that it was not possible to quantify (in revenue terms) the behavioural effects of abolishing the earnings rule. In any case, the supply side effects will cut both ways. Some additional elderly people may choose to work but they may to some extent displace younger people in the workforce. Some elderly people who already choose to work beyond state retirement age may be encouraged to work longer hours, but others may feel that they can afford to work less now that they can also receive their pension in full.

JM

J P MCINTYRE

At the risk of being a kill-joy, I would advise against para. 114:

(a) I am not sure that enough of the audience are familiar with the collected sayings of Mr. Darman!

(b) The abolition only extends to the pensioners' earnings rule, so that even if one accepted it as a tax on the "duck" test, it would not be the abolition of a whole tax.

(c) It is unwise to stir up the perception of this kind of rule as a "tax". That will only further encourage people to regard as a "tax" (and press the Chancellor to relieve) all the other earnings rules and - more important - the cut off of means-tested benefits, parental contributions, legal aid, etc., etc. But these are methods of targetting benefits, i.e. expenditure measures and not taxes. In other contexts, the Chancellor has disputed the argument that the poverty trap is a high marginal "tax" which he could or should reduce just like the higher rates of personal income tax.

I have attempted a redraft on the copy below, but these points together really go to the heart of the paragraph and I would advise omitting it.

JA

J. ANSON

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 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.

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 pensioners' ~~notorious~~ earnings rule, any pensioner who decides to continue to work after reaching the state pension ~~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 discourage ~~penalise~~ people ~~pensioners~~ who wished to work beyond retirement age in this way, and pledged that we would phase out this ~~abolish the~~ earnings rule.

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~~ [2] 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]~~ 125 million in 1989-90, which will be entirely met from the Reserve~~s~~. But the true cost of this measure will be considerably less than this, to the extent ~~given the additional income tax and employers' National Insurance Contributions that will flow from the~~ it leads to an increase in the number~~s~~ of elderly at work, and thus to additional tax revenue. ~~once this harsh disincentive has been removed~~.

Ch has already changed

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.

overblown

114. Although this is an important improvement in the benefit regime, many people regard the pensioners' earnings rule as more like a tax on their initiative in remaining in work. To those who feel that way, I might even ~~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~~

claim to have abolished a seventh tax. But my innate modesty and natural reticence inhibits me from doing so.

FINANCIAL SECRETARY

Robert/01.1.3.89

BUDGET SECRET

FINANCIAL SECRETARY TO THE TREASURY

COPY NO: 1 OF 15

FROM: FINANCIAL SECRETARY
DATE: 1 March 1989

CHANCELLOR

cc Chief Secretary
Paymaster General
Economic Secretary
Mr Scholar
Mr Culpin
Mr Gilhooly
Miss Wallace
Mrs Chaplin
Mr Tyrie
Mr Call

Mr Isaac)
Mr Painter) IR
Mr Beighton)

BUDGET STATEMENT: TAX SECTION

You asked for comments on the latest draft. I also attach my suggestions for passages on unit trusts and Keith.

Business Taxation

para 7: I would replace the last sentence with "Between the two limits, the effective rate of tax will vary between 25 and 35 per cent".

para 9: amend the last sentence to read "These changes will reduce the corporation tax burden for X companies currently above the small profits limit".

para 10: for a definition of close companies, "generally those that are unquoted and controlled by a small number of people.

para 11: I am unhappy with the implied idea that the close company apportionment rules are a "burden" on businesses in the same way as (say) rates are. They only bite if the company is both profitable <u>and</u> does not distribute. I would prefer the flavour to be more along the lines of "a simplification of the tax system".

para 16: You could make a passing reference at the end to the consultative document on swaps, which is a specific issue within the foreign exchange field.

Taxes on Savings

para 27: insert after "but" in the second line "the totality of savings within the economy. In other words, we must include....." and then as before.

para 28: clarify the point by amending the piece after "has" in the third line to "not occurred because gross saving has fallen. Rather, it is the result of the sharp increase in personal borrowing. And the...." and then as before.

para 31: I think we need the point that this has happened despite the stock market crash in 1987.

para 35: say when this happened (calendar year 1987?)

para 39: replace "preponderately invested" with "invest wholly or mainly".

para 41: I think we need the flavour of two separate points here. First, with PEPs as they are, the longer you stay in, the more tax relief you get. But with front-end relief, you have an incentive to take your tax relief and run. Secondly, to mitigate that incentive you would need a mass of complex legislation to protect the exit charge and to try to prevent round tripping and loanbacks.

para 44: these are SAYE share option schemes.

para 45: redraft as follows:-

"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. These are trusts set up for the benefit of a company's employees, which invest in the company's shares and then distribute them to the workforce. It is already possible to establish an ESOP; indeed, a number exist in the UK. But I propose to make it clear that for companies that make payments to enable an ESOP to purchase shares in the company, those payments will qualify for corporation tax relief, provided that the ESOP meets certain requirements designed to ensure that the shares become directly owned by the employees within a reasonable time. This relief will override the existing reliance on case law which is proving restrictive. I hope that it will encourage more British companies, particularly in the unquoted sector, to consider setting up ESOPs."

para 49: I think you should mention the material interest changes.

para 52: replace "sui generis" with "unique".

para 54: it is <u>life</u> profits which get unduly favourable tax treatment, not pensions profits! You could also mention the other pensions measures.

para 55: on the yield of the package, I would stick to "broadly neutral".

para 58: I would put the rate cut and the abolition of LAPD <u>before</u> the restriction of acquisition expenses (ie before para 56).

para 62: is this statement true? What about double tax relief through BES Link Schemes?

para 63-67 I would mention decoupling <u>after</u> you have announced the details of the cap.

para 83: this is very vague. I would either be more specific, or drop it.

R.C.M.J.

pp NORMAN LAMONT

C

A

ANNEX 1

UNIT TRUSTS

On unit trusts, there are two ways of presenting this measure:-

a) as a response to European competition:

"Later this year, UK unit trusts will be able to compete freely in Europe and will face competition from EC investment schemes here. At present, trusts investing in gilts or bonds face a tax disadvantage. ~~Eliminate~~ They pay corporation tax at 35% on their income but can pass on a credit of only ~~25%~~ the basic rate to their investor. So I have decided that from 1 January 1990, as for life assurance companies, the corporation tax rate on unit trusts that come within the EC rules will be ~~cut to 25%~~ the. Their investors will then get full credit for all the tax the trusts pay. I am also removing an unfair advantage which offshore umbrella funds enjoy over unit trusts: from today, switches between the individual parts of these umbrella funds will be liable to tax."

Set equal to the basic rate

b) as a measure designed to remove unit trusts' disadvantages relative to direct investment in non-equity securities, in which case it might be better to draft it as;

"At present UK unit trusts investing in gilts or bonds, and investors in such trusts, face a tax disadvantage. These trusts pay corporation tax at 35% on their income but can pass on a credit of only 25% to their investors. I have decided that from 1 January 1990, as for life assurance companies, the corporation tax rate on authorised unit trusts recognised under the UCITS Directive will be cut to 25%. Their investors will then get full credit for all the tax the trusts pay. I am also removing an unfair advantage which offshore umbrella funds enjoy over unit trusts: from today, switches between the individual parts of these umbrella funds will be liable to tax. Together these measures will put UK unit trusts on a fairer footing to compete with their foreign counterparts."

I definitely prefer the first option. It accurately reflects the reason for the changes. And you must make it clear that the rate cut applies only to UCITS trusts, otherwise people might think it applies to all collective investment vehicles. Moreover, if you present it as a general measure, all those <u>not</u> affected (such as futures and options funds) will press for the same treatment.

We will of course be considering the tax position of non-UCITS collective investment vehicles over the coming year.

ANNEX 2

KEITH

Finally, on Keith, I would insert a short paragraph after the section on taxpayer confidentiality. Again this could be drafted in 2 ways, depending on how detailed you want to be.

EITHER:

"I shall also be bringing up to date the powers of the Inland Revenue to enforce the collection of tax and the safeguards available to taxpayers. This will very largely complete the task I began in 1985 of implementing the recommendations in the first two volumes of Lord Keith's Report on the Enforcement Powers of the Revenue Departments, those relating to Income and Corporation Tax, Capital Gains Tax and VAT. I should like to take this opportunity not only to repeat my thanks to Lord Keith and his team for their comprehensive and rigorous reports, but also to thank the very large number of individuals and organisations who have taken part in the wide measure of consultation which we have subsequently undertaken."

OR:

"I shall also be bringing forward in the Finance Bill measures to implement the remainder of the recommendations of the first two volumes of the Keith Report on compliance. These will simplify the system of interest and other penalties for tax offences, and cover the information powers of the Revenue. This will very largely complete the task I began in 1985. I should like to take this opportunity not only to repeat my thanks to Lord Keith and his team for their comprehensive and rigorous reports, but also to thank the very large number of individuals and organisations who have taken part in the wide measure of consultation which we have subsequently undertaken."

I prefer the second option. It is more specific, but it sounds less sinister.

MRS CHAPLIN

chex.pj/jc/1.3.2

BUDGET CONFIDENTIAL

FROM: MRS JUDITH CHAPLIN
1st March 1989

MISS WALLACE

cc Chancellor
Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Mr Tyrie
Mr Call

Ch/ NB X over

MPW

BUDGET STATEMENT

As requested I have given you my copy of the speech marked with my drafting comments. Below are some additional points.

1. Paragraphs 6-23. As the business taxation section has a good message, it seems a pity not to emphasise this either at the beginning or at the end, with a sentence such as:

> "These measures taken together represent a considerable reduction and simplification of the burden of business taxation, particularly for small businesses."

OT

2. Paragraphs 24-30. At the beginning of the taxes on saving section there are three ideas: that savings include corporate savings and public sector savings as well as personal savings; that gross savings have been relatively stable; and that tax reform should not be used in response to short-term changes. This makes the beginning of this section seem complicated and I think it would be better without paragraph 28.

3. Paragraph 63. I think the first sentence of this paragraph is unclear. It is also rather negative and I think it is best omitted as the following sentence follows well from the end of paragraph 62.

4. Paragraphs 109-110. I agree that it is a bull point to say that the final pledge of the 1979 Manifesto is to be fulfilled. My concern is that it will encourage the rereading of that Manifesto by the Opposition and commentators. Although so much of it has been achieved, it does have some unfortunate sentences in it, for example "The prospect of very high mortgage interest rates deters some people from buying their homes and the reality can cause acute difficulties to those who have done so. Mortgage rates have risen steeply because the Government's financial mismanagement. Our plans for cutting Government spending and borrowing will lower them." The rate in that year was 11.75 or lower.

5. Paragraph 114. Is the "duck test" well enough known to be used in this context?

JC

JUDITH CHAPLIN

INLAND REVENUE

BUDGET SECRET covering BUDGET [...]nd
BUDGET SECRET - BLO

CSM/9/1

Inland Revenue
Central Division

Somerset House
London WC2R 1LB
Telephone 01-438-7221

Copy No 1 of 8

Miss M P Wallace
Room 13/2
Chancellor's Office
HM Treasury

1 March 1989

Dear Moira

BUDGET SPEECH: TAX SECTION

1. Thank you for copying your submissions of 27 and 28 February and the Chancellor's redrafts of the Speech. The extra copies you supplied have facilitated handling for which I am very grateful.

2. I am returning to you copy 31 of your note of 27 February and copy 36 of your note of 28 February. On each, our textual suggestions have been annotated in red and explanatory comments, where necessary, in blue. I am also enclosing a redraft of the section on stamp duty and a copy of a note from Mr Isaac, to which I shall return.

3. I should like to pass on the following comments in addition to those noted on the draft.

Paragraphs 8, 9 and 58: These are giving a fairly clear signal, well before the Income Tax section, that there is going to be no change in the basic rate. Is the Chancellor content to do that?

Paragraph 41: Mr Isaac's note (copy attached) is, I think, self-explanatory. On his second point - international experience - some research here into US and French legislation on, respectively, Loi Monory (or its successor) and IRAs suggests that, if pressed, we might find it difficult to justify the assertion that front-end reliefs have to be "festooned with a complex web of restrictions". The redraft, and Mr Isaac's alternative formulation, with the reference to "all experience shows that" both avoid this difficulty.

int exp. pensions

Paragraph 53: The question here is whether the Chancellor wants to rule out the possibility of more radical reform in 1990. I understand that at a recent meeting, the Financial Secretary expressed the view that Option A for investment linked business should remain on the table for 1990.

Paragraph 94: The Chancellor has asked the Paymaster-General to look at this paragraph. One point he might wish to consider is whether the invitation to charities to mount an information campaign might invite the rejoinder that the Government should contribute towards the cost.

4. I am copying this letter (without the enclosures) to the Revenue recipients of your submissions and to Steve McManus.

Yours

Charles

C S McNICOL

ISAAC
PEPS

BUDGET SECRET

FROM: A J G ISAAC
DATE: 1.3.89

cc Mr Corlett
Mr Kuczys

MR MCNICOL

BUDGET SPEECH: PARAGRAPH 41: PEPS

You have had from Mr Corlett and Mr Kuczys a revised draft to paragraph 41.

It might be worth offering to the Treasury, perhaps in addition, a slightly expanded version of this passage, together with a word of explanation.

The explanation is that there are two rather different points compressed in the present draft, and a risk that the Chancellor's audience might find itself confused accordingly:

- First, most of those pressing for front-end relief want no exit charge, or at least no exit charge if the investment is retained for some minimum period. In effect, most people in the lobby are pressing for an Exchequer subsidy. The Chancellor has said he sees no justification for this.

- Second, if nevertheless there is a fully equivalent exit charge (so that "the degree of relief is in principle the same in both cases"), then you need a "complex web of restrictions to prevent abuse". (And of course you need precisely the same restrictions, even if you are seeking a tax subsidy, but insist on an exit charge if funds are withdrawn before the end of the minimum holding period).

Finally, on a point of detail, the present draft bases the need for a "complex web of restrictions" on international experience. We are looking to see what further material we can gather on this aspect on the United States and French schemes. Meanwhile, of course, there are very relevant domestic UK precedents in pensions and the business expansion scheme.

I have tried to capture some of these thoughts in the attached revised draft of the fourth sentence of paragraph 41.

"In particular, I have not been persuaded by those who have suggested a so called "front end" relief for PEPS. It is of the essence of the PEP scheme that there is complete tax exemption; there is no tax when money is invested in a PEP and no tax when money is withdrawn. The alternative 'front-ended' approach - which could in principle give the same degree of relief - would be to give tax relief when money is invested in PEP and charge tax when money is withdrawn. I see no justification for going further than that; and even on that basis all experience shows that any scheme of front end relief would need to be festooned with a complex web of restrictions to prevent abuse. I prefer the simpler approach and I am confident......"

A J G ISAAC

chex.pj/jc/2.3.1

CHAPLIN

BUDGET CONFIDENTIAL

FROM: MRS JUDITH CHAPLIN
2nd March 1989

MISS WALLACE

cc Chancellor
Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Mr Gieve
Mr Tyrie
Mr Call

BUDGET STATEMENT

As agreed I have sent you my comments in manuscript on the draft speech. Below are some additional comments:

1. The last sentence of the first paragraph sounds valedictory; is that what the Chancellor wants?

2. Paragraph 12. I think this paragraph needs to say that people forget too easily the situation of 1979. I wonder, too, whether it is worth getting in the thought that as they have become more used to economic success a relatively minor step backwards releases all the gloom and doom prophecies yet again.

pause for b?

OK but not backwards

3. Paragraph 16. I think the statistics paragraphs fit in quite well where you have them, although they could go earlier as John Gieve suggests. I think they need to include somewhere the thought that policy is not determined solely by the statistics, nor invalidated by inaccurate ones.

Yes

4. Paragraph 21. It seems to me there are two problems from paragraph 21 on. The first is that paragraphs 21-27 are written in normal English, whereas much of the monetary policy section is written in official English. Second, much of the speech between these two paragraphs 21-27 is on monetary policy and therefore the section headed Monetary Policy is often repetitive.

I think it important to give the reasons why demand - particularly borrowing - has increased (paragraphs 19 and 20).

It would presumably be best to follow this with why interest rates are the appropriate weapon, why they are well targeted and, because they are well targeted, that they will be unpopular but that rising inflation would be worse. The reasons why companies are not as affected and that the policy is now showing signs of working. These points are in the monetary policy section (paragraphs 1-9) as well as partially in the earlier section, from about paragraph 21. Would it not be better to start the monetary policy section there, and merge these two parts? I have put the paragraphs numbers where they overlap next to the paragraphs in the Monetary Policy Section. However, it would mean that the future path of inflation and GDP would be under the Monetary Section.

/ nor on?

5. Fiscal policy, paragraph 11. At the moment this reads as though fine-tuning by fiscal policy is a good thing and only not done because it doesn't work quickly enough. I think this paragraph needs to contain the points that fiscal policy is part of the overall policy - to counter the "only one instrument" argument - that there has been tight fiscal policy throughout the last year and, in the event, even tighter than planned, and that the role of fiscal policy is essentially medium term and related to improving the supply side.

6. Paragraph 14. This states the objective of a balanced budget, whereas the actual figures for the PSDR in future years are at the end of this section. I think I would take out paragraph 14 and state the objective of a balanced budget at the end of the section.

7. The tax section needs the thought that changes and reductions should be sustainable.

JC

JUDITH CHAPLIN

CHIEF SECRETARY

cs /mins

BUDGET SECRET

No 1 of 6 Copies

0333

CHIEF SECRETARY TO THE TREASURY

FROM: MISS C EVANS
DATE: 2 March 1989

MISS WALLACE

cc:PS/Financial Secretary
~~Mr Anson~~
Mr McIntyre

MISS WALLACE

BUDGET STATEMENT: TAX SECTION

The Chief Secretary's amendments are as follows:

Paragraph 105: delete 2nd and 3rd sentences. Insert: 'in 1987 I introduced a new higher age allowance for those over 50. I now propose to extend this to all those aged 75 and over. As a consequence ¾ of all those over 75 will not be liable to tax"

Paragraph 107: should include the cost of the tax relief for pensioners' health insurance premiums.

Paragraph 108: add at start: "I have one further change to make which will benefit many pensioners. Under the present earnings rule ..." (If notorious why wait 10 years?)

Paragraph 114: The Chief Secretary didn't recognise the duck test. He does like Mr Anson's redraft.

CE

MISS C EVANS
Private Secretary

chex.pj/jc/2.3.1

BUDGET CONFIDENTIAL

FROM: MRS JUDITH CHAPLIN
2nd March 1989

MISS WALLACE

cc Chancellor
Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Mr Gieve
Mr Tyrie
Mr Call

BUDGET STATEMENT

As agreed I have sent you my comments in manuscript on the draft speech. Below are some additional comments:

1. The last sentence of the first paragraph sounds valedictory; is that what the Chancellor wants?

2. Paragraph 12. I think this paragraph needs to say that people forget too easily the situation of 1979. I wonder, too, whether it is worth getting in the thought that as they have become more used to economic success a relatively minor step backwards releases all the gloom and doom prophecies yet again.

3. Paragraph 16. I think the statistics paragraphs fit in quite well where you have them, although they could go earlier as John Gieve suggests. I think they need to include somewhere the thought that policy is not determined solely by the statistics, nor invalidated by inaccurate ones.

4. Paragraph 21. It seems to me there are two problems from paragraph 21 on. The first is that paragraphs 21-27 are written in normal English, whereas much of the monetary policy section is written in official English. Second, much of the speech between these two paragraphs 21-27 is on monetary policy and therefore the section headed Monetary Policy is often repetitive.

I think it important to give the reasons why demand - particularly borrowing - has increased (paragraphs 19 and 20).

It would presumably be best to follow this with why interest rates are the appropriate weapon, why they are well targeted and, because they are well targeted, that they will be unpopular but that rising inflation would be worse. The reasons why companies are not as affected and that the policy is now showing signs of working. These points are in the monetary policy section (paragraphs 1-9) as well as partially in the earlier section, from about paragraph 21. Would it not be better to start the monetary policy section there, and merge these two parts? I have put the paragraphs numbers where they overlap next to the paragraphs in the Monetary Policy Section. However, it would mean that the future path of inflation and GDP would be under the Monetary Section.

5. <u>Fiscal policy</u>, paragraph 11. At the moment this reads as though fine-tuning by fiscal policy is a good thing and only not done because it doesn't work quickly enough. I think this paragraph needs to contain the points that fiscal policy is part of the overall policy - to counter the "only one instrument" argument - that there has been tight fiscal policy throughout the last year and, in the event, even tighter than planned, and that the role of fiscal policy is essentially medium term and related to improving the supply side.

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7. The tax section needs the thought that changes and reductions should be sustainable.

JC

JUDITH CHAPLIN

mg.ee/dlcp/2.3-mw

BUDGET SECRET

COPY NO. 1 OF 5.

From : D L C Peretz
Date : 2 March 1989

MISS WALLACE

cc Sir T Burns
Mr Scholar
Mr Riley

BUDGET STATEMENT : ECONOMIC SECTION

A few comments on your draft of 28 February.

2. First, a general point. There seems to be rather a lot of overlap between the paragraphs that follow page 10, and those in the earlier section. The result is two "goes" at describing the effectiveness of last year's tightening of monetary policy : first in the "economic background" section, and then in the "monetary policy" section. That said, I am not at all sure how this can be avoided without changing the structure yet again.

3. On smaller points :-

i) in paragraph 21, do we really want to say that the tightening of monetary policy is "the only effective means" of countering inflationary pressure? This does not, quite, square with the more traditional sentence at the beginning of paragraph 2 of the second section, or with paragraph 11.

ii) in the last sentence of paragraph 22 it is mortgage payments that are adjusted, not mortgages. Perhaps the sentence might start "Mortgagors whose monthly payments are adjusted ...".

iii) second part, paragraph 2. The section in square brackets would, I think, come better at the end of paragraph 8 - replacing the sentences that are there. Alternatively, it could come in the earlier section (for example in paragraph 26).

PEM wrote!

iv) second part, paragraphs 9 and 10. To bring this into line with the MTFS, I suggest inserting the words ", and to the exchange rate" at the end of the first sentence of paragraph 9; and deleting the first sentence of paragraph 10.

v) second part, paragraphs 15 and 16. In para 15 I suggest "will permanently reduce" in the first sentence; "net debt interest costs" in the second sentence. Para 16, first sentence : delete "[sterling]".

D L C PERETZ

chex.ul/mw.ph/31

FROM: MISS M P WALLACE
DATE: 3 MARCH 1989

CHANCELLOR

BUDGET SPEECH: ECONOMIC SECTION

For this one, I have broken with tradition, and am not giving you a clean text that has been agreed with the rest of the office. This for all sorts of obvious reasons. Not least, that everyone wanted to work on their own ideas until pretty much the last minute today. But also, frankly, you are obviously going to write this one from scratch, and we all agreed that there was more point in giving you different bits of paper reflecting different people's opinions.

2. So, in the folder behind you have:

(i) An updated version of what Terry/Peter gave you last week. The structure is now, I think, even better. The big problem - and everyone has come to this conclusion simultaneously - is that a tripartite structure doesn't work. You have to say so much about monetary policy in the economic background bit, in order not to appear cavalier about inflation, that if you do a separate monetary policy section, you can only repeat yourself. So the mandarins have abolished the monetary policy section, and amalgamated it into the background.

(ii) I have also included another version of what I gave you myself last week, meant to be a "Lawsonised" rewrite of Peter/Terry. Here again, an obvious improvement would be to amalgamate the economic background and monetary policy bits. Alex had indicated on his copy how that might be done. And I have recorded various comments from other people too, to give you an idea of how the office reacts.

(iii) I have also scribbled various thoughts on the new mandarin draft. I am afraid I don't feel I have much to contribute on fiscal policy, which Terry himself comments is rather "ragged". This is clearly the tricky bit, and I am afraid everyone is waiting for your lead. Alex has done you a note of his thoughts on it.

John Grieve also - his minute, behind.

3. So, my thoughts are mainly confined to the background/monetary policy section. As I say, I have scribbled over one copy of the mandarin text, but there are a few general thoughts I might as well throw in for what they are worth.

4. As always, the most important thing to get right is the kick-off. I am sure the tone of what I produced may not be quite right ("over triumphalist"). But I do think it is far better to begin with something positive that sets the tone, cheers up the troops, and puts the whole thing in perspective. If you begin with a rehearsal of the Government's achievements, that allows you to make the (crucial) points that if supply-side arteries are unblocked then successes are achieved, and problems overcome. You can then move on to say why all this has happened - medium term framework, determination, etc. If you do it the other way round, you kick-off with the MTFS, and up pops the "defeat of inflation" in your second paragraph, which is not the most comfortable point to carry off as everyone is settling into their seats

5. I think Judith and Robert - see notes in this folder - are also getting at something similar. Robert's note (in which he explains for my benefit speech writing, economic policy, and everything) was probably meant for the novice speech writer rather than the Chancellor, but it gives you an idea of what he has in

mind - something philosophical, Mais, IEA etc. Judith wants something a little more political. [I also strongly agree with Judith that something sympathetic about homeowners and mortgages wd be a help.]

6. As far as content is concerned, I have one or two lingering reservations about the Peter/Terry draft. Obviously, it needs to lose some of the more Cabinet paperish concepts - domestic demand, stock building etc. But if it is Kosher to put some more "difficult" material in the Budget Speech, then I agree with Robert that the analysis of the economic background should be carried through much more fully in terms of the nominal framework. At the moment, money GDP does seem to appear and disappear as convenient.

7. The point Robert makes about beefing up the emphasis on micro/supply side policy is also important I think. The whole thing is a bit fixated on inflation. I might also add in support a thought the Chief Secretary mentioned to me, to the effect that we must get across an impression of the complete transformation of the supply side, which will still be there, when we have finished pausing for breath.

8. Another point on which I am afraid I am still agnostic, is the question of where the stats adjustment should be explained. It's tricky wherever you do it. But I am still attracted to the idea of taking the bull by the horns and attaching it to investment. Otherwise, we still have to festoon the investment paragraphs "so far as we can tell" - and that is supposed to be one of our really strong points.

9. The current account is also clearly a problem. John Gieve's idea of mentioning no numbers at all, and simply saying that you think 1989 will be about the same as 1988 is attractive. If you do mention both numbers, again I wonder if it is worth being a little bolder - perhaps something along the lines of "no matter what the number is, the analysis is the same, and the policy is

the same". My reasoning is that the greatest risk is that you seem to be taking credit for producing a lower number. Still on the current account, I also wonder whether we can describe it more in terms of investment/saving, rather than all this talk about imports, capacity constraints etc.

10. Finally, there are one or two points in the Peter/Terry draft where I think we would be accused of having our cake and eating it. For example, this might not be a year to lecture the US about its trade deficit. (In any case, the passage on the world economy needs shortening). I also think we run that risk if we make too much of financial market deregulation as the reason for the borrowing boom - since once of the high points of our speech is the bonfire of controls! (A Scholar draft* of that is also enclosed, position to be decided). The problem here is not that there is a contradiction, but rather that there is no time to explain why not.

MOIRA WALLACE

[* a jolly good one, shd work well.]

McINTYRE
NICs

 BUDGET SECRET Copy No. 1 of 15

FROM: J P MCINTYRE
DATE: 3 March 1989

PS/CHANCELLOR (Miss Wallace)

cc PS/Chief Secretary
PS/Financial Secretary
PS/Paymaster General
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Anson
Mr Scholar
Mr Culpin
Mr Gieve
PS/IR
PS/C&E

BUDGET STATEMENT: TAX SECTION

I have the following comments on the draft circulated with your minute of 2 March, which I have discussed with Mr Anson.

2. In paragraph 3 on the first page, I suggest a new second sentence on the following lines:

poss

> "This was a considerable improvement on the previous position, when low paid employees with earnings above the lower earnings limit had to pay the full 9 per cent rate."

3. The next sentence would then read:

> "However, it had the unfortunate effect that, at three points on the income scale..."

4. On the second page, you might add to the end of the first full paragraph:

> "Those paid less than the lower earnings limit will continue to have no liability for contributions".

5. In the next paragraph on the same page, "for employees" might be inserted after "exist" in the second line.

6. On the third page, "or the self employed" might be added to the end of the first paragraph.

7. In the next paragraph, the cost in the second year, rounded to the nearest £100 million, is now £2800 million.

JM

J P MCINTYRE

SCHOLAR
NICS

pf.dc.145 BUI[...]RET TOP

COPY NO 1 OF 17 COPIES

FROM M C SCHOLAR
DATE 3 MARCH 1989

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Anson
Mr Culpin
Mr Gieve
Mr McIntyre
Mrs Chaplin
Mr Tyrie
Mr Call

PS/IR

NICs - BUDGET SPEECH

One thing about the passage circulated today concerns me: it opens you too much to the criticism that you are acknowledging that what you did in 1985 was wrong.

2. I suggest the attached alternative opening section, which draws on an earlier version by Mr Culpin.

MCS

M C SCHOLAR

NATIONAL INSURANCE CONTRIBUTIONS

I have one further measure to propose.

It has long been a feature of the National Insurance system that, once people earn more than the lower earnings limit, which in 1989-90 will be £43, they have to pay National Insurance contributions at the same rate on the whole of their earnings. This creates what has come to be known as a step at the lower earnings limit.

I started the process of reform in my 1985 Budget, by reducing the starting rate of contributions from 9 per cent with to an 5 per cent, I cut the cost of employing the young and unskilled, among whom unemployment was then high and rising; and I reduced substantially the burden of national insurance contributions on the very low paid.

I had, however, to contain the cost; and the only way I could sensibly do this was to create two lower rates, 5 per cent and 7 per cent, and to retain the long-standing rule that people pay the same rate of contributions on the whole of their earnings. This ~~had~~ has had the ~~unfortunate~~ inevitable side-effect that, at a few points on the income scale, people can be worse off if they earn more. Their extra earnings take them from a lower rate band to a higher one, and they therefore lose more in National Insurance contributions than they gain in extra pay.

In agreement with my rhf the Secretary of State for Social Services I now propose a simple reform ... [continues as in your draft].

SCHOLAR
NICS

pf.dc.145 **BUDGET SECRET**

TOP **COPY NO 13 OF 17 COPIES**

FROM M C SCHOLAR
DATE 3 MARCH 1989

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Anson
Mr Culpin
Mr Gieve
Mr McIntyre
Mrs Chaplin
Mr Tyrie
Mr Call

PS/IR

NICs - BUDGET SPEECH

One thing about the passage circulated today concerns me: it opens you too much to the criticism that you are acknowledging that what you did in 1985 was wrong.

2. I suggest the attached alternative opening section, which draws on an earlier version by Mr Culpin.

MCS

M C SCHOLAR

This passage is absolutely crucial. i. I think that the ~~phraseology~~ 'contain the cost', referring to 1985, implies that we're not doing so now.

ii. I see some advantages in saying that we have now ~~put~~ got the structure of employee NICs right, although it may provoke employers to say 'what about us?'

45/B

NATIONAL INSURANCE CONTRIBUTIONS

I have one further measure to propose.

It has long been a feature of the National Insurance system that, once people earn more than the lower earnings limit, which in 1989-90 will be £43, they have to pay National Insurance contributions at the same rate on the whole of their earnings. This creates what has come to be known as a step at the lower earnings limit.

I started the process of reform in my 1985 Budget, by reducing the starting rate of contributions from 9 per cent to 5 per cent. I cut the cost of employing the young and unskilled, among whom unemployment was then high and rising; and I reduced substantially the burden of national insurance contributions on the very low paid.

I was able to do this, with little money available !

~~I had, however, to contain the cost; and the only~~ ~~I did this, within the tight fiscal framework~~, by creating ~~way I could sensibly do this was to create~~ two lower rates, 5 per cent and 7 per cent, and ~~to~~ retaining the long-standing rule that people pay the same rate of contributions on the whole of their earnings. This ~~had the unfortunate side-effect that~~ inevitably meant that, at a few points on the income scale, people ~~can~~ could be worse off

~~Key to continuity point~~

if they earn more. Their extra earnings take them from a lower rate band to a higher one, and they therefore lose more in National Insurance contributions than they gain in extra pay.

In agreement with my rhf the Secretary of State for Social Services I now propose ~~a simple~~ structural reform ~~of~~ ~~to complete this~~ employees NICs ... [continues as in your draft].

to complete the reform of the employees' NICs structure .....

SCHOLAR

pf.dc.147 **BUDGET CONFIDENTIAL**

FROM M C SCHOLAR
DATE 3 MARCH 1989

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Paymaster General
Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr Wicks
Mr Hardcastle
Mr Culpin
Mr Odling-Smee
Mr Peretz
Mr Riley
Mr Ilett
Miss O'Mara
Mr Gieve
Miss Wallace
Mrs Chaplin
Mr Tyrie
Mr Call

PS/IR

~~Actually, not a problem~~ ~~that~~ ~~if monetary policy section deceased. Cd perfectly well be~~ ~~the~~ jam in sandwich before fiscal policy (see x in para 3)

MPW

NLW

Mary

BUDGET STATEMENT: COBO AND STERLING CAPITAL MARKET DEREGULATION

I attach a draft section for the speech, as you requested.

2. I suggest that it comes at the beginning of the monetary policy section, following the order of the FSBR. oops!

3. I do not think you need to mention local authorities; nor do I think that the reference to repeal of the 1946 Borrowing (Control and Guarantees) Act should cause problems with QL colleagues.

MCS

M C SCHOLAR

Pearl TB version

I am afraid it is rather tagged on in the final fiscal policy section

CONFIDENTIAL

typed out in speech format behind.

N

THE ECONOMIC BACKGROUND

This Government has now been in power for almost 10 years. And today I am publishing the tenth edition of the Medium Term Financial Strategy. It is an occasion for looking back and assessing achievements as well as charting the course for the future.

2. The Government came into office with two central objectives: to defeat inflation and to breathe life into a moribund economy. It had a clear strategy to achieve this. Monetary policy was to be used to bring inflation down. Supply side policies were to remove restrictions, to free the economy and to stimulate energy and effort - so as to create wealth and increase the rate of non-inflationary growth. Fiscal policy was designed to bring the nation's accounts into balance, and within that to reform and reduce taxation while containing public expenditure and setting clear priorities.

3. An economy cannot be transformed overnight. These policies can only work if consistently applied in the medium term. The results can only be fully realised in the longer term. The Medium Term Financial Strategy expressed our intentions in unequivocal terms. For almost a decade it has provided a clear and disciplined framework for business and industry which has seized the opportunity and completely changed its attitude. British companies are determined to survive in fiercely competitive world markets, and are equipped to do so. The improved ability of the economy to supply goods and services has been the key to the improvements in living standards we have been able to achieve.

4. The results have been impressive by any standards. In an increasingly open world economy, no nation can be insulated from the impact of events which take place beyond our shores. Events do not take the smooth path shown in economic models. What Governments have to do is to put the right economic policies in place, and stick to them. Provided they do that, they can survive the difficult times, and excel in the good ones.

5. This is what we have done and it has brought outstanding success.

6. Between 1974 and 1979 inflation averaged 15 per cent. Since 1983 it has averaged 5 per cent. This is the answer to those who doubted that inflation could be controlled by the pursuit of a steady, disciplined monetary policy.

7. This success against inflation has not been achieved at the expense of the growth of output. We are now well into an unprecedented eighth year of steady, sustainable growth averaging in excess of 3 per cent a year. Output in the UK has grown faster than 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.

8. The cornerstone of this dramatic improvement in performance has been a large and sustained improvement in productivity which for the economy as a whole has been ahead of all other major industrialised countries with the exception of Japan (and for manufacturing has exceeded even Japan).

9. 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.

10. And they enjoy better public services too. For while the Government has kept the growth of public expenditure within that of the economy as a whole, so that its share of national income has fallen, that has not prevented a substantial increase in expenditure in real terms and the increase has been directed to priority services, such as health, law and order, and capital spending.

11. Of course as national income has grown so have consumers' expenditure and living standards - but this has not been just candy floss. Over the last 7 years, investment has grown almost

twice as fast as consumption. In the previous 14 years consumption grew faster on all but three occasions. And it is not only at home that we have built up income-producing assets. The UK now has one of the largest net stocks of overseas assets in the world.

12. The last ten years, then, have been a time of extraordinary 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.

13. It is against this background that we can consider developments over the past 12 months. 1988 was a year of rapid growth throughout the world, largely because of a rapid growth of business investment. Output in the major industrial countries may have risen by an average of 4 per cent and world trade in manufactures by 10 per cent. Growth exceeded expectations in each of the major countries; in most cases substantially so. Even those European economies that have been sluggish in recent years are now experiencing faster growth. Partly as a result of the strength of activity commodity prices have risen. Consumer price inflation has also edged up a little in a number of countries - emphasised by the remarkably uniform experience of faster than expected price increases in January. In response to the emerging signs of inflationary pressure monetary policy has been tightened in many countries.

14. Once again the UK economy also grew more rapidly than most of the other major economies, continuing our remarkable record of sustained growth. However it was a much more uneven year. Unemployment has fallen by more than half a million and is now lower than in most other major economies in Europe. Profitability rose to its highest levels since the 1960s. Productivity growth continued to outpace our own past performance and that of other countries. Companies are in a strong position and have been investing heavily to meet future demand.

15. A detailed assessment of the UK economy is clouded however by the large and growing inconsistencies that have appeared in our macroeconomic statistics. While two of our measures of national output have shown rapid growth, the third has been affected by under-recording of expenditure and has been showing a different picture, suggesting indeed that the output actually fell in the second half of the year. We are taking steps to improve the collection of statistics and the national accounts, but that is bound to be a lengthy process. In the meantime we have had to form the best view we can of what is really happening in the economy.

16. In order to provide a basis from which to understand developments this year, to compare them with the past, and to forecast next year the Treasury has had to make adjustments to the recorded figures to produce more coherent figures for 1988. These adjustments draw on the results of the CSO work and are described in the Red Book. While this exercise is essential to make sense of the past it cannot disguise the high degree of uncertainty. There is even greater uncertainty about the prospects for next year.

17. It looks as if we have now had a second successive year with GDP growth at about 4½ per cent, the first time this has happened since the mid-sixties. Manufacturing output has grown particularly rapidly, by 5½ per cent in 1987 and over 7 per cent in 1988. Manufacturing output is now 7 per cent above its previous peak in the first half of 1974. Within those totals domestic demand grew by some 7 per cent last year, mainly because of the strength of investment and stockbuilding, but also reflecting continued rapid growth in consumer spending.

18. Taking account both of the recorded figures and survey evidence, it seems likely that the growth of total fixed investment will have been well into double figures last year - the largest increase for almost 25 years.

19. In some respects however we have had too much of a good thing. Monetary growth has been too rapid. Domestic demand has grown faster than even the economy's improved capacity to supply, leading to inflationary pressures, which have appeared both directly in the pick-up of the underlying rate of inflation and indirectly in a sharp growth of imports and hence a widening current account deficit.

20. Consumers have seen their real incomes rise significantly and have felt more confident about the future; as a result they have been prepared to finance their spending by borrowing more. Part of the borrowing boom has been due to the housing market. A significant house price bubble emerged last year and with it a rapid turnover in housing. It is likely this had a significant effect on consumption in general and spending on durables in particular.

21. As in the past this increase in inflationary pressure has been countered by a tightening of monetary policy. That is why we have the MTFS. It points to the need for policy action when things get off track in one way or another. Interest rates have been raised and we will stay high until inflation is clearly subsiding.

22. There are now increasing signs that this determined action has begun to be effective. Measured on a 12 month basis M0 growth will start the year above the top of this range, reflecting rapid growth in the spring and summer of 1988. However, the growth of M0 has slowed appreciably, and over the last six months the annualised growth has been very low. I am confident that the 12 month figures will before long come within the target range.

23. The growth of spending by households has been checked. The housing market has cooled down particularly in the South East, with both house prices and lending for house purchase rising much less rapidly than in the middle of last year, and showing signs of falling in some areas. And part of the effect of higher interest rates has yet to have its impact because monthly payments on many

mortgages are adjusted only once a year generally in the first four months of the year. So for some the full effect of last year's increases will not be felt until next month.

24. Retail sales have levelled off in the last 3 months, and sales of some consumer durables in particular have fallen. Indicators of consumer confidence suggest that expenditure growth in the year ahead will be modest. The personal sector savings ratio should as a result begin to recover.

25. Meanwhile, company sector saving remains high and the signs are that the very strong investment performance of the last two years will continue in 1989, though growth will probably be at a less heady pace. The rate of return on capital is at its highest level for over twenty years, and the extra investment that this is generating will help to underpin the supply side improvements of recent years.

26. There should be no surprise at this result. The deregulation of financial markets has given households and companies the freedom to adjust their borrowing to suit their own preferences and for a while this has led to a faster growth of total credit.

27. But at the same time, changes in interest rates have become a more powerful weapon in the fight against inflation. They now impact on a much higher level of borrowing, and the effects are no longer muffled by direct controls.

28. As well as being a powerful instrument, interest rates are also well-directed in current circumstances. They are having an important influence in cooling the housing market, which has been a major force behind the strong growth in borrowing and consumers' expenditure over the past year. The greatest effect is in the south of England where inflationary pressures have arguably been strongest. And they are having a bigger impact on households, who are now substantial net borrowers, than on companies who generally are now in far better financial shape than a few years ago.

29. It is the household sector that is most vulnerable to increases in short term interest rates. The company sector is well placed to benefit from the fact that long term interest rates have remained remarkably stable, and well below short rates - an indication of the markets' confidence that inflation will be brought down.

30. I am very conscious of the effects of last year's rise in interest rates on individual home owners and other borrowers. But however unwelcome high interest rates are now they are far preferable to the damage that is done by high rates of inflation.

31. Even with a further strong growth of investment this year the slowdown in consumer spending growth is likely to lead to a fall in the growth of total domestic demand from 7 per cent in 1988 to 3 per cent in 1989. Growth through the year is forecast to be lower still at 2 per cent. As a result it is likely that growth of output too will be well below trend over the coming year. But even with relatively slow growth through the year GDP in 1989 could still be 2½ per cent higher than 1988. This may seem disappointing by the standards we have come to expect in the last few years. But it is a respectable figure, and with investment likely to remain high the medium-term growth prospects are good.

32. As is well known, in the short term higher interest rates exaggerate the published inflation rate because of the perverse inclusion of mortgage interest payments.

33. The latest rise in the mortgage rate will almost certainly lead to inflation as recorded by the RPI approaching 8 per cent for a while (although excluding mortgage interest payments the rate should remain below 6 per cent). But as the effects of the rises in mortgage rates during last year begin to drop out, inflation itself should fall back, maybe reaching 5½ per cent by the fourth quarter of this year and 4½ per cent by the second quarter of 1990. Some temporary slowdown in growth is probably inevitable as we get inflation back on a downward path and we are utterly determined to do that. How painful and marked the

slowdown has to be is very much in the hands of management through industry. It is up to them to ensure that the temporary rise in inflation during the first half of this year does not lead to an unwarranted rise in pay and other costs. A failure by industry to control its costs will make the slowdown more painful and can only be at the expense of future employment prospects.

34. Much has been written about the decline of personal sector saving. In fact this has been offset by higher company saving, and the total private sector saving ratio has changed relatively little. But with private sector investment in the economy growing rapidly there has inevitably been a large deterioration in the current account. The extent of this is uncertain and during last year the move into deficit may be exaggerated to some extent by the published figures. The preliminary estimate published for 1988 is £16 billion, but the "balancing item" in the balance of payments - which consists of unrecorded flows to the UK was even greater than the recorded deficit. Indeed at 4 per cent of national output it was at unprecedented levels. The Treasury exercise to produce more coherent accounts suggests that the recorded current account deficit may overstate the position by [£3-4 billion].

35. Nevertheless, the current account deficit remains a large one. The slowdown in domestic demand will lead to its reduction, but this is unlikely to occur quickly. The continued strong growth of investment could keep imports of capital goods high for the time being, and it may take a little while for the adverse effects on trade performance of very high capacity utilisation in some industries to unwind. Even though the deficit is likely to fall through the coming year, the outturn for 1989 as a whole might be much the same as that for 1988. Experience over the past year shows that there is no difficulty in financing a temporary current account deficit of this size so long as the Government is determined to maintain an appropriate monetary policy.

36. In part the outcome will depend upon developments in the rest of the world. The latest indicators suggest that activity in the major economies remains strong, though increases in short-term interest rates to counter rising inflation may lead to some slow down through 1989. GNP growth may fall from 4 per cent in 1988 to a still healthy 3 per cent this year.

37. One threat to this prospect is that the persistence of sizeable current account imbalances between the largest economies could lead to renewed turmoil in financial markets. Domestic demand growth in the US needs to slow, and the US Government needs to reduce its Budget deficit; at the same time, the surplus countries - Germany and Japan - need to remove the obstacles which restrict the growth of their domestic markets.

38. Monetary policy in the world economy, as in Britain, must remain the first bulwark against inflation. We must also look for continued international co-operation on exchange rates and policy to promote external stability and extend further the long period of expansion in the world economy now in its seventh year. I can assure the House that the UK will continue to play its full part in this co-operation.

39. Throughout the history of the MTFS the primary focus of fiscal policy has been the Public Sector Borrowing Requirement - or as it has now become the Public Sector Debt Repayment.

40. When we came to office the PSBR was almost 6 per cent of GDP - and had been virtually 10 per cent of GDP in 1976-76. This borrowing requirement was steadily reduced during the years of the MTFS and in 1987-88 we moved to repaying debt.

41. In last year's Budget I announced major tax reforms, including cuts in both the basic and higher rates of income tax. Yet despite this I budgeted for a Public Sector Debt Repayment last year of some £3 billion, or ¾ per cent of GDP. In the event, the public finances have turned out considerably stronger. The forecast I gave in the Autumn Statement was for a PSDR of

£10 billion, or 2 per cent of GDP. Our latest estimate comfortably exceeds even this - a debt repayment of some £14 billion.

42. No other major country enjoys a comparable surplus on its budget. The improvement owes something to the buoyancy of the economy. Tax revenues have been significantly higher than expected and public expenditure is likely to be some £x billion below the planning total we provided for. In addition we have had somewhat higher privatisation proceeds than originally planned. Even so this is a remarkable achievement following years of hard work in reducing the deficit by myself and my colleagues.

43. The massive repayment of public debt over the past 2 years 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 2 years mean that debt interest costs are lower by £x billion a year. Indeed, debt reduction on this scale means that in this year's Finance Bill I shall have to take a new power, not needed before, to enable gilts to be acquired by the NLF, for cancellation.

44. The dramatic improvement in the United Kingdom'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 buy-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.

45. Similarly it has proved possible to restructure part of the Government's foreign currency debt, launching an innovative and cost-effective programme of Treasury Bills denominated in ecu. The first experimental six-monthly tenders for these bills have proved extremely successful, and I can announce today that the programme will be continuing, at a level of around ecu 2½ billion.

46. Last year I set out the principle of a balanced budget over the medium term. This is a position in which the State makes no claim on the nation's saving, or on flows of finance from overseas.

47. There are bound to be fluctuations from year to year but it has always been a characteristic of our fiscal policy that it should be concerned with the medium term. Fiscal policy objectives are best set for the medium to long term and set to embrace tax and expenditure measures which improve the performance of the economy.

48. We have sought to resist those siren voices who would use fiscal policy in the vain attempt to manage demand. This would place a burden on fiscal policy it cannot meet. And we have sought to avoid unnecessary changes to tax rates; reductions have only been made when it was prudent to do so and we could be confident they could be sustained.

49. This medium-term focus and requirement to avoid unnecessary fluctuations in tax rates points to a cautious approach to policy this year despite the size of the debt repayment. There are many uncertainties about recent developments and where we are in the cycle. The return to a sustainable growth rate is likely to lead to some reversal of the favourable cyclical effects on public finances which we have recently experienced. But we cannot be sure of the size or timing of these effects. Given the prospect for a declining share of public expenditure in GDP we may well be in a position to reduce taxes. But given the uncertainties I have already mentioned I have decided to play safe and make no change in the overall tax burden. This means that I will be planning for another sizeable PSDR in the coming financial year; indeed one of the same size as I expect to achieve this year - £14 billion. Beyond 1989-90 I expect to see the public sector debt repayment revert gradually towards zero.

50. Even so, despite the unchanged PSDR this year, the natural tendency for the non-oil tax burden to rise as a result of fiscal drag means there is some scope to make adjustments to individual tax rates.

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Ch

A new intro, plus a few comments marked.
I realise Terry's piece completely omits any forward-looking MTFS stuff: target, money GDP, balanced Budget etc

AA

ALEX'S REVISED INTRO

1. I am today publishing the tenth edition of the Government's medium-term financial strategy. Setting economic strategy in a medium-term framework has been one of the central features of this Government's approach. It is one that has served us well and will continue to serve us well. It means - crucially - that we do not bend to every puff of wind that comes along: we resist the blandishments of those who urge reflation or deflation in automatic response to every new number that fashion dictates should assume special significance. Of course, if there are clear signs that the economy is being blown off course - most importantly if there are signs of a build-up of inflationary pressures - then we act, and act promptly. But that is within a general philosophy that the Government should set a sound medium-term framework and leave it to the private sector to operate with confidence within it.

2. The Government came to office with two central objectives: to defeat inflation and to breath life into a moribund economy. It had a clear strategy to achieve this. Monetary policy was to be used to bring inflation down. Supply side policies were to be used to remove restrictions, to free the economy and to stimulate

energy and effort - so as to create wealth and provide the conditions for non-inflationary growth. Fiscal policy was designed to bring the nation's accounts into balance, and within that to reform and reduce taxation while containing overall public expenditure and switching resources into priority programmes.

3. An economy cannot be transformed overnight. And it is often impossible to move forward on all fronts at once. In the early years of this Government our first great task was to stamp out the inflationary fires that had raged in the '70s, and had done such enormous damage to the British economy. Between 1974 and 1979 inflation averaged 15 per cent. By 1983 we had brought it down to 5 per cent, and that is what it has averaged since. [This is the answer to those who doubted that inflation could be controlled by the pursuit of a steady, disciplined monetary policy.]

4. It was not surprising that, in those early years, while the inflationary psychology was being broken, less progress would be made on improving the supply performance of the economy. But once business and industry had realised the dramatic changes being made to the economic climate, they responded with vigour and enthusiasm. As a result we are now well into an

Contradicts MTFS

unprecedented eighth year of steady, sustainable growth averaging over 3 per cent a year. Output in the United Kingdom has grown faster than in all the other major European countries during the '80s - a marked contrast with the two previous decades when the UK was at the bottom of the league.

5. Once again, it is not surprising that, during a period of particularly rapid growth, little further progress has yet been made in reducing inflation, though it is ~~a~~ in marked contrast to ~~either~~ earlier periods of rapid growth that underlying inflation has remained remarkably steady. It has moved up recently, and that is why I have tightened monetary policy to bring it down again, something I shall be discussing in more detail later. But it is evidence of the transformation of the British economy and of British economic policy that we have had a period of sustained rapid growth, with a dramatic and welcome fall in unemployment, without the surge to double digit inflation which killed off even short-lived upturns in the seventies.

Then continue with Terry's para 8

Alex

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See revised edn

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You should already have new para I did for Moira on world inflation

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?

(making the point that inflation picked up earlier in the UK than elsewhere, & as a result we tightened policy earlier).

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MISSING is any section on setting targets or anything at all on Money GDP.

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(repetition)

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34. Much has been written about the decline of personal sector saving. In fact this has been offset by higher company saving, and the total private sector saving ratio has changed relatively little. But with private sector investment in the economy growing rapidly there has inevitably been a large deterioration in the current account. The extent of this is uncertain and during last year the move into deficit may be exaggerated to some extent by the published figures. The preliminary estimate published for 1988 is £16 billion, but the "balancing item" in the balance of payments - which consists of unrecorded flows to the UK was even greater than the recorded deficit. Indeed at 4 per cent of national output it was at unprecedented levels. The Treasury exercise to produce more coherent accounts suggests that the recorded current account deficit may overstate the position by [£3-4 billion].

35. Nevertheless, the current account deficit remains a large one. The slowdown in domestic demand will lead to its reduction, but this is unlikely to occur quickly. The continued strong growth of investment could keep imports of capital goods high for the time being, and it may take a little while for the adverse effects on trade performance of very high capacity utilisation in some industries to unwind. Even though the deficit is likely to fall through the coming year, the outturn for 1989 as a whole might be much the same as that for 1988. Experience over the past year shows that there is no difficulty in financing a temporary current account deficit of this size so long as the Government is determined to maintain an appropriate monetary policy.

36. In part the outcome will depend upon developments in the rest of the world. The latest indicators suggest that activity in the major economies remains strong, though increases in short-term interest rates to counter rising inflation may lead to some slow down through 1989. GNP growth may fall from 4 per cent in 1988 to a still healthy 3 per cent this year.

37. One threat to this prospect is that the persistence of sizeable current account imbalances between the largest economies could lead to renewed turmoil in financial markets. Domestic demand growth in the US needs to slow, and the US Government needs to reduce its Budget deficit; at the same time, the surplus countries - Germany and Japan - need to remove the obstacles which restrict the growth of their domestic markets.

38. Monetary policy in the world economy, as in Britain, must remain the first bulwark against inflation. We must also look for continued international co-operation on exchange rates and policy to promote external stability and extend further the long period of expansion in the world economy now in its seventh year. I can assure the House that the UK will continue to play its full part in this co-operation.

39. Throughout the history of the MTFS the primary focus of fiscal policy has been the Public Sector Borrowing Requirement - or as it has now become the Public Sector Debt Repayment.

40. When we came to office the PSBR was almost 6 per cent of GDP - and had been virtually 10 per cent of GDP in 1976-76. This borrowing requirement was steadily reduced during the years of the MTFS and in 1987-88 we moved to repaying debt.

41. In last year's Budget I announced major tax reforms, including cuts in both the basic and higher rates of income tax. Yet despite this I budgeted for a Public Sector Debt Repayment last year of some £3 billion, or ¾ per cent of GDP. In the event, the public finances have turned out considerably stronger. The forecast I gave in the Autumn Statement was for a PSDR of

£10 billion, or 2 per cent of GDP. Our latest estimate comfortably exceeds even this - a debt repayment of some £14 billion.

42. No other major country enjoys a comparable surplus on its budget. The improvement owes something to the buoyancy of the economy. Tax revenues have been significantly higher than expected and public expenditure is likely to be some £x billion below the planning total we provided for. In addition we have had somewhat higher privatisation proceeds than originally planned. Even so this is a remarkable achievement, following years of hard work in reducing the deficit by myself and my colleagues.

43. The massive repayment of public debt over the past 2 years 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 2 years mean that debt interest costs are lower by £x billion a year. Indeed, debt reduction on this scale means that in this year's Finance Bill I shall have to take a new power, not needed before, to enable gilts to be acquired by the NLF, for cancellation.

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46. Last year I set out the principle of a balanced budget over the medium term. This is a position in which the State makes no claim on the nation's saving, or on flows of finance from overseas.

47. There are bound to be fluctuations from year to year but it has always been a characteristic of our fiscal policy that it should be concerned with the medium term. Fiscal policy objectives are best set for the medium to long term and set to embrace tax and expenditure measures which improve the performance of the economy.

48. We have sought to resist those siren voices who would use fiscal policy in the vain attempt to manage demand. This would place a burden on fiscal policy it cannot meet. And we have sought to avoid unnecessary changes to tax rates; reductions have only been made when it was prudent to do so and we could be confident they could be sustained.

49. This medium-term focus and requirement to avoid unnecessary fluctuations in tax rates points to a cautious approach to policy this year despite the size of the debt repayment. There are many uncertainties about recent developments and where we are in the cycle. The return to a sustainable growth rate is likely to lead to some reversal of the favourable cyclical effects on public finances which we have recently experienced. But we cannot be sure of the size or timing of these effects. Given the prospect for a declining share of public expenditure in GDP we may well be in a position to reduce taxes. But given the uncertainties I have already mentioned I have decided to play safe and make no change in the overall tax burden. This means that I will be planning for another sizeable PSDR in the coming financial year; indeed one of the same size as I expect to achieve this year - £14 billion. Beyond 1989-90 I expect to see the public sector debt repayment revert gradually towards zero.

50. Even so, despite the unchanged PSDR this year, the natural tendency for the non-oil tax burden to rise as a result of fiscal drag means there is some scope to make adjustments to individual tax rates.

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CLEAN PEM/TB

PEM/TB version

THE ECONOMIC BACKGROUND

This Government has now been in power for almost 10 years. And today I am publishing the tenth edition of the Medium Term Financial Strategy. It is an occasion for looking back and assessing achievements as well as charting the course for the future.

2. The Government came into office with two central objectives: to defeat inflation and to breathe life into a moribund economy. It had a clear strategy to achieve this. Monetary policy was to be used to bring inflation down. Supply side policies were to remove restrictions, to free the economy and to stimulate energy and effort - so as to create wealth and increase the rate of non-inflationary growth. Fiscal policy was designed to bring the nation's accounts into balance, and within that to reform and reduce taxation while containing public expenditure and setting clear priorities.

3. An economy cannot be transformed overnight. These policies can only work if consistently applied in the - medium term. The results can only be fully realised in the longer term. The Medium Term Financial Strategy expressed our intentions in unequivocal terms. For almost a decade it has provided a clear and disciplined

framework for business and industry which has seized the opportunity and completely changed its attitude. British companies are determined to survive in fiercely competitive world markets, and are equipped to do so. The improved ability of the economy to supply goods and services has been the key to the improvements in living standards we have been able to achieve.

4. The results have been impressive by any standards. In an increasingly open world economy, no nation can be insulated from the impact of events which take place beyond our shores. Events do not take the smooth path shown in economic models. What Governments have to do is to put the right economic policies in place, and stick to them. Provided they do that, they can survive the difficult times, and excel in the good ones.

5. This is what we have done and it has brought outstanding success.

6. Between 1974 and 1979 inflation averaged 15 per cent. Since 1983 it has averaged 5 per cent. This is the answer to those who doubted that inflation could be controlled by the pursuit of a steady, disciplined monetary policy.

7. This success against inflation has not been achieved at the expense of the growth of output. We are now well into an unprecedented eighth year of steady, sustainable growth averaging in excess of 3 per cent a year. Output in the UK has grown faster than 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.

8. The cornerstone of this dramatic improvement in performance has been a large and sustained improvement in productivity which for the economy as a whole has been ahead of all other major industrialised countries with the exception of Japan (and for manufacturing has exceeded even Japan).

9. 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.

10. And they enjoy better public services too. For while the Government has kept the growth of public expenditure within that of the economy as a whole, so that its share of national income has fallen, that has not prevented a substantial increase in expenditure in real terms and the increase has been directed to

?

priority services, such as health, law and order, and capital spending.

11. Of course as national income has grown so have consumers' expenditure and living standards - but this has not been just candy floss. Over the last 7 years, investment has grown almost twice as fast as consumption. In the previous 14 years consumption grew faster on all but three occasions. And it is not only at home that we have built up income-producing assets. The UK now has one of the largest net stocks of overseas assets in the world.

12. The last ten years, then, have been a time of extraordinary 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.

13. It is against this background that we can consider developments over the past 12 months. 1988 was a year of rapid growth throughout the world, largely because of a rapid growth of business investment. Output in the

major industrial countries may have risen by an average of 4 per cent and world trade in manufactures by 10 per cent. Growth exceeded expectations in each of the major countries; in most cases substantially so. Even those European economies that have been sluggish in recent years are now experiencing faster growth. Partly as a result of the strength of activity commodity prices have risen. Consumer price inflation has also edged up a little in a number of countries - emphasised by the remarkably uniform experience of faster than expected price increases in January. In response to the emerging signs of inflationary pressure monetary policy has been tightened in many countries.

14. Once again the UK economy also grew more rapidly than most of the other major economies, continuing our remarkable record of sustained growth. However it was a much more uneven year. Unemployment has fallen by more than half a million and is now lower than in most other major economies in Europe. Profitability rose to its highest levels since the 1960s. Productivity growth continued to outpace our own past performance and that of other countries. Companies are in a strong position and have been investing heavily to meet future demand.

15. A detailed assessment of the UK economy is clouded however by the large and growing inconsistencies that have appeared in our macroeconomic statistics. While two of our measures of national output have shown rapid growth, the third has been affected by under-recording of expenditure and has been showing a different picture, suggesting indeed that the output actually fell in the second half of the year. We are taking steps to improve the collection of statistics and the national accounts, but that is bound to be a lengthy process. In the meantime we have had to form the best view we can of what is really happening in the economy.

16. In order to provide a basis from which to understand developments this year, to compare them with the past, and to forecast next year the Treasury has had to make adjustments to the recorded figures to produce more coherent figures for 1988. These adjustments draw on the results of the CSO work and are described in the Red Book. While this exercise is essential to make sense of the past it cannot disguise the high degree of uncertainty. There is even greater uncertainty about the prospects for next year.

17. It looks as if we have now had a second successive year with GDP growth at about 4½ per cent,

CHECK

1st time for 6 successive yrs (1983-88 inc) @ 3% or better

[also wh. [illegible] 6 yr period - 1958-64 or 1982-88?]

the first time this has happened since ~~the mid-sixties~~. NO!
Manufacturing output has grown particularly rapidly, by 5½ per cent in 1987 and over 7 per cent in 1988. Manufacturing output is now 7 per cent above its previous peak in the first half of 1974. Within those totals domestic demand grew by some 7 per cent last year, mainly because of the strength of investment and stockbuilding, but also reflecting continued rapid growth in consumer spending.

18. Taking account both of the recorded figures and survey evidence, it seems likely that the growth of total fixed investment will have been well into double figures last year - the largest increase for almost 25 years.

19. In some respects however we have had too much of a good thing. Monetary growth has been too rapid. Domestic demand has grown faster than even the economy's improved capacity to supply, leading to inflationary pressures, which have appeared both directly in the pick-up of the underlying rate of inflation and indirectly in a sharp growth of imports and hence a widening current account deficit.

20. Consumers have seen their real incomes rise significantly and have felt more conficent about the future; as a result they have been preparec to finance their spending by borrowing more. Part of the borrowing boom has been due to the housing market. A significant house price bubble emerged last year and with it a rapid turnover in housing. It is likely this had a significant effect on consumption in general and spending on durables in particular.

21. As in the past this increase in inflationary pressure has been countered by a tightening of monetary policy. That is why we have the MTFS. It points to the need for policy action when things get off track in one way or another. Interest rates have been raised and we will stay high until inflation is clearly subsiding.

22. There are now increasing signs that this determined action has begun to be effective. Measured on a 12 month basis M0 growth will start the year above the top of this range, reflecting rapid growth in the spring and summer of 1988. However, the growth of M0 has slowed appreciably, and over the last six months the annualised growth has been very low. I am confident that the 12 month figures will before long come within the target range.

23. The growth of spending by households has been checked. The housing market has cooled down particularly in the South East, with both house prices and lending for house purchase rising much less rapidly than in the middle of last year, and showing signs of falling in some areas. And part of the effect of higher interest rates has yet to have its impact because monthly payments on many
mortgages are adjusted only once a year generally in the first four months of the year. So for some the full effect of last year's increases will not be felt until next month.

24. Retail sales have levelled off in the last 3 months, and sales of some consumer durables in particular have fallen. Indicators of consumer confidence suggest that expenditure growth in the year ahead will be modest. The personal sector savings ratio should as a result begin to recover.

25. Meanwhile, company sector saving remains high and the signs are that the very strong investment performance of the last two years will continue in 1989, though growth will probably be at a less heady pace. The rate of return on capital is at its highest level

for over twenty years, and the extra investment that this is generating will help to underpin the supply side improvements of recent years.

26. There should be no surprise at this result. The deregulation of financial markets has given households and companies the freedom to adjust their borrowing to suit their own preferences and for a while this has led to a faster growth of total credit.

27. But at the same time, changes in interest rates have become a more powerful weapon in the fight against inflation. They now impact on a much higher level of borrowing, and the effects are no longer muffled by direct controls.

28. As well as being a powerful instrument, interest rates are also well-directed in current circumstances. They are having an important influence in cooling the housing market, which has been a major force behind the strong growth in borrowing and consumers' expenditure over the past year. The greatest effect is in the south of England where inflationary pressures have arguably been strongest. And they are having a bigger impact on households, who are now substantial net borrowers, than

on companies who generally are now in far better financial shape than a few years ago.

29. It is the household sector that is most vulnerable to increases in short term interest rates. The company sector is well placed to benefit from the fact that long term interest rates
have remained remarkably stable, and well below short rates - an indication of the markets' confidence that inflation will be brought down.

30. I am very conscious of the effects of last year's rise in interest rates on individual home owners and other borrowers. But however unwelcome high interest rates are now they are far preferable to the damage that is done by high rates of inflation.

31. Even with a further strong growth of investment this year the slowdown in consumer spending growth is likely to lead to a fall in the growth of total domestic demand from 7 per cent in 1988 to 3 per cent in 1989. Growth through the year is forecast to be lower still at 2 per cent. As a result it is likely that growth of output too will be well below trend over the coming year. But even with relatively slow growth through the year GDP in 1989 could still be 2½ per cent higher than

1988. This may seem disappointing by the standards we have come to expect in the last few years. But it is a respectable figure, and with investment likely to remain high the medium-term growth prospects are good.

32. As is well known, in the short term higher interest rates exaggerate the published inflation rate because of the perverse inclusion of mortgage interest payments.

33. The latest rise in the mortgage rate will almost certainly lead to inflation as recorded by the RPI approaching 8 per cent for a while (although excluding mortgage interest payments the rate should remain well below 6 per cent). But as the effects of the rises in mortgage rates during last year begin to drop out, inflation itself should fall back, maybe reaching 5½ per cent by the fourth quarter of this year and 4½ per cent by the second quarter of 1990. Some temporary slowdown in growth is probably inevitable as we get inflation back on a downward path and we are utterly determined to do that. How painful and marked the slowdown has to be is very much in the hands of management through industry. It is up to them to ensure that the temporary rise in inflation during the first half of this year does not lead to an unwarranted rise in pay and other costs. A failure by industry to

control its costs will make the slowdown more painful and can only be at the expense of future employment prospects.

34. Much has been written about the decline of personal sector saving. In fact this has been offset by higher company saving, and the total private sector saving ratio has changed relatively little. But with private sector investment in the economy growing rapidly there has inevitably been a large deterioration in the current account. The extent of this is uncertain and during last year the move into deficit may be exaggerated to some extent by the published figures. The preliminary estimate published for 1988 is £16 billion, but the "balancing item" in the balance of payments - which consists of unrecorded flows to the UK was even greater than the recorded deficit. Indeed at 4 per cent of national output it was at unprecedented levels. The Treasury exercise to produce more coherent accounts suggests that the recorded current account deficit may overstate the position by [£3-4 billion].

35. Nevertheless, the current account deficit remains a large one. The slowdown in domestic demand will lead to its reduction, but this is unlikely to occur quickly. The continued strong growth of investment could keep

imports of capital goods high for the time being, and it may take a little while for the adverse effects on trade performance of very high capacity utilisation in some industries to unwind. Even though the deficit is likely to fall through the coming year, the outturn for 1989 as a whole might be much the same as that for 1988. Experience over the past year shows that there is no difficulty in financing a temporary current account deficit of this size so long as the Government is determined to maintain an appropriate monetary policy.

36. In part the outcome will depend upon developments in the rest of the world. The latest indicators suggest that activity in the major economies remains strong, though increases in short-term interest rates to counter rising inflation may lead to some slow down through 1989. GNP growth may fall from 4 per cent in 1988 to a still healthy 3 per cent this year.

37. One threat to this prospect is that the persistence of sizeable current account imbalances between the largest economies could lead to renewed turmoil in financial markets. Domestic demand growth in the US needs to slow, and the US Government needs to reduce its Budget deficit; at the same time, the surplus

countries - Germany and Japan - need to remove the obstacles which restrict the growth of their domestic markets.

38. Monetary policy in the world economy, as in Britain, must remain the first bulwark against inflation. We must also look for continued international co-operation on exchange rates and policy to promote external stability and extend further the long period of expansion in the world economy now in its seventh year. I can assure the House that the UK will continue to play its full part in this co-operation.

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41. In last year's Budget I announced major tax reforms, including cuts in both the basic and higher

rates of income tax. Yet despite this I budgeted for a Public Sector Debt Repayment last year of some £3 billion, or ¾ per cent of GDP. In the event, the public finances have turned out considerably stronger. The forecast I gave in the Autumn Statement was for a PSDR of

£10 billion, or 2 per cent of GDP. Our latest estimate comfortably exceeds even this - a debt repayment of some £14 billion.

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43. The massive repayment of public debt over the past 2 years 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 2 years mean that debt interest costs are lower by

£x billion a year. Indeed, debt reduction on this scale means that in this year's Finance Bill I shall have to take a new power, not needed before, to enable gilts to be acquired by the NLF, for cancellation.

44. The dramatic improvement in the United Kingdom'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 buy-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.

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which the State makes no claim on the nation's saving, or on flows of finance from overseas.

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49. This medium-term focus and requirement to avoid unnecessary fluctuations in tax rates points to a cautious approach to policy this year despite the size of the debt repayment. There are many uncertainties about recent developments and where we are in the cycle. The return to a sustainable growth rate is likely to lead to some reversal of the favourable cyclical effects

on public finances which we have recently experienced. But we cannot be sure of the size or timing of these effects. Given the prospect for a declining share of public expenditure in GDP we may well be in a position to reduce taxes. But given the uncertainties I have already mentioned I have decided to play safe and make no change in the overall tax burden. This means that I will be planning for another sizeable PSDR in the coming financial year; indeed one of the same size as I expect to achieve this year - £14 billion. Beyond 1989-90 I expect to see the public sector debt repayment revert gradually towards zero.

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ANNOTATED
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PEM | TB version

Ch/ This arrived latish so I have only had time to mark on my thoughts. Some passages are common to this & "annotated mpw" so that's worth a look.

mpw.

THE ECONOMIC BACKGROUND

[Needs beefing up but that can wait]

This Government has now been in power for almost 10 years. And today I am publishing the tenth edition of the Medium Term Financial Strategy. [It is an occasion for looking back and assessing achievements as well as charting the course for the future.]

Rephrase - all still true! Sounds like this about to be debunked.

officialspeak - expand.

?

2. The Government came into office with two central objectives: to defeat inflation and to breathe life into a moribund economy. It had a clear strategy to achieve this. Monetary policy was to be used to bring inflation down. Supply side policies were to remove restrictions, to free the economy and to stimulate energy and effort - so as to create wealth and increase the rate of non-inflationary growth. Fiscal policy was designed to bring the nation's accounts into balance, and within that to reform and reduce taxation ~~while~~ and containing public expenditure and setting clear priorities.

Reads oddly - apologetic. As if postponing "the results". 10 years is a longer term, and results are there. Take credit

3. An economy cannot be transformed overnight. These policies can only work if consistently applied in the - medium term. The results can only be fully realised in the longer term. The Medium Term Financial Strategy expressed our intentions in unequivocal terms. For almost a decade it has provided a clear and disciplined

Cd all be much expanded. And more emphasis on supply side. [Which will be ? more how British companies see it.]

framework for business and industry which has seized the opportunity and completely changed its attitude. British companies are determined to survive in fiercely competitive world markets, and are equipped to do so. The improved ability of the economy to supply goods and services has been the key to the improvements in living standards we have been able to achieve.

Don't like. Prefer "supply response".

4. The results have been impressive by any standards. [In an increasingly open world economy, no nation can be insulated from the impact of events which take place beyond our shores.] Although Events do not take the smooth path shown in economic models, What Governments have to do is to put the right economic policies in place, and stick to them. Provided they do that, they can survive the difficult times, and excel in the good ones.

5. This is what we have done and it has brought outstanding success.

6. Between 1974 and 1979 inflation averaged 15 per cent. Since 1983 it has averaged 5 per cent. This is the answer to those who doubted that inflation could be controlled by the pursuit of a steady, disciplined monetary policy.

double[1] negative

7. This success against inflation has not been achieved at the expense of the growth of output. We are now well into an unprecedented eighth year of steady, sustainable growth averaging in excess of 3 per cent a year. Output in the UK has grown faster than 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.

needs light touch

8. The cornerstone of this dramatic improvement in performance has been a large and sustained improvement in productivity which for the economy as a whole has been ahead of all other major industrialised countries with the exception of Japan (and for manufacturing has exceeded even Japan).

9. 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.

"the nation" or "we all"

10. And ~~they~~ enjoy better public services too. For while the Government has kept the growth of public expenditure within that of the economy as a whole, so that its share of national income has fallen, that has not prevented a substantial increase in expenditure in real terms and the increase has been directed to

too heavy for here. Save for fiscal pol.

(2) double negative!

priority services, such as health, law and order, and capital spending.

Substantially mine.

Good.

11. Of course as national income has grown so have consumers' expenditure and living standards - but this has not been just candy floss. Over the last 7 years, investment has grown almost twice as fast as consumption. In the previous 14 years consumption grew faster on all but three occasions. And it is not only at home that we have built up income-producing assets. The UK now has one of the largest net stocks of overseas assets in the world.

need more user-friendly link

?

12. The last ten years, then, have been a time of extraordinary 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.

13. It is against this background that we can consider developments over the past 12 months. 1988 was a year of rapid growth throughout the world, largely because of a rapid growth of business investment. Output in the

might be worth suppressing to make UK shine rather more major industrial countries may have risen by an average of 4 per cent and world trade in manufactures by 10 per cent. Growth exceeded expectations in each of the major countries; in most cases substantially so. Even those European economies that have been sluggish in recent years are now experiencing faster growth. Partly as a result of the strength of activity commodity prices have risen. Consumer price inflation has also edged up a little in a number of countries - emphasised by the remarkably uniform experience of faster than expected price increases in January. In response to the emerging signs of inflationary pressure monetary policy has been tightened in many countries.

quite countr- & figs (nsh) ([illegible])

cf UK?

14. Once again the UK economy also grew more rapidly than most of the other major economies, continuing our remarkable record of sustained growth. However it was a much more uneven year. Unemployment has fallen by more than half a million and is now lower than in most other major economies in Europe. Profitability rose to its highest levels since the 1960s. Productivity growth continued to outpace our own past performance and that of other countries. Companies are in a strong position and have been investing heavily to meet future demand.

That's how it looks to us, perhaps. But not to outside world. In any case what follows does not demonstrate this. Too much ≠ uneven.

Sounds like bad news. Obscured? made more difficult?

15. A detailed assessment of the UK economy is clouded however by the large and growing inconsistencies that have appeared in our macroeconomic statistics. While two of our measures of national output have shown rapid growth, the third has been affected by under-recording of expenditure and has been showing a different picture, suggesting [indeed], even that [the] output actually fell in the second half of the year. We are taking steps to improve the collection of statistics and the national accounts, but that is bound to be a lengthy process. In the meantime we have had to form the best view we can of what is really happening in the economy.

jargon?

16. In order to provide a basis from which to understand developments this year, to compare them with the past, and to forecast next year the Treasury has had to make adjustments to the recorded figures to produce more coherent figures for 1988. These adjustments draw on the results of the CSO work and are described in the Red Book. While this exercise is essential to make sense of the past it cannot disguise the high degree of uncertainty. There is even greater uncertainty about the prospects for next year.

ominous

17. It looks as if we have now had a second successive year with GDP growth at about 4½ per cent,

not, perhaps, entirely helpful. "unprecedented boom"?

the first time this has happened since the mid-sixties. Manufacturing output has grown particularly rapidly, by 5½ per cent in 1987 and over 7 per cent in 1988. Manufacturing output is now 7 per cent above its previous peak in the first half of 1974. Within those totals domestic demand grew by some 7 per cent last year, mainly because of the strength of investment and stockbuilding, but also reflecting continued rapid growth in consumer spending.

Cabinet paper speak

18. Taking account both of the recorded figures and those survey evidence, it seems likely that the growth of total fixed investment will have been well into double figures last year - the largest increase for almost 25 years.

Sounds v. shifty.

19. In some respects however we have had too much of a good thing. Monetary growth has been too rapid. Domestic demand has grown faster than even the economy's improved capacity to supply, leading to inflationary pressures, which have appeared both directly in the pick-up of the underlying rate of inflation and indirectly in a sharp growth of imports and hence a widening current account deficit.

The right thought but, I still feel, too slangy for B. speech.

don't like this formula. Prefer my own [para 20] with investment > ~~spending~~ saving = c a/c def.

[obvious riposte: tax cuts.]

20. Consumers have seen their real incomes rise significantly and have felt more conficent about the future; as a result they have been preparec to finance their spending by borrowing more. Part of the borrowing boom has been due to the housing market. A significant house price bubble emerged last year and with it a rapid turnover in housing. It is likely this had a significant effect on consumption in general and spending on durables in particular.

explain washing machines, etc...

21. As in the past the response is this increase in inflationary pressure has been countered by a tightening of monetary policy. That is why we have the MTFS. It points to the need for policy action when things get off track in one way or another. Interest rates have been raised and we will stay high until inflation is clearly subsiding.

Expand

?

v long

22. There are now increasing signs that this determined action has begun to be effective. Measured on a 12 month basis M0 growth will start the year above the top of this range, reflecting rapid growth in the spring and summer of 1988. However, the growth of M0 has slowed appreciably, and over the last six months the annualised growth has been very low. I am confident that the 12 month figures will before long come within the target range.

must remember to set one! I think Terry's word processor may have eaten a paragraph here!

23. The growth of spending by households has been checked. The housing market has cooled down particularly in the South East, with both house prices and lending for house purchase rising much less rapidly than in the middle of last year, and showing signs of falling in some areas. And part of the effect of higher interest rates has yet to have its impact because monthly payments on many

stabilising in most areas

mortgages are adjusted only once a year generally in the first four months of the year. So for some the full effect of last year's increases will not be felt until next month.

in Jan or April

24. Retail sales have levelled off in the last 3 months, and sales of some consumer durables in particular have fallen. Indicators of consumer confidence suggest that expenditure growth in the year ahead will be modest. The personal sector savings ratio should as a result begin to recover.

i.e. "people are miserable"

interest rates → spell out

25. Meanwhile, company sector saving remains high and the signs are that the very strong investment performance of the last two years will continue in 1989, though growth will probably be at a less heady pace. The rate of return on capital is at its highest level

pejorative

for over twenty years, and the extra investment that this is generating will help to underpin the supply side improvements of recent years.

?

See my minute. Difficult to pull off.

26. There should be no surprise at this result. The deregulation of financial markets has given households and companies the freedom to adjust their borrowing to suit their own preferences and for a while this has led to a faster growth of total credit.

This, too, is quite sophisticated but cd be done.

Will audience understand?

27. But at the same time, changes in interest rates have become a more powerful weapon in the fight against inflation. They now impact on a much higher level of borrowing, and the effects are no longer muffled by direct controls.

28. As well as being ~~a~~ powerful [instrument,] interest rates are also well-directed in current circumstances. They are having an important influence in cooling the housing market, which has been a major force behind the strong growth in borrowing and consumers' expenditure over the past year. The greatest effect is in the south of England where inflationary pressures have arguably been strongest. And they are having a bigger impact on households, who are now substantial net borrowers, than

on companies who generally are now in far better financial shape than a few years ago.

Want a more neutral word - "affected by": and must associate with statement that this is as should be.

29. It is the household sector that is most vulnerable to increases in short term interest rates. The company sector is well placed to benefit from the fact that long term interest rates

have remained remarkably stable, and well below short rates - an indication of the markets' confidence that inflation will be brought down.

Needs a bit more colour/ sympathy.

30. I am very conscious of the effects of last year's rise in interest rates on individual home owners and other borrowers. But however unwelcome high interest rates are now they are far preferable to the damage that is done by high rates of inflation.

How about some Money GDP here?

In any case v. difficult to follow.

31. Even with a further strong growth of investment this year the slowdown in consumer spending growth is likely to lead to a fall in the growth of total domestic demand from 7 per cent in 1988 to 3 per cent in 1989. Growth through the year is forecast to be lower still at 2 per cent. As a result it is likely that growth of output too will be well below trend over the coming year. But even with relatively slow growth through the year GDP in 1989 could still be 2½ per cent higher than

1988. This may seem disappointing by the standards we have come to expect in the last few years. But it is a respectable figure, and with investment likely to remain high the medium-term growth prospects are good.

32. As is well known, in the short term higher interest rates exaggerate the published inflation rate because of the perverse inclusion of mortgage interest payments.

33. The latest rise in the mortgage rate will almost certainly lead to inflation as recorded by the RPI approaching (a peak of) 8 per cent for a while (although excluding mortgage interest payments the rate should will remain below 6 per cent). But from the summer onwards after [illegible] ~~as the effects of the rises in mortgage rates during last year begin to drop out, inflation itself~~ should fall back, maybe reaching 5½ per cent by the fourth quarter of this year and 4½ per cent by the second quarter of 1990. Some temporary slowdown in growth is probably inevitable as we get inflation back on a downward path and we are utterly determined to do that. How painful and marked the slowdown has to be is very much in the hands of management through industry. It is up to them to ensure that the temporary rise in inflation during the first half of this year does not lead to an unwarranted rise in pay and other costs. A failure by industry to

i.e it will be painful + marked, only matter of degree?!

which? ←

people prefer months to quarters

v important to get across that slowdown in growth ≠ slump control its costs will make the slowdown more painful and can only be at the expense of future employment prospects.

Different link? This now well covered in Section II.

34. Much has been written about the decline of personal sector saving. In fact this has been offset by higher company saving, and the total private sector saving ratio has changed relatively little. But with private sector investment in the economy growing rapidly there has inevitably been a large deterioration in the current account. The extent of this is uncertain and during last year the move into deficit may be exaggerated to some extent by the published figures. The preliminary estimate published for 1988 is £16 billion, but the "balancing item" in the balance of payments - which consists of unrecorded flows to the UK - was even greater than the recorded deficit. Indeed at 4 per cent of national output it was at unprecedented levels. The Treasury exercise to produce more coherent accounts suggests that the recorded current account deficit may overstate the position by [£3-4 billion].

already done this once. §19

strengthen

better make clear this is the b.i. not the c a/c def!

35. Nevertheless, the current account deficit remains a large one. The slowdown in domestic demand will lead to its reduction, but this is unlikely to occur quickly. The continued strong growth of investment could keep

Again, cd explain in terms of inv. & saving.

imports of capital goods high for the time being, and it may take a little while for the adverse effects on trade performance of very high capacity utilisation in some industries to unwind. Even though the deficit is likely to fall through the coming year, the outturn for 1989 as a whole might be much the same as that for 1988. Experience over the past year shows that there is no difficulty in financing a temporary current account deficit of this size so long as the Government is determined to maintain an appropriate monetary policy.

does not sound like you.

which this Govt is!

Explain?

36. In part the outcome will depend upon developments in the rest of the world. The latest indicators suggest that activity in the major economies remains strong, though increases in short-term interest rates to counter rising inflation may lead to some slow down through 1989. GNP growth may fall from 4 per cent in 1988 to a still healthy 3 per cent this year.

pot/kettle

37. One threat to this prospect is [that the persistence of sizeable current account imbalances between the largest economies could lead to] renewed turmoil in financial markets. Domestic demand growth in the US needs to slow, and the US Government needs to reduce its Budget deficit; at the same time, the surplus

Shorten? drop?

countries - Germany and Japan - need to remove the obstacles which restrict the growth of their domestic markets.

38. Monetary policy in the world economy, as in Britain, must remain the [first] bulwark against inflation. We must also look for continued international co-operation on exchange rates and policy to promote external stability and extend further the long period of expansion in the world economy now in its seventh year. I can assure the House that the UK will continue to play its full part in this co-operation.

[What's the 2nd?]

cf our painful/marked slowdown

Rejig so end on some remark about Mon. pol Then COBO.

39. Throughout the history of the MTFS the primary focus of fiscal policy has been the Public Sector Borrowing Requirement - or as it has now become the Public Sector Debt Repayment.

40. When we came to office the PSBR was almost 6 per cent of GDP - and had been virtually 10 per cent of GDP in 1976-76. This borrowing requirement was steadily reduced during the years of the MTFS and in 1987-88 we moved to repaying debt.

41. In last year's Budget I announced major tax reforms, [including cuts in both the basic and higher

which the State makes no claim on the nation's saving, or on flows of finance from overseas.

47. There are bound to be fluctuations from year to year but it has always been a characteristic of our fiscal policy that it should be concerned with the medium term. Fiscal policy objectives are best set for the medium to long term and set to embrace tax and expenditure measures which improve the performance of the economy.

I don't get this.

and succeeded!

48. We have sought to resist those siren voices who would use fiscal policy in the vain attempt to manage demand. This would place a burden on fiscal policy it cannot meet. And we have sought to avoid unnecessary changes to tax rates; tax reductions have only been made when it was prudent to do so and we could be confident they could be sustained.

?

49. This medium-term focus and requirement to avoid unnecessary fluctuations in tax rates points to a cautious approach to policy this year despite the size of the debt repayment. There are many uncertainties about recent developments and where we are in the cycle. The return to a sustainable growth rate is likely to lead to some reversal of the favourable cyclical effects

What wd a necessary fluctuation be?

Make positive - sustainable reductions

on public finances which we have recently experienced. But we cannot be sure of the size or timing of these effects. Given the prospect for a declining share of public expenditure in GDP we may well be in a position to reduce taxes. But given the uncertainties I have already mentioned I have decided to play safe and make no change in the overall tax burden. This means that I will be planning for another sizeable PSDR in the coming financial year; indeed one of the same size as I expect to achieve this year - £14 billion. Beyond 1989-90 I expect to see the public sector debt repayment revert gradually towards zero.

50. Even so, despite the unchanged PSDR this year, the natural tendency for the non-oil tax burden to rise as a result of fiscal drag means there is some scope to make adjustments to individual tax rates.

x [tax reform]
continue process

TERRY ON ECONOMIC BACKGROUND

CONFIDENTIAL

THE ECONOMIC BACKGROUND

This Government has now been in power for almost 10 years. And today I am publishing the tenth edition of the Medium Term Financial Strategy. It is an occasion for looking back and assessing achievements as well as charting the course for the next ten years.

2. At the very heart of the Government's strategy has been the determination to bear down on inflation and the MTFS has provided a clear and disciplined nominal framework within which we have pursued this strategy.

3. 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 side response of the economy has been the key to the improvements in living standards we have been able to achieve.

4. 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.

5. This describes exactly what has been achieved in the UK and it has brought outstanding success.

6. Between 1974 and 1979 inflation averaged 15 per cent. Since 1982 it has averaged 5 per cent. This is the answer to those who doubted that inflation could be controlled by the pursuit of a steady, disciplined monetary policy.

7. And success against inflation has not been achieved at the expense of the growth of output. We have now had an unprecedented eight years of steady, sustainable growth averaging in excess of 3 per cent a year. Output in the UK has grown faster than 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.

8. The cornerstone of this dramatic improvement in performance has been a large and sustained improvement in productivity which for the economy as a whole has been ahead of all other major industrialised countries with the exception of Japan.

9. 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.

10. 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.

11. And while total consumption has risen rapidly over the past year - by some x per cent - fixed investment has grown even more rapidly. 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. And it is not only at home that we have seen the accumulation of assets. The UK now has one of the largest stocks of net overseas assets in the world.

12. 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 case 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.

13. It is against this background that we can consider developments over the past 12 months. Once again the UK economy grew rapidly, continuing the remarkable record of sustained growth.

14. In detail it was a more uneven year. Unemployment has fallen by more than half a million. Profitability rose to its highest levels since the 1960s. Productivity growth continued to outpace our own past performance and that of other countries. Companies are in a strong position and have been investing heavily to meet future demand.

15. But if anything we have had too much of a good thing. Domestic demand has grown faster than the economy's capacity to supply, leading to inflationary pressures, manifesting itself both directly in the pick-up of the underlying rate of inflation and indirectly in a sharp growth of imports and hence a widening current account deficit.

16. Growth in the rest of the world was also more buoyant last year than forecast a year ago, largely because of a rapid growth of business investment. Output in the G7 may have risen by an average of 4 per cent and world trade in manufactures by 10 per cent. Growth exceeded expectations in each of the major industrial countries; in most cases substantially so. Even those European economies that have been sluggish in recent years are now experiencing faster growth. Partly as a result of the strength of activity, consumer price inflation edged up a little in a number of countries and most commodity prices have risen. As a response monetary policy has been tightened in many countries.

17. The UK has experienced a sharper acceleration of output than most of its G7 partners. Unemployment has fallen faster than in any other major country and is now lower than in most of the major European economies, though still higher than in Japan and the US. It looks as if we have now had a second successive year with GDP growth at about 4½ per cent, the first time this has happened since the ~~mid-sixties~~. Manufacturing output has grown

for over 20 yrs.

particularly rapidly, by 5½ per cent in 1987 and over 7 per cent in 1988. Manufacturing output is now [ ] per cent above its previous peak in 1974.

18. Unscrambling the composition of this growth is very complicated because of the difficulties with recent macroeconomic statistics. The expenditure components of GDP sum to only 2½ per cent growth. By the second half of the year the difference between the level of GDP as measured by output and expenditure measures was nearly 7 per cent - the equivalent of more than two years' growth in normal circumstances. There were also enormous discrepancies, or balancing items, in the main sectoral accounts, adding to the difficulties involved in interpreting the behaviour in particular sectors.

19. In a recent article the CSO have attempted to produce a more coherent set of accounts for 1985, 1986 and 1987 but so far they have been unable to extend this exercise to cover 1988. In order to provide a basis from which to understand developments this year, and to forecast next year the Treasury has made its own adjustment to the recorded figures to produce more coherent figures for 1988. These adjustments draw on the results of the CSO reconciliation exercise and are described fully in the Red Book. More detail is set out in a separate Treasury press notice. While this exercise is essential to make sense of the past it cannot disguise the degree of uncertainty. And this means there is even greater uncertainty about the prospects for next year.

20. The adjusted figures suggest that domestic demand grew by some 7 per cent last year, mainly because of the strength of investment, but also reflecting continued rapid growth in consumer spending.

21. The recorded growth of fixed investment is only 6½ per cent. But in the light of past revisions and the discrepancies in the figures it seems likely that the growth of total fixed investment will have been well into double figures last year - the largest increase for almost 25 years. Whatever the truth it is clear that investment has grown rapidly.

22. Consumers have seen their real incomes rise significantly and have felt more confident about the future; as a result they have been prepared to finance their spending by borrowing more. Part of the borrowing boom has been due to the housing market. A significant house price bubble emerged last year and with it a rapid turnover in housing. It is likely this had a significant effect on consumption in general and spending on durables in particular.

23. As already mentioned, the increase in demand pressures has led to some increase in inflationary pressure. This has been countered by the only effective means: a tightening of monetary policy. There are now increasing signs that this firm action has begun to check the growth of spending by households. The growth of the narrow measure of the money supply, M0, has begun to slow down appreciably. The housing market has cooled down markedly, particularly in the South East, with both house prices and lending for house purchase rising much less rapidly than in the middle of last year, and showing signs of falling in some areas. And part of the effect of higher interest rates has yet to have its impact. Those mortgages that are adjusted only once a year will only now be feeling the effects of last year's increases in interest rates.

Some [illegible]

24. The growth of retail sales in general has moderated, and sales of some consumer durables have fallen. Indicators of consumer confidence suggest that expenditure growth in the year ahead will be modest. The personal sector savings ratio should as a result begin to recover.

25. Meanwhile, company sector saving remains high and the signs are that the very strong investment performance of the last two years will continue in 1989, though growth will probably be at a less heady pace. The rate of return on capital is at its highest level for over twenty years, and the extra investment that this is generating will help to underpin the supply side improvements of recent years.

26. Even with a further strong growth of investment this year the slowdown in consumer spending growth is likely to lead to a fall in the growth of total domestic demand in 1989 to 3 per cent. Growth in the year to the first half of 1990 is forecast to be lower still at 2 per cent. Given this slowdown of domestic demand it is likely that growth will be well below trend over the coming year. But even with relatively slow growth through the year GDP in 1989 could still be 2½ per cent higher than 1988. This may seem disappointing by the standards we have come to expect in the last few years. But it is a respectable figure, and with investment likely to remain high the medium-term growth prospects are good.

27. As is well known, in the short term higher interest rates exaggerate the published inflation rate because of the perverse inclusion of mortgage interest payments.

28. The latest rise in the mortgage rate will almost certainly lead to inflation as recorded by the RPI approaching 8 per cent for a while (although excluding mortgage interest payments the rate should remain below 6 per cent). But as the effects of the rises in mortgage rates during last year begin to drop out, RPI inflation itself should fall back, maybe reaching 5½ per cent by the fourth quarter of this year and 4½ per cent by the second quarter of 1990. It is vital for the longer run performance of the economy that the temporary rise in inflation during the first half of this year does not lead to a pay explosion.

29. The current account of the balance of payments reflects the interplay of private sector investment and saving. The declining personal sector saving has been offset by higher company saving, and the total private sector saving ratio has changed relatively little. But in these circumstances a rising share of investment in the economy has inevitably involved a large deterioration in the current account. The extent of this is uncertain and during last year the move into deficit may be exaggerated to some extent by the published figures. The preliminary estimate published for 1988 is £14½ billion, but the "balancing item" in the balance of payments - which consists of unrecorded flows to the UK - for the

first three quarters was even greater than the recorded deficit. The Treasury exercise to produce more coherent accounts suggests that the recorded current account deficit may overstate the position by £3-4 billion.

30. Nevertheless, the current account deficit remains a large one. The slowdown in domestic demand will lead to its reduction, but this is unlikely to occur quickly. The continued strong growth of investment could keep imports of capital goods high for the time being, and it may take a little while for the adverse effects on trade performance of very high capacity utilisation in some industries to unwind. Even though the deficit could well fall during the coming year, the outturn for 1989 as a whole might be much the same as that for 1988. Experience over the past year shows that there is no difficulty in financing a temporary current account deficit of this size so long as the Government is determined to maintain an appropriate monetary policy.

31. In part the outcome will depend upon developments in the rest of the world. The latest indicators suggest that activity in the major economies remains strong, though increases in short-term interest rates to counter rising inflation may lead to some slow down through 1989. GNP growth may fall from 4 per cent in 1988 to a still healthy 3 per cent this year.

32. One threat to this prospect is that the persistence of sizeable current account imbalances between the largest economies could lead to renewed turmoil in financial markets. Domestic demand growth in the US needs to slow, and the US Government needs to reduce its Budget deficit; at the same time, the surplus countries - Germany and Japan - need to remove the obstacles which restrict the growth of their domestic markets.

33. To this end 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.

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MR CULPIN

cc Mr Gilhooly
Miss Hay
Mr Michie
Mr Macpherson
Mr Flanagan
Mr Ford

BUDGET STATEMENT

Bits of the tax section attached. Grateful if someone could have a look at them, befor I put them to the Chancellor tonight, since much of it I have just invented off the top of my head.

The stuff I have attached is meant to be pretty much continuous speech up to and including life assurance (except that the pensions section is still in notespeak). After that point, I have only attached passages I have composed myself - and otherwise I shall simply be scissors and pasting what I've been given, and adding in the missing links.

[signature]

BUDGET SECRET

W/F Sox

CHANCELLOR

BUDGET PRESENTATION

I agree with Robert that the popular message should be " £3 off, nothing on" combined with the distributional point that this is of most benefit to the lower paid and the stern anti-inflationary stance.

Of the subsidiary themes set out in his note of 16 February, I would highlight the following: share ownership and participation,pensioners [where we can point to the package for poorer pensioners as an offset to the lack of the £3],small firms and the self-employed.

The most difficult questions on the tax side are probably:

- why nothing off income tax?

-how can it be right to "reduce" prices of drink and tobacco?Is it not cynical manipulation of the RPI at the cost of lives ?

-have you given up on radical reform of taxation of savings?

But the more difficult issues arise this year on the economic front. The questions include:

-are you not forecasting a fierce recession with falling manufacturing output and rising unemployment?

-forecast shows we are back to stop-go?

-if a "giveaway" of under £2 billion is all that is prudent this year with the economy already slowing down, wasn't £4 billion a mistake last year?

The key question here is the tone of the answers ie. are we giving the impression that the action has been taken and things should be getting better from now on, or are we saying that we do need a period of restraint to get back on track?

Jn Gieve

JOHN GIEVE

GIEVE PRESENTATION

BUDGET SECRET

Alternative: Pension schemes only qualify ... This means that ...

① Savings for

① Green Paper

rate of income tax. Their investors will then get full credit for all the tax the trusts pay.

58. I now turn to pensions.

The tax relief on contributions means that people can put money into pension funds out of untaxed income. And the build-up of this money is untaxed in the hands of pension funds.

59. Of all forms of savings, perhaps the most favourable tax treatment is that accorded to pension schemes. ~~This~~ A relief of this generosity is necessarily circumscribed by Inland Revenue rules. But at the moment these attempt to constrain not just the tax relief but the pension itself. Pension schemes only qualify for tax relief if they meet certain conditions, notably that they may not exceed ⅔ of final salary: and if they fall foul of these conditions they lose all relief.

60. ~~But~~ As a result, tax law has effectively come to ~~set a limit on~~ limit the overall pension someone can receive. This is neither desirable nor necessary. 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 tax privileges. Thus, employers will henceforth be free to provide whatever pensions package they believe necessary to recruit and reward their employees. P. w/o limit t.r. unlimited.

B

Deregulating pensions in this way

61. ~~This change~~ enables me to deal with the ~~another~~ anomaly in the existing tax reliefs for pensions; namely that ~~there is no limit to them at all, in cash terms:~~ the present rules, restrictive as they are, do not put a cash ~~upper limit~~ ceiling on relief [redacted]: the higher an individual's salary, the greater the pension they can have, and the more tax privilege relief that goes with it. Of course, someone who receives a very

? tax privilege

high salary will expect a good pension. 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 effectively available with no ~~upper limit~~ overall cash ceiling whatever.

62. 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.

63. I therefore propose to set a limit on the pensions which may be paid from tax-approved occupational schemes, based on ~~earnings~~ final salary 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.

64. 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

wrong. I have correction somewhere.

now be complete freedom to provide benefits above the Inland Revenue limits, though without the tax advantages.

drop? No.

65. The introduction of this ceiling on tax relief also enables me to simplify and improve the rules for the majority of pension scheme members, in particular to improve the conditions under which people can take early retirement.

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

drop. leave for FST!

67. Furthermore, if AVC investments perform very well, occupational pensions may at present have to be reduced to keep total benefits within the permitted limits. I propose that in future any surplus AVC funds should be returned to employees, subject to a special tax charge. This will remove the penalty on good investment performance.

87

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

69. 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.

70. 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 propose to~~ remove the obstacles to greater individual involvement in personal pension plans.

71. 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

"the middle aged"

[JOKE]

contributions until later on in their working life. It will also improve the position of personal pensions in relation 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.

72. 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 through AVCs.

73. 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.

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

chex.rm/mw/18

~~ACJA~~

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FROM: MISS M P WALLACE
DATE: 6 March 1989

PS/FINANCIAL SECRETARY

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]

Moira
A few minor comments
Abs

BUDGET STATEMENT: TAX SECTION

The Chancellor was most grateful to all those who commented on last week's version of the tax section (my minute of 27 February). I attach his latest version, with the amendments side-lined.

2. There are one or two specific points which you might like to note.

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(i) The Chancellor has decided, on balance, not to include Keith, so the Financial Secretary may want to mention it in his speech.

(ii) The Chancellor has also decided not to mention the consultative document on swaps in the Budget speech.

(iii) He has deleted the bulk of what was formerly paragraph 41 - the explanation of why other PEP modifications had been ruled out - but he feels this might usefully be developed for defensive briefing.

(iv) For the moment, he has retained a paragraph on deep discounted bonds, with the other CGT changes. But, depending on how he revises the first section of the speech, it is possible that these could be replaced by an allusion in a more general section on COBO.

3. He would be grateful if any further comments on this revise could reach me be close tomorrow, Tuesday 7 March.

MW

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 is very much narrower in scope than the present Official Secrets Act. In particular, it does not cover information in the possession of either the Inland Revenue or Customs & Excise concerning the private affairs of specific taxpayers.

3. I am sure that the whole House will agree that it is essential for taxpayer confidentiality to be 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 Revenue Departments to reveal information about the private affairs of a specific 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 both 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. Ever since the corporation tax reform I introduced in 1984, the rate of corporation tax for small companies, defined for this purpose as those with annual profits of less than £100,000, has 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 £100,000 and £½ million the effective rate of tax gradually rises from 25 to 35 per cent.

8. I propose to keep the small companies rate in line with the basic rate of income tax for 1989-90 and to leave the main corporation tax rate unchanged . But I propose to increase the small companies' rate band substantially, by 50 per cent.

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9. Thus the small companies' rate 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 benefit of the small companies rate.

This is very × disjointed - minimalist amendments suggested

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

11. For employees, I [also] have to set the scales for the private use of company cars. This remains far and away the most widespread benefit in kind. When I doubled the car scales in last year's Budget, I made it clear that this still left it significantly undertaxed.

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12. Accordingly, I propose to increase the car scales by one third for 1989-90. The yield from this will be £160 million in 1989-90 and £200 million in 1990-91. There will be no change in the fuel scales.

[13. There is one further tightening in the general area of employee benefits which I believe it right to make. There is an extra statutory concession which exempts from income tax additional housing costs paid by an employer when an existing employee moves to a higher cost area. This relief blunts the market forces which should be leading employers to relocate in lower cost areas, and I therefore propose that it should be withdrawn. Anyone who has moved, or entered into a commitment to move, before today will, however, continue to receive the relief. At the same time I propose to put on a proper statutory footing the more important and fully justified extra statutory concession exempting from tax payments made by an employer to cover an employee's inevitable moving costs when he is required to move house because of his job.]

14. 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.

on business taxation

15. Finally, I have two major simplifications to propose, both of which follow from the income tax reforms I introduced last Budget.

16. One of the many undesirable features of an income tax system with several higher rates was that since a taxpayer's marginal rate could well be very different in different years, the question of which year income was attributed to made a great deal of difference. To remove the scope for manipulation, the rule was that income was taxed in the year to which it related, on an accruals basis.

17. This is still the basis of Schedule E and poses no problem at all for the vast majority of employees, who are on PAYE. But for about half a million people,

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mainly directors, who do not receive their income in the year to which it formally relates, it causes untold complication, with needless form-filling long after the tax year is over. With only one higher rate of income tax, the potential for this abuse is gone. I therefore propose that income tax under Schedule E should in future be assessed on a receipts basis, with the simple principle that you pay the tax when you receive the income. Initially, this will have a transitional cost of £80 million, but in the long term it will yield both extra revenue and significant Inland Revenue staff savings.

18. The reduction in the top rate of income tax to 40 per cent in last year's Budget also enables me to make a major simplification of the tax treatment of that section of the small business sector known as close companies - generally, unquoted companies that are controlled by five or fewer people.

19. The rules for the so-called apportionment of close companies' income 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

CHECK

and repeal the legislation

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small businesses, and particularly family businesses, will welcome this substantial simplification.

20. 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 most of its profits and other investment income will therefore be taxed at 40 per cent, equivalent to the higher rate of income tax.

TAXES ON SAVING

21. I now turn to the taxation of saving.

22. 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.

23. Certainly it is desirable that, over the medium-term, we generate as a nation a level of saving [high] large enough to finance a high level of investment. But what matters in this context is not personal savings alone, but also corporate savings [too], which are running at historically high levels, and public sector savings,

which have of course been boosted by the move to budget surplus.

24. 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 not occurred because gross saving has fallen; rather it is the result of the sharp increase in personal borrowing. And the appropriate remedy for that is to raise the cost of borrowing, and with it the return on saving, as we have done.

as / and it has fallen not because of a decline in / but / as a

25. Above all, it is essential that tax reform is always seen in a medium-term, even a long-term time-scale. It is wholly inappropriate as an answer to what are essentially cyclical phenomena. 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.

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

Will this raise hollow laughs in present circs? Would omit.

27. Meanwhile, I have a number of specific tax measures to announce today to the same end.

28. 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 further tax at all, either on the dividends they receive or on any capital gains they may eventually make - indeed, there is no need for them to get involved with the Inland Revenue at all.

29. 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 in 1987.

sale of new [plans / PEPs]

30. Since then, however, the [rate of growth] has slowed down, not least as a result of the changed climate in the equity market since the October 1987 Stock Exchange crash.

31. So the time has come to improve and simplify PEPs and give them a new lease of life.

32. 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.

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33. 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 investment through a PEP, a unit or investment trust must invest wholly or mainly in UK equities.

34. Third, at present, only cash may be paid into a PEP. I propose that investors should also be permitted to place directly into a PEP shares obtained by subscribing to new equity issues, including privatisation issues.

35. Finally, I propose to make a number of important simplifications to the PEP rules so as to make the scheme more flexible, better directed to the needs of small and new investors, and cheaper to administer.

36. 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.

or 'equities'?

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

38. 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 10,000 companies and benefiting some $1^{3}/_{4}$ million employees. 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 are £1,250 or 10 per cent of salary up to a ceiling of £5,000. I propose to raise these limits to £2,000 and £6,000 respectively.

X

less of a mouthful

39. Second, I propose to increase the monthly limit on [for] contributions to all-employee save-as-you-earn share option 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.

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40. 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. These are distinguished from ordinary approved employee share schemes by the fact that they

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use a wider variety of finance, acquire more shares and tend to operate on a longer timescale. I propose to make it clear that companies' contributions to ESOPs qualify for corporation tax relief, provided they meet certain requirements designed to ensure that the employees acquire direct ownership of the shares within a reasonable time. I hope that this will encourage more British companies, particularly in the unquoted sector, to consider setting up ESOPs.

41. 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. The same benefits can flow from profit related pay.

42. This was one of the reasons why, in my 1987 Budget, I introduced a tax relief to encourage its development. I have some improvements to make to this scheme, too.

43. First, as I have previously announced, I propose to abolish the restriction that, to qualify for the tax relief, 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.

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44. Third, I propose to enable employers to set up schemes for headquarters and other central units using the profits of the whole company or group for their profit calculations. ¶ And fourth, to help share schemes and ESOPs as well as profit related pay, I propose ~~changing~~ to change the material interest rules which ~~be~~ may at present unnecessarily exclude employees from their schemes where they already benefit from a trust set up for employees.

45. Taken together, the package of measures I have announced to encourage wider share ownership in general, and employee share ownership 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.

46. I now turn to life assurance.

47. The tax regime for life assurance is <u>sui generis</u>. The present system dates back to the First World War and 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.

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48. 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.

49. Since then, I have considered very carefully the representations the industry has made, and taken full account both of the changes to the regulation of 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 important changes to propose, based for the most part on the general tax reform principle of seeking lower rates on a broader base.

50. First, many life offices run a pension business alongside their life assurance business, and they are not required to keep the two businesses separate for tax purposes. This enables them to set the unrelieved expenses of the pensions business against the income and gains of their life business, thus giving their life

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profits unduly favourable tax treatment. I propose to end this anomaly.

51. This change, which will come into force on 1 January 1990, will yield £155 million in 1990-91. The remainder of the changes I have to propose constitute a broadly balanced package which, because of the transitional provisions, will reduce the taxation of life assurance in 1990-91 by some £110 million.

52. 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 being deductible immediately, as now. To give the industry time to adjust, this change will be phased in gradually over the next four years, starting on 1 January, 1990.

X 53. 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 these issues will have to wait for next year's Finance Bill.

54. But I can say here and now that I propose, 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 both the income and the 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.

55. 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 somewhat in subsequent years.

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

57. Later this year, UK unit trusts will be able to compete freely in Europe and will face competition from analogous Community investment schemes here. At present, trusts investing in gilts or bonds face a tax disadvantage. They pay corporation tax at 35 per cent on their income but can pass on a credit of only the basic rate to their investor. So I propose that from 1 January 1990, as for life assurance companies, the corporation tax rate on unit trusts that come within the new European Community rules will be equal to the basic

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rate of income tax. Their investors will then get full credit for all the tax the trusts pay.

58. I now turn to pensions.

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

60. But as a result, tax law has effectively come to set a limit on the overall pension someone can receive. This is neither desirable nor necessary. 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 tax privileges. Thus, employers will henceforth be free to provide whatever pensions package they believe necessary to recruit and reward their employees.

61. This change enables me to deal with another anomaly in the existing tax reliefs for pensions; namely that there is no limit to them at all, in cash terms: the higher an individual's salary, the greater the pension they can have, and the more tax relief that goes with it. Of course, someone who receives a very

high salary will expect a good pension. 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 effectively available with no upper limit whatever.

62. 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.

63. 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.

64. 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

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now be complete freedom to provide benefits above the Inland Revenue limits, though without the tax advantages.

65. The introduction of this ceiling on tax relief also enables me to simplify and improve the rules for the majority of pension scheme members, in particular to improve the conditions under which people can take early retirement.

66. I also propose to simplify very substantially the rules concerning additional voluntary contributions or AVCs. In particular, the present requirements for free standing AVCs 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.

67. Furthermore, if AVC investments perform very well, occupational pensions may at present have to be reduced to keep total benefits within the permitted limits. I propose that in future any surplus AVC funds should be returned to employees, subject to a special tax charge. This will remove the penalty on good investment performance.

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

69. 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.

70. 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 propose to remove the obstacles to greater individual involvement in personal pension plans.

71. 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

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contributions until later on in their working life. It will also improve the position of personal pensions in relation 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.

72. 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 through AVCs.

73. 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.

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

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75. I refer, of course, to Independent Taxation. For there can be little doubt that one of the greatest disincentives to saving in the present tax system is the treatment of the savings of married women. At present a wife's income from savings has to be disclosed to her husband and taxed at his marginal rate. Independent Taxation will change all that. In particular, those married women who have little or no earnings will in future be able to set their personal allowance against their savings income. Independent Taxation is a major reform. Preparations are well in hand for its introduction in April next year, and three new leaflets are now [have just become] available from Inland Revenue offices to explain all the main features of the new system.

TAXES ON SPENDING

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

77. As the House knows Her Majesty's Government are obliged to implement the European Court's judgement that certain of our zero rates of VAT on supplies to business, notably on non-residential construction, are not lawful. This derives from the Court's

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interpretation of the Community's Sixth VAT directive to which the UK agreed in 1977. The necessary changes will be introduced in this year's Finance Bill, and draft clauses have already been published.

78. In implementing the judgement I have sought to do as much as possible to minimise the burden. From 1 April VAT will not be payable in respect of all non-residential construction unless carried out under a contract entered into before the court ruling. And from 1 August landlords will have the option to tax rents, which mean that in most cases no extra VAT will be paid at all.

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79. These measures of mitigation will reduce the burden on the private sector from £450 million to just £35 million in the first year rising to £110 million in a full year. There will also be a yield of £xyz million from the public sector, which has been fully taken into account in the Public Expenditure plans already announced.

are these figs for VAT on non-domestic construction only? if not, swap paras 79 & 80

B.L.O.

80. VAT will not be payable until July 1990 on water for industry or on fuel and power - and then only on business users above a specified threshold. Private households will remain zero rated.

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81. I have been particularly concerned about the impact of the European Court's ruling on charities. Unfortunately charities' business activities cannot lawfully be shielded from the effects of the ruling but I have been able to retain zero-rates for construction, water, fuel and power for all charities' non-business activities and for most non-residential accommodation such as old people's homes, students hostels and hospices as well as churches.

82. In these special circumstances, I have considered whether there is anything further I can sensibly do to assist charities with their VAT bills. Accordingly, I propose to relieve charities from VAT on fund raising events, on sterilising equipment for medical use, and on classified advertising.

83. I also propose to relieve from car tax cars leased to the disabled. [Add, if possible, statistics on benefit to individual.]

84. But in 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

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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.

85. 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 and marketing campaign to promote [about] it. I am particularly glad that my noble Friend, the Viscount Whitelaw, has agreed to become Chairman of the new Payroll Giving Association, which will co-ordinate efforts in this field.

86. I now turn to the excise duties.

87. 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 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 only some 5 per cent of total

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petrol sales, 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 £20 or so.

88. 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 switch to unleaded petrol, their cars will no longer be able to use leaded petrol. Others wrongly imagine that their car's performance would suffer if were they to use unleaded fuel.

89. 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 nearly fourpence a gallon. If this reduction is fully passed on to the 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 ninepence a gallon, or twopence a litre, cheaper than four star leaded petrol. This will be one of the most substantial differentials between the

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price of leaded and unleaded petrol within the European Community.

90. But I do not intend to stop there. I also propose to raise the tax on two and three star petrol by roughly fourpence a gallon, so that the pump price of these grades will be as high as that of four star. This should encourage garages to phase out two star petrol, which is already down to about 6 per cent of the total market, thus enabling them 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.

91. 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.

92. They will of course also lead to a loss of revenue of some £40 million in 1989-90. I propose to recoup this from Vehicle Excise 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 rates of duty for the heaviest non-articulated lorries, to put them on a more equal footing with articulated lorries. These changes will also simplify the system, reducing the number of separate rates of Vehicle Excise Duty from 220 to 70.

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

TAXATION OF INCOME

94. Nor do I propose any change this year to either the basic or higher rate of income tax.

95. Since I aligned the rates of income and capital gains tax in last year's Budget, it follows that I also propose no change this year in the capital gains tax rates. However, I do have a few changes to capital gains tax to propose.

96. With the advent of independent taxation from April 1990, married women will acquire their own capital gains tax threshold, so that a married couple will enjoy two such exemptions. In the light of this, I propose to maintain the capital gains tax threshold at £5,000 for 1989-90.

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97. Second, I propose to abolish the general holdover relief for gifts.

98. This was rightly introduced by my predecessor in 1980, 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 simple form of tax avoidance.

99. 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.

100. In the case of gifts of personal belongings, these benefit from chattels relief, under which any items worth less than £3000 on disposal are entirely exempt from capital gains tax. I propose to double the chattels exemption limit [for capital gains tax] to £6000.

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101. The last of these three capital gains tax proposals is to change the tax treatment of certain bonds so as to simplify the tax rules and prevent a loss

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of yield by the use of indexation to create losses and the conversion of income into capital gains.

102. To return to income tax, I propose to raise all the main income tax thresholds and allowances by the statutory indexation factor of 6.8 per cent, rounded up. Thus 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.

103. The single age allowance will rise by £220 to £3,400, and the married age allowance by £350 to £5,385. The higher level of age allowance will rise by £230 to £3540 for a single person, and by £360 to £5565 for a married couple.

104. I propose a number of measures to help the elderly. In 1987 I introduced a new higher age allowance, for those over 80. I now propose to extend this to all aged 75 and over. This will take an additional 15,000 elderly single people and married couples out of tax altogether. As a result, three quarters of all those over 75 will not be liable to income tax at all.

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105. 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. I propose that in future it should be withdrawn at the rate of £1 of allowance for each £2 of income above the limit, instead of the present withdrawal rate of £2 in every £3. This means that the marginal tax rate for those in the withdrawal band will be reduced to well below 40 per cent, thus meeting a large number of representations I received last year.

106. The Finance Bill will also include the provisions to establish the new tax relief for the over 60s health insurance premiums, which I announced to the House in January, and which will take effect from April next year. [at a cost of £40 million in 1990-91.]

do we need this?

107. I have one further change to make to help pensioners. Under the 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.

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108. The Manifesto on which we were first elected in 1979 acknowledged that it was wrong to discourage people who wished to work beyond retirement age in this way, and pledged that we would phase out this earnings rule.

109. That is precisely what we shall do. 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 2 October, the earliest practicable date. The necessary legislation will be included in the Social Security Bill currently before the House.

110. The cost to public expenditure will be £125 million in 1989-90, which will be entirely met from the Reserve. But the net cost of this measure will of course be reduced by the increased income tax payable on increased pensions.

111. 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.

112. I am sure the whole House will welcome this long overdue reform.

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113. If one were to adopt the so-called "duck test" now in vogue across the Atlantic, the pensioners' earnings rule would probably qualify as a tax, and I would now be able to claim to have abolished a sixth tax. But sound tax principles coupled with my innate modesty and natural reticence prevent me from doing so.

NATIONAL INSURANCE CONTRIBUTIONS

114. I have one further measure to propose.

115. It has long been a feature of the National Insurance system that, once people earn more than the lower earnings limit, which in 1989-90 will be £43, they have to pay National Insurance contributions at the same rate on the whole of their earnings up to the upper earnings limit. There are currently three different rates - 5 per cent and 7 per cent for those on low pay and the standard rate of 9 per cent,

116. The two reduced rates, which I introduced for both employers and employees in my 1985 Budget, cut the cost of employing the young and unskilled, among whom unemployment was then high and rising, and cut the

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burden of national insurance contributions on the very low paid. But the highly desirable reduction in the steep step at the lower earnings limit was at the expense of two small steps further up the earnings scale. This inevitably means that, at certain points on the income scale, people can still be worse off if they earn more. Their extra earnings take them from a lower rate band to a higher one, and they therefore lose more in National Insurance contributions than they gain in extra pay.

117. In agreement with my Rt Hon Friend the Secretary of State for Social Security, I now propose to complete my 1985 reform. For everyone who pays employee National Insurance contributions, I propose to reduce to only 2 per cent the rate of contributions on earnings up to and including the lower earnings limit. On earnings above that limit, there will be a single rate of 9 per cent, up to the upper earnings limit, which has already been set for 1989-90 at £325 a week.

118. This will abolish altogether the steps which at present exist at earnings, for 1989-90, of £75 and £115 a week. The step which has always existed at the lower earnings limit, where people first come into the National Insurance system, is the entry ticket to the

full array of contributory benefits. As such, it is an essential feature of the contributory principle. But my proposals will further reduce this step very considerably, to only 86 pence a week in 1989-90.

119. There will be no change in the contributions payable by employers.

120. This reform will significantly reduce the burden of employees' National Insurance contributions across the board. For the lowest paid, that burden is now heavier than the burden of income tax. This is the most effective measure I can take to lighten it. For everyone on half average earnings or more, the reform will leave them £3 a week more of their own money; and most of the benefit will go to those below average earnings.

121. The chances will take effect from 1 October, the earliest practicable date. The cost will be some £1 billion in 1989-90 and £2,800 million in 1990-91. The necessary legislation will be included in the Social Security Bill currently before the House.

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122. The total additional cost of all the measures in this Budget, on an indexed basis, is under £2 billion in 1989-90 and £3½ billion in 1990-91.

[Peroration to follow]

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FROM: MISS M P WALLACE
DATE: 6 March 1989

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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]

BUDGET STATEMENT: TAX SECTION

The Chancellor was most grateful to all those who commented on last week's version of the tax section (my minute of 27 February). I attach his latest version, with the amendments side-lined.

2. There are one or two specific points which you might like to note.

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(i) The Chancellor has decided, on balance, not to include Keith, so the Financial Secretary may want to mention it in his speech.

(ii) The Chancellor has also decided not to mention the consultative document on swaps in the Budget speech.

(iii) He has deleted the bulk of what was formerly paragraph 41 - the explanation of why other PEP modifications had been ruled out - but he feels this might usefully be developed for defensive briefing.

(iv) For the moment, he has retained a paragraph on deep discounted bonds, with the other CGT changes. But, depending on how he revises the first section of the speech, it is possible that these could be replaced by an allusion in a more general section on COBO.

3. He would be grateful if any further comments on this revise could reach me be close tomorrow, Tuesday 7 March.

MOIRA WALLACE

chex.ps/mw/4

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BUDGET

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 is very much narrower in scope than the present Official Secrets Act. In particular, it does not cover information in the possession of either the Inland Revenue or Customs & Excise concerning the private affairs of specific taxpayers.

3. I am sure that the whole House will agree that it is essential for taxpayer confidentiality to be 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 Revenue Departments to reveal information about the private affairs of a specific 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 both 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. Ever since the corporation tax reform I introduced in 1984, the rate of corporation tax for small companies, defined for this purpose as those with annual profits of less than £100,000, has 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 £100,000 and £½ million the ~~effective~~ average rate of tax gradually rises from 25 to 35 per cent.

✓ SWM

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8. I propose to keep the small companies rate in line with the basic rate of income tax for 1989-90 and to leave the main corporation tax rate unchanged . But I propose to increase the small companies' rate band substantially, by 50 per cent.

9. Thus the small companies' rate 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 benefit of the small companies rate.

AA

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

AA

11. For employees I ~~also~~ have to set the scales for the private use of company cars. This remains far and away the most widespread benefit in kind. When I doubled the car scales in last year's Budget, I made it clear that this still left ~~it~~ this benefit significantly undertaxed.

MCS

12. Accordingly, I propose to increase the car scales by one third for 1989-90. The yield from this will be £160 million in 1989-90 and £200 million in 1990-91. There will be no change in the fuel scales.

The Chancellor has, of course, decided to exclude this from the Budget package for this year.

~~[13. There is one further tightening in the general area of employee benefits which I believe it right to make. There is an extra statutory concession which exempts from income tax additional housing costs paid by an employer when an existing employee moves to a higher cost area. This relief blunts the market forces which should be leading employers to relocate in lower cost areas, and I therefore propose that it should be withdrawn. Anyone who has moved, or entered into a commitment to move, before today will, however, continue to receive the relief. At the same time I propose to put on a proper statutory footing the more important and fully justified extra statutory concession exempting from tax payments made by an employer to cover an employee's inevitable moving costs when he is required to move house because of his job.]~~

FST

14. Over the years I have received a number [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

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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.

AA

15. Finally, on business taxation I have two major simplifications to propose, both of which follow from the income tax reforms I introduced last Budget.

FST (✓ ?

16. One of the many undesirable features of an income tax system with several higher rates was that since a taxpayer's marginal rate could well be very different in different years, the question of [when which year] income was [recognised attributed to] made a great deal of difference. ~~To remove the scope for manipulation, the rule was that income was taxed in the year~~ in which it was earned ~~to which it related, on an accruals basis.~~

Suggested redraft attached: see covering letter. FST

~~17. This is still the~~ statutory ~~basis of Schedule E and poses no problem at all for the vast majority of employees, who are on PAYE. But for about half a million people,~~

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FST

~~mainly directors, who do not receive their income in the year to~~ in ~~which it formally relates,~~ is earned ~~it causes untold complication, with needless form-filling long after the tax year is over. With only one higher rate of income tax, the potential for this abuse is gone.~~ substantially reduced I therefore propose that income tax under Schedule E should in future be assessed on a receipts basis, with the simple principle that you pay the tax when you receive the income. Initially, this will have a transitional cost of £80 million in 1989-90 and £60 million in 1990-91, but in the long term it will yield both extra revenue and significant Inland Revenue staff savings. a significant saving in both taxpayer time and Inland Revenue staff.

FST

✓ (or leave the figures out altogether, – could mislead as it stands)

✓ MCS

why?

18. The reduction in the top rate of income tax to 40 per cent in last year's Budget also enables me to make a major simplification of the tax treatment of ~~that section of~~ hundreds of thousands of companies in the small business sector known as close companies - generally, unquoted companies that are controlled by five or fewer people. ~~There are many hundreds of thousands of such companies~~

MPW ×

19. The rules for the so-called apportionment of close companies' income are notoriously complex, taking up some twenty pages of impenetrable legislation. These rules are no longer needed and I propose to abolish them and repeal the legislation. I believe that ~~many [hundreds of thousands]~~ of

See covering letter

✓ IR CHECK

AA.

small incorporated businesses, and particularly family businesses, will welcome this substantial simplification.

20. 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 most of its profits and other investment income will therefore be taxed at 40 per cent, equivalent to the higher rate of income tax.

TAXES ON SAVING

21. I now turn to the taxation of saving.

✓ AA

22. 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.

or "enough savings to finance" JG

AA

✓JG

AA

23. Certainly it is desirable that, over the medium-term, we generate as a nation a level of saving ~~high~~ large enough to finance a high level of investment. But what matters [in this context] for that is not personal savings alone, but also corporate savings ~~too~~, which are running at historically high levels, and public sector savings,

which have of course been boosted by the move to budget surplus.

SJP

Repetition!

AA

24. Moreover, ~~the fall in~~ the personal savings ratio, ~~which is of course~~ measured in net terms, that is to say as gross saving net of borrowing, and it has fallen not because of a decline in ~~has not occurred because~~ gross saving ~~has fallen~~; but rather as a ~~it is the~~ result of the sharp increase in personal borrowing. And the appropriate remedy for that is to raise the cost of borrowing, and with it the return on saving, as we have done.

Ch: para 25 is a Grieve rewrite. I strongly agree with bit I have highlighted and so does RPC
- M.

to encourage enterprise and improve the working of the economy

25. Above all, the role of ~~it is essential that~~ tax reform is ~~always seen~~ in the ~~a~~ medium-term and beyond. ~~even a long-term time-scale.~~ It is wholly inappropriate as an answer to short term and ~~what are essentially~~ cyclical phenomena. ~~In that context,~~ So, on the taxation of savings the Government's policy is clear. It is to strengthen and deepen popular capitalism in Britain, by encouraging in particular wider share ownership.

FST sees contradiction AA marks "hollow laugh" cd omit.

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

27. Meanwhile, I have a number of specific tax measures to announce today to the same end.

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General comment from RPC - PEPs is the first headline. Worth beefing up more?

28. 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 further tax at all, either on the dividends they receive or on any capital gains they may [eventually] make - indeed, there is no need for them to get involved with the Inland Revenue at all.

✓ mpw.

29. 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 in 1987.

AA

MCS ✓

which followed

sale of new [plans / PEPs]

30. Since then, however, the rate of growth has slowed down, not least as a result of the changed climate in the equity market [since] the October 1987 Stock Exchange crash.

disagree mpw.

lessens implication that they are dead on their feet

31. So the time has come to improve and simplify PEPs and give them a new ~~lease of~~ life.

32. 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.

?
Existing limit more complicated than straight £750 : better to omit

33. 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 investment through a PEP, a unit or investment trust must invest wholly or mainly in UK equities.

34. Third, at present, only cash may be paid into a PEP. I propose that investors should also be permitted to place directly into a PEP shares obtained by subscribing to new equity issues, including privatisation issues.

35. Finally, I propose to make a number of important simplifications to the PEP rules so as to make the scheme more flexible, better directed to the needs of small and new investors, and cheaper to administer.

[FST – ?]
wider share

36. 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.

✓ AA – equities

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SECRET

B.L.O.

SECRET

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

(discretionary schemes not included in the figures which follow

X Cd we say: "more than"? See covering letter

√AA

√ (10% limit is unaltered)

38. It is a striking fact that the number of approved all employee share schemes has risen from a mere 30 in 1979 to almost 1,600 today, involving 10,000 companies ~~and~~ already benefiting some $1^{3}/_{4}$ million employees. 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 are £1,250 or 10 per cent of salary up to a ceiling of £5,000. I propose to raise these cash limits to £2,000 and £6,000 respectively.

AA

39. Second, I propose to increase the monthly limit ~~for~~ on contributions to all-employee save-as-you-earn share option 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.

40. 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. These are distinguished from ordinary approved employee share schemes by the fact that they

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use a wider variety of finance, acquire more shares and tend to operate on a longer timescale. I propose to [make it clear] ensure that companies' contributions to ESOPs qualify for corporation tax relief, provided they meet certain requirements designed to ensure that the employees acquire direct ownership of the shares within a reasonable time. I hope that this will encourage more British companies, particularly in the unquoted sector, to consider setting up ESOPs.

JG – (thinks we shd make more of this if it is entirely new – I'm not sure it is)

41. Those firms with employee share ownership schemes have no doubt that ~~it~~ that helps to improve company performance, ~~by~~ giving the workforce a direct personal interest in its the company's profitability and success. The same benefits [can] flow from profit related pay.

/ MPW

X

42. This was one of the reasons why, in my 1987 Budget, I introduced a tax relief to encourage its development. I have some improvements to make to this scheme, too.

43. First, as I have previously announced, I propose to abolish the restriction that, to qualify for the tax relief, [prospective] profit-related pay must (expected to be) 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.

At present, (position is viewed at the outset on the assumption of unchanged profits

I prefer pencil version

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Ch/ The break from the shopping list of WSO measures to the two "biggies" is not well-signalled at the moment, ~~the~~ for such a change of pace. Robert and I feel there's a case for either

(i) bringing up the reference to the consultative document - after all this is no surprise; or

(ii) some linking passage - conclude passage dealing with direct personal savings. "now turn to savings through institutions ...."

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Attracted to either? MPW

44. Third, I propose to enable employers to set up schemes for headquarters and other central units using the profits of the whole company or group for their profit calculations. And fourth, to help share schemes and ESOPs as well as profit related pay, I propose ~~changing~~ to change the so called [AA] material interest rules which ~~be~~ may at present unnecessarily exclude employees from ~~their~~ schemes where they can already benefit from a trust set up for employees.

✓ MCS
change will benefit most those employees who can benefit, but where they do not, only to a limited extent.

45. Taken together, the package of measures I have announced to encourage wider share ownership in general, and employee share ownership (and 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.

(to reflect PRP improvements
Ind leave out.
M

[see MPW note opposite]

46. I now turn to life assurance.

47. The tax regime for life assurance is sui generis. The present system dates back to the First World War and 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.]

MPW
[point already made + and makes us sound just a shade avaricious?]

Ch/

re para 49. I don't feel it sounds "like you" to back away from radical reform (tho' there is a case for pointing out to L.A. industry how nice you have been) and, as you see FST/IR have problems with this wording.

How about: "In the light of these factors, I have decided that the right thing is to make a number of reforms within the existing structure, based for the most part etc...."

MPW.

48. 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~~ June the Inland Revenue issued with my authority a major consultative document on the taxation of life assurance.

JG: introducing (disagree - M) X

49. Since then, I have considered very carefully the representations the industry has made, and taken full account both of the changes to the regulation of 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 reform~~s~~ canvassed in the consultative document. But I do have a number of important changes to propose, based for the most part on the general tax reform principle of seeking lower rates on a broader base.

Ch/ see my note opposite
MPW

Fin. Sec. has decided that Budget Day Press Release should mention possibility of proceeding with Option A in 1990. (See covering letter)

50. First, many life offices run a pension business alongside their other life ~~[assurance]~~ business, and [they are not required to keep the two businesses entirely separate for tax purposes. This enables them to] can set the unrelieved expenses of the pension~~s~~ business against the income and gains of their life business, thus giving their life

X

See covering letter

X

IR are being v. stubborn/dull on this. How about "pure life assurance" here. If 'entirely' causes problems drop passage I have bracketed?

X

para 51

The remainder of the changes I have to propose constitute a package that will be broadly neutral over a run of years, but which will reduce the taxation of life assurance ~~£~~ by some £110 million in 1990-91 profits unduly favourable tax treatment. [I propose to end this anomaly.] The Life Offices themselves have accepted that this treatment is anomalous + I propose to end it.

FST (see covering letter

a number of and [other minor pension business measures

51. This change, which will come into force on 1 January 1990, will yield some £150 [£155] million in 1990-91. [The remainder of the changes I have to propose constitute a broadly balanced package which, because of the transitional provisions, will reduce the taxation of life assurance in 1990-91 by some £110 million.]

this degree of precision might sound a little spurious see my redraft opposite

52. 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 should in future be spread over a period of seven years [rather than being deductible immediately, as now.] To give the industry time to adjust, this change will be phased in gradually over the next four years, starting on 1 January, 1990.

MPW (

AA (?)

53. 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 these issues will have to wait for next year's Finance Bill.

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54. But I can say here and now that I propose, as from 1 January 1990, to abolish Life Assurance ~~Premium~~ Policy Duty. And I also propose, from the same date, to reduce the rate of tax payable on the policy holders' share of 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.

JG

see covering letter

55. The net revenue effect of [this reform] all these reforms 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 somewhat in subsequent years.]

Do we need to say this? The interface with para 51 is ~~are~~ v. difficult

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

MPW

57. Later this year, UK unit trusts will be able to compete freely in Europe and will face competition from analogous Community investment schemes here. [At present, trusts investing in gilts or bonds face a tax disadvantage. They pay corporation tax at 35 per cent on their income but can pass on a credit of only the basic rate to their investor. So] I propose that from 1 January 1990, as for life assurance companies, the corporation tax rate on unit trusts that come within the new European Community rules will be equal to the basic

Can we shorten as per square brackets. [RPC/MPW suggestion]

rate of income tax. Their investors will then get full credit for all the (UK) tax the trusts pay.

See also FST's comment in his minute.

Ch/ Robert and I have suggested a slight rejigging of paras 59→63, behind at (A). Mostly same material, but too complicated to mark on this. MP

58. I now turn to pensions.

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

60. But, as a result, tax law has effectively come to set a limit on the overall pension someone can receive. This is neither desirable nor necessary. 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 tax privileges. Thus, employers will henceforth be free to provide whatever pensions package they believe necessary to recruit and reward their employees.

61. This change enables me to deal with another anomaly in the existing tax reliefs for pensions; namely that there is no limit to them at all, in cash terms: the higher an individual's salary, the greater the pension they can have, and the more tax relief that goes with it. Of course, someone who receives a very

✓ ? "he or she" ?

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JG wd omit: will be much quoted against you.

high salary will expect a good pension. 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 effectively available with no upper limit whatever.

62. 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.

LJH

63. I therefore propose to set a limit on the pensions which may be paid from tax-approved and relevant statutory occupational schemes, based on final salary earnings of £60,000 a year. I have deliberately set the ceiling at a level which will leave the vast majority of employees unaffected at the present time, 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.

RPC

MCS

64. The new ceiling will apply only to pension schemes set up on or after today, or to new members joining existing schemes, on or after ~~today~~ 1 June. And, as I have already said, there will

now be complete freedom to provide benefits above the Inland Revenue limits, though without the tax advantages. Govt will be considering further the implications for the statutory public service pension schemes taking account of developments in the private sector and of any future recommendations by the TSRB.

LJH.

expand? FST

65. The introduction of this ceiling on tax relief also enables me to simplify and improve the rules for the majority of pension scheme members, in particular to improve the conditions under which people can take early retirement.

✓ MCS

✓ MCS

mpw

66. I also propose to simplify very substantially the rules concerning additional voluntary contributions to pension schemes or AVCs as they have become known. In particular, the present requirements for free standing AVCs place a heavy administrative burden on employers [at the point where an employee wants to start paying AVCs]. In future, they [necessary checks] will be greatly reduced. In many cases employers will not need to be involved at all.

67. Furthermore, if AVC investments perform very well, occupational pensions may at present have to be reduced to keep total benefits within the permitted limits. I propose that in future any surplus AVC funds should be returned to employees, subject to a special tax charge. This will remove the penalty on good investment performance.

mpw
(covered later)

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

69. 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.

mpw

mpw
FST - "vague"
MCS - "delphic"

mpw.

70. 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 propose to remove the obstacles to greater individual involvement in personal pension plans.

✓ RPC
(no need to mention

71. 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

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contributions until later on in their working life. It will also improve the position of personal pensions in relation 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.

72. 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 cash limit on the tax relief available to any individual. They should give a boost, in particular, to saving through personal pensions and through AVCs.

✓ MCS
✓ MCS

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

, for unit trusts
AA
AA

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

? omit the first 'more'?

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2, I.T. limits

75. I refer, of course, to Independent Taxation. For there can be little doubt that one of the greatest disincentives to saving in the present tax system is the treatment of the savings of married women. At present a wife's income from savings has to be disclosed to her husband and taxed at his marginal rate. Independent Taxation will change all that. In particular, those married women who have little or no earnings will in future ~~be able to set~~ have their own personal allowance to set against their savings income. Independent Taxation is a major reform. Preparations are well in hand for its introduction in April next year, and three new leaflets ~~have just become~~ are now – AA available from Inland Revenue offices to explain all the main features of the new system.

Insert piece on 'trusts' attached.

"limp" RPC

Ch/ I wasn't sure if you wanted to add the Mace pamphlets here. I don't like it at all. Trusts is even worse here – and the first I've heard of it. If we must have these can we hide them somewhere else?

TAXES ON SPENDING

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

77. As the House knows Her Majesty's Government are obliged to implement the European Court's judgement that certain of our zero rates ~~of~~ VAT ~~on supplies to business~~, notably on non-residential construction, are not lawful. This derives from the Court's

mp

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(7) VAT

BUDGET

C+E: mention minor property changes? (NO!)

interpretation of the Community's Sixth VAT directive to which the UK agreed in 1977. The necessary changes will be introduced in this year's Finance Bill, and draft clauses have already been published.

SECRET

78. In implementing the judgement I have sought to do as much as possible to minimise the burden. From 1 April VAT will be payable in respect of all non-residential construction unless carried out under ~~a contract~~ agreements entered into before the court ruling. And from 1 August landlords will have the option to tax rents, which means that in most cases no extra VAT will be paid at all.

✓ C+E

79. These measures ~~of mitigation~~ will reduce the burden of the construction charges on the private sector ~~from £450 million~~ to just £35 million in the first year rising to £110 million in 1992-93 ~~a full year~~. There will also be a yield of £~~xyz~~ 250 million from construction carried out for the public sector, [~~which has been fully taken into account in the Public Expenditure plans already announced.~~] but we have protected public sector construction programmes by making compensating adjustments, where necessary, to individual programmes

✓ C+E

Without them the yield from construction wd have been £450m ~~in a full~~ by 1992-93

C+E

✓ JA

B.L.O. SECRET

80. VAT will not be payable until July 1990 on water for industry or on fuel and power - and then only on business users above a specified threshold. Private households will remain zero rated.

reads oddly without antecedent mention in para 77

MPW

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81. I have been particularly concerned about the impact of the European Court's ruling on charities. Unfortunately charities' business activities cannot lawfully be shielded from the effects of the ruling but I have been able to retain zero-rates for construction, water, fuel and power for all charities' non-business activities for churches, and for most ~~non-~~residential accommodation such as old people's homes, students hostels and hospices [as well as churches.]

MPW

MPW

82. In these special circumstances, I have considered whether there is anything further I can sensibly do to assist charities [with their VAT bills]. Accordingly, I propose to relieve charities from VAT on fund raising events, on sterilising equipment for medical use, and on classified advertising.

AA

MPW

83. I also propose to relieve from car tax cars leased to the disabled. [Add, if possible, statistics on benefit to individual.] This is equivalent to a saving of about £400 on each vehicle leased to a disabled person.

C+E

84. But in 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

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3,400 schemes have now been set up, and over 100,000 employees are already participating, quite a few of them giving up to the full £240 annual limit for tax relief. I now propose to double that limit to £480, or £40 a month.

mpm

85. 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 and marketing campaign ~~about~~ to promote it. [I am particularly glad that my Rt Hon and noble Friend, the Viscount Whitelaw, has agreed to become Chairman of the new Payroll Giving Association, which will co-ordinate efforts in this field.] Suggested insert attached ‡

AA

? Rt Hon and

Subject to checking with PMG's office that announcement to this effect has been made.

86. I now turn to the excise duties.

87. 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 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 only some 5 per cent of total

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petrol sales, even though two-thirds of the cars now on the road could use it, either without any adjustment or else with ~~a conversion~~ an adjustment costing only some £20 or so.

C+E

88. 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~~ adjustment cost is. Many are under the false impression that, if they do switch 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.

MCS is v. uneasy about this para - we are not experts world outside full of them. C+E

EST - 'line' to take is "no perceptible difference in performance if you switch from 4*.

89. 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 nearly fourpence a gallon. If this reduction is fully passed on to the 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 ~~ninepence~~ nearly tenpence a gallon, or just over twopence a litre, cheaper than four star leaded petrol. This will be one of the most substantial differentials between the

[RPC points out that talking in terms of a reduction rather gives game away that not increasing other duties eg 4 star - at least on petrol. Cd rephrase in terms of increasing differential. Interested? M.]

MCS suggests switch to duty/VAT differential [9p looks increasingly shaky] Look to oil cos to see motorist gets proper benefit

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price of leaded and unleaded petrol within the European Community.

90. But I do not intend to stop there. I also propose to raise the tax on two and three star petrol by roughly fourpence a gallon, so that the pump price of these grades will be at least as high as that of four star. This should encourage garages to phase out two star petrol, which is already down to about 6 per cent of the total market, thus enabling them 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.

C+E

C+E

91. 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.

92. They will of course also lead to a loss of revenue of some £40 million in 1989-90. I propose to recoup this from Vehicle Excise 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.

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I also propose to increase the rates of duty for the heaviest non-articulated lorries, to put them on a more equal footing with articulated lorries. These changes will also simplify the system, reducing the number of separate rates of Vehicle Excise Duty ~~from 220 to~~ by over 70.

[not true - oops, my fault]

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

TAXATION OF INCOME

94. Nor do I propose any change this year to either the basic or higher rates of income tax. [tho' I have some proposals to make later to NICs]

FST (dislike)

95. Since I aligned the rates of income and capital gains tax in last year's Budget, it follows that I also propose no change this year in the capital gains tax rates. However, I do have a few other changes to capital gains tax to propose.

FST also suggests put CGT pre IT. (I also dislike this suggestion)

96. With the advent of independent taxation from April 1990, married women will acquire their own capital gains tax threshold, so that a married couple will enjoy two such exemptions. In the light of this, I propose to maintain the capital gains tax threshold at £5,000 for 1989-90.

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97. Second, I propose to abolish the general holdover relief for gifts.

" — must have been introduced by Sir G H!" MCS.

98. This was rightly introduced by my predecessor in 1980, when there was still capital transfer tax on lifetime gifts, in order to avoid a form of double taxation. But the tax on most lifetime giving has since been abolished, and the relief is increasingly used as a simple form of tax avoidance.

(to be strictly accurate

99. But while the general holdover relief will go, I propose to retain it for gifts of business, farm and heritage assets, ~~and also~~ The relief for all gifts to charities will remain and I am extending it to gifts of land to housing associations. And of course gifts between husband and wife will continue to be exempt.

As withdrawal of a relief is mentioned (along with the exceptions) it seems appropriate to mention a new relief.

↑ but a bit confusing!

100. In the case of gifts of personal belongings, these benefit from chattels relief, under which any items worth less than £3000 on disposal are entirely exempt from capital gains tax. I propose to double the chattels exemption limit [for capital gains tax] to £6000.

AA

101. The last of these [three] capital gains tax proposals ~~is to~~ will change the tax treatment of certain bonds so as to simplify the tax rules and prevent a loss

MCS

MCS

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of yield by the use of indexation to create losses and the conversion of income into capital gains.

102. To return to income tax, I propose to raise all the main income tax thresholds and allowances by the statutory indexation factor of 6.8 per cent, rounded up. Thus 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.

103. The single age allowance will rise by £220 to £3,400, and the married age allowance by £350 to £5,385. The higher level of age allowance will rise by £230 to £3540 for a single person, and by £360 to £5565 for a married couple.

?

✓

ignore

?

This sentence would be true ~~before the~~ even before the extension to the 75s & over. The suggested amendments lessens the sense of causality.

104. I propose a number of measures to help the elderly. In 1987 I introduced a new higher level of age allowance, for those ~~over~~ aged 80 and over. I now propose to extend this to all those aged 75 and over. This will take an additional 15,000 elderly single people and married couples out of tax altogether. ~~As a result,~~ After the change, three quarters of all those ~~over~~ aged 75 and over will not be liable to income tax at all.

105. 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. I propose that in future it should be withdrawn at the rate of £1 of allowance for each £2 of income above the limit, instead of the present ~~withdrawal~~ rate of £2 in every £3. This means that the marginal tax rate for those in the withdrawal band will be reduced to well below 40 per cent, thus meeting a large number of representations I have received in the last year.

✓ X

? SWM "only 37½%"

[a 2½p cut in the basic rate w be pretty significant]

106. The Finance Bill will also include the provisions to establish the new tax relief for the over-60s' health insurance premiums, which I announced to the House in January, and which will take effect from April next year, [at a cost of £40 million in 1990-91.]

do we need? AA

✓ X X

make more of this? FST.

[I say, let PM!]

107. I have one further change to make to help pensioners. Under the earnings rule, any retirement 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. This rule applies for [up to] 5 years after state pension age

(?) PMcI

✓ PMcI

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108. The Manifesto on which we were first elected in 1979 acknowledged that it was wrong to discourage people who wished to work beyond retirement age in this way, and pledged that we would phase out this earnings rule.

RPC - wants "abolish" back tho' phase out was Manifesto

109. That is precisely what we shall do. 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 ~~2~~ 1 October, the earliest practicable date. The necessary legislation will be included in the Social Security Bill currently before the House.

110. The cost to public expenditure will be £125 million in 1989-90, which will be entirely met from the Reserve. But the net cost of this measure will [of course] be reduced by the [~~increased~~] income tax payable on the increased pensions.

2 of courses

the

111. 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.

112. I am sure the whole House will welcome this long overdue reform.

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113. If one were to adopt the so-called "duck test" now in vogue across the Atlantic, the pensioners' earnings rule would probably qualify as a tax, and I would now be able to claim to have abolished a sixth tax. But sound tax principles coupled with my innate modesty and natural reticence prevent me from doing so.

NATIONAL INSURANCE CONTRIBUTIONS

114. I have one further measure to propose.

115. It has long been a feature of the National Insurance system that, once people earn more than the lower earnings limit, which in 1989-90 will be £43, they have to pay National Insurance contributions at the same rate on the whole of their earnings up to the upper earnings limit. There are currently three different rates - 5 per cent and 7 per cent for those on low er pay and the standard rate of 9 per cent. It is an inevitable consequence of this system * (over) these points have come to be known, somewhat inelegantly, as the National Insurance steps.

✓ JGil

RPC

116. The two reduced rates, which I introduced for both employers and employees in my 1985 Budget, cut the cost of employing the young and unskilled, among whom unemployment was then high and rising, and cut the

burden of national insurance contributions on the very low paid. But the highly desirable reduction in the steep step at the lower earnings limit was at the expense of two small steps further up the earnings scale. This inevitably means that, at certain points on the income scale, people can still be worse off if they earn more. Their extra earnings take them from a lower rate band to a higher one, and they therefore lose more in National Insurance contributions than they gain in extra pay. "This is a genuine disincentive to overtime and lower-paid workers generally."

? JGil

*

? FST

117. In agreement with my Rt Hon Friend the Secretary of State for Social Security, I now propose to complete my 1985 reform. For everyone who pays employee National Insurance contributions, I propose to reduce to only 2 per cent the rate of contributions on earnings up to and including the lower earnings limit. On earnings above that limit, there will be a single rate of 9 per cent, up to the upper earnings limit, which has already been set for 1989-90 at £325 a week.

"Goes too far" - RPC [build on, carry further ... but complete a hostage to fortune, given employers, self-employed etc.]

118. This will abolish altogether the steps which at present exist at earnings, for 1989-90, of £75 and £115 a week. The step which has always existed at the lower earnings limit, where people first come into the National Insurance system, is the entry ticket to the

full array of contributory benefits. As such, it is an essential feature of the contributory principle. But my proposals will [further] reduce this step [very considerably,] to only 86 pence a week in 1989-90.

"more than half"

119. There will be no change in the contributions payable by employers.

120. This reform will significantly reduce the burden of employees' National Insurance contributions across the board. For the lowest paid, that burden is now heavier than the burden of income tax. This is the most effective measure I can take to lighten it. For everyone on half average earnings or more, the reform will leave them £3 a week more of their own money; and most of the benefit will go to those below average earnings.

[illegible] IR make (obvious) point that this only because more below average earnings, but this, I assume, OK?

✓ ✗

121. The changes will take effect from [1] October, the earliest practicable date. The cost will be some £1 billion in 1989-90 and £2,800 million in 1990-91. The necessary legislation will be included in the Social Security Bill currently before the House.

122. The total additional cost of all the measures in this Budget, on an indexed basis, is under £2 billion in 1989-90 and £3½ billion in 1990-91.

[Peroration to follow]

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